DNB FINANCIAL CORP /PA/
Form 10-K
April 27, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended

December 31, 2006
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 0-16667

(Exact Name of registrant as specified in its charter)

Pennsylvania	**23-2222567**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

-

4 Brandywine Avenue, Downingtown, Pennsylvania	**19335**
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: **(610) 269-1040**
Securities registered pursuant to Section 12 (b) of the Act: N/A

Securities registered pursuant to Section 12 (g) of the Act:
Common stock, par value $1.00 per share
(Title of class)

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference 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 an accelerated filer (as defined in Rule 12b-2 of the Act). [ ] Yes [X] No

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

As of March 26, 2007, $45.2 million of the Registrant's Common Stock, $1 par value per share, was held by non-affiliates of the Registrant.

As of March 26, 2007, the Registrant had outstanding 2,503,953 shares of Common Stock, $1 par value per share.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement relating to the Annual Meeting of Shareholders are incorporated by reference into Parts III and IV of this Form 10-K.

DNB FINANCIAL CORPORATION

Table of Contents

DNB FINANCIAL CORPORATION
FORM 10-K

Forward-Looking Statements

This report contains statements that are not of historical facts and may pertain to future operating results or events or management's expectations regarding those results or events. These are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities and Exchange Act of 1934. These forward-looking statements may include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements contained in this report that are not historical facts. When used in this report, the words "expects", "anticipates", "intends", "plans", "believes", "seeks", "estimates", or words of similar meaning, o or conditional verbs, such as "will", "would", "should", "could", or "may" are generally intended to identify forward-looki statements. Forward-looking statements involve certain risks and uncertainties, and actual results may differ materially from those contemplated by such statements. For example, actual results may be adversely affected by the following possibilities: (1) competitive pressures among financial institutions may increase; (2) changes in interest rates may reduce banking interest margins; (3) general economic conditions and real estate values may be less favorable than contemplated; (4) adverse legislation or regulatory requirements may be adopted; (5) other unexpected contingencies may arise; (6) DNB may change one or more strategies described in this document; or (7) management's evaluation of certain facts, circumstances or trends and the appropriate responses to them may change. These forward-looking statements are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are either beyond our control or not reasonably capable of predicting at this time. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. Actual results may differ materially from the results discussed in these forward-looking statements. Readers of this report are accordingly cautioned not to place undue reliance on forward-looking statements. DNB disclaims any intent or obligation to update publicly any of the forward-looking statements herein, whether in response to new information, future events or otherwise.

Part I

Item 1. Business

(a) General Description of Registrant's Business and Its Development

DNB Financial Corporation (the "Registrant" or "DNB"), a Pennsylvania business corporation, is a bank holding company registered with and supervised by the Board of Governors of the Federal Reserve System (Federal Reserve Board). The Registrant was incorporated on October 28, 1982 and commenced operations on July 1, 1983 upon consummation of the acquisition of all of the outstanding stock of Downingtown National Bank, now known as DNB First, National Association (the "Bank"). Since commencing operations, DNB's business has consisted primarily of managing and supervising the Bank, and its principal source of income has been derived from the Bank. At December 31, 2006, DNB had total consolidated assets, total liabilities and stockholders' equity of $525.2 million, $493.8 million, and $31.4 million, respectively.

The Bank was organized in 1861. The Bank is a national banking association that is a member of the Federal Reserve System, the deposits of which are insured by the Federal Deposit Insurance Corporation ("FDIC"). The Bank is a full service commercial bank providing a wide range of services to individuals and small to medium sized businesses in the southeastern Pennsylvania market area, including accepting time, demand, and savings deposits and making secured and unsecured commercial, real estate and consumer loans. In addition, the Bank has ten full service and two limited service branches and a full-service wealth management group known as "DNB Advisors". The Bank's financial subsidiary, DNB Financial Services, Inc., is a Pennsylvania licensed insurance agency, which, together with the Bank, sells a broad variety of insurance and investment products. The Bank's other subsidiary, Downco, Inc. was incorporated in December 1995 for the purpose of acquiring and holding other real estate owned acquired through foreclosure or deed in-lieu-of foreclosure and now owns certain Bank-occupied real estate.

(b) Financial Information About Segments

In accordance with generally accepted accounting principles in the United States, the Registrant and the Bank operate as one segment, and therefore do not report financial information for multiple segments of their business.

(c) Narrative Description of Business

The Bank's headquarters is located at 4 Brandywine Avenue, Downingtown, Pennsylvania. As of December 31, 2006, the Bank had total assets of $524.7 million, total deposits of $381.2 million and total stockholders' equity of $40.4 million. The Bank's business is not seasonal in nature. The FDIC, to the extent provided by law, insures its deposits. At December 31, 2006, the Bank had 121 full-time employees and 18 part-time employees.

The Bank derives its income principally from interest charged on loans and, to a lesser extent, interest earned on investments and fees received in connection with the origination of loans and for other services. The Bank's principal expenses are interest expense on deposits and borrowings and operating expenses. Funds for activities are provided principally by operating revenues, deposit growth and the repayment of outstanding loans and investments.

The Bank encounters vigorous competition from a number of sources, including other commercial banks, thrift institutions, other financial institutions and financial intermediaries. In addition to commercial banks, Federal and state savings and loan associations, savings banks, credit unions and industrial savings banks actively compete in the Bank's market area to provide a wide variety of banking services. Mortgage banking firms, real estate investment trusts, finance companies, insurance companies, leasing companies and brokerage companies, financial affiliates of industrial companies and certain government agencies provide additional competition for loans and for certain financial services. The Bank also competes for interest-bearing funds with a number of other financial intermediaries, which offer a diverse range of investment alternatives, including brokerage firms and mutual fund companies.

Supervision and Regulation - Registrant

Sarbanes-Oxley Act of 2002 - On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which imposed significant additional requirements and restrictions on publicly-held companies, such as the Registrant. These provisions include new requirements governing the composition and responsibilities of audit committees, financial disclosures and reporting and restrictions on personal loans to directors and officers. Sarbanes-Oxley, inter alia, now mandates chief executive and chief financial officer certifications of periodic financial reports, additional financial disclosures concerning off-balance sheet items, and speedier transaction reporting requirements for executive officers, directors and 10% shareholders. Rules promulgated and to be promulgated by the SEC pursuant to Sarbanes-Oxley impose substantial reporting and compliance obligations on management and boards of directors, and new obligations and restrictions have been placed on auditors and audit committees that is intended to enhance their independence from management. In addition, penalties for non-compliance with the federal securities laws are heightened. While the Registrant has and will incur significant additional expense complying with Sarbanes Oxley requirements, the Registrant does not anticipate this legislation to have any other material adverse impact on the Registrant.

Federal Banking Laws

The Registrant is subject to a number of complex Federal banking laws, most notably the provisions of the Bank Holding Company Act of 1956, as amended ("Bank Holding Company Act") and the Change in Bank Control Act of 1978 ("Change in Control Act"), and to supervision by the Federal Reserve Board.

Bank Holding Company Act - Financial Holding Companies

The Bank Holding Company Act requires a "company" (including the Registrant) to secure the prior approval of the Federal Reserve Board before it owns or controls, directly or indirectly, more than five percent (5%) of the voting shares or substantially all of the assets of any bank. It also prohibits acquisition by any "company" (including the Registrant) of more than five percent (5%) of the voting shares of, or interest in, or all or substantially all of the assets of, any bank located outside of the state in which a current bank subsidiary is located unless such acquisition is specifically authorized by laws of the state in which such bank is located. A "bank holding company" (including the Registrant) is prohibited from engaging in or acquiring direct or indirect control of more than five percent (5%) of the voting shares of any company engaged in non-banking activities unless the Federal Reserve Board, by order or regulation, has found such activities to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In making this determination, the Federal Reserve Board considers whether the performance of these activities by a bank holding company would offer benefits to the public that outweigh possible adverse effects. Applications under the Bank Holding Company Act and the Change in Control Act are subject to review, based upon the record of compliance of the applicant with the Community Reinvestment Act of 1977 ("CRA"). See further discussion below.

The Registrant is required to file an annual report with the Federal Reserve Board and any additional information that the Federal Reserve Board may require pursuant to the Bank Holding Company Act. The Federal Reserve Board may also make examinations of the Registrant and any or all of its subsidiaries. Further, under Section 106 of the 1970 amendments to the Bank Holding Company Act and the Federal Reserve Board's regulations, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit or provision of credit or provision of any property or services. The so-called "anti-tie-in" provisions state generally that a bank may not extend credit, lease, sell property or furnish any service to a customer on the condition that the customer provide additional credit or service to the bank, to its bank holding company or to any other subsidiary of its bank holding company or on the condition that the customer not obtain other credit or service from a competitor of the bank, its bank holding company or any subsidiary of its bank holding company.

Permitted Non-Banking Activities. The Federal Reserve Board permits bank holding companies to engage in non-banking activities so closely related to banking or managing or controlling banks as to be a proper incident thereto. A number of activities are authorized by Federal Reserve Board regulation, while other activities require prior Federal Reserve Board approval. The types of permissible activities are subject to change by the Federal Reserve Board. Recent revisions to the Bank Holding Company Act contained in the Federal Gramm-Leach Bliley Act of 1999 permit certain eligible bank holding companies to qualify as "financial holding companies" and thereupon engage in a wider variety of financial services such as securities and insurance activities.

Gramm-Leach Bliley Act of 1999 ("GLB"). This law repeals certain restrictions on bank and securities firm affiliations, and allows bank holding companies to elect to be treated as a "financial holding company" that can engage in approved "financial activities," including insurance, securities underwriting and merchant banking. Banks without holding companies can engage in many of these new financial activities through a "financial subsidiary." The law also mandates functional regulation of bank securities activities. Banks' exemption from broker-dealer regulation would be limited to, for example, trust, safekeeping, custodian, shareholder and employee benefit plans, sweep accounts, private placements (under certain conditions), self-directed IRAs, third party networking arrangements to offer brokerage services to bank customers, and the like. It also requires banks that advise mutual funds to register as investment advisers. The legislation provides for state regulation of insurance, subject to certain specified state preemption standards. It establishes which insurance products banks and bank subsidiaries may provide as principal or underwriter, and prohibits bank underwriting of title insurance, but also preempts state laws interfering with affiliations. GLB prohibits approval of new de novo thrift charter applications by commercial entities and limits sales of existing so-called "unitary" thrifts to commercial entities. The law bars banks, savings and loans, credit unions, securities firms and insurance companies, as well as other "financial institutions," from disclosing customer account numbers or access codes to unaffiliated third parties for telemarketing or other direct marketing purposes, and enables customers of financial institutions to “opt out” of having their personal financial information shared with unaffiliated third parties, subject to exceptions related to the processing of customer transactions and joint financial services marketing arrangements with third parties, as long as the institution discloses the activity to its customers and requires the third party to keep the information confidential. It requires policies on privacy and disclosure of information to be disclosed annually, requires federal regulators to adopt comprehensive regulations for ensuring the security and confidentiality of consumers’ personal information, and allows state laws to give consumers greater privacy protections. The GLB is likely to increase the competition the Bank faces, and this increased competition is likely to come from a wider variety of non-banking competitors as well as banks.

Change in Bank Control Act

Under the Change in Control Act, no person, acting directly or indirectly or through or in concert with one or more other persons, may acquire "control" of any Federally insured depository institution unless the appropriate Federal banking agency has been given 60 days prior written notice of the proposed acquisition and within that period has not issued a notice disapproving of the proposed acquisition or has issued written notice of its intent not to disapprove the action. The period for the agency's disapproval may be extended by the agency. Upon receiving such notice, the Federal agency is required to provide a copy to the appropriate state regulatory agency, if the institution of which control is to be acquired is state chartered, and the Federal agency is obligated to give due consideration to the views and recommendations of the state agency. Upon receiving a notice, the Federal agency is also required to conduct an investigation of each person involved in the proposed acquisition. Notice of such proposal is to be published and public comment solicited thereon. A proposal may be disapproved by the Federal agency if the proposal would have anticompetitive effects, if the proposal would jeopardize the financial stability of the institution to be acquired or prejudice the interests of its depositors, if the competence, experience or integrity of any acquiring person or proposed management personnel indicates that it would not be in the interest of depositors or the public to permit such person to control the institution, if any acquiring person fails to furnish the Federal agency with all information required by the agency, or if the Federal agency determines that the proposed transaction would result in an adverse effect on a deposit insurance fund. In addition, the Change in Control Act requires that, whenever any Federally insured depository institution makes a loan or loans secured, or to be secured, by 25% or more of the outstanding voting stock of a Federally insured depository institution, the president or chief executive officer of the lending bank must promptly report such fact to the appropriate Federal banking agency regulating the institution whose stock secures the loan or loans.

Pennsylvania Banking Laws

Under the Pennsylvania Banking Code of 1965, as amended ("PA Code"), the Registrant is permitted to control an unlimited number of banks, subject to prior approval of the Federal Reserve Board as more fully described above. The PA Code authorizes reciprocal interstate banking without any geographic limitation. Reciprocity between states exists when a foreign state's law authorizes Pennsylvania bank holding companies to acquire banks or bank holding companies located in that state on terms and conditions substantially no more restrictive than those applicable to such an acquisition by a bank holding company located in that state. Interstate ownership of banks in Pennsylvania with banks in Delaware, Maryland, New Jersey, Ohio, New York and other states is currently authorized. However, state laws still restrict de novo formations of branches in other states. Pennsylvania law also provides Pennsylvania state chartered institutions elective parity with the power of national banks, federal thrifts, and state-chartered institutions in other states as authorized by the Federal Deposit Insurance Corporation ("Competing Institutions"). In some cases, this may give state chartered institutions broader powers than national banks such as the Bank, and may increase competition the Bank faces from other banking institutions.

Environmental Laws

The Registrant, the Bank and the Bank's customers are subject in the course of their activities to a growing number of Federal, state and local environmental laws and regulations. Neither the Registrant nor the Bank anticipates that compliance with environmental laws and regulations will have any material effect on capital expenditures, earnings, or on its competitive positions.

Supervision and Regulation - Bank

The operations of the Bank are subject to Federal and State statutes applicable to banks chartered under the banking laws of the United States, to members of the Federal Reserve System and to banks whose deposits are insured by the FDIC. Bank operations are also subject to regulations of the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve Board and the FDIC.

The primary supervisory authority of the Bank is the OCC, who regularly examines the Bank. The OCC has the authority to prevent a national bank from engaging in an unsafe or unsound practice in conducting its business.

Federal and state banking laws and regulations govern, among other things, the scope of a bank's business, the investments a bank may make, the reserves against deposits a bank must maintain, loans a bank makes and collateral it takes, the activities of a bank with respect to mergers and consolidations and the establishment of branches. All nationally and state-chartered banks in Pennsylvania are permitted to maintain branch offices in any county of the state. National bank branches may be established only after approval by the OCC. It is the general policy of the OCC to approve applications to establish and operate domestic branches, including ATMs and other automated devices that take deposits, provided that approval would not violate applicable Federal or state laws regarding the establishment of such branches. The OCC reserves the right to deny an application or grant approval subject to conditions if (1) there are significant supervisory concerns with respect to the applicant or affiliated organizations, (2) in accordance with CRA, the applicant's record of helping meet the credit needs of its entire community, including low and moderate income neighborhoods, consistent with safe and sound operation, is less than satisfactory, or (3) any financial or other business arrangement, direct or indirect, involving the proposed branch or device and bank "insiders" (directors, officers, employees and 10% or greater shareholders) involves terms and conditions more favorable to the insiders than would be available in a comparable transaction with unrelated parties.

The Bank, as a subsidiary of a bank holding company, is subject to certain restrictions imposed by the Federal Reserve Act on any extensions of credit to the bank holding company or its subsidiaries, on investments in the stock or other securities of the bank holding company or its subsidiaries and on taking such stock or securities as collateral for loans. The Federal Reserve Act and Federal Reserve Board regulations also place certain limitations and reporting requirements on extensions of credit by a bank to principal shareholders of its parent holding company, among others, and to related interests of such principal shareholders. In addition, such legislation and regulations may affect the terms upon which any person becoming a principal shareholder of a holding company may obtain credit from banks with which the subsidiary bank maintains a correspondent relationship.

Prompt Corrective Action. Federal banking law mandates certain "prompt corrective actions" which Federal banking agencies are required to take, and certain actions which they have discretion to take, based upon the capital category into which a Federally regulated depository institution falls. Regulations have been adopted by Federal bank regulatory agencies setting forth detailed procedures and criteria for implementing prompt corrective action in the case of any institution, which is not adequately capitalized. Under the rules, an institution will be deemed to be "adequately capitalized" or better if it exceeds the minimum Federal regulatory capital requirements. However, it will be deemed "undercapitalized" if it fails to meet the minimum capital requirements, "significantly undercapitalized" if it has a total risk-based capital ratio that is less than 6.0%, a Tier 1 risk-based capital ratio that is less than 3.0%, or a leverage ratio that is less than 3.0%, and "critically undercapitalized" if the institution has a ratio of tangible equity to total assets that is equal to or less than 2.0%. The rules require an undercapitalized institution to file a written capital restoration plan, along with a performance guaranty by its holding company or a third party. In addition, an undercapitalized institution becomes subject to certain automatic restrictions including a prohibition on the payment of dividends, a limitation on asset growth and expansion, and in certain cases, a limitation on the payment of bonuses or raises to senior executive officers, and a prohibition on the payment of certain "management fees" to any "controlling person". Institutions that are classified as undercapitalized are also subject to certain additional supervisory actions, including increased reporting burdens and regulatory monitoring, a limitation on the institution's ability to make acquisitions, open new branch offices, or engage in new lines of business, obligations to raise additional capital, restrictions on transactions with affiliates, and restrictions on interest rates paid by the institution on deposits. In certain cases, bank regulatory agencies may require replacement of senior executive officers or directors, or sale of the institution to a willing purchaser. If an institution is deemed to be “critically undercapitalized” and continues in that category for four quarters, the statute requires, with certain narrowly limited exceptions, that the institution be placed in receivership.

Under the Federal Deposit Insurance Act, the OCC possesses the power to prohibit institutions regulated by it, such as the Bank, from engaging in any activity that would be an unsafe and unsound banking practice and in violation of the law. Moreover, Federal law enactments have expanded the circumstances under which officers or directors of a bank may be removed by the institution’s Federal supervisory agency; unvested and further regulated lending by a bank to its executive officers, directors, principal shareholders or related interests thereof; and unvested management personnel of a bank from serving as directors or in other management positions with certain depository institutions whose assets exceed a specified amount or which have an office within a specified geographic area; and unvested management personnel from borrowing from another institution that has a correspondent relationship with their bank.

Capital Rules. Pursuant to The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”) and the laws it amended, the Federal banking agencies have issued certain “risk-based capital” guidelines, which supplemented existing capital requirements. In addition, the OCC imposes certain “leverage” requirements on national banks such as the Bank. Banking regulators have authority to require higher minimum capital ratios for an individual bank or bank holding company in view of its circumstances.

The risk-based guidelines require all banks and bank holding companies to maintain two “risk-weighted asset” ratios. The first is a minimum ratio of total capital (“Tier 1” and “Tier 2” capital) to risk-weighted assets equal to 8.00%; the second is a minimum ratio of “Tier 1” capital to risk-weighted assets equal to 4.00%. Assets are assigned to five risk categories, with higher levels of capital being required for the categories perceived as representing greater risk. In making the calculation, certain intangible assets must be deducted from the capital base. The risk-based capital rules are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies and to minimize disincentives for holding liquid assets.

The risk-based capital rules also account for interest rate risk. Institutions with interest rate risk exposure above a normal level, would be required to hold extra capital in proportion to that risk. A bank’s exposure to declines in the economic value of its capital due to changes in interest rates is a factor that the banking agencies will consider in evaluating a bank’s capital adequacy. The rule does not codify an explicit minimum capital charge for interest rate risk. The Bank currently monitors and manages its assets and liabilities for interest rate risk, and management believes that the interest rate risk rules, which have been implemented and proposed will not materially adversely affect the Bank’s operations.

The OCC’s “leverage” ratio rules require national banks which are rated the highest by the OCC in the composite areas of capital, asset quality, management, earnings and liquidity to maintain a ratio of “Tier 1” capital to “adjusted total assets” (equal to the bank’s average total assets as stated in its most recent quarterly Call Report filed with the OCC, minus end-of-quarter intangible assets that are deducted from Tier 1 capital) of not less than 3.00%. For banks which are not the most highly rated, the minimum “leverage” ratio will range from 4.00% to 5.00%, or higher at the discretion of the OCC, and is required to be at a level commensurate with the nature of the riskiness of the bank’s condition and activities.

For purposes of the capital requirements, “Tier 1” or “core” capital is defined to include common stockholders’ equity and certain non-cumulative perpetual preferred stock and related surplus. “Tier 2” or “qualifying supplementary” capital is defined to include a bank’s allowance for credit losses up to 1.25% of risk-weighted assets, plus certain types of preferred stock and related surplus, certain “hybrid capital instruments” and certain term subordinated debt instruments.

Management does not anticipate that the foregoing capital rules will have a material effect on the Registrant’s business and capital plans.

Deposit Insurance Assessments. All Federally insured depository institutions pay special assessments toward the funding of interest payments on FICO bonds, which were issued in 1989 to fund the savings and loan bailout. The special assessments are calculated on a deposit-by-deposit basis. The FDIC sets the Financing Corporation assessment rate every quarter. Currently, the special assessment rate is 1.32 basis points on all assessable deposits.

The FDIC sets deposit insurance assessment rates on a semiannual basis. The FDIC has authority to impose or change the assessment rates within its discretion to maintain the deposit insurance fund's reserve ratio at the required levels. While the required ratio was designated at 1.25% prior to 2006, the Deposit Insurance Reform Act of 2005 (the "Reform Act") changes the designated ratio to a required range, giving the FDIC authority to establish the reserve level within that range. For further information, please refer to "Deposit Insurance Reform Act" on page 8.

An institution's semiannual deposit insurance assessment is computed primarily by multiplying its "average assessment base" (generally, total insurable domestic deposits) for the prior semiannual period by one-half the annual assessment rate applicable to that institution depending upon its risk category, which is based on capital and supervisory factors.

Interstate Banking. Federal law permits interstate bank mergers and acquisitions. Limited branch purchases are still subject to state laws. Pennsylvania law permits out-of-state banking institutions to establish branches in Pennsylvania with the approval of the Pennsylvania Banking Department, provided the law of the state where the banking institution is located would permit a Pennsylvania banking institution to establish and maintain a branch in that state on substantially similar terms and conditions. It also permits Pennsylvania banking institutions to maintain branches in other states. Bank management anticipates that interstate banking will continue to increase competitive pressures in the Bank's market by permitting entry of additional competitors, but management is of the opinion that this will not have a material impact upon the anticipated results of operations of the Bank.

Bank Secrecy Act and OFAC. Under the Bank Secrecy Act ("BSA"), the Bank is required to report to the Internal Revenue Service, currency transactions of more than $10,000 or multiple transactions of which the Bank is aware in any one day that aggregate in excess of $10,000. Civil and criminal penalties are provided under the BSA for failure to file a required report, for failure to supply information required by the BSA or for filing a false or fraudulent report. The Department of the Treasury's Office of Foreign Asset Control ("OFAC") administers and enforces economic and trade sanctions against targeted foreign countries, terrorism-sponsoring jurisdictions and organizations, and international narcotics traffickers based on U.S. foreign policy and national security goals. OFAC acts under presidential wartime and national emergency powers and authority granted by specific legislation to impose controls on transactions and freeze foreign assets under U.S. jurisdiction. Acting under authority delegated from the Secretary of the Treasury, OFAC promulgates, develops, and administers the sanctions under its statutes and executive orders. OFAC requirements are separate and distinct from the BSA, but both OFAC requirements and the BSA share a common national security goal. Because institutions and regulators view compliance with OFAC sanctions as related to BSA compliance obligations, supervisory examination for OFAC compliance is typically connected to examination of an institution's BSA compliance. Examiners focus on a banking organization's compliance processes and evaluate the sufficiency of a banking organization's implementation of policies, procedures and systems to ensure compliance with OFAC regulations.

USA PATRIOT Act. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (together with its implementing regulations, the "Patriot Act"), designed to deny terrorists and others the ability to obtain access to the United States financial system, has significant implications for banks and other financial institutions. It requires the Registrant and its subsidiary to implement new policies and procedures or amend existing policies and procedures with respect to, anti-money laundering, compliance, suspicious activity and currency transaction reporting and due diligence on customers, as well as related matters. The Patriot Act permits and in some cases requires information sharing for counter-terrorist purposes between federal law enforcement agencies and financial institutions, as well as among financial institutions, and it requires federal banking agencies to evaluate the effectiveness of an institution in combating money laundering activities, both in ongoing examinations and in connection with applications for regulatory approval.

The Registrant has incurred significant additional expense in complying with BSA,OFAC and Patriot Act requirements in 2006. The Registrant's management had previously identified weaknesses in the Bank's BSA, OFAC and Patriot Act compliance program (the "BSA" compliance program") and committed to a focused program to strengthen it' BSA compliance program in 2006.

Deposit Insurance Reform Act of 2005. Pursuant to the Federal Deposit Insurance Reform Act of 2005, the FDIC merged the Bank Insurance Fund (BIF) and Savings Insurance Fund (SAIF) to form the Deposit Insurance Fund (DIF) effective March 31, 2006.

On April 1, 2006, the FDIC issued an interim rule, made final in September 2006, to implement the deposit insurance coverage changes of the Federal Deposit Insurance Reform Act of 2005. The rule: (1) increases the deposit insurance limit for certain retirement plan deposits to $250,000 effective April 1, 2006 (the basic insurance limit for other depositors such as individuals, joint accountholders, businesses, government entities and trusts remains at $100,000), (2) provides per-participant insurance coverage to employee benefit plan accounts, even if the depository institution at which the deposits are placed is not authorized to accept employee benefit plan deposits and (3) allows the FDIC to consider inflation adjustments to increase the insurance limits for all deposit accounts every five years, beginning in 2010.

On November 2, 2006, the FDIC set the designated reserve ratio for the deposit insurance fund at 1.25% of estimated insured deposits, and adopted final regulations to implement the risk-based deposit insurance assessment system mandated by the Deposit Insurance Reform Act of 2005, which is intended to more closely tie each bank's deposit insurance assessments to the risk it poses to the deposit insurance fund. Under the new risk-based assessment system, the FDIC will evaluate each institution's risk based on three primary factors -- supervisory ratings for all insured institution, financial ratios for most institutions, and long-term debt issuer ratings for large institutions that have them. An institution's assessment rate will depend upon the level of risk it poses to the deposit insurance system as measured by these factors. The new rates for most institutions will vary between 5 and 7 cents for every $100 of domestic insurable deposits.

The new assessment rates will take effect at the beginning of 2007. However, the Deposit Insurance Reform Act of 2005 provides credits to institutions that paid high premiums in the past to bolster the FDIC's insurance reserves, as a result of which the FDIC has announced that a majority of banks will have assessment credits to initially offset all of their premiums in 2007. Management does not believe it is possible at this time to reliably estimate the net assessment cost, if any that may be imposed on the Bank. There are a number of uncertain factors that could affect the assessment rate that the FDIC will decide to apply to the Bank and the actual assessment credit that will be available to the Bank in 2007.

Other Laws and Regulations. The Bank is subject to a variety of consumer protection laws, including the Truth in Lending Act, the Truth in Savings Act adopted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, the Electronic Funds Transfer Act, the Real Estate Settlement Procedures Act and the regulations adopted hereunder. In the aggregate, compliance with these consumer protection laws and regulations involves substantial expense and administrative time on the part of the Bank and the Registrant.

Legislation and Regulatory Changes. From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities and/or affecting the competitive balance between banks and other financial institutions. Proposals to change the laws and regulations governing the operations and taxation of banks, bank holding companies and other financial institutions are frequently made in Congress, and before various bank regulatory agencies. No prediction can be made as to the likelihood of any major changes or the impact such changes might have on the Registrant and its subsidiary Bank.

Effect of Government Monetary Policies. The earnings of the Registrant are and will be affected by domestic economic conditions and the monetary and fiscal policies of the United States Government and its agencies (particularly the Federal Reserve Board). The monetary policies of the Federal Reserve Board have had and will likely continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order, among other things, to curb inflation or combat a recession. The Federal Reserve Board has a major effect upon the levels of bank loans, investments and deposits through its open market operations in United States Government securities and through its regulation of, among other things, the discount rate on borrowing of member banks and the reserve requirements against member bank deposits. It is not possible to predict the nature and impact of future changes in monetary and fiscal policies.

(d) Financial Information About Geographical Areas

All of the Registrant’s revenues are attributable to customers located in the United States, and primarily from customers located in Southeastern Pennsylvania. All of Registrant’s assets are located in the United States and in Southeastern Pennsylvania. Registrant has no activities in foreign countries and hence no risks attendant to foreign operations.

(e) Available Information

Registrant files reports with the Securities and Exchange Commission (“SEC”). The public may read and copy any materials we file with the SEC at the SEC’s Public Reference Room at 450 fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC Internet site’s address is http://www.sec.gov. The Registrant maintains a corporate website at www.dnbfirst.com. We will provide printed copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to these reports at no charge upon written request. Requests should be made to DNB Financial Corporation, 4 Brandywine Avenue, Downingtown, PA 19335, Attention: Gerald F. Sopp, Chief Financial Officer.

Item 1A. Risk Factors

Here are some of the risks that affect DNB's business:

Our Profitability is Affected by Interest Rate Changes. Our profitability depends largely on our net interest income. This is the difference between our interest income on loans, investments and other assets, and our interest expense on our deposits, borrowing and other liabilities. We try to identify and manage interest rate risk, which is the risk that we will not be able to keep investing our money at a higher rate than we borrow it. To manage interest rate risks, we have to keep track of the interest we earn and the interest we pay. When interest rates change, the relationship between our interest income and our interest expense changes. Interest rate changes can be complex. For example, the relationship between short-term interest rates and long-term interest rates can change. We try to limit the chances that these changes may make us less profitable. The types of assets and liabilities we have can also affect our profitability when interest rates change.

For example:

(a) Our assets and liabilities may change interest rates at different times.
(b) Our assets and liabilities may not mature at the same time.
(c) Some types of assets and liabilities may be repayable sooner or later as interest rates change.

Normally, we expect our assets and liabilities not to have the same sensitivity to changes in interest rates. This means that a change in interest rates will normally either increase or decrease our net income. As of December 31, 2006, we were in a liability sensitive position, meaning that, when interest rates change, the rates we pay on our liabilities change more quickly than the rates we earn on our assets. In this situation, an increase in interest rates could reduce our net income. In addition, as of December 31, 2006, our liabilities, on average were scheduled to be repaid sooner than our assets. As a result, when short-term interest rates rise faster than long-term interest rates, the interest we pay on our liabilities will increase faster than the interest we receive on our assets, which can reduce our net income. We cannot predict interest rate changes or the relationships between long-term interest rates and short-term interest rates.

Heavy Competition. We now face strong competition from many Pennsylvania and out-of-state banking and thrift institutions, many of which have been in business for a number of years and have established customer bases. We expect to continue to face this strong competition in the future. Competition also comes from other businesses that provide financial services, including consumer loan companies, credit unions, mortgage brokers, insurance companies, securities brokerage firms, investment advisors, money market funds and other mutual funds, and private lenders. Many of these competitors have resources greater than ours. They have the advantages of an established market presence and customer base, name recognition and a greater capital base. While our strategy is to attract customers by providing personalized services and making use of the business and personal ties of our management, there is no assurance we will keep or increase market acceptance and be able to operate profitably. Many financial service providers believe our primary market area, Chester County, is an attractive market because of its strong economic growth. As a result, we are experiencing particularly intense competition in our primary marketplace. This includes attempts at new entry into the market by established competitors that had not previously done business in Chester County, as well as the formation of new banks with management that are experienced in the Chester County market. All of these factors may adversely impact our ability to maintain or increase our profitability.

Small Size and Geographic Restrictions. We are a community bank and do not have the capital resources or the number of people that many of our competitors have. In addition, we cannot provide as many products or services as some of our competitors, making it more difficult for us to compete. Our market territory is relatively small, which limits our ability to diversify our credit risks and increase our business.

Real Estate Loans. Like many community banks, many of our loans are commercial loans secured primarily by commercial real estate. We are more vulnerable to losses on these loans if commercial real estate generally suffers a downturn in values. As a result, if commercial real estate values decline in the future, our profitability could be adversely affected.

Dependence on Interest Income. Our profitability depends heavily on net interest income. This means we can only be profitable if we lend money at higher interest rates than we borrow it through deposits and other debt. Recently the margin between lending rates and borrowing rates has gotten smaller, causing our net interest income to decline. While we are increasing fee-based income to make us less dependent on interest rates for profitability, we have not completed the implementation of strategies to increase our fee-based income. If interest rate margins shrink further, or if we are unable to diversify our business to generate greater fee-based income, our profitability may be negatively impacted.

Dependence on Key Personnel. As a community bank, our success will depend greatly on the continued services of our executive officers. In order to be successful, we must attract, retain and motivate key employees, and if we fail to do that, our profits could be hurt. We may not be successful in continuing to recruit experienced people for positions with us, or in retaining necessary people. If we lose Mr. Latoff’s or Mr. Hieb’s services or those of other key personnel, our future prospects could be harmed.

Director and Officer Liability Limitations. Under our articles of incorporation and Pennsylvania law, our directors and officers may not be liable to us unless they breach a duty of loyalty, or they engage in intentional misconduct or violate the law, or if they gain an improper personal benefit. Our bylaws permit us to indemnify our officers and directors to the fullest extent permitted by law for all expenses incurred in settlement of actions against them in connection with their service to us. Because we indemnify our directors and officers, there is a risk they could make riskier decisions than they would make if we did not offer them this protection.

Risks Related to Balance Sheet Repositioning. We announced a comprehensive plan designed to reposition our balance sheet and improve core earnings. The plan calls for a substantial reduction in the size of the investment portfolio and expansion of the loan portfolio through new originations, increased loan participations, as well as strategic loan and lease receivable purchases. We also announced plans to reduce debt borrowings with cash flows from existing loans and investments and from new core deposit growth. It is possible we will not be able to originate new loans or additional core deposits as quickly as planned, or that changes in interest rates will make this strategy less effective in achieving our profitability goals. If we do not achieve our balance sheet repositioning or revenue enhancement goals, our profitability may be adversely affected.

Concentration of Voting Control. As of February 23, 2007, William S. Latoff, our Chairman and Chief Executive Officer, owned 121,903 shares of our common stock, including 4,630 shares of unvested stock that will vest on May 25, 2008. He can also obtain 52,869 additional shares of common stock by exercising options he has previously been granted by the Company. Therefore, with the shares of common stock represented by options, he potentially controls 6.87% of issued and outstanding voting stock. He has expressed his intent to purchase additional shares of our common stock in the future. We are likely to grant him additional stock options, unvested stock or other equity-based compensation that would increase his voting percentage further. Our directors and officers as a group now own a total of 223,714 shares of our common stock, including 10,748 shares of unvested stock that will vest in the future. They can also acquire 183,003 additional shares of common stock by exercising options they have been granted. With the shares of common stock represented by options granted to them, our directors and officers as a group potentially control 14.45% of our issued and outstanding voting stock. Many of our directors and officers have indicated their intent to purchase additional shares of common stock in the future. Further, it is likely they will be granted additional stock options, unvested stock or other equity-based compensation that would further increase the total voting percentage of our directors and officers. We believe ownership of stock causes our directors and officers to have the same interests as our shareholders, but it also gives them the ability to vote as shareholders for matters that are in their personal interest.

Possible Future Capital Needs. There is no assurance we will be able to generate sufficient capital through retained earnings to achieve our operating and growth goals. We may require additional capital in the future to support growth and expansion, to increase our legal lending limit, and to accept increased deposits. If we are not able to raise sufficient capital at an acceptable cost, we may not reach our profitability goals and the value of a shareholder's investment may be adversely affected.

Possible Dilution from Future Equity or Debt Offerings. We may make additional offerings of equity or debt privately or publicly without further approval by holders of our common stock. These offerings may include senior debt, subordinated debt, additional trust preferred securities or common or preferred stock, any of which we can issue without shareholder approval. Additional debt or equity could be issued at prices that are greater or lower than the market price of our shares. The offerings could dilute the book value, voting control or market value of shares you purchase under the Plan.

If the Economy Gets Worse in Our Market, our Profits Could Be Hurt. Recent news reports indicate economists are cautious about the U.S. economy in 2007. Our profits can be hurt if the economy does not do well in areas where we do business, because we may not be able to find as many creditworthy borrowers, or borrowers may decide to borrow less, or our losses on defaulted loans can increase if borrowers have financial problems.

If our Allowance for Credit Losses is Not Enough to Cover Future Credit Losses, or if We Do Not Manage our Credit Risks, our Earnings Could Decrease. We make assumptions and judgments about the collectibility of our loans, including the creditworthiness of our borrowers and the value of any collateral securing our loans. To determine our allowance for credit losses, we review our loans and our experience with loan losses and late loan payments, and we evaluate economic conditions. If we make the wrong assumptions, our allowance for credit losses may not be large enough to cover future losses on our loans. We also might make other mistakes in managing our credit risks. For example, we might not identify credit risks in a loan or in our portfolio accurately. We might make mistakes in managing our loans or in trying to recover losses. These mistakes might reduce our income, or require us to apply more of our income to add to the allowance for credit losses, or both. Either of these results would hurt our profits. Our bank regulators also have to review our allowance for credit losses. If our regulators decide we should increase it, we have to apply more of our income to do so, which might reduce our profits.

We Have a Concentration of Exposure to Some Borrowers, Which Adds to our Risks. The total amount of loans we make to a group of related borrowers is called our exposure to a borrowing relationship. As of December 31, 2006, the largest exposure we had to a group of related borrowers was $5.7 million. This equaled 12.4% of the total amount of our regulatory capital. For these purposes, our regulatory capital includes our stated capital, our capital surplus, and certain portions of our allowance for credit losses, with further adjustments, as required by our banking regulators. The standard lending limit for national banks is equal to 15% of this regulatory capital. As of December 31, 2006, our total exposure to our 10 largest borrowing relationships was approximately $47.3 million. This was approximately 103.6% of our regulatory capital for these purposes. Because a default on a loan to one borrower in a group of related borrowers can often result in defaults on the other loans to related borrowers, and because larger loan amounts produce more losses to a bank when they go into a default, if any of these loans goes into default and we cannot recover all we have lent, there is a greater risk that a default on these loans will produce a greater loss, and consequently a greater reduction in our profitability. If the total exposure to a few borrowing relationships gets too big in relation to a bank's capital, it increases the risk that loan defaults on those borrowing relationships will reduce the bank's capital. Without enough capital, a bank cannot operate profitably and may be subject to regulatory enforcement action.

Changes in Regulations and Accounting Rules May Hurt our Earnings. Section 404 of the Sarbanes-Oxley Act requires many companies to increase costs to strengthen their internal control. We do not know yet whether that requirement will apply to us, but we have to make changes in our accounting and auditing in case it will. In addition, our auditors are charging us more because they have to do more work in auditing our records. Other recent accounting changes, such as the new rules for recognizing expenses associated with the value of stock options we grant to employees, are changing our accounting and business practices. The USA Patriot Act, OFAC and new regulations under the Bank Secrecy Act are also requiring us to spend more and these costs are expected to increase substantially during 2007 and succeeding years as we augment our BSA compliance program. The Bank may not be in full compliance in these areas and, while management is actively assessing and working to strengthen the Bank's BSA, OFAC and Patriot Act compliance, there is a risk that the Bank could be exposed to enforcement action, civil money penalties or other adverse actions in the future based on any shortcomings that may be identified in the Bank's historic BSA compliance program implementation. Other new bank regulations are also being adopted, and we must spend money to comply with them. In other cases, such as with our trust preferred securities, Bank Owned Life Insurance and tax and accounting positions we have taken, we depend upon Congress, regulatory agencies and accounting rulemaking bodies not to make changes in their current positions on the proper treatment of many of our activities. Any changes in these positions could hurt our financial position and our profitability. We do not know what other rules will be adopted in the future or whether new rules will be adopted. New rules and changes in rules may increase our expenses in complying with them. This may hurt our future profits in ways we cannot predict now.

Unexpected Events Affecting our Marketing Partners Could Hurt Our Revenues. Over recent years, we have sold more products and services jointly with other organizations, and we have relied more on other organizations to provide services to us to support our activities. We believe this trend will continue and that we will be more dependent in the future on other organizations in order to run our business efficiently and profitably. If an unexpected loss or problem affects one of these organizations, it could cost us money or hurt our ability to be profitable. While we try to plan for these risks, we may not predict some of these types of events.

Our Expansion Plans May Not be Successful. We have been adding branches and offices, and we may add more in the future. We do this so that we can provide our products and services to more customers, which we believe will make us more profitable. New offices cost us more money, but we expect them to become profitable after a time. If new offices do not become as profitable as we hope or do not become profitable as quickly as we expect, our profits may be hurt.

Unexpected Disasters May Hurt Our Profitability and Your Investment. Terrorist acts, conflicts, wars and natural disaster may seriously harm our business and revenue, costs and expenses and financial condition and stock price. While we try to make contingency plans to help continue our business if a disaster occurs, we might not anticipate every type of disaster, and our plans might fail. In addition, some disasters might be so overwhelming that we would not be able to recover from them. These situations could hurt our profitability and in the worst case could destroy our business and wipe out your investment.

Here are some risks that do not affect our business but could affect the value of an investment in DNB Common Stock:

On a Liquidation or in Certain Other Cases, Our Debt Holders May Hold Rights Superior to Shareholders. We have issued trust preferred securities that constitute indebtedness. These securities contain covenants requiring us to repay the debt with interest. If we fail to do so, the holders of that debt will have rights to seek repayment, and their claims on our assets will have priority over your claim as a shareholder.

Our Governing Documents May Reduce the Influence of an Individual Shareholder. Our articles of incorporation and bylaws give our directors substantial control over who sits on our board of directors and what proposals are presented to our shareholder to consider. For example, the board is divided into three staggered classes of directors. Only one class gets re-elected each year. As a result, it may take at least two years for a majority of directors to change. Second, under our articles of incorporation, a shareholder may not cumulate votes for the election of directors. As a result, the same majority of shareholders may control the election of each director position. Third, our bylaws impose time limits and other requirements on a shareholder who wants to nominate a director or make a proposal for new business at a shareholder meeting. As a result, the nomination or proposal may be delayed until the shareholder meets these requirements. These provisions may also give our management more time to evaluate and respond to a shareholder nomination or proposal and, if management believes the nomination or proposal is not in the best interests of shareholders, to advocate that it not be adopted.

Our Governing Documents May Make it More Difficult for Another Company to Buy DNB. Our articles of incorporation and bylaws contain provisions that may make it harder for another company to acquire control of DNB. For example, a change in control of DNB cannot occur unless it has been approved by shareholders owning at least 75% of the shares of DNB common stock or by two-thirds of DNB's directors. In addition, the board of directors may oppose another company's offer to buy DNB from its shareholders and in doing so may consider many factors not directly involving the current value of DNB stock. We believe these provisions help DNB become more profitable because they let our management concentrate on developing the profitability of DNB's business for the benefit of our shareholders. As a result of these provisions, if another company tries to offer shareholders a higher price than shareholders can obtain by selling them in the open market, our shareholders may not be able to sell their shares to the other company without the approval of our board of directors.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

The main office of the Bank is located at 4 Brandywine Avenue, Downingtown, Pennsylvania 19335. The Registrant's registered office is also at this location. The Registrant pays no rent or other form of consideration for the use of the Bank's main office as its principal executive office. The Bank leases its operations center located at 104-106 Brandywine Avenue, Downingtown. With the exception of the West Goshen office, Exton office, West Chester office and limited service offices in Newtown Square and at Tel Hai Retirement Community, all of which are leased, the Bank owns all of its existing branches as described below which had a net book value of $4.8 million including leasehold improvements at December 31, 2006. The Bank's trust department and wealth management unit, operating under the name, "DNB Advisors," have offices in the Bank's Exton Office.

The bank has twelve offices located in Chester and Delaware Counties, Pennsylvania. In addition to the Main Office discussed above, they are:

Office	Office Location	Owned/Leased
Caln Office	1835 East Lincoln Highway, Coatesville	Owned
East End Office	701 East Lancaster Avenue, Downingtown	Owned
Exton Office	410 Exton Square Parkway, Exton	Leased
Kennett Square Office	215 E. Cypress St., Kennett Square	Owned
Lionville Office	Intersection of Route 100 and Welsh Pool Road, Exton	Owned
Little Washington Office	Route 322 and Culbertson Run Road, Downingtown	Owned
Ludwig's Corner Office	Intersection of Routes 100 and 401, Chester Springs	Owned
Tel Hai Office	Tel Hai Retirement Community, Honey Brook (Limited Service)	Leased
West Goshen Office	1115 West Chester Pike, West Chester	Leased
West Chester Office	2 North Church Street, West Chester	Leased
Newtown Square Office	3409 West Chester Pike, Suite 102, Newtown Square (Limited Service)	Leased

On April 26, 2006 the Bank signed an agreement to lease a parcel of land in Chadds Ford township, Delaware County, Pennsylvania, for the purpose of developing the premises to accommodate a future branch. The Bank expects to begin operations of the new branch in May of 2007.

Item 3. Legal Proceedings

DNB is a party to a number of lawsuits arising in the ordinary course of business. While any litigation causes an element of uncertainty, management is of the opinion that the liability, if any, resulting from the actions, will not have a material effect on the accompanying financial statements.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Part II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

(a) Market Price of and Dividends on Registrant's Common Equity

DNB Financial Corporation's common stock is listed under the symbol "DNBF" on the Over-The-Counter Electronic Bulletin Board, an automated quotation service, made available through and governed by the NASDAQ system. Current price information is available from account executives at most brokerage firms as well as the firms listed at the back of this report who are market makers of DNB's common stock. There were approximately 1,250 stockholders who owned 2.5 million shares of common stock outstanding at February 23, 2007.

The following table sets forth the quarterly high and low prices for a share of DNB's common stock during the periods indicated. Prices for the sale of stock are based upon transactions reported by the brokerage firms of Boenning & Scattergood, Inc. and Ferris, Baker Watts, Inc. These over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions. The quoted high and low bids prices are limited only to those transactions known by management to have occurred and there may, in fact, have been additional transactions of which management is unaware. Prices have been adjusted to reflect stock dividends.

	2006		2005	
	High	Low	High	Low
First quarter	$ 21.43	$ 18.48	$ 26.76	$ 24.27
Second quarter	20.57	20.00	25.67	24.09
Third quarter	20.71	19.86	23.81	21.31
Fourth quarter	20.70	19.80	21.09	18.05

The information required with respect to the frequency and amount of the Registrant's cash dividends declared on each class of its common equity for the two most recent fiscal years is set forth in the section of this report titled, "Item 6 - Selected Financial Data" on page 17.

The information required with respect to securities authorized for issuance under the Registrant's equity compensation plans is set forth in "Item 12 - Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters" on page 79.

(b) Recent Sales of Unregistered Securities

Not applicable

(c) Purchases of Equity Securities by the Registrant and Affiliated Purchasers

The following table provides information on repurchases by or on behalf of DNB or any “affiliated purchaser” (as defined in Regulation 10b-18(a)(3)) of its common stock in each month of the quarter ended December 31, 2006:

Period	Total Number Of Shares Purchased		Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (a)
October 1, 2006 - October 31, 2006	1,050	$	20.43	1,050	144,974
November 1, 2006 - November 30, 2006	1,050		20.14	1,050	143,924
December 1, 2006 - December 31, 2006	6,750		20.69	6,750	137,174
Total	**8,850**	$	20.59	**8,850**	**137,174**

(a) On July 25, 2001, DNB authorized the buyback of up to 192,938 shares of its common stock over an indefinite period. On August 27, 2004, DNB increased the buyback from 192,938 to 376,228 shares of its common stock over an indefinite period. This number has been adjusted to reflect the 5% stock dividend issued in December 2006.

(d) Corporation Performance Graph

The following graph presents the 5 year cumulative total return on DNB Financial Corporation’s common stock, compared to the S&P 500 Index and S&P Financial Index for the 5 year period ended December 31, 2006. The comparison assumes that $100 was invested in the Corporation’s common stock and each of the foregoing indices and that all dividends have been reinvested.

Item 6. Selected Financial Data

The selected financial data set forth below is derived in part from, and should be read in conjunction with, the Consolidated Financial Statements and Notes thereto, contained elsewhere herein.

At or For the Year Ended December 31
(Dollars in thousands, except share data)

	2006	2005	2004	2003	2002
RESULTS OF OPERATIONS					
Interest income	$ **28,249**	$ 23,427	$ 20,233	$ 18,894	$ 21,498
Interest expense	**13,368**	9,313	6,833	7,421	9,430
Net interest income	**14,881**	14,114	13,400	11,473	12,068
Provision for credit losses	**—**	—	—	—	—
Other non-interest income	**3,414**	2,356	2,940	2,540	2,645
Other-than-temporary impairment charge	**—**	—	(2,349)	—	—
Total non-interest income	**3,414**	2,356	591	2,540	2,645
Non-interest expense	**16,507**	14,411	13,189	12,622	11,257
Income before income taxes	**1,788**	2,059	802	1,391	3,456
Income tax expense (benefit)	**41**	(89)	504	(10)	728
Net income	$ **1,747**	$ 2,148	$ 298	$ 1,401	$ 2,728
PER SHARE DATA*					
Basic earnings	$ **0.70**	$ 0.97	$ 0.13	$ 0.64	$ 1.23
Diluted earnings	**0.69**	0.96	0.13	0.62	1.21
Cash dividends	**0.50**	0.47	0.45	0.43	0.41
Book value	**11.58**	11.45	10.86	11.52	11.79
Weighted average Common shares outstanding - basic	**2,500,173**	2,221,478	2,183,308	2,199,743	2,222,649
FINANCIAL CONDITION					
Total assets	$ **525,242**	$ 473,046	$ 441,059	$ 409,013	$ 384,368
Loans and leases	**329,466**	288,130	232,577	203,553	187,585
Allowance for credit losses	**4,226**	4,420	4,436	4,559	4,546
Deposits	**381,027**	339,627	323,144	292,436	287,802
Borrowings	**110,538**	99,880	90,643	88,720	68,728
Stockholders' equity	**31,411**	30,186	24,738	25,372	26,208
SELECTED RATIOS					
Return on average stockholders' equity	5.73%	8.31%	1.16%	5.47%	10.66%
Return on average assets	**0.35**	0.48	0.07	0.35	0.72
Average equity to average assets	**6.18**	5.77	6.05	6.41	6.76
Loans to deposits	**86.47**	84.84	71.97	69.61	65.18
Dividend payout ratio	**71.37**	49.39	334.34	68.83	33.67

*

Per share data and shares outstanding have been adjusted for the 5% stock dividends in December of 2006, 2005, 2004, 2003 and 2002.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

I. Introductory Overview

DNB Financial Corporation is a bank holding company whose bank subsidiary, DNB First, National Association (the "Bank") is a nationally chartered commercial bank with trust powers, and a member of the FDIC. DNB provides a broad range of banking services to individual and corporate customers through its twelve community offices located throughout Chester and Delaware Counties, Pennsylvania. DNB is a community banking organization that focuses its lending and other services on businesses and consumers in the local market area. DNB funds all these activities with retail and business deposits and borrowings. Through its DNB Advisors division, the Bank provides wealth management and trust services to individuals and businesses. The Bank and its subsidiary, DNB Financial Services, Inc. through the name "DNB Financial Services," make available certain non-depository products and services, such as securities brokerage, mutual funds, life insurance and annuities.

DNB earns revenues and generates cash flows by lending funds to commercial and consumer customers in its marketplace. DNB generates its largest source of interest income through its lending function. Secondary sources of interest income are DNB's investment portfolio, which provide liquidity and cash flows for future lending needs.

In addition to interest earned on loans and investments, DNB earns revenues from fees it charges customers for non-lending services. These services include wealth management and trust services; brokerage and investment services; cash management services; banking and ATM services; as well as safekeeping and other depository services.

To implement the culture changes necessary at DNB First to become an innovative community bank capable of meeting challenges of the 21st century, we embarked on a strategy called "Loyalty, Bank On It." In recognizing the importance of loyalty in our everyday lives, we have embraced this concept as the cornerstone of DNB First's new culture beginning in 2006. To that end, DNB continues to make appropriate investments in all areas of our business, including people, technology, facilities and marketing.

Highlights of DNB's results for the year-end December 31, 2006 include:

· Net interest income increased 5.4%

· Solid loan growth - up 14.3%

· Steady growth in deposits - up 12.2%

Earnings. For the year ended December 31, 2006, DNB reported net income of $1.7 million, a decease of $401,000 from the $2.1 million reported for the year ended December 31, 2005, or $0.69 per share versus $0.96 per share, respectively, on a fully diluted basis. DNB's earnings were impacted by the general economic conditions challenging all commercial banking institutions - the flat yield curve and increased pricing competition on loans and deposits. In addition, earnings were further depressed by a $2.1 million increase in non interest expense to $16.5 million. This increase was due almost entirely to strategic moves designed to increase future revenue and improve profitability. Earnings for 2005 were favorably impacted when DNB reversed a portion of the previously recorded valuation allowance for deferred tax assets and recognized a related income tax benefit of $308,000. A significant portion of the reversal was associated with a tax gain recognized on the sale of two operations buildings as well as an additional reversal made in connection with the sale of agency preferred securities, which is discussed in detail on page 20 under the heading "*Investment Portfolio Restructure*".

18

The following table sets forth selected quarterly financial data and earnings per share for the periods indicated. Per share data have been adjusted for the five percent (5%) stock dividends paid in 2006 and 2005.

Quarterly Financial Data

(Dollars in thousands, except per share data)	**2006** Fourth Quarter	**2006** Third Quarter	**2006** Second Quarter	**2006** First Quarter	2005 Fourth Quarter	2005 Third Quarter	2005 Second Quarter	2005 First Quarter
Interest income	**$ 7,452**	**$ 7,308**	**$ 7,018**	**$ 6,471**	$ 6,325	$ 6,180	$ 5,715	$ 5,207
Interest expense	**3,690**	**3,557**	**3,222**	**2,899**	2,689	2,487	2,255	1,882
Net interest income	**3,762**	**3,751**	**3,796**	**3,572**	3,636	3,693	3,460	3,325
Provision for credit losses	**—**	**—**	**—**	**—**	(120)	75	30	15
Other non-interest income	**829**	**871**	**899**	**815**	779	761	760	56
Total non-interest income	**829**	**871**	**899**	**815**	779	761	760	56
Non-interest expense	**4,309**	**4,187**	**4,144**	**3,867**	3,754	3,678	3,538	3,441
Income (loss) before income taxes	**282**	**435**	**551**	**520**	781	701	652	(75)
Income tax (benefit) expense	**(98)**	**18**	**65**	**56**	(64)	114	15	(154)
Net income	**380**	**417**	**486**	**464**	845	587	637	79
Basic earnings per share	**$ 0.15**	**$ 0.17**	**$ 0.20**	**$ 0.18**	$ 0.39	$ 0.28	$ 0.31	$ 0.04
Diluted earnings per share	**0.15**	**0.17**	**0.19**	**0.18**	0.39	0.28	0.30	0.04
Cash dividends per share	**$ 0.124**	**$ 0.124**	**$ 0.124**	**$ 0.124**	$ 0.118	$ 0.118	$ 0.118	$ 0.118

Asset Quality. Total non-performing loans were $821,000 at December 31, 2006 compared to $1.4 million at December 31, 2005. Non-performing loans to total loans were .25% at December 31, 2006 compared to .47% at December 31, 2005. DNB's asset quality remains strong compared to its peer group. The allowance for credit losses was $4.2 million at December 31, 2006, compared to $4.4 million at December 31, 2005. The allowance to total loans was 1.28% at December 31, 2006 compared to 1.53% at December 31, 2005.

II. Overview of Financial Condition - Major Changes and Trends

At December 31, 2006, DNB had consolidated assets of $525.2 million and a Tier I/Leverage Capital -Ratio of 8.28%. Loans and leases comprise 66.4% of earning assets, while investments and federal funds sold constitute the remainder. During 2006, assets increased $52.2 million to $525.2 million at December 31, 2006, compared to $473.0 million at December 31, 2005. Investment securities increased $7.8 million to $154.2 million, while the loan and lease portfolio grew $41.3 million, or 14.35%, to $329.5 million. Deposits increased $41.4 million to $381.0 million at December 31, 2006. DNB credit quality remained strong, as did the allowance for credit losses, which was 1.28% of total loans and leases. DNB's delinquency ratio (total delinquent loans and leases to total loans and leases) was 1.03% at December 31, 2006 up from .94% at December 31, 2005. DNB's liabilities are comprised of a high level of core deposits with a low cost of funds in addition to a moderate level of borrowings with costs that are more volatile than core deposits.

During the last few years, a flat yield curve and significant margin compression contributed to lower levels of earnings.

19

During 2005, DNB completed a private placement of 265,730 shares of its common stock to 53 accredited investors at a price of $21.00 per share, realizing total offering proceeds of $5.6 million. DNB’s management team and board of directors organized the offering. There were no brokerage or underwriting commissions paid in relation to the private placement.

Comprehensive 5-Year Plan. During 2003, management developed a strategic 5-year plan designed to reposition its balance sheet and improve core earnings. As part of the plan, management announced its intentions to substantially reduce the size of its investment portfolio and expand its loan portfolio through new originations, increased loan participations, as well as strategic loan and lease receivable purchases. Management also planned a reduction in the absolute level of borrowings with cash flows from existing loans and investments as well as from new core deposit growth. A detailed discussion on DNB’s progress follows below.

Investment Portfolio Restructure. As part of its previously announced balance sheet repositioning, DNB took advantage of the interest rate environment to restructure a significant portion of its investment securities portfolio. In March 2005, DNB sold $73.3 million of structured securities, government agency preferred stock, longer-term municipal securities, as well as corporate securities, resulting in a net pre-tax loss of $699,000. In total, net pre-tax gains of $300,000 were recognized during 2005, on the sale of preferred stock. As such, the gains recognized on the sale of the preferred stock (capital assets) resulted in a reversal of a portion of a previously recorded valuation allowance for deferred tax assets of $102,000 for 2005. This amount contributed to a reduction in income tax expense for 2005.

The majority of the proceeds received on the sale of these investments were re-invested into higher yielding agency mortgage-backed securities, agency bonds and municipal securities. Management believed that the restructured portfolio will result in more stable earnings and cash flow, as well as improved value metrics.

Continued Progress in Balance Sheet Repositioning. In 2006, DNB continued moving forward on its five year plan and increased loans and leases by $41.3 million or 14.4%. Commercial loans and leases increase $26.0 million and residential and consumer increased $15.3 million. Deposits grew $41.4 million or 12.19% and customer repurchase agreements grew $9.1 million or 25.16%.

DNB’s financial objectives are focused on diluted earnings per share growth and return on average equity. In order to achieve its financial objectives, DNB defined the following strategies as part of the 5-Year Plan:

- Grow loans and diversify the mix
- Reduce the size of the investment portfolio
- Reduce long-term borrowings
- Enhance the branch network and alternative delivery options
- Focus on profitable customer segments
- Grow and diversify non-interest income

Management’s strategies are designed to direct DNB’s tactical investment decisions and support financial objectives. DNB’s most significant revenue source continues to be net interest income, defined as total interest income less interest expense, which in 2006 accounted for approximately 81.3% of total revenue. To produce net interest income and consistent earnings growth over the long-term, DNB must generate loan and deposit growth at acceptable economic spreads within its market area. To generate and grow loans and deposits, DNB must focus on a number of areas including, but not limited to, the economy, branch expansion, sales practices, customer satisfaction and retention, competition, customer behavior, technology, product innovation and credit performance of its customers.

Management has made a concerted effort to improve the measurement and tracking of business lines and overall corporate performance levels. Improved information systems have increased DNB’s ability to track key indicators and enhance corporate performance levels. Better measurement against goals and objectives and increased accountability will be integral in attaining desired loan, deposit and fee income production.

III. DNB's Principal Products and Services

Loans and Lending Services. DNB's primary source of earnings and cash flows is derived from its lending function. More than sixty- seven percent of DNB's portfolio relates to commercial loans and lease products. DNB focuses on providing these products to small to mid-size businesses throughout Chester and Delaware Counties. In keeping with DNB's goal to match customer business initiatives with products designed to meet their needs, DNB offers a wide variety of fixed and variable rate loans that are priced competitively. DNB serves this market by providing funds for the purchase of business property or ventures, working capital lines, lease financing for equipment and for a variety of other purposes. Net loan and lease growth in the commercial loan and lease portfolios amounted to $26.0 million or 13.3% in 2006.

As a community bank, DNB also serves consumers by providing home equity and home mortgages, as well as term loans for the purchase of consumer goods. During the current low interest rate environment, there has been a high demand for consumer home equity loan products. DNB has successfully met this demand with a variety of fixed and variable rate home equity loans and lines, secured by first or second liens on the borrowers' primary residence. At December 31, 2006, consumer loans totaled $54.8 million, up 13.21% from 2005.

In addition to providing funds to customers, DNB also provides a variety of services to its commercial customers. These services, such as cash management, commercial sweep accounts, internet banking, letters of credit and other lending products, are designed to meet our customer needs and help them become successful. DNB provides these -services to assist its customers in obtaining financing, securing business opportunities, providing access to new resources and managing cash flows.

Deposit Products and Services. DNB's primary source of funds is derived from customer deposits, which are typically generated by DNB's twelve branch offices. DNB's deposit base, while highly concentrated in central Chester County, extends to southern Chester County and into parts of Delaware and Lancaster Counties. In addition, a growing amount of new deposits are being generated through expanded government service offerings and as a part of comprehensive loan or wealth management relationships.

The majority of DNB's deposit mix consists of low costing core deposits, (demand, NOW and savings accounts). The remaining deposits are comprised of rate-sensitive money market and time products. DNB offers tiered savings and money market accounts, designed to attract high dollar, less volatile funds. Certificates of deposit and IRAs are traditionally offered with interest rates commensurate with their terms.

Non-Deposit Products and Services. DNB offers non-deposit products and services through its subsidiaries under the names "DNB Financial Services" ("DNBFS") and "DNB Advisors." Revenues under these entities were $707,000, $712,000 and $633,000 or 3.9%, 4.35% and 4.5% of total revenues for 2006, 2005 and 2004, respectively.

DNB Financial Services. Through a partnership with UVEST Financial Services, DNBFS offers a complete line of investment and insurance products.

- Fixed & Variable Annuities
- 401k Rollovers
- Self-Directed IRAs
- Mutual Funds
- Long Term Care Insurance
- Life Insurance
- Disability Insurance
- Self Employed Pension (SEP)
- Defined Benefit Plans
- Stocks
- Bonds
- Full Services Brokerage
- 529 College Savings Plans
- Estate Accounts
- Trust Services

DNB Advisors. DNB Advisors offers a full line of products and services, which includes the following.

- Investment Management
- Estate Settlement
- Custody Services
- Safekeeping
- Investment Advisory
- Trust Services
- Retirement Planning

IV. Material Challenges, Risks and Opportunities

A. Interest Rate Risk Management. Interest rate risk is the exposure to adverse changes in net interest income due to changes in interest rates. DNB considers interest rate risk a predominant risk in terms of its potential impact on earnings. Interest rate risk can occur for any one or more of the following reasons: (a) assets and liabilities may mature or re-price at different times; (b) short-term or long-term market rates may change by different amounts; or (c) the remaining maturity of various assets or liabilities may shorten or lengthen as interest rates change.

The principal objective of the Bank's interest rate risk management is to evaluate the interest rate risk included in certain on and off balance sheet accounts, determine the level of risk appropriate given the Bank's business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with approved guidelines. Through such management, the Bank seeks to reduce the vulnerability of its operations to changes in interest rates. The Bank's Asset Liability Committee (the "ALCO") is responsible for reviewing the Bank's asset/liability policies and interest rate risk position and making decisions involving asset liability considerations. The ALCO meets on a monthly basis and reports trends and the Bank's interest rate risk position to the Board of Directors. The extent of the movement of interest rates is an uncertainty that could have a negative impact on the earnings of the Bank.

1. Net Interest Margin

DNB's net interest margin is the ratio of net interest income to average interest-earning assets. Unlike the interest rate spread, which measures the -difference between the rates on earning assets and interest paying liabilities, the net interest margin measures that spread plus the effect of net free funding sources. This is a more meaningful measure of profitability because a bank can have a narrow spread but a high level of -equity and non-interest-bearing deposits, resulting in a good net interest margin. One of the most critical challenges DNB faced over the last several years was the impact of historically low interest rates and a narrower spread between short-term rates and long-term rates as noted in the tables below.

	December 31,					
	2006	**2005**	**2004**	**2003**	**2002**	**2001**
Prime	**8.25%**	7.25%	5.25%	4.00%	4.25%	4.75%
Federal Funds Sold ("FFS")	**5.25%**	4.25%	2.25%	1.00%	1.25%	1.75%
6 month Treasury	**5.08%**	4.25%	2.56%	1.00%	1.21%	1.80%

Historical Yield Spread

	December 31,				
	2006	**2005**	**2004**	**2003**	**2002**
FFS to 5 Year U.S. Treasury	**-0.56%**	0.10%	1.38%	2.25%	1.53%
FFS to 10 Year U.S. Treasury	**-0.55%**	0.14%	1.99%	3.27%	2.58%

In late 2003, management and the Board of Directors of DNB reviewed the declines in DNB's net interest margin and in that connection evaluated DNB's funds management practices to assess the quantity and quality of risk management over interest rate risk and liquidity risk. Based on the review, they determined that the decline in DNB's net interest margin and the relatively high level of interest rate risk resulted from a number of factors. Those factors included the following: slow loan growth; a dependency on investment portfolio income and a reliance on wholesale borrowings to fund investments; and high levels of cash flow coming from mortgage related products during a historically low interest rate environment. Management and the Board of Directors decided to take the following actions to address the decline in net interest income: improve DNB's Strategic Plan and related controls to address the net income contribution of the loan portfolio; complete a review of DNB's Liquidity Policy, as well as its Asset/Liability Management Policy and revise them where necessary; restructure the investment portfolio to mitigate risks of future prepayments; increase monitoring and assessment of leverage strategies; make greater use of available outside resources for -monitoring and managing interest rate risk and asset/liability risks; evaluate asset/liability policies to determine that risk limits are appropriate; and provide for independent periodic evaluation of information and methods used in asset/liability and interest rate risk management.

The items mentioned above were critical factors in management's decision to reposition a portion of its investment portfolio to improve earnings. Since 2003, management has focused its efforts on positioning the balance sheet for increased rates. In anticipation of higher rates, management attempted to shorten the duration of its investment portfolio and lengthen the maturity of its deposit base. As a result, the size of the investment portfolio has decreased by $20.2 million or 11.6% over the last three years. These funds have been used to pay-down FHLB borrowings and to fund loan and lease growth. DNB's investment portfolio was 29.4% of DNB's balance sheet at December 31, 2006 compared to 31.0%, 38.5% and 42.6% at December 31, 2005, 2004 and 2003 respectively.

The table below provides, for the periods indicated, information regarding: (i) DNB's average balance sheet; (ii) the total dollar amounts of interest income from interest-earning assets and the resulting -average yields (tax-exempt yields and yields on agency preferred stock that have a 70% dividend received deduction ("DRD") have been adjusted to a tax equivalent basis using a 34% tax rate); (iii) the total dollar amounts of interest expense on interest-bearing liabilities and the resulting average costs; (iv) net interest income; (v) net interest rate spread; and (vi) net interest margin. Average balances were calculated based on daily balances. Non-accrual loan balances are included in total loans. Loan fees and costs are included in interest on total loans.

Average Balances, Rates, and Interest Income and Expense
(Dollars in thousands)

	Year Ended December 31								
	2006			2005			2004		
	Average Balance	**Interest**	**Yield/ Rate**	**Average Balance**	**Interest**	**Yield/ Rate**	**Average Balance**	**Interest**	**Yield/ Rate**
ASSETS									
Interest-earning assets:									
Investment securities:									
Taxable	**$ 109,027**	**$ 4,699**	**4.31%**	$ 128,238	$ 5,063	3.95%	$ 150,179	$ 4,949	3.30%
Tax-exempt	**31,989**	**1,924**	**6.01**	28,380	1,664	5.86	24,422	1,529	6.26
Tax-preferred DRD	—	—	—	2,199	77	3.50	10,991	362	3.29
Total securities	**141,016**	**6,623**	**4.70**	158,817	6,804	4.28	185,592	6,840	3.69
Cash and cash equivalents	**13,853**	**347**	**2.51**	13,085	218	1.66	4,812	64	1.33
Total loans and leases	**321,289**	**22,110**	**6.88**	259,077	17,056	6.58	218,513	13,987	6.40
Total interest-earning assets	**476,158**	**29,080**	**6.11**	430,979	24,078	5.59	408,917	20,891	5.11
Non-interest-earning assets	**17,297**			16,965			15,837		
Total assets	**$ 493,455**			$ 447,944			$ 424,754		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest-bearing liabilities:									
Savings deposits	**$ 211,647**	**$ 4,257**	**2.01%**	$ 193,205	$ 2,438	1.26%	$ 183,283	$ 1,141	0.62%
Time deposits	**96,964**	**3,870**	**3.99**	74,549	2,096	2.81	68,631	1,534	2.24
Total interest-bearing Deposits	**308,611**	**8,127**	**2.63**	267,754	4,534	1.69	251,914	2,675	1.06
Federal funds purchased	**799**	**43**	**5.38**	624	21	3.44	858	12	1.42
Repurchase agreements	**38,920**	**1,535**	**3.94**	30,549	821	2.69	11,926	145	1.22
FHLB advances	**50,843**	**2,852**	**5.61**	59,506	3,278	5.51	77,376	3,626	4.69
Other borrowings	**9,974**	**811**	**8.13**	8,990	659	7.32	5,870	375	6.38
Total interest-bearing Liabilities	**409,147**	**13,368**	**3.27**	367,423	9,313	2.53	347,944	6,833	1.96
Demand deposits	**50,595**			52,863			49,214		
Other liabilities	**3,241**			1,803			1,886		
Stockholders' equity	**30,472**			25,855			25,710		
Total liabilities and									

stockholders' equity	**$ 493,455**	$ 447,944	$ 424,754
Net interest income	**$ 15,712**	$ 14,765	$ 14,058
Interest rate spread	**2.84%**	3.05%	3.15%
Net interest margin	**3.30%**	3.43%	3.44%

24

Although DNB believes that the non-GAAP financial measures included in the Average Balance table above enhance investor's understanding of DNB's business and performance, and DNB management uses these non-GAAP financial measures in evaluating DNB's performance, these non-GAAP financial measures should not be considered an alternative to GAAP. The reconciliation of these non-GAAP financial measures to GAAP is presented below.

Reconciliation of Non-GAAP Financial Measures
Year Ended December 31

	2006		**2005**		**2004**	
(Dollars in thousands)	**Interest**	**Yield/Rate**	**Interest**	**Yield/Rate**	**Interest**	**Yield/Rate**
Securities - tax-exempt	**$ 1,273**	**3.98%**	$ 1,101	3.88%	$ 1,009	4.13%
Tax equivalent adjustments	**651**		563		520	
Securities - tax equivalent yield	**1,924**	**6.01**	1,664	5.86	1,529	6.26
Securities - tax-preferred DRD	—	—	57	2.57	266	2.42
Tax equivalent adjustments	—		20		96	
Securities - tax equivalent yield	—	—	77	3.50	362	3.29
Loans and leases	**21,930**	**6.83**	16,988	6.56	13,945	6.38
Tax equivalent adjustments	**180**		68		42	
Loans and leases - tax equivalent yield	**22,110**	**6.88**	17,056	6.58	13,987	6.40
Net interest income	**14,881**		14,114		13,400	
Tax equivalent adjustments	**831**		651		658	
Net interest income tax equivalent	**$ 15,712**		$ 14,765		$ 14,058	
Net interest rate spread, no tax adjustment		**2.81%**		2.90%		2.98%
Net interest margin, no tax adjustment		**3.13%**		3.27%		3.28%

2. *Rate / Volume Analysis*

During 2006, net interest income increased $947,000 or 6.4% on a tax equivalent basis, to $15.7 million, from $14.8 million in 2005. As shown in the Rate/Volume Analysis below, $2.4 million was attributable to volume changes mostly attributable to loan and lease growth, which accounted for $4.3 million, offset by $688,000 related to investment portfolio run-off. The average balance on loans and leases were $321.3 million in 2006 compared to $259.1 million in 2005, representing an increase of $62.2 million, or 24.0%, year-over-year. The $2.4 million increase to net interest income was offset by a $1.5 million decrease related to rate changes. As in 2005, the rates on DNB's interest-bearing liabilities increased at a faster pace than the rates on DNB's interest-earning assets, which had a negative impact on interest income. The tax equivalent yield on loans and leases increased to 6.88% for 2006 compared to 6.58% for 2005. The cost of interest-bearing deposits increased to 2.63% for 2006 compared to 1.69% for 2005. DNB's composite cost of funds increased to 3.27% in 2006 compared to 2.53% in 2005.

During 2005, net interest income increased $707,000 or 5.0% on a tax equivalent basis, to $14.8 million, from $14.1 million in 2004. As shown in the Rate/Volume Analysis below, $1.8 million was attributable to volume changes mostly attributable to loan and lease growth, which accounted for $2.7 million, offset by $942,000 related to investment portfolio run-off. The average balance on loans and leases were $259.1 million in 2005 compared to $218.5 million in 2004, representing an increase of $40.6 million, or 18.6%, year-over-year. The $1.8 million increase to net interest income was offset by a $1.1 million decrease related to rate changes. Basically, the rates on DNB's interest-bearing liabilities increased at a faster pace than the rates on DNB's interest-earning assets, which had a negative impact on interest income and was mostly attributable to DNB's deposit base. The tax equivalent yield on loans and leases increased to 6.58% for 2005 compared to 6.40% for 2004. The cost of interest-bearing deposits increased to 1.69% for 2005 compared to 1.06% for 2004. DNB's composite cost of funds increased to 2.53% in 2005 compared to 1.96% in 2004.

The following tables set forth, among other things, the extent to which changes in interest rates and changes in the average balances of interest-earning assets and interest-bearing liabilities have affected interest income and expense for the periods noted (tax-exempt yields and yields on agency-preferred stock that have a 70% dividend received deduction have been adjusted to a tax equivalent basis using a 34% tax rate). For each category of interest-earning assets and interest-bearing liabilities, information is provided with respect to changes attributable to (i) changes in rate (change in rate multiplied by old volume) and (ii) changes in volume (change in volume multiplied by new rate). The net change attributable to the combined impact of rate and volume has been allocated proportionately to the change due to rate and the change due to volume.

Rate / Volume Analysis

(Dollars in thousands)	**2006 Versus 2005 Change Due To**			**2005 Versus 2004 Change Due To**		
	Rate	**Volume**	**Total**	**Rate**	**Volume**	**Total**
Interest-earning assets:						
Loans and leases	**$ 772**	**$ 4,281**	**$ 5,053**	$ 399	$ 2,671	$ 3,070
Investment securities:						
Taxable	**464**	**(828)**	**(364)**	979	(866)	113
Tax-exempt	**43**	**217**	**260**	(96)	232	136
Tax-preferred DRD	**-**	**(77)**	**(77)**	23	(308)	(285)
Cash and cash equivalents	**111**	**19**	**130**	16	138	154
Total	**1,390**	**3,612**	**5,002**	1,321	1,867	3,188
Interest-bearing liabilities:						
Savings deposits	**1,447**	**371**	**1,818**	1,173	125	1,298
Time deposits	**879**	**895**	**1,774**	395	166	(561)
Federal funds purchased	**12**	**10**	**22**	17	(8)	9
Repurchase agreements	**384**	**330**	**714**	175	501	676
FHLB advances	**61**	**(486)**	**(425)**	637	(984)	(347)
Other borrowings	**72**	**80**	**152**	55	229	284
Total	**2,855**	**1,200**	**4,055**	2,452	29	2,481)
Net interest income	**$ (1,465)**	**$ 2,412**	**$ 947**	$ (1,131)	$ 1,839	$ 707

The tax-equivalent adjustments included in the Rate / Volume Analysis above are presented in the table "Reconciliation of Non-GAAP Financial Measures" on page 25.

3. Interest Rate Sensitivity Analysis

The largest component of DNB's total income is net interest income, and the majority of DNB's financial instruments are comprised of interest rate-sensitive assets and liabilities with various terms and maturities. The primary objective of management is to maximize net interest income while minimizing interest rate risk. Interest rate risk is derived from timing differences in the re-pricing of assets and liabilities, loan prepayments, deposit withdrawals, and differences in lending and funding rates. The Asset/Liability Committee ("ALCO") actively seeks to monitor and control the mix of in-terest rate-sensitive assets and interest rate-sensitive -liabilities.

ALCO continually evaluates interest rate risk management opportunities, including the use of derivative financial instruments. Management believes that hedging instruments currently available are not cost-effective, and therefore, has focused its efforts on increasing DNB's spread by attracting lower-costing retail deposits and in some instances, borrowing from the FHLB of Pittsburgh.

DNB reports its callable agency, callable corporate notes and callable municipal investments ($43.4 million at December 31, 2006) and callable FHLB advances ($40 million at December 31, 2006) at their Option Adjusted Spread ("OAS") modified duration date, as opposed to the call or maturity date. In management's opinion, using modified duration dates on callable securities and advances provides a better estimate of the option exercise date under any interest rate environment. The OAS methodology is an approach whereby the likelihood of option exercise takes into account the coupon on the security, the distance to the call date, the maturity date and current interest rate volatility. In addition, prepayment assumptions derived from historical data have been applied to mortgage-related securities, which are included in investments.

B. Liquidity and Market Risk Management

Liquidity is the ability to meet current and future financial obligations. The Bank further defines liquidity as the ability to respond to deposit outflows as well as maintain flexibility to take advantage of lending and investment opportunities. The Bank's primary sources of funds are operating earnings, deposits, principal and interest payments on loans, proceeds from loan sales, sales and maturities of mortgage-backed and investment securities, and FHLB advances. The Bank uses the funds generated to support its lending and investment activities as well as any other demands for liquidity such as deposit outflows. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows, mortgage prepayments, loan and security sales and the exercise of call features are greatly influenced by general interest rates, economic conditions and competition.

The objective of DNB's asset/liability management function is to maintain consistent growth in net interest income within DNB's policy limits. This objective is accomplished through the management of liquidity and interest rate risk, as well as customer offerings of various loan and deposit products. DNB maintains adequate liquidity to meet daily funding requirements, anticipated deposit withdrawals, or asset opportunities in a timely manner. Liquidity is also necessary to meet obligations during unusual, extraordinary or adverse operating circumstances, while avoiding a significant loss or cost. DNB's foundation for liquidity is a stable deposit base as well as a marketable investment portfolio that provides cash flow through regular maturities or that can be used for collateral to secure funding in an emergency. As part of its liquidity management, DNB maintains assets, which comprise its primary liquidity (Federal funds sold, investments and interest-bearing cash balances, less pledged securities.

C. Credit Risk Management

DNB defines credit risk as the risk of default by a customer or counter-party. The objective of DNB's credit risk management strategy is to quantify and manage credit risk on an aggregate portfolio basis as well as to limit the risk of loss resulting from an individual customer default. Credit risk is managed through a combination of underwriting, documentation and collection standards. DNB's credit risk management strategy calls for regular credit examinations and quarterly management reviews of large credit exposures and credits experiencing credit quality deterioration. DNB's loan review procedures provide objective assessments of the quality of underwriting, documentation, risk grading and charge-off procedures, as well as an assessment of the allowance for credit loss reserve analysis process.

D. Management of Others Risks

As a financial institution, DNB's earnings are significantly affected by general business and economic conditions. These conditions include short-term and long-term interest rates, inflation, monetary supply, fluctuations in both debt and equity capital markets, and the strength of the United States economy and local economics in which we operate. For example, an economic downturn, increase in unemployment, or other events that negatively impact household and/or corporate incomes could decrease the demand for DNB's loan and non-loan products and services and increase the number of customers who fail to pay interest or principal on their loans. Geopolitical conditions can also affect DNB's earnings. Acts or threats of terrorism, actions taken by the United States or other governments in response to acts or threats of terrorism and our military conflicts including the aftermath of the war with Iraq, could impact business conditions in the United States.

E. Competition

In addition to the challenges related to the interest rate environment, community banks in Chester County have been experiencing increased competition from large regional and international banks entering DNB's marketplace through mergers and acquisitions. Competition for loans and deposits has negatively affected DNB's net interest margin. To compensate for the increased competition, DNB, along with other area community banks, has aggressively sought and marketed customers who have been disenfranchised by these mergers. To attract these customers, DNB has introduced new deposit products, such as the Partnership banking program, the “Platinum” account, the Executive and employee package as well as the Business package. In addition, DNB has introduced Market Managers and Personal Bankers to serve the special banking needs of its clients.

27

F. Bank Secrecy Act/OFAC/Patriot Act Implementation

Management of the Bank had previously determined that its BSA compliance program needed to be improved to a level commensurate with BSA, OFAC and Patriot Act related risks to which the Bank is exposed. An action plan was developed to strengthen the Bank's compliance with the goal of completing it by the end of the third quarter of 2006. The action plan includes assessing the Bank's customer base for high-risk activity, and expanding and augmenting policies and procedures to establish protocols with respect to identification, evaluation and compliance responses to certain types of potentially high-risk individuals. Additionally, the Bank has strengthened training and now further involves its front-line personnel in this process.

The Bank's management has increased the frequency with which it reports BSA compliance program activity to its board of directors and continues to focus its board of directors more frequently and more thoroughly on BSA compliance program requirements, including the identification of high-risk customers and the processes the Bank uses to evaluate and monitor them. The Bank has and will continue to formalize, structure and document compliance in a more disciplined way, including more stringent policies and formal periodic review. The Bank has taken a more aggressive posture in identifying customers and transactions that are potentially subject to the filing of Suspicious Activity Reports ("SARs") and in appropriate cases expects to file SARs.

The Bank has and will continue to improve its management information systems to improve identification, evaluation and reporting of certain types of high risk or suspicious transactions and activities. The Bank will be augmenting its BSA compliance staff. Management has and will continue to strengthen its day-to-day audit processes to more effectively validate and test the Bank's BSA compliance program procedures and records. The planned improvements to the BSA compliance program were substantially completed in 2006. Management will continue to address the Bank's BSA compliance needs, in order to establish the Bank as an institution that will not pose a target to those who would use the U.S. financial system to further criminal or terroristic ends.

V. <u>Material Trends and Uncertainties</u>

The industry is experiencing an on-going and widespread trend of consolidation in response to shrinking margins, as well as competitive and economic challenges. In an effort to broaden market share by capitalizing on operational efficiencies, larger institutions have been acquiring smaller regional and community banks and thrifts. Chester County has witnessed many recent mergers due to attractive demographics, commercial expansion and other growth indicators. As a result of these factors, the operating environment is very competitive as Chester County hosts over 45 banks, thrifts and credit unions. In addition, brokerage firms, mutual fund companies and boutique investment firms are prevalent, given the county's attractive demographics. This intense competition continually puts pressures on DNB's margins and operating results as competitors offer a full range of loan, deposit and investment products and services. In addition, many of these competitors are much larger than DNB and consistently outspend the Bank in marketing to attract new customers and buy market share. DNB anticipates these pressures will continue to adversely affect operating results.

VI. <u>Recent Developments</u>

There are at least three widely acknowledged areas of near-term concern that could pose risks to the local and national economies going forward: a spike in energy prices, a decline in home prices, and a retrenchment in consumer spending arising from record consumer indebtedness. The consequences that any of these developments might have for economic growth could range from modest to severe, depending on how events transpire over the next few years.

Energy Prices. With time the economy should be able to adjust to higher energy prices, but in the short run, any supply-disrupting events, including labor strikes, severe weather, or terrorism, may cause energy prices to jump. By varying degrees, these spikes would be likely to weigh on overall economic growth while adding volatility to the outlook. Moreover, this risk is likely to continue for several more years, given the long lags required to add new energy production capacity and expectations for continued global growth in energy demand.

Home Prices. The risk of a housing slowdown is another area of concern going forward. The recent housing boom has been unprecedented in modern U.S. history. It has been suggested by many analysts that the housing boom has been a significant contributor to gains in consumer spending in recent years. Because consumer spending accounts for over two-thirds of U.S. economic activity, any shock to consumer spending, such as that which might be caused by a housing slowdown, is a concern to overall economic growth.

Consumer Spending. A large, long-term increase in consumer indebtedness has raised concerns that the next U.S. recession could originate in the household sector. The housing boom of recent years has resulted in a surge in new consumer debt, most of it in the form of mortgages. Consumers have gradually become more indebted over time - so much so that they are now spending more in aggregate than they earn. Home prices will not boom forever. Even a moderation in home-price growth would reduce the amount of new home equity added to the economy each year. This slower accumulation of wealth, coupled with rising interest rates that increase the cost of tapping that wealth, could soon begin to curtail the pace of U.S. consumer spending growth. Just as there has been a positive wealth effect from soaring home prices in recent years, the concern is that an end to the housing boom could result in a slowdown in consumer spending growth.

B. Regulatory Developments

As a national bank and a publicly traded corporation, DNB has a wide-range of regulatory supervision. Over the past few years the regulatory environment has significantly changed, as bank regulators act to monitor economic pressures while the Federal government acts to monitor corporate activities. Bank regulators have increased their scrutiny of asset/liability management, underwriting and capital policies, while Federal regulators have increased their scrutiny on employee compensation arrangements, stock activity, and insider transactions. To help monitor insider transactions and other areas of concern, Congress enacted the Sarbanes-Oxley Act of 2002, which requires members of the Board of Directors to be more knowledgeable and involved with the Bank, imposes more stringent corporate governance standards on publicly held companies, and prompts more transparent disclosure to investors. Fundamentally, the Sarbanes-Oxley Act of 2002 requires more ownership of, and accountability for, financial -information by the Board and oversight committees. It also requires increased documentation reporting and review by management in all areas of the Bank and the Corporation.

C. Accounting Developments Affecting DNB

On January 1, 2006, DNB adopted SFAS 123R using the modified prospective transition method. SFAS 123R revised 2004 (SFAS 123R), “Share-Based Payment” which replaced Statement of Financial Accounting Standards No. 123 (SFAS 123), “Accounting for Stock-Based Compensation” and superseded APB Opinion No. 25 (APB 25), “Accounting for Stock Issued to Employees” and amended FASB Statement No. 95, “Statement of Cash Flows.’’ Under this transition method, compensation cost to be recognized beginning in the first quarter of 2006 would include: (a) compensation cost for the portion of share-based payment awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payment awards granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Results for prior periods were not impacted due to DNB’s stock options that were previously granted vested immediately. No new options were granted in 2006, therefore DNB did not recognize any compensation cost related to options for 2006. As further discussed in Note 1 on page 52, the estimated impact that the fair value method would have had on DNB’s net income and net income per share if SFAS 123R had been in effect during 2005 was a reduction of $572,000 or $0.25 per share and during 2004 was a reduction of $344,000 or $0.16 per share.

In February 2006, the FASB issued SFAS No. 155, "*Accounting for Certain Hybrid Financial Instruments.*" This Statement amends FASB Statements No. 133 and No. 140. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, *"Application of Statement 133 to Beneficial Interests in Securitized Financial Assets."* This Statement: a) permits fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; b) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133; c) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; d) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and e) amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period for that fiscal year. Provisions of this Statement may be applied to instruments that an entity holds at the date of adoption on an instrument-by-instrument basis. SFAS 155 is effective for DNB on January 1, 2007 and is not expected to have a material impact on DNB's consolidated financial statements upon adoption.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets". SFAS 156 amends SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." SFAS 156 permits, but does not require, an entity to choose either the amortization method or the fair value measurement method for measuring each class of separately recognized servicing assets and servicing liabilities. SFAS 156 is effective for DNB on January 1, 2007 and is not expected to have a material impact on DNB's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. The statement defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The statement also establishes a framework for measuring fair value by creating a three-level fair value hierarchy that ranks the quality and reliability of information used to determine fair value, and requires new disclosures of assets and liabilities measured at fair value based on their level in the hierarchy. The Statement is effective for DNB on January 1, 2008. DNB has not yet determined if the adoption of this statement to have a material impact on its financial position or results of operations.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plan" ("SFAS 158"). SFAS 158 requires an employer to recognize on their balance sheet the funded status of its defined pension plans and other post-retirement plans as of December 31, 2006. An under-funded position would create a liability and an over-funded position would create an asset, with a correlating deferred tax asset or liability. The net impact would be an adjustment to equity as accumulated other comprehensive income (loss.) Employers must also recognize as a component of other comprehensive income (loss), net of tax, the actuarial gains and losses and the prior service costs and credits that arise during the period. DNB adopted the recognition and disclosure provisions of SFAS 158 on December 31, 2006. The effect of adopting SFAS 158 on DNB's financial condition at December 31, 2006 has been included in the accompanying consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value and amends SFAS 115 to, among other things, require certain disclosures for amounts for which the fair value option is applied. Additionally, this Statement provides that an entity may reclassify held-to-maturity and available-for-sale securities to the trading account when the fair value option is elected for such securities, without calling into question the intent to hold other securities to maturity in the future. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of SFAS 157. DNB has not completed its assessment of SFAS 159 and the impact, if any, on the consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes" - an interpretation of FASB Statement No. 109 (FIN 48).* This interpretation of SFAS No. 109 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The interpretation is effective for fiscal years beginning after December 15, 2006. DNB has reserves related to certain of its tax positions, which would be subject to analysis under FIN 48. DNB will adopt FIN 48 as of January 1, 2007, as required. The cumulative effect of adopting FIN 48 will be recorded in retained earnings. DNB has not yet determined whether the adoption of FIN 48 will have a significant impact on DNB's consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ("SAB 108"). This guidance was issued to resolve diversity in current practice among registrants. The bulletin establishes that registrants must quantify the impact of correcting all misstatements on the financial statements by using both the rollover and iron curtain approaches to evaluate the errors. The rollover approach quantifies the misstatement based on the amount of the error originating in the current year income statement and the iron curtain approach quantifies a misstatement based on the amount of the error existing in the balance sheet at the end of the fiscal year. The bulletin contains guidance on correcting errors under the dual approach and transition guidance. SAB 108 is effective for the Company's December 31, 2006 annual financial statements. The adoption of SAB 108 did not have a material impact on DNB's financial position or results of operations.

In September 2006, the Emerging Issues Task Force issued EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF 06-4 concludes that for a split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with SFAS 106 (if, in substance, a postretirement benefit plan exits) or APB Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The consensus is effective for fiscal years beginning after December 15, 2007. This EITF is applicable to the Replacement Plan referenced in Note 14 on page 68. DNB is currently evaluating the effect that EITF No. 06-4 will have on its financial statements when implemented.

In September 2006, the Emerging Issues Task Force issued EITF 06-5, Accounting for Purchases of Life Insurance-Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4. This consensus concludes that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. A consensus also was reached that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). The consensuses are effective for fiscal years beginning after December 15, 2006. This EITF is applicable to the BOLI already recognized in DNB's statement of condition. DNB is currently evaluating the effect that EITF No. 06-5 will have on its financial statements when implemented.

D. Internal Developments Affecting DNB

1. Changes in Key Management Positions

On November, 17, 2006, Thomas M. Miller, the Chief Lending Officer of DNB resigned as Chief Lending Officer and the DNB board of directors approved the appointment of Albert J. Melfi, Jr., age 54, as Executive Vice President and Chief Lending Officer of DNB and the Bank.

On December 26, 2006, Gerald F. Sopp, accepted appointment as Executive Vice President and Chief Financial Officer of the registrant, DNB Financial Corporation ("DNB"). Mr. Sopp's appointment and his employment with DNB were effective January 2, 2007.

In addition to these important changes, management is in the process of expanding its lending and support staff to facilitate loan growth as part of its balance sheet restructuring plan. DNB believes that these changes will be integral to achieving its long-term strategic goals.

2. DNB's Retail Bank

In order to support the Bank's five-year strategic plan, which calls for strong growth in deposits, loans and fee income, a new position was created in each branch, a Personal Banker. A majority of DNB's Personal Bankers are licensed in life and health insurance. Some are also Series 6 and 63 securities license holders. With these licenses and the knowledge that goes with them, these staff members are better equipped to discuss the broad range of their clients' needs and can provide them more tailored financial solutions. On April 26, 2006 the Bank signed an agreement to lease a parcel of land in Chadds Ford township, Delaware County, Pennsylvania, for the purpose of developing the premises to accommodate a future branch. The Bank expects to begin operations of the new branch in May of 2007.

VII. <u>Critical Accounting Policies and Estimates</u>

The following discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principals generally accepted in the United States of America. Generally accepted accounting principles are complex and require management to apply significant judgment to various accounting, reporting and disclosure matters. Management must use assumptions and estimates to apply these principles where actual measurement is not possible or practical. Actual results may differ from these estimates under different assumptions or conditions.

In management's opinion, the most critical accounting policies and estimates impacting DNB's consolidated financial statements are listed below. These policies are critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. For a complete discussion of DNB's significant accounting policies, see the footnotes to the Consolidated Financial Statements and discussion throughout this financial review document.

1. <u>Determination of the allowance for credit losses</u>. Credit loss allowance policies involve significant judgments and assumptions by management which may have a material impact on the carrying value of net loans and, potentially, on the net income recognized by DNB from period to period. The allowance for credit losses is based on management's ongoing evaluation of the loan and lease portfolio and reflects an amount considered by management to be its best estimate of the amount necessary to absorb known and inherent losses in the portfolio. Management considers a variety of factors when establishing the allowance, such as the impact of current economic conditions, diversification of the portfolios, delinquency statistics, results of loan review and related classifications, and historic loss rates. In addition, certain individual loans which management has identified as problematic are specifically provided for, based upon an evaluation of the borrower's perceived ability to pay, the estimated adequacy of the underlying collateral and other relevant factors. In addition, regulatory authorities, as an integral part of their examinations, periodically review the allowance for credit losses. They may require additions to the allowance based upon their judgments about information available to them at the time of examination. Although provisions have been established and segmented by type of loan, based upon management's assessment of their differing inherent loss characteristics, the entire allowance for credit losses is available to absorb further losses in any category.

Management uses significant estimates to determine the allowance for credit losses. Because the allowance for credit losses is dependent, to a great extent, on conditions that may be beyond DNB's control, management's estimate of the amount necessary to absorb allowance for credit losses and actual credit losses could differ. DNB's current judgment is that the valuation of the allowance for credit losses remains appropriate at December 31, 2006.

2. <u>Realization of deferred income tax items</u>. Estimates of deferred tax assets and deferred tax liabilities make up the asset category titled "net deferred taxes". These estimates involve significant judgments and assumptions by management, which may have a material impact on the carrying value of net deferred tax assets for financial reporting purposes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis, as well as operating loss carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance would be established against deferred tax assets when in the judgment of management, it is more likely than not that such deferred tax assets will not become available. For a more detailed description of these items, refer to Footnote 11 (Federal Income Taxes) to DNB's audited consolidated financial statements for the fiscal year ended December 31, 2006.

3. <u>Other-than temporary impairment of investment securities</u>. FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities states, in part: for individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). While FASB Statement No. 115 uses a debt security as an example, similar considerations exist for investments in marketable equity securities. Accordingly, judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors.

- Fair value is significantly below cost and the decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area, the decline has existed for an extended period of time or Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

VIII. 2006 Financial Results

A. Liquidity

Management maintains liquidity to meet depositors' needs for funds, to satisfy or fund loan commitments, and for other operating purposes. DNB's foundation for liquidity is a stable and loyal customer deposit base, cash and cash equivalents, and a marketable investment portfolio that provides periodic cash flow through regular maturities and amortization, or that can be used as collateral to secure funding. Primary liquidity includes investments, Federal funds sold, and interest-bearing cash balances, less pledged securities. DNB also anticipates scheduled payments and prepayments on its loan and mortgage-backed securities portfolios. In addition, DNB maintains borrowing arrangements with various correspondent banks, the Federal Home Loan Bank of Pittsburgh and the Federal Reserve Bank of Philadelphia to meet short-term liquidity needs. Through these relationships, DNB has available credit of approximately $127.0 million. Management believes that DNB has adequate resources to meet its short-term and long-term funding requirements.

As of December 31, 2006, deposits totaled $381.0 million, up $41.4 million from $339.6 million at December 31, 2005. There were approximately $103.0 million in certificates of deposit scheduled to mature during the next twelve months. At December 31, 2006, DNB had $62.1 million in un-funded loan commitments. In addition, there were $7.6 million in un-funded letters of credit. Management anticipates the majority of these commitments will be funded by means of normal cash flows.

The following table sets forth the composition of DNB's deposits at the dates indicated.

Deposits By Major Classification
(Dollars in thousands)

	December 31				
	2006	**2005**	**2004**	**2003**	**2002**
Non-interest-bearing deposits	**$ 50,852**	$ 51,407	$ 53,402	$ 52,788	$ 45,117
Interest-bearing deposits:					
NOW	**82,579**	78,664	79,527	67,158	50,400
Money market	**66,352**	45,390	42,199	55,412	59,457
Savings	**54,956**	77,216	77,897	46,630	39,569
Certificates	**108,970**	70,621	53,558	52,611	74,560
IRA	**17,318**	16,329	16,561	17,837	18,699
Total deposits	**$ 381,027**	$ 339,627	$ 323,144	$ 292,436	$ 287,802

B. Capital Resources and Adequacy

Stockholders' equity was $31.4 million at December 31, 2006 compared to $30.2 million at December 31, 2005. The increase was primarily the result of net income and other comprehensive income offset by cash dividends paid.

Management believes that the Corporation and the Bank have each met the definition of "well capitalized" for regulatory purposes on December 31, 2006. The Bank's capital category is determined for the purposes of applying the bank regulators' "prompt corrective action" regulations and for determining levels of deposit insurance assessments and may not constitute an accurate representation of the Corporation's or the Bank's overall financial condition or prospects. The Corporation's capital exceeds the FRB's minimum lever-age ratio requirements for bank holding companies (see additional discussion in Regulatory Matters - Footnote 17 to DNB's consolidated financial statements).

Under federal banking laws and regulations, DNB and the Bank are required to maintain minimum capital as determined by certain regulatory ratios. Capital adequacy for regulatory purposes, and the capital category assigned to an institution by its regulators, may be determinative of an institution's overall financial condition.

In addition, the Federal Reserve Bank (the "FRB") leverage ratio rules require bank holding companies to maintain a minimum level of "primary capital" to total assets of 5.5% and a minimum level of "total capital" to total assets of 6%. For this purpose, (i) "primary capital" includes, among other items, common stock, certain perpetual debt instruments such as eligible Trust Preferred Securities, contingency and other capital reserves, and the allowance for credit losses, (ii) "total capital" includes, among other things, certain subordinated debt, and "total assets" is increased by the allowance for credit losses. DNB's primary capital ratio and its total capital ratio are both 8.3%. Based on the foregoing, as of December 31, 2006, both DNB and the Bank would be deemed to be "well capitalized" for regulatory purposes.

C. Results of Operations

1. Summary of Performance

(a) Summary of Results

For the year ended December 31, 2006, DNB reported net income for the 2006 full year of $1.7 million versus $2.1 million for 2005. Per share earnings on a fully diluted basis were $0.69 down from $0.96 for the prior year.

While loans and deposits and net interest income grew in 2006, DNB's earnings were impacted by the general economic conditions challenging all commercial banking institutions - the inverted yield curve and increased pricing competition on loans and deposits. In addition, earnings were further depressed by a $2.1 million increase in non interest expense to $16.5 million. This increase was due almost entirely to strategic moves designed to increase future revenue and improve profitability:

- The addition of experienced revenue producing personnel in the lending and retail divisions.
- Increased consulting expenses in connection with the efficiency project announced in the second quarter.
- The cost of new offices in Newtown Square and West Chester.
- Costs related to the opening of a new office in Chadds Ford in 2007.

DNB has focused on building franchise value in 2006 by investing in strategies that will improve earnings and increase market share in the future. DNB has grown deposits in spite of a difficult environment and with an experienced lending staff in place we'll continue to see steady loan growth. The efficiencies initiated in 2006 will be fully realized in 2007 resulting in lower costs and greater productivity, positioning DNB well for improved earnings in

2007 and beyond.

(b) Significant Events, Transactions and Economic Changes Affecting Results

Despite a great many challenges in 2006, DNB made tremendous strides in positioning itself for future growth and profitability. Some of the accomplishments include the following:

- A company-wide initiative to improve efficiency and enhance the customer's experience. Brintech, Inc., a nationally recognized bank-consulting firm was hired to assist in this study. As a result of this initiative, DNB developed ways to more effectively utilize technology, streamline processes and procedures, and maximize the effectiveness of all employees. Fourteen full-time positions were eliminated, saving approximately $575,000 in salaries and benefits, with a majority of the staff reductions coming through attrition.
- A realignment of the organization to provide a keen focus on customer relationships and operational excellence. The Chairman and CEO assumed direct responsibility for managing all customer contact staff and the President and COO was made responsible for managing all operational areas as well as assuming responsibilities of the Chief Credit Officer. This division of responsibilities will provide the appropriate level of management attention to truly differentiate DNB from its competitors.
- A new merchandising program was implemented , throughout DNB's branch network, with the objective of strengthening the customers' perception of the DNB First brand, increase sales, improve customer awareness of the many products and services DNB offers, provide an interesting and professional sales environment and a clear and consistent message supporting its brand. DNB has received positive feedback on this program from its customers and staff.

(c) Trends and Uncertainties

Since June 2004, the federal funds rate target has been raised 16 times, by a total of 400 basis points. However, in part because of continued strong demand for U.S. Treasury and agency debt by foreign investors, long-term U.S. interest rates have been slower to rise. The result has been a significant flattening of the Treasury yield curve, to the point where it has actually become inverted. The average spread between 10-year U.S. Treasury yields and the federal funds rate has declined from 3.72% as recently as May 2004 to -0.58% in December 2006. The inverted yield curve, along with heightened competition for loans and deposits, has put downward pressure on the average net interest margin of most financial institutions. DNB's profitability depends largely on our net interest margin. Continued downward pressure could have a significant impact on the future earnings of DNB.

(d) Material Changes in Results

Please refer to the discussion above in the section titled "Significant Events, Transactions and Economic Changes Affecting Results".

(e) Effect of Inflation and Changing Rates

For detailed discussion of the effects of inflation and changes in rates on DNB's results, refer to the discussion below on Net Interest Income.

2. Net Interest Income

DNB's earnings performance is primarily dependent upon its level of net interest income, which is the excess of interest income over interest expense. Interest income includes interest earned on loans and leases (net of interest reversals on non-performing loans), investments and Federal funds sold, as well as net loan fee amortization and dividend income. Interest expense includes the interest cost for deposits, FHLB advances, repurchase agreements, corporate debentures, Federal funds purchased and other borrowings.

2006 Results Compared to 2005 Results

In 2006, DNB continued its progress to reposition its balance sheet as net interest income increased year-over-year by $767,000 to $14.9 million. This increase was primarily due to a higher volume of interest-earning assets with higher yields offset by an increased cost of funds on interest-bearing liabilities. The higher volume of interest-earning assets was attributable to strong loan growth offset by investment portfolio run-off. The higher yield on the interest-earning assets as well as the increased cost of funds on interest-bearing liabilities was a result of a rising interest rate environment as the Fed funds rate increased by 100 basis points since December 2005. The Fed funds rate was 5.25% at December 31, 2006.

Interest on loans and leases was $21.9 million for 2006 compared to $17.0 million for 2005. The average balance on loans and leases was $321.3 million with an average yield of 6.88% compared to an average balance of $259.1 million with an average yield of 6.58%. The increase in the average balance was the result of implementing DNB's strategic plan to aggressively grow the balance sheet through loan originations, participations and purchases. This has been accomplished with the addition of key revenue producing personnel as well as by adding a loan production office in Newtown Square. The increase in yield was the result of the rising interest rate environment mentioned above.

Interest and dividends on investment securities was $6.0 and $6.2 million for 2006 and 2005, respectively. The average balance on investment securities was $141.0 million with an average yield of 4.70% in 2006 compared to $158.8 million with an average yield of 4.28% in 2005. The decrease in balance was the result of investment portfolio run-off, which was part of DNB's strategic plan. The increase in yield was the result of DNB taking advantage of the interest rate environment to restructure a significant portion of its investment securities portfolio. In March 2005, DNB sold $73.3 million of structured securities, government agency preferred stock, longer-term municipal securities, as well as corporate securities. The majority of the proceeds received on the sale of these investments were re-invested into higher yielding agency mortgage-backed securities, agency bonds and municipal securities.

Interest on deposits was $8.1 million for 2006 compared to $4.5 million for 2005. The average balance of interest-bearing deposits was $308.6 million with an average rate of 2.63% for 2006 compared to $267.8 million with an average rate of 1.69% for 2005. The increase in average balance was primarily the result of aggressive marketing of deposit relationships in an effort to fund loan growth. The increase in rate was primarily the result of an increase in the cost of funds resulting from the rising interest rate environment.

Interest on FHLB advances was $2.9 million for 2006 compared to $3.3 million for 2005. The average balance on FHLB advances was $50.8 million with an average rate of 5.61% for 2006 compared to $59.5 million with an average rate of 5.51% for 2005. The decrease in the average balance was the result of FHLB borrowings that matured and were repaid. The increase in rate was the result of the FHLB borrowings that matured and were repaid were lower cost borrowings.

Interest on repurchase agreements was $1.5 million for 2006 compared to $821,000 for 2005. The average balance on repurchase agreements was $38.9 million with an average rate of 3.94% for 2006 compared to $30.6 million with an average rate of 2.69% for 2005. The increase in average balance was primarily the result of aggressive marketing of customer relationships resulting in a need to fund loan growth. The increase in rate was primarily the result of an increase in the cost of funds resulting from the rising interest rate environment.

2005 Results Compared to 2004 Results

In 2005, DNB continued its progress to reposition its balance sheet as net interest income increased year-over-year by $714,000 to $14.1 million. This increase was primarily due to a higher volume of interest-earning assets with higher yields offset by an increased cost of funds on interest-bearing liabilities. The higher volume of interest-earning assets was attributable to strong loan growth offset by investment portfolio run-off. The higher yield on the interest-earning assets as well as the increased cost of funds on interest-bearing liabilities was a result of a rising interest rate environment as the Fed funds rate increased by 300 basis points since June 2004. The Fed funds rate was 4.25% at December 31, 2005.

Interest on loans and leases was $17.0 million for 2005 compared to $13.9 million for 2004. The average balance on loans and leases was $259.1 million with an average yield of 6.58% compared to an average balance of $218.5 million with an average yield of 6.40%. The increase in the average balance was the result of implementing DNB's strategic plan to aggressively grow the balance sheet through loan originations, participations and purchases. This has been accomplished with the addition of key revenue producing personnel as well as by adding a loan production office in Newtown Square. The increase in yield was the result of the rising interest rate environment mentioned above.

Interest and dividends on investment securities was $6.2 million for both 2005 and 2004. The average balance on investment securities was $158.8 million with an average yield of 4.28% in 2005 compared to $185.6 million with an average yield of 3.69% in 2004. The decrease in balance was the result of investment portfolio run-off, which was part of DNB's strategic plan. The increase in yield was the result of DNB taking advantage of the interest rate environment to restructure a significant portion of its investment securities portfolio. In March 2005, DNB sold $73.3 million of structured securities, government agency preferred stock, longer-term municipal securities, as well as corporate securities. The majority of the proceeds received on the sale of these investments were re-invested into higher yielding agency mortgage-backed securities, agency bonds and municipal securities. Management believes that the restructured portfolio will result in more stable earnings and cash flow, as well as improved value metrics.

Interest on deposits was $4.5 million for 2005 compared to $2.7 million for 2004. The average balance of interest-bearing deposits was $267.8 million with an average rate of 1.69% for 2005 compared to $251.9 million with an average rate of 1.06% for 2004. The increase in average balance was primarily the result of aggressive marketing of deposit relationships in an effort to fund loan and lease growth. The increase in rate was primarily the result of an increase in the cost of funds resulting from the rising interest rate environment.

Interest on FHLB advances was $3.3 million for 2005 compared to $3.6 million for 2004. The average balance on FHLB advances was $59.5 million with an average rate of 5.51% for 2005 compared to $77.4 million with an average rate of 4.69% for 2004. The decrease in the average balance was the result of FHLB borrowings that matured and were repaid. The increased average rate in 2005 resulted from lower levels of overnight FHLB borrowings in 2005, compared to 2004.

3. Provision for Credit Losses

To provide for known and inherent losses in the loan and lease portfolio, DNB maintains an allowance for credit losses. There were no provisions for credit losses made during the periods ended December 31, 2006, 2005 and 2004, since management determined the allowance for credit losses was adequate based on its analysis.

During 2005, DNB provided $120,000 to the allowance for credit losses through the three quarterly periods ended September 30, 2005. This provision was based on the deterioration of three loans to one borrower during this nine-month period. However, during the fourth quarter, DNB received a large pay down and signed a forbearance agreement in connection with these loans. As a result of this triggering event, the $120,000 provision that was previously booked to the allowance was reversed. For a detailed discussion on DNB's reserving methodology, refer to "Item 1 - Determination of the allowance for credit losses" which can be found under "Critical Accounting Policies and Estimates".

4. Non-Interest Income

Non-interest income includes service charges on deposit products; fees received in connection with the sale of non-depository products and services, including fiduciary and investment advisory services offered through DNB Advisors; securities brokerage products and services and insurance products and services offered through DNB Financial Services; and other sources of income such as increases in the cash surrender value of Bank Owned Life Insurance ("BOLI"), net gains on sales of investment securities and other real estate owned ("OREO") properties. In addition, DNB receives fees for cash management, merchant services, debit cards, safe deposit box rentals, check cashing and similar activities.

2006 Results Compared to 2005 Results

Non-interest income was $3.4 million for 2006 compared to $2.4 Million for 2005. This increase was primarily due to DNB restructuring its investment portfolio in 2005 and when it reported a $699,000 pre-tax loss on the sale of securities. Additionally, the increase in non-interest income was also partly due to additional service charges on deposit accounts.

Service charges on deposit accounts were $1.7 million for 2006 compared to $1.4 million for 2005. This increase was primarily attributable to non-sufficient funds (“NSF”) fees, which increased $306,000 year-over-year.

2005 Results Compared to 2004 Results

Non-interest income was $2.4 million for 2005 compared to $591,000 for 2004. This increase was primarily due to the $2.35 million impairment recognized in the fourth quarter of 2004. In addition, DNB restructured its investment portfolio in the first quarter of 2005 and reported a $699,000 pre-tax loss on the sale of securities. The increase in non-interest income was also partly due to higher levels of commissions earned on the sales of annuities, coupled with additional service charges on deposit accounts.

Service charges on deposit accounts were $1.4 million for 2005 compared to $1.3 million for 2004. This increase was primarily attributable to non-sufficient funds (“NSF”) fees, which increased $74,000 year-over-year.

Wealth management fees were $712,000 for 2005 compared to $633,000 for 2004. This increase was primarily the result of growth in fee income derived on the sale of annuities through DNB’s subsidiary, DNB Financial Services.

5. Non-Interest Expense

Non-interest expense includes salaries & employee benefits, furniture & equipment, occupancy, professional & consulting fees as well as marketing, printing & supplies and other less significant expense items.

2006 Results Compared to 2005 Results

Non-interest expense was $16.5 million for 2006 compared to $14.4 million for 2005.

Salary and employee benefits. Salary and employee benefits was $9.1 million for 2006 compared to $8.2 million for 2005. The increase was largely attributable to the substantial investment in key staff, principally revenue producing personnel. DNB continued to make significant progress by adding seasoned individuals who will provide DNB with additional leadership serving the Private Banking, Credit and Retail needs of our customers.

Furniture and equipment. Furniture and equipment expense was $1.4 million for 2006 compared to $1.2 million for 2005. The increase was primarily attributable to depreciation on additional equipment purchased at DNB’s new West Chester office as well as additional hardware and software upgrades made during 2006 for the bank.

Occupancy. Occupancy expense was $1.3 million for 2006 compared to $1.0 million for 2005. The increase was associated with an increase in rent expense resulting from a full years rent expense recognized in 2006, versus a partial years rent expense recognized in 2005 on new offices opened in 2005 in Newtown Square and West Chester. Additionally, on April 26, 2006 the Bank signed an agreement to lease a parcel of land in Chadds Ford township, Delaware County, Pennsylvania, for the purpose of developing the premises to accommodate a future branch. The Bank expects to begin operations of the new branch in May 2007, however, has been paying rent on the land since July 2006.

Professional and consulting. Professional and consulting expenses were $1.6 million for 2006 compared to $1.1 million for 2005. The primary reason for the increase was due expenses recognized relating to the efficiency project started in the second quarter of 2006. This project has helped to streamline many processes throughout the bank, which will help to decrease non-interest expense in the future along with a reduction of 14 full time equivalent employees. Additionally, DNB outsourced its internal audit function during 2006 and the cost of outsourcing is included in professional and consulting expenses for 2006.

2005 Results Compared to 2004 Results

Non-interest expense was $14.4 million for 2005 compared to $13.2 million for 2004.

Salary and employee benefits. Salary and employee benefits was $8.2 million for 2005 compared to $7.3 million for 2004. The increase was largely attributable to the substantial investment in key staff, principally revenue producing personnel. DNB continued to make significant progress by adding seasoned individuals who will provide DNB with additional leadership serving the Private Banking, Credit and Retail needs of our customers.

Professional and consulting. Professional and consulting expenses were $1.1 million for 2005 compared to $823,000 for 2004. The primary reason for the increase was due to the following. First, a marketing firm was engaged to assist DNB with several marketing initiatives which includes (a) Providing a comprehensive analysis of DNB's product and service offerings, competitive position and customer profiles, including interviews with selected samples of customers of DNB and other financial institutions; (b) Consulting with and assisting DNB's management in establishing strategies for branding based on the foregoing analysis and research; (c) Assisting DNB with marketing, public relations and customer relations strategies to implement the new branding strategies. Second, DNB hired a third-party to assist in its efforts to comply with the provisions of the Sarbanes-Oxley Act. Third, fees associated with a third-party providing network support increased as a result of the growth in the Bank’s overall staff and other initiatives such as the opening DNB’s Newtown Square Loan Production Office and West Chester branch facilities as well as upgrading DNB’s network. Lastly, audit and legal expenses increased as the result of several initiatives designed to increase share ownership in the Company by management and employees. These initiatives included the implementation of DNB’s new Incentive Equity and Deferred Compensation Plan and incorporating the Company’s stock into the DNB First 401-k Retirement Plan

6. Income Taxes

2006 Results Compared to 2005 Results

Income tax expense was $41,000 for 2006 compared to a benefit of $89,000 for 2005. Income tax expense (benefit) for each period differs from the amount determined at the statutory rate of 34% due to tax-exempt income on loans and investment securities, DNB's ownership of BOLI policies and tax credits recognized on a low-income housing limited partnership. During 2005, DNB reversed a portion of the previously recorded valuation allowance for deferred tax assets and recognized a related income tax benefit of $308,000. Most of the reversal was associated with a tax gain recognized on the sale of two operations buildings as well as an additional reversal that was made in connection with the sale of agency preferred securities both of which are “Capital Assets” as defined under Internal Revenue Code Section 1221.

With regard to the previously recorded valuation allowance, DNB recognized a pre-tax other-than-temporary impairment charge during 2004 totaling $2.3 million or 24% of the book value on four agency preferred stock issues totaling $9.98 million. The other-than-temporary impairment charges were recognized due to the negative impact on the market value of these securities caused by the ongoing accounting, management, and regulatory oversight issues confronting Fannie Mae and Freddie Mac.

DNB was required to recognize other-than-temporary impairment under guidance provided by the Financial Accounting Standards Board (FASB 115) and the Securities and Exchange Commission (SEC). The perpetual preferred agency securities that DNB owned at December 31, 2004 (preferred stock) were “Capital Assets” as defined under Internal Revenue Code (IRC) Section 1221. In general, when the preferred stock securities would be sold or disposed of, any net gain or loss on such securities would generate a capital gain or capital loss. It was anticipated that the sale of the preferred stock securities would give rise to a realized capital loss for income tax purposes. Realized capital losses can only be used to offset capital gain income and not ordinary taxable income from operations (IRC Section 1211(a)). To the extent a corporate taxpayer is unable to utilize a net realized capital loss, such losses can be carried forward to each of the 5 taxable years succeeding such loss year (IRC Section 1212(a)(1)(B)). If unutilized after 5 taxable years, such capital losses will expire unused. Neither DNB, nor its wholly owned subsidiary DNB First, National Association, had a history of generating such capital gains within the past 3 tax years, nor did the management of DNB anticipate that it would generate such capital gains within five (5) years of the anticipated sale of these securities. When the impairment charge was recognized, DNB contemplated selling some or all of these securities during 2005. The 5 year period to recover the capital loss would start when these securities were sold. At December 31, 2004, DNB did not anticipate recognizing gains from the sale of any capital assets that it may have held as of this date (including these preferred stock securities) during the next 5 - 6 years. As a result, management determined that it was more likely than not that the income tax benefits associated with the above impairment write down would not be realizable and accordingly recorded a valuation allowance for deferred tax asset in the amount of $733,000.

2005 Results Compared to 2004 Results

Income tax (benefit) expense was ($89,000) for 2005 compared to $504,000 for 2004. Income tax (benefit) expense for each period differs from the amount determined at the statutory rate of 34% due to tax-exempt income on loans and investment securities, DNB's ownership of BOLI policies and tax credits recognized on a low-income housing limited partnership. During 2005, DNB reversed a portion of the previously recorded valuation allowance for deferred tax assets and recognized a related income tax benefit of $308,000. Most of the reversal was associated with a tax gain recognized on the sale of two operations buildings as well as an additional reversal that was made in connection with the sale of agency preferred securities both of which are “Capital Assets” as defined under Internal Revenue Code Section 221.

With regard to the previously recorded valuation allowance, DNB recognized a pre-tax other-than-temporary impairment charge during 2004 totaling $2.3 million or 24% of the book value on four agency preferred stock issues totaling $9.98 million. The other-than-temporary impairment charges were recognized due to the negative impact on the market value of these securities caused by the ongoing accounting, management, and regulatory oversight issues confronting Fannie Mae and Freddie Mac.

DNB was required to recognize other-than-temporary impairment under guidance provided by the Financial Accounting Standards Board (FASB 115) and the Securities and Exchange Commission (SEC). The perpetual preferred agency securities that DNB owned at December 31, 2004 (preferred stock) were “Capital Assets” as defined under Internal Revenue Code (IRC) Section 1221. In general, when the preferred stock securities would be sold or disposed of, any net gain or loss on such securities would generate a capital gain or capital loss. It was anticipated that the sale of the preferred stock securities would give rise to a realized capital loss for income tax purposes. Realized capital losses can only be used to offset capital gain income and not ordinary taxable income from operations (IRC Section 1211(a)). To the extent a corporate taxpayer is unable to utilize a net realized capital loss, such losses can be carried forward to each of the 5 taxable years succeeding such loss year (IRC Section 1212(a)(1)(B)). If unutilized after 5 taxable years, such capital losses will expire unused. Neither DNB, nor its wholly owned subsidiary DNB First, National Association, had a history of generating such capital gains within the past 3 tax years, nor did the management of DNB anticipate that it would generate such capital gains within five (5) years of the anticipated sale of these securities. When the impairment charge was recognized, DNB contemplated selling some or all of these securities during 2005. The 5 year period to recover the capital loss would start when these securities were sold. At December 31, 2004, DNB did not anticipate recognizing gains from the sale of any capital assets that it may have held as of this date (including these preferred stock securities) during the next 5 - 6 years. As a result, management determined that it was more likely than not that the income tax benefits associated with the above impairment write down would not be realizable and accordingly recorded a valuation allowance for deferred tax asset in the amount of $733,000.

Financial Condition Analysis

1. *Investment Securities*

DNB’s investment portfolio consists of US agency securities, mortgage-backed securities issued by US Government agencies, collateralized mortgage obligations, state and municipal securities, bank stocks, and other bonds and notes. In addition to generating revenue, DNB maintains the investment portfolio to manage interest rate risk, provide liquidity, provide collateral for borrowings and to diversify the credit risk of earning assets. The portfolio is structured to maximize DNB’s net interest income given changes in the economic environment, liquidity position and balance sheet mix.

Given the nature of the portfolio, and its generally high credit quality, management normally expects to realize all of its investment upon the maturity of such instruments. Management determines the appropriate classification of securities at the time of purchase. Investment securities are classified as: (a) securities held to maturity ("HTM") based on management's intent and ability to hold them to maturity; (b) trading account ("TA") securities that are bought and held principally for the purpose of selling them in the near term; and (c) securities available for sale ("AFS"). DNB does not currently maintain a trading account portfolio.

Securities classified as AFS include securities that may be sold in response to changes in interest rates, changes in prepayment assumptions, the need to increase regulatory capital or other similar requirements. DNB does not necessarily intend to sell such securities, but has classified them as AFS to provide flexibility to respond to liquidity needs.

DNB's investment portfolio (HTM and AFS securities) totaled $150.6 million at December 31, 2006, up 5% from $143.0 million at December 31, 2005.

The following tables set forth information regarding the composition, stated maturity and average yield of DNB's investment security portfolio as of the dates indicated (tax-exempt yields have been adjusted to a tax equivalent basis using a 34% tax rate). The first two tables do not include amortization or anticipated prepayments on mortgage-backed securities. Callable securities are included at their stated maturity dates.

Investment Maturity Schedule, Including Weighted Average Yield
(Dollars in thousands)

	December 31, 2006						
Held to Maturity	**Less than 1 Year**	**1-5 Years**	**5-10 Years**	**Over 10 Years**	**No Stated Maturity**	**Total**	**Yield**
US Government agency obligations	$ **1,000**	$ **3,728**	$ **—**	$ **—**	$ **—**	$ **4,728**	3.37%
US agency mortgage-backed securities	**—**	**343**	**633**	**216**	**—**	**1,192**	**4.82**
Collateralized mortgage obligations	**—**	**—**	**—**	**6,929**	**—**	**6,929**	**3.61**
State and municipal tax-exempt	**—**	**291**	**1,200**	**4,591**	**—**	**6,082**	**3.61**
Total	$ **1,000**	$ **4,362**	$ **1,833**	$ **11,736**	$ **—**	$ **18,931**	3.63%
Percent of portfolio	5%	23%	10%	62%	—%	100%	
Weighted average yield	3.25%	3.41%	4.14%	3.66%	—%	3.63%	

Available for Sale	**Less than 1 Year**	**1-5 Years**	**5-10 Years**	**Over 10 Years**	**No Stated Maturity**	**Total**	**Yield**
US Government agency obligations	$ **22,931**	$ **26,840**	$ **—**	$ **—**	$ **—**	$ **49,771**	5.00%
US agency mortgage-backed securities	**—**	**—**	**3,534**	**45,688**	**—**	**49,222**	**4.64**
State and municipal tax-exempt	**—**	**2,573**	**1,479**	**28,553**	**—**	**32,605**	**4.06**
Equity securities	**—**	**—**	**—**	**—**	**38**	**38**	**3.20**
Total	$ **22,931**	$ **29,413**	$ **5,013**	$ **74,241**	$ **38**	$ **131,636**	4.63%
Percent of portfolio	18%	22%	4%	56%	—%	100%	
Weighted average yield	5.88%	4.16%	3.99%	4.48%	3.20%	4.63%	

Composition of Investment Securities
(Dollars in thousands)

December 31

	2006		2005	
	Held to Maturity	Available for Sale	Held to Maturity	Available for Sale
US Government agency obligations	$ 4,728	$ 49,771	$ 10,586	$ 34,794
US agency mortgage-backed securities	1,192	49,222	1,586	56,181
Collateralized mortgage obligations	6,929	—	8,623	—
State and municipal tax-exempt	6,082	32,605	6,138	25,062
Equity securities	—	38	—	37
Total	$ 18,931	$ 131,636	$ 26,933	$ 116,074

2. Loans and Lease Portfolio

DNB's loan and lease portfolio consists primarily of commercial and residential real estate loans, commercial loans and lines of credit (including commercial construction), commercial leases and consumer loans. The portfolio provides a stable source of interest income, monthly amortization of principal and, in the case of adjustable rate loans, re-pricing opportunities.

Net loans and leases were $325.2 million at December 31, 2006, up $41.5 million or 14.6% from 2005. Commercial loans increased $16.4 million or 19.7% to $99.6 million, commercial leases decreased $900,000 or 3.8% to $23.0 million, residential mortgage loans increased $8.9 million or 20.4% to $52.6 million, consumer loans increased $6.4 million or 13.2% to $54.8 million and commercial mortgage loans increased $10.6 million or 11.9% to $99.5 million. The increase in the commercial loans and leases continues to reflect DNB's commitment to commercial and residential development in Chester and Delaware counties as well as northern Delaware.

The following table sets forth information concerning the composition of total loans outstanding, net of the allowance for credit losses, as of the dates indicated.

Total Loan and Lease Outstanding, Net of Allowance for Credit Losses

(Dollars in thousands)	December 31				
	2006	**2005**	**2004**	**2003**	**2002**
Residential mortgages	**$ 52,636**	$ 43,738	$ 18,677	$ 16,048	$ 26,120
Commercial mortgages	**99,493**	88,921	87,795	89,027	83,322
Commercial loans	**99,572**	83,156	63,595	54,587	48,151
Commercial leases	**22,994**	23,934	19,300	8,434	1,285
Consumer	**54,771**	48,381	43,210	35,457	28,707
Total loans and leases	**329,466**	288,130	232,577	203,553	187,585
Less allowance for credit losses	**(4,226)**	(4,420)	(4,436)	(4,559)	(4,546)
Net loans and leases	**$ 325,240**	$ 283,710	$ 228,141	$ 198,994	$ 183,039

The following table sets forth information concerning the contractual maturities of the loan portfolio, net of unearned income and fees. For amortizing loans, scheduled repayments for the maturity category in which the payment is due are not reflected below, because such information is not readily available.

Loan and Lease Maturities	**December 31, 2006**			
(Dollars in thousands)	**Less than 1 Year**	**1-5 Years**	**Over 5 Years**	**Total**
Residential mortgages	**$ 4,096**	**$ 28,230**	**$ 20,310**	**$ 52,636**
Commercial mortgages	**12,632**	**33,574**	**53,287**	**99,493**
Commercial term loans	**36,441**	**29,511**	**33,620**	**99,572**
Commercial leases	**1,848**	**20,618**	**528**	**22,994**
Consumer loans	**1,071**	**25,314**	**28,386**	**54,771**
Total loans and leases	**56,088**	**137,247**	**136,131**	**329,466**
Loans and leases with fixed interest rates	**10,524**	**76,387**	**51,387**	**138,298**
Loans and leases with variable interest rates	**45,564**	**60,860**	**84,744**	**191,168**
Total loans and leases	**$ 56,088**	**$ 137,247**	**$ 136,131**	**$ 329,466**

42

3. Non-Performing Assets

Total non-performing assets decreased $529,000 to $821,000 at December 31, 2006, compared to $1.4 million at December 31, 2005. The decrease was primarily attributable to two loans associated with one customer totaling $882,000 that paid off in 2006. As a result of the decrease in non-performing loans, the non-performing loans to total loans ratio decreased to .25% at December 31, 2006 from .47% at December 31, 2005. DNB has a significant level of commercial and commercial real estate loans and continues to work diligently to improve asset quality and position itself for possible economic downturns by tightening underwriting standards and improving lending policies and procedures. Non-performing assets have, and will continue to have, an impact on earnings, therefore management intends to continue working aggressively to reduce the level of such assets.

Non-performing assets are comprised of non-accrual loans, loans delinquent over ninety days and still accruing, troubled debt restructurings ("TDRs") and other real estate owned ("OREO"). Non-accrual loans are loans on which the accrual of interest ceases when the collection of principal or interest payments is determined to be doubtful by management. It is the policy of DNB to discontinue the accrual of interest when principal or interest payments are delinquent 90 days or more (unless the loan principal and interest are determined by management to be fully secured and in the process of collection), or earlier, if considered prudent. Interest received on such loans is applied to the principal balance, or may in some instances, be recognized as income on a cash basis. OREO includes both real estate obtained as a result of, or in lieu of, foreclosure. Any significant change in the level of non-performing assets is dependent, to a large extent, on the economic climate within DNB's market area.

DNB's Credit Policy Committee monitors the performance of the loan and lease portfolio to identify potential problem assets on a timely basis. Committee members meet to design, implement and review asset recovery strategies, which serve to maximize the recovery of each troubled asset. As of December 31, 2006, DNB had $5.3 million of loans, which, although performing at that date, are believed to require increased supervision and review; and may, depending on the economic environment and other factors, become non-performing assets in future periods. The amount of such loans at December 31, 2005 was $3.7 million. The majority of the loans are secured by commercial real estate, with lesser amounts being secured by residential real estate, inventory and receivables.

The following table sets forth those assets that are: (i) placed on non-accrual status, (ii) contractually delinquent by 90 days or more and still accruing, (iii) troubled debt restructurings other than those included in items (i) and (ii), and (iv) OREO as a result of foreclosure or voluntary transfer to DNB.

Non-Performing Assets
(Dollars in thousands)

	December 31				
	2006	**2005**	**2004**	**2003**	**2002**
Non-accrual loans:					
Residential mortgage	**$ —**	$ —	$ 117	$ 165	$ 285
Commercial mortgage	**—**	5	25	2,142	1,057
Commercial	**42**	1,017	231	233	1,758
Leases	**38**	83	—	—	—
Consumer	**635**	—	16	16	254
Total non-accrual loans	**715**	1,105	389	2,556	3,354
Loans 90 days past due and still accruing	**106**	245	36	472	514
Troubled debt restructurings	**—**	—	—	—	—
Total non-performing loans	**821**	1,350	425	3,028	3,868
Other real estate owned	**—**	—	—	—	—
Total non-performing assets	**$ 821**	$ 1,350	$ 425	$ 3,028	$ 3,868

Asset quality ratios:					
Non-performing loans to total loans	**0.3%**	0.5%	0.2%	1.5%	2.1%
Non-performing assets to total assets	**0.1**	0.3	0.1	0.7	1.0
Allowance for credit losses to:					
Total loans and leases	**1.3**	1.5	1.9	2.2	2.4
Non-performing loans and leases	**514.7**	327.3	1,043.8	150.5	117.5

4. <u>Allowance for Credit Losses</u>

To provide for known and inherent losses in the loan and lease portfolios, DNB maintains an allowance for credit losses. Provisions for credit losses are charged against income to increase the allowance when necessary. Loan and lease losses are charged directly against the allowance and recoveries on previously charged-off loans and leases are added to the allowance. In establishing its allowance for credit losses, management considers the size and risk exposure of each segment of the loan and lease portfolio, past loss experience, present indicators of risk such as delinquency rates, levels of non-accruals, the potential for losses in future periods, and other relevant factors. Management's evaluation of the loan and lease portfolio generally includes reviews of problem borrowers of $100,000 or greater. Consideration is also given to examinations performed by regulatory agencies, primarily the Office of the Comptroller of the Currency ("OCC).

In establishing and reviewing the allowance for adequacy, Management establishes the allowance for credit losses in accordance with generally accepted accounting principles in the United States and the guidance provided in the Securities and Exchange Commission's Staff Accounting Bulletin 102 (SAB 102). Its methodology for assessing the appropriateness of the allowance consists of several key elements which include: specific allowances for identified problem loans; formula allowances for commercial and commercial real estate loans; and allowances for pooled homogenous loans. As a result, management has taken into consideration factors and variables which may influence the risk of loss within the loan portfolio, including: (i) trends in delinquency and non-accrual loans; (ii) changes in the nature and volume of the loan portfolio; (iii) effects of any changes in lending policies; (iv) experience, ability, and depth of management; (v) quality of loan review; (vi) national and local economic trends and conditions; (vii) concentrations of credit; and (viii) effect of external factors on estimated credit losses. The unallocated portion of the allowance is intended to provide for probable likelihood that the bank would advance funds into a known troubled situation, and then sustain a loss on the newly advanced funds. The risk of loss factors are then applied against the percentage of un-funded commitments in each category of loans. In addition, DNB reviews historical loss experience for the commercial real estate, commercial, residential real estate, home equity and consumer installment loan pools to determine a historical loss factor. The historical loss factors are then applied to the current portfolio balances to determine the required reserve percentage for each loan pool based on risk rating.

DNB's percentage of allowance for credit losses to total loans and leases was 1.28% at December 31, 2006 compared to 1.53% and 1.91% for the years ended December 31, 2005 and 2004, respectively. There were no provisions made during these years since management determined the allowance for credit losses was adequate and provided for known and inherent credit losses. Net charge-offs were $194,000 in 2006 compared to $16,000 and $123,000 in 2005 and 2004, respectively. The percentage of net charge-offs to total average loans and leases was .06%, .01% and 0.6% during the same respective periods.

Analysis of Allowance for Credit Losses
(Dollars in thousands)

	Year Ended December 31				
	2006	**2005**	**2004**	**2003**	**2002**
Beginning balance	**$ 4,420**	$ 4,436	$ 4,559	$ 4,546	$ 4,809
Provisions	**—**	—	—	—	—
Loans charged off:					
Real estate	**—**	—	—	(10)	—
Commercial	**—**	(31)	(8)	(302)	(221)
Leases	**(360)**	—	(75)	—	—
Consumer	**(5)**	(15)	(105)	(14)	(89)
Total charged off	**(365)**	(46)	(188)	(326)	(310)
Recoveries:					
Real estate	**8**	6	16	111	18

Commercial	**44**	20	14	220	18
Leases	**117**	—	—	—	—
Consumer	**2**	4	35	8	11
Total recoveries	**171**	30	65	339	47
Ending balance	**$ 4,226**	$ 4,420	$ 4,436	$ 4,559	$ 4,546

The following table sets forth the composition of DNB's allowance for credit losses at the dates indicated.

Composition of Allowance for Credit Losses
(Dollars in thousands)

	December 31									
	2006		**2005**		**2004**		**2003**		**2002**	
	Amount	**Percent of Loan Type to Total Loans**	**Amount**	**Percent of Loan Type to Total Loans**	**Amount**	**Percent of Loan Type to Total Loans**	**Amount**	**Percent of Loan Type to Total Loans**	**Amount**	**Percent of Loan Type to Total Loans**
Real estate	**$ 954**	**46%**	$ 927	46%	$1,033	46%	$1,495	51%	$1,598	58%
Commercial*	**1,155**	**30**	1,220	29	1,640	27	1,752	27	1,943	26
Leases	**1,191**	**7**	1,132	8	952	8	450	4	77	1
Consumer	**347**	**17**	305	17	310	19	288	18	331	15
Unallocated	**579**	**—**	836	—	501	—	574	—	597	—
Total	**$4,226**	**100%**	$4,420	100%	$4,436	100%	$4,559	100%	$4,546	100%

*Includes commercial construction

5. Certain Regulatory Matters

Dividends payable to the Corporation by the Bank are subject to certain regulatory limitations. Under normal circumstances, the payment of dividends in any year without regulatory permission is limited to the net profits (as defined for regulatory purposes) for that year, plus the retained net profits for the preceding two calendar years. The sum of these items amounted to $1.9 million for the year ended December 31, 2006.

The FDIC has authority to assess and change federal deposit insurance assessment rates on assessable deposits of the Bank. For further information, please refer to the discussion of FDIC deposit insurance assessments under Part I, Item 1 ("Business"), section (c) ("Narrative Description of Business") - "Supervision and Regulation - Bank" under the heading "Deposit Insurance Assessments" on page 7 of this report. If additional deposit insurance premiums were assessed in future years, they would reduce the earnings and profitability of DNB. Bank management cannot predict whether the deposit insurance fund reserve level will remain above the Designated Reserve Ratio of 1.25%, or, if it does not, what assessment rate the FDIC might impose in future periods.

Please refer to Footnote 17 to DNB's Consolidated Financial Statements on page 75 of this report for a table that summarizes required capital ratios and the corresponding regulatory capital positions of DNB and the Bank at December 31, 2006.

6. Off Balance Sheet Arrangements

In the normal course of business, various commitments and contingent liabilities are outstanding, such as guarantees and commitments to extend credit, borrow money or act in a fiduciary capacity, which are not reflected in the consolidated financial statements. Management does not anticipate any significant losses as a result of these commitments.

DNB had outstanding stand-by letters of credit totaling $7.6 million and unfunded loan and lines of credit commitments totaling $62.1 million at December 31, 2006.

These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet. The exposure to credit loss, in the event of non-performance by the party to the financial instrument for commitments to extend credit and stand-by letters of credit, is represented by the contractual amount. Management uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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 the payment of a fee. DNB evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral, if any, obtained upon the extension of credit, usually consists of real estate, but may include securities, property or other assets.

Stand-by letters of credit are conditional commitments issued by DNB to guarantee the performance or repayment of a financial obligation of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risks involved in issuing letters of credit are essentially the same as those involved in extending loan facilities to customers. DNB holds various collateral to support these commitments.

DNB maintains borrowing arrangements with a correspondent bank and the FHLB of Pittsburgh, as well as access to the discount window at the Federal Reserve Bank of Philadelphia to meet short-term liquidity needs. Through these relationships, DNB has available credit of approximately $127.0 million.

Approximately $96.8 million of assets are held by DNB Advisors in a fiduciary or agency -capacity. These assets are not assets of DNB, and are not included in the consolidated financial statements.

The following table sets forth DNB's known contractual obligations as of December 31, 2006. The amounts presented below do not include interest.

		Payments Due by Period			
		Less than	**1-3**	**3-5**	**More than**
(Dollars in thousands)	**Total**	**1 Year**	**Years**	**Years**	**5 Years**
Contractual Obligations					
FHLB advances	$ 40,450	$ 450	$ 7,000	$ 23,000	$ 10,000
Repurchase agreements	45,120	45,120	—	—	—
Capital lease obligations	689	14	34	44	597
Operating lease obligations	3,701	519	956	576	1,650
Junior subordinated debentures	9,279	—	—	—	9,279
Total	**$ 99,239**	**$ 46,103**	**$ 7,990**	**$ 23,620**	**$ 21,526**

		Expiration by Period			
		Less than	**1-3**	**3-5**	**More than**
(Dollars in thousands)	**Total**	**1 Year**	**Years**	**Years**	**5 Years**
Off Balance Sheet Obligations					
Commitments to extend credit	$ 62,116	$ 13,795	$ 17,478	$ 11,896	$ 18,947
Letters of credit	7,607	3,360	4,181	—	66
Total	**$ 69,723**	**$ 17,155**	**$ 21,659**	**$ 11,896**	**$ 19,013**

Item 7a. Quantitative and Qualitative Disclosures About Market Risk

To measure the impacts of longer-term asset and liability mismatches beyond two years, DNB utilizes Modified Duration of Equity and Economic Value of Equity ("EVE") models. The modified duration of equity measures the potential price risk of equity to changes in interest rates. A longer modified duration of equity indicates a greater degree of risk to rising interest rates. Because of balance sheet optionality, an EVE analysis is also used to dynamically model the present value of asset and liability cash flows, with rates ranging up or down 200 basis points. The economic value of equity is likely to be different if rates change. Results falling outside prescribed ranges require action by management. At December 31, 2006 and December 31, 2005, DNB's variance in the economic value of equity as a percentage of assets with an instantaneous and sustained parallel shift of 200 basis points was within its negative 3% guideline, as shown in the table below. The change as a percentage of the present value of equity with a 200 basis point increase or decrease at December 31, 2006 and December 31, 2005, was within DNB's negative 25% guideline.

	December 31, 2006			**December 31, 2005**		
Change in rates	**Flat**	**-200bp**	**+200bp**	Flat	-200bp	+200bp
EVE	**$ 48,771**	**$ 45,426**	**$ 43,466**	$ 60,579	$ 55,559	$ 54,967
Change		(3,345)	(5,305)		(5,020)	(5,612)
Change as a % of assets		(0.6%)	(1.0%)		(1.1%)	(1.2%)
Change as a % of PV equity		(6.9%)	(10.9%)		(8.3%)	(9.3%)

47

Item 8. Financial Statements and Supplementary Data

DNB Financial Corporation and Subsidiaries
Consolidated Statements of Financial Condition
(Dollars in thousands, except share data)

	December 31	
	2006	**2005**
Assets		
Cash and due from banks	**$ 11,611**	$ 14,421
Federal funds sold	**12,616**	7,762
Cash and cash equivalents	**24,227**	22,183
AFS Investment securities, at market value (amortized cost of $132,805 in 2006 and $117,580 in 2005)	**131,636**	116,074
HTM Investment securities (fair value $18,393 in 2006 and $26,213 in 2005)	**18,931**	26,933
Other investment securities	**3,608**	3,367
Total investment securities	**154,175**	146,374
Loans and leases	**329,466**	288,130
Allowance for credit losses	**(4,226)**	(4,420)
Net loans and leases	**325,240**	283,710
Office property and equipment, net	**7,699**	6,733
Accrued interest receivable	**2,420**	2,134
Bank owned life insurance	**7,036**	6,642
Core deposit intangible	**358**	407
Net deferred taxes	**2,499**	2,326
Other assets	**1,588**	2,537
Total assets	**$ 525,242**	$ 473,046
Liabilities and Stockholders' Equity		
Liabilities		
Non-interest-bearing deposits	**$ 50,852**	$ 51,407
Interest-bearing deposits:		
NOW	**82,579**	78,664
Money market	**66,352**	45,390
Savings	**54,956**	77,216
Time	**126,288**	86,950
Total deposits	**381,027**	339,627
FHLB advances	**55,450**	53,850
Repurchase agreements	**45,120**	36,050
Junior subordinated debentures	**9,279**	9,279
Other borrowings	**689**	701
Total borrowings	**110,538**	99,880
Accrued interest payable	**1,061**	939
Other liabilities	**1,205**	2,414
Total liabilities	**493,831**	442,860
Commitments and contingencies (Note 15)		
Stockholders' Equity		
Preferred stock, $10.00 par value; 1,000,000 shares authorized; none issued	**—**	—

Common stock, $1.00 par value; 10,000,000 shares authorized; 2,711,438 and 2,701,040 issued, respectively		**2,712**		2,572
Treasury stock, at cost; 206,631 and 211,958 shares, respectively		**(4,158)**		(4,253)
Surplus		**34,875**		34,802
Accumulated deficit		**(688)**		(1,196)
Accumulated other comprehensive loss, net		**(1,330)**		(1,739)
Total stockholders' equity		**31,411**		30,186
Total liabilities and stockholders' equity	**$**	**525,242**	$	473,046

See accompanying notes to consolidated financial statements.

48

DNB Financial Corporation and Subsidiaries
Consolidated Statements of Operations
(Dollars in thousands)

	Year Ended December 31 2006	2005	2004
Interest Income:			
Interest and fees on loans and leases	**$ 21,930**	$ 16,988	$ 13,945
Interest and dividends on investment securities:			
Taxable	**4,699**	5,063	4,949
Exempt from federal taxes	**1,273**	1,101	1,009
Tax-preferred dividends received deduction	**—**	57	266
Interest on cash and cash equivalents	**347**	218	64
Total interest income	**28,249**	23,427	20,233
Interest Expense:			
Interest on NOW, money market and savings	**4,257**	2,438	1,141
Interest on time deposits	**3,870**	2,096	1,534
Interest on FHLB advances	**2,852**	3,278	3,626
Interest on repurchase agreements	**1,535**	821	145
Interest on junior subordinated debentures	**716**	562	277
Interest on other borrowings	**138**	118	110
Total interest expense	**13,368**	9,313	6,833
Net interest income	**14,881**	14,114	13,400
Provision for credit losses	**—**	—	—
Net interest income after provision for credit losses	**14,881**	14,114	13,400
Non-interest Income:			
Service charges	**1,668**	1,362	1,323
Wealth management	**707**	712	633
Increase in cash surrender value of BOLI	**244**	214	208
Other-than-temporary impairment charge	**—**	—	(2,349)
Securities gains (losses)	**13**	(662)	(16)
Gain on sale of land	**—**	—	259
Other fees	**782**	730	533
Total non-interest income	**3,414**	2,356	591
Non-interest Expense:			
Salaries and employee benefits	**9,139**	8,161	7,320
Furniture and equipment	**1,380**	1,248	1,204
Occupancy	**1,256**	968	868
Professional and consulting	**1,606**	1,117	823
Marketing	**494**	519	638
Printing and supplies	**389**	305	342
Other expenses	**2,243**	2,093	1,994
Total non-interest expense	**16,507**	14,411	13,189
Income before income taxes	**1,788**	2,059	802
Income tax expense (benefit)	**41**	(89)	504

Net Income	**$**	**1,747**	$	2,148	$	298
Earnings per share:						
Basic	**$**	**0.70**	$	0.97	$	0.13
Diluted	**$**	**0.69**	$	0.96	$	0.13
Cash dividends per share	**$**	**0.50**	$	0.47	$	0.45
Weighted average common shares outstanding:						
Basic		**2,500,173**		2,221,478		2,183,308
Diluted		**2,517,769**		2,249,110		2,218,023

See accompanying notes to consolidated financial statements.

DNB Financial Corporation and Subsidiaries
Consolidated Statements of Stockholders' Equity and Comprehensive Income
(Dollars in thousands)

	Comprehensive Income	Common Stock	Treasury Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance at January 1, 2004		$ 2,041	$ (3,097)	$ 26,373	$ 1,092	$ (1,037)	$ 25,372
Comprehensive Income:							
Net income	$ 298	—	—	—	298	—	298
Other comprehensive income, net of tax:							
Unrealized gains on investments	89	—	—	—	—	89	89
Total comprehensive income	$ 387						
Reclass for other-than-temporary impairment charge		—	—	—	—	889	889
Cash dividends		—	—	—	(981)	—	(981)
Cash payment for fractional shares		—	—	—	(9)	—	(9)
Issuance of stock dividends		103	—	2,570	(2,673)	—	—
Purchase of treasury shares		—	(1,391)	—	—	—	(1,391)
Exercise of stock options		26	—	445	—	—	471
Balance at December 31, 2004		2,170	(4,488)	29,388	(2,273)	(59)	24,738
Comprehensive Income:							
Net income	$ 2,148	—	—	—	2,148	—	2,148
Other comprehensive loss, net of tax:							
Unrealized losses on investments	(935)	—	—	—	—	(935)	(935)
Unrealized actuarial losses - pension	(745)	¾	¾	¾	¾	(745)	(745)
Total comprehensive income	$ 468						
Release of unvested stock		3	—	88	—	—	91
Common stock issued		266	—	5,259	—	—	5,525
Cash dividends		—	—	—	(1,064)	—	(1,064)
Cash payment for fractional shares		—	—	—	(7)	—	(7)
Issuance of stock dividends		122	—	(122)	—	—	—
Purchase of treasury shares		—	(5)	—	—	—	(5)
Sale of treasury shares to 401-K plan		—	240	9	—	—	249
Exercise of stock options		11	—	180	—	—	191
		2,572	(4,253)	34,802	(1,196)	(1,739)	30,186

Balance at December 31, 2005							
Comprehensive Income:							
Net income	$ 1,747	—	—	—	1,747	—	1,747
Other comprehensive loss, net of tax:							
Unrealized gains on investments	222	—	—	—	—	222	222
Total comprehensive income	$ 1,969						
Release of unvested stock		4	—	128	—	—	132
Cash dividends		¾	¾	¾	(1,233)	—	(1,233)
Cash payment for fractional shares		—	—	—	(6)	—	(6)
Issuance of stock dividends		129	—	(129)	—	—	—
Adjustment to initially apply FASB Statement No. 158, net of tax		¾	¾	¾	¾	187	187
Purchase of treasury shares		—	(310)	—	—	—	(310)
Sale of treasury shares to 401-K plan		—	405	(12)	—	—	393
Exercise of stock options		7	—	61	—	—	68
Stock compensation tax benefit		—	—	25	—	—	25
Balance at December 31, 2006		**$ 2,712**	$ (4,158)	**$ 34,875**	**$ (688**	$(1,330))	**$ 31,411**

See accompanying notes to consolidated financial statements.

DNB Financial Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(Dollars in thousands)

	Year Ended December 31		
	2006	**2005**	**2004**
Cash Flows From Operating Activities:			
Net income	**$ 1,747**	$ 2,148	$ 298
Adjustments to reconcile net income to net cash provided (used) by operating activities:			
Depreciation, amortization and accretion	**1,186**	1,315	1,498
Unvested stock amortization	**132**	91	—
Securities (gains) losses	**(13)**	662	16
Gain on sale of land	**—**	—	259
Deferred gain on sale of buildings	**—**	(812)	¾
Loss on other-than-temporary impairment	**—**	—	2,349
Increase in accrued interest receivable	**(286)**	(362)	(28)
Decrease in other assets	**152**	260	760
Tax benefit on exercised stock options	**—**	31	64
Increase in investment in BOLI	**(244)**	(197)	(208)
Increase in interest payable	**122**	16	23
Increase in deferred tax benefit	**(384)**	(518)	(131)
(Decrease) increase in other liabilities	**(80)**	(326)	25
Net Cash Provided By Operating Activities	**2,332**	2,308	4,925
Cash Flows From Investing Activities:			
Proceeds from maturities and paydowns - AFS securities	**12,907**	23,161	49,245
Proceeds from maturities and paydowns - HTM securities	**7,948**	6,337	11,872
Purchase of AFS securities	**(28,287)**	(105,443)	(68,251)
Proceeds from sale of AFS - securities	**—**	95,780	9,469
Net (increase) decrease in other investments	**(241)**	662	753
Net increase in loans and leases	**(41,530)**	(55,569)	(29,147)
Purchase of BOLI	**(150)**	(150)	(150)
Proceeds from the sale of property and equipment	**—**	1,683	518
Purchase of property and equipment	**(1,930)**	(1,285)	(1,197)
Net Cash Used By Investing Activities	**(51,283)**	(34,824)	(26,888)
Cash Flows From Financing Activities:			
Net increase in deposits	**41,400**	16,483	30,708
Increase (decrease) in FHLB advances	**1,600**	(7,800)	(21,350)
Proceeds from short term repurchase agreements	**9,070**	12,923	23,127
Increase in junior subordinated debentures	**—**	4,124	¾
Decrease in lease obligations	**(12)**	(10)	(9)
Dividends paid	**(1,239)**	(1,071)	(990)
Proceeds from the issuance of common stock	**—**	5,525	¾
Proceeds from issuance of stock under stock option plan	**68**	160	407
Tax benefit on exercised stock options	**25**	¾	¾
Sale (purchase) of treasury stock, net	**83**	244	(1,391)

Net Cash Provided By Financing Activities		**50,995**		30,578		30,502
Net Change in Cash and Cash Equivalents		**2,044**		(1,938)		8,539
Cash and Cash Equivalents at Beginning of Year		**22,183**		24,121		15,582
Cash and Cash Equivalents at End of Year	**$**	**24,227**	$	22,183	$	24,121
Supplemental Disclosure of Cash Flow Information:						
Cash paid during the period for:						
Interest	**$**	**13,246**	$	9,297	$	6,810
Income taxes		**153**		101		458
Supplemental Disclosure of Non-cash Flow Information:						
Change in unrealized losses on AFS securities	**$**	**337**	$	1,409	$	1,482
Change in deferred taxes due to change in unrealized losses on AFS securities		**(115)**		(474)		(504)
Increase in junior subordinated debentures		¾		¾		155

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

DNB Financial Corporation (the "Corporation" or "DNB") through its wholly owned subsidiary, DNB First, National Association (the "Bank") formerly Downingtown National Bank, has been serving individuals and small to medium sized businesses of Chester County, Pennsylvania since 1861. DNB Capital Trust I and II are special purpose Delaware business trusts (see additional discussion in Junior Subordinated Debentures-Footnote 9). The Bank is a locally managed commercial bank providing personal and commercial loans and deposit products, in addition to investment and trust services from twelve community offices. The Bank encounters vigorous competition for market share from commercial banks, thrift institutions, credit unions and other financial intermediaries.

The consolidated financial statements of DNB and its subsidiary, the Bank, which together are managed as a single operating segment, are prepared in accordance with generally accepted accounting principles applicable to the banking industry. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and affect revenues and expenses for the period. Actual results could differ significantly from those estimates.

The more significant accounting policies are summarized below. Prior period amounts not affecting net income are reclassified when necessary to conform with current year classifications.

Principles of Consolidation — The accompanying consolidated financial statements include the accounts of the Corporation and its wholly owned subsidiary, the Bank. All significant inter-company transactions have been eliminated.

Cash and Due From Banks —For purposes of the consolidated statement of cash flows, cash and due from banks, and federal funds sold are considered to be cash equivalents. Generally, federal funds are sold for one-day periods. DNB is required to maintain certain daily reserve balances in accordance with Federal Reserve Board requirements. The average reserve balance maintained at the Federal Reserve for the years ended December 31, 2006 and 2005 was approximately $43,016 and $391,000 respectively.

Investment Securities— Investment securities are classified and accounted for as follows:

Held-To-Maturity ("HTM")— includes debt and non-readily marketable equity securities that DNB has the positive intent and ability to hold to maturity. Debt securities are reported at cost, adjusted for amortization of premiums and accretion of discounts. Non-readily marketable equity securities are carried at cost, which approximates liquidation value.

Trading Account ("TA") — includes securities that are generally held for a short term in anticipation of market gains. Such securities would be carried at fair value with realized and unrealized gains and losses on trading account securities included in the statement of operations. DNB did not have any securities classified as TA during 2006, 2005 or 2004.

Available-For-Sale ("AFS") — includes debt and equity securities not classified as HTM or TA securities. Securities classified as AFS are securities that DNB intends to hold for an indefinite period of time, but not necessarily to maturity. Such securities are reported at fair value, with unrealized holding gains and losses excluded from earnings and reported, net of tax (if applicable), as a separate component of stockholders' equity. Realized gains and losses on the sale of AFS securities are computed on the basis of specific identification of the adjusted cost of each security.

Other Investment Securities — includes investments in Federal Home Loan Bank (FHLB), Federal Reserve Bank (FRB) and Atlantic Central Bankers Bank (ACBB) stock which are carried at cost and are redeemable at par with certain restrictions. Investments in these stocks are necessary to participate in FHLB, FRB and ACBB programs.

Amortization of premiums and accretion of discounts for all types of securities are computed using a method approximating a level-yield basis.

Loans and Leases — Loans and leases are stated net of unearned discounts, unamortized net loan origination fees and the allowance for credit losses. Interest income is recognized on an accrual basis. The accrual of interest on loans and leases is generally discontinued when loans become 90 days past due or earlier when, in management's judgment, it is determined that a reasonable doubt exists as to its collectibility. When a loan or lease is placed on non-accrual, interest accruals cease and uncollected accrued interest is reversed and charged against current income. Additional interest payments on such loans or leases are generally applied to principal or recognized to income on a cash basis. A non-accrual loan or lease may be restored to accrual status when management expects to collect all contractual principal and interest due and the borrower has demonstrated a sustained period of repayment performance in accordance with the contractual terms.

Deferred Loan Fees and Costs — Loan origination and commitment fees and related direct-loan origination costs of completed loans are deferred and accreted to income as a yield adjustment over the life of the loan using the level-yield method. The accretion to income is discontinued when a loan is placed on non-accrual status. When a loan is paid off, any unamortized net deferred fee balance is credited to income. When a loan is sold, any unamortized net deferred fee balance is considered in the calculation of gain or loss.

Allowance for Credit Losses — The allowance for loan and lease losses is an estimate of the credit loss risk in our loan and lease portfolio. The allowance is based on two basic principles of accounting: (1) Statement of Financial Accounting Standards ("SFAS") No. 5 "Accounting for Contingencies," which requires that losses be accrued when it is probable that a loss has occurred at the balance sheet date and such loss can be reasonably estimated; and (2) SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," which requires that losses be accrued on impaired loans based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance. DNB's credit loss allowance policies involve significant judgments and assumptions by management which may have a material impact on the carrying value of net loans and, potentially, on the net income recognized by DNB from period to period. The allowance for credit losses is based on management's ongoing evaluation of the loan and lease portfolio and reflects an amount considered by management to be its best estimate of the amount necessary to absorb known and inherent losses in the portfolio. Management considers a variety of factors when establishing the allowance, such as the impact of current economic conditions, diversification of the portfolios, delinquency statistics, results of loan review and related classifications, and historic loss rates. In addition, certain individual loans which management has identified as problematic are specifically provided for, based upon an evaluation of the borrower's perceived ability to pay, the estimated adequacy of the underlying collateral and other relevant factors. In addition, regulatory authorities, as an integral part of their examinations, periodically review the allowance for credit losses. They may require additions to the allowance based upon their judgments about information available to them at the time of examination. Although provisions are established and segmented by type of loan, based upon management's assessment of their differing inherent loss characteristics, the entire allowance for credit losses is available to absorb losses in any category.

Management uses significant estimates to determine the allowance for credit losses. Because the allowance for credit losses is dependent, to a great extent, on conditions that may be beyond DNB's control, management's estimate of the amount necessary to absorb allowance for credit losses and actual credit losses could differ. DNB's current judgment is that the valuation of the allowance for credit losses remains appropriate at December 31, 2006.

Other Real Estate Owned — Other real estate owned ("OREO") consists of properties acquired as a result of, or in-lieu-of, foreclosure. Properties classified as OREO are reported at the lower of carrying value or fair value, less estimated costs to sell. Costs relating to the development or improvement of the properties are capitalized and costs relating to holding the properties are charged to expense. DNB did not have any OREO at December 31, 2006 or December 31, 2005.

Office Properties and Equipment — Office properties and equipment are recorded at cost. Depreciation is computed using the straight-line method over the expected useful lives of the assets. The costs of maintenance and repairs are expensed as they are incurred; renewals and betterments are capitalized. All long-lived assets are reviewed for impairment, based on the fair value of the asset. In addition, long-lived assets to be disposed of are generally reported at the lower of carrying amount or fair value, less costs to sell. Gains or losses on disposition of premises and equipment are reflected in operations.

Other Assets— Financing costs related to the issuance of the junior subordinated debentures are being amortized over the life of the debentures and are included in other assets.

Income Taxes — DNB accounts for income taxes in accordance with the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in income in the period that includes the enactment date. The Corporation files a consolidated Federal income tax return with the IRS.

Pension Plan — The Bank maintains a noncontributory defined benefit pension plan covering substantially all employees over the age of 21 with one year of service. Plan benefits are based on years of service and the employee's monthly average compensation for the highest five consecutive years of their last ten years of service (see Note 14 - Benefit Plans).

Stock Option Plan — DNB has stock option plans for certain employees that were accounted for under the intrinsic value method prior to January 1, 2006. Because the exercise price at the date of the grant is equal to the market value of the stock, no compensation expense has been recognized. On January 1, 2006, DNB adopted SFAS 123R using the modified prospective transition method. SFAS 123R revised 2004 (SFAS 123R), "Share-Based Payment" replaced SFAS No. 123 (SFAS 123), "Accounting for Stock-Based Compensation" and superseded APB Opinion No. 25 (APB 25), "Accounting for Stock Issued to Employees" and amended SFAS No. 95, "Statement of Cash Flows.'' Under this transition method, compensation cost to be recognized beginning in the first quarter of 2006 would include: (a) compensation cost for the portion of share-based payment awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payment awards granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Results for prior periods were not restated. DNB did not have any unvested options at January 1, 2006 as all options issued prior to this date vested immediately. Additionally, no new options were granted in 2006, therefore, DNB did not recognize any compensation cost related to options for 2006.

Had DNB determined compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123, DNB's net income and earnings per share would have been reduced to the proforma amounts for 2005 and 2004 presented below:

	Year Ended December 31	
(Dollars in thousands, except per share data)	**2005**	**2004**
Net income - as reported	$ 2,148	$ 298
Less: Stock option expense	572	344
Proforma net income (loss)	$ 1,576	$ (46)
EPS - diluted - as reported	$ 0.96	$ 0.13
Less: Stock option expense	.26	.16

Proforma earnings (loss) per share - diluted	$ 0.70	$ (0.03)

54

Earnings Per Share (EPS) — Basic EPS is computed based on the weighted average number of common shares outstanding during the year. Diluted EPS reflects the potential dilution that could occur from the exercise of stock options and is computed using the treasury stock method. Stock options and awards for which the exercise price exceeds the average market price over the period have an anti-dilutive effect on EPS and, accordingly, are excluded from the EPS calculation.

Earnings per share, dividends per share and weighted average shares outstanding have been adjusted to reflect the effects of the 5% stock dividend paid in December 2006, 2005 and 2004.

Trust Assets — Assets held by DNB Advisors in fiduciary or agency capacities are not included in the consolidated financial statements since such items are not assets of DNB. Operating income and expenses of DNB Advisors are included in the consolidated statements of operations and are recorded on an accrual basis.

Statements of Cash Flows — For purposes of the statements of cash flows, DNB considers cash in banks, amounts due from banks, and Federal funds sold to be cash equivalents. Generally, Federal funds are sold for one-day periods.

Recent Accounting Pronouncements

In February 2006, the FASB issued SFAS No. 155, "*Accounting for Certain Hybrid Financial Instruments."* This Statement amends FASB Statements No. 133 and No. 140. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, *"Application of Statement 133 to Beneficial Interests in Securitized Financial Assets."* This Statement: a) permits fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; b) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133; c) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; d) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and e) amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period for that fiscal year. Provisions of this Statement may be applied to instruments that an entity holds at the date of adoption on an instrument-by-instrument basis. SFAS 155 is effective for DNB on January 1, 2007 and is not expected to have a material impact on DNB's consolidated financial statements upon adoption.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets". SFAS 156 amends SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." SFAS 156 permits, but does not require, an entity to choose either the amortization method or the fair value measurement method for measuring each class of separately recognized servicing assets and servicing liabilities. SFAS 156 is effective for DNB on January 1, 2007 and is not expected to have a material impact on DNB's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. The statement defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The statement also establishes a framework for measuring fair value by creating a three-level fair value hierarchy that ranks the quality and reliability of information used to determine fair value, and requires new disclosures of assets and liabilities measured at fair value based on their level in the hierarchy. The Statement is effective for DNB on January 1, 2008. DNB has not yet determined if the adoption of this statement will have a material impact on its financial position or results of operations.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plan" ("SFAS 158"). SFAS 158 requires an employer to recognize on their balance sheet the funded status of its defined pension plans and other post-retirement plans as of December 31, 2006. An under-funded position would create a liability and an over-funded position would create an asset, with a correlating deferred tax asset or liability. The net impact would be an adjustment to equity as accumulated other comprehensive income (loss.) Employers must also recognize as a component of other comprehensive income (loss), net of tax, the actuarial gains and losses and the prior service costs and credits that arise during the period. DNB adopted the recognition and disclosure provisions of SFAS 158 on December 31, 2006. The effect of adopting SFAS 158 on DNB's financial condition at December 31, 2006 has been included in the accompanying consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value and amends SFAS 115 to, among other things, require certain disclosures for amounts for which the fair value option is applied. Additionally, this Statement provides that an entity may reclassify held-to-maturity and available-for-sale securities to the trading account when the fair value option is elected for such securities, without calling into question the intent to hold other securities to maturity in the future. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of SFAS 157. DNB has not completed its assessment of SFAS 159 and the impact, if any, on the consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes" - an interpretation of FASB Statement No. 109 (FIN 48).* This interpretation of SFAS No. 109 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The interpretation is effective for fiscal years beginning after December 15, 2006. DNB has reserves related to certain of its tax positions, which would be subject to analysis under FIN 48. DNB will adopt FIN 48 as of January 1, 2007, as required. The cumulative effect of adopting FIN 48 will be recorded in retained earnings. DNB does not expect that the adoption of FIN 48 will have a significant impact on DNB's consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ("SAB 108"). This guidance was issued to resolve diversity in current practice among registrants. The bulletin establishes that registrants must quantify the impact of correcting all misstatements on the financial statements by using both the rollover and iron curtain approaches to evaluate the errors. The rollover approach quantifies the misstatement based on the amount of the error originating in the current year income statement and the iron curtain approach quantifies a misstatement based on the amount of the error existing in the balance sheet at the end of the fiscal year. The bulletin contains guidance on correcting errors under the dual approach and transition guidance. SAB 108 is effective for the Company's December 31, 2006 annual financial statements. The adoption of SAB 108 did not have a material impact on DNB's financial position or results of operations.

In September 2006, the Emerging Issues Task Force issued EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF 06-4 concludes that for a split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with SFAS 106 (if, in substance, a postretirement benefit plan exits) or APB Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. The consensus is effective for fiscal years beginning after December 15, 2007. This EITF is applicable to the Replacement Plan referenced in Note 14 on page 68. DNB is currently evaluating the effect that EITF No. 06-4 will have on its financial statements when implemented.

In September 2006, the Emerging Issues Task Force issued EITF 06-5, Accounting for Purchases of Life Insurance-Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4. This consensus concludes that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. A consensus also was reached that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). The consensuses are effective for fiscal years beginning after December 15, 2006. This EITF is applicable to the BOLI already recognized in DNB's statement of condition. DNB is currently evaluating the effect that EITF No. 06-5 will have on its financial statements when implemented.

2) INVESTMENT SECURITIES

The amortized cost and estimated fair values of investment securities, as of the dates indicated, are summarized as follows:

	December 31, 2006			
(Dollars in thousands)	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Estimated Fair Value**
Held To Maturity				
US government agency obligations	**$ 4,728**	**$ ¾**	$ (109)	**$ 4,619**
US agency mortgage-backed securities	**1,192**	**2**	(8)	**1,186**
Collateralized mortgage obligations	**6,929**	**¾**	(431)	**6,498**
State and municipal tax-exempt	**6,082**	**14**	(6)	**6,090**
Total	**$ 18,931**	**$ 16**	$ (554)	**$ 18,393**
Available For Sale				
US government agency obligations	**50,194**	**¾**	(423)	**49,771**
US agency mortgage-backed securities	**50,023**	**68**	(869)	**49,222**
State and municipal tax-exempt	**32,551**	**215**	(161)	**32,605**
Equity securities	**37**	**1**	**—**	**38**
Total	**$ 132,805**	**$ 284**	$ (1,453)	**$ 131,636**

	December 31, 2005			
(Dollars in thousands)	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Estimated Fair Value**
Held To Maturity				
US government agency obligations	$ 10,586	$ ¾	$ (181)	$ 10,405
US agency mortgage-backed securities	1,585	8	(10)	1,583
Collateralized mortgage obligations	8,623	¾	(519)	8,104
State and municipal tax-exempt	6,138	10	(27)	6,121
Total	$ 26,933	$ 18	$ (737)	$ 26,213
Available For Sale				
US government agency obligations	35,229	¾	(435)	34,794
US agency mortgage-backed securities	57,187	10	(1,016)	56,181
State and municipal tax-exempt	25,127	72	(137)	25,062
Equity securities	37	—	—	37
Total	$ 117,580	$ 82	$ (1,588)	$ 116,074

Included in unrealized losses are market losses on securities that have been in a continuously unrealized loss position for twelve months or more and those securities that have been in a continuous unrealized loss position for less than twelve months. The table below details the aggregate unrealized losses and aggregate fair value of the underlying securities whose fair values are below their values at December 31, 2006 and 2005.

	December 31, 2006					
(Dollars in thousands)	**Total Fair Value**	**Total Unrealized Loss**	**Fair value Impaired Less Than 12 Months**	**Unrealized Loss Less Than 12 Months**	**Fair value Impaired More Than 12 Months**	**Unrealized Loss More Than 12 Months**
Held To Maturity						
US Government agency obligations	**$ 4,619**	**$ (109)**	**$ ¾**	**$ ¾**	**$ 4,619**	**$ (109)**
Collateralized mortgage obligations	**6,498**	**(431)**	**¾**	**¾**	**6,498**	**(431)**
State and municipal tax-exempt	**2,344**	**(6)**	**500**	**¾**	**1,844**	**(6)**
US agency mortgage-backed securities	**658**	**(8)**	**324**	**(1)**	**334**	**(7)**
Total	**$ 14,119**	**$ (554)**	**$ 824**	**$ (1)**	**$ 13,295**	**$ (553)**
Available For Sale						
US Government agency obligations	**$ 49,771**	**$ (424)**	**$ 14,991**	**$ (6)**	**$ 34,780**	**$ (418)**
State and municipal tax-exempt	**12,721**	**(160)**	**6,210**	**(82)**	**6,511**	**(78)**
US agency mortgage-backed securities	**43,199**	**(869)**	**567**	**(3)**	**42,632**	**(866)**
Total	**$ 105,691**	**$ (1,453)**	**$ 21,768**	**$ (91)**	**$ 83,923**	**$ (1,362)**

	December 31, 2005					
(Dollars in thousands)	**Total Fair Value**	**Total Unrealized Loss**	**Fair value Impaired Less Than 12 Months**	**Unrealized Loss Less Than 12 Months**	**Fair value Impaired More Than 12 Months**	**Unrealized Loss More 12 Months**
Held To Maturity						
US Government agency obligations	$ 10,405	$ (181)	$ ¾	$ ¾	$ 10,405	$ (181)
Collateralized mortgage obligations	8,104	(519)	¾	¾	8,104	(519)
State and municipal tax-exempt	785	(27)	785	(27)	¾	¾
US agency mortgage-backed securities	425	(10)	¾	¾	425	(10)
Total	$ 19,719	$ (737)	$ 785	$ (27)	$ 18,934	$ (710)
Available For Sale						

US Government agency obligations	$	34,794	$	(435)	$	34,794	$	(435)	$	¾	$	¾
State and municipal tax-exempt		13,200		(137)		13,200		(137)		¾		¾
US agency mortgage-backed securities		53,969		(1,016)		37,918		(532)		16,051		(484)
Total	$	101,963	$	(1,588)	$	85,912	$	(1,104)	$	16,051	$	(484)

DNB has $84 million in securities available for sale, which have had fair values below book value for at least twelve continuous months at December 31, 2006. The total unrealized loss of these securities was $1.4 million. The impaired securities consist of fixed and variable rate government agency MBS securities. The unrealized losses on the mortgage-related securities are attributed to extension risk resulting from slower prepayment speeds in a rising rate environment. Management believes that the impairment associated with these and all other securities, where fair value is below book value at December 31, 2006, is only temporary.

The amortized cost and estimated fair value of investment securities as of December 31, 2006, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid without penalties.

	Held to Maturity		Available for Sale	
(Dollars in thousands)	**Amortized Cost**	**Estimated Fair Value**	**Amortized Cost**	**Estimated Fair Value**
Due in one year or less	**$ 1,000**	**$ 993**	**$ 22,984**	**$ 22,931**
Due after one year through five years	**4,362**	**4,252**	**29,814**	**29,413**
Due after five years through ten years	**1,833**	**1,833**	**5,140**	**5,013**
Due after ten years	**11,736**	**11,315**	**74,830**	**74,241**
No stated maturity	**-**	**-**	**37**	**38**
Total investment securities	**$ 18,931**	**$ 18,393**	**$ 132,805**	**$ 131,636**

DNB sold $0, $95.8 million and $9.4 million of securities from the AFS portfolio during 2006, 2005 and 2004. Gains and losses resulting from investment sales, redemptions or calls were as follows:

	Year Ended December 31		
(Dollars in thousands)	**2006**	**2005**	**2004**
Gross realized gains	**$ 13**	$ 509	$ 71
Gross realized losses	**¾**	1,171	87
Net realized loss	**$ 13**	$ (662)	$ (16)

At December 31, 2006 and 2005, investment securities with a carrying value of approximately $101.9 million and $83.2 million, respectively, were pledged to secure public funds, repurchase agreements and for other purposes as required by law. See Footnote 7 regarding the use of certain securities as collateral.

(3) LOANS AND LEASES

	December 31	
(Dollars in thousands)	**2006**	**2005**
Residential mortgage	**$ 52,636**	$ 43,738
Commercial mortgage	**99,493**	88,921
Commercial	**99,572**	83,156
Leases	**22,994**	23,934
Consumer	**54,771**	48,381
Total loans and leases	**$ 329,466**	$ 288,130
Less allowance for credit losses	**(4,226)**	(4,420)
Net loans and leases	**$ 325,240**	$ 283,710

Included in the loan portfolio are loans for which DNB has ceased the accrual of interest (i.e. Non-accrual loans). Loans of approximately $715,000, $1.1 million and $389,000 as of December 31, 2006, 2005 and 2004, respectively, were on a non-accrual basis. DNB also had loans of approximately $106,000, $46,000 and $36,000 that were 90 days or more delinquent, but still accruing as of December 31, 2006, 2005 and 2004, respectively. If contractual interest income had been recorded on non-accrual loans, interest would have been increased as shown in the following table:

	Year Ended December 31		
(Dollars in thousands)	**2006**	**2005**	**2004**
Interest income which would have been recorded			

under original terms	**$**	**56**	$	87	$	31
Interest income recorded during the year		**(28)**		(8)		(5)
Net impact on interest income	**$**	**28**	$	79	$	26

59

DNB had $3.7 million of loans, which, although performing at December 31, 2006, are believed to require increased supervision and review, and may, depending on the economic environment and other factors, become non-performing assets in future periods. There was $3.7 million of such loans at December 31, 2005. The majority of these loans are secured by commercial real estate with lesser amounts being secured by residential real estate, inventory and receivables.

DNB has a significant concentration of residential and commercial mortgage loans collateralized by first mortgage liens on properties located in Chester County. DNB did not have any concentration of loans to borrowers engaged in similar activities that exceed 10% of total loans at December 31, 2006, except for loans of approximately $49.9 million relating to commercial real-estate buildings. See Footnote 7 regarding the use of certain loans as collateral.

(4) ALLOWANCE FOR CREDIT LOSSES

Changes in the allowance for credit losses, for the years indicated, are as follows:

	Year Ended December 31		
(Dollars in thousands)	**2006**	**2005**	**2004**
Beginning balance	**$ 4,420**	$ 4,436	$ 4,559
Provisions	**—**	—	—
Loans charged off	**(5)**	(46)	(113)
Leases charged off	**(360)**	—	(75)
Recoveries	**171**	30	65
Net (charge-offs) recoveries	**(194)**	(16)	(123)
Ending balance	**$ 4,226**	$ 4,420	$ 4,436

There were no provisions for credit losses made during the periods ended December 31, 2006, 2005 and 2004, since management determined the allowance for credit losses was adequate based on its analysis. For a detailed discussion on DNB's reserving methodology, refer to "Item 1 - Determination of the allowance for credit losses which can be found under Critical Accounting Policies and Estimates".

Impaired loans are those for which the Company has recorded a specific reserve. Information regarding impaired loans is presented as follows:

	Year Ended December 31		
(Dollars in thousands)	**2006**	**2005**	**2004**
Total recorded investment	**$ 641**	$ 916	$ 216
Average recorded investment	**962**	1,118	1,083
Specific allowance allocation	**76**	442	—
Total cash collected	**1,145**	564	2,249
Interest income recorded	**4**	18	133

(5) OFFICE PROPERTY AND EQUIPMENT

(Dollars in thousands)	Estimated Useful Lives	December 31 2006	2005
Land		**$ 611**	$ 611
Buildings	5-31.5 years	**7,065**	5,927
Furniture, fixtures and equipment	2-20 years	**11,468**	10,675
Total cost		**19,144**	17,213
Less accumulated depreciation		**(11,445)**	(10,480)
Office property and equipment, net		**$ 7,699**	$ 6,733

Amounts charged to operating expense for depreciation for the years ended December 31, 2006, 2005 and 2004 amounted to $965,000, $867,000 and $838,000, respectively.

On November 18, 2005, the Bank sold its operations center and an adjunct administrative office at 104-106 Brandywine Avenue, to an unaffiliated buyer for $1,700,000 and leased the Property from the buyer for an initial term ending December 1, 2010, on a triple net basis for an initial annual basic lease rental of approximately $176,000. The lease gives the Bank successive options to renew its term for three additional terms of five years each at a basic rent to be established at a fair market rental taking into account all of the terms and conditions of this lease, and an option to terminate the lease at any time on 120 days prior notice.

(6) DEPOSITS

Included in interest bearing time deposits are certificates of deposit issued in amounts of $100,000 or more. These certificates and their remaining maturities were as follows:

(Dollars in thousands)	December 31 2006	2005
Three months or less	**$ 14,420**	$ 7,082
Over three through six months	**15,147**	4,539
Over six through twelve months	**16,235**	7,760
Over one year through two years	**1,940**	5,832
Over two years	**575**	3,666
Total	**$ 48,317**	$ 28,879

(7) FHLB ADVANCES AND SHORT-TERM BORROWED FUNDS

DNB's short-term borrowed funds consist of borrowings at the Federal Home Loan Bank (FHLB) of Pittsburgh, repurchase agreements and Federal funds purchased. Repurchase agreements and Federal funds purchased generally represent one-day borrowings. Borrowings at the FHLB consist of overnight and 90 day borrowings. DNB had $45.1 million with an average rate of 3.90% in repurchase agreements at December 31, 2006. DNB had $15.0 million in overnight FHLB borrowings at December 31, 2006.

In addition to short-term borrowings, DNB maintains other borrowing arrangements with the FHLB. DNB has a maximum borrowing capacity at the FHLB of approximately $127.0 million. At December 31, 2006, DNB had $40.5 million of outstanding advances, which mature at various dates through the year-ended December 31, 2015, as shown in the table below. The $40 million of advances maturing in 2009 and thereafter are convertible term advances and are callable, at the FHLB's option, at various dates starting on January 25, 2007. If an advance is called by the FHLB, DNB has the option of repaying the borrowing, or continue to borrow at three month Libor plus 10-14 basis points, depending on the advance. FHLB advances may be collateralized by a pledge of unencumbered investment securities, certain mortgage loans or a lien on the Bank's FHLB stock.

(Dollars in thousands)	**December 31, 2006** Weighted Average Rate		**Amount**
Due by December 31, 2007	3.57%	$	450
Due by December 31, 2009	5.45		7,000
Due by December 31, 2011	5.84		23,000
Thereafter	5.86		10,000
Total	**5.71%**	**$**	**40,450**

(8) CAPITAL LEASE OBLIGATIONS

Included in other borrowings is a long-term capital lease agreement, which relates to DNB's West Goshen branch. As of December 31, 2006 the branch has a carrying amount of $503,000, net of accumulated depreciation of $247,000, and is included in the balance of office properties and equipment in the accompanying statements of financial condition. The following is a schedule of the future minimum lease payments, together with the present value of the net minimum lease payments, as of December 31, 2006:

(Dollars in thousands) Year ended December 31		**Amount**
2007	$	106
2008		106
2009		106
2010		106
2011		106
Thereafter		1,129
Total minimum lease payments		1,659
Less amount representing interest		(970)
Present value of net minimum lease payments	**$**	**689**

(9) JUNIOR SUBORDINATED DEBENTURES

DNB has two issuances of junior subordinated debentures (the "debentures") as follows. The majority of the proceeds of each issuance were invested in DNB's subsidiary, DNB First, National Association, to increase the Bank's capital levels. The junior subordinated debentures issued in each case qualify as a component of capital for regulatory purposes.

DNB Capital Trust I

DNB's first issuance of junior subordinated debentures was on July 20, 2001. This issuance of debentures are floating rate and were issued to DNB Capital Trust I, a Delaware business trust in which DNB owns all of the common equity. DNB Capital Trust I issued $5.0 million of floating rate (6 month Libor plus 3.75%, with a cap of 12%) capital preferred securities to a qualified institutional buyer. The proceeds of these securities were used by the Trust, along with DNB's capital contribution, to purchase $5,155,000 principal amount of DNB's floating rate junior subordinated debentures. The preferred securities have been redeemable since July 25, 2006 and must be redeemed upon maturity of the debentures on July 25, 2031.

DNB Capital Trust II

DNB’s second issuance of junior subordinated debentures was on March 30, 2005. This issuance of debentures are floating rate and were issued to DNB Capital Trust II, a Delaware business trust in which DNB owns all of the common equity. DNB Capital Trust II issued $4 million of floating rate (the rate is fixed at 6.56% for the first 5 years and will adjust at a rate of 3-month LIBOR plus 1.77% thereafter) capital preferred securities. The proceeds of these securities were used by the Trust, along with DNB's capital contribution, to purchase $4.1 million principal amount of DNB's floating rate junior subordinated debentures. The preferred securities are redeemable by DNB on or after May 23, 2010, or earlier in the event of certain adverse tax or bank regulatory developments. The preferred securities must be redeemed upon maturity of the debentures on May 23, 2035.

(10) FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value assumptions, methods, and estimates are set forth below for DNB's financial instruments.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time DNB's entire holdings of a particular financial instrument. Because no market exists for a significant portion of DNB's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments.

Cash, Federal Funds Sold, Investment Securities, Accrued Interest Receivable and Accrued Interest Payable

The carrying amounts for short-term investments (cash and Federal funds sold) and accrued interest receivable and payable approximate fair value. The fair value of investment securities is estimated based on bid prices published in financial newspapers or bid quotations received from securities dealers. The carrying amount of non-readily marketable equity securities approximates liquidation value.

Loans

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, commercial mortgages, residential mortgages, consumer and student loans, and non-accrual loans. The fair value of performing loans is calculated by discounting expected cash flows using an estimated market discount rate. Expected cash flows include both contractual cash flows and prepayments of loan balances. Prepayments on consumer loans were determined using the median of estimates of securities dealers for mortgage-backed investment pools.

The estimated discount rate considers credit and interest rate risk inherent in the loan portfolios and other factors such as liquidity premiums and incremental servicing costs to an investor. Management has made estimates of fair value discount rates that it believes to be reasonable. However, because there is no market for many of these financial instruments, management has no basis to determine whether the fair value presented below would be indicative of the value negotiated in an actual sale.

The fair value for non-accrual loans was derived through a discounted cash flow analysis, which includes the opportunity costs of carrying a non-performing asset. An estimated discount rate was used for all non-accrual loans, based on the probability of loss and the expected time to recovery.

Deposits and Borrowings

The fair value of deposits with no stated -maturity, such as non-interest-bearing deposits, savings, NOW and money market accounts, is equal to the amount payable on demand at December 31, 2006 and 2005. The fair values of time deposits and borrowings are based on the present value of contractual cash flows. The discount rates used to compute present values are estimated using the rates currently offered for deposits of similar maturities in DNB's marketplace and rates currently being offered for borrowings of similar maturities.

Off-balance-sheet Instruments

Off-balance-sheet instruments are primarily comprised of loan commitments, which are generally priced at market at the time of funding. Fees on commitments to extend credit and stand-by letters of credit are deemed to be immaterial and these instruments are expected to be settled at face value or expire unused. It is impractical to assign any fair value to these instruments. At December 31, 2006 and 2005, un-funded loan commitments totaled $62.1 million and $50.1 million, respectively. Stand-by letters of credit totaled $7.6 million and $7.0 million at December 31, 2006 and 2005, respectively.

The following tables summarize information for all on-balance-sheet financial instruments.

	December 31			
	2006		2005	
(Dollars in thousands)	**Carrying Amount**	**Estimated Fair Value**	**Carrying Amount**	**Estimated Fair Value**
Financial assets				
Cash and Federal funds sold	**$ 24,227**	**$ 24,227**	$ 22,183	$ 22,183
Investment securities - AFS	**131,636**	**131,636**	116,074	116,074
Investment securities - HTM	**18,931**	**18,393**	30,673	29,954
Net loans and leases	**325,240**	**319,190**	283,710	288,379
Accrued interest receivable	**2,420**	**2,420**	2,134	2,134
Financial liabilities				
Deposits	**381,027**	**361,444**	339,627	312,607
Borrowings	**110,538**	**109,720**	99,880	102,125
Accrued interest payable	**1,061**	**1,061**	939	939

(11) FEDERAL INCOME TAXES

Income tax expense (benefit) was comprised of the following:

	Year Ended December 31		
(Dollars in thousands)	**2006**	**2005**	**2004**
Current tax expense:			
Federal	**$ 425**	$ 429	$ 635
State	**—**	—	—
Deferred income tax (benefit):			
Federal	**(384)**	(518)	(131)
State	**—**	—	—
Income tax expense (benefit)	**$ 41**	$ (89)	$ 504

64

The effective income tax rates of 2% for 2006, (4%) for 2005 and 63% for 2004 were different than the applicable statutory Federal income tax rate of 34%. The reason for these differences follows:

	Year Ended December 31		
(Dollars in thousands)	**2006**	**2005**	**2004**
Federal income taxes at statutory rate	**$ 608**	$ 700	$ 273
Decrease resulting from:			
Low income housing credits	**(36)**	(36)	(36)
Tax-exempt interest and dividend preference	**(498)**	(394)	(419)
Change in valuation allowance	**29**	(308)	733
Bank owned life insurance	**(83)**	(73)	(71)
Other, net increase (decrease)	**21**	22	24
Income tax (benefit) expense	**$ 41**	$ (89)	$ 504

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below:

	December 31	
(Dollars in thousands)	**2006**	**2005**
Deferred tax assets:		
Allowance for credit losses	**$ 1,437**	$ 1,503
Unrealized losses on securities available for sale	**398**	512
Unrealized loss on pension obiligation	**288**	384
AMT credit carryforward	**381**	239
Low income housing tax credit carryforward	**407**	314
Capital loss disallowance	**454**	425
Unvested stock awards	**76**	31
Deferred gain on sale / leaseback on buildings	**214**	270
Deferred compensation (SERP)	**38**	—
Non accrued interest	**146**	87
Charitable contributions carryover	**48**	—
Joint venture difference	**59**	43
Total gross deferred tax assets	**3,946**	3,808
Deferred tax liabilities:		
Depreciation	**(272)**	(333)
Pension expense	**(293)**	(327)
Tax bad debt reserve	**(167)**	(142)
Bank shares tax credit	**(68)**	(68)
Prepaid expenses	**(193)**	(187)
Total gross deferred tax liabilities	**(993)**	(1,057)
Valuation allowance	**(454)**	(425)
Net deferred tax asset	**$ 2,499**	$ 2,326

In 2004, DNB recorded a valuation allowance of $733,000. The valuation allowance relates to the $2,283,968 other-than-temporary impairment write-down of preferred stock, which DNB believed was not more likely than not to be realized. Based upon DNB's current tax history and the anticipated level of future taxable income, management believed the remaining net deferred tax asset would, more likely than not, be realized.

With regards to the previously recorded valuation allowance, DNB recognized a pre-tax other-than-temporary impairment charge during 2004 totaling $2.3 million or 24% of the book value on four agency preferred stock issues totaling $9.98 million. The other-than-temporary impairment charges were recognized due to the negative impact on the market value of these securities caused by the ongoing accounting, management, and regulatory oversight issues confronting Fannie Mae and Freddie Mac.

DNB was required to recognize other-than-temporary impairment under guidance provided by the Financial Accounting Standards Board (FASB115) and the Securities and Exchange Commission (SEC). The perpetual preferred agency securities that DNB owned at December 31, 2004 (preferred stock) were "Capital Assets" as defined under Internal Revenue Code (IRC) Section 1221. In general, when the preferred stock securities would be sold or disposed of, any net gain or loss on such securities would generate a capital gain or capital loss. It was anticipated that the sale of the preferred stock securities would give rise to a realized capital loss for income tax purposes. Realized capital losses can only be used to offset capital gain income and not ordinary taxable income from operations (IRC Section 1211(a). To the extent a corporate taxpayer is unable to utilize a net realized capital loss, such losses can be carried forward to each of the 5 taxable years succeeding such loss year (IRC Section 1212(a)(1)(B)). If unutilized after 5 taxable years, such capital losses will expire unused. Neither DNB, nor its wholly owned subsidiary DNB First, National Association, had a history of generating such capital gains within the past 3 tax years, nor did the management of DNB anticipate that it would generate such capital gains within five (5) years of the anticipated sale of these securities. When the impairment charge was recognized, DNB contemplated selling some or all of these securities during 2005. The 5 year period to recover the capital loss would start when these securities were sold. At December 31, 2004, DNB did not anticipate recognizing gains from the sale of any capital assets that it may have held as of this date (including these preferred stock securities) during the next 5 - 6 years. As a result, management determined that it was more likely than not that the income tax benefits associated with the above impairment write down would not be realizable and accordingly recorded a valuation allowance for deferred tax asset in the amount of $733,000.

During 2005, DNB reversed a portion of the previously recorded valuation allowance for deferred tax assets and recognized a related income tax benefit of $308,000. A significant portion of the reversal was associated with a tax capital gain recognized on the sale of two operations buildings, as well as an additional reversal made in connection with the sale of agency preferred securities, both of which are considered "Capital Assets" as defined under Internal Revenue Code (IRC) Section 1221.

During 2006, DNB increased the valuation allowance for federal tax assets by $25,000 related to additional capital loss tax benefits that management believes will not be realized.

During 2006, DNB recorded an income tax benefit of $25,000 relating to the exercise of stock options by employees and directors. This benefit was credited to surplus. In addition, DNB had AMT and low-income housing tax credit (LIHC) carryforwards, as of December 31, 2006, of $381,000 and $407,000, respectively. The AMT credit carryforward has an indefinite life. The LIHC carryforward has a life of twenty years and will expire in the year 2023, if not used. DNB also has a charitable contribution carryover of $141,000 at December 31, 2006, which will expire on December 31, 2011 if not utilized.

(12) EARNINGS PER SHARE

Basic earnings per share ("EPS") is computed based on the weighted average number of common shares outstanding during the period. Diluted EPS reflects the potential dilution that could occur from the exercise of stock options and is computed using the treasury stock method. The difference between basic and diluted EPS, for DNB, is attributable to stock options and unvested stock. Stock options and unvested stock awards for which the exercise or the grant price exceeds the average market price over the period have an anti-dilutive effect on EPS and, accordingly, are excluded from the calculation. At December 31, 2006, there were 115,202 anti-dilutive stock options outstanding as well as 13,528 anti-dilutive stock awards. At December 31, 2005, there were 90,000 anti-dilutive stock options outstanding and 16,884 anti-dilutive stock awards and at December 31, 2004 there were 41,500 anti-dilutive stock options outstanding. EPS, dividends per share, and weighted average shares outstanding have been adjusted to reflect the effect of the 5% stock dividend paid in December 2006. The dilutive effect of stock options on basic earnings per share is presented below.

	Year Ended December 31								
	2006			2005			2004		
(In thousands, except share data)	**Income**	**Shares**	**Amount**	**Income**	**Shares**	**Amount**	**Income**	**Shares**	**Amount**
Basic EPS									
Income available to common stockholders	**$ 1,747**	**2,500**	**$ 0.70**	$ 2,148	2,221	$ 0.97	$ 298	2,183	$ 0.13
Diluted EPS									
Effect of dilutive common stock options	—	**18**	**(.01)**	—	28	(.01)	—	35	—
Income available to common stockholders	**$ 1,747**	**2,518**	**$ 0.69**	$ 2,148	2,249	$ 0.96	$ 298	2,218	$ 0.13

(13) OTHER COMPREHENSIVE (LOSS) -INCOME

The tax effects allocated to each component of "Other Comprehensive (Loss) Income" are as follows:

(Dollars in thousands)	**Before-Tax Amount**	**Tax Benefit (Expense)**	**Net-of-Tax Amount**
Year Ended December 31, 2006:			
Unrealized losses on securities:			
Unrealized holding gains arising during the period	**$ 348**	$ (118)	**$** 230
Less reclassification for gains included in net income	**(13)**	5	(8)
Other Comprehensive Income	**$ 335**	$ (113)	**$** 222
Year Ended December 31, 2005:			
Unrealized losses on securities:			
Unrealized holding losses arising during the period	$ **(2,071)**	$ 699	$ (1,372)
Less reclassification for losses included in net income	**662**	(225)	437
Unrealized actuarial losses - pension	**(1,129)**	384	(745)
Other Comprehensive Loss	$ **(2,538)**	$ 858	$ (1,680)
Year Ended December 31, 2004:			
Unrealized losses on securities:			
Unrealized holding gains arising during the period	$ **1,497**	$ (508)	$ 989
Reclass for other-than-temporary impairment charge	**(1,347)**	458	(889)
Less reclassification for losses included in net income	**16**	(5)	11
Other Comprehensive Income	$ **134**	$ (45)	$ 89

(14) BENEFIT PLANS

Pension Plan

The Bank maintains a defined benefit pension plan (the "Plan") covering all employees, including officers, who have been employed for one year and have attained 21 years of age. Prior to May 1, 1985, an individual must have attained the age of 25 and accrued one year of service. The Plan provides pension benefits to eligible retired employees at 65 years of age equal to 1.5% of their average monthly pay multiplied by their years of accredited service (maximum 40 years). The accrued benefit is based on the monthly average of their highest five consecutive years of their last ten years of service. The Plan generally covers only full-time employees.

Effective December 31, 2003, DNB amended its Plan so that no participants will earn additional benefits under the Plan after December 31, 2003. As a result of this amendment, no further service or compensation will be credited under the Plan after December 31, 2003. The Plan, although frozen, will continue to provide benefit payments and employees can still earn vesting credits until retirement.

The following table sets forth the Plan's funded status, as of the measurement dates of December 31, 2006 and 2005 and amounts recognized in DNB's consolidated financial statements at December 31, 2006 and 2005:

	December 31	
(Dollars in thousands)	**2006**	**2005**
Projected Benefit obligation	$ **(6,850)**	$ (6,641)
Accumulated benefit obligation	**(6,850)**	(6,641)
Fair value of plan assets	**6,866**	6,475
Amounts recognized in the statement of financial position consist of:		
Assets	**16**	963
Liabilities	**—**	1,129
Funded status	**$ 16**	$ (166)
Amounts recognized in accumulated other comprehensive income consist of:		
Net loss	**847**	1,129
Net transition obligation (asset)	**—**	—
Total	**$ 847**	$ 1,129

The amounts and changes in DNB's pension benefit obligation and fair value of plan assets for the year ended December 31, 2006 are as follows:

	Year ended December 31	
(Dollars in thousands)	**2006**	**2005**
Change in benefit obligation		
Benefit obligation at beginning of year	**$ 6,641**	$ 6,362
Interest cost	**383**	391
Actuarial loss	**213**	349
Benefits paid	**(387)**	(461)
Benefit obligation at end of year	**$ 6,850**	$ 6,641
Change in plan assets		
Fair value of assets at beginning of year	**$ 6,475**	$ 6,552
Actual return on plan assets	**778**	384
Employer contribution	**—**	—
Benefits paid	**(387)**	(461)
Fair value of assets at end of year	**$ 6,866**	$ 6,475

The Plan's assets are invested using an asset allocation strategy in units of certain equity, bond, real estate and money market funds.

Net periodic pension costs for the years indicated include the following components:

	Year Ended December 31		
(Dollars in thousands)	**2006**	2005	2004
Service cost	**$ 16**	$ 21	$ 21
Interest cost	**383**	391	372
Expected return on plan assets	**(409)**	(414)	(402)
Amortization of transition asset	**—**	(1)	(19)
Recognized net actuarial loss	**111**	98	47
Net periodic cost	**$ 101**	$ 95	$ 19
Assumptions used:			
Discount rate	**5.75%**	5.75%	6.00%
Rate of increase in compensation level	**N/A**	N/A	N/A
Expected long-term rate of return on assets	**6.50**	6.50	7.00

DNB's estimated future benefit payments are as follows:

(Dollars in thousands)	**Benefits**
2007	$ 387
2008	386
2009	400
2010	401
2011	380
2012-2016	2,102

On November 24, 1999, the Bank and Henry F. Thorne, its then current Chief Executive Officer (the "Executive"), entered into a Death Benefit Agreement providing for supplemental death and retirement benefits for him (the "Supplemental Plan"). The Supplemental Plan provided that the Bank and the Executive share in the rights to the cash surrender value and death benefits of a split-dollar life insurance policy (the "Policy") and provided for additional compensation to the Executive, equal to any income tax consequences related to the Supplemental Plan until retirement. The Policy is designed to provide the Executive, upon attaining age 65, with projected annual after-tax distributions of approximately $35,000, funded by loans against the cash surrender value of the Policy. In addition, the Policy is intended to provide the Executive with a projected death benefit of $750,000. Neither the insurance company nor the Bank guaranteed any minimum cash value under the Supplemental Plan.

On December 23, 2003, the Supplemental Plan was replaced by a Retirement and Death Benefit Agreement (the "Replacement Plan"). Pursuant to the Replacement Plan, ownership of the Policy was transferred to the Bank to comply with certain Federal income tax law changes, and the Bank may establish a trust for the purpose of funding the benefits to be provided under the Replacement Plan, or the Bank's obligations under the Replacement Plan and similar agreements or plans which it may enter into or establish for the benefit of the Executive, other employees of the Bank, or both.

The Replacement Plan provides that if the Executive remains employed continuously by the Bank until age 65, he shall, upon his termination of employment for any reason other than Cause, receive an annual retirement benefit of $34,915, payable monthly, from the date of his termination of employment until his death. If Executive's employment with the Bank terminates prior to age 65 for any reason other than Cause, he will be entitled to an annual retirement benefit payable monthly commencing the month after he reaches age 65 until his death, but in this event his annual retirement benefit will be equal to that proportion of the $34,915 annual benefit his actual years of service with the

Bank bears to the years of service he would have completed had he remained employed continuously by the Bank until age 65. In either case, he will also be entitled to receive monthly a tax allowance calculated, subject to certain assumptions, to substantially compensate him for his federal and state income, employment and excise tax liabilities attributable to the retirement benefit and the tax allowance.

Supplemental Executive Retirement Plan for Chairman and Chief Executive Officer

On December 20, 2006, the Board of Directors of DNB Financial Corporation approved a Supplemental Executive Retirement Plan (also known as a SERP) for its Chairman and Chief Executive Officer, William S. Latoff. The purpose of the SERP is to provide Mr. Latoff a pension supplement beginning at age 70 for 10 years in approximately equal amounts each year and to compensate him for the loss of retirement plan funding opportunities from his other business interests because of his commitments to DNB as Chairman and CEO. Mr. Latoff was age 55 when DNB hired him as Chairman and CEO. Pursuant to the SERP, DNB proposes to make annual contributions of $70,000 prior to December 31 each year, commencing in 2006, until 2018, the year in which Mr. Latoff turns age 70, for a total of 13 installments. These contributions will be funded under a Trust Agreement (also known as a rabbi trust) between DNB Financial Corporation, as grantor, and its wholly owned subsidiary DNB First, National Association, as trustee, which was also approved by the Board of Directors of DNB Financial Corporation on December 20, 2006.

401(k) Retirement Savings Plan

During the fourth quarter of 1994, the Bank adopted a retirement savings plan intended to comply with Section 40l(k) of the Internal Revenue Code of 1986. Prior to January 1, 2004, employees became eligible to participate after 6 months of service, and would thereafter participate in the 401(k) plan for any year in which they have been employed by the Bank for at least 501 hours. Effective January 1, 2004, employees were eligible to participate in the plan immediately after hire and regardless of the hours they were employed in any year. Effective July 1, 2005 all employees, with the exception of on-call employees, were eligible to participate in the plan immediately after hire and regardless of the hours they were employed in any year. In general, amounts held in a participant’s account are not distributable until the participant terminates employment with the Bank, reaches age 59½, dies or becomes permanently disabled.

Participants are permitted to authorize pre-tax savings contributions, and beginning July 1, 2006, after-tax contributions, to a separate trust established under the 401(k) plan, subject to limitations on deductibility of contributions imposed by the Internal Revenue Code. The Bank makes matching contributions of $.25 for every dollar of deferred salary, up to 6% of each participant’s annual compensation. Each participant is 100% vested at all times in employee and employer contributions. The Corporation’s matching contributions to the 40l(k) plan was $94,000, $81,000 and $66,000 in 2006, 2005 and 2004, respectively.

Profit Sharing Plan

The Bank initiated a Profit Sharing Plan for eligible employees in 2004. Under the plan, employees are immediately eligible for benefits and will be 100% vested after 3 years of service. In order to receive the profit sharing contribution an employee must be employed on the last day of each plan year to participate in benefits. The plan provides that the Bank will make contributions beginning in 2005 for the 2004 plan year equal to 3% of the eligible participant’s W-2 wages.

Safe Harbor Contribution - Beginning January 1, 2005, the Bank adopted a safe harbor plan, which requires a 3% qualified non-elective contribution to be made to any employee with wages in the current year. Vesting is 100% at all times.

DNB’s related expense associated with the Profit Sharing Plan was $252,000, $187,000 and $178,000 in 2006, 2005 and 2004, respectively.

Stock Option Plan

DNB has a Stock Option Plan for employees and directors. Under the plan, options (both qualified and non-qualified) to purchase a maximum of 612,732 shares of DNB’s common stock could be issued to employees and directors.

Under the plan, option exercise prices must equal the fair market value of the shares on the date of option grant and the option exercise period may not exceed ten years. Vesting of options under the plan is determined by the Plan Committee. There were 112,763, 86,526 and 210,395 shares available for grant at December 31, 2006, 2005 and 2004, respectively.

The per share weighted-average fair value of stock options granted during 2005 and 2004 was $6.87 and $7.52 on the date of grant using the Black-Scholes option valuation model with the following weighted-average assumptions used for grants for the years ended December 31:

	Year Ended December 31	
(Dollars in thousands)	**2005**	**2004**
Dividend yield	1.99%	2.05%
Expected volatility	25.05	25.13
Risk-free interest rate	4.45	4.21
Expected lives (in years)	10.00	10.00

Stock option activity is indicated below. Stock options have been adjusted for the 5% stock dividends in December of 2006, 2005 and 2004.

	Number Outstanding	**Weighted Average Exercise Price**
Outstanding January 1, 2004	180,857	$ 16.69
Granted	45,754	23.92
Exercised	(33,077)	14.16
Forfeited	(1,806)	22.68
Outstanding December 31, 2004	191,729	18.80
Granted	126,079	21.16
Exercised	(12,100)	13.24
Forfeited	(2,209)	23.89
Outstanding December 31, 2005	303,498	19.96
Granted	—	—
Exercised	(7,005)	9.59
Forfeited	(26,236)	21.41
Outstanding December 31, 2006	**270,258**	**$ 20.09**

The weighted-average price and weighted average remaining contractual life for the outstanding options are listed below for the dates indicated. All outstanding options are exercisable.

		December 31, 2006	
		Weighted Average	
Range of Exercise Prices	**Number** Outstanding	**Exercise Price**	**Remaining Contractual Life**
8.00-10.99	10,764	9.69	3.50 years
11.00-13.99	16,388	11.96	3.12 years
14.00-19.99	127,903	18.30	6.98 years
20.00-23.99	69,449	23.36	5.43 years
24.00-25.49	45,754	25.49	8.30 years

Total	**270,258**	**$**	**20.09**	**6.43 years**

Stock-Based Compensation

DNB maintains an Incentive Equity and Deferred Compensation Plan. The plan provides that up to 231,525 (as adjusted for subsequent stock dividends) shares of common stock may be granted, at the discretion of the Board, to individuals of the Company. During 2006 and 2005, DNB granted 0 and 18,390 shares of unvested stock, issuable on the earlier of three years after the date of the grant or a change in control of DNB if the recipients are then employed by DNB ("Vest Date"). Upon issuance of the shares, resale of the shares is unvested for an additional two years, during which the shares may not be sold, pledged or otherwise disposed of. Prior to the Vest Date and in the event the recipient terminates association with DNB for reasons other than death, disability or change in control, the recipient forfeits all rights to the shares that would otherwise be issued under the grant. Share awards granted by the plan were recorded at the date of award based on the market value of shares. Awards are being amortized to expense over the three-year cliff-vesting period. During this three-year period, DNB records compensation expense equal to the value of the shares being amortized. For the year ended December 31, 2006 and 2005, $133,000 and $92,000, respectively was amortized to expense. At December 31, 2006 and 2005, 218,659 and 213,797 shares were reserved for future grants under the plan. There were no shares granted prior to 2005.

Stock grant activity is indicated below. The shares have been adjusted for the 5% stock dividends in December 2005 and 2006.

	Shares
Outstanding - January 1, 2005	¾
Granted	18,390
Forfeited	(662)
Outstanding - December 31, 2005	**17,728**
Granted	¾
Forfeited	(4,862)
Outstanding - December 31, 2006	**12,866**

(15) COMMITMENTS, CONTINGENT LIABILITIES AND OFF-BALANCE-SHEET RISK

In the normal course of business, various commitments and contingent liabilities are outstanding, such as guarantees and commitments to extend credit, borrow money or act in a fiduciary capacity, which are not reflected in the consolidated financial statements. Management does not anticipate any significant losses as a result of these commitments.

DNB had outstanding stand-by letters of credit in the amount of approximately $7.6 million and un-funded loan and lines of credit totaling $62.1 million at December 31, 2006, of which, $66.8 million was variable rate and $2.9 million was fixed rate.

These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet. The exposure to credit loss in the event of nonperformance by the party to the financial instrument for commitments to extend credit and stand-by letters of credit is represented by the contractual amount. Management uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Stand-by letters of credit are conditional commitments issued by DNB to guarantee the performance or repayment of a financial obligation of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risks involved in issuing letters of credit are essentially the same as those involved in extending loan facilities to customers. DNB holds various collateral to support these commitments.

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. DNB evaluates each customer’s creditworthiness on a case-by-case -basis. The amount of collateral, if any, obtained upon the extension of credit, usually consists of real estate, but may include securities, property or other assets.

DNB maintains borrowing arrangements with a correspondent bank and the FHLB of Pittsburgh, as well as access to the discount window at the Federal Reserve Bank of Philadelphia to meet short-term liquidity needs. Through these relationships, DNB has available credit of approximately $127.0 million.

Approximately $96.8 million of assets are held by DNB Advisors in a fiduciary or agency -capacity. These assets are not assets of DNB, and are not included in the consolidated financial statements.

DNB is a party to a number of lawsuits arising in the ordinary course of business. While any litigation causes an element of uncertainty, management is of the opinion that the liability, if any, resulting from the actions, will not have a material effect on the accompanying financial statements.

(16) PARENT COMPANY FINANCIAL INFORMATION

Condensed financial information of DNB Financial Corporation (parent company only) follows:

Condensed Statements of Financial Condition

(Dollars in thousands)	December 31	
	2006	**2005**
Assets		
Cash	**$ 165**	**$ 299**
Investment securities	**38**	**37**
Investment in subsidiary	**40,725**	**39,489**
Other assets	**156**	**156**
Total assets	**$ 41,084**	**$ 39,981**
Liabilities and Stockholders' Equity		
Liabilities		
Junior subordinated debentures	**$ 9,279**	**$ 9,279**
Other liabilities	**394**	**516**
Total liabilities	**9,673**	**9,795**
Stockholders' Equity	**31,411**	**30,186**
Total liabilities and stockholders' equity	**$ 41,084**	**$ 39,981**

Condensed Statements of Operations

(Dollars in thousands)	Year Ended December 31		
	2006	**2005**	**2004**
Income:			
Equity in undistributed income (loss) of subsidiary	**$ 1,221**	$ 1,638	$ (412)
Dividends from subsidiary	**1,240**	1,071	990
Total Income	**2,461**	2,709	578
Expenses:			
Interest expense	**714**	561	277
Other expenses	—	—	3
Total expense	**714**	561	280
Net income	**$ 1,747**	$ 2,148	$ 298

Condensed Statements of Cash Flows

(Dollars in thousands)	Year Ended December 31		
	2006	**2005**	**2004**
Cash Flows From Operating Activities:			
Net income	**$ 1,747**	$ 2,148	$ 298
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed (income) loss of subsidiary	**(1,221)**	(1,638)	412
Unvested stock amortization	**132**	91	—
Net change in other liabilities	**11**	40	307
Net change in other assets	**1**	6	9
Net Cash Provided by Operating Activities	**670**	647	1,026
Cash Flows From Investing Activities:			
Payments for investments in and advances to subsidiaries	**258**	(9,672)	—
Sale or repayment of investments in and advances to subsidiaries	**3**	33	—
Purchase of available for sale security	**(1)**	(37)	—
Sales and maturities of available for sale security	—	—	1,225
Net Cash Provided (Used) by Investing Activities	**260**	(9,676)	1,225
Cash Flows From Financing Activities:			
Proceeds from advances from subsidiaries	**—**	4,124	—
Proceeds from issuance of common stock	**485**	5,965	346
Purchase of treasury stock	**(310)**	(5)	(1,391)
Dividends paid	**(1,239)**	(1,071)	(990)
Net Cash (Used) Provided by Financing Activities	**(1,064)**	9,013	(2,035)
Net Change in Cash and Cash Equivalents	**(134)**	(16)	216
Cash at Beginning of Period	**299**	315	99
Cash at End of Period	**$ 165**	$ 299	$ 315

(17) REGULATORY MATTERS

Dividends payable to the Corporation by the Bank are subject to certain regulatory limitations. Under normal circumstances, the payment of dividends in any year without regulatory permission is limited to the net profits (as defined for regulatory purposes) for that year, plus the retained net profits for the preceding two calendar years, which amounted to $1.9 million for the year ended December 31, 2006.

Federal banking agencies impose three minimum capital requirements — Total risk-based, Tier 1 and Leverage capital. The risk-based capital ratios measure the adequacy of a bank's capital against the riskiness of its assets and off-balance sheet activities. Failure to maintain adequate capital is a basis for "prompt corrective action" or other regulatory enforcement action. In assessing a bank's capital adequacy, regulators also consider other factors such as interest rate risk exposure; liquidity, funding and market risks; quality and level of earnings; concentrations of credit, quality of loans and investments; risks of any nontraditional activities; effectiveness of bank policies; and management's overall ability to monitor and control risks.

Quantitative measures established by regulation to ensure capital adequacy require DNB to maintain certain minimum amounts and ratios as set forth below. Management believes that DNB and the Bank meet all capital adequacy requirements to which they are subject. The Bank is considered "Well Capitalized" under the regulatory framework for prompt corrective action. To be categorized as Well Capitalized, the Bank must maintain minimum ratios as set forth below. There are no conditions or events since the most recent regulatory notification that management believes would have changed the Bank's category. Actual capital amounts and ratios are presented below.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
(Dollars in thousands)	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
DNB Financial Corporation						
December 31, 2006:						
Total risk-based capital	**$ 45,682**	**13.29%**	**$ 27,504**	**8.00%**	**$ 34,380**	**10.00%**
Tier 1 capital	**41,384**	**12.04**	**13,752**	**4.00**	**20,628**	**6.00**
Tier 1 (leverage) capital	**41,384**	**8.28**	**19,987**	**4.00**	**24,984**	**5.00**
December 31, 2005:						
Total risk-based capital	$ 43,752	13.77%	$ 25,422	8.00%	$ 31,778	10.00%
Tier 1 capital	39,773	12.52	12,711	4.00	19,067	6.00
Tier 1 (leverage) capital	39,773	8.61	18,468	4.00	23,085	5.00
DNB First, N.A.						
December 31, 2006:						
Total risk-based capital	**$ 45,708**	**13.32%**	**$ 27,451**	**8.00%**	**$ 34,314**	**10.00%**
Tier 1 capital	**41,419**	**12.07**	**13,725**	**4.00**	**20,588**	**6.00**
Tier 1 (leverage) capital	**41,419**	**8.30**	**19,966**	**4.00**	**24,958**	**5.00**
December 31, 2005:						
Total risk-based capital	$ 43,770	13.79%	$ 25,389	8.00%	$ 31,736	10.00%
Tier 1 capital	39,797	12.54	12,695	4.00	19,042	6.00
Tier 1 (leverage) capital	39,797	8.63	18,450	4.00	23,063	5.00

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
DNB Financial Corporation:

We have audited the accompanying consolidated statements of financial condition of DNB Financial Corporation and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of DNB Financial Corporation and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in note 1 to the consolidated financial statements, the Corporation adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, *a revision of FASB Statement No. 123*, *Accounting for Stock-Based Compensation*, effective January 1, 2006.

Philadelphia, Pennsylvania
March 20, 2007

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 9a. Controls and Procedures

DNB's Chief Executive Officer and Chief Financial Officer have reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of December 31, 2006, the end of the period covered by this report, in accordance with the requirements of Exchange Act Rule 240.13a-15(b). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that DNB's current disclosure controls and procedures are effective and timely, providing them with material information relating to DNB and its subsidiaries required to be disclosed in the report DNB files under the Exchange Act.

Item 9b. Other Information

None

Part III

Item 10. Directors and Executive Officers of the Registrant

The information required herein with respect to Registrant's directors and officers is incorporated by reference to pages 4-7, 13-14 and 21-23 of the Registrant's Proxy Statement for the 2007 Annual Meeting of Stockholders, and the information required herein with respect to compliance with Section 16(a) of the Securities Exchange Act of 1934 is incorporated by reference to page 6 of the Registrant's Proxy Statement for the Annual Meeting of Stockholders. The Registrant has adopted a Code of Ethics that applies to the Registrant's principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions. The Registrant's current Code of Ethics is incorporated herein by reference as Exhibit 14 to this report.

Item 11. Executive Compensation

The information required herein is incorporated by reference to pages 7-32 of the Registrant's Proxy Statement for the 2007 Annual Meeting of Stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

(a) Information Regarding Equity Compensation Plans

The following table summarizes certain information relating to equity compensation plans maintained by the Registrant as of December 31, 2006:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in first column)
Equity compensation plans approved by security holders:			
1995 Stock Option Plan	270,258	$20.09	112,763
2004 Incentive Equity and Deferred Compensation Plan	12,866	N/A	218,659
Equity compensation plans not approved by security holders	¾	¾	¾
Total	283,124	N/A	331,422

(b) The balance of the information required herein is incorporated by reference to page 2 of the Registrant's Proxy Statement for the 2007 Annual Meeting of Stockholders.

Item 13. Certain Relationships and Related Transactions

The information required herein is incorporated by reference to pages 31-32 of the Registrant's Proxy Statement for the 2007 Annual Meeting of Stockholders.

Item 14. Principal Accountant Fees and Services

The information required herein is incorporated by reference to page 33 of the Registrant's Proxy Statement for the 2007 Annual Meeting of Stockholders.

Part IV

Item 15. Exhibits, Financial Statement Schedules.

(a)(1) Financial Statements.

The consolidated financial statements listed below, together with an opinion of KPMG LLP dated March 20, 2007 with respect thereto, are set forth beginning at page 48 of this report under Item 8, “Financial Statements and Supplementary Data.”

DNB Financial Corporation and Subsidiaries:

Report of Independent Registered Public Accounting Firm
Consolidated Statements of Financial Condition
Consolidated Statements of Operations
Consolidated Statements of Stockholder’s Equity and Comprehensive Income
Consolidated Statements of Cash Flows
Notes to Consolidated Financial Statements
Selected Quarterly Financial Data (Unaudited)

(a)(2) Not applicable

(a)(3) Exhibits, pursuant to Item 601 of Regulation S-K.

The exhibits listed on the Index to Exhibits on pages 82 - 84 of this report are incorporated by reference or filed or furnished herewith in response to this Item.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DNB FINANCIAL CORPORATION

March 26, 2007

BY: /s/ William S. Latoff
William S. Latoff, Chairman of the Board and Chief Executive Officer

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

/s/ William J. Hieb William Hieb, President and Chief Operating Officer	March 26, 2007
/s/ Gerald F. Sopp Gerald F. Sopp Chief Financial Officer (Principal Accounting Officer)	March 26, 2007
/s/ Thomas A. Fillippo Thomas A. Fillippo Director	March 26, 2007
/s/ Mildred C. Joyner Mildred C. Joyner Director	March 26, 2007
/s/ James J. Koegel James J. Koegel Director	March 26, 2007
/s/ Eli Silberman Eli Silberman Director	March 26, 2007
/s/ James H. Thornton James H. Thornton Vice-Chairman of the Board	March 23, 2007

81

Index to Exhibits

Exhibit No. Under Item 601 of Regulation S-K		Description of Exhibit and Filing Information
3	(i)	Amended and Restated Articles of Incorporation, as amended effective June 15, 2001, filed on August 14, 2001, as Item 6(a) to Form 10Q (No. 0-16667) and incorporated herein by reference.
	(ii)	By-laws of the Registrant as amended December 19, 2001, filed on March 24, 2002 at Item 3b to Form 10-K for the fiscal year ended December 31, 2001 (No. 0-16667) and incorporated herein by reference.
4		Registrant has certain debt obligations outstanding, for none of which do the instruments defining holders rights authorize an amount of securities in excess of 10% of the total assets of the Registrant and its subsidiaries on a consolidated basis. Registrant agrees to furnish copies of such agreements to the Commission on request.
10	(a)*	Amended and Restated Change of Control Agreements dated December 20, 2006 between DNB Financial Corporation and DNB First, N.A. and the following executive officers, each in the form filed herewith: Ronald K. Dankanich, Bruce E. Moroney, C. Tomlinson Kline III, and Richard J. Hartmann.
	(b)**	1995 Stock Option Plan of DNB Financial Corporation (as amended and restated, effective as of April 27, 2004), filed on March 29, 2004 as Appendix A to Registrant's Proxy Statement for its Annual Meeting of Stockholders held April 27, 2004, and incorporated herein by reference.
	(c)*	Form of Change of Control Agreements, as amended November 10, 2003, filed on November 14, 2003 as Item 10(e) to Form 8-K (No. 0-16667) and incorporated herein by reference between DNB Financial Corporation and DNB First, N.A. and each of the following Directors: (i) dated November 10, 2005 with James H. Thornton, James J. Koegel and Eli Silberman, and (ii) dated February 23, 2005 with Mildred C. Joyner, and dated February 22, 2006 with Thomas Fillippo.
	(d)***	DNB Financial Corp. Incentive Equity and Deferred Compensation Plan, filed March 10, 2005 as item 10(i) to Form 10-K for the fiscal year-ended December 31, 2004 (No. 0-16667) and incorporated herein by reference.
	(e)*	Amended and Restated Change of Control Agreement among DNB Financial Corporation, DNB First, N.A. and William S. Latoff, dated December 20, 2006, filed herewith.
	(f)*	Agreement of Lease dated February 10, 2005 between Headwaters Associates, a Pennsylvania general partnership, as Lessor, and DNB First, National Association as Lessee for a portion of premises at 2 North Church Street, West Chester, Pennsylvania, filed March 10, 2005 as Item 10(l) to Form 10-K for the fiscal year ended December 31, 2004 (No. 0-16667) and incorporated herein by reference, as amended by Addendum to Agreement of Lease dated as of November 15, 2005, filed March 23, 2006 as Item 10(l) to Form 10-K for the fiscal year ended December 31, 2005 (No. 0-16667) and incorporated herein by

reference, and as further amended by Second Addendum to Agreement of Lease dated as of May 25, 2006, filed August 14, 2006 as Item 10(l) to Form 10-Q for the fiscal quarter ended June 30, 2006 (No. 0-16667) and incorporated herein by reference.

(g) Marketing Services Agreement between TSG, INC., a Pennsylvania business corporation (the "Service Provider") for which Eli Silberman, a Director of Registrant, is the President and owner dated March 14, 2006, filed May 10, 2006 as Item 10(m) to Form 10-Q for the fiscal quarter ended March 31, 2006 (No. 0-16667) and incorporated herein by reference.

(h)** Form of Stock Option Agreement for grants prior to 2005 under the Registrant's Stock Option Plan, filed May 11, 2005 as Item 10(n) to Form 10-Q for the fiscal quarter ended March 31, 2005 (No. 0-16667) and incorporated herein by reference.

(i)** Form of Nonqualified Stock Option Agreement for April 18, 2005 and subsequent grants under the Stock Option Plan, filed May 11, 2005 as Item 10(o) to Form 10-Q for the fiscal quarter ended March 31, 2005 (No. 0-16667) and incorporated herein by reference.

(j) Agreement of Sale dated June 1, 2005 between DNB First, National Association (the "Bank"), as seller, and Papermill Brandywine Company, LLC, a Pennsylvania limited liability company, as buyer ("Buyer") with respect to the sale of the Bank's operations center and an adjunct administrative office (the "Property") and accompanying (i) Agreement of Lease between the Buyer as landlord and the Bank as tenant, pursuant to which the Property will be leased back to the Bank, and (ii) Parking Easement Agreement to provide cross easements with respect to the Property, the Buyer's other adjoining property and the Bank's other adjoining property, filed August 15, 2005 as Item 10(p) to Form 10-Q for the fiscal quarter ended June 30, 2005 (No. 0-16667) and incorporated herein by reference.

(k) Agreement of Lease dated November 18, 2005 between Papermill Brandywine Company, LLC, a Pennsylvania limited liability company ("Papermill"), as Lessor, and DNB First, National Association as Lessee for the banks operations center and adjunct administrative office, filed March 23, 2006 as Item 10(q) to Form 10-K for the fiscal year ended December 31, 2005 (No. 0-16667) and incorporated herein by reference.

(l)* Amended and Restated Change of Control Agreement among DNB Financial Corporation, DNB First, N.A. and William J. Hieb, filed herewith.

(m)** Form of Nonqualified Stock Option Agreement for grants on and after December 22, 2005 under the Stock Option Plan, filed March 23, 2006 as Item 10(s) to Form 10-K for the fiscal year ended December 31, 2005 (No. 0-16667) and incorporated herein by reference.

(n)*** Deferred Compensation Plan For Directors of DNB Financial Corporation (adopted effective October 1, 2006), filed November 14, 2006 as Item 10(s) to Form 10-Q for the fiscal quarter ended September 30, 2006 (No. 0-16667) and incorporated herein by reference.

(o)*** DNB Financial Corporation Deferred Compensation Plan (adopted effective October 1, 2006), filed November 14, 2006 as Item 10(t) to Form 10-Q for the fiscal quarter ended September 30, 2006 (No. 0-16667) and incorporated herein by reference.

(p)*** Trust Agreement, effective as of October 1, 2006, between DNB Financial Corporation and DNB First, National Association (Deferred

Compensation Plan), filed November 14, 2006 as Item 10(u) to Form 10-Q for the fiscal quarter ended September 30, 2006 (No. 0-16667) and incorporated herein by reference.

	(q)*	Change of Control Agreements among DNB Financial Corporation, DNB First, N.A. and each of the following executive officers, each in the form filed herewith: Albert J. Melfi, Jr. and Gerald F. Sopp.
	(r)***	DNB Financial Corporation Supplemental Executive Retirement Plan for William J. Latoff, dated as of December 20, 2006, filed herewith.
	(s)***	Trust Agreement effective as of December 20, 2006 between DNB Financial Corporation and DNB First, N.A. (William S. Latoff SERP), filed herewith.
	(t)*	DNB Offer Letter to Albert J. Melfi, Jr., dated November 10, 2006, filed herewith.
	(u)*	DNB Offer Letter to Gerald F. Sopp, dated December 20, 2006, filed herewith.
11		Registrant's Statement of Computation of Earnings Per Share is set forth in Footnote 12 to Registrant's consolidated financial statements at page 67 of this Form 10-K under Item 8, "Financial Statements and Supplementary Data," and is incorporated herein by reference.
21		List of Subsidiaries, filed herewith.
23		Consent of KPMG LLP, filed herewith.
14		Code of Ethics as amended and restated effective February 23, 2005, filed March 10, 2005 as Item 10(m) to Form 10-K for the fiscal year ended December 31, 2004 (No. 0-16667) and incorporated herein by reference.
31.1		Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer, filed herewith.
31.2		Rule 13a-14(a)/15d-14(a)Certification of Chief Financial Officer, filed herewith.
32.1		Section 1350 Certification of Chief Executive Officer, filed herewith.
32.2		Section 1350 Certification of Chief Financial Officer, filed herewith.
	*	Management contract or compensatory plan arrangement.
	**	Shareholder approved compensatory plan pursuant to which the Registrant's Common Stock may be issued to employees of the Corporation.
	***	Non-shareholder approved compensatory plan pursuant to which the Registrant's Common Stock may be issued to employees of the Corporation.

DNB FINANCIAL CORPORATION

CORPORATE HEADQUARTERS
4 Brandywine Avenue
Downingtown, PA 19335
Tel. 610-269-1040 Fax 484-359-3176
Internet http://www.dnbfirst.com

FINANCIAL INFORMATION
Investors, brokers, security analysts and others desiring financial information should contact Gerald F. Sopp at 484-359-3143 or gsopp@dnbfirst.com

AUDITORS
KPMG LLP
1601 Market Street
Philadelphia, PA 19103-2499

COUNSEL
Stradley, Ronon, Stevens and Young, LLP
30 Valley Stream Parkway
Malvern, PA 19355

REGISTRAR AND STOCK TRANSFER AGENT
Registrar and Transfer Company
10 Commerce Drive
Cranford, NJ 07016
800-368-5948

MARKET MAKERS
Boenning & Scattergood, Inc.
800-842-8928
Ferris, Baker Watts, Inc.
877-840-0012
Janney Montgomery Scott, Inc.
800-526-6397
Ryan Beck & Company
800-223-8969

DIRECTORS

William S. Latoff
Chairman and Chief Executive Officer

James H. Thornton
Vice Chairman

Thomas A. Fillippo, Sr.
William J. Hieb
Mildred C. Joyner
James J. Koegel
Eli Silberman

DIRECTORS EMERITUS

Ellis Y. Brown III
Robert J. Charles
I. Newton Evans, Jr.
Thomas R. Greenleaf
Vernon J. Jameson
Ilario S. Polite
Henry F. Thorne

EXECUTIVE OFFICERS

William S. Latoff
Chairman and Chief Executive Officer

William J. Hieb
President and Chief Operating Officer

Ronald K. Dankanich
Executive Vice President
Operations, IT and HR

Richard J. Hartmann
Executive Vice President
Retail Banking and Marketing

Albert J. Melfi, Jr.
Executive Vice President
Chief Lending Officer

Gerald F. Sopp
Executive Vice President
Chief Financial Officer

Bruce E. Moroney
Executive Vice President
Chief Accounting Officer

DNB FIRST, N.A.

DIRECTORS

William S. Latoff
Chairman and Chief Executive Officer

William J. Hieb
President and Chief Operating Officer

Thomas A. Fillippo
Mildred C. Joyner
James J. Koegel
Eli Silberman
James H. Thornton