FIDELITY D & D BANCORP INC
Form 10-Q
November 13, 2007

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

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

**For the quarterly period ended September 30, 2007**

**OR**

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

**For the transition period from to**

**Commission file number: 333-90273**

# FIDELITY D & D BANCORP, INC.

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

Address of principal executive offices:

**BLAKELY & DRINKER ST.**

**DUNMORE, PENNSYLVANIA 18512**

TELEPHONE:

**570-342-8281**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subjected to such filing requirements for the past 90 days.

x YES o NO

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

o YES x NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. at October 31, 2007, the latest practicable date, was 2,072,929 shares.

**FIDELITY D & D BANCORP, INC.**

Form 10-Q September 30, 2007

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**PART I Financial Information**

**Item 1: Financial Statements**

**FIDELITY D & D BANCORP, INC. AND SUBSIDIARY**

Consolidated Balance Sheets

| | | September 30, 2007 (unaudited) | | December 31, 2006 (audited) |
|---|---|---|---|---|
| Assets: | | | | |
| Cash and due from banks | $ | 13,187,169 | $ | 13,732,137 |
| Interest-bearing deposits with financial institutions | | 183,943 | | 68,711 |
| Total cash and cash equivalents | | 13,371,112 | | 13,800,848 |
| Available-for-sale securities | | 120,700,576 | | 98,841,364 |
| Held-to-maturity securities | | 1,196,077 | | 1,569,372 |
| Federal Home Loan Bank Stock | | 3,558,300 | | 3,795,100 |
| Loans and leases, net (allowance for loan losses of $4,990,855 in 2007 and $5,444,303 in 2006) | | 420,790,921 | | 417,199,048 |
| Loans available-for-sale (fair value $388,121 in 2007; $123,156 in 2006) | | 382,000 | | 122,000 |
| Bank premises and equipment, net | | 13,306,479 | | 11,324,465 |
| Cash surrender value of bank owned life insurance | | 8,408,987 | | 8,177,961 |
| Other assets | | 4,399,408 | | 4,788,105 |
| Accrued interest receivable | | 2,880,243 | | 2,502,576 |
| Foreclosed assets held for sale | | 107,036 | | 197,149 |
| Total assets | $ | 589,101,139 | $ | 562,317,988 |
| Liabilities: | | | | |
| Deposits: | | | | |
| Interest-bearing | $ | 368,512,228 | $ | 336,592,620 |
| Non-interest-bearing | | 70,544,329 | | 73,741,975 |
| Total deposits | | 439,056,557 | | 410,334,595 |
| Accrued interest payable and other liabilities | | 4,658,726 | | 4,179,170 |
| Short-term borrowings | | 28,579,498 | | 33,656,150 |
| Long-term debt | | 62,917,875 | | 62,536,210 |
| Total liabilities | | 535,212,656 | | 510,706,125 |
| Shareholders equity: | | | | |
| Preferred stock authorized 5,000,000 shares with no par value; none issued | | | | |
| Capital stock authorized 10,000,000 shares with no par value; issued and outstanding, 2,072,929 shares in 2007 and 2,057,433 shares in 2006 | | 19,214,460 | | 18,702,537 |
| Retained earnings | | 35,851,823 | | 33,874,118 |

| | | | | |
|---|---|---|---|---|
| Accumulated other comprehensive loss | | (1,177,800) | | (964,792) |
| Total shareholders equity | | 53,888,483 | | 51,611,863 |
| Total liabilities and shareholders equity | $ | 589,101,139 | $ | 562,317,988 |

See notes to consolidated financial statements

**FIDELITY D & D BANCORP, INC. AND SUBSIDIARY**

Consolidated Statements of Income

(unaudited)

| | Three Months Ended September 30, 2007 | Three Months Ended September 30, 2006 | Nine Months Ended September 30, 2007 | Nine Months Ended September 30, 2006 |
|---|---|---|---|---|
| Interest income: | | | | |
| Loans and leases: | | | | |
| Taxable | $ 7,223,183 | $ 7,122,621 | $ 21,540,100 | $ 20,500,909 |
| Nontaxable | 122,594 | 104,193 | 350,463 | 357,813 |
| Interest-bearing deposits with financial institutions | 2,190 | 2,045 | 6,911 | 6,821 |
| Investment securities: | | | | |
| U.S. government agency and corporations | 1,093,098 | 918,070 | 3,029,358 | 2,789,335 |
| States and political subdivisions (nontaxable) | 124,922 | 149,611 | 374,273 | 440,929 |
| Other securities | 278,100 | 239,280 | 804,522 | 668,492 |
| Federal funds sold | 48,259 | 58,746 | 102,913 | 94,872 |
| Total interest income | 8,892,346 | 8,594,566 | 26,208,540 | 24,859,171 |
| Interest expense: | | | | |
| Deposits | 3,420,693 | 3,132,402 | 9,977,394 | 8,279,425 |
| Securities sold under repurchase agreements | 124,089 | 177,668 | 355,122 | 476,543 |
| Other short-term borrowings and other | 26,013 | 51,661 | 360,025 | 275,852 |
| Long-term debt | 899,196 | 919,338 | 2,466,898 | 3,018,121 |
| Total interest expense | 4,469,991 | 4,281,069 | 13,159,439 | 12,049,941 |
| Net interest income | 4,422,355 | 4,313,497 | 13,049,101 | 12,809,230 |
| (Credit) provision for loan losses | (60,000) | 75,000 | (60,000) | 325,000 |
| Net interest income after provision for loan losses | 4,482,355 | 4,238,497 | 13,109,101 | 12,484,230 |
| Other income: | | | | |
| Service charges on deposit accounts | 784,847 | 698,839 | 2,179,086 | 1,965,620 |
| Gain (loss) on sale of: | | | | |
| Loans | 52,821 | 20,707 | 120,717 | 62,550 |
| Investment securities | | | | (166) |
| Premises and equipment | 1,248 | (16,334) | 74,881 | (14,774) |
| Leased assets | | | | 15,154 |
| Foreclosed assets held-for-sale | 405 | (4,416) | 143,154 | (3,795) |
| Fees and other service charges | 469,440 | 437,479 | 1,333,700 | 1,324,463 |
| Total other income | 1,308,761 | 1,136,275 | 3,851,538 | 3,349,052 |
| Other expenses: | | | | |
| Salaries and employee benefits | 2,201,532 | 2,078,715 | 6,501,861 | 6,059,586 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Premises and equipment | | 807,978 | | 810,235 | | 2,398,088 | | 2,434,645 |
| Advertising | | 156,848 | | 164,855 | | 499,473 | | 453,132 |
| Other | | 1,022,813 | | 941,959 | | 2,990,345 | | 2,919,300 |
| | | | | | | | | |
| Total other expenses | | 4,189,171 | | 3,995,764 | | 12,389,767 | | 11,866,663 |
| | | | | | | | | |
| Income before provision for income taxes | | 1,601,945 | | 1,379,008 | | 4,570,872 | | 3,966,619 |
| | | | | | | | | |
| Provision for income taxes | | 424,023 | | 349,032 | | 1,189,866 | | 966,392 |
| | | | | | | | | |
| Net income | $ | 1,177,922 | $ | 1,029,976 | $ | 3,381,006 | $ | 3,000,227 |
| | | | | | | | | |
| Per share data: | | | | | | | | |
| Net income - basic | $ | 0.57 | $ | 0.51 | $ | 1.64 | $ | 1.47 |
| Net income - diluted | $ | 0.57 | $ | 0.51 | $ | 1.64 | $ | 1.47 |
| Dividends | $ | 0.24 | $ | 0.22 | $ | 0.68 | $ | 0.66 |

**FIDELITY D & D BANCORP, INC. AND SUBSIDIARY**

Consolidated Statements of Changes in Shareholders Equity

For the nine months ended September 30, 2007 and 2006

| | Capital stock Shares | Capital stock Amount | Retained earnings | Accumulated other comprehensive income (loss) | Total |
|---|---|---|---|---|---|
| Balance, December 31, 2005 (audited) | 1,854,217 | $ 10,594,901 | $ 39,363,461 | $ (1,112,333) | $ 48,846,029 |
| Cumulative effect of change in accounting principle, net of tax | | | (343,717) | | (343,717) |
| Total comprehensive income: | | | | | |
| Net income | | | 3,000,227 | | 3,000,227 |
| Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects | | | | (30,125) | (30,125) |
| Comprehensive income | | | | | 2,970,102 |
| Issuance of common stock through Employee Stock Purchase Plan | 1,571 | 48,151 | | | 48,151 |
| Dividends reinvested through Dividend Reinvestment Plan | 12,023 | 427,003 | | | 427,003 |
| Stock-based compensation expense | | 28,744 | | | 28,744 |
| Cash dividends declared | | | (1,349,656) | | (1,349,656) |
| Stock dividend declared | 185,394 | 7,462,100 | (7,469,548) | | (7,448) |
| Balance, September 30, 2006 (unaudited) | 2,053,205 | $ 18,560,899 | $ 33,200,767 | $ (1,142,458) | $ 50,619,208 |
| Balance, December 31, 2006 (audited) | 2,057,433 | $ 18,702,537 | $ 33,874,118 | $ (964,792) | $ 51,611,863 |
| Total comprehensive income: | | | | | |
| Net income | | | 3,381,006 | | 3,381,006 |
| Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects | | | | (367,665) | (367,665) |
| Change in cash flow hedge intrinsic value | | | | 154,657 | 154,657 |
| Comprehensive income | | | | | 3,167,998 |
| Issuance of common stock through Employee Stock Purchase Plan | 2,266 | 67,820 | | | 67,820 |
| Dividends reinvested through Dividend Reinvestment Plan | 13,230 | 437,145 | | | 437,145 |
| Stock-based compensation expense | | 6,958 | | | 6,958 |
| Cash dividends declared | | | (1,403,301) | | (1,403,301) |
| Balance, September 30, 2007 (unaudited) | 2,072,929 | $ 19,214,460 | $ 35,851,823 | $ (1,177,800) | $ 53,888,483 |

See Notes to Consolidated Financial Statements

**FIDELITY DEPOSIT & DISCOUNT BANCORP, INC. AND SUBSIDIARY**

Consolidated Statements of Cash Flows

(unaudited)

| | Nine Months Ended September 30, 2007 | Nine Months Ended September 30, 2006 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 3,381,006 | $ 3,000,227 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation, amortization and accretion | 929,540 | 1,005,861 |
| (Credit) provision for loan losses | (60,000) | 325,000 |
| Deferred income tax expense (benefit) | 27,890 | (27,073) |
| Stock-based compensation expense | 6,958 | 28,744 |
| Loss from investment in limited partnership | 60,300 | 67,500 |
| Proceeds from sale of loans available-for-sale | 12,121,477 | 8,081,253 |
| Originations of loans available-for-sale | (12,260,760) | (8,011,308) |
| Increase in cash surrender value of life insurance | (231,026) | (213,273) |
| Net gain on sale of loans | (120,717) | (62,550) |
| Net loss on sale of investment securities | | 166 |
| Net (gain) loss on sale of foreclosed assets held-for-sale | (143,154) | 3,795 |
| Net (gain) loss on disposal of premises and equipment | (74,881) | 14,774 |
| Change in: | | |
| Accrued interest receivable | (377,667) | (800,347) |
| Other assets | (102,938) | (185,187) |
| Accrued interest payable and other liabilities | 480,771 | 493,341 |
| Net cash provided by operating activities | 3,636,799 | 3,720,923 |
| Cash flows from investing activities: | | |
| Held-to-maturity securities: | | |
| Proceeds from maturities, calls and principal pay-downs | 372,503 | 274,397 |
| Available-for-sale securities: | | |
| Proceeds from sales | | 1,537,338 |
| Proceeds from maturities, calls and principal pay-downs | 9,784,761 | 16,798,981 |
| Purchases | (31,953,887) | (22,776,489) |
| Net decrease in FHLB stock | 236,800 | 1,368,800 |
| Net increase in loans and leases | (3,883,909) | (7,005,816) |
| Proceeds from sale of premises and equipment | 248,833 | 1,560 |
| Acquisition of bank premises and equipment | (2,584,363) | (1,026,158) |
| Proceeds from sale of foreclosed assets held-for-sale | 584,088 | 55,890 |
| Net cash used in investing activities | (27,195,174) | (10,771,497) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 28,721,962 | 40,231,147 |
| Net decrease in short-term borrowings | (5,076,652) | (5,946,258) |
| Repayments of long-term debt | (19,618,335) | (34,114,126) |
| Proceeds from long-term debt advances | 20,000,000 | 16,000,000 |
| Proceeds from employee stock purchase plan | 67,820 | 48,151 |
| Dividends paid, net of dividends reinvested | (966,156) | (922,653) |
| Cash payments in lieu of fractional shares on stock dividend | | (7,448) |

| | | | | |
|---|---|---|---|---|
| Net cash provided by financing activities | | 23,128,639 | | 15,288,813 |
| Net (decrease) increase in cash and cash equivalents | | (429,736) | | 8,238,239 |
| Cash and cash equivalents, beginning | | 13,800,848 | | 12,594,540 |
| Cash and cash equivalents, ending | $ | 13,371,112 | $ | 20,832,779 |

See notes to consolidated financial statements

**FIDELITY D & D BANCORP, INC.**

**Notes to Consolidated Financial Statements**

**(unaudited)**

## 1. Nature of operations and critical accounting policies

**Nature of operations**

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

**Principles of consolidation**

The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation. Prior period amounts are reclassified when necessary to conform to the current period s presentation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

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

In the opinion of management, the consolidated balance sheets as of September 30, 2007 and December 31, 2006 and the related consolidated statements of income for the three- and nine- month periods ended September 30, 2007 and 2006 and changes in shareholders equity and cash flows for the nine months ended September 30, 2007 and 2006 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company s audited financial statements for the year ended December 31, 2006, and the notes included therein, included within the Company s Annual Report filed on Form 10-K.

**Critical accounting policies**

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

A material estimate that is particularly susceptible to significant change is the determination of the allowance for loan losses (the allowance). Management believes that the allowance, as of September 30, 2007, is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make materially different assumptions, and could, therefore, calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company s allowance. Such agencies may require the Company to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company s investment securities. The Company receives estimated fair values of investment securities from an independent valuation service. In developing these fair values, the valuation service uses estimates of cash flows, based on historical performance of similar instruments in similar interest rate environments. Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, management may obtain price quotes from more than one source. Available-for-sale (AFS) securities are carried at fair value on the consolidated balance sheet, with unrealized gains and losses, net of income tax, reported separately within shareholders equity through accumulated other comprehensive income (loss).

The fair value of residential mortgage loans, classified as AFS, is obtained from the Federal National Mortgage Association or the Pennsylvania Housing Finance Authority. To determine the fair value of student loans, classified as AFS, the Bank uses the pricing obtained from the most recent student loans sold from its AFS portfolio. From time-to-time, the Bank may originate Small Business Administration (SBA) loans AFS. The fair value of SBA loans, classified as AFS, is obtained from an outside pricing source. The market to which the Bank sells mortgage and other loans is restricted and price quotes from other sources are not typically obtained. As of September 30, 2007, the AFS loan portfolio consisted of residential mortgages.

## 2. Earnings per share

Basic earnings per share (EPS) is computed by dividing net income available to common shareholders by the weighted-average number of common stock outstanding for the period. Diluted EPS is computed in the same manner as basic EPS but reflects the potential dilution that could occur if stock options to issue additional common stock were exercised, which would then result in additional stock outstanding to share in or dilute the earnings of the Company. The Company maintains two share-based compensation plans that may generate additional potential dilutive common shares. Generally, dilution would occur if Company-issued stock options were exercised and converted into common stock.

In the computation of diluted EPS, the Company uses the treasury stock method to determine the dilutive effect of its granted but unexercised stock options. Under this method, the assumed proceeds received from shares issued, in a hypothetical stock option exercise, are assumed to be used to purchase treasury stock. Pursuant to the guidance of Statement of Financial Accounting Standard (SFAS) No. 128, *Earnings Per Share,* proceeds include: proceeds from the exercise of outstanding stock options; compensation cost for future service that the Company has not yet recognized; and any windfall tax benefits that would be credited directly to shareholders equity when the grant generates a tax deduction (or a reduction in proceeds if there is a charge to equity). For a further discussion on the Company s stock option plans, see Note 3, below.

The following table illustrates the data used in computing basic EPS and a reconciliation to derive at the components of diluted EPS for the periods indicated:

| **Nine months ended September 30,** | | **2007** | | **2006** |
|---|---|---|---|---|
| Basic EPS: | | | | |
| Net income available to common shareholders | $ | 3,381,006 | $ | 3,007,227 |
| Weighted-average common shares outstanding | | 2,064,578 | | 2,045,872 |
| Basic EPS | $ | 1.64 | $ | 1.47 |
| | | | | |
| Diluted EPS: | | | | |
| Net income available to common shareholders | $ | 3,381,006 | $ | 3,007,227 |
| Weighted-average common shares outstanding | | 2,064,578 | | 2,045,872 |
| Dilutive potential common shares | | 608 | | 1,454 |

| | | | | |
|---|---|---|---|---|
| Weighted-average common shares and dilutive potential shares | | 2,065,186 | | 2,047,326 |
| Diluted EPS | $ | 1.64 | $ | 1.47 |

### 3. Stock plans

The Company uses the fair value method of accounting for stock-based compensation provided under SFAS 123R, *Share Based Payment*. SFAS 123R requires that the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. SFAS 123R applies to all share-based payment transactions in which an entity acquires goods or services by issuing (or offering to issue) its shares, share options, or other equity instruments (except for those held by an ESOP) or by incurring liabilities (1) in amounts based (even in part) on the price of the entity s shares or other equity instruments, or (2) that require (or may require) settlement by the issuance of an entity s shares or other equity instruments.

The Company has two stock-based compensation plans (the stock option plans). The stock option plans were shareholder-approved and permit the grant of share-based compensation awards to its directors, key officers and certain other employees. The Company believes that these stock option plans better align the interest of its directors, key officers and employees with the interest of its shareholders. The Company further believes that the granting of share-based awards, under the provisions of the stock option plans, is necessary to retain the knowledge base, continuity and expertise of its directors, key officers and certain employees.

The Company established the 2000 Independent Directors Stock Option Plan and reserved 55,000 shares of its un-issued capital stock for issuance under the plan. Under the 2000 Independent Directors Stock Option Plan, each outside director is awarded stock options to purchase 500 shares of the Company s common stock on the first business day of January, each year, at the fair market value on date of grant. No stock options were awarded during the first nine months of 2007 or for the year ended December 31, 2006, due to the directors voluntary election to forego the award. At September 30, 2007 there were 14,850 unexercised stock options outstanding under this plan. On October 2, 2007, the Company amended the 2000 Independent Directors Stock Option Plan. For a further discussion on the amendment, see Note 6, below.

The Company also established the 2000 Stock Incentive Plan and reserved 55,000 shares of its un-issued capital stock for issuance under the plan. Under the 2000 Stock Incentive Plan, key officers and certain other employees are eligible to be awarded qualified stock options to purchase the Company s common stock at the fair market value on the date of grant. No stock options were awarded during the first nine months of 2007. During the first nine months of 2006, 2,200 stock options were issued under this plan at a grant-date fair value of $6.21 per share. The options vest over a six month period and for the nine months ended September 30, 2006 approximately $14,000 of stock-based compensation expense was recorded and is included as a component of salaries and employee benefits in the consolidated statements of income. As of September 30, 2007, there were 5,830 unexercised stock options outstanding under this plan. On October 2, 2007, the Company amended the 2000 Stock Incentive Plan. For a further discussion on this amendment, see Note 6, below.

In addition to the two stock option plans above, the Company has established the 2002 Employee Stock Purchase Plan (the ESPP) and reserved 110,000 shares of its un-issued capital stock for issuance under the plan. The plan was designed to promote broad-based employee ownership of the Company s stock. Under the 2002 ESPP, employees may have automatic payroll deductions to purchase the Company s capital stock at a discounted price based on the fair market value of the Company s capital stock on either the commencement date or termination date. At September 30, 2007, 8,317 shares have been issued under the ESPP. The ESPP is considered a compensatory plan and, as such, is required to comply with the provisions of SFAS 123R. The Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the nine months ended September 30, 2007 and 2006, compensation expense related to the ESPP approximated $7,000 and $15,000, respectively, and is included as a component of salaries and employee benefits in the consolidated statements of income.

### 4. Derivative instruments

As part of the Company s overall interest rate risk management strategy, the Company has adopted a policy whereby the Company may periodically use derivative instruments to minimize significant fluctuations in earnings caused by interest rate volatility. This interest rate risk management strategy entails the use of interest rate floors, caps and swaps. During the fourth quarter of 2006, the Company entered into a three-year interest rate floor derivative agreement on $20,000,000 notional value of its prime-based loan portfolio. The transaction required the payment of a premium by the Company to the seller for the right to receive payments in the event national prime drops below a pre-determined level (strike rate), essentially converting floating rate loans to fixed rate loans when prime drops below the contractual strike rate. When purchased, the Company recorded an asset representing the fair value of the hedge at the time of purchase. The Company has designated this agreement as a cash flow hedge pursuant to SFAS No. 133. Accordingly, the change in the fair value of the instrument related to the hedge s intrinsic value, or approximately $155,000, is recorded as a component of other comprehensive income (OCI) in the consolidated statement of changes in shareholders equity and the portion of the change in fair value related to the time value expiration, or approximately $131,000, is recorded in the consolidated statements of income as a reduction of interest income for the nine months ended September 30, 2007. No gain or loss has been recognized in earnings due to hedge ineffectiveness as of September 30, 2007. As of September 30, 2007, the Company does not expect to reclassify any amount from OCI to earnings over the next twelve months and no hedge has been discontinued.

Also, as of September 30, 2007, the fair value of the derivative contract approximated $249,000 and is a component of other assets in the consolidated balance sheet.

## 5. Recent accounting pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement 109, *Accounting for Income Taxes*.

The Company adopted FIN 48 during the first quarter of 2007 and has evaluated its material tax positions as of September 30, 2007. The adoption of FIN 48 does not have an immediate effect on its consolidated financial statements. Under the more-likely-than-not threshold guidelines, the Company believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. In periods subsequent to September 30, 2007, determinations of potentially adverse material tax positions will be evaluated to determine whether an uncertain tax position may have previously existed or has been originated. In the event an adverse tax position is determined to exist, penalty and interest will be accrued, in accordance with the Internal Revenue Service guidelines, and recorded as a component of other expenses in the Company s consolidated statements of income.

As of September 30, 2007, there were no unrecognized tax benefits that, if recognized, would significantly affect the Company s effective tax rate. Also, as of September 30, 2007, there were no penalties and interest recognized in the consolidated statements of income as a result of the adoption of FIN 48, nor does the Company foresee a change in its material tax positions that would give rise to the non-recognition of an existing tax benefit during the forthcoming twelve months.

## 6. Subsequent events

On October 2, 2007, the Board of Directors of the Company approved amendments to the 2000 Stock Incentive Plan (the Incentive Plan) and the 2000 Independent Directors Stock Option Plan (the Directors Plan) (collectively, the Plans).

Various amendment provisions to the Plans concerning the administration of the Plans are intended to qualify the Plans for exemption from the application of Section 409A of the Internal Revenue Code, as contemplated by the recently released final Treasury Regulations under the Code. The Incentive Plan was also amended to provide that no qualified stock options will be granted after the date of the amendment. The Directors Plan was also amended to remove the automatic stock option grant in January of each year and allow the grant of stock options at any time at the discretion of the Company s Board of Directors. The Directors Plan also adds a six-month vesting period for options granted.

The Company does not expect the amendments to the Plans to have a material impact on the results of operations or financial condition of the Company.

**Item 2: Management s Discussion and Analysis of Financial Condition and Results of Operations**

The following is management s discussion and analysis of the significant changes in the consolidated financial condition of the Company as of September 30, 2007 compared to December 31, 2006 and the results of operations for the three and nine months ended September 30, 2007 and 2006. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company s 2006 Annual Report filed on Form 10-K.

**Forward-looking statements**

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

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

the timing and occurrence or non-occurrence of events may be subject to circumstances beyond our control;

there may be increases in competitive pressure among financial institutions or from non-financial institutions;

changes in the interest rate environment may reduce interest margins;

changes in deposit flows, loan demand or real estate values may adversely affect our business;

changes in accounting principles, policies or guidelines may cause our financial condition to be perceived differently;

general economic conditions, either nationally or locally in some or all areas in which we do business, or conditions in the securities markets or the banking industry may be less favorable than we currently anticipate;

legislative or regulatory changes may adversely affect our business;

technological changes may be more rapid, difficult or expensive than we anticipate;

success or consummation of new business initiatives may be more difficult or expensive than we anticipate;

acts of war or terrorism; or

natural disaster.

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

Readers should review the risk factors described in other documents that we file or furnish, from time to t