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, 2008

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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

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

o YES x NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. at October 31, 2008, the latest practicable date, was 2,062,182 shares.

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FIDELITY D & D BANCORP, INC.

Form 10-Q September 30, 2008

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PART I Financial Information

Item 1: Financial Statements

FIDELITY D & D BANCORP, INC. AND SUBSIDIARY

Consolidated Balance Sheets

		September 30, 2008 (unaudited)		December 31, 2007 (audited)
Assets:				
Cash and due from banks	$	12,806,375	$	10,204,714
Interest-bearing deposits with financial institutions		568,924		204,102
Total cash and cash equivalents		13,375,299		10,408,816
Available-for-sale securities		86,233,884		121,836,851
Held-to-maturity securities		945,665		1,147,309
Federal Home Loan Bank Stock		4,770,700		3,302,900
Loans and leases, net (allowance for loan losses of $4,205,566 in 2008; $4,824,401 in 2007)		426,455,593		421,424,379
Loans available-for-sale (fair value $642,573 in 2008; $842,923 in 2007)		632,400		827,250
Bank premises and equipment, net		16,018,219		12,964,932
Cash surrender value of bank owned life insurance		8,728,568		8,488,663
Other assets		8,418,646		4,403,723
Accrued interest receivable		2,535,931		2,500,696
Foreclosed assets held-for-sale		1,428,507		107,036
Total assets	$	569,543,412	$	587,412,555
Liabilities:				
Deposits:				
Interest-bearing	$	365,812,303	$	360,912,740
Non-interest-bearing		69,619,234		64,795,621
Total deposits		435,431,537		425,708,361
Accrued interest payable and other liabilities		4,335,911		4,147,869
Short-term borrowings		17,086,314		39,656,354
Long-term debt		62,071,661		62,708,677
Total liabilities		518,925,423		532,221,261
Shareholders equity:				
Preferred stock authorized 5,000,000 shares with no par value; none issued				
Capital stock, no par value (10,000,000 shares authorized; 2,075,182 shares issued and 2,062,182 shares outstanding in 2008; 2,072,929 shares issued and outstanding in		19,410,306		19,223,363

2007)				
Treasury stock, at cost (13,000 shares in 2008; none in 2007)		(379,810)		
Retained earnings		38,044,530		36,564,157
Accumulated other comprehensive loss		(6,457,037)		(596,226)
Total shareholders equity		50,617,989		55,191,294
Total liabilities and shareholders equity	$	569,543,412	$	587,412,555

See notes to consolidated financial statements

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FIDELITY D & D BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Income

(unaudited)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Interest income:				
Loans and leases:				
Taxable	$ 6,811,968	$ 7,223,183	$ 20,396,282	$ 21,540,100
Nontaxable	93,454	122,594	256,860	350,463
Interest-bearing deposits with financial institutions	606	2,190	2,408	6,911
Investment securities:				
U.S. government agency and corporations	1,047,561	1,093,098	3,584,878	3,029,358
States and political subdivisions (nontaxable)	170,098	124,922	469,330	374,273
Other securities	295,753	278,100	976,447	804,522
Federal funds sold		48,259	91,133	102,913
Total interest income	8,419,440	8,892,346	25,777,338	26,208,540
Interest expense:				
Deposits	2,598,805	3,420,693	8,663,941	9,977,394
Securities sold under repurchase agreements	11,545	124,089	92,141	355,122
Other short-term borrowings and other	142,954	26,013	256,625	360,025
Long-term debt	786,989	899,196	2,395,484	2,466,898
Total interest expense	3,540,293	4,469,991	11,408,191	13,159,439
Net interest income	4,879,147	4,422,355	14,369,147	13,049,101
Provision (credit) for loan losses	130,000	(60,000)	255,000	(60,000)
Net interest income after provision for loan losses	4,749,147	4,482,355	14,114,147	13,109,101
Other income:				
Service charges on deposit accounts	715,528	784,847	2,216,127	2,179,086
Gain (loss) on sale of:				
Loans	64,778	52,821	215,974	120,717
Investment securities	16,775		25,428	
Premises and equipment	(34,674)	1,248	(35,658)	74,881
Foreclosed assets held-for-sale	33,685	405	42,794	143,154
Other-than-temporary impairment on securities	(403,031)		(403,031)	
Fees and other service charges	451,382	469,440	1,344,020	1,333,700

Total other income		844,443		1,308,761		3,405,654		3,851,538
Other expenses:								
Salaries and employee benefits		2,474,969		2,201,532		7,364,817		6,501,861
Premises and equipment		813,380		807,978		2,385,489		2,398,088
Advertising		242,937		156,848		579,641		499,473
Other		1,141,368		1,022,813		3,179,996		2,990,345
Total other expenses		4,672,654		4,189,171		13,509,943		12,389,767
Income before provision for income taxes		920,936		1,601,945		4,009,858		4,570,872
Provision for income taxes		179,821		424,023		975,850		1,189,866
Net income	$	741,115	$	1,177,922	$	3,034,008	$	3,381,006
Per share data:								
Net income - basic	$	0.35	$	0.57	$	1.46	$	1.64
Net income - diluted	$	0.35	$	0.57	$	1.46	$	1.64
Dividends	$	0.25	$	0.24	$	0.75	$	0.68

See Notes to Consolidated Financial Statements

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FIDELITY D & D BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Changes in Shareholders Equity

For the nine months ended September 30, 2008 and 2007

	Capital stock Shares	Capital stock Amount	Treasury stock Shares	Treasury stock Amount	Retained earnings	Accumulated other comprehensive income (loss)	Total
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
Balance, December 31, 2007 (audited)	2,072,929	$ 19,223,363		$	$ 36,564,157	$ (596,226)	$ 55,191,294
Total comprehensive loss:							
Net income					3,034,008		3,034,008
Change in net unrealized holding losses on available-for-sale securities, net of reclassification adjustment and tax effects						(5,957,194)	(5,957,194)
Change in cash flow hedge intrinsic value						96,383	96,383
Comprehensive loss							(2,826,803)
Issuance of common stock through Employee Stock Purchase Plan	2,253	57,891					57,891
Stock-based compensation expense		129,052					129,052
Purchase of treasury stock			(13,000)	(379,810)			(379,810)
Cash dividends declared					(1,553,635)		(1,553,635)
Balance, September 30, 2008 (unaudited)	2,075,182	$ 19,410,306	(13,000)	$ (379,810)	$ 38,044,530	$ (6,457,037)	$ 50,617,989

See Notes to Consolidated Financial Statements

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FIDELITY DEPOSIT & DISCOUNT BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Cash Flows

(unaudited)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Cash flows from operating activities:		
Net income	$ 3,034,008	$ 3,381,006
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	442,338	929,540
Provision (credit) for loan losses	255,000	(60,000)
Deferred income tax expense	158,834	27,890
Stock-based compensation expense	129,052	6,958
Loss from investment in limited partnership	60,300	60,300
Proceeds from sale of loans available-for-sale	42,687,143	12,121,477
Originations of loans available-for-sale	(11,163,004)	(12,260,760)
Increase in cash surrender value of life insurance	(239,905)	(231,026)
Net gain on sale of loans	(215,974)	(120,717)
Net gain on sale of investment securities	(25,428)	
Net gain on sale of foreclosed assets held-for-sale	(42,794)	(143,154)
Net loss (gain) on disposal of premises and equipment	35,658	(74,881)
Other-than-temporary impairment on securities	403,031	
Change in:		
Accrued interest receivable	(35,235)	(377,667)
Other assets	(1,625,694)	(102,938)
Accrued interest payable and other liabilities	130,552	480,771
Net cash provided by operating activities	33,987,882	3,636,799
Cash flows from investing activities:		
Held-to-maturity securities:		
Proceeds from maturities, calls and principal pay-downs	201,209	372,503
Available-for-sale securities:		
Proceeds from sales	48,402,449	
Proceeds from maturities, calls and principal pay-downs	30,445,671	9,784,761
Purchases	(51,961,087)	(31,953,887)
Net (increase) decrease in FHLB stock	(1,467,800)	236,800
Net increase in loans and leases	(37,941,827)	(3,883,909)
Proceeds from sale of premises and equipment	600	248,833
Acquisition of bank premises and equipment	(3,662,291)	(2,584,363)
Proceeds from sale of foreclosed assets held-for-sale	262,406	584,088
Net cash used in investing activities	(15,720,670)	(27,195,174)
Cash flows from financing activities:		
Net increase in deposits	9,723,176	28,721,962
Net decrease in short-term borrowings	(22,570,040)	(5,076,652)
Repayments of long-term debt	(637,016)	(19,618,335)
Proceeds from long-term debt advances		20,000,000
Proceeds from employee stock purchase plan	57,891	67,820

Dividends paid, net of dividends reinvested		(1,553,635)		(966,156)
Purchase of treasury stock		(321,105)		
Net cash (used in) provided by financing activities		(15,300,729)		23,128,639
Net increase (decrease) in cash and cash equivalents		2,966,483		(429,736)
Cash and cash equivalents, beginning		10,408,816		13,800,848
Cash and cash equivalents, ending	$	13,375,299	$	13,371,112

See notes to consolidated financial statements

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FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

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 its 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, 2007.

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, 2008 and December 31, 2007 and the related consolidated statements of income for the three- and nine-month periods ended September 30, 2008 and 2007 and changes in shareholders equity and cash flows for the nine months ended September 30, 2008 and 2007 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, 2007, 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 relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at September 30, 2008 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions, and could, therefore, calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the

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Company s allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company s investment securities. Generally, the fair value of the Company s investments in debt instruments is primarily impacted by changes in interest rates. As interest rates rise, the fair value of securities will decrease; as interest rates fall the fair value of securities will increase. The Company conducts periodic reviews and evaluations of the securities portfolio to determine if the decline in the fair value of any security below its cost basis is other-than-temporary. Generally the Company views changes in fair value caused by changes in interest rates as temporary, which is consistent with our experience. If we deem a decline to be other-than-temporary, the security is written down to a new cost basis with a corresponding charge to current period earnings that is reported as a component of non-interest income. See Note 5, Recent Accounting Pronouncements, below and Comparison of Financial Condition at September 30, 2008 and December 31, 2007, Investment securities, in Management s Discussion and Analysis of Financial Condition and Results of Operations, Part 2 of this item, also below, for further discussions on other-than-temporary impairment.

The Company receives estimated fair values of investment securities from either an independent valuation service or determines fair value using the income approach utilizing the discount rate adjustment technique with 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 or models. 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 originated and classified as AFS, is obtained from the Federal National Mortgage Association (FNMA) and the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan and lease portfolio to loans AFS. Under these rare circumstances, pricing may be obtained from other entities and the loans are transferred at the lower of cost or market value and simultaneously sold.

2. Earnings per share

Basic earnings per share (EPS) is computed by dividing 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 the treasury stock method, the assumed proceeds received from shares issued, in a hypothetical stock option exercise, are assumed to be used to purchase treasury stock. For a further discussion on the Company s stock option plans, see Note No. 3, Stock plans, 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,		**2008**		**2007**
Basic EPS:				
Net income available to common shareholders	$	3,034,008	$	3,381,006
Weighted-average common shares outstanding		2,071,242		2,064,578
Basic EPS	$	1.46	$	1.64
Diluted EPS:				
Net income available to common shareholders	$	3,034,008	$	3,381,006
Weighted-average common shares outstanding		2,071,242		2,064,578
Dilutive potential common shares		85		608
Weighted-average common shares and dilutive potential shares		2,071,327		2,065,186
Diluted EPS	$	1.46	$	1.64

3. Stock plans

The Company uses the fair value method of accounting for stock-based compensation provided under Statement of Financial Accounting Standard (SFAS) No. 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,

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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.

Under the stock option plans, options are granted with an exercise price equal to the market price of the Company s stock at the date of grant. The awards vest based on six months of continuous service from the date of grant and have 10-year contractual terms. Stock-based compensation expense is recognized over the six-month vesting period. Generally, all shares that are granted become fully vested. Stock-based compensation is recorded in the consolidated income statement as a component of salaries and employee benefits.

The Company established the 2000 Independent Directors Stock Option Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. No stock options were awarded during the nine months of 2008 and 2007. As of September 30, 2008, there were 30,150 unexercised stock options outstanding under this plan.

The Company also established the 2000 Stock Incentive Plan and has reserved 55,000 shares of its un-issued capital stock for issuance under the plan. During the nine months ended September 30, 2008, 2,000 stock options were issued under this plan at a weighted-average grant-date fair value of $4.85 per share. The Company uses the Black-Scholes Option Pricing Valuation Model to determine the fair value of awarded options on the date of grant. The model considers expected volatility, expected dividends, risk-free interest rate and the expected term. No stock options were awarded during the first nine months of 2007. As of September 30, 2008, there were 12,830 unexercised stock options outstanding under this plan.

The following tables illustrate stock-based compensation expense recognized during the three- and nine- months ended September 30, 2008 and 2007 and the unrecognized stock-based compensation expense as of September 30, 2008 and December 31, 2007 for each of the Company s stock option plans:

	Three months ended September 30, 2008	Three months ended September 30, 2007	Nine months ended September 30, 2008	Nine months ended September 30, 2007
Stock-based compensation expense:				
Director s Plan	$	$	$ 90,550	$
Incentive Plan	2,314		35,562	
Total stock-based compensation expense	$ 2,314	$	$ 126,112	$

	As of: September 30, 2008	As of: December 31, 2007
Unrecognized stock-based compensation expense:		

Director s Plan	$	$	90,550
Incentive Plan			25,872
Unrecognized stock-based compensation expense	$	$	116,422

In addition to the two stock option plans, the Company 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 ESPP, employees may elect 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, 2008, 10,570 shares have been issued under the ESPP. The Company recognizes compensation expense on its ESPP on the date the shares are purchased. For the nine months ended September 30, 2008 and 2007, compensation expense related to the ESPP approximated $3,000 and $7,000, respectively, and is included as components of salaries and employee benefits in the consolidated statements of income.

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4. Derivative instruments

As part of the Company s overall interest rate risk management strategy, the Company has adopted a policy whereby it 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, *Accounting for Derivative Instruments and Hedging Activities.* Accordingly, the change in the fair value of the instrument related to the hedge s intrinsic value, or approximately $96,000 and $155,000 for the nine months ended September 30, 2008 and 2007, respectively, is recorded as a component of other comprehensive income (loss) (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 $12,000 and $131,000 for the nine months ended September 30, 2008 and 2007, respectively, is recorded in the consolidated statements of income as a reduction of interest income. No gain or loss has been recognized in earnings due to hedge ineffectiveness as of September 30, 2008. As of September 30, 2008, 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, 2008 and December 31, 2007, the fair value of the derivative contract approximated $525,000 and $441,000 and is recorded as a component of other assets in the consolidated balance sheet.

5. Recent accounting pronouncements

On January 1, 2008, the Company adopted SFAS 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measurements required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 establishes a valuation hierarchy for disclosure of the inputs used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on our own assumptions to measure assets and liabilities at fair value. Level 3 pricing for securities may also include unobservable inputs based upon broker-traded transactions. A financial asset or liability s classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The adoption of this statement had no effect on the Company s financial statements.

In February 2008 the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 to fiscal years beginning after November 15, 2008 for non-financial assets and non-financial liabilities that are not recognized or disclosed at fair value in the financial statements on a recurring basis. In October 2008, FASB issued FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for that Asset is not Active*, which clarifies the application of FAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

The initial implementation of SFAS 157 for financial instruments did not have a material impact on the Company s financial condition or results of operations. The financial results for the third quarter of 2008 were impacted by the fair value measurement for one preferred term security that resulted in the recognition of an other-than-temporary impairment (OTTI). The market for the Company s investment in preferred term securities continues to be inactive and therefore fair value is determined using the income approach, or the present value of future cash flows. The fair values were based on an income approach utilizing more complex models that applies discount rate adjustment technique, which maximizes the use of observable inputs and minimizes the use of unobservable adjustments. Inputs include yields for similar credit and investment grade ratings of comparable instruments, with adjustments for liquidity premiums to determine an appropriate risk adjusted discount rate for each issue. By using the income approach as described, the Company is able to determine a more representative fair value for its preferred term securities as compared to a market approach for the securities where pricing is unrealistic due to the inactivity. The Company s investment in preferred term securities consists of 13 pooled issues with each issue containing subordinated tiers collateralized predominately by multiple bank issuers. As of September 30, 2008, the Company s investment in corporate bonds consisted of preferred term securities, a component of securities AFS with a combined market value of $13,128,000, or $8,338,000 below their amortized cost basis of $21,466,000.

The following table illustrates the financial instruments measured at fair value on a recurring basis segregated by hierarchy fair value levels (dollars in thousands):

		Fair value measurements at September 30, 2008 using:		
	Total carrying value at September 30, 2008	**Quoted prices in active markets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**
Assets:				
Available-for-sale securities	$ 86,234	$ 462	$ 72,644	$ 13,128
Loans available-for-sale	632		632	
Derivative instrument	525		525	
Total	$ 87,391	$ 462	$ 73,801	$ 13,128

Equity securities in the available-for-sale securities portfolio are measured at fair value using quoted market prices for identical assets and are classified within Level 1of the valuation hierarchy. Other than the Company s investment in corporate bonds, all other debt securities in the available-for-sale securities portfolio are measured at fair value using quoted prices from an independent third party that provide valuation services for similar assets, with similar terms in actively traded markets. The Company s investment grade preferred term securities, classified under corporate bonds, include both observable and unobservable inputs to determine fair value as described above and, therefore, are considered Level 3 inputs. Once the market activity, including new issues, begins to occur, and

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the unobservable subjective inputs are replaced by market activity, these securities may be transferred out of Level 3 into a Level 2 classification by management. Loans available-for-sale are measured at fair value from quotes received through secondary market sources, i.e., FNMA or FHLB, who provide pricing for similar assets with similar terms in actively traded markets. The derivative instrument, included in other assets, is measured at fair value from pricing provided by a third party who considers observable interest rates, forward yield curves at commonly quoted intervals and volatility.

The following table illustrates the changes in Level 3 financial instruments measured at fair value on a recurring basis for the periods indicated (dollars in thousands):

	As of and for the three months ended September 30, 2008	As of and for the nine months ended September 30, 2008
Assets:		
Balance at beginning of period	$ 16,866	$ 16,335
Realized / unrealized gains (losses):		
in earnings	(397)	(397)
in comprehensive income	(3,275)	(7,142)
Purchases, sales, issuances and settlements, amortization and accretion, net	(66)	4,332
Transfers into (out of) Level 3		
Balance at end of period	$ 13,128	$ 13,128

The following table illustrates the financial instruments measured at fair value on a nonrecurring basis segregated by hierarchy fair value levels (dollars in thousands):

	Total carrying value at September 30, 2008	Fair value measurements at September 30, 2008 using: Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Impaired loans	$ 1,652	$ 15	$ 668	$ 969

Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secures the impaired loan include: quoted market prices for identical assets classified as Level 1 inputs; observable inputs, employed by certified appraisers, for similar assets classified as Level 2 inputs. In cases where valuation techniques included inputs that are unobservable and are based on estimates and assumptions developed by management from the best information available under each circumstance, the asset valuation is classified as Level 3 inputs.

On January 1, 2008, the Company adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 allows companies to elect to follow fair value accounting for certain financial assets and liabilities in an effort to mitigate volatility in earnings without having to apply complex hedge accounting provisions. The Company did not elect the fair value option for any of its financial instruments as of September 30, 2008 and therefore the adoption of this statement had no effect on the Company s financial statements.

In March 2008, the Financial Accounting Standards Board issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. SFAS 161 amends and expands the disclosure requirements of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. It requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2008. The Company does not expect the adoption of this pronouncement to have a material impact on its consolidated financial statements.

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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, 2008 compared to December 31, 2007 and the results of operations for the three- and nine- months ended September 30, 2008 and 2007. Current performance may not be indicative of future results. This discussion should be read in conjunction with the Company s 2007 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 time, with the Securities and Exchange Commission, including Annual Reports to Shareholders, Annual Reports filed on Form 10-K and other current reports filed or furnished on Form 8-K.

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General

The Company s principal revenues are derived from interest, dividends and fees earned on its interest-earning assets, which are comprised of loans, securities and other short-term investments. The Company s principal expenses consist of interest paid on its interest-bearing liabilities, which are comprised of deposits, short- and long-term borrowings and operating and general expenses. The Company s profitability depends primarily on its net interest income. Net interest income is the difference between interest income and interest expense. Interest income is generated from yields on interest-earning assets which consist principally of loans and investment securities. Interest expense is incurred from rates paid on interest-bearing liabilities, which consist of deposits and borrowings. Net interest income is dependent upon the interest-rate spread (i.e., the difference between the yields earned on its interest-earning assets and the rates paid on its interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. The interest rate spread is significantly impacted by: changes in interest rates and market yield curves and their related impact on cash flows; the composition and characteristics of interest-earning assets and interest-bearing liabilities; differences in the maturity and re-pricing characteristics of assets compared to the maturity and re-pricing characteristics of the liabilities that fund them and by the competition in our marketplace.

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

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

COMPARISON OF RESULTS OF OPERATIONS

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

Overview

Net income for the third quarter of 2008 was $741,000 compared to $1,178,000 recorded in the same quarter of 2007. Diluted earnings per share was $0.35 and $0.57 for each of the respective periods. For the nine months ended September 30, 2008, net income was $3,034,000, or $1.46 per share compared to $3,381,000, or $1.64 per share for the nine months ended September 30, 2007. The decline in net income for both the quarter and nine months ended September 30, 2008 was principally the result of provisions for loan losses recorded in the 2008 periods compared to credits for loan losses in 2007, an increase in other expenses and a decrease in non-interest income. Net interest income improved 10% for both the three and nine months ended September 30, 2008 compared to the same periods in 2007. For the quarter and nine months ended September 30, 2008, non-interest income included a non-cash OTTI charge in the amount of $403,000 related to the Company s investment portfolio. The Company s investment portfolio includes a pooled preferred term security and an equity position in FNMA common stock, whose market values declined by $397,000 and $6,000, respectively, below their cost basis and based on analyses, management has deemed both declines in market value to be other-than-temporary.

Excluding the OTTI charge, in non-interest income, net income would have been $1,007,000, or $0.48 per fully diluted share and $3,300,000, or $1.59 per fully diluted share of the quarter and nine months ended September 30, 2008, respectively. The following table reconciles net income as reported to pro forma net operating income for the periods indicated:

	Three months ended		Nine months ended	
	September 30, 2008			
	Amount	Per share	Amount	Per share
Net income, as reported	$ 741,115	$ 0.35	$ 3,034,008	$ 1.46
Other-than-temporary impairment	403,031	0.20	403,031	0.20
Tax effect	(137,031)	(0.07)	(137,031)	(0.07)
Net operating earnings	$ 1,007,115	$ 0.48	$ 3,300,008	$ 1.59

Return on average assets (ROA) and return on average shareholders equity (ROE) were 0.50% and 5.63%, respectively, for the three months ended September 30, 2008 compared to 0.81% and 8.80% for the respective period in 2007. For the nine months ended September 30, 2008 and 2007, ROA and ROE were 0.69% and 7.42%, compared to 0.79% and 8.57%, respectively. The decline in both ROA and ROE for the quarter and nine months ended September 30, 2008 was due to lower levels of net income. Excluding the aforementioned OTTI charge, ROA and ROE would have been 0.69% and 7.65% for the three months ended September 30, 2008 and 0.75% and 8.07% for the nine months ended September 30, 2008.

Net interest income and interest sensitive assets / liabilities

For the three months ended September 30, 2008, net interest income increased $457,000, or 10%, to $4,879,000 from $4,422,000 for the three months ended September 30, 2007 and increased $1,320,000, or 10%, to $14,369,000 for the nine months ended September 30, 2008 from $13,049,000 for the nine months ended September 30, 2007. The tax-equivalent net interest margin increased to 3.62% for the three months ended September 30, 2008 from 3.31% for the three months ended September 30, 2007 and increased to 3.57% for the nine months ended September 30, 2008 from 3.34% for the nine months ended September 30, 2007. The net interest rate spread increased to 3.10% for the three months ended September 30, 2008 from 2.60% for the three months ended September 30, 2007 and increased to 3.01% for the nine months ended September 30, 2008 from 2.62% for the nine months ended September 30, 2007. The average balance of net interest-earning assets increased $5,749,000 to $552,007,000 for the three months ended September 30, 2008 from $546,258,000 for the three months ended September 30, 2007 and increased $14,743,000 to $553,408,000 million for the nine months ended September 30, 2008 from $538,665,000 for the nine months ended September 30, 2007.

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The increases in net interest income, the net interest margin and the net interest rate spread for the three and nine months ended September 30, 2008, compared to the three and nine months ended September 30, 2007, were primarily due to decreases in interest expense, partially offset by decreases in interest income for each of the comparative periods. The decrease in interest expense for the three and nine months ended September 30, 2008, compared to the three and nine months ended September 30, 2007 was primarily due to decreases in the average rates paid on interest bearing-liabilities partially offset by increases in the average balances of interest-bearing liabilities. The decreases in interest income for the three and nine months ended September 30, 2008 compared to the three and nine months ended September 30, 2007 were primarily due to decreases in the average yields on interest-earning assets.

Interest income declined $473,000, or 5%, to $8,419,000 for the three months ended September 30, 2008, from $8,892,000 for the three months ended September 30, 2007 primarily due to a decrease in the average yield on interest-earning assets to 6.17% for the three months ended September 30, 2008 from 6.56% for the three months ended September 30, 2007. The decrease in the average yield on interest-earning assets was primarily the result of decreases in the average volume of mortgage loans plus the average yield in the commercial loan portfolio. The increase in the average balance of interest-earning assets was primarily due to an increase in the average balance of investments.

For the nine months ended September 30, 2008, interest income decreased $431,000, or 2%, to $25,777,000 from $26,208,000 for the nine months ended September 30, 2007 primarily due to a decrease in the average yield on interest-earning assets to 6.32% for the nine months ended September 30, 2008 from 6.60% for the nine months ended September 30, 2007, partially offset by the $14,743,000 increase in the average balance of interest-earning assets. The increase in the average balance of interest-earning assets was primarily due to increases in the average balances of total investments and federal funds sold, partially offset by a decrease in the loan and lease portfolio caused by the sale of residential mortgage loans during the first quarter of 2008.

Interest expense decreased $930,000, or 21%, to $3,540,000 for the three months ended September 30, 2008 from $4,470,000 for the three months ended September 30, 2007 primarily due to a decrease in the average cost of interest-bearing liabilities to 3.07% from 3.96% for the comparative periods due to the decrease in the average costs on transactional deposits. The average balance of interest-bearing liabilities increased $10,227,000 for the three months ended September 30, 2008 compared to the three months ended September 30, 2007 primarily from an increase in the average balance of short-term overnight borrowings.

For the nine months ended September 30, 2008, interest expense decreased $1,751,000, or 13%, to $11,408,000 from $13,159,000 for the nine months ended September 30, 2007 primarily due to a decrease in the average cost of interest-bearing liabilities to 3.31% from 3.98% for the comparative periods due to decreases in the average cost of deposits. During the same period, average interest-bearing deposits increased $20,315,000 partially offsetting the effect of the decline in interest costs for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007.

The national economy continues to border on, if not already having entered into, a recession and the housing and real estate markets continue to decline. The current operating environment is the result of the significant disruption and volatility in the financial and capital market places which began in the second half of 2007 and continues today. Due to concerns over the economy, the Federal Open Market Committee (FOMC) reduced the federal funds rate by 100 basis points during the second half of 2007 and by 225 basis points during the first nine months of 2008. These actions have resulted in a more positively sloped yield curve as well as volatility in mortgage loan interest rates, in which a reduction may accelerate prepayments and refinancing to lower rates. The national prime rate, the benchmark rate banks use to set rates on various lending and other interest sensitive financial instruments, has been reduced by similar amounts during the same periods. Generally, this situation causes floating rate assets to re-price at lower yields, and also causes fixed-rate assets to originate at yields lower than the yields earned in the prior comparable period, thereby reducing interest income. To help mitigate this effect, in 2008the Company sold $28,100,000 of low yielding mortgage loans and used the proceeds to initially purchase investment securities, fund commercial loan growth, reduce overnight borrowings and help fund the Company s branch office expansion project. During the third quarter of 2008, the company sold approximately $35,000,000 in investment securities and used the proceeds to further reduce debt and fund loan growth. The Company s Asset Liability Management team meets regularly to discuss interest rate risk and if necessary adjust interest rates on deposits in response to rate movements that stem from the FOMC so that net interest income is not disproportionately impacted during volatile rate environments. This proactive attention to interest rate risk in conjunction with our interest rate hedging strategy, as described in Note No. 4, Derivative instruments, within the notes to the consolidated financial statements in Part I, Item 1, should continue to help contain the Company s net interest income at acceptable levels.

The table that follows sets forth a comparison of average balance sheet amounts and their corresponding fully tax-equivalent (FTE) interest income and expense and annualized tax-equivalent yield and cost for the periods indicated (dollars in thousands):

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	Three months ended September 30, 2008	2007	Nine months ended September 30, 2008	2007	Year ended December 31, 2007
Average interest-earning assets:					
Loans and leases	$ 426,002	$ 425,502	$ 414,809	$ 423,811	$ 424,781
Investments	125,901	116,969	134,010	112,063	116,217
Federal funds sold		3,626	4,465	2,604	1,948
Interest-bearing deposits	104	161	124	187	184
Total	$ 552,007	$ 546,258	$ 553,408	$ 538,665	$ 543,130
Average interest-bearing liabilities:					
Other interest-bearing deposits	$ 191,697	$ 191,526	$ 193,508	$ 196,036	$ 194,452
Certificates of deposit	168,730	167,815	179,712	156,869	161,418
Borrowed funds	86,778	67,392	75,498	70,552	71,573
Repurchase agreements	10,907	21,152	12,166	19,132	19,580
Total	$ 458,112	$ 447,885	$ 460,884	$ 442,589	$ 447,023
Interest income (FTE):					
Loans and leases	$ 6,953	$ 7,409	$ 20,785	$ 22,071	$ 29,477
Investments	1,611	1,568	5,301	4,424	6,219
Federal funds sold		48	91	103	103
Interest-bearing deposits	1	2	2	7	9
Total	$ 8,565	$ 9,027	$ 26,179	$ 26,605	$