

FIRST NATIONAL COMMUNITY BANCORP INC  
Form 10-Q  
May 08, 2015

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended March 31, 2015**

**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 No. 000-53869**



Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

|                                       |                              |
|---------------------------------------|------------------------------|
| <b>Common Stock, \$1.25 par value</b> | <b>16,500,945 shares</b>     |
| (Title of Class)                      | (Outstanding at May 8, 2015) |

|  |    |
|--|----|
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## PART I. Financial Information

**Item 1. Financial Statements****FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****(unaudited)**

| (in thousands, except share data)  | March 31,<br>2015 | December 31,<br>2014 |
|--|-------------------|----------------------|
| <b>Assets</b>  |                   |                      |
| Cash and cash equivalents:   |                   |                      |
| Cash and due from banks  | \$ 19,985         | \$ 22,657            |
| Interest-bearing deposits in other banks                                   | 17,390            | 13,010               |
| Total cash and cash equivalents  | 37,375            | 35,667               |
| Securities available for sale, at fair value                               | 204,635           | 218,989              |
| Stock in Federal Home Loan Bank of Pittsburgh, at cost                     | 3,061             | 2,803                |
| Loans held for sale  | -                 | 603                  |
| Loans, net of allowance for loan and lease losses of \$10,944 and \$11,520 | 661,221           | 658,747              |
| Bank premises and equipment, net   | 11,221            | 11,003               |
| Accrued interest receivable  | 2,118             | 2,075                |
| Intangible assets  | 261               | 302                  |
| Bank-owned life insurance  | 28,952            | 28,817               |
| Other real estate owned  | 2,369             | 2,255                |
| Other assets   | 9,028             | 8,768                |
| Total assets   | \$ 960,241        | \$ 970,029           |
| <b>Liabilities</b>   |                   |                      |
| Deposits:  |                   |                      |
| Demand (non-interest-bearing)  | \$ 134,993        | \$ 124,064           |
| Interest-bearing   | 640,118           | 671,272              |
| Total deposits   | 775,111           | 795,336              |
| Borrowed funds:  |                   |                      |
| Federal Home Loan Bank of Pittsburgh advances                              | 67,612            | 61,194               |
| Subordinated debentures  | 25,000            | 25,000               |
| Junior subordinated debentures   | 10,310            | 10,310               |
| Total borrowed funds   | 102,922           | 96,504               |
| Accrued interest payable   | 10,788            | 10,262               |
| Other liabilities  | 15,678            | 16,529               |
| Total liabilities  | 904,499           | 918,631              |
| Shareholders' equity   |                   |                      |

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|  |            |            |
|--|------------|------------|
| Preferred shares (\$1.25 par)  |            |            |
| Authorized: 20,000,000 shares at March 31, 2015 and December 31, 2014                              |            |            |
| Issued and outstanding: 0 shares at March 31, 2015 and December 31, 2014                           | -          | -          |
| Common shares (\$1.25 par)   |            |            |
| Authorized: 50,000,000 shares at March 31, 2015 and December 31, 2014                              |            |            |
| Issued and outstanding: 16,500,945 shares, March 31, 2015 and 16,484,419 shares, December 31, 2014 | 20,626     | 20,605     |
| Additional paid-in capital   | 61,801     | 61,781     |
| Accumulated deficit  | (28,651 )  | (32,126 )  |
| Accumulated other comprehensive income   | 1,966      | 1,138      |
| Total shareholders' equity   | 55,742     | 51,398     |
| Total Liabilities and shareholders' equity   | \$ 960,241 | \$ 970,029 |

The accompanying notes to consolidated financial statements are an integral part of these statements.

**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(unaudited)**

| (in thousands, except share data)                           | Three months ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2015                            | 2014     |
| Interest income   |                                 |          |
| Interest and fees on loans                                  | \$6,472                         | \$6,494  |
| Interest and dividends on securities                        |                                 |          |
| U.S. government agencies                                    | 971                             | 743      |
| State and political subdivisions, tax-free                  | 50                              | 710      |
| State and political subdivisions, taxable                   | 26                              | 98       |
| Other securities  | 157                             | 56       |
| Total interest and dividends on securities                  | 1,204                           | 1,607    |
| Interest on interest-bearing deposits in other banks        | 21                              | 23       |
| Total interest income                                       | 7,697                           | 8,124    |
| Interest expense  |                                 |          |
| Interest on deposits  | 683                             | 865      |
| Interest on borrowed funds                                  |                                 |          |
| Interest on Federal Home Loan Bank of Pittsburgh advances   | 120                             | 96       |
| Interest on subordinated debentures                         | 563                             | 563      |
| Interest on junior subordinated debentures                  | 49                              | 49       |
| Total interest on borrowed funds                            | 732                             | 708      |
| Total interest expense                                      | 1,415                           | 1,573    |
| Net interest income before credit for loan and lease losses | 6,282                           | 6,551    |
| Credit for loan and lease losses                            | (494                            | ) (1,570 |
| Net interest income after credit for loan and lease losses  | 6,776                           | 8,121    |
| Non-interest income   |                                 |          |
| Deposit service charges                                     | 674                             | 690      |
| Net gain on the sale of securities                          | 2,224                           | 1,568    |
| Net gain on the sale of mortgage loans held for sale        | 40                              | 75       |
| Net loss on the sale of education loans                     | -                               | (13      |
| Net gain on the sale of other real estate owned             | 5                               | 29       |
| Gain on branch divestitures                                 | -                               | 607      |
| Loan-related fees   | 90                              | 93       |
| Income from bank-owned life insurance                       | 135                             | 167      |
| Other   | 251                             | 237      |
| Total non-interest income                                   | 3,419                           | 3,453    |
| Non-interest expense  |                                 |          |
| Salaries and employee benefits                              | 3,139                           | 3,400    |
| Occupancy expense   | 633                             | 644      |
| Equipment expense   | 384                             | 356      |
| Data processing expense                                     | 448                             | 522      |

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|                                    |         |         |
|------------------------------------|---------|---------|
| Regulatory assessments             | 409     | 673     |
| Bank shares tax                    | 217     | 176     |
| Expense of other real estate owned | 100     | 163     |
| Legal expense                      | 163     | 647     |
| Professional fees                  | 301     | 450     |
| Insurance expense                  | 198     | 282     |
| Other operating expenses           | 790     | 678     |
| Total non-interest expense         | 6,782   | 7,991   |
| Income before income taxes         | 3,413   | 3,583   |
| Provision for income taxes         | (62     | ) 70    |
| Net income                         | \$3,475 | \$3,513 |

Earnings per share:

|         |        |        |
|---------|--------|--------|
| Basic   | \$0.21 | \$0.21 |
| Diluted | \$0.21 | \$0.21 |

|  |     |     |
|--|-----|-----|
| Cash dividends declared per common share | \$- | \$- |
|--|-----|-----|

WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:

|         |            |            |
|---------|------------|------------|
| Basic   | 16,490,111 | 16,471,569 |
| Diluted | 16,490,111 | 16,472,435 |

The accompanying notes to consolidated financial statements are an integral part of these statements.



**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(unaudited)**

| (in thousands)   | Three months ended<br>March 31, |          |
|--|---------------------------------|----------|
|  | 2015                            | 2014     |
| Net income   | \$ 3,475                        | \$ 3,513 |
| Other comprehensive income:                                  |                                 |          |
| Unrealized gains on securities available for sale            | 3,478                           | 6,404    |
| Taxes  | (1,182 )                        | (2,177 ) |
| Net of tax amount  | 2,296                           | 4,227    |
| Reclassification adjustment for gains included in net income | (2,224 )                        | (1,200 ) |
| Taxes  | 756                             | 408      |
| Net of tax amount  | (1,468 )                        | (792 )   |
| Total other comprehensive income                             | 828                             | 3,435    |
| Comprehensive income   | \$ 4,303                        | \$ 6,948 |

The accompanying notes to consolidated financial statements are an integral part of these statements.

**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY****For the Three Months Ended March 31, 2015 and 2014****(unaudited)**

| (in thousands, except per share data)                            | Number<br>of Common<br>Shares | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>(Loss)<br>Income | Total<br>Shareholders'<br>Equity |
|--|-------------------------------|-----------------|----------------------------------|------------------------|---|----------------------------------|
| BALANCES, DECEMBER 31, 2013                                      | 16,471,569                    | \$ 20,589       | \$ 61,627                        | \$ (45,546 )           | \$ (3,092 )   | \$ 33,578                        |
| Net income for the period  | -                             | -               | -                                | 3,513                  | -   | 3,513                            |
| Restricted stock awards  | -                             | -               | 10                               | -                      | -   | 10                               |
| Other comprehensive income, net of tax of \$1,769                | -                             | -               | -                                | -                      | 3,435   | 3,435                            |
| Balances, March 31, 2014   | 16,471,569                    | \$ 20,589       | \$ 61,637                        | \$ (42,033 )           | \$ 343  | \$ 40,536                        |
| BALANCES, DECEMBER 31, 2014                                      | 16,484,419                    | \$ 20,605       | \$ 61,781                        | \$ (32,126 )           | \$ 1,138  | \$ 51,398                        |
| Net income for the period  | -                             | -               | -                                | 3,475                  | -   | 3,475                            |
| Common shares issued under long-term incentive compensation plan | 16,526                        | 21              | (21 )                            | -                      | -   | -                                |
| Restricted stock awards  | -                             | -               | 41                               | -                      | -   | 41                               |
| Other comprehensive income, net of tax of \$426                  | -                             | -               | -                                | -                      | 828   | 828                              |
| Balances, March 31, 2015   | 16,500,945                    | \$ 20,626       | \$ 61,801                        | \$ (28,651 )           | \$ 1,966  | \$ 55,742                        |

**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

| (in thousands)   | Three Months Ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2015                            | 2014      |
| Operating activities:  |                                 |           |
| Net income   | \$3,475                         | \$3,513   |
| Adjustments to reconcile net income to net cash (used in ) provided by operating activities: |                                 |           |
| Investment securities amortization (accretion), net  | 463                             | 295       |
| Equity in trust  | (1 )                            | (1 )      |
| Depreciation and amortization  | 360                             | 382       |
| Stock-based compensation   | 41                              | 10        |
| Credit for loan and lease losses   | (494 )                          | (1,570 )  |
| Valuation adjustment for off-balance sheet commitments                                       | (21 )                           | (113 )    |
| Gain on the sale of available-for-sale securities  | (2,224 )                        | (1,200 )  |
| Gain on the sale of held-to-maturity securities  | -                               | (368 )    |
| Gain on the sale of loans held for sale  | (40 )                           | (75 )     |
| Loss on the sale of education loans  | -                               | 13        |
| Gain on branch divestiture   | -                               | (607 )    |
| Gain on the sale of other real estate owned  | (5 )                            | (29 )     |
| Valuation adjustment of other real estate owned  | 12                              | 53        |
| Income from bank-owned life insurance  | (135 )                          | (167 )    |
| Proceeds from the sale of loans held for sale  | 1,085                           | 2,524     |
| Funds used to originate loans held for sale  | (442 )                          | (1,698 )  |
| Increase in interest receivable  | (43 )                           | (399 )    |
| Increase in prepaid expenses and other assets  | (324 )                          | (453 )    |
| Increase in interest payable   | 526                             | 568       |
| (Decrease) increase in accrued expenses and other liabilities                                | (2,278 )                        | 4,822     |
| Total adjustments  | (3,520 )                        | 1,987     |
| Net cash (used in) provided by operating activities  | (45 )                           | 5,500     |
| Cash flows from investing activities:  |                                 |           |
| Maturities, calls and principal payments of available-for-sale securities                    | 2,236                           | 1,502     |
| Proceeds from the sale of available-for-sale securities                                      | 35,948                          | 11,062    |
| Proceeds from the sale of held-to-maturity securities  | -                               | 2,686     |
| Purchases of available-for-sale securities   | (19,802 )                       | (37,129 ) |
| Net purchase of Federal Home Loan Bank of Pittsburgh stock                                   | (258 )                          | (396 )    |
| Proceeds from the sale of education loans  | -                               | 2,537     |
| Net increase in loans to customers   | (2,083 )                        | (12,606 ) |
| Proceeds from the sale of other real estate owned  | 37                              | 798       |
| Proceeds from the sale of bank premises and equipment through branch divestitures            | -                               | 2,504     |
| Purchases of property and equipment  | (518 )                          | (380 )    |

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|   |           |           |
|---|-----------|-----------|
| Net cash provided by (used in) investing activities         | 15,560    | (29,422 ) |
| Cash flows from financing activities:                       |           |           |
| Net decrease in deposits                                    | (20,225 ) | (49,065 ) |
| Proceeds from Federal Home Loan Bank of Pittsburgh advances | 6,512     | 17,500    |
| Repayment of Federal Home Loan Bank of Pittsburgh advances  | (94 )     | (10,089 ) |
| Net cash used in financing activities                       | (13,807 ) | (41,654 ) |
| Net increase (decrease) in cash and cash equivalents        | 1,708     | (65,576 ) |
| Cash and cash equivalents at beginning of period            | 35,667    | 103,556   |
| Cash and cash equivalents at end of period                  | \$37,375  | \$37,980  |
| Supplemental cash flow information                          |           |           |
| Cash paid during the period for:                            |           |           |
| Interest  | \$889     | \$1,005   |
| Income taxes  | -         | 25        |
| Other transactions:   |           |           |
| Available-for-sale securities purchased, not settled        | (1,013 )  | -         |
| Principal balance of loans transferred to OREO              | 149       | -         |
| Change in deferred gain on sale of other real estate owned  | (9 )      | 2         |

The accompanying notes to consolidated financial statements are an integral part of these statements.

**FIRST NATIONAL COMMUNITY BANCORP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1. Basis of Presentation**

The consolidated financial statements are comprised of the accounts of First National Community Bancorp, Inc., and its wholly owned subsidiary, First National Community Bank (the “Bank”), as well as the Bank’s wholly owned subsidiaries (collectively, the “Company”). The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”) and general practices within the banking industry. In the opinion of management, all adjustments necessary for a fair presentation of the results for the quarterly period ended March 31, 2015 have been included in the consolidated financial statements. All intercompany balances and transactions have been eliminated in consolidation. Prior period amounts have been reclassified when necessary to conform to the current period’s presentation. These reclassifications did not have an impact on the operating results or financial position of the Company. The operating results and financial position of the Company for the three months ended March 31, 2015, may not be indicative of future results of operations and financial position.

The preparation of financial statements in accordance 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to change in the near term are the allowance for loan and lease losses (“ALLL”), investment security valuations, the evaluation of investment securities and other real estate owned (“OREO”) for impairment, and the evaluation of deferred income taxes.

These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s audited financial statements, included in its Annual Report filed on Form 10-K as of and for the year ended December 31, 2014.

**Note 2. New Authoritative Accounting Guidance**

ASU 2014-04, Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure,” clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (a) the creditor obtaining legal title to residential

real estate property upon completion of a foreclosure or (b) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): “Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,” changes the criteria for reporting a discontinued operation. Under the new guidance, a disposal of a component of an entity or group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on the entity’s operations and financial results. This new guidance reduces complexity by removing the complex and extensive implementation guidance and illustrations that are necessary to apply the current definition of a discontinued operation. The new guidance also requires expanded disclosures about discontinued operations that will provide users with more information about the assets, liabilities, revenues and expenses of a discontinued operation and will require pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting, which will provide users with information about the ongoing trends in a reporting organization’s results from continuing operations. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

ASU 2014-11, Transfers and Servicing (Topic 860): “Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures,” changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements by aligning the accounting for these transactions with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial assets and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward arrangement, which has resulted in outcomes referred to as off-balance sheet accounting. ASU 2014-11 also requires a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction, and requires expanded disclosure about the nature of the collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

ASU 2014-14, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure,” requires that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure; (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

### **Accounting Guidance to be Adopted in Future Periods**

ASU 2014-09, Revenue from Contracts with Customers (Topic 606): Section A, “Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs-Contract with Customers (Subtopic 340-40);” Section B, “Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables;” and Section C, “Background Information and Basis for Conclusions,” provides a robust framework for addressing revenue recognition issues, and upon its effective date, replaces almost all existing revenue recognition guidance, including industry specific guidance, in current GAAP. The core principle of ASU 2014-09 is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 will also result in enhanced interim and annual disclosures, both qualitative and quantitative, about revenue in order to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. ASU 2014-09 is effective in annual reporting periods beginning after December 15, 2016 and the interim periods within that year for public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or over-the-counter market and employee benefit plans that file or furnish financial statements to the SEC. On April 29, 2015, the FASB issued for public comment a proposed ASU that would defer the effective date of ASU 2014-09 for both public and private entities for one year. A final decision is subject to the FASB’s due process requirement. The Company will adopt this guidance in accordance with the final outcome of the FASB’s extension proposal, and is currently evaluating the effect this guidance may have on its operating results or financial position.

ASU 2014-12, Compensation – Stock Compensation (Topic 718): “Accounting for Share-Based Payments When the Terms of an Award Provide that a Performance Target Could be Achieved after the Requisite Service Period,” requires a performance target that affects vesting and that can be achieved after the requisite service period to be treated as a performance condition. To account for such awards, an entity should apply existing guidance as it relates to awards with performance conditions that affect vesting. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service periods. The total amount of compensation cost

should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern,” defines management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and provide guidance for related footnote disclosures. ASU 2014-15 requires an entity’s management to assess the entity’s ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically ASU 2014-15: (1) provides a definition of the term substantial doubt; (2) requires an evaluation as to whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable); (3) provides principles for considering the mitigating effect of management’s plans; (4) requires certain disclosures when substantial doubt is alleviated; and (5) require an express statement and other disclosures when substantial doubt is not alleviated. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The adoption of this guidance on December 31, 2016 is not expected to have a material effect on the operating results or financial position of the Company.



ASU 2015-01, Income Statement – Extraordinary and Unusual Items (Subtopic 225-20): “Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items,” will alleviate uncertainty for preparers, auditors and regulators because auditors and regulators will no longer be required to evaluate whether a preparer presented an unusual and/or infrequent item appropriately. Although ASU 2015-01 eliminates the concept of extraordinary items, the presentation and disclosure guidance for items that are unusual in nature or infrequent in occurrence has been retained and has been expanded to include items that are both unusual in nature or infrequent in occurrence. The nature and financial effects of each event or transaction is required to be presented as a separate component of income from continuing operations or, alternatively, in the notes to the financial statements. ASU 2015-01 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption of this guidance is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-02, Consolidation (Topic 810): “Amendments to the Consolidation Analysis,” improves targeted areas of the consolidation guidance and reduces the number of consolidation models. The new consolidation standard changes the way reporting enterprises evaluate whether (a) they should consolidate limited partnerships and similar entities, (b) fees paid to a decision maker or service provider are variable interests in a variable interest entity (“VIE”), and (c) variable interests in a VIE held by related parties of the reporting enterprise require the reporting enterprise to consolidate the VIE. It also eliminates the VIE consolidation model based on majority exposure to variability that applied to certain investment companies and similar entities. ASU 2015-02 is effective for public entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-03, Interest – Imputation of Interest (Subtopic 835-30): “Simplifying the Presentation of Debt Issuance Costs,” more closely aligns the presentation of debt issuance costs under U.S. GAAP with the presentation under comparable IFRS standards. Under ASU 2015-03 debt issuance costs related to a recognized debt liability will no longer be recorded as a separate asset, but will be presented on the balance sheet as a direct deduction from the debt liability, similar to the presentation of debt discounts. The costs will continue to be amortized to interest expense using the effective interest method. ASU 2015-03 is effective for public entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, and requires retrospective application to all prior periods presented in the financial statements. Early adoption of this guidance is permitted. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-05, Intangibles – Goodwill and Other Internal-Use Software (Subtopic 350-40): “Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement,” provides explicit guidance on a customer’s accounting for fees paid in a cloud computing environment. Specifically, the amendments in this ASU provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. ASU 2015-05 is effective for public entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption of this

guidance is permitted. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

### **Note 3. Regulatory Matters**

The Bank was under a Consent Order (the “Order”) from the Office of the Comptroller of the Currency (“OCC”) dated September 1, 2010. On March 25, 2015, after meeting all of the requirements of the Order, the Bank was fully and completely released from the Order. The Company has been, and continues to be, subject to a Written Agreement (the “Agreement”) with the Federal Reserve Bank of Philadelphia (the “Reserve Bank”) dated November 24, 2010.

*Federal Reserve Agreement.* The Agreement requires the Company to undertake certain actions within designated timeframes, and to operate in compliance with the provisions thereof during its term. The material provisions of the Agreement are set forth below with a description of the status of the Company’s efforts to comply with such provisions:

(i) the Company’s Board was required to take appropriate steps to fully utilize the Company’s financial and managerial resources to serve as a source of strength to the Bank, including taking steps to ensure that the Bank complied with its Consent Order entered into with the OCC;

The Company has taken, and continues to take, steps the Board of Directors believes are appropriate to use the Company’s financial and managerial resources to serve as a source of strength to the Bank.

(ii) the Company may not declare or pay any dividends without the prior written approval of the Reserve Bank and the Director of the Division of Banking Supervision and Regulation (the “Director”) of the Federal Reserve Board;

The Company has acknowledged the prohibition on payment of dividends without the prior written consent of the Reserve Bank and Director. The Company has not paid any dividends since the effective date of the Agreement.

(iii) the Company may not take dividends or other payments representing a reduction of the Bank’s capital without the prior written approval of the Reserve Bank;

The Company has acknowledged the prohibition on taking dividends or any other capital distributions from the Bank without the prior written consent of the Reserve Bank. On September 8, 2014, the Company sent a request to the Reserve Bank to approve a dividend from the Bank in the amount of \$1.0 million. The dividend was to be used to cure the interest deferral on the junior subordinated debentures. The Company received written non-objection to allow the \$1.0 million dividend payment from the Bank and cure of the interest deferral on the junior subordinated debentures in the amount of \$921 thousand. The \$1.0 million dividend payment from the Bank to the Company and the interest deferral payment on the junior subordinated debentures were completed in December 2014. The Company made a subsequent request for and has received approval from the Reserve Bank to permit payment of the quarterly interest payment on the junior subordinated debentures, which was due and paid by the Company on March 15, 2015. In April 2015, the Company made an additional request to the Reserve Bank to approve a dividend from the Bank to the Company related to interest payments on the junior subordinated debentures and principal payments on the subordinated debentures.

(iv) the Company and its nonbank subsidiary may not make any payment of interest, principal or other amounts on the Company’s subordinated debentures or junior subordinated debentures without the prior written approval of the Reserve Bank and the Director;

The Company has acknowledged the prohibition on any payment related to the Company’s subordinated debentures and junior subordinated debentures without the written approval of the Reserve Bank and Director. Previously, the Company has not made any payments of interest, principal or other amounts on either of the Company’s debentures or junior subordinated debentures since the effective date of the Agreement.

On September 8, 2014, the Company sent to the Reserve Bank requests for approval for the Company to receive a \$1.0 million capital distribution from the Bank, and to make a distribution on the junior subordinated debentures to cure the interest deferral. The Company received approval from the Reserve Bank in November 2014 to cure and pay the interest deferral. On December 15, 2014, the Company paid all deferred and currently payable accrued interest totaling \$921 thousand. On February 2, 2015, the Company received approval from the Reserve Bank to pay the

regular quarterly interest payment, which was due and paid on March 15, 2015. In April 2015, the Company made an additional request to the Reserve Bank to approve a dividend from the Bank to the Company related to interest payments on the junior subordinated debentures and principal payments on the subordinated debentures.

(v) the Company may not make any payment of interest, principal or other amounts on debt owed to insiders of the Company without the prior written approval of the Reserve Bank and Director;

The Company has acknowledged the prohibition on any payment related to the debt owed to insiders of the Company without the written approval of the Reserve Bank and Director. The Company has not made any payments related to debt owed to insiders since the effective date of the Agreement. In April 2015, the Company made a request to the Reserve Bank to receive a dividend from the Bank and make pro-rata principal payments on the subordinated debentures including those debentures held by insiders of the Company.

(vi) the Company and its nonbank subsidiary may not incur, increase or guarantee any debt without the prior written approval of the Reserve Bank;

The Company has acknowledged the prohibition on incurring, increasing or guaranteeing any debt without the written approval of the Reserve Bank other than permitted borrowings by the Bank from the Federal Home Loan Bank ("FHLB"). The Company has not incurred, increased or guaranteed any debt since the effective date of the Agreement.

(vii) the Company may not purchase or redeem any shares of its stock without the prior written approval of the Reserve Bank;

The Company has acknowledged the prohibition on purchasing or redeeming any shares of its stock without the written approval of the Reserve Bank. The Company has not purchased or redeemed any shares of its stock since the effective date of the Agreement.

(viii) the Company was required to submit to the Reserve Bank, by January 23, 2011, an acceptable written plan to maintain sufficient capital at the Company on a consolidated basis. Thereafter, the Company must notify the Reserve Bank within 45 days of the end of any quarter in which the Company's capital ratios fall below the approved capital plan's minimum ratios, and submit an acceptable written plan to increase the Company's capital ratios above the capital plan's minimums;

The Company has developed a Capital Plan that it believes is acceptable and maintains sufficient capital at the Company on a consolidated basis. The Company notified the Reserve Bank that the OCC issued a written determination of supervisory non-objection to the 2014-2016 Capital Plan in June 2014, and that the Bank's Board of Directors adopted the plan in June 2014. The annual update and revision to the Capital Plan for the three-year period January 1, 2015 to December 31, 2017 was completed in conjunction with the annual budget and strategic planning initiatives and provided to the Reserve Bank in January 2015.

(ix) the Company was required to immediately take all actions necessary to ensure that: (1) each regulatory report accurately reflects the Company's condition on the date for which it is filed and all material transactions between the Company and its subsidiaries; (2) each such report is prepared in accordance with its instructions; and (3) all records indicating how the report was prepared are maintained for supervisory review;

The Company believes that it has taken actions to ensure that all required regulatory reports are filed to accurately reflect its financial condition on the date filed, are prepared in accordance with instructions and that records detailing how the reports were filed are maintained and available for supervisory review.

(x) the Company was required to submit to the Reserve Bank, by January 23, 2011, acceptable written procedures to strengthen and maintain internal controls to ensure all required regulatory reports and notices filed with the Board of Governors are accurate and filed in accordance with the instructions for preparation;

The Company believes that it has designed effective written procedures and strengthened internal controls so that all required Board of Governors reports and notices filed are accurate, timely and in accordance with instructions. The written procedures were provided to the Reserve Bank on January 21, 2011.

(xi) the Company was required to submit to the Reserve Bank, by January 8, 2011, a cash flow projection for 2011, reflecting the Company's planned sources and uses of cash, and submit a cash flow projection for each subsequent calendar year at least one month prior to the beginning of such year;

The Company created a cash flow projection for 2011 and submitted it to the Reserve Bank on January 7, 2011 in accordance with requirements of the Agreement. Similar projections for 2012, 2013, 2014 and 2015 were provided to the Reserve Bank within the time requirements prescribed in the Agreement.

(xii) the Company must comply with: (1) the notice provisions of Section 32 of the FDI Act and Subpart H of Regulation Y in appointing any new director or senior executive officer or changing the duties of any senior executive

officer; and (2) the restrictions on indemnification and severance payments of Section 18(k) of the FDI Act and Part 359 of the FDIC's regulations;

The Company has acknowledged the notice requirements on the appointment of any new director or senior executive officer. The Company has filed the appropriate notice for each new director or senior executive officer since the date of the Agreement.

The Company acknowledges the restriction on indemnification and severance payments under Section 18(k) of the FDI Act and Part 359 of the FDIC's regulations. The Company has not made any such indemnification or severance payments since the effective date of the Agreement without obtaining prior regulatory non-objection and regulatory concurrence from the FDIC as required by Part 359.

(xiii) the Board must submit written progress reports within 30 days of the end of each calendar quarter.

The Company's Board of Directors has filed each of the required written progress reports with the Reserve Bank since the Agreement was executed.

Banking regulations also limit the amount of dividends that may be paid without prior approval of the Bank's regulatory agency. At March 31, 2015, the Company and the Bank are restricted from paying any dividends, without regulatory approval based on provisions contained in the Written Agreement.

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

In July 2013, the Federal Reserve, the OCC and the FDIC approved the final Basel III capital framework for U.S. banking organizations (the “Regulatory Capital Rules”) implementing regulatory capital reforms and changes required by the Dodd-Frank Act.

The Regulatory Capital Rules are effective on January 1, 2014; however, the mandatory compliance date for the Company and the Bank as “standardized approach” banking organizations began on January 1, 2015 and is subject to transitional provisions extending to January 1, 2019. The Regulatory Capital Rules include new risk-based capital and leverage ratios and refine the definition of what constitutes “capital” for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Company and the Bank under the Regulatory Capital Rules will be:

- a new common equity Tier I capital ratio of 4.50%;
- a Tier I capital ratio of 6.00% (increased from 4.00%);
- a total capital ratio of 8.00% (unchanged from current rules); and
- a Tier I leverage ratio of 4.00% for all institutions.

The Regulatory Capital Rules also establish a “capital conservation buffer” above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier I capital and result in the following minimum ratios effective January 1, 2019:

- a common equity Tier I capital ratio of 7.00%;
- a Tier I capital ratio of 8.50%; and
- a total capital ratio of 10.50%.

The new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase by that amount each year until fully implemented in January 2019 at 2.50%. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that could be utilized for such actions.

The Regulatory Capital Rules also implement revisions and clarifications consistent with Basel III regarding the various components of Tier I capital, including common equity, unrealized gains and losses, as well as certain instruments that will no longer qualify as Tier I capital, some of which will be phased out over time.

The Regulatory Capital Rules also revise the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Bank, if their capital levels begin to show signs of

weakness. These revisions took effect January 1, 2015. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions will be required to meet the following increased capital level requirements in order to qualify as “well capitalized:”

- a new common equity Tier I risk-based capital ratio of 6.50%;
- a Tier I risk-based capital ratio of 8.00% (increased from 6.00%);
- a total risk-based capital ratio of 10.00% (unchanged from current rules); and
- a Tier I leverage ratio of 5.00%.

The Regulatory Capital Rules set forth certain changes for the calculation of risk-weighted assets, which are required to be utilized beginning January 1, 2015. The provisions applicable to banking organizations under the “standardized approach” include changes with respect to risk weights for commercial real estate loans, past due exposures and conversion factors for commitments with an original maturity of one year or less.

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

Current quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).



The Company's and the Bank's actual capital positions and ratios at March 31, 2015 and December 31, 2014 are presented in the following table:

### Capital Analysis

| (in thousands)                                   | March 31,<br>2015 | December 31,<br>2014 |
|--|-------------------|----------------------|
| Company:   |                   |                      |
| Tier I common equity                             | \$ 53,646         | N/A                  |
| Tier I capital                                   | 63,646            | \$ 59,930            |
| Tier II capital:                                 |                   |                      |
| Subordinated notes                               | 17,500            | 25,000               |
| Allowable portion of allowance for loan losses   | 8,697             | 8,591                |
| Total tier II capital                            | 26,197            | 33,591               |
| Total risk-based capital                         | 89,843            | 93,521               |
| Total risk-weighted assets                       | \$ 693,098        | \$ 683,956           |
| Total average assets (for Tier I leverage ratio) | \$ 968,240        | \$ 990,346           |
| Bank:  |                   |                      |
| Tier I common equity                             | \$ 101,137        | N/A                  |
| Tier I capital                                   | 101,137           | \$ 96,816            |
| Tier II capital:                                 |                   |                      |
| Allowable portion of allowance for loan losses   | 8,692             | 8,587                |
| Total tier II capital                            | 8,692             | 8,587                |
| Total risk-based capital                         | 109,829           | 105,403              |
| Total risk-weighted assets                       | \$ 692,707        | \$ 683,576           |
| Total average assets (for Tier I leverage ratio) | \$ 968,119        | \$ 990,407           |

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The following tables present summary information regarding the Company's and the Bank's risk-based capital and related ratios at March 31, 2015 and December 31, 2014:

| (dollars in thousands)                         | Actual    |         | For Capital Adequacy Purposes |         | To Be Well Capitalized Under Prompt Corrective Action Provision |          |
|--|-----------|---------|-------------------------------|---------|---|----------|
|  | Amount    | Ratio   | Amount                        | Ratio   | Amount  | Ratio    |
| March 31, 2015                                 |           |         |                               |         |   |          |
| Total capital (to risk-weighted assets)        |           |         |                               |         |   |          |
| Company  | \$89,843  | 12.96%  | \$>=55,448                    | >=8.00% | \$>=69,310  | >=10.00% |
| Bank   | \$109,829 | 15.86%  | \$>=55,417                    | >=8.00% | \$>=69,271  | >=10.00% |
| Tier I capital (to risk-weighted assets)       |           |         |                               |         |   |          |
| Company  | \$63,646  | 9.18 %  | \$>=41,586                    | >=6.00% | \$>=55,448  | >=8.00%  |
| Bank   | \$101,137 | 14.60%  | \$>=41,562                    | >=6.00% | \$>=55,417  | >=8.00%  |
| Tier I common equity (to risk-weighted assets) |           |         |                               |         |   |          |
| Company  | \$53,646  | 7.74 %  | \$>=31,189                    | >=4.50% | \$>=45,051  | >=6.50%  |
| Bank   | \$101,137 | 14.60%  | \$>=31,172                    | >=4.50% | \$>=45,026  | >=6.50%  |
| Tier I capital (to average assets)             |           |         |                               |         |   |          |
| Company  | \$63,646  | 6.57 %  | \$>=38,730                    | >=4.00% | \$>=48,412  | >=5.00%  |
| Bank   | \$101,137 | 10.45 % | \$>=38,725                    | >=4.00% | \$>=48,406  | >=5.00%  |

| (dollars in thousands)                   | Actual    |        | For Capital Adequacy Purposes |        | To Be Well Capitalized Under Prompt Corrective Action Provision |         |
|--|-----------|--------|-------------------------------|--------|---|---------|
|  | Amount    | Ratio  | Amount                        | Ratio  | Amount  | Ratio   |
| December 31, 2014                        |           |        |                               |        |   |         |
| Total capital (to risk-weighted assets)  |           |        |                               |        |   |         |
| Company                                  | \$93,521  | 13.67% | \$>54,717                     | >8.00% | N/A   | N/A     |
| Bank                                     | \$105,403 | 15.42% | \$>54,686                     | >8.00% | \$>68,358   | >10.00% |
| Tier I capital (to risk-weighted assets) |           |        |                               |        |   |         |
| Company                                  | \$59,930  | 8.76 % | \$>27,358                     | >4.00% | N/A   | N/A     |
| Bank                                     | \$96,816  | 14.16% | \$>27,343                     | >4.00% | \$>41,015   | >6.00%  |
| Tier I capital (to average assets)       |           |        |                               |        |   |         |
| Company                                  | \$59,930  | 6.05 % | \$>39,614                     | >4.00% | N/A   | N/A     |
| Bank                                     | \$96,816  | 9.78 % | \$>39,616                     | >4.00% | \$>49,520   | >5.00%  |

**Note 4. LOANS**

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The following table summarizes loans receivable, net, by category at March 31, 2015 and December 31, 2014:

| (in thousands)                                 | March 31,<br>2015 | December 31,<br>2014 |
|--|-------------------|----------------------|
| Residential real estate                        | \$ 125,488        | \$ 122,832           |
| Commercial real estate                         | 226,800           | 233,473              |
| Construction, land acquisition and development | 21,790            | 18,835               |
| Commercial and industrial                      | 131,895           | 132,057              |
| Consumer                                       | 122,967           | 122,092              |
| State and political subdivisions               | 42,206            | 40,205               |
| Total loans, gross                             | 671,146           | 669,494              |
| Unearned income                                | (87 )             | (98 )                |
| Net deferred loan costs                        | 1,106             | 871                  |
| Allowance for loan and lease losses            | (10,944 )         | (11,520 )            |
| Loans, net                                     | \$ 661,221        | \$ 658,747           |

The Company has granted loans, letters of credit and lines of credit to certain executive officers and directors of the Company as well as to certain related parties of executive officers and directors. These loans, letters of credit and lines of credit were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and, when made, did not involve more than normal risk of collectability. See Note 10 to these consolidated financial statements for more information about related party transactions.

The Company originates one- to four-family mortgage loans for sale in the secondary market. During the quarter ended March 31, 2015, the Company sold \$1.0 million of one- to four-family mortgages. The Company retains servicing rights on these mortgages. As part of its current asset/liability management strategy, the Company is retaining up to \$10.0 million in residential mortgages in the loan portfolio. The Company did not have any residential mortgage loans held for sale at March 31, 2015. At December 31, 2014, there was \$603 thousand of one- to four-family residential mortgages held-for-sale.

The Company sold substantially all of its education loans, which are categorized as consumer loans, to a third party during the three months ended March 31, 2014. The education loans had a recorded investment of \$2.6 million at the time of sale. The Company recognized a loss of \$13 thousand upon the sale of these loans which is included in non-interest income for the three months ended March 31, 2014.

The Company does not have any lending programs commonly referred to as subprime lending. Subprime lending generally targets borrowers with weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, bankruptcies, or borrowers with questionable repayment capacity as evidenced by low credit scores or high debt-burden ratios.

See Note 2 to the Company's consolidated financial statements included in the 2014 Form 10-K for information about the risk characteristics related to the Company's loan segments.

The Company provides for loan losses based on the consistent application of its documented ALLL methodology. Loan losses are charged to the ALLL and recoveries are credited to it. Additions to the ALLL are provided by charges against income based on various factors which, in management's judgment, deserve current recognition of estimated probable losses. Loan losses are charged-off in the period the loans, or portions thereof, are deemed uncollectible. Generally, the Company will record a loan charge-off (including a partial charge-off) to reduce a loan to the estimated recoverable amount based on its methodology detailed below. The Company regularly reviews the loan portfolio and makes adjustments for loan losses in order to maintain the ALLL in accordance with GAAP. The ALLL consists primarily of the following two components:

Specific allowances are established for impaired loans, which are defined by the Company as all loan relationships with an aggregate outstanding balance greater than \$100 thousand that are rated substandard and on non-accrual status, rated doubtful or loss, and all troubled debt restructured loans (“TDRs”). The amount of impairment provided for as an allowance is represented by the deficiency, if any, between the carrying value of the loan and either (a) (1) the present value of expected future cash flows discounted at the loan’s effective interest rate, (b) the loan’s observable market price, or (c) the fair value of the underlying collateral, less estimated costs to sell, for collateral dependent loans. Impaired loans that have no impairment losses are not considered for general valuation allowances described below. If the Company determines that collection of the impairment amount is remote, the Company will record a charge-off.

General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired. The Company divides its portfolio into loan segments for loans exhibiting similar characteristics. Loans rated special mention or substandard and accruing, which are embedded in these loan segments, are then separated from these loan segments. These loans are then subject to an analysis placing increased emphasis on the credit risk associated with these specific loans. The Company applies an estimated loss rate to each loan segment. The loss rates applied are based on the Company’s own historical loss experience based on the loss rate for each segment of (2) loans with similar risk characteristics in its portfolio. In addition, management evaluates and applies certain qualitative or environmental factors that are likely to cause estimated credit losses associated with the Company’s existing portfolio to differ from historical experience, which are discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the ALLL that is established, which could have a material negative effect on the Company’s operating results or financial condition.

Management makes adjustments for loan losses based on its evaluation of several qualitative and environmental factors, including but not limited to:

changes in national, local, and business economic conditions and developments, including the condition of various market segments;

- changes in the nature and volume of the Company's loan portfolio;
- changes in the Company's lending policies and procedures, including underwriting standards, collection, charge-off and recovery practices and results;
- changes in the experience, ability and depth of the Company's lending management and staff;
- changes in the quality of the Company's loan review system and the degree of oversight by the Company's Board of Directors;
- changes in the trend of the volume and severity of past due and classified loans, including trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications;
- the existence and effect of any concentrations of credit and changes in the level of such concentrations;
- the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Company's current loan portfolio; and
- analysis of customers' credit quality, including knowledge of their operating environment and financial condition.

Each quarter, management evaluates the ALLL and adjusts the ALLL as appropriate through a provision for loan losses. While the Company uses the best information available to make evaluations, future adjustments to the ALLL may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of its examination process, the OCC periodically reviews the Company's ALLL. The OCC may require the Company to adjust the ALLL based on its analysis of information available to it at the time of its examination.

Based on its evaluation of the ALLL, management established an unallocated reserve of \$39 thousand and \$45 thousand at March 31, 2015 and December 31, 2014, respectively. As previously mentioned, as part of its evaluation, management applies loss rates to each loan segment which are based on historical loss experience for that segment. The Company has experienced net recoveries related to its construction, land acquisition and development segment of the loan portfolio for the majority of the quarters over the previous three years, which have resulted in an overall negative historical loss factors and consequently related negative provisions for this particular loan segment at March 31, 2015 and December 31, 2014. Based on the higher risk characteristics inherent in this segment of the portfolio, management reversed the negative provisions related to the negative historical loss factors and established the unallocated reserves.

The following table summarizes activity in the ALLL, by loan category, for the three months ended March 31, 2015 and 2014:

| (in thousands) | Real Estate    |                | Construction,<br>Land<br>Acquisition<br>and<br>Development | Commercial<br>and<br>Industrial | Consumer | State and<br>Political<br>Subdivisions | Unallocated | Total |
|----------------|----------------|----------------|--|---------------------------------|----------|--|-------------|-------|
|                | Real<br>Estate | Real<br>Estate |  |                                 |          |  |             |       |
|                |                |                |  |                                 |          |  |             |       |

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Three months ended

March 31, 2015:

Allowance for loan losses:

|                                       |          |          |        |          |          |        |       |           |
|---------------------------------------|----------|----------|--------|----------|----------|--------|-------|-----------|
| Beginning balance,<br>January 1, 2015 | \$ 1,772 | \$ 4,663 | \$ 665 | \$ 2,104 | \$ 1,673 | \$ 598 | \$ 45 | \$ 11,520 |
| Charge-offs                           | (68 )    | -        | -      | (70 )    | (139 )   | -      | -     | (277 )    |
| Recoveries                            | 6        | 2        | -      | 65       | 122      | -      | -     | 195       |
| Provisions (credits)                  | (179 )   | (334 )   | 99     | (101 )   | 42       | (15 )  | (6 )  | (494 )    |
| Ending balance, March 31,<br>2015     | \$ 1,531 | \$ 4,331 | \$ 764 | \$ 1,998 | \$ 1,698 | \$ 583 | \$ 39 | \$ 10,944 |

Three months ended

March 31, 2014:

Allowance for loan losses:

|                                       |          |          |        |          |          |        |      |           |
|---------------------------------------|----------|----------|--------|----------|----------|--------|------|-----------|
| Beginning balance,<br>January 1, 2014 | \$ 2,287 | \$ 6,017 | \$ 924 | \$ 2,321 | \$ 1,789 | \$ 679 | \$ - | \$ 14,017 |
| Charge-offs                           | (9 )     | -        | -      | (23 )    | (237 )   | -      | -    | (269 )    |
| Recoveries                            | 8        | 6        | 240    | 63       | 94       | -      | -    | 411       |
| Provisions (credits)                  | (172 )   | (493 )   | (289 ) | (549 )   | 9        | (76 )  | -    | (1,570 )  |
| Ending balance, March 31,<br>2014     | \$ 2,114 | \$ 5,530 | \$ 875 | \$ 1,812 | \$ 1,655 | \$ 603 | \$ - | \$ 12,589 |

The following table represents the allocation of the ALLL and the related loan balance, by loan category, disaggregated based on the impairment methodology at March 31, 2015 and December 31, 2014:

| (in thousands)                        | Real Estate           |                      | Construction,<br>Land<br>Acquisition<br>and<br>Development | Commercial<br>and<br>Industrial | Consumer         | State and<br>Political<br>Subdivision | Unallocated | Total            |
|---------------------------------------|-----------------------|----------------------|--|---------------------------------|------------------|---------------------------------------|-------------|------------------|
|                                       | Residential<br>Estate | Commercial<br>Estate |  |                                 |                  |                                       |             |                  |
| <b>March 31, 2015</b>                 |                       |                      |  |                                 |                  |                                       |             |                  |
| Allowance for loan losses:            |                       |                      |  |                                 |                  |                                       |             |                  |
| Individually evaluated for impairment | \$6                   | \$315                | \$95   | \$-                             | \$1              | \$-                                   | \$-         | \$417            |
| Collectively evaluated for impairment | 1,525                 | 4,016                | 669  | 1,998                           | 1,697            | 583                                   | 39          | 10,527           |
| <b>Total</b>                          | <b>\$1,531</b>        | <b>\$4,331</b>       | <b>\$764</b>   | <b>\$1,998</b>                  | <b>\$1,698</b>   | <b>\$583</b>                          | <b>\$39</b> | <b>\$10,944</b>  |
| Loans receivable:                     |                       |                      |  |                                 |                  |                                       |             |                  |
| Individually evaluated for impairment | \$2,735               | \$6,518              | \$347  | \$31                            | \$358            | \$-                                   | \$-         | \$9,989          |
| Collectively evaluated for impairment | 122,753               | 220,282              | 21,443   | 131,864                         | 122,609          | 42,206                                | -           | 661,157          |
| <b>Total</b>                          | <b>\$125,488</b>      | <b>\$226,800</b>     | <b>\$21,790</b>  | <b>\$131,895</b>                | <b>\$122,967</b> | <b>\$42,206</b>                       | <b>\$-</b>  | <b>\$671,146</b> |
| <b>December 31, 2014</b>              |                       |                      |  |                                 |                  |                                       |             |                  |
| Allowance for loan losses:            |                       |                      |  |                                 |                  |                                       |             |                  |
| Individually evaluated for impairment | \$51                  | \$331                | \$1  | \$-                             | \$1              | \$-                                   | \$-         | \$384            |
| Collectively evaluated for impairment | 1,721                 | 4,332                | 664  | 2,104                           | 1,672            | 598                                   | 45          | 11,136           |
| <b>Total</b>                          | <b>\$1,772</b>        | <b>\$4,663</b>       | <b>\$665</b>   | <b>\$2,104</b>                  | <b>\$1,673</b>   | <b>\$598</b>                          | <b>\$45</b> | <b>\$11,520</b>  |
| Loans receivable:                     |                       |                      |  |                                 |                  |                                       |             |                  |
| Individually evaluated for impairment | \$2,487               | \$6,660              | \$256  | \$32                            | \$361            | \$-                                   | \$-         | \$9,796          |
| Collectively evaluated for impairment | 120,345               | 226,813              | 18,579   | 132,025                         | 121,731          | 40,205                                | -           | 659,698          |
| <b>Total</b>                          | <b>\$122,832</b>      | <b>\$233,473</b>     | <b>\$18,835</b>  | <b>\$132,057</b>                | <b>\$122,092</b> | <b>\$40,205</b>                       | <b>\$-</b>  | <b>\$669,494</b> |

#### Credit Quality Indicators – Commercial Loans



Management continuously monitors the credit quality of the Company's commercial loans by regularly reviewing certain credit quality indicators. Management utilizes credit risk ratings as the key credit quality indicator for evaluating the credit quality of the Company's loan receivables.

The Company's commercial loan classification and credit grading processes are part of the lending, underwriting, and credit administration functions to ensure an ongoing assessment of credit quality. Accurate and timely loan classification and credit grading is a critical component of loan portfolio management. Loan officers are required to review their loan portfolio risk ratings regularly for accuracy. The loan review function uses the same risk rating system in the loan review process. Quarterly, the Company engages an independent third party to assess the quality of the loan portfolio and evaluate the accuracy of ratings with the loan officer's and management's assessment.

A formal loan classification and credit grading system reflects the risk of default and credit losses. A written description of the risk ratings is maintained that includes a discussion of the factors used to assign appropriate classifications of credit grades to loans. The process identifies groups of loans that warrant the special attention of management. The risk grade groupings provide a mechanism to identify risk within the loan portfolio and provide management and the Board with periodic reports by risk category. The credit risk ratings play an important role in the establishment and evaluation of the provision for loan and lease losses and the ALLL. After determining the historical loss factor which is adjusted for qualitative and environmental factors for each portfolio segment, the portfolio segment balances that have been collectively evaluated for impairment are multiplied by the general reserve loss factor for the respective portfolio segments to determine the general reserve. Loans that have an internal credit rating of special mention or substandard follow the same process; however, the qualitative and environmental factors are further adjusted for the increased risk.

The Company utilizes a loan rating system that assigns a degree of risk to commercial loans based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. Management analyzes these non-homogeneous loans individually by grading the loans as to credit risk and probability of collection for each type of loan. Commercial loans include commercial indirect auto loans which are not individually risk rated, and construction, land acquisition and development loans include residential construction loans which are also not individually risk rated. These loans are monitored on a pool basis due to their homogeneous nature as described in "Credit Quality Indicators – Other Loans" below. The Company risk rates certain residential real estate loans and consumer loans that are part of a larger commercial relationship using its credit grading system as described in "Credit Quality Indicators – Commercial Loans." The grading system contains the following basic risk categories:

1. Minimal Risk
2. Above Average Credit Quality

3. Average Risk
4. Acceptable Risk
5. Pass - Watch
6. Special Mention
7. Substandard - Accruing
8. Substandard - Non-Accrual
9. Doubtful
10. Loss

This analysis is performed on a quarterly basis using the following definitions for risk ratings:

Pass - Assets rated 1 through 5 are considered pass ratings. These assets show no current or potential problems and are considered fully collectible. All such loans are considered collectively for ALLL calculation purposes. However, accruing TDRs that have been performing for an extended period of time, do not represent a higher risk of loss, and have been upgraded to a pass rating are evaluated individually for impairment.

Special Mention – Assets classified as special mention assets do not currently expose the Company to a sufficient degree of risk to warrant an adverse classification but do possess credit deficiencies or potential weaknesses deserving close attention. Special Mention assets have a potential weakness or pose an unwarranted financial risk which, if not corrected, could weaken the asset and increase risk in the future.

Substandard - Assets classified as substandard have well defined weaknesses based on objective evidence, and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful - Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable based on current circumstances.

Loss - Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted.

### Credit Quality Indicators – Other Loans

Certain residential real estate loans, consumer loans, and commercial indirect auto loans are monitored on a pool basis due to their homogeneous nature. Loans that are delinquent 90 days or more are placed on non-accrual status unless collection of the loan is in process and reasonably assured. The Company utilizes accruing versus non-accruing status as the credit quality indicator for these loan pools. The following table presents the recorded investment in loans receivable by loan category and credit quality indicator at March 31, 2015 and December 31, 2014:

|  | <b>Credit Quality Indicators</b> |                            |                    |                 |             |                                |                           |                               |                           |                        |
|--|----------------------------------|----------------------------|--------------------|-----------------|-------------|--------------------------------|---------------------------|-------------------------------|---------------------------|------------------------|
|  | <b>March 31, 2015</b>            |                            |                    |                 |             |                                |                           |                               |                           |                        |
|  | <b>Commercial Loans</b>          |                            |                    |                 |             | <b>Other Loans</b>             |                           |                               |                           |                        |
|  | <b>Pass</b>                      | <b>Special<br/>Mention</b> | <b>Substandard</b> | <b>Doubtful</b> | <b>Loss</b> | <b>Subtotal<br/>Commercial</b> | <b>Accruing<br/>Loans</b> | <b>Non-accruing<br/>Loans</b> | <b>Subtotal<br/>Other</b> | <b>Total<br/>Loans</b> |
| Residential real estate                        | \$ 20,901                        | \$ 442                     | \$ 1,052           | \$ -            | \$ -        | \$ 22,395                      | \$ 102,493                | \$ 600                        | \$ 103,093                | \$ 125,488             |
| Commercial real estate                         | 198,254                          | 13,696                     | 14,850             | -               | -           | 226,800                        | -                         | -                             | -                         | 226,800                |
| Construction, land acquisition and development | 13,982                           | 1,476                      | 5,562              | -               | -           | 21,020                         | 770                       | -                             | 770                       | 21,790                 |
| Commercial and industrial                      | 122,514                          | 2,265                      | 2,046              | -               | -           | 126,825                        | 5,036                     | 34                            | 5,070                     | 131,895                |
| Consumer                                       | 3,106                            | 26                         | 121                | -               | -           | 3,253                          | 119,455                   | 259                           | 119,714                   | 122,967                |
| State and political subdivisions               | 40,603                           | 1,041                      | 562                | -               | -           | 42,206                         | -                         | -                             | -                         | 42,206                 |
| <b>Total</b>                                   | <b>\$ 399,360</b>                | <b>\$ 18,946</b>           | <b>\$ 24,193</b>   | <b>\$ -</b>     | <b>\$ -</b> | <b>\$ 442,499</b>              | <b>\$ 227,754</b>         | <b>\$ 893</b>                 | <b>\$ 228,647</b>         | <b>\$ 671,146</b>      |

|                                | <b>Credit Quality Indicators</b> |                            |                    |                 |             |                                |                           |                               |                           |                        |
|--------------------------------|----------------------------------|----------------------------|--------------------|-----------------|-------------|--------------------------------|---------------------------|-------------------------------|---------------------------|------------------------|
|                                | <b>December 31, 2014</b>         |                            |                    |                 |             |                                |                           |                               |                           |                        |
|                                | <b>Commercial Loans</b>          |                            |                    |                 |             | <b>Other Loans</b>             |                           |                               |                           |                        |
|                                | <b>Pass</b>                      | <b>Special<br/>Mention</b> | <b>Substandard</b> | <b>Doubtful</b> | <b>Loss</b> | <b>Subtotal<br/>Commercial</b> | <b>Accruing<br/>Loans</b> | <b>Non-accruing<br/>Loans</b> | <b>Subtotal<br/>Other</b> | <b>Total<br/>Loans</b> |
| Residential real estate        | \$ 19,892                        | \$ 451                     | \$ 1,077           | \$ -            | \$ -        | \$ 21,420                      | \$ 100,576                | \$ 836                        | \$ 101,412                | \$ 122,832             |
| Commercial real estate         | 204,252                          | 13,217                     | 16,004             | -               | -           | 233,473                        | -                         | -                             | -                         | 233,473                |
| Construction, land acquisition | 10,910                           | 1,423                      | 5,566              | -               | -           | 17,899                         | 936                       | -                             | 936                       | 18,835                 |

|  |            |           |           |      |      |            |            |          |            |            |
|--|------------|-----------|-----------|------|------|------------|------------|----------|------------|------------|
| and<br>development                     |            |           |           |      |      |            |            |          |            |            |
| Commercial<br>and industrial           | 122,261    | 1,962     | 2,397     | -    | -    | 126,620    | 5,437      | -        | 5,437      | 132,057    |
| Consumer                               | 3,414      | -         | 125       | -    | -    | 3,539      | 118,377    | 176      | 118,553    | 122,092    |
| State and<br>political<br>subdivisions | 38,685     | 925       | 595       | -    | -    | 40,205     | -          | -        | -          | 40,205     |
| Total                                  | \$ 399,414 | \$ 17,978 | \$ 25,764 | \$ - | \$ - | \$ 443,156 | \$ 225,326 | \$ 1,012 | \$ 226,338 | \$ 669,494 |

Included in loans receivable are loans for which the accrual of interest income has been discontinued due to deterioration in the financial condition of the borrowers. The recorded investment in these non-accrual loans was \$5.2 million and \$5.5 million at March 31, 2015 and December 31, 2014, respectively. Generally, loans are placed on non-accrual status when they become 90 days or more delinquent, and remain on non-accrual status until they are brought current, have six months of performance under the loan terms, and factors indicating reasonable doubt about the timely collection of payments no longer exist. Therefore, loans may be current in accordance with their loan terms, or may be less than 90 days delinquent and still be on a non-accrual status. There were no loans past due 90 days or more and still accruing at March 31, 2015 and December 31, 2014.

The following tables present the detail, and delinquency status, of past due and non-accrual loans at March 31, 2015 and December 31, 2014:

### Performing and Non-Performing Loan Delinquency Status

| (in thousands)                                 | March 31, 2015<br>Delinquency Status |            |            |            | Total      |
|--|--------------------------------------|------------|------------|------------|------------|
|  | 0-29<br>Days                         | 30-59 Days | 60-89 Days | >= 90 Days |            |
|  | Past Due                             | Past Due   | Past Due   | Past Due   |            |
| Performing (accruing) loans:                   |                                      |            |            |            |            |
| Real estate:                                   |                                      |            |            |            |            |
| Residential real estate                        | \$ 124,297                           | \$ 353     | \$ 81      | \$ -       | \$ 124,731 |
| Commercial real estate                         | 222,736                              | 52         | -          | -          | 222,788    |
| Construction, land acquisition and development | 21,420                               | 370        | -          | -          | 21,790     |
| Total real estate                              | 368,453                              | 775        | 81         | -          | 369,309    |
| Commercial and industrial                      | 131,475                              | 242        | 22         | -          | 131,739    |
| Consumer                                       | 121,654                              | 969        | 85         | -          | 122,708    |
| State and political subdivisions               | 42,206                               | -          | -          | -          | 42,206     |
| Total performing (accruing) loans              | 663,788                              | 1,986      | 188        | -          | 665,962    |
| Non-accrual loans:                             |                                      |            |            |            |            |
| Real estate:                                   |                                      |            |            |            |            |
| Residential real estate                        | 486                                  | 13         | 32         | 226        | 757        |
| Commercial real estate                         | 291                                  | 3,535      | 151        | 35         | 4,012      |
| Construction, land acquisition and development | -                                    | -          | -          | -          | -          |
| Total real estate                              | 777                                  | 3,548      | 183        | 261        | 4,769      |
| Commercial and industrial                      | 11                                   | 35         | -          | 110        | 156        |

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|                                  |           |          |        |        |           |
|----------------------------------|-----------|----------|--------|--------|-----------|
| Consumer                         | 47        | 27       | 37     | 148    | 259       |
| State and political subdivisions | -         | -        | -      | -      | -         |
| Total non-accrual loans          | 835       | 3,610    | 220    | 519    | 5,184     |
| Total loans receivable           | \$664,623 | \$ 5,596 | \$ 408 | \$ 519 | \$671,146 |

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**Performing and Non-Performing Loan Delinquency Status**

| (in thousands)                                 | December 31, 2014        |                        |                        |                        | Total      |
|--|--------------------------|------------------------|------------------------|------------------------|------------|
|  | Delinquency Status       |                        |                        |                        |            |
|  | 0-29<br>Days<br>Past Due | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | >= 90 Days<br>Past Due |            |
| Performing (accruing) loans:                   |                          |                        |                        |                        |            |
| Real estate:                                   |                          |                        |                        |                        |            |
| Residential real estate                        | \$ 121,407               | \$ 420                 | \$ -                   | \$ -                   | \$ 121,827 |
| Commercial real estate                         | 229,207                  | 136                    | -                      | -                      | 229,343    |
| Construction, land acquisition and development | 18,740                   | -                      | 95                     | -                      | 18,835     |
| Total real estate                              | 369,354                  | 556                    | 95                     | -                      | 370,005    |
| Commercial and industrial                      | 131,621                  | 90                     | 135                    | -                      | 131,846    |
| Consumer                                       | 120,204                  | 1,334                  | 378                    | -                      | 121,916    |
| State and political subdivisions               | 40,205                   | -                      | -                      | -                      | 40,205     |
| Total performing (accruing) loans              | 661,384                  | 1,980                  | 608                    | -                      | 663,972    |
| Non-accrual loans:                             |                          |                        |                        |                        |            |
| Real estate:                                   |                          |                        |                        |                        |            |
| Residential real estate                        | 495                      | 99                     | 17                     | 394                    | 1,005      |
| Commercial real estate                         | 288                      | 3,628                  | 19                     | 195                    | 4,130      |
| Construction, land acquisition and development | -                        | -                      | -                      | -                      | -          |
| Total real estate                              | 783                      | 3,727                  | 36                     | 589                    | 5,135      |
| Commercial and industrial                      | 55                       | -                      | 52                     | 104                    | 211        |
| Consumer                                       | 42                       | -                      | 58                     | 76                     | 176        |
| State and political subdivisions               | -                        | -                      | -                      | -                      | -          |
| Total non-accrual loans                        | 880                      | 3,727                  | 146                    | 769                    | 5,522      |
| Total loans receivable                         | \$ 662,264               | \$ 5,707               | \$ 754                 | \$ 769                 | \$ 669,494 |

The following tables present a distribution of the recorded investment, unpaid principal balance and the related allowance for the Company's impaired loans, which have been analyzed for impairment under ASC 310, at March 31, 2015 and December 31, 2014. Non-accrual loans, other than TDRs, with aggregate loan relationship balances less than the \$100 thousand loan relationship threshold are not evaluated individually for impairment and are accordingly not included in the following tables. However, these loans are evaluated collectively for impairment as homogenous pools in the general allowance under ASC Topic 450. Total non-accrual loans, other than TDRs, with balances less than the \$100 thousand loan relationship threshold, that were evaluated under ASC Topic 450 amounted to \$1.0 million at March 31, 2015 and December 31, 2014.

| (in thousands)  | March 31, 2015      |                          |                   |
|---|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no allowance recorded:                             |                     |                          |                   |
| Real estate:  |                     |                          |                   |
| Residential real estate                                 | \$1,177             | \$1,234                  | \$ -              |
| Commercial real estate                                  | 4,474               | 5,166                    | -                 |
| Construction, land acquisition and development          | 68                  | 68                       | -                 |
| Total real estate loans                                 | 5,719               | 6,468                    | -                 |
| Commercial and industrial                               | 31                  | 58                       | -                 |
| Consumer  | -                   | -                        | -                 |
| State and political subdivisions                        | -                   | -                        | -                 |
| Total impaired loans with no related allowance recorded | 5,750               | 6,526                    | -                 |
| With a related allowance recorded:                      |                     |                          |                   |
| Real estate:  |                     |                          |                   |
| Residential real estate                                 | 1,558               | 1,558                    | 6                 |
| Commercial real estate                                  | 2,044               | 2,044                    | 315               |
| Construction, land acquisition and development          | 279                 | 279                      | 95                |
| Total real estate loans                                 | 3,881               | 3,881                    | 416               |
| Commercial and industrial                               | -                   | -                        | -                 |
| Consumer  | 358                 | 358                      | 1                 |
| State and political subdivisions                        | -                   | -                        | -                 |
| Total impaired loans with a related allowance recorded  | 4,239               | 4,239                    | 417               |
| Total impaired loans:                                   |                     |                          |                   |
| Real estate:  |                     |                          |                   |
| Residential real estate                                 | 2,735               | 2,792                    | 6                 |
| Commercial real estate                                  | 6,518               | 7,210                    | 315               |
| Construction, land acquisition and development          | 347                 | 347                      | 95                |



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|                                  |         |          |        |
|----------------------------------|---------|----------|--------|
| Total real estate loans          | 9,600   | 10,349   | 416    |
| Commercial and industrial        | 31      | 58       | -      |
| Consumer                         | 358     | 358      | 1      |
| State and political subdivisions | -       | -        | -      |
| Total impaired loans             | \$9,989 | \$10,765 | \$ 417 |

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| (in thousands)  | December 31, 2014      |                                |                      |
|---|------------------------|--------------------------------|----------------------|
|   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
| With no allowance recorded:                             |                        |                                |                      |
| Real estate:  |                        |                                |                      |
| Residential real estate                                 | \$385                  | \$410                          | \$ -                 |
| Commercial real estate                                  | 4,401                  | 5,024                          | -                    |
| Construction, land acquisition and development          | 68                     | 68                             | -                    |
| Total real estate loans                                 | 4,854                  | 5,502                          | -                    |
| Commercial and industrial                               | 32                     | 59                             | -                    |
| Consumer  | -                      | -                              | -                    |
| State and political subdivisions                        | -                      | -                              | -                    |
| Total impaired loans with no related allowance recorded | 4,886                  | 5,561                          | -                    |
| With a related allowance recorded:                      |                        |                                |                      |
| Real estate:  |                        |                                |                      |
| Residential real estate                                 | 2,102                  | 2,137                          | 51                   |
| Commercial real estate                                  | 2,259                  | 2,259                          | 331                  |
| Construction, land acquisition and development          | 188                    | 188                            | 1                    |
| Total real estate loans                                 | 4,549                  | 4,584                          | 383                  |
| Commercial and industrial                               | -                      | -                              | -                    |
| Consumer  | 361                    | 361                            | 1                    |
| State and political subdivisions                        | -                      | -                              | -                    |
| Total impaired loans with a related allowance recorded  | 4,910                  | 4,945                          | 384                  |
| Total impaired loans:                                   |                        |                                |                      |
| Real estate:  |                        |                                |                      |
| Residential real estate                                 | 2,487                  | 2,547                          | 51                   |
| Commercial real estate                                  | 6,660                  | 7,283                          | 331                  |
| Construction, land acquisition and development          | 256                    | 256                            | 1                    |
| Total real estate loans                                 | 9,403                  | 10,086                         | 383                  |
| Commercial and industrial                               | 32                     | 59                             | -                    |
| Consumer  | 361                    | 361                            | 1                    |
| State and political subdivisions                        | -                      | -                              | -                    |
| Total impaired loans                                    | \$9,796                | \$10,506                       | \$ 384               |

The total recorded investment in impaired loans, which consists of non-accrual loans with an aggregate loan relationship of greater than \$100,000 and TDRs, amounted to \$10.0 million and \$9.8 million at March 31, 2015 and December 31, 2014, respectively. The related allowance recorded for impaired loans was \$0.4 million at March 31, 2015 and December 31, 2014.

The following table presents the average balance and interest income by loan category recognized on impaired loans for the three months ended March 31, 2015 and 2014:

| (in thousands)                                 | Three Months Ended March 31, |                     |                 |                     |
|--|------------------------------|---------------------|-----------------|---------------------|
|  | 2015                         |                     | 2014            |                     |
|  | Average Balance              | Interest Income (1) | Average Balance | Interest Income (1) |
| Residential real estate                        | \$ 2,897                     | \$ 33               | \$ 1,790        | \$ 14               |
| Commercial real estate                         | 6,567                        | 30                  | 6,628           | 31                  |
| Construction, land acquisition and development | 349                          | 4                   | 304             | 4                   |
| Total real estate                              | 9,813                        | 67                  | 8,722           | 49                  |
| Commercial and industrial                      | 31                           | -                   | 129             | -                   |
| Consumer                                       | 359                          | 3                   | 457             | 4                   |
| State and political subdivisions               | -                            | -                   | -               | -                   |
| Total impaired loans                           | \$ 10,203                    | \$ 70               | \$ 9,308        | \$ 53               |

(1) Interest income represents income recognized on performing TDRs.

The additional interest income that would have been earned on non-accrual and restructured loans for the quarter ended on March 31, 2015 and 2014 in accordance with their original terms approximated \$91 thousand and \$103 thousand, respectively.

### Troubled Debt Restructured Loans

TDRs at March 31, 2015 and December 31, 2014 were \$9.4 million and \$9.0 million, respectively. Accruing and non-accruing TDRs were \$5.8 million and \$3.6 million, respectively at March 31, 2015 and \$5.3 million and \$3.7 million, respectively at December 31, 2014. Approximately \$417 thousand and \$346 thousand in specific reserves have been established for these loans as of March 31, 2015 and December 31, 2014, respectively. The Company was not committed to lend additional funds to any loan classified as a TDR at March 31, 2015.

The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan, an extension of the maturity date, capitalization of real estate taxes or a permanent reduction of the recorded investment in the loan.

The following tables show the pre- and post- modification recorded investment in loans modified as TDRs by loan category during the three months ended March 31, 2015 and 2014:

|  | Three Months Ended March 31,          |                                  |                                       |                                  |
|--|---------------------------------------|----------------------------------|---------------------------------------|----------------------------------|
|  | 2015                                  |                                  | 2014                                  |                                  |
|  | Pre-Modification<br>Outstanding       | Post-Modification<br>Outstanding | Pre-Modification<br>Outstanding       | Post-Modification<br>Outstanding |
|  | Number<br>of<br>Recorded<br>Contracts | Investments                      | Number<br>of<br>Recorded<br>Contracts | Investments                      |
| (dollars in thousands)                         |                                       |                                  |                                       |                                  |
| Troubled debt restructuring:                   |                                       |                                  |                                       |                                  |
| Residential real estate                        | 2                                     | \$ 656                           | 2                                     | \$ 183                           |
| Commercial real estate                         | -                                     | -                                | 4                                     | 238                              |
| Construction, land acquisition and development | 1                                     | 96                               | -                                     | -                                |
| Commercial and industrial                      | -                                     | -                                | -                                     | -                                |
| Consumer                                       | -                                     | -                                | 1                                     | 135                              |
| States and political subdivisions              | -                                     | -                                | -                                     | -                                |
| Total new troubled debt restructurings         | 3                                     | \$ 752                           | 7                                     | \$ 556                           |

The three loans modified as TDRs during the three months ended March 31, 2015 increased the ALLL by \$94 thousand at March 31, 2015, and the seven loans modified as TDRs during the three months ended March 31, 2014 increased the ALLL by \$1 thousand.

The following tables present the types of modifications made during the three months ended March 31, 2015 and 2014:

| (in thousands)         | Three months ended March 31, 2015 |                        |  |                           |          |                                   | Total  |
|------------------------|-----------------------------------|------------------------|--|---------------------------|----------|-----------------------------------|--------|
|                        | Residential Real Estate           | Commercial Real Estate | Construction, Land Acquisition and Development | Commercial and Industrial | Consumer | States and Political Subdivisions |        |
| Types of modification: |                                   |                        |  |                           |          |                                   |        |
| Extension of term      | \$ 656                            | \$ -                   | \$ 96  | \$ -                      | \$ -     | \$ -                              | \$ 752 |
| Total modifications    | \$ 656                            | \$ -                   | \$ 96  | \$ -                      | \$ -     | \$ -                              | \$ 752 |

| (in thousands)                                | Three months ended March 31, 2014 |                        |  |                           |          |                                   | Total  |
|---|-----------------------------------|------------------------|--|---------------------------|----------|-----------------------------------|--------|
|   | Residential Real Estate           | Commercial Real Estate | Construction, Land Acquisition and Development | Commercial and Industrial | Consumer | States and Political Subdivisions |        |
| Type of modification:                         |                                   |                        |  |                           |          |                                   |        |
| Extension of term                             | \$-                               | \$ 238                 | \$ -   | \$ -                      | \$ 135   | \$ -                              | \$ 373 |
| Extension of term and capitalization of taxes | 240                               | -                      | -  | -                         | -        | -                                 | 240    |
| Total modifications                           | \$240                             | \$ 238                 | \$ -   | \$ -                      | \$ 135   | \$ -                              | \$ 613 |

There were no TDRs which re-defaulted (defined as past due 90 days) during the three months ended March 31, 2015 and 2014 and for which the payment re-default occurred within one year of the modification.

#### Note 5. Other Real Estate Owned

The following table presents the composition of OREO at March 31, 2015 and December 31, 2014:

| (in thousands)                | March 31, 2015 | December 31, 2014 |
|-------------------------------|----------------|-------------------|
| Land/lots                     | \$ 1,252       | \$ 1,287          |
| Commercial real estate        | 941            | 941               |
| Residential real estate       | 176            | 27                |
| Total other real estate owned | \$ 2,369       | \$ 2,255          |

The following table presents the activity in OREO for the three months ended March 31, 2015 and 2014:

| (in thousands)              | For the Three Months Ended<br>March 31, |          |
|-----------------------------|---|----------|
|                             | 2015                                    | 2014     |
| Balance, January 1,         | \$ 2,255                                | \$ 4,246 |
| Property foreclosures       | 149                                     | -        |
| Valuation adjustments       | (12 )                                   | (53 )    |
| Carrying value of OREO sold | (23 )                                   | (771 )   |
| Balance, March 31,          | \$ 2,369                                | \$ 3,422 |

There were no consumer mortgage loans that were in the process of foreclosure at March 31, 2015. There was one residential real estate property with a carrying value of \$149 thousand that was foreclosed upon during the three months ended March 31, 2015. There were three residential real estate properties with an aggregate carrying value of \$176 thousand included in OREO at March 31, 2015, and two properties with an aggregate carrying value of \$27 thousand included in OREO at December 31, 2014.

The following table details the components of net expense of OREO for the three months ended March 31, 2015 and 2014:

| (in thousands)                                     | Three Months Ended |        |
|--|--------------------|--------|
|  | March 31,          |        |
|  | 2015               | 2014   |
| Insurance  | \$ 14              | \$ 27  |
| Legal fees   | 20                 | 9      |
| Maintenance  | -                  | 10     |
| Professional fees                                  | -                  | 10     |
| Real estate taxes                                  | 26                 | 49     |
| Utilities  | 10                 | 3      |
| Other  | 18                 | 5      |
| Valuation adjustments                              | 12                 | 53     |
| Total expense                                      | 100                | 166    |
| Income from the operation of foreclosed properties | -                  | (3 )   |
| Net expense of OREO                                | \$ 100             | \$ 163 |

#### Note 6. Securities

Securities have been classified as available-for-sale or held-to-maturity in the consolidated financial statements according to management's intent. The following tables present the amortized cost, gross unrealized gains and losses, and the fair value of the Company's securities at March 31, 2015 and December 31, 2014:

| (in thousands)                                    | March 31, 2015 |                     |                                 |            |
|---|----------------|---------------------|---------------------------------|------------|
|   | Amortized Cost | Gross Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Available-for-sale:                               |                |                     |                                 |            |
| Obligations of U.S. government agencies           | \$26,502       | \$ 425              | \$ -                            | \$26,927   |
| Obligations of state and political subdivisions   | 11,199         | 111                 | 3                               | 11,307     |
| U.S. government/government-sponsored agencies:    |                |                     |                                 |            |
| Collateralized mortgage obligations - residential | 25,304         | 491                 | 3                               | 25,792     |
| Collateralized mortgage obligations - commercial  | 62,167         | 807                 | 7                               | 62,967     |
| Residential mortgage-backed securities            | 72,742         | 1,260               | -                               | 74,002     |
| Corporate debt securities                         | 500            | -                   | 75                              | 425        |
| Negotiable certificates of deposit                | 2,232          | 13                  | -                               | 2,245      |
| Equity securities                                 | 1,010          | -                   | 40                              | 970        |
| Total available-for-sale securities               | \$201,656      | \$ 3,107            | \$ 128                          | \$204,635  |





| (in thousands)                                    | December 31, 2014 |                                |                                 |            |
|---|-------------------|--------------------------------|---------------------------------|------------|
|   | Amortized Cost    | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Available-for-sale:                               |                   |                                |                                 |            |
| Obligations of U.S. government agencies           | \$29,246          | \$ 77                          | \$ 47                           | \$29,276   |
| Obligations of state and political subdivisions   | 23,132            | 1,380                          | 3                               | 24,509     |
| U.S. government/government-sponsored agencies:    |                   |                                |                                 |            |
| Collateralized mortgage obligations - residential | 26,129            | 103                            | 1                               | 26,231     |
| Collateralized mortgage obligations - commercial  | 61,017            | 492                            | 253                             | 61,256     |
| Residential mortgage-backed securities            | 73,998            | 441                            | 341                             | 74,098     |
| Corporate debt securities                         | 500               | -                              | 80                              | 420        |
| Negotiable certificates of deposit                | 2,232             | -                              | -                               | 2,232      |
| Equity securities                                 | 1,010             | -                              | 43                              | 967        |
| Total available-for-sale securities               | \$217,264         | \$ 2,493                       | \$ 768                          | \$218,989  |

At March 31, 2015 and December 31, 2014, securities with a carrying amount of \$202.2 million and \$217.6 million, respectively, were pledged as collateral to secure public deposits and for other purposes.

The following table shows the amortized cost and approximate fair value of the Company's available-for-sale debt securities at March 31, 2015 using contractual maturities. Expected maturities will differ from contractual maturity because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Because collateralized mortgage obligations and residential mortgage-backed securities are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

| (in thousands)                         | March 31, 2015 |            |
|--|----------------|------------|
|  | Amortized Cost | Fair Value |
| Amounts maturing in:                   |                |            |
| One year or less                       | \$-            | \$-        |
| After one year through five years      | 2,232          | 2,245      |
| After five years through ten years     | 35,631         | 36,128     |
| After ten years                        | 2,570          | 2,531      |
| Collateralized mortgage obligations    | 87,471         | 88,759     |
| Residential mortgage-backed securities | 72,742         | 74,002     |
| Total                                  | \$200,646      | \$203,665  |

Gross proceeds from the sale of available-for-sale securities were \$35.9 million and \$11.1 million for the three months ended March 31, 2015 and March 31, 2014, respectively, with gross gains of \$2.2 million and \$1.2 million, respectively realized upon the sales. There were no losses realized upon the sales for the three months ended March 31, 2015 and 2014.

In the first quarter of 2014, the Company sold its entire held-to-maturity portfolio consisting of four obligations of states and political subdivisions with an aggregate amortized cost of \$2.3 million. Gross proceeds received from the sale of the held-to-maturity portfolio were \$2.7 million for the three months ended March 31, 2014, with gross gains of \$0.4 million realized upon the sale. The four securities were tax-exempt, zero-coupon bonds of California municipalities. These securities were sold as part of management's strategy to reduce the amount of potential credit and concentration risk within the investment portfolio.

The following tables indicate the length of time that individual available-for-sale securities have been in a continuous unrealized loss position at March 31, 2015 and December 31, 2014:

| (dollars in thousands)                            | March 31, 2015       |            |                         |                      |            |                         |                      |            |                         |
|---|----------------------|------------|-------------------------|----------------------|------------|-------------------------|----------------------|------------|-------------------------|
|   | Less than 12 Months  |            |                         | 12 Months or Greater |            |                         | Total                |            |                         |
|   | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses |
| Obligations of US government agencies             | -                    | \$-        | \$ -                    | -                    | \$-        | \$ -                    | -                    | \$ -       | \$ -                    |
| Obligations of state and political subdivisions   | -                    | -          | -                       | 1                    | 256        | 3                       | 1                    | 256        | 3                       |
| U.S. government/government-sponsored agencies:    |                      |            |                         |                      |            |                         |                      |            |                         |
| Collateralized mortgage obligations - residential | 2                    | 1,271      | 3                       | -                    | -          | -                       | 2                    | 1,271      | 3                       |
| Collateralized mortgage obligations - commercial  | 1                    | 5,229      | 7                       | -                    | -          | -                       | 1                    | 5,229      | 7                       |
| Residential mortgage-backed securities            | -                    | -          | -                       | -                    | -          | -                       | -                    | -          | -                       |
| Corporate debt securities                         | -                    | -          | -                       | 1                    | 425        | 75                      | 1                    | 425        | 75                      |
| Negotiable certificates of deposit                | -                    | -          | -                       | -                    | -          | -                       | -                    | -          | -                       |
| Equity Securities                                 | -                    | -          | -                       | 1                    | 960        | 40                      | 1                    | 960        | 40                      |
| Total   | 3                    | \$6,500    | \$ 10                   | 3                    | \$1,641    | \$ 118                  | 6                    | \$ 8,141   | \$ 128                  |

| (dollars in thousands)                            | December 31, 2014    |            |                         |                      |            |                         |                      |            |                         |
|---|----------------------|------------|-------------------------|----------------------|------------|-------------------------|----------------------|------------|-------------------------|
|   | Less than 12 Months  |            |                         | 12 Months or Greater |            |                         | Total                |            |                         |
|   | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses |
| Obligations of U.S. government agencies           | 2                    | \$9,513    | \$ 47                   | -                    | \$-        | \$ -                    | 2                    | \$ 9,513   | \$ 47                   |
| Obligations of state and political subdivisions   | -                    | -          | -                       | 1                    | 254        | 3                       | 1                    | 254        | 3                       |
| U.S. government/government-sponsored agencies:    |                      |            |                         |                      |            |                         |                      |            |                         |
| Collateralized mortgage obligations - residential | 1                    | 653        | 1                       | -                    | -          | -                       | 1                    | 653        | 1                       |
| Collateralized mortgage obligations - commercial  | 7                    | 32,513     | 105                     | 3                    | 8,693      | 148                     | 10                   | 41,206     | 253                     |
| Residential mortgage-backed securities            | 3                    | 16,659     | 56                      | 6                    | 37,619     | 285                     | 9                    | 54,278     | 341                     |
| Corporate debt securities                         | -                    | -          | -                       | 1                    | 420        | 80                      | 1                    | 420        | 80                      |
| Negotiable certificates of deposit                | -                    | -          | -                       | -                    | -          | -                       | -                    | -          | -                       |
| Equity securities                                 | -                    | -          | -                       | 1                    | 957        | 43                      | 1                    | 957        | 43                      |
| Total   | 13                   | \$59,338   | \$ 209                  | 12                   | \$47,943   | \$ 559                  | 25                   | \$ 107,281 | \$ 768                  |

Management evaluates individual securities in an unrealized loss position quarterly for OTTI. As part of its evaluation, management considers, among other things, the length of time a security's fair value is less than amortized cost, the severity of decline, any credit deterioration of the issuer, whether or not management intends to sell the security, and whether it is more likely than not that the Company will be required to sell the security prior to recovery of its amortized cost.

Securities issued by U.S. government or U.S. government-sponsored agencies, including single-maturity bonds, residential mortgage-backed securities, and residential and commercial CMOs, comprise the majority of the Company's securities portfolio. Management performed a review of the fair values of all securities in an unrealized loss position as of March 31, 2015 and determined that movements in the fair values of the securities were consistent with the change in market interest rates. At March 31, 2015, the Company held six securities that were in an unrealized loss position, with three of those securities in an unrealized loss position for more than 12 months. All but one of the securities in an unrealized loss position at March 31, 2015 were debt securities. Additionally, management considers the severity of each security's unrealized loss position, placing greater emphasis on any security with a unrealized loss greater than 5.0% of its amortized cost. At March 31, 2015, there was one security, a corporate debt security, with an unrealized loss greater than 5.0% of its amortized cost. The security, a floating rate bond of JP Morgan Chase, had an unrealized loss of \$75 thousand, or 15.0%, of its amortized cost at March 31, 2015. This bond was originally issued by Chase Manhattan Bank. JP Morgan Chase, surviving after the merger, is one of the largest banks in the world with a legacy dating back to 1799. JP Morgan Chase was considered well capitalized under regulatory capital guidelines at March 31, 2015.

The remaining five securities in an unrealized position at March 31, 2015 included three securities issued by a U.S. government or government-sponsored agency, one obligation of a state and political subdivision and one equity security. The obligations of the U.S. government or government-sponsored agencies are securities issued by GNMA and FHLMC that are currently rated Aaa by Moody's Investor Services or AAA by Standard & Poor's ("S&P") and are guaranteed by the U.S. government. The one state and political subdivision obligation in an unrealized loss position at March 31, 2015 was a general-purpose debt obligation, which has an S&P credit rating of A+, is secured by the unlimited taxing power of the issuer and carries a secondary level of credit enhancement. The one equity security in an unrealized loss position at March 31, 2015 was a mutual fund investment that qualifies the Company for credit under the Community Reinvestment Act. The mutual fund is comprised of one- to four-family residential mortgage-backed securities collateralized by properties within the Company's geographical market. In aggregate, unrealized losses totaled \$128 thousand, which represented only 0.06%, of the total amortized cost of investment securities at March 31, 2015.

To date, the Company has received all scheduled principal and interest payments and expects to fully collect all future contractual principal and interest payments. The Company does not intend to sell the securities nor is it more likely than not that the Company will be required to sell the securities prior to recovery of their amortized cost. Based on the result of its review and considering the attributes of these debt and equity securities, management concluded that the individual unrealized losses were temporary and OTTI did not exist at March 31, 2015.

Investments in FHLB and Federal Reserve Bank (“FRB”) stock, which have limited marketability, are carried at cost and totaled \$4.4 million and \$4.2 million at March 31, 2015 and December 31, 2014, respectively. FRB stock of \$1.3 million is included in Other Assets at March 31, 2015 and December 31, 2014. Management noted no indicators of impairment for the FHLB of Pittsburgh and FRB of Philadelphia stock at March 31, 2015.

#### **Note 7. Fair Value Measurements**

In determining fair value, the Company uses various valuation approaches, including market, income and cost approaches. Accounting standards establish a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability, which are developed based on market data obtained from sources independent of the Company. Unobservable inputs reflects the Company’s assumptions about the assumptions the market participants would use in pricing an asset or liability, which are developed based on the best information available in the circumstances.

The fair value hierarchy gives the highest priority to unadjusted quoted market prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). A financial asset or liability’s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The fair value hierarchy is broken down into three levels based on the reliability of inputs as follows:

- Level 1 valuation is based upon unadjusted quoted market prices for identical instruments traded in active markets.

- Level 2 valuation is based upon quoted market prices for similar instruments traded in active markets, quoted market prices for identical or similar instruments traded in markets that are not active and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by market data; and

- Level 3 valuation is derived from other valuation methodologies including discounted cash flow models and similar techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in determining fair value.

A description of the valuation methodologies used for assets recorded at fair value, and for estimating fair value of financial instruments not recorded at fair value, is set forth below.

#### **Cash, Short-term Investments, Accrued Interest Receivable and Accrued Interest Payable**

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

## Securities

The estimated fair values of available-for-sale equity securities are determined by obtaining quoted prices on nationally recognized exchanges (Level 1 inputs). The estimated fair values for the Company's investments in obligations of U.S. government agencies, obligations of state and political subdivisions, government-sponsored agency CMOs, government-sponsored agency residential mortgage-backed securities, and corporate debt securities are obtained by the Company from a nationally-recognized pricing service. This pricing service develops estimated fair values by analyzing like securities and applying available market information through processes such as benchmark curves, benchmarking of like securities, sector groupings and matrix pricing (Level 2 inputs), to prepare valuations. Matrix pricing is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things and are based on market data obtained from sources independent from the Company. The Level 2 investments in the Company's portfolio are priced using those inputs that, based on the analysis prepared by the pricing service, reflect the assumptions that market participants would use to price the assets. The Company has determined that the Level 2 designation is appropriate for these securities because, as with most fixed-income securities, those in the Company's portfolio are not exchange-traded, and such non-exchange-traded fixed income securities are typically priced by correlation to observed market data. The Company has reviewed the pricing service's methodology to confirm its understanding that such methodology results in a valuation based on quoted market prices for similar instruments traded in active markets, quoted markets for identical or similar instruments traded in markets that are not active and model-based valuation techniques for which the significant assumptions can be corroborated by market data as appropriate to a Level 2 designation.

For those securities for which the inputs used by an independent pricing service were derived from unobservable market information (Level 3 inputs), the Company evaluates the appropriateness and quality of each price. The Company reviewed the volume and level of activity for all classes of securities and attempted to identify transactions which may not be orderly or reflective of a significant level of activity and volume. For securities meeting these criteria, the quoted prices received from either market participants or an independent pricing service may be adjusted, as necessary, to estimate fair value. If applicable, the adjustment to fair value was derived based on present value cash flow model projections prepared by the Company or obtained from third party providers utilizing assumptions similar to those incorporated by market participants.

The Company did not own any securities for which fair value was determined using Level 3 inputs at March 31, 2015 and December 31, 2014. The Company did own one security issued by a state and political subdivision that was valued using level 3 inputs during 2014, which was paid off prior to December 31, 2014. This security had a credit rating that was either withdrawn or downgraded by nationally recognized credit rating agencies, and as a result the market for these securities had become inactive. This security was historically priced using Level 2 inputs. The credit ratings withdrawal and downgrade have resulted in a decline in the level of significant other observable inputs for this investment security at the measurement dates. Broker pricing and bid/ask spreads were very limited for this security. At March 31, 2014, the Company had obtained a bid indication from a third-party municipal trading desk to determine the fair value of this security.

## **Loans**

Except for collateral dependent impaired loans, fair values of loans are estimated by discounting the projected future cash flows using market discount rates that reflect the credit, liquidity, and interest rate risk inherent in the loan. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. The estimated fair value of collateral dependent impaired loans is based on the appraised loan value or other reasonable offers less estimated costs to sell. The Company does not record loans at fair value on a recurring basis. However from time to time, a loan is considered impaired and an allowance for credit losses is established. The specific reserves for collateral dependent impaired loans are based on the fair value of the collateral less estimated costs to sell. The fair value of the collateral is generally based on appraisals. In some cases, adjustments are made to the appraised values due to various factors including age of the appraisal, age of comparables included in the appraisal, and known changes in the market and in the collateral. When significant adjustments are based on unobservable inputs, the resulting fair value measurement is categorized as a Level 3 measurement.

## **Loans Held For Sale**

Fair values of mortgage loans held for sale are based on commitments on hand from investors or prevailing market prices.



### **Mortgage Servicing Rights**

The fair value of mortgage servicing rights is estimated using a discounted cash flow model that applies current estimated prepayments derived from the mortgage-backed securities market and utilizes a current market discount rate for observable credit spreads. The Company does not record mortgage servicing rights at fair value on a recurring basis.

### **Restricted Stock**

Ownership in equity securities of FHLB of Pittsburgh and the FRB is restricted and there is no established market for their resale. The carrying amount is a reasonable estimate of fair value.

### **Deposits**

The fair value of demand deposits, savings deposits, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated based on discounted cash flows using FHLB advance rates currently offered for similar remaining maturities.

### **Borrowed funds**

The Company uses discounted cash flows using rates currently available for debt with similar terms and remaining maturities to estimate fair value.

**Commitments to extend credit and standby letters of credit**

The fair value of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of off-balance sheet commitments is insignificant and therefore not included in the table for non-recurring assets and liabilities.

**Assets measured at fair value on a recurring basis**

The following tables detail the financial asset amounts that are carried at fair value and measured at fair value on a recurring basis at March 31, 2015 and December 31, 2014, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine the fair value:

| (in thousands)                                    | Fair Value Measurements at March 31, 2015 |  |   |   |
|---|---|--|---|---|
|   | Fair Value                                | Quoted Prices<br>in Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Other<br>Unobservable<br>Inputs<br>(Level 3) |
| Available-for-sale securities:                    |   |  |   |   |
| Obligations of U.S. government agencies           | \$ 26,927                                 | \$ -   | \$ 26,927   | \$ -  |
| Obligations of state and political subdivisions   | 11,307                                    | -  | 11,307  | -   |
| U.S. government/ government-sponsored agencies:   |   |  |   |   |
| Collateralized mortgage obligations - residential | 25,792                                    | -  | 25,792  | -   |
| Collateralized mortgage obligations - commercial  | 62,967                                    | -  | 62,967  | -   |
| Residential mortgage-backed securities            | 74,002                                    | -  | 74,002  | -   |
| Corporate debt securities                         | 425                                       | -  | 425   | -   |
| Negotiable certificates of deposit                | 2,245                                     | -  | 2,245   | -   |
| Equity securities                                 | 970                                       | 970  | -   | -   |
| Total available-for-sale securities               | \$ 204,635                                | \$ 970   | \$ 203,665  | \$ -  |

|  | Fair Value Measurements at December 31, 2014 |  |  |
|--|--|--|--|
|  | Quoted Prices<br>in Active Markets           | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Other<br>Unobservable<br>Inputs |
|  |  |  |  |

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| (in thousands)                                    | Fair Value | for Identical<br>Assets<br>(Level 1) | (Level 2)  | (Level 3) |
|---|------------|--------------------------------------|------------|-----------|
| Available-for-sale securities:                    |            |                                      |            |           |
| Obligations of U.S. government agencies           | \$ 29,276  | \$ -                                 | \$ 29,276  | \$ -      |
| Obligations of state and political subdivisions   | 24,509     | -                                    | 24,509     | -         |
| U.S. government/ government-sponsored agencies:   |            |                                      |            |           |
| Collateralized mortgage obligations - residential | 26,231     | -                                    | 26,231     | -         |
| Collateralized mortgage obligations - commercial  | 61,256     | -                                    | 61,256     | -         |
| Residential mortgage-backed securities            | 74,098     | -                                    | 74,098     | -         |
| Corporate debt securities                         | 420        | -                                    | 420        | -         |
| Negotiable certificates of deposit                | 2,232      | -                                    | 2,232      | -         |
| Equity securities                                 | 967        | 967                                  | -          | -         |
| Total available-for-sale securities               | \$ 218,989 | \$ 967                               | \$ 218,022 | \$ -      |

The following tables present a reconciliation and statement of operations classifications of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three month periods ended March 31, 2015 and 2014:

Fair Value Measurements

Using Significant Unobservable Inputs (Level 3)

| (in thousands)                               | State and Political Subdivisions<br>Three Months Ended March 31, |        |
|--|--|--------|
|  | 2015   | 2014   |
| Balance at January 1,                        | \$ -   | \$ 571 |
| Amortization                                 | -  | -      |
| Accretion                                    | -  | -      |
| Purchases                                    | -  | -      |
| Paydowns                                     | -  | (145 ) |
| Total gains or losses (realized/unrealized): |  |        |
| Included in earnings                         | -  | -      |
| Included in other comprehensive income       | -  | 11     |
| Balance at March 31,                         | \$ -   | \$ 437 |

There were no transfers between levels within the fair value hierarchy during the periods ended March 31, 2015 and 2014.

**Assets measured at fair value on a non-recurring basis**

The following tables present assets and liabilities measured at fair value on a non-recurring basis:

| (in thousands)                      | Fair Value Measurements at March 31, 2015 |  |   |   |
|-------------------------------------|---|--|---|---|
|                                     | Fair Value<br>(1)                         | Quoted Prices in<br>Active<br>markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Other<br>Unobservable<br>Inputs<br>(Level 3) |
| Collateral-dependent impaired loans | \$ 5,732                                  | \$ -   | \$ -  | \$ 5,732  |
| Other real estate owned             | \$ 14                                     | \$ -   | \$ -  | \$ 14   |

Fair Value Measurements at December 31, 2014

Quoted Prices in Significant Significant

| (in thousands)                      | Fair Value (1) | Active<br>markets for<br>Identical Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Other<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------------------|----------------|--|--|--|
| Collateral-dependent impaired loans | \$ 5,380       | \$ -   | \$ -                                       | \$ 5,380                                     |
| Other real estate owned             | \$ 2,087       | \$ -   | \$ -                                       | \$ 2,087                                     |

(1) Represents carrying value and related write-downs for which adjustments are based on appraised value less estimated selling costs. Management may make adjustments to the appraised values as necessary to consider declines in real estate values since the time of the appraisal. Such adjustments are based on management's knowledge of the local real estate markets.

Collateral-dependent impaired loans are classified as Level 3 assets and the estimated fair value of the collateral is based on the appraised value or other reasonable offers less estimated costs to sell. The Company estimates selling costs at 10.0% of appraised value. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance or is charged off. The amount shown is the balance of impaired loans, net of any charge-offs and the related allowance for loan losses. The related allowance representing the adjustment of the recorded investment to fair value at March 31, 2015 and December 31, 2014 was \$146 thousand and \$102 thousand, respectively. Included in the adjustment at March 31, 2015, was a full valuation allowance for one collateral dependent impaired construction, land acquisition and development loan for which the Company was unable to obtain a current appraisal prior to the valuation date. The collateral supporting this loan is located in Monroe County. Based on the decline in real estate values in this market area, management decided that a full valuation allowance in the amount of \$94 thousand was warranted at March 31, 2015. There were no additional valuation adjustments other than 10.0% for estimated selling costs at December 31, 2014.

OREO properties are recorded at fair value less the estimated cost to sell at the date of the Company's acquisition of the property. For OREO properties, the Company generally estimates selling costs at 10.0% of appraised value. Subsequent to the Company's acquisition, the balance may be written down further. It is the Company's policy to obtain certified external appraisals of real estate collateral underlying impaired loans and OREO, and estimate fair value using those appraisals. Other valuation sources may be used, including broker price opinions, letters of intent and executed sale agreements. Adjustments of the carrying value of OREO to fair value in the form of valuation adjustments at March 31, 2015 and December 31, 2014 totaled \$12 thousand and \$1.6 million, respectively.

The Company discloses fair value information about financial instruments, whether or not recognized in the Statement of Financial Condition, for which it is practicable to estimate that value. The following estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, management judgment is required to interpret data and develop fair value estimates. Accordingly, the estimates below are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The following table summarizes the estimated fair values of the Company's financial instruments at March 31, 2015 and at December 31, 2014:

| (in thousands)                  | Fair Value Measurement | March 31, 2015 |            | December 31, 2014 |            |
|---------------------------------|------------------------|----------------|------------|-------------------|------------|
|                                 |                        | Carrying Value | Fair Value | Carrying Value    | Fair Value |
| Financial assets                |                        |                |            |                   |            |
| Cash and short term investments | Level 1                | \$37,375       | \$37,375   | \$35,667          | \$35,667   |
| Securities available for sale   | See previous table     | 204,635        | 204,635    | 218,989           | 218,989    |
| FHLB and FRB Stock              | Level 2                | 4,411          | 4,411      | 4,154             | 4,154      |
| Loans held for sale             | Level 2                | -              | -          | 603               | 603        |
| Loans, net                      | Level 3                | 661,221        | 661,164    | 658,747           | 659,231    |
| Accrued interest receivable     | Level 2                | 2,118          | 2,118      | 2,075             | 2,075      |
| Mortgage servicing rights       | Level 3                | 278            | 855        | 333               | 898        |
| Financial liabilities           |                        |                |            |                   |            |
| Deposits                        | Level 2                | 775,111        | 765,927    | 795,336           | 779,986    |
| Borrowed funds                  | Level 2                | 102,922        | 106,579    | 96,504            | 100,020    |
| Accrued interest payable        | Level 2                | 10,788         | 10,788     | 10,262            | 10,262     |

#### Note 8. Earnings per Share

For the Company, the numerator of both the basic and diluted earnings per common share is net income available to common shareholders (which is equal to net income less dividends on preferred stock and related discount accretion). The weighted average number of common shares outstanding used in the denominator for basic earnings per common share is increased to determine the denominator used for diluted earnings per common share by the effect of potentially dilutive common share equivalents utilizing the treasury stock method. For the Company, common share equivalents are outstanding stock options to purchase the Company's common shares and unvested restricted stock.

The following table presents the calculation of both basic and diluted earnings per common share for the three months ended March 31, 2015 and 2014:

| (in thousands, except share data)                            | Three months ended |            |
|--|--------------------|------------|
|  | March 31,          |            |
|  | 2015               | 2014       |
| Net income   | \$3,475            | \$3,513    |
| Basic weighted-average number of common shares outstanding   | 16,490,111         | 16,471,569 |
| Plus: Common share equivalents                               | -                  | 866        |
| Diluted weighted-average number of common shares outstanding | 16,490,111         | 16,472,435 |
| Income per common share:                                     |                    |            |
| Basic  | \$0.21             | \$0.21     |
| Diluted  | \$0.21             | \$0.21     |

For the three months ended March 31, 2014, common share equivalents in the table above are related entirely to the incremental shares of unvested restricted stock. There were no common share equivalents related to incremental shares of restricted stock for the three months ended March 31, 2015, as the weighted-average price of the Company's common stock was below the fair value on the grant dates.

Common share equivalents, in the table above, exclude stock options of 64,479 for the three months ended March 31, 2015 and 77,937 for the three months ended March 31, 2014 with exercise prices that exceed the average market price of the Company's common shares during the periods presented. Inclusion of these stock options would be anti-dilutive to the diluted earnings per common share calculation.

#### **Note 9. Other Comprehensive Income**

The following tables summarize the reclassifications out of accumulated other comprehensive income:

| Three Months Ended March 31, 2015 |
|-----------------------------------|
| Amount                            |
| Reclassified                      |
| from                              |
| Accumulated                       |



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|  |               |  |
|--|---------------|--|
| (in thousands)   | Other         | Affected Line Item in the                    |
| Available-for-sale securities:   | Comprehensive | Income Consolidated Statements of Operations |
| Reclassification adjustment for net gains reclassified into net income | \$ (2,224)    | Net gain on sale of securities               |
| Taxes  | 756           | Income taxes                                 |
| Net of tax amount  | \$ (1,468)    |  |

|  |  |
|--|--|
|  | Three Months Ended March 31, 2014            |
| (in thousands)   | Amount                                       |
| Available-for-sale securities:   | Reclassified                                 |
| Reclassification adjustment for net gains reclassified into net income | from   |
| Taxes  | Accumulated                                  |
| Net of tax amount  | Other  |
|  | Affected Line Item in the                    |
|  | Comprehensive                                |
|  | Income Consolidated Statements of Operations |
|  | \$ (1,200) Net gain on sale of securities    |
|  | 408 Income taxes                             |
|  | \$ (792 )                                    |

The following table summarizes the changes in accumulated other comprehensive income, net of tax:

| (in thousands)   | Three Months Ended<br>March 31, |             |
|--|---------------------------------|-------------|
|  | 2015                            | 2014        |
| Beginning balance  | \$ 1,138                        | \$ (3,092 ) |
| Other comprehensive income before reclassifications              | 2,296                           | 4,227       |
| Amounts reclassified from accumulated other comprehensive income | (1,468 )                        | (792 )      |
| Net other comprehensive income during the period                 | 828                             | 3,435       |
| Ending balance   | \$ 1,966                        | \$ 343      |

#### Note 10. Related Party Transactions

The Company and the Bank have engaged in and intend to continue to engage in banking and financial transactions in the conduct of its business with directors and executive officers of the Company and the Bank and their related parties.

The Company has granted loans, letters of credit and lines of credit to directors, executive officers and their related parties. The following table summarizes the changes in the total amounts of such outstanding loans and advances under lines of credit, net of any participations sold, as well as repayments during the three months ended March 31, 2015 and 2014:

| (in thousands)                    | For the Three Months Ended<br>March 31, 2015 |           |
|-----------------------------------|--|-----------|
|                                   | 2015   | 2014      |
| Balance January 1,                | \$ 36,783                                    | \$ 29,301 |
| Additions, new loans and advances | 23,888                                       | 9,749     |
| Repayments                        | (18,407 )                                    | (6,223 )  |
| Balance March 31,                 | \$ 42,264                                    | \$ 32,827 |

At March 31, 2015, there were no loans to directors, executive officers and their related parties which were not performing in accordance with the terms of the loan agreements.

Included in related party loans is a commercial line of credit with a company owned by a director with a net balance outstanding of \$5.3 million at March 31, 2015. The gross balance outstanding for this loan was \$8.8 million at March 31, 2015. The Company has sold a participation interest in this line to the same director in the amount of \$5.2 million,

of which \$3.5 million is outstanding. The Company receives a 25 basis point annual servicing fee from this director on the participation balance.

Deposits from directors, executive officers and their related parties held by the Company at March 31, 2015 and December 31, 2014 amounted to \$87.2 million and \$77.4 million, respectively. Interest paid on the deposits amounted to \$36 thousand and \$23 thousand for the three months ended on March 31, 2015 and 2014, respectively.

In the course of its operations, the Company acquires goods and services from and transacts business with various companies of related parties. The Company believes these transactions were made on the same terms as those for comparable transactions with unrelated parties. The Company recorded payments for these services of \$406 thousand and \$492 thousand for the three months ended March 31, 2015 and 2014, respectively.

Subordinated notes held by officers and directors and/or their related parties totaled \$9.0 million at both March 31, 2015 and December 31, 2014. There was no interest paid to directors on these notes for the three months ended on March 31, 2015 and 2014. Interest accrued and unpaid on the notes totaled \$3.8 million at March 31, 2015.

#### **Note 11. Stock Compensation Plans**

On August 30, 2000, the Company's Board adopted the 2000 Employee Stock Incentive Plan (the "Stock Incentive Plan") in which options could have been granted to key officers and other employees of the Company. The aggregate number of shares which could have been issued upon exercise of the options under the plan could not exceed 1,100,000 shares. Options and rights granted under the Stock Incentive Plan became exercisable six months after the date the options are awarded and expire ten years after the award date. Upon exercise, the shares are issued from the Company's authorized but unissued stock. The Stock Incentive Plan expired on August 30, 2010. Therefore, no further grants will be made under the plan.

The Board also adopted on August 30, 2000, the 2000 Independent Directors Stock Option Plan (the “Directors’ Stock Plan”) for directors who were not officers or employees of the Company. The aggregate number of shares issuable under the Directors’ Stock Plan could not exceed 550,000 shares and were exercisable six months from the date the awards are granted and expired three years after the award date. Upon exercise, the shares are issued from the Company’s authorized but unissued shares. The Directors’ Stock Plan expired on August 30, 2010, therefore, no further grants will be made under the plan.

No compensation expense related to options under either the Stock Incentive Plan or the Directors’ Stock Plan was required to be recorded in the three months ended March 31, 2015 and 2014.

The following table summarizes the status of the Company’s stock option plans:

|  | Three Months Ended March 31, |  |          |  |
|--|------------------------------|--|----------|--|
|  | 2015                         |  | 2014     |  |
|  | Shares                       | Weighted<br>Average<br>Exercise<br>Price | Shares   | Weighted<br>Average<br>Exercise<br>Price |
| Outstanding at January 1.  | 64,479                       | \$ 15.87                                 | 82,598   | \$ 15.98                                 |
| Granted  | -                            | -  | -        | -  |
| Exercised  | -                            | -  | -        | -  |
| Forfeited  | -                            | -  | (4,661 ) | 16.05                                    |
| Outstanding at March 31,   | 64,479                       | \$ 15.87                                 | 77,937   | \$ 15.98                                 |
| Options exercisable at March 31,                                 | 64,479                       | \$ 15.87                                 | 77,937   | \$ 15.98                                 |
| Weighted average fair value of options granted during the period |                              | \$ -                                     |          | \$ -                                     |
| Stock-based compensation expense                                 |                              | \$ -                                     |          | \$ -                                     |

At March 31, 2015 and 2014 the exercisable options had no total intrinsic value and there was no unrecognized compensation expense.

The following table presents information pertaining to options outstanding at March 31, 2015:

| Options Outstanding |             |                                  | Options Excercisable |                     |
|---------------------|-------------|----------------------------------|----------------------|---------------------|
| Number              | Contractual | Weighted                         | Number               | Weighted            |
|                     |             | Average<br>Remaining<br>Exercise |                      | Average<br>Exercise |

| Range of Exercise Price | Outstanding | Life | Price    | Exercisable Price |
|-------------------------|-------------|------|----------|-------------------|
| \$10.81 - \$23.13       | 64,479      | 2.5  | \$ 15.87 | 64,479 \$ 15.87   |

On November 27, 2013, the Board of Directors adopted the 2013 Employee Stock Grant Plan (the “2013 Stock Grant Plan”) under which shares of common stock not to exceed 15,000 were authorized to be granted to employees. On December 2, 2013, the Company granted 50 shares of the Company’s common stock to each active full and part time employee. There were 14,400 shares granted under the 2013 Stock Grant Plan at a fair value of \$4.26 per share. On October 29, 2014, the Board of Directors adopted the 2014 Employee Stock Grant Plan (the “2014 Stock Grant Plan”) under which shares of stock not to exceed 13,500 were authorized to be granted to employees. On December 1, 2014, the Company granted 50 shares of the Company’s common stock to each active full and part time employee. There were 12,850 share granted under the 2014 Stock Grant Plan at a fair value of \$6.02 per share. The total cost of these grants, which was included in salary expense in the Consolidated Statements of Income, amounted to \$77 thousand and \$61 thousand for the years ended December 31, 2014 and 2013, respectively. No additional shares were granted under either plan.

The Board of Directors, upon the recommendation of the Compensation Committee, formally adopted a Long-Term Incentive Compensation Plan (“LTIP”) on October 23, 2013. The LTIP was ratified at the 2013 Annual Shareholders Meeting on December 23, 2013. The LTIP is designed to reward executives and key employees for their contributions to the long-term success of the Company, primarily as measured by the increase in the Company’s stock price. The LTIP authorizes up to 1,200,000 shares of common stock for issuance and provides the Board with the authority to offer several different types of long-term incentives, including stock options, stock appreciation rights, restricted stock, restricted stock units, performance units and performance shares. The Board approved initial awards under the terms of the LTIP, which were granted to executives and key employees on March 1, 2014. The initial grant was comprised solely of 45,750 shares of restricted stock. On March 1, 2015, an additional 84,900 shares of restricted stock were awarded under the LTIP. At March 31, 2015, there were 1,069,683 shares of common stock available for award under the LTIP. For the three months ended March 31, 2015 and 2014, stock-based compensation expense, which is included in salaries and employee benefits expense in the Consolidated Statements of Income, totaled \$41 thousand and \$10 thousand. Total unrecognized compensation expense related to unvested restricted stock awards was \$659 thousand and \$297 thousand at March 31, 2015 and 2014, respectively.

The following table presents the status of the Company’s unvested restricted stock awards as of, and during the three months ended, March 31, 2015 and 2014:

|                        | Three Months Ended March 31,<br>2015 |  | Three Months Ended March 31,<br>2014 |  |
|------------------------|--------------------------------------|--|--------------------------------------|--|
|                        | Restricted<br>Shares                 | Weighted-<br>Average<br>Grant Date<br>Fair Value | Restricted<br>Shares                 | Weighted-<br>Average<br>Grant Date<br>Fair Value |
| Unvested at January 1, | 45,750                               | \$ 6.70  | -                                    | \$ -   |
| Awards granted         | 84,900                               | 5.75   | 45,750                               | 6.70   |
| Forfeitures            | (333 )                               | 6.70   | -                                    | -  |
| Vestings               | (16,526 )                            | 6.70   | -                                    | -  |
| Unvested at March 31,  | 113,791                              | \$ 5.99  | 45,750                               | \$ 6.70  |

## Note 12. Income Taxes

The Company evaluates the carrying amount of its deferred tax assets on a quarterly basis, or more frequently, if necessary, in accordance with guidance set forth in ASC Topic 740 “Income Taxes,” and applies the criteria in the guidance to determine whether it is more likely than not that some portion, or all, of the deferred tax asset will not be realized within its life cycle, based on the weight of available evidence. If management determines based on available evidence, both positive and negative, that it is more likely than not that some portion or all of the deferred tax asset will not be realized in future periods, a valuation allowance is calculated and recorded. These determinations are inherently subjective and depend upon management’s estimates and judgments used in their evaluation of both positive and negative evidence. The Company’s deferred tax position has been affected by several significant transactions that occurred in prior years. These transactions included the provision for loan losses, the level of non-accrual loans,

valuation of other real estate owned and other-than-temporary impairment losses incurred on certain available-for-sale securities, and resulted in the Company being in a cumulative deficit position since 2009. Accordingly, under applicable accounting guidance, the Company has established a full valuation allowance for its net deferred tax assets, excluding deferred tax assets or liabilities related to unrealized holding gains and losses on available-for-sale securities. Valuation allowances, related to net deferred tax assets, established by the Company amounted to \$30.3 million at March 31, 2015 and December 31, 2014.

In evaluating available evidence, management considers, among other factors, historical financial performance, expectation of future earnings, the ability to carry back losses to recoup taxes previously paid, length of statutory carry forward periods, experience with operating loss and tax credit carry forwards not expiring unused, tax planning strategies and timing of reversals of temporary differences. In assessing the need for a valuation allowance, management carefully weighed both positive and negative evidence currently available. The weight given to the potential effect of positive and negative evidence must be commensurate with the extent to which it can objectively verified. In particular, additional scrutiny must be given to deferred tax assets of an entity that has incurred taxable losses during the three most recent years because it is significant negative evidence that is objective and verifiable and therefore difficult to overcome. While the Company generated taxable income in the first quarter of 2015 and for the year ended December 31, 2014, it recorded taxable losses for the years ended December 31, 2013 and 2012.

When determining the need for a valuation allowance, the Company assessed the possible sources of taxable income available under tax law to realize a tax benefit for deductible temporary differences and carryforwards as defined in ASC Topic 740. While the Company has shown substantial book net income in 2013, 2014 and in the first quarter of 2015, these amounts have been the result of significant non-recurring or non-taxable transactions, such as the credit for loan and lease losses, legal settlements and gains on the sales of securities. The Company utilizes a three-year rolling measurement of results when assessing whether it is in a cumulative loss position. Until such time when the Company's cumulative results are positive, it does not believe there is sufficient positive evidence to overcome the negative evidence presented. The Company will exclude future taxable income as a factor until it can show consistent and sustainable profitability. Based on the analysis of available positive and negative evidence, management determined that the established valuation allowance equal to 100.0% of net deferred tax assets, excluding deferred tax assets or liabilities related to unrealized holding gains and losses on available-for-sale securities, should be maintained.

The Company recorded a credit for income tax expense of \$62 thousand for the three months ended March 31, 2015, and a provision for income tax expense of \$70 for the three months ended March 31, 2014. Both amounts were entirely related to alternative minimum tax.

### **Note 13. Contingencies**

On August 8, 2011, the Company announced that it had received document subpoenas from the SEC. The information requested generally related to disclosure and financial reporting by the Company and the restatement of the Company's financial statements for the year ended December 31, 2009, and the quarters ended March 31, 2010 and June 30, 2010. On January 28, 2015, the Company and the SEC entered into a settlement agreement resolving these issues related to disclosure and financial reporting and the restatements of the Company's financial statements for the year ended December 31, 2009 and the quarters ended March 31, 2010 and June 30, 2010. As part of this settlement agreement, on January 30, 2015, the Company paid a civil money penalty of \$175 thousand to the SEC. The Company accrued for the \$175 thousand civil money penalty in its 2014 results of operations.

On May 24, 2012, a putative shareholder filed a complaint in the Court of Common Pleas for Lackawanna County ("Shareholder Derivative Suit") against certain present and former directors and officers of the Company (the "Individual Defendants") alleging, inter alia, breach of fiduciary duty, abuse of control, corporate waste, and unjust enrichment. The Company was named as a nominal defendant. The parties to the Shareholder Derivative Suit commenced settlement discussions and on December 18, 2013, the Court entered an Order Granting Preliminary Approval of Proposed Settlement subject to notice to shareholders. On February 4, 2014, the Court issued a Final Order and Judgment for the matter granting approval of a Stipulation of Settlement (the "Settlement") and dismissing all claims against the Company and the Individual Defendants. As part of the Settlement, there was no admission of liability by the Individual Defendants. Pursuant to the Settlement, the Individual Defendants, without admitting any fault, wrongdoing or liability, agreed to settle the derivative litigation for \$5.0 million. The \$5.0 million Settlement payment was made to the Company on March 28, 2014. The Individual Defendants reserved their rights to indemnification under the Company's Articles of Incorporation and Bylaws, resolutions adopted by the Board, the Pennsylvania Business Corporation Law and any and all rights they have against the Company's and the Bank's insurance carriers. In addition, in conjunction with the Settlement, the Company accrued \$2.5 million related to fees and costs of the plaintiff's attorneys, which was included in non-interest expense in the Consolidated Statements of Income for the year ended December 31, 2013. On April 1, 2014, the Company paid the \$2.5 million related to fees and costs of the plaintiff's attorneys and partial indemnification of the Individual Defendants in the amount of \$2.5 million, and as such, as of March 31, 2015 \$2.5 million remains accrued in other liabilities related to the potential indemnification of the Individual Defendants. The Company settled any and all claims it had or may have had against Demetrius & Company, LLC, John Demetrius and Robert L. Rossi & Company in connection with the Shareholder Derivative Suit in 2014.

On September 5, 2012, Fidelity and Deposit Company of Maryland ("F&D") filed an action against the Company and the Bank, as well as several current and former officers and directors of the Company, in the United States District Court for the Middle District of Pennsylvania. F&D has asserted a claim for the rescission of a directors' and officers'



insurance policy and a bond that it had issued to the Company. On November 9, 2012, the Company and the Bank answered the claim and asserted counterclaims for the losses and expenses already incurred by the Company and the Bank. The Company and the other defendants are defending the claims and have opposed F&D's requested relief by way of counterclaims, breaches of contract and bad faith claims against F&D for its failure to fulfill its obligations to the Company and the Bank under the insurance policy. At this time, the matter is in the discovery stage and the Company cannot reasonably determine the outcome or potential range of loss in connection with this matter.

On August 13, 2013, Steven Antonik, individually, as Administrator of the Estate of Linda Kluska, William R. Howells, and Louise A. Howells, on behalf of themselves and others similarly situated, filed a consumer protection class action against the Company and Bank in the Lackawanna County Court of Common Pleas, seeking equitable, injunction and monetary relief to address an alleged pattern and practice of wrong doing by the Bank relating to the repossession and sale of the Plaintiffs' and class members' financed motor vehicles. This matter is in the discovery stage. At this time, the Company cannot reasonably determine the outcome or potential range of loss.

On September 17, 2013, Charles Saxe, III individually and on behalf of all others similarly situated filed a consumer class action against the Bank in the Lackawanna County Court of Common Pleas alleging violations of the Pennsylvania Uniform Commercial Code in connection with the repossession and resale of financed vehicles. This matter is in the discovery stage. At this time the Company cannot reasonably determine the outcome or potential range of loss.

On January 22, 2014, the Bank was advised by the Department of Treasury's Financial Crimes Enforcement Network ("FinCEN") that FinCEN was investigating the Bank for alleged violations of the Bank Secrecy Act ("BSA"). On May 28, 2014, the Bank was advised by the Office of the Comptroller of the Currency ("OCC") that the OCC was investigating allegations that the Bank failed to file timely SARS. On November 18, 2014, both FinCEN and OCC advised the Bank that they intended on assessing civil money penalties against the Bank. Subsequent to November 18, 2014, the Bank had been in discussions with both regulatory agencies about the alleged BSA violations. On February 27, 2015, the Bank reached a comprehensive settlement with FinCEN and OCC to resolve the BSA allegations. In order to settle the matter, the Bank consented to an aggregate civil money penalty assessment of \$1.5 million which was accrued for at December 31, 2014 and included in non-interest expense for the year ended December 31, 2014. The Company paid the \$1.5 million civil money penalty on February 27, 2015.

The Company has been subject to tax audits and is also a party to routine litigation involving various aspects of its business, such as claims to enforce liens, condemnation proceedings on properties in which the Company holds security interests, claims involving the making and servicing of real property loans and other issues incident to its business, none of which is expected to have a material adverse impact on the consolidated financial condition, results of operations or liquidity of the Company.

There have been no changes in the status of the other litigation disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

## Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")

This Quarterly Report should be read in conjunction with the more detailed and comprehensive disclosures included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014. In addition, please read this section in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

The Company is in the business of providing customary retail and commercial banking services to individuals and businesses within its primary market area located in Northeastern Pennsylvania.

## **FORWARD-LOOKING STATEMENTS**

The Company may from time to time make written or oral "forward-looking statements," including statements contained in the Company's filings with the Securities and Exchange Commission ("SEC"), in its reports to shareholders, and in

other communications by the Company, which are made in good faith by the Company pursuant to the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995.

These forward-looking statements include statements with respect to the Company’s beliefs, plans, objectives, goals, expectations, anticipations, estimates and intentions, that are subject to significant risks and uncertainties, and are subject to change based on various factors (some of which are beyond the Company’s control). The words “may,” “could,” “should,” “would,” “believe,” “anticipate,” “estimate,” “expect,” “intend,” “plan” and similar expressions are intended to identify forward-looking statements. The following factors, among others, could cause the Company’s financial performance to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements: the strength of the United States economy in general and the strength of the local economies in the Company’s markets; the effects of, and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System; inflation, interest rate, market and monetary fluctuations; the timely development of and acceptance of new products and services; the ability of the Company to compete with other institutions for business; the composition and concentrations of the Company’s lending risk and the adequacy of the Company’s reserves to manage those risks; the valuation of the Company’s investment securities; the ability of the Company to pay dividends or repurchase common shares; the ability of the Company to retain key personnel; the impact of any pending or threatened litigation against the Company; the marketability of shares of the Company and fluctuations in the value of the Company’s share price; the impact of the Company’s ability to comply with its regulatory agreements and orders; the effectiveness of the Company’s system of internal controls; the ability of the Company to attract additional capital investment; the impact of changes in financial services’ laws and regulations (including laws concerning capital adequacy, taxes, banking, securities and insurance); the impact of technological changes and security risks upon the Company’s information technology systems; changes in consumer spending and saving habits; the nature, extent, and timing of governmental actions and reforms, and the success of the Company at managing the risks involved in the foregoing and other risks and uncertainties, including those detailed in the Company’s filings with the SEC.

The Company cautions that the foregoing list of important factors is not all inclusive. Readers are also cautioned not to place undue reliance on any forward-looking statements, which reflect management’s analysis only as of the date of this report, even if subsequently made available by the Company on its website or otherwise. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company to reflect events or circumstances occurring after the date of this report.

Readers should carefully review the risk factors described in the Annual Report and other documents that the Company periodically files with the Securities and Exchange Commission, including its Form 10-K for the year ended December 31, 2014.

## **CRITICAL ACCOUNTING POLICIES**

In preparing the consolidated financial statements, management has made estimates, judgments and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated statements of condition and results of operations for the periods indicated. Actual results could differ significantly from those estimates.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of its financial condition and results of operations. Management has identified the policies on the determination of the allowance for loan and lease losses ("ALLL"), securities' valuation and impairment evaluation, and the valuation of other real estate owned ("OREO") and income taxes to be critical, as management is required to make subjective and/or complex judgments about matters that are inherently uncertain and could be most subject to revision as new information becomes available.

The judgments used by management in applying the critical accounting policies discussed below may be affected by a further and prolonged deterioration in the economic environment, which may result in changes to future financial results. Specifically, subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the ALLL in future periods, and the inability to collect on outstanding loans could result in increased loan losses. In addition, the valuation of certain securities in the Company's investment portfolio could be negatively impacted by illiquidity or dislocation in marketplaces resulting in significantly depressed market prices thus leading to impairment losses.

### *Allowance for Loan and Lease Losses*

Management continually evaluates the credit quality of the Company's loan portfolio, and performs a formal review of the adequacy of the ALLL on a quarterly basis. The ALLL is established through a provision for loan losses charged to earnings and is maintained at a level management considers adequate to absorb estimated probable losses inherent in the loan portfolio as of the evaluation date. Loans, or portions of loans, determined by management to be uncollectible are charged off against the ALLL, while recoveries of amounts previously charged off are credited to the ALLL.

Determining the amount of the ALLL is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, qualitative factors, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. Various banking regulators, as an integral part of their examination of the Company, also review the ALLL. Such regulators may require, based on their judgments about information available to them at the time of their examination, that certain loan balances be charged off or require that adjustments be made to the ALLL. Additionally, the ALLL is determined, in part, by the composition and size of the loan portfolio.

The ALLL consists of three components, a specific component, a general component and an unallocated component. The specific component relates to loans that are classified as impaired. For such loans, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers all other loans and is based on historical loss experience adjusted by qualitative factors. The general reserve component of the ALLL is based on pools of unimpaired loans segregated by loan segment and risk rating categories of "Pass", "Special Mention" or "Substandard and Accruing." Historical loss factors and various qualitative factors are applied based on the risk profile in each risk rating category to determine the appropriate reserve related to those loans. Substandard loans on nonaccrual status above the \$100 thousand loan relationship threshold and all loans considered troubled debt restructurings ("TDRs") are classified as impaired. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

See Note 4- "Loans" of the notes to consolidated financial statements included in Item 1 hereof for additional information about the ALLL.

### *Securities Valuation*

Management utilizes various inputs to determine the fair value of its investment portfolio. To the extent they exist, unadjusted quoted market prices in active markets (Level 1) or quoted prices for similar assets or models using inputs that are observable, either directly or indirectly (Level 2) are utilized to determine the fair value of each investment in the portfolio. In the absence of observable inputs or if markets are illiquid, valuation techniques are used to determine fair value of any investments that require inputs that are both unobservable and significant to the fair value measurement (Level 3). For Level 3 inputs, valuation techniques are based on various assumptions, including, but not limited to, cash flows, discount rates, adjustments for nonperformance and liquidity, and liquidation values. A significant degree of judgment is involved in valuing investments using Level 3 inputs. The use of different assumptions could have a positive or negative effect on the Consolidated Statements of Financial Condition or results of operations. See Note 6-“Securities” and Note 7-“Fair Value Measurements” of the notes to consolidated financial statements included in Item 1 hereof for additional information about the Company’s securities valuation techniques.

On a quarterly basis, management evaluates individual investment securities having unrealized losses to determine whether or not the security is other-than-temporarily-impaired (“OTTI”). The analysis of OTTI requires the use of various assumptions, including but not limited to, the length of time an investment’s fair value is less than book value, the severity of the investment’s decline, any credit deterioration of the issuer, whether management intends to sell the security, and whether it is more-likely-than-not that the Company will be required to sell the security prior to recovery of its amortized cost basis. Debt investment securities deemed to be OTTI are written down by the impairment related to the estimated credit loss, and the non-credit related impairment loss is recognized in other comprehensive income. The Company did not recognize OTTI charges on investment securities for the three months ended March 31, 2015 and 2014 within the Consolidated Statements of Income.

### *Other Real Estate Owned*

OREO consists of property acquired by foreclosure, abandonment or conveyance of deed in-lieu of foreclosure of a loan, and bank premises that is no longer used for operation or for future expansion. OREO is held for sale and is initially recorded at fair value less costs to sell at the date of acquisition or transfer, which establishes a new cost basis. Upon acquisition of the property through foreclosure or deed-in-lieu of foreclosure, any write-down to fair value less estimated selling costs is charged to the ALLL. The determination is made on an individual asset basis. Bank premises no longer used for operations or future expansion are transferred to OREO at fair value less estimated selling costs with any related write-down included in non-interest expense unless conditions warrant an adjustment to value, as determined by management. Subsequent to acquisition, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value less cost to sell. Fair value is determined through external appraisals, current letters of intent, broker price opinions or executed agreements of sale. Costs relating to the development and improvement of the OREO properties may be capitalized; holding period costs and any subsequent changes to the valuation allowance are charged to expense as incurred.

*Income Taxes*

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in our consolidated financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences could impact our consolidated financial condition or results of operations.

The Company records an income tax provision or benefit based on the amount of tax, including alternative minimum tax, currently payable or receivable and the change in deferred tax assets and liabilities. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial and tax reporting purposes. Management conducts quarterly assessments of all available positive and negative evidence to determine the amount of deferred tax assets that will more likely than not be realized. The Company establishes a valuation allowance for deferred tax assets and records a charge to income if management determines, based on available evidence at the time the determination is made, that it is more likely than not that some portion or all of the deferred tax assets will not be realized. In evaluating the need for a valuation allowance, management considers past operating results, estimates of future taxable income based on approved business plans, future capital requirements and ongoing tax planning strategies. This evaluation process involves significant management judgment about assumptions that are subject to change from period to period depending on the related circumstances. The recognition of deferred tax assets requires management to make significant assumptions and judgments about future earnings, the periods in which items will impact taxable income, future corporate tax rates, and the application of inherently complex tax laws. The use of different estimates can result in changes in the amounts of deferred tax items recognized, which can result in equity and earnings volatility because such changes are reported in current period earnings. On December 31, 2010, the Company established a valuation allowance equal to 100 percent of its net deferred tax asset, excluding deferred tax assets and liabilities related to unrealized holding gains and losses on available-for-sale securities, and has maintained such an allowance through March 31, 2015.

In connection with determining the income tax provision or benefit, the Company considers maintaining liabilities for uncertain tax positions and tax strategies that management believes contain an element of uncertainty. Periodically, the Company evaluates each of its tax positions and strategies to determine whether a liability for uncertain tax benefits is required. As of March 31, 2015 and December 31, 2014, the Company determined that it did not have any uncertain tax positions or tax strategies and that no liability was required to be recorded.

### **New Authoritative Accounting Guidance**

ASU 2014-04, Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure,” clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (a) the creditor obtaining legal title to residential real estate property upon completion of a foreclosure or (b) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): “Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,” changes the criteria for reporting a discontinued operation. Under the new guidance, a disposal of a component of an entity or group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on the entity’s operations and financial results. This new guidance reduces complexity by removing the complex and extensive implementation guidance and illustrations that are necessary to apply the current definition of a discontinued operation. The new guidance also requires expanded disclosures about discontinued operations that will provide users with more information about the assets, liabilities, revenues and expenses of a discontinued operation and will require pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting, which will provide users with information about the ongoing trends in a reporting organization’s results from continuing operations. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

ASU 2014-11, Transfers and Servicing (Topic 860): “Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures,” changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements by aligning the accounting for these transactions with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial assets and a contemporaneous repurchase financing could be accounted for on a combined basis as a



forward arrangement, which has resulted in outcomes referred to as off-balance sheet accounting. ASU 2014-11 also requires a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction, and requires expanded disclosure about the nature of the collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

ASU 2014-14, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): “Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure,” requires that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure; (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The adoption of this guidance on January 1, 2015 did not have a material effect on the operating results or financial position of the Company.

### **Accounting Guidance to be Adopted in Future Periods**

ASU 2014-09, Revenue from Contracts with Customers (Topic 606): Section A, “Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and Deferred Costs-Contract with Customers (Subtopic 340-40);” Section B, “Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables;” and Section C, “Background Information and Basis for Conclusions,” provides a robust framework for addressing revenue recognition issues, and upon its effective date, replaces almost all existing revenue recognition guidance, including industry specific guidance, in current GAAP. The core principle of ASU 2014-09 is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 will also result in enhanced interim and annual disclosures, both qualitative and quantitative, about revenue in order to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. ASU 2014-09 is effective in annual reporting periods beginning after December 15, 2016 and the interim periods within that year for public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or over-the-counter market and employee benefit plans that file or furnish financial statements to the SEC. On April 29, 2015, the FASB issued for public comment a proposed ASU that would defer the effective date of ASU 2014-09 for both public and private entities for one year. The Company will adopt this guidance in accordance with the final outcome of the FASB’s extension proposal, and is currently evaluating the effect this guidance may have on its operating results or financial position.

ASU 2014-12, Compensation – Stock Compensation (Topic 718): “Accounting for Share-Based Payments When the Terms of an Award Provide that a Performance Target Could be Achieved after the Requisite Service Period,” requires a performance target that affects vesting and that can be achieved after the requisite service period to be treated as a performance condition. To account for such awards, an entity should apply existing guidance as it relates to awards with performance conditions that affect vesting. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service periods. The total amount of compensation cost should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern,” defines management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and provide guidance for related footnote disclosures. ASU 2014-15 requires an entity’s management to assess the entity’s ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically ASU 2014-15: (1) provides a definition of the term substantial doubt; (2) requires an evaluation as to whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s

ability to continue as a going concern within one year after the date the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable); (3) provides principles for considering the mitigating effect of management's plans; (4) requires certain disclosures when substantial doubt is alleviated; and (5) require an express statement and other disclosures when substantial doubt is not alleviated. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The adoption of this guidance on December 31, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-01, Income Statement – Extraordinary and Unusual Items (Subtopic 225-20): “Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items,” will alleviate uncertainty for preparers, auditors and regulators because auditors and regulators will no longer be required to evaluate whether a preparer presented an unusual and/or infrequent item appropriately. Although ASU 2015-01 eliminates the concept of extraordinary items, the presentation and disclosure guidance for items that are unusual in nature or infrequent in occurrence has been retained and has been expanded to include items that are both unusual in nature or infrequent in occurrence. The nature and financial effects of each event or transaction is required to be presented as a separate component of income from continuing operations or, alternatively, in the notes to the financial statements. ASU 2015-01 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption of this guidance is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-02, Consolidation (Topic 810): “Amendments to the Consolidation Analysis,” improves targeted areas of the consolidation guidance and reduces the number of consolidation models. The new consolidation standard changes the way reporting enterprises evaluate whether (a) they should consolidate limited partnerships and similar entities, (b) fees paid to a decision maker or service provider are variable interests in a variable interest entity (“VIE”), and (c) variable interests in a VIE held by related parties of the reporting enterprise require the reporting enterprise to consolidate the VIE. It also eliminates the VIE consolidation model based on majority exposure to variability that applied to certain investment companies and similar entities. ASU 2015-02 is effective for public entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-03, Interest – Imputation of Interest (Subtopic 835-30): “Simplifying the Presentation of Debt Issuance Costs,” more closely aligns the presentation of debt issuance costs under U.S. GAAP with the presentation under comparable IFRS standards. Under ASU 2015-03 debt issuance costs related to a recognized debt liability will no longer be recorded as a separate asset, but will be presented on the balance sheet as a direct deduction from the debt liability, similar to the presentation of debt discounts. The costs will continue to be amortized to interest expense using the effective interest method. ASU 2015-03 is effective for public entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, and requires retrospective application to all prior periods presented in the financial statements. Early adoption of this guidance is permitted. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

ASU 2015-05, Intangibles – Goodwill and Other Internal-Use Software (Subtopic 350-40): “Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement,” provides explicit guidance on a customer’s accounting for fees paid in a cloud computing environment. Specifically, the amendments in this ASU provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. ASU 2015-05 is effective for public entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption of this guidance is permitted. The adoption of this guidance on January 1, 2016 is not expected to have a material effect on the operating results or financial position of the Company.

## **Executive Summary**

The following overview should be read in conjunction with this MD&A in its entirety.

On March 25, 2015, the Office of the Comptroller of the Currency (“OCC”) notified First National Community Bank, the Company’s wholly-owned subsidiary (the “Bank”), that it was fully and completely released from the Consent Order it entered into with the OCC in September 2010. The release signifies that the OCC determined that the Bank had met all of the requirements mandated by the Consent Order. The Company anticipates a reduction in its noninterest expense, including FDIC insurance, OCC assessment and general liability and fidelity bond insurance which have been elevated due to operating under the Consent Order. In addition, while operating under the Consent Order, the Company was prohibited from using brokered deposits as a source of liquidity. With the release from the Consent Order, the Company can now utilize brokered deposits as a funding alternative. The Company continues to be subject to a Written Agreement dated November 24, 2010 entered into with the Federal Reserve Bank of Philadelphia.

The Company recorded net income of \$3.5 million, or \$0.21 per diluted common share, for both the three months ended March 31, 2015 and 2014. Comparing the three months ended March 31, 2015 and 2014, decreases in net interest income, non-interest income and the credit for loan and lease losses were almost entirely offset by a reduction

in non-interest expense. Annualized return on average assets and return on average equity were 1.45% and 26.34%, respectively, for the three months ended March 31, 2015, compared to 1.46% and 38.45%, respectively, for three months ended March 31, 2014. The Company did not pay any dividends during the three months ended March 31, 2015 and 2014.

Total assets decreased \$9.8 million, or 1.0%, to \$960.2 million at March 31, 2015 from \$970.0 million at December 31, 2014. The balance sheet reduction was due primarily to a \$20.2 million, or 2.5%, decrease in total deposits to \$775.1 million at March 31, 2015 from \$795.3 million at December 31, 2014. Loans, net of deferred loan origination fees and costs, unearned income and the ALLL grew \$2.5 million, or 0.4%, while available-for-sale investment securities decreased \$14.4 million, or 6.6%.

The decrease in total deposits was due to a \$31.1 million, or 4.6%, decline in interest-bearing deposits, which resulted primarily from the cyclical deposit outflows from several large commercial and municipal accounts and the expected runoff of \$11.8 million in certificates of deposit obtained through QwickRate®, a national listing service and \$4.5 million in brokered certificates of deposit. Partially offsetting these outflows was an increase in non-interest-bearing demand deposits of \$10.9 million, or 8.8%, which reflected the Company's continued focus on core deposit growth. The Company's borrowings with the FHLB increased \$6.4 million, or 10.5%, to \$67.6 million at March 31, 2015 from \$61.2 million at December 31, 2014.

Total shareholders' equity increased \$4.3 million, or 8.4%, to \$55.7 million at March 31, 2015 from \$51.4 million at December 31, 2014. The capital improvement resulted primarily from net income of \$3.5 million, coupled with a \$0.8 million increase in accumulated other comprehensive income, which resulted from appreciation in the fair value of available-for-sale securities offset by the tax impact of the appreciation.

Management will continue to build on the initiatives put in place in 2014 and implement additional strategies focused on growing core deposits, increasing net interest income, generating additional non-interest revenue streams and further reducing non-interest expenses.

In addition, plans are underway to transition to a new core bank operating system in the fall of 2015. The conversion to a more robust system will provide the Company with new technologies to improve day-to-day operations and reporting capabilities, and allow it to create efficiencies and provide customers with delivery system enhancements and greater customer service.

## **Summary of Performance**

### **Net Interest Income**

Net interest income is the difference between (i) interest income(interest and fees on interest-earning assets), and (ii) interest expense(interest paid on the Company's deposits and borrowed funds). Net interest income represents the largest component of the Company's operating income and, as such, is the primary determinant of profitability. Net interest income is impacted by variations in the volume, rate and composition of earning assets and interest-bearing liabilities, changes in general market rates and the level of non-performing assets. Interest income is shown on a fully tax-equivalent basis and is calculated by adjusting tax-free interest using a marginal tax rate of 34.0% in order to equate the yield to that of taxable interest rates. Tax-equivalent net interest income and the net interest margin were largely impacted by the repositioning of the investment portfolio from tax-exempt obligations of state and political subdivisions to taxable investments. This repositioning was part of the Company's tax planning strategies designed to utilize its net operating loss carryovers. Net interest income on a tax-equivalent basis decreased \$614 thousand comparing the three-month periods ending March 31, 2015 and 2014. The Company's tax-equivalent net interest margin, compressed 24 basis points to 2.85% during the three months ended March 31, 2015 from 3.09% for the same three months of 2014. Tax-equivalent net interest margin, a key measurement used in the banking industry to measure income from earning assets relative to the cost to fund those assets, is calculated by dividing tax-equivalent net interest income by average interest-earning assets. The margin decrease was primarily due to lower yields on the investment portfolio caused by the repositioning from tax-exempt securities to taxable and an overall decrease in the average balance of the investment portfolio. Rate spread, the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities shown on a fully tax-equivalent basis, was 2.73% for the three months ended March 31, 2015, a decrease of 24 basis points compared to 2.97% for the same period of 2014.

Interest income on a tax equivalent basis decreased \$772 thousand to \$7.9 million for the three-month period ended March 31, 2015 compared to \$8.7 million in 2014. As mentioned above, the decrease primarily resulted from the repositioning of the investment portfolio. The average balance of tax-exempt investments decreased \$57.9 million, or 93.1%, to \$4.3 million for the three months ended March 31, 2015 from \$62.1 million for the same three months of 2014, which caused a \$1.0 million corresponding decrease to tax-equivalent interest income. The average balance of

taxable investments increased \$26.8 million, or 16.0%, but was only able to mitigate the decrease by \$153 thousand. With regard to the loan portfolio, a \$22.6 million, 3.5%, increase in the average balance of loans was more than entirely offset by a 15 basis point reduction in the tax-equivalent yield on the portfolio. Taxable loans averaged \$23.2 million higher, while the average balances of tax-exempt loans decreased \$0.6 million, which resulted in a net increase in interest income of \$223 thousand. The tax-equivalent yield on the loan portfolio fell 15 basis points to 3.94% in the first quarter of 2015 from 4.09% for the same quarter of 2014, which caused a corresponding decrease to tax-equivalent interest income of \$250 thousand. The decrease in loan yields reflected competitive pressures for commercial loans within our market area and current promotions involving short-term residential mortgage products and indirect auto loans. In addition, as part of its asset/liability strategy, the Company is currently retaining mortgages which in the past were predominantly originated for sale on the secondary market.

Partially offsetting the decrease in interest income was a \$158 thousand reduction in interest expense to \$1.4 million for the three months ended March 31, 2015 from \$1.6 million for the same three months of 2014. The 10.0% reduction in interest expense was predominantly caused by a \$27.5 million, or 3.5%, decrease in average interest-bearing liabilities, coupled with a 5 basis point decline in the cost of funds to 0.75% in 2015 from 0.80% in 2014. A \$60.7 million, or 8.4%, decrease in average deposits, driven by decreases in time deposits, was the primary factor leading to the decrease in average interest-bearing liabilities and resulted in a reduction to interest expense of \$142 thousand. The Company experienced decreases in average time deposits over \$100 thousand and other time deposits of \$43.5 million and \$18.8 million, respectively. The decrease in large denomination time deposits reflected the planned maturity and runoff of certificates of deposit originated through QwickRate®, a national deposit listing service. The decrease in other time deposits resulted from the planned runoff of QwickRate® certificates, the maturity of \$4.5 million in brokered certificates and maturing certificates of customers bearing higher interest rates that were not renewed given the current low rate environment. As part of the Company's asset/liability strategy, maturing certificates were replaced through generating core deposits and lower-costing FHLB of Pittsburgh advances. As a result of this strategy, the average balance of borrowed funds increased \$33.2 million, or 50.4%, to \$99.0 million for the three months ended March 31, 2015 from \$65.8 million for the same three months of 2014. The increase in average borrowed funds resulted in additional interest expense of \$288 thousand. With regard to fund costs, the Company's cost of deposits and borrowings decreased 6 basis points and 134 basis points, respectively comparing the three months ended March 31, 2015 and 2014, and resulted in a combined decrease in interest expense of \$304 thousand.

Net interest income depends upon the relative amount of interest-earning assets and interest-bearing liabilities and the interest rate earned or paid on them. The following table presents certain information about the Company's Consolidated Statements of Financial Condition and Consolidated Statements of Income for the three month periods ended March 31, 2015 and 2014, and reflects the average yield on assets and average cost of liabilities for the periods indicated. Such yields and costs are calculated by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods shown. Average balances are derived from average daily balances. The yields include amortization of fees which are considered adjustments to yields.

| (dollars in thousands)                                | Three Months Ended |          |                |                 |          |                |
|---|--------------------|----------|----------------|-----------------|----------|----------------|
|   | March 31, 2015     |          |                | March 31, 2014  |          |                |
|   | Average Balance    | Interest | Yield/<br>Cost | Average Balance | Interest | Yield/<br>Cost |
| <b>ASSETS</b>   |                    |          |                |                 |          |                |
| Earning assets (2)(3)                                 |                    |          |                |                 |          |                |
| Loans-taxable(4)                                      | \$633,731          | \$6,148  | 3.88 %         | \$610,513       | \$6,160  | 4.04 %         |
| Loans-tax free (4)                                    | 41,125             | 491      | 4.78 %         | 41,709          | 506      | 4.85 %         |
| Total loans (1)(2)                                    | 674,856            | 6,639    | 3.94 %         | 652,222         | 6,666    | 4.09 %         |
| Securities-taxable                                    | 194,268            | 1,154    | 2.38 %         | 167,454         | 897      | 2.14 %         |
| Securities-tax free                                   | 4,283              | 76       | 7.10 %         | 62,140          | 1,076    | 6.93 %         |
| Total securities (1)(5)                               | 198,551            | 1,230    | 2.48 %         | 229,594         | 1,973    | 3.44 %         |
| Interest-bearing deposits in other banks              | 34,708             | 21       | 0.24 %         | 36,018          | 23       | 0.26 %         |
| Total earning assets                                  | 908,115            | 7,890    | 3.48 %         | 917,834         | 8,662    | 3.77 %         |
| Non-earning assets                                    | 72,990             |          |                | 74,588          |          |                |
| Allowance for loan and lease losses                   | (11,514)           |          |                | (14,130)        |          |                |
| Total assets  | \$969,591          |          |                | \$978,292       |          |                |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>           |                    |          |                |                 |          |                |
| Interest-bearing liabilities                          |                    |          |                |                 |          |                |
| Interest-bearing demand deposits                      | \$328,438          | 120      | 0.15 %         | \$331,144       | 112      | 0.14 %         |
| Savings deposits                                      | 91,908             | 15       | 0.07 %         | 87,631          | 15       | 0.07 %         |
| Time deposits over \$100,000                          | 116,674            | 210      | 0.72 %         | 160,149         | 306      | 0.76 %         |
| Other time deposits                                   | 121,173            | 338      | 1.12 %         | 139,968         | 432      | 1.23 %         |
| Total interest-bearing deposits                       | 658,193            | 683      | 0.42 %         | 718,892         | 865      | 0.48 %         |
| Borrowed funds and other interest-bearing liabilities | 99,046             | 732      | 2.96 %         | 65,846          | 708      | 4.30 %         |
| Total interest-bearing liabilities                    | 757,239            | 1,415    | 0.75 %         | 784,738         | 1,573    | 0.80 %         |
| Demand deposits                                       | 132,316            |          |                | 132,712         |          |                |
| Other liabilities                                     | 26,525             |          |                | 23,785          |          |                |
| Shareholders' equity                                  | 53,511             |          |                | 37,057          |          |                |
| Total liabilities and shareholders' equity            | \$969,591          |          |                | \$978,292       |          |                |
| Net interest income/interest rate spread (6)          |                    | 6,475    | 2.73 %         |                 | 7,089    | 2.97 %         |
| Tax equivalent adjustment                             |                    | (193 )   |                |                 | (538 )   |                |
| Net interest income as reported                       |                    | \$6,282  |                |                 | \$6,551  |                |
| Net interest margin (7)                               |                    |          | 2.85 %         |                 |          | 3.09 %         |



- (1) Interest income is presented on a tax equivalent basis using a 34% rate.
- (2) Loans are stated net of unearned income.
- (3) Non-accrual loans are included in loans within earning assets.
- (4) Loan fees included in interest income are not significant.
- (5) The yields for securities that are classified as available-for-sale are based on the average historical amortized cost.
- (6) Interest rate spread represents the difference between the average yield on interest-earning assets and the cost of interest-bearing liabilities and is presented on a tax-equivalent basis.
- (7) Net interest income as a percentage of total average interest earning assets.

## Rate Volume Analysis

The most significant impact on net income between periods is derived from the interaction of changes in the volume and rates earned or paid on interest-earning assets and interest-bearing liabilities. The volume of earning assets, specifically loans and investments, compared to the volume of interest-bearing liabilities represented by deposits and borrowings, combined with the spread, produces the changes in net interest income between periods. Components of interest income and interest expense are presented on a tax-equivalent basis using the statutory federal income tax rate of 34%.

The following table summarizes the effect that changes in volumes of earning assets and interest-bearing liabilities and the interest rates earned and paid on these assets and liabilities have on net interest income. The net change or mix component attributable to the combined impact of rate and volume changes has been allocated proportionately to the change due to volume and the change due to rate.

| (in thousands)  | March 31,<br>2015 vs. 2014 |                |                 |
|---|----------------------------|----------------|-----------------|
|   | Increase (Decrease)        |                |                 |
|   | Due to<br>Volume           | Due to<br>Rate | Total<br>Change |
| Interest income:                                      |                            |                |                 |
| Loans - taxable                                       | \$230                      | \$(242 )       | \$(12 )         |
| Loans - tax free                                      | (7 )                       | (8 )           | (15 )           |
| Total loans   | 223                        | (250 )         | (27 )           |
| Securities - taxable                                  | 153                        | 104            | 257             |
| Securities - tax free                                 | (1,023)                    | 23             | (1,000)         |
| Total securities                                      | (870 )                     | 127            | (743 )          |
| Interest-bearing deposits in other banks              | (1 )                       | (1 )           | (2 )            |
| Total interest income                                 | (648 )                     | (124 )         | (772 )          |
| Interest expense:                                     |                            |                |                 |
| Interest-bearing demand deposits                      | (1 )                       | 9              | 8               |
| Savings deposits                                      | 1                          | (1 )           | -               |
| Time deposits over \$100,000                          | (87 )                      | (9 )           | (96 )           |
| Other time deposits                                   | (55 )                      | (39 )          | (94 )           |
| Total interest-bearing deposits                       | (142 )                     | (40 )          | (182 )          |
| Borrowed funds and other interest-bearing liabilities | 288                        | (264 )         | 24              |
| Total interest expense                                | 146                        | (304 )         | (158 )          |
| Net interest income                                   | \$(794 )                   | \$180          | \$(614 )        |

## Provision for Loan and Lease Losses

Management closely monitors the loan portfolio and the adequacy of the ALLL by considering underlying borrower financial performance and collateral values and associated credit risks. Future material adjustments may be necessary to the provision for loan and lease losses and the ALLL if economic conditions or loan performance differ substantially from the assumptions management used in making its evaluation of the ALLL. The provision for loan and lease losses is an expense charged against net interest income to provide for probable losses attributable to uncollectible loans and is based on management's analysis of the adequacy of the ALLL. A credit to loan and lease losses reflects the reversal of amounts previously charged to the ALLL.

The Company recorded a credit for loan and lease losses of \$0.5 million for the three month period ended March 31, 2015, compared to a credit of \$1.6 million for the three months ended March 31, 2014. The release of reserves in the first quarter of 2015 reflected the continued improvement in asset quality metrics and reductions in historical loss and qualitative factors.

### **Non-interest Income**

For the three months ended March 31, 2015 and 2014, non-interest income totaled \$3.4 million and \$3.5 million, respectively. The change resulted primarily from a \$607 thousand decrease in gains on branch divestitures, which was non-recurring and resulted from the sale of the Company's Monroe County branches in the first quarter of 2014. In addition, the Company experienced decreases in net gains on the sale of mortgage loans and OREO of \$35 thousand and \$24 thousand, respectively, and a decrease in income from bank-owned life insurance of \$32 thousand. Partially offsetting these decreases was an increase in net gains on the sale of securities of \$656 thousand to \$2.2 million for the first quarter of 2015 from \$1.6 million for the same quarter of 2014.

## **Non-interest Expense**

Non-interest expense decreased \$1.2 million, or 15.1%, to \$6.8 million for the three month period ended March 31, 2015, from \$8.0 million for the same period in 2014. The decrease primarily reflected significant reductions in legal expense, professional fees, regulatory assessments and salaries and employee benefits. Legal expense decreased \$484 thousand, or 74.8% to \$163 thousand for the three months ended March 31, 2015 from \$647 thousand for the same three months of 2014, and reflected the resolution of costly litigation. Professional fees declined \$149 thousand, or 33.1%, as the Company continued to reduce its reliance on outside consultants and focused on managing controllable expenses.

During the first quarter of 2014, the Company was notified by the Federal Deposit Insurance Corporation (“FDIC”) that its risk category for FDIC assessments had improved from a risk category III to a risk category II based upon the Company’s most recent regulatory examination. Due to the change in risk categories, the Company’s initial base assessment rate for deposit insurance decreased from 0.23 basis points to 0.14 basis points. The new assessment rate became effective on February 18, 2014. In addition, the Company had been paying a 100% surcharge on its assessment charged by the OCC. During the second half of 2014, because of the improvement in risk category, the surcharge was reduced to 50.0%. These changes in assessment rates resulted in a \$264 thousand, or 39.2%, decrease in regulatory assessments. Due to its recent release from the Consent Order, the Company anticipates a further reduction in assessments imposed by regulatory authorities.

Salaries and employee benefits expense decreased \$261 thousand, or 7.7%, to \$3.1 million for the three months ended March 31, 2015 from \$3.4 million for the same period of 2014, primarily reflecting a sustained decrease in the number of full-time equivalent employees and no rate increase in health insurance premiums.

## **Provision for Income Taxes**

The Company recorded a credit for income tax expense of \$62 thousand for the first quarter of 2015, compared to a provision for income tax expense of \$70 thousand in 2014, which were both related entirely to alternative minimum tax. In future periods, the Company anticipates that it will have a minimal tax provision or benefit until such time as it is able to reverse the deferred tax asset valuation allowance.

The Company evaluates the carrying amount of its deferred tax assets on a quarterly basis, or more frequently, if necessary, in accordance with guidance set forth in ASC Topic 740 “Income Taxes,” and applies the criteria in the guidance to determine whether it is more likely than not that some portion, or all, of the deferred tax asset will not be realized within its life cycle, based on the weight of available evidence. If management determines based on available evidence, both positive and negative, that it is more likely than not that some portion or all of the deferred tax asset

will not be realized in future periods, a valuation allowance is calculated and recorded. These determinations are inherently subjective and depend upon management's estimates and judgments used in their evaluation of both positive and negative evidence.

In evaluating available evidence, management considers, among other factors, historical financial performance, expectation of future earnings, the ability to carry back losses to recoup taxes previously paid, length of statutory carry forward periods, experience with operating loss and tax credit carry forwards not expiring unused, tax planning strategies and timing of reversals of temporary differences. In assessing the need for a valuation allowance, management carefully weighed both positive and negative evidence currently available. The weight given to the potential effect of positive and negative evidence must be commensurate with the extent to which it can be objectively verified. In particular, additional scrutiny must be given to deferred tax assets of an entity that has incurred taxable losses during the three most recent years because it is significant negative evidence that is objective and verifiable and therefore difficult to overcome. While the Company generated taxable income in the first quarter of 2015 and for the year ended December 31, 2014, it recorded taxable losses in 2013 and 2012.

When determining the need for a valuation allowance, the Company assessed the possible sources of taxable income available under tax law to realize a tax benefit for deductible temporary differences and carryforwards as defined in ASC Topic 740. While the Company has shown substantial book net income in 2013 and 2014 and for the first quarter of 2015, these amounts have been the result of significant non-recurring or non-taxable transactions, such as the credit for loan and lease losses, legal settlements and gains on the sales of securities. The Company utilizes a three-year rolling measurement of results when assessing whether it is in a cumulative loss position. Until such time when the Company's cumulative results are positive, it does not believe there is sufficient positive evidence to overcome the negative evidence presented. The Company will exclude future taxable income as a factor until it can show consistent and sustainable profitability. Based on the analysis of available positive and negative evidence, management determined that the established valuation allowance equal to 100.0% of net deferred tax assets, excluding deferred tax assets or liabilities related to unrealized holding gains and losses on available-for-sale securities, should be maintained.

The Company recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax bases of assets and liabilities. The net deferred tax asset, not including unrealized holding gains and losses on available-for-sale securities, approximated \$30.3 million at March 31, 2015 and December 31, 2014. Accordingly, the Company recorded a valuation allowance for the entire balance of the net deferred tax assets at March 31, 2015 and December 31, 2014. The deferred tax asset will continue to be analyzed on a quarterly basis for changes affecting realization.

In 2014, management assessed and implemented tax planning strategies available to the Company in order to generate taxable income, prevent a net operating loss or tax credit carryforward from expiring unused and promote the realization of existing deferred tax assets. These strategies included the repositioning of the securities portfolio from tax-exempt to taxable investments through the sale of available-for-sale investment securities with fair values greater than book values and the redeployment of cash and cash equivalents into higher yielding investment options.

Sustained profitability is a driving factor used to determine when projections of future taxable income become more reliable and can again be used to assess the ability to fully realize the deferred tax asset. When the determination is made to include projections of future taxable income as a factor, the valuation allowance will be reduced accordingly resulting in a corresponding increase in net income.

The Company calculates its current and deferred tax provision based on estimates and assumptions that could differ from actual results reflected in income tax returns filed during the subsequent year. Any adjustments required based on filed returns are recorded when identified in the subsequent year.

## **FINANCIAL CONDITION**

### **Assets**

Total assets decreased \$9.8 million, or 1.0%, to \$960.2 million at March 31, 2015 from \$970.0 million at December 31, 2014. The decrease resulted primarily from a decrease in total deposits of \$20.2 million, or 2.5%. The Company experienced moderate loan demand, which resulted in a \$2.5 million, or 0.4%, increase in loans, net of unearned income and the ALLL. Available-for-sale securities decreased \$14.4 million, or 6.6%, as management continued to reposition the investment portfolio. Cash and cash equivalents increased \$1.7 million, while total borrowed funds, specifically with the FHLB of Pittsburgh, increased \$6.4 million when comparing March 31, 2015 to December 31, 2014.

### **Cash and Cash Equivalents**

Cash and cash equivalents were relatively stable, increasing only \$1.7 million, or 4.8%, during the three months ended March 31, 2015 to \$37.4 million from \$35.7 million at December 31, 2014. The Company did not pay any dividends during the quarter ended March 31, 2015 as it suspended paying dividends to conserve capital and comply with regulatory requirements since 2009.

## Securities

The Company's investment securities portfolio provides a source of liquidity needed to meet expected loan demand and provides a source of interest income to increase profitability. Additionally, the Company utilizes the investment securities portfolio to meet pledging requirements to secure public deposits and for other purposes. Investment securities are classified as held-to-maturity and carried at amortized cost when the Company has the positive intent and ability to hold them to maturity. Securities not classified as held-to-maturity are classified as available-for-sale and are carried at fair value, with unrealized holding gains and losses reported as a component of shareholders' equity in accumulated other comprehensive income (loss), net of tax. The Company determines the appropriate classification of investment securities at the time of purchase. At March 31, 2015 and December 31, 2014, all securities were classified as available-for-sale. The decision to purchase or sell investment securities is based upon the current assessment of long- and short-term economic and financial conditions, including the interest rate environment and asset/liability management strategies. Securities with limited marketability and/or restrictions, such as FHLB of Pittsburgh and FRB stocks, are carried at cost. FRB stock is included in other assets.

At March 31, 2015, the Company's investment portfolio was comprised principally of securities issued by U.S. government or U.S. government-sponsored agencies, which include residential mortgage-backed securities, residential and commercial collateralized mortgage obligations ("CMOs") and single-maturity bonds, and taxable obligations of state and political subdivisions. Except for U.S. government and government-sponsored agencies, there were no securities of any individual issuer that exceeded 10.0% of shareholders' equity at March 31, 2015.

The following table presents the carrying value of available-for-sale securities, which are carried at fair value at March 31, 2015 and December 31, 2014:

| (in thousands)                                    | March 31,<br>2015 | December 31,<br>2014 |
|---|-------------------|----------------------|
| Available-for-sale securities                     |                   |                      |
| Obligations of U.S. government agencies           | \$ 26,927         | \$ 29,276            |
| Obligations of state and political subdivisions   | 11,307            | 24,509               |
| U.S. government/ government-sponsored agencies:   |                   |                      |
| Collateralized mortgage obligations - residential | 25,792            | 26,231               |
| Collateralized mortgage obligations - commercial  | 62,967            | 61,256               |
| Residential mortgage-backed securities            | 74,002            | 74,098               |
| Corporate debt securities                         | 425               | 420                  |
| Negotiable certificates of deposit                | 2,245             | 2,232                |
| Equity securities                                 | 970               | 967                  |
| Total   | \$ 204,635        | \$ 218,989           |

Management monitors the Company's investment portfolio regularly and adjusts the investment strategy to reflect changes in liquidity needs, asset/liability strategy and tax planning requirements. Management actions during the first quarter of 2015 continued to reflect the Company's current investment strategy designed to reduce potential credit and concentration risk within the balance sheet, manage interest rate risk by shortening the duration of the portfolio, and reduce tax-free holdings as required under tax planning initiatives, as well as the Company's liquidity needs. The Company currently has \$52.7 million in net operating loss ("NOL") carryovers, which it uses to offset any taxable income. In addition, the Company has established a full valuation allowance for its deferred tax assets. Because of this tax position, the Company does not benefit from holding tax-exempt obligations of state and political subdivisions. Accordingly, current tax planning initiatives focus on generating sustained taxable income to be able to reduce NOL carryovers and begin reversing the deferred tax asset valuation allowance.

As part of this strategy, the Company sold 25 of its available-for-sale securities including 18 tax-exempt and 3 taxable obligations of state and political subdivisions, 3 commercial CMOs and 1 U.S. government agency bonds during the three months ended March 31, 2015. The securities sold had an aggregate amortized cost of \$33.7 million. Gross proceeds received totaled \$35.9 million, with net gains of \$2.2 million realized upon the sales and included in non-interest income.

Securities purchased during the first quarter of 2015 totaled \$20.8 million and included \$12.2 million in commercial CMOs of U.S. government-sponsored agencies and \$8.6 million in taxable obligations of states and political subdivisions.



The following table presents the maturities of available-for-sale securities, based on carrying value at March 31, 2015 and the weighted-average yields of such securities calculated on the basis of the amortized cost and effective yields weighted for the scheduled maturity of each security. The yields on obligations of states and political subdivisions are presented on a tax-equivalent basis using an effective interest rate of 34.0%. Because residential and commercial collateralized mortgage obligations and residential mortgage-backed securities are not due at a single maturity date, they are not included in the maturity categories in the following summary:

| (dollars in thousands)                            | March 31, 2015     |                  |                 |                  | Collateralized<br>Mortgage<br>Obligations<br>and<br>Mortgage-Backed<br>Securities |        | No Fixed<br>Maturity | Total |
|---|--------------------|------------------|-----------------|------------------|---|--------|----------------------|-------|
|   | Within<br>One Year | > 1 – 5<br>Years | 6 - 10<br>Years | Over<br>10 Years |   |        |                      |       |
| Available-for-sale securities                     |                    |                  |                 |                  |   |        |                      |       |
| Obligations of U.S. government agencies           | \$-                | \$-              | \$26,927        | \$-              | \$-   | \$-    | \$26,927             |       |
| Yield   |                    |                  | 1.95 %          |                  |   |        | 1.95 %               |       |
| Obligations of state and political subdivisions   | -                  | -                | 9,201           | 2,106            | -   | -      | 11,307               |       |
| Yield   |                    |                  | 2.48 %          | 6.73 %           |   |        | 3.27 %               |       |
| Government-sponsored agencies:                    |                    |                  |                 |                  |   |        |                      |       |
| Collateralized mortgage obligations - residential | -                  | -                | -               | -                | 25,792  | -      | 25,792               |       |
| Yield   |                    |                  |                 |                  | 2.31 %  |        | 2.31 %               |       |
| Collateralized mortgage obligations - commercial  | -                  | -                | -               | -                | 62,967  | -      | 62,967               |       |
| Yield   |                    |                  |                 |                  | 2.23 %  |        | 2.23 %               |       |
| Residential mortgage-backed securities            | -                  | -                | -               | -                | 74,002  | -      | 74,002               |       |
| Yield   |                    |                  |                 |                  | 2.06 %  |        | 2.06 %               |       |
| Corporate debt securities                         |                    |                  |                 | 425              | -   | -      | 425                  |       |
| Yield   |                    |                  |                 | 0.90 %           |   |        | 0.90 %               |       |
| Negotiable certificates of deposit                |                    | 2,245            | -               | -                | -   | -      | 2,245                |       |
| Yield   |                    | 1.97 %           |                 |                  |   |        | 1.97 %               |       |
| Equity securities                                 | -                  | -                | -               | -                | -   | 970    | 970                  |       |
| Yield   |                    |                  |                 |                  |   | 3.50 % | 3.50 %               |       |
| Total available-for-sale securities               | \$-                | \$2,245          | \$36,128        | \$2,531          | \$162,761   | \$970  | \$204,635            |       |
| Weighted yield                                    | 0.00 %             | 1.97 %           | 2.08 %          | 5.75 %           | 2.16 %  | 3.50 % | 2.20 %               |       |

Management evaluates individual securities in an unrealized loss position quarterly for OTTI. As part of its evaluation, management considers, among other things, the length of time a security's fair value is less than amortized cost, the severity of decline, any credit deterioration of the issuer, whether or not management intends to sell the security, and whether it is more likely than not that the Company will be required to sell the security prior to recovery of its amortized cost.

Securities issued by U.S. government or U.S. government-sponsored agencies, including single-maturity bonds, residential mortgage-backed securities, and residential and commercial CMOs, comprise the majority of the Company's securities portfolio. Management performed a review of the fair values of all securities in an unrealized loss position as of March 31, 2015 and determined that movements in the fair values of the securities were consistent with the change in market interest rates. At March 31, 2015, the Company held six securities that were in an unrealized loss position, with three of those securities in an unrealized loss position for more than 12 months. All but one of the securities in an unrealized loss position at March 31, 2015 were debt securities. Additionally, management considers the severity of each security's unrealized loss position, placing greater emphasis on any security with a unrealized loss greater than 5.0% of its amortized cost. At March 31, 2015, there was one security, a corporate debt security, with an unrealized loss greater than 5.0% of its amortized cost. The security, a floating rate bond of JP Morgan Chase, had an unrealized loss of \$75 thousand, or 15.0%, of its amortized cost at March 31, 2015. This bond was originally issued by Chase Manhattan Bank. JP Morgan Chase, surviving after the merger, is one of the largest banks in the world with a legacy dating back to 1799. JP Morgan Chase was considered well capitalized under regulatory capital guidelines at March 31, 2015.

The remaining five securities in an unrealized loss position at March 31, 2015 included three securities issued by a U.S. government or government-sponsored agency, one obligation of a state and political subdivision and one equity security. The obligations of the U.S. government or government-sponsored agencies are securities issued by GNMA and FHLMC that are currently rated Aaa by Moody's Investor Services or AAA by Standard & Poor's ("S&P") and are guaranteed by the U.S. government. The one state and political subdivision obligation in an unrealized loss position at March 31, 2015 was a general-purpose debt obligation, which has an S&P credit rating of A+, is secured by the unlimited taxing power of the issuer and carries a secondary level of credit enhancement. The one equity security in an unrealized loss position at March 31, 2015 was a mutual fund investment that qualifies the Company for credit under the Community Reinvestment Act. The mutual fund is comprised of one- to four-family residential mortgage-backed securities collateralized by properties within the Company's geographical market. In aggregate, unrealized losses totaled \$128 thousand, which represented only 0.06%, of the total amortized cost of investment securities at March 31, 2015.

To date, the Company has received all scheduled principal and interest payments and expects to fully collect all future contractual principal and interest payments. The Company does not intend to sell the securities nor is it more likely than not that the Company will be required to sell the securities prior to recovery of their amortized cost. Based on the result of its review and considering the attributes of these debt and equity securities, management concluded that the individual unrealized losses were temporary and OTTI did not exist at March 31, 2015.

Investments in FHLB and Federal Reserve Bank (“FRB”) stock, which have limited marketability, are carried at cost and totaled \$4.4 million and \$4.2 million at March 31, 2015 and December 31, 2014, respectively. FRB stock of \$1.3 million is included in Other Assets at March 31, 2015 and December 31, 2014. Management noted no indicators of impairment for the FHLB of Pittsburgh and FRB of Philadelphia stock at March 31, 2015.

## **Loans**

During the first three months of 2015, the Company experienced moderate demand for its lending products. However, the unanticipated paydowns related to several large commercial relationships partially offset demand and resulted in an increase in total loans of \$1.6 million, or 0.2%, to \$671.1 million at March 31, 2015 from \$669.5 million at December 31, 2014. Historically, commercial lending activities have represented a significant portion of the Company’s loan portfolio. This includes commercial and industrial loans, commercial real estate loans and construction, land acquisition and development loans.

From a collateral standpoint, a majority of the Company’s loan portfolio consisted of loans secured by real estate. Real estate secured loans, which include commercial real estate, construction, land acquisition and development, residential real estate loans and home equity lines of credit (“HELOCs”), decreased \$2.1 million, or 0.5%, to \$402.9 million at March 31, 2015 from \$405.0 million at December 31, 2014. The majority of the decrease was concentrated in commercial real estate loans, as several larger commercial real estate loans paid off during the quarter. Real estate secured loans as a percentage of total gross loans declined to 60.0% at March 31, 2015 from 60.5% as of December 31, 2014.

Commercial and industrial loans were relatively stable, decreasing only \$0.2 million during the first quarter to \$131.9 million at March 31, 2015 from \$132.1 million at December 31, 2014. Commercial and industrial loans consist primarily of equipment loans, working capital financing, automobile floor plans, revolving lines of credit and loans secured by cash and marketable securities. Commercial real estate loans, which include long-term commercial mortgage financing primarily secured by first or second lien mortgages, decreased \$6.7 million, or 2.9%, to \$226.8 million at March 31, 2015 from \$233.5 million at December 31, 2014. The decrease reflected the payoff of several larger commercial mortgages during the first quarter of 2015. Construction, land acquisition and development loans increased \$3.0 million, or 15.7%, during the quarter to \$21.8 million at March 31, 2015 from \$18.8 million at December 31, 2014. The Company continually monitors its exposure to this higher-risk portfolio segment.

Residential real estate loans totaled \$125.5 million at March 31, 2015, an increase of \$2.7 million, or 2.2%, from \$122.8 million at December 31, 2014. The components of residential real estate loans include fixed-rate and variable-rate mortgage loans. HELOCs are not included in this category but are included in consumer loans. The Company primarily underwrites fixed-rate purchase and refinance of residential mortgage loans for sale in the secondary market to reduce interest rate risk and provide funding for additional loans. However, as part of the Company's current asset/liability management strategy, up to \$10.0 million of fixed-rate residential mortgage loans that are eligible for sale on the secondary market are being retained in the portfolio. In addition, in January 2015, management began a campaign to promote the Company's "WOW" residential mortgage product. This product is a non-saleable mortgage with maturity terms of 7.5, 10 and 14.5 years that offers customers an attractive fixed interest rate, low closing cost and quicker close.

Consumer loans increased \$0.9 million, or 0.7%, during the first three months of 2015 to \$123.0 million at March 31, 2015 from \$122.1 million at December 31, 2014. The increase was concentrated in the Company's portfolio of indirect automobile loans. Loans to state and municipal governments increased \$2.0 million, or 5.0%, to \$42.2 million at March 31, 2015 from \$40.2 million at December 31, 2014. The increase was attributable to new originations.

The following table summarizes loans receivable, net by category at March 31, 2015 and December 31, 2014:

| (in thousands)                                 | March 31,<br>2015 | December 31,<br>2014 |
|--|-------------------|----------------------|
| Residential real estate                        | \$ 125,488        | \$ 122,832           |
| Commercial real estate                         | 226,800           | 233,473              |
| Construction, land acquisition and development | 21,790            | 18,835               |
| Commercial and industrial                      | 131,895           | 132,057              |
| Consumer                                       | 122,967           | 122,092              |
| State and political subdivisions               | 42,206            | 40,205               |
| Total loans, gross                             | 671,146           | 669,494              |
| Unearned income                                | (87 )             | (98 )                |
| Net deferred loan costs                        | 1,106             | 871                  |
| Allowance for loan and lease losses            | (10,944 )         | (11,520 )            |
| Loans, net                                     | \$ 661,221        | \$ 658,747           |

The following table presents industry concentrations within the Company's loan portfolio at March 31, 2015 and December 31, 2014:

| (in thousands)                               | March 31, 2015 |                     | December 31, 2014 |                     |   |
|--|----------------|---------------------|-------------------|---------------------|---|
|  | Amount         | % of Gross<br>Loans | Amount            | % of Gross<br>Loans |   |
| Retail space/ shopping centers               | \$ 32,680      | 4.87                | % \$ 33,140       | 4.95                | % |
| Automobile dealers                           | 24,501         | 3.65                | % 24,194          | 3.61                | % |
| Colleges and Universities                    | 17,166         | 2.56                | % 16,680          | 2.49                | % |
| Land subdivision                             | 15,252         | 2.27                | % 15,220          | 2.27                | % |
| 1-4 family residential investment properties | 14,184         | 2.11                | % 12,764          | 1.91                | % |
| Office complexes/units                       | 12,673         | 1.89                | % 17,249          | 2.58                | % |
| Physicians                                   | 6,709          | 1.00                | % 13,636          | 2.04                | % |

### Asset Quality

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at the amount of unpaid principal, net of unearned interest, deferred loan fees and costs, and reduced by the ALLL. The ALLL is established through a provision for loan and lease losses charged to earnings.

The Company has established and consistently applies loan policies and procedures designed to foster sound underwriting and credit monitoring practices. The Company manages credit risk through the efforts of loan officers,

the loan review function, and the Loan Quality and the ALLL management committees, as well as oversight from the Board of Directors. The Company continually evaluates its credit risk management practices to ensure it is reacting to problems in the loan portfolio in a timely manner, although, as is the case with any financial institution, a certain degree of credit risk is dependent in part on local and general economic conditions that are beyond the Company's control.

Under the Company's risk rating system, loans that are rated pass/watch, special mention, substandard, doubtful, or loss are reviewed regularly as part of the Company's risk management practices. The Company's Loan Quality Committee, which consists of key members of senior management, finance and credit administration, meets monthly or more often as necessary to review individual problem credits and workout strategies and provides monthly reports to the Board of Directors.

A loan is considered impaired when it is probable that the Company will be unable to collect all amounts due (including principal and interest) according to the contractual terms of the note and loan agreement. For purposes of the Company's analysis, loans that are modified under a troubled debt restructuring ("TDRs"), loan relationships with an aggregate outstanding balance greater than \$100 thousand rated substandard and non-accrual, and loans that are identified as doubtful or loss are considered impaired. Impaired loans are analyzed individually to determine the amount of impairment. The Company utilizes the fair value of collateral method for collateral-dependent loans. A loan is considered to be collateral dependent when repayment of the loan is expected to be provided through the liquidation of the collateral held. For impaired loans that are secured by real estate, external appraisals are obtained annually, or more frequently as warranted, to ascertain a fair value so that the impairment analysis can be updated. Should a current appraisal not be available at the time of impairment analysis, other sources of valuation may be used including, current letters of intent, broker price opinions or executed agreements of sale. For non-collateral-dependent loans, the Company measures impairment based on the present value of expected future cash flows, net of any deferred fees and costs, discounted at the loan's original effective interest rate.

Loans to borrowers that are experiencing financial difficulty that are modified and result in the Company granting concessions to the borrower are classified as TDRs and are considered to be impaired. Such concessions generally involve an extension of a loan's stated maturity date, a reduction of the stated interest rate, payment modifications, capitalization of property taxes with respect to residential mortgage loans or a combination of these modifications. Non-accrual TDRs are returned to accrual status if principal and interest payments, under the modified terms, are brought current, are performing under the modified terms for six consecutive months, and management believes that collection of the remaining interest and principal is probable.

Non-performing loans are monitored on an ongoing basis as part of the Company's loan review process. Additionally, work-out efforts continue and are actively monitored for non-performing loans and OREO through the Loan Quality Committee. A potential loss on a non-performing asset is generally determined by comparing the outstanding loan balance to the fair market value of the pledged collateral, less cost to sell.

Loans are placed on non-accrual when a loan is specifically determined to be impaired or when management believes that the collection of interest or principal is doubtful. This generally occurs when a default of interest or principal has existed for 90 days or more, unless such loan is well secured and in the process of collection, or when management becomes aware of facts or circumstances that the loan would default before 90 days. The Company determines delinquency status based on the number of days since the date of the borrower's last required contractual loan payment. When the interest accrual is discontinued, all unpaid interest income is reversed and charged back against current earnings. Any subsequent cash payments received are applied, first to the outstanding loan amounts, then to the recovery of any charged-off loan amounts, with any excess treated as a recovery of lost interest. A non-accrual loan is returned to accrual status when the loan is current as to principal and interest payments, is performing according to contractual terms for six consecutive months and future payments are reasonably assured.

Management actively manages impaired loans in an effort to reduce loan balances by working with customers to develop strategies to resolve borrower difficulties, through sale or liquidation of collateral, foreclosure, and other

appropriate means. Real estate values in the Company's market area have appeared to stabilize. In addition, employment conditions within the Company's market area have shown substantial improvement. However, continued improvement of these metrics cannot be assured. Any weakening of economic and employment conditions could result in real estate devaluations which could negatively impact asset quality and, accordingly, cause an increase in the provision for loan and lease losses.

Under the fair value of collateral method, the impaired amount of the loan is deemed to be the difference between the loan amount and the fair value of the collateral, less the estimated costs to sell. For the Company's calculations for real estate secured loans, a factor of 10% is generally utilized to estimate costs to sell, which is based on typical cost factors, such as a 6% broker commission, 1% transfer taxes, and 3% various other miscellaneous costs associated with the sales process. If the valuation indicates that the fair value has deteriorated below the carrying value of the loan, the difference between the fair values and the principal balance is charged off. For impaired loans for which the value of the collateral less costs to sell exceeds the loan value, the impairment is considered to be zero.

The following table presents non-performing loans, including non-performing TDRs, OREO and accruing TDRs at March 31, 2015 and December 31, 2014:

| (in thousands)                                      | March 31,<br>2015 | December 31,<br>2014 |      |   |
|---|-------------------|----------------------|------|---|
| Non-accrual loans                                   | \$ 5,184          | \$ 5,522             |      |   |
| Loans past due 90 days or more and still accruing   | -                 | -                    |      |   |
| Total non-performing loans                          | 5,184             | 5,522                |      |   |
| Other real estate owned                             | 2,369             | 2,255                |      |   |
| Total non-performing loans and OREO                 | \$ 7,553          | \$ 7,777             |      |   |
| Accruing TDRs                                       | \$ 5,807          | \$ 5,282             |      |   |
| Non-performing loans as a percentage of gross loans | 0.77              | %                    | 0.82 | % |



Management continued to manage problem credits through heightened work-out efforts on non-performing loans and aggressively disposing of its holdings of foreclosed properties. The Company's asset quality continued to improve during the first quarter of 2015. Total non-performing loans and OREO decreased \$0.2 million to \$7.6 million at March 31, 2015 from \$7.8 million at December 31, 2014. The Company's ratio of non-performing loans to total gross loans improved to 0.77% at March 31, 2015 from 0.82% at December 31, 2014, as management continued to reduce the balance of non-accrual loans. The Company's ratio of non-performing loans and OREO as a percentage of shareholders' equity decreased to 13.5% at March 31, 2015 from 15.1% at December 31, 2014.

The average balance of impaired loans was \$10.2 million and \$9.3 million for the three months ended March 31, 2015 and 2014, respectively. The Company recorded \$70 thousand and \$53 thousand of interest income on impaired loans for the three months ended March 31, 2015 and 2014, respectively.

The following table presents the changes in non-performing loans for the three months ended March 31, 2015 and 2014:

| (in thousands)   | March 31, |         |
|--|-----------|---------|
|  | 2015      | 2014    |
| Balance at January 1,  | \$5,522   | \$6,375 |
| Loans newly placed on non-accrual                            | 332       | 497     |
| Changes in loans past due 90 days or more and still accruing | -         | 13      |
| Loans transferred to OREO                                    | (149 )    | -       |
| Loans returned to performing status                          | -         | (213 )  |
| Loans charged-off  | (270 )    | (246 )  |
| Loan payments received                                       | (251 )    | (638 )  |
| Balance at March 31,   | \$5,184   | \$5,788 |

The additional interest income that would have been earned on non-accrual and restructured loans for the quarter ended on March 31, 2015 and 2014 in accordance with their original terms approximated \$91 thousand and \$103 thousand, respectively.

The following table presents accruing loan delinquencies and non-accrual loans as a percentage of gross loans at March 31, 2015 and December 31, 2014:

#### Accruing Loan Delinquencies and Non-accrual Loans

|                     | March 31,<br>2015 |   | December 31,<br>2014 |   |
|---------------------|-------------------|---|----------------------|---|
| Accruing:           |                   |   |                      |   |
| 30-59 days          | 0.30              | % | 0.30                 | % |
| 60-89 days          | 0.03              | % | 0.09                 | % |
| 90+ days            | 0.00              | % | 0.00                 | % |
| Non-accrual         | 0.77              | % | 0.82                 | % |
| Total delinquencies | 1.10              | % | 1.21                 | % |

The decrease in total delinquencies as a percentage of gross loans at March 31, 2015 was primarily due to a decrease in non-performing loans. In its evaluation for the ALLL, management considers a variety of qualitative factors including changes in the volume and severity of delinquencies.

### **Allowance for Loan and Lease Losses**

The ALLL represents management's estimate of probable loan losses inherent in the loan portfolio. The ALLL is analyzed in accordance with GAAP and is maintained at a level that is based on management's evaluation of the adequacy of the ALLL in relation to the risks inherent in the loan portfolio.

As part of its evaluation, management considers qualitative and environmental factors, including, but not limited to:

- changes in national, local, and business economic conditions and developments, including the condition of various market segments;

- changes in the nature and volume of the Company's loan portfolio;
- changes in the Company's lending policies and procedures, including underwriting standards, collection, charge-off and recovery practices and results;
- changes in the experience, ability and depth of the Company's management and staff;
- changes in the quality of the Company's loan review system and the degree of oversight by the Company's Board of Directors;
- changes in the trend of the volume and severity of past due and classified loans, including trends in the volume of non-accrual loans, TDRs and other loan modifications;
- the existence and effect of any concentrations of credit and changes in the level of such concentrations;
- the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Company's current loan portfolio; and
- analysis of customers' credit quality, including knowledge of their operating environment and financial condition.

Evaluations are intrinsically subjective, as the results are estimated based on management knowledge and experience and are subject to interpretation and modification as information becomes available or as future events occur. Management monitors the loan portfolio on an ongoing basis with emphasis on weakness in both the real estate market and the economy in general and its effect on repayment. Adjustments to the ALLL are made based on management's assessment of the factors noted above.

For purposes of its analysis, all loan relationships with an aggregate balance greater than \$100 thousand that are rated substandard and non-accrual, identified as doubtful or loss, and all TDRs are considered impaired and are analyzed individually to determine the amount of impairment. Circumstances such as construction delays, declining real estate values, and the inability of the borrowers to make scheduled payments have resulted in these loan relationships being classified as impaired. The Company utilizes the fair value of collateral method for collateral-dependent loans and TDRs for which repayment depends on the sale of collateral. For non-collateral-dependent loans and TDRs, the Company measures impairment based on the present value of expected future cash flows discounted at the loan's original effective interest rate. With regard to collateral-dependent loans, appraisals are received at least annually to ensure that impairment measurements reflect current market conditions. Should a current appraisal not be available at the time of impairment analysis, other valuation sources including current letters of intent, broker price opinions or executed agreements of sale may be used. Only downward adjustments are made based on these supporting values. Included in all impairment calculations is a cost to sell adjustment of approximately 10%, which is based on typical cost factors, including a 6% broker commission, 1% transfer taxes and 3% various other miscellaneous costs associated with the sales process. Sales costs are periodically reviewed and revised based on actual experience. The ALLL analysis is adjusted for subsequent events that may arise after the end of the reporting period but before the financial reports are filed.

The Company's ALLL consists of both specific and general components. At March 31, 2015, the ALLL that related to impaired loans that are individually evaluated for impairment, the guidance for which is provided by ASC 310 "Impairment of a Loan" ("ASC 310"), was \$417 thousand, or 3.8%, of the total ALLL. A general allocation of \$10.5 million was calculated for loans analyzed collectively under ASC 450 "Contingencies" ("ASC 450"), which represented 96.2% of the total ALLL of \$10.9 million. The ratio of the ALLL to total loans at March 31, 2015 and December 31, 2014 was 1.63% and 1.72%, respectively, based on total loans of \$671.1 million and \$669.5 million, respectively. The decrease in the ALLL as a percentage of total loans reflects asset quality improvements and lower levels of net

charge-offs than in the past, coupled with increased loan demand.

Based on its evaluation of the ALLL, management established an unallocated reserve of \$39 thousand and \$45 thousand at March 31, 2015 and December 31, 2014, respectively. As previously mentioned, as part of its evaluation, management applies loss rates to each loan segment which are based on historical loss experience for that segment. The Company has experienced net recoveries related to its construction, land acquisition and development segment of the loan portfolio for the majority of the quarters over the previous three years, which have resulted in an overall negative historical loss factors and consequently related negative provisions for this particular loan segment at March 31, 2015 and December 31, 2014. Based on the higher risk characteristics inherent in this segment of the portfolio, management reversed the negative provisions related to the negative historical loss factors and established the unallocated reserves.

The following table presents an allocation of the ALLL and percent of loans in each category at March 31, 2015 and December 31, 2014:

| (in thousands)                                 | March 31, 2015                       |        |   | December 31, 2014                    |        |   |
|--|--------------------------------------|--------|---|--------------------------------------|--------|---|
|  | Percentage of Loans in Each Category |        |   | Percentage of Loans in Each Category |        |   |
|  | Allowance to Total                   |        | % | Allowance to Total                   |        | % |
|  | Amount                               | Loans  |   | Amount                               | Loans  |   |
| Residential real estate                        | \$1,531                              | 18.70  | % | \$1,772                              | 18.35  | % |
| Commercial real estate                         | 4,331                                | 33.79  | % | 4,663                                | 34.87  | % |
| Construction, land acquisition and development | 764                                  | 3.25   | % | 665                                  | 2.81   | % |
| Commercial and industrial                      | 1,998                                | 19.65  | % | 2,104                                | 19.72  | % |
| Consumer                                       | 1,698                                | 18.32  | % | 1,673                                | 18.24  | % |
| State and political subdivision                | 583                                  | 6.29   | % | 598                                  | 6.01   | % |
| Unallocated                                    | 39                                   | 0.00   | % | 45                                   | 0.00   | % |
| Total  | \$10,944                             | 100.00 | % | \$11,520                             | 100.00 | % |

The following table presents an analysis of ALLL for the three months ended March 31, 2015 and 2014.

| (in thousands)                                 | For the three months ended March 31, |           |
|--|--------------------------------------|-----------|
|  | 2015                                 | 2014      |
| Balance at beginning of period                 | \$ 11,520                            | \$ 14,017 |
| Charge-offs:                                   |                                      |           |
| Residential real estate                        | 68                                   | 9         |
| Commercial real estate                         | -                                    | -         |
| Construction, land acquisition and development | -                                    | -         |
| Commercial and industrial                      | 70                                   | 23        |
| Consumer                                       | 139                                  | 237       |
| State and political subdivisions               | -                                    | -         |
| Total charge-offs                              | 277                                  | 269       |
| Recoveries of charged-off loans:               |                                      |           |
| Residential real estate                        | 6                                    | 8         |
| Commercial real estate                         | 2                                    | 6         |
| Construction, land acquisition and development | -                                    | 240       |
| Commercial and industrial                      | 65                                   | 63        |
| Consumer                                       | 122                                  | 94        |
| State and political subdivisions               | -                                    | -         |
| Total recoveries                               | 195                                  | 411       |
| Net charge-offs (recoveries)                   | 82                                   | (142)     |
| Credit for loan and lease losses               | (494)                                | (1,570)   |

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|   |           |   |           |    |
|---|-----------|---|-----------|----|
| Balance at end of period  | \$ 10,944 |   | \$ 12,589 |    |
| Net charge-offs (recoveries) during the period as a percentage of average loans outstanding during the period | 0.01      | % | (0.02     | )% |
| Allowance for loan and lease losses as a percentage of gross loans at end of period                           | 1.63      | % | 1.93      | %  |

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**Other Real Estate Owned**

At March 31, 2015, OREO consisted of 15 properties with an aggregate carrying value of \$2.4 million, an increase of \$0.1 million from \$2.3 million at December 31, 2014. The Company foreclosed on one property with a carrying value of \$149 thousand during the three months ended March 31, 2015. There were no properties foreclosed upon during the three months ended March 31, 2014. There was one sale and one partial sale of one property with a carrying value of \$23 thousand during the three months ended March 31, 2015. During the three months ended March 31, 2014, three properties with an aggregate carrying value of \$771 thousand were sold. Net gains on the sale of other real estate owned were \$5 thousand and \$29 thousand, respectively for the three months ended March 31, 2015 and 2014. The expenses related to maintaining OREO, net of any income from operation of the properties, as well as the subsequent write-down of property values related to declines in value subsequent to foreclosure amounted to \$100 thousand for the three months ended March 31, 2015, compared to \$163 thousand for the same period in 2014.

The Company actively markets OREO properties for sale through a variety of channels including internal marketing and the use of outside brokers/realtors. The carrying value of OREO is generally calculated at an amount not greater than 90% of the most recent fair market appraised value. A 10% factor is generally used to estimate costs to sell, which is based on typical cost factors, such as 6% broker commission, 1% transfer taxes, and 3% various other miscellaneous costs associated with the sales process. This market value is updated on an annual basis or more frequently if new valuation information is available. Further deterioration in the real estate market could result in additional losses on these properties.

The following table presents the activity in OREO:

| (in thousands)               | March 31, |         |
|------------------------------|-----------|---------|
|                              | 2015      | 2014    |
| Balance, beginning of period | \$2,255   | \$4,246 |
| Property foreclosures        | 149       | -       |
| Valuation adjustments        | (12 )     | (53 )   |
| Carrying value of OREO sold  | (23 )     | (771 )  |
| Balance, end of period       | \$2,369   | \$3,422 |

The following schedule reflects a breakdown of OREO for the periods reviewed:

| (in thousands) | For the Three Months Ended |              |
|----------------|----------------------------|--------------|
|                | March 31,                  | December 31, |
|                | 2015                       | 2014         |
| Land / lots    | \$ 1,252                   | \$ 1,287     |

|                               |          |          |
|-------------------------------|----------|----------|
| Commercial real estate        | 941      | 941      |
| Residential real estate       | 176      | 27       |
| Total other real estate owned | \$ 2,369 | \$ 2,255 |

## Liabilities

Total liabilities were \$904.5 million at March 31, 2015, a decrease of \$14.1 million, or 1.5%, from \$918.6 million at December 31, 2014. Deposit liabilities decreased \$20.2 million, or 2.5%, to \$775.1 million at March 31, 2015 compared to \$795.3 million at December 31, 2014. The decrease in total deposits was due to a \$31.1 million, or 4.6%, decline in interest-bearing deposits, which resulted primarily from the deposit outflows from several large commercial and school district accounts and the expected maturities of \$11.8 million in certificates of deposit obtained through QwickRate®, a national listing service and \$4.5 million in brokered certificates of deposit. Partially offsetting these outflows was an increase in non-interest-bearing demand deposits of \$10.9 million, or 8.8%, which reflected the Company's continued focus on core deposit growth. Partially offsetting the decrease in total deposits was an increase in FHLB advances of \$6.4 million, or 10.5%, to \$67.6 million at March 31, 2015 from \$61.2 million at December 31, 2014.

## Equity

Total shareholders' equity increased \$4.3 million, or 8.4%, to \$55.7 million at March 31, 2015 from \$51.4 million at December 31, 2014. Net income of \$3.5 million, coupled with a \$0.8 million increase in accumulated other comprehensive income were the primary factors leading to the capital improvement. The increase in accumulated other comprehensive income was attributed to appreciation in the fair value of securities held in the available-for-sale portfolio. Book value per common share was \$3.38 at March 31, 2015 compared to \$3.12 at December 31, 2014.



## **Liquidity**

The term liquidity refers to the ability of the Company to generate sufficient amounts of cash to meet its cash flow needs. Liquidity is required to fulfill the borrowing needs of the Company's credit customers and the withdrawal and maturity requirements of its deposit customers, as well as to meet other financial commitments. The Company's liquidity position is impacted by several factors, which include, among others, loan origination volumes, loan and investment maturity structure and cash flows, deposit demand and certificate of deposit maturity structure and retention. The Company has liquidity and contingent funding policies in place that are designed with controls in place to provide advanced detection of potentially significant funding shortfalls, establish methods for assessing and monitoring risk levels, and institute prompt responses that may alleviate a potential liquidity crisis. Management monitors the Company's liquidity position and fluctuations daily, so that the Company can adapt accordingly to market influences and balance sheet trends. Management also forecasts liquidity needs, performs stress tests on its liquidity levels and develops strategies to ensure adequate liquidity at all times.

The Company's statements of cash flows present the change in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents, cash and due from banks and interest-bearing deposits in other banks, are the Company's most liquid assets. At March 31, 2015, cash and cash equivalents totaled \$37.4 million, a slight increase of \$1.7 million compared to \$35.7 million at December 31, 2014. Cash outlays for financing activities used \$13.8 million, which were more than entirely mitigated by a net cash inflow from investment activities of \$15.6 million during the three months ended March 31, 2015. The \$13.8 million in cash used in financing activities resulted primarily from the \$20.2 million decrease in total deposits, partially offset by a net increase of \$6.4 million in advances through the FHLB of Pittsburgh. The \$15.6 million in cash provided by investing activities, resulted primarily from \$38.2 million in proceeds from sales, maturities, calls and principal reductions from securities, partially offset by \$19.8 million in securities purchased and a \$2.1 million net increase in loans to customers.

## **Interest Rate Sensitivity**

Market risk is the risk to earnings and/or financial position resulting from adverse changes in market rates or prices, such as interest rates, foreign exchange rates or equity prices. The Company's exposure to market risk is primarily interest rate risk associated with our lending, investing and deposit gathering activities, all of which are other than trading. Changes in interest rates affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. In addition, variations in interest rates affect the underlying economic value of our assets, liabilities and off-balance sheet items.

### *Asset and Liability Management*

The Company manages these objectives through its Asset and Liability Management Committee (“ALCO”) and its Rate and Liquidity and Investment Committees, which consist of the members of senior management and certain members of the finance department. Members of the committees meet regularly to develop balance sheet strategies affecting the future level of net interest income, liquidity and capital. The major objectives of ALCO are to:

- manage exposure to changes in the interest rate environment by limiting the changes in net interest margin to an acceptable level within a reasonable range of interest rates;
- ensure adequate liquidity and funding;
- maintain a strong capital base; and
- maximize net interest income opportunities.

ALCO monitors the Company’s exposure to changes in net interest income over both a one-year planning horizon and a longer-term strategic horizon. ALCO uses net interest income simulations and economic value of equity (“EVE”) simulations as the primary tools in measuring and managing the Company’s position and considers balance sheet forecasts, the Company’s liquidity position, the economic environment, anticipated direction of interest rates and the Company’s earnings sensitivity to changes in these rates in its modeling. In addition, ALCO has established policy tolerance limits for acceptable negative changes in net interest income. Furthermore, as part of its ongoing monitoring, ALCO has been enhanced to require periodic back testing of modeling results, which involves after-the-fact comparisons of projections with the Company’s actual performance to measure the validity of assumptions used in the modeling techniques.

*Earnings at Risk and Economic Value at Risk Simulations*

*Earnings at Risk*

Earnings-at-risk simulation measures the change in net interest income and net income under various interest rate scenarios. Specifically, given the current market rates, ALCO looks at “earnings at risk” to determine anticipated changes in net interest income from a base case scenario with scenarios of + 200/-100 basis points changes to interest rates. The simulation takes into consideration that not all assets and liabilities re-price equally and simultaneously with market rates (i.e., savings rate).

*Economic Value at Risk*

While earnings-at-risk simulation measures the short-term risk in the balance sheet, economic value (or portfolio equity) at risk measures the long-term risk by finding the net present value of the future cash flows from the Company’s existing assets and liabilities. ALCO examines this ratio regularly, and given the current rate environment, has utilized rate shocks of +200/- 100 basis points for simulation purposes. Management recognizes that, in some instances, this ratio may contradict the “earnings at risk” ratio.

While ALCO regularly performs a wide variety of simulations under various strategic balance sheet and treasury yield curve scenarios, the following results reflect the Company’s sensitivity over the subsequent twelve months based on the following assumptions:

- Asset and liability levels using March 31, 2015 as a starting point;
- Cash flows are based on contractual maturity and amortization schedules with applicable prepayments derived from internal historical data and external sources; and
- Cash flows are reinvested into similar instruments so as to keep interest-earning asset and interest-bearing liability levels constant.

The following table illustrates the simulated impact of a 200 basis point upward and a 100 basis point downward movement in interest rates on net interest income and the change in economic value. The impact of the rate movements were developed by simulating the effect of rates changing over a twelve-month period from the March 31, 2015 levels.

|  | RATES + 200 |    | RATES – 100 |    | POLICY LIMITS |
|--|-------------|----|-------------|----|---------------|
| Earnings at risk:                          |             |    |             |    |               |
| Percent change in net interest income      | 1.0         | %  | (0.6        | )% | -10.0%/-5.0%  |
| Economic value at risk:                    |             |    |             |    |               |
| Percent change in economic value of equity | (1.2        | )% | (10.3       | )% | -20.0%/-10.0% |

Under the model, the Company's net interest income is expected to increase 1.0%, while the Company's economic value of equity is expected to decrease 1.2%, under a 200 basis point upward movement in interest rates. The anticipated increase in net interest income reflects the composition of the Company's loan portfolio, which is comprised of a significant balance of variable-rate loans, which will reprice immediately or in the near term. In comparison, results for a similar model at December 31, 2014 simulated a 0.9% increase in net interest income under a 200 basis point upward movement in interest rates.

This analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These simulations are based on numerous assumptions: the nature and timing of interest rate levels, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, reinvestment/replacements of asset and liability cash flows, and other factors. While assumptions reflect current economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions, including changes in interest rates, customer preferences, competition and liquidity needs, or what actions ALCO might take in responding to these changes.

### Off-Balance Sheet Arrangements

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with U.S. GAAP, are not recorded in our consolidated financial statements or are recorded in amounts that differ from the notional amounts. These transactions involve, to varying degrees, elements of credit, interest rate, and liquidity risk. Such transactions are used for general corporate purposes and for customer needs. Corporate purpose transactions are used to help manage credit, interest rate, and liquidity risk or to optimize capital. Customer transactions are used to manage customers' requests for funding.

For the three months ended March 31, 2015, the Company did not engage in any off-balance sheet transactions that would have or would be reasonably likely to have a material effect on its consolidated financial condition.

### Item 3 — Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in the Company's exposure to market risk during the first three months of 2015. For discussion of the Company's exposure to market risk, refer to Item 7A, Quantitative and Qualitative Disclosures about Market Risk, contained in the Company's Form 10-K for the year ended December 31, 2014.

### Item 4 — Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls and procedures were effective as of March 31, 2015.

There were no changes made to the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II Other Information

### Item 1 — Legal Proceedings.

On August 8, 2011, the Company announced that it had received document subpoenas from the SEC. The information requested generally related to disclosure and financial reporting by the Company and the restatement of the Company's financial statements for the year ended December 31, 2009, and the quarters ended March 31, 2010 and June 30, 2010. On January 28, 2015, the Company and the SEC entered into a settlement agreement resolving these issues related to disclosure and financial reporting and the restatements of the Company's financial statements for the year ended December 31, 2009 and the quarters ended March 31, 2010 and June 30, 2010. As part of this settlement agreement, on January 30, 2015, the Company paid a civil money penalty of \$175 thousand to the SEC. The Company

accrued for the \$175 thousand civil money penalty in its 2014 results of operations, which was included in non-interest expense.

On May 24, 2012, a putative shareholder filed a complaint in the Court of Common Pleas for Lackawanna County (“Shareholder Derivative Suit”) against certain present and former directors and officers of the Company (the “Individual Defendants”) alleging, inter alia, breach of fiduciary duty, abuse of control, corporate waste, and unjust enrichment. The Company was named as a nominal defendant. The parties to the Shareholder Derivative Suit commenced settlement discussions and on December 18, 2013, the Court entered an Order Granting Preliminary Approval of Proposed Settlement subject to notice to shareholders. On February 4, 2014, the Court issued a Final Order and Judgment for the matter granting approval of a Stipulation of Settlement (the “Settlement”) and dismissing all claims against the Company and the Individual Defendants. As part of the Settlement, there was no admission of liability by the Individual Defendants. Pursuant to the Settlement, the Individual Defendants, without admitting any fault, wrongdoing or liability, agreed to settle the derivative litigation for \$5.0 million. The \$5.0 million Settlement payment was made to the Company on March 28, 2014. The Individual Defendants reserved their rights to indemnification under the Company’s Articles of Incorporation and Bylaws, resolutions adopted by the Board, the Pennsylvania Business Corporation Law and any and all rights they have against the Company’s and the Bank’s insurance carriers. The Company has recorded a liability for this indemnification in other liabilities. In addition, in conjunction with the Settlement, the Company accrued \$2.5 million related to fees and costs of the plaintiff’s attorneys, which was included in non-interest expense in the Consolidated Statements of Income for the year ended December 31, 2013. On April 1, 2014, the Company paid the \$2.5 million related to fees and costs of the plaintiff’s attorneys and partial indemnification of the Individual Defendants in the amount of \$2.5 million, and as such, as of March 31, 2015, \$2.5 million remains accrued in other liabilities related to the potential indemnification of the Individual Defendants. The Company settled any and all claims it had or may have had against Demetrius & Company, LLC, John Demetrius and Robert L. Rossi & Company in connection with the Shareholder Derivative Suit during 2014.

On September 5, 2012, Fidelity and Deposit Company of Maryland (“F&D”) filed an action against the Company and its subsidiary, First National Community Bank, as well as several current and former officers and directors of the Company, in the United States District Court for the Middle District of Pennsylvania. F&D has asserted a claim for the rescission of a directors’ and officers’ insurance policy and a bond that it had issued to the Company. On November 9, 2012, the Company and the Bank answered the claim and asserted counterclaims for the losses and expenses already incurred by the Company and the Bank. The Company and the other defendants are defending the claims and have opposed F&D’s requested relief by way of counterclaims, breaches of contract and bad faith claims against F&D for its failure to fulfill its obligations to the Company and the Bank under the insurance policy. At this time, the matter is in the discovery stage and the Company cannot reasonably determine the outcome or potential range of loss in connection with this matter.

On August 13, 2013, Steven Antonik, individually, as Administrator of the Estate of Linda Kluska, William R. Howells, and Louise A. Howells, on behalf of themselves and others similarly situated, filed a consumer protection class action against the Company and Bank in the Lackawanna County Court of Common Pleas, seeking equitable, injunction and monetary relief to address an alleged pattern and practice of wrong doing by the Bank relating to the repossession and sale of the Plaintiffs’ and class members’ financed motor vehicles. This matter is in the discovery stage. At this time the Company cannot reasonably determine the outcome or potential range of loss.

On September 17, 2013, Charles Saxe, III individually and on behalf of all others similarly situated filed a consumer class action against the Bank in the Lackawanna County Court of Common Pleas alleging violations of the Pennsylvania Uniform Commercial Code in connection with the repossession and resale of financed vehicles. This matter is in the discovery stage. At this time the Company cannot reasonably determine the outcome or potential range of loss.

On January 22, 2014, the Bank was advised by the Department of Treasury’s Financial Crimes Enforcement Network (“FinCEN”) that FinCEN was investigating the Bank for alleged violations of the Bank Secrecy Act (“BSA”). On May 28, 2014 the Bank was advised by the Office of the Comptroller of the Currency (“OCC”) that the OCC was investigating allegations that the Bank failed to file timely SARS. On November 18, 2014, both FinCEN and OCC advised the Bank that they intended on assessing civil money penalties against the Bank. Subsequent to November 18, 2014, the Bank had been in discussions with both regulatory agencies about the alleged BSA violations. On February 27, 2015, the Bank reached a comprehensive settlement with FinCEN and OCC to resolve the BSA allegations. In order to settle the matter, the Bank consented to an aggregate civil money penalty assessment of \$1.5 million which was accrued for at December 31, 2014 and included in non-interest expense in the Consolidated Statements of Income for the year ended December 31, 2014. The Company paid the \$1.5 million civil money penalty on February 27, 2015.

The Company has been subject to tax audits and is also a party to routine litigation involving various aspects of its business, such as claims to enforce liens, condemnation proceedings on properties in which the Company holds security interests, claims involving the making and servicing of real property loans and other issues incident to its business, none of which is expected to have a material adverse impact on the consolidated financial condition, results

of operations or liquidity of the Company.

Item 1A — Risk Factors.

Management of the Company does not believe there have been any material changes in the risk factors that were previously disclosed in the Company's Form 10-K for the year ending December 31, 2014.

Item 2 — Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3 - Defaults upon Senior Securities.

None.

Item 4 — Mine Safety Disclosures.

Not applicable.

Item 5 - Other Information.

None.



Item 6 — Exhibits.

The following exhibits are filed herewith or incorporated by reference.

|                  |  |
|------------------|--|
| EXHIBIT 3.1      | Amended and Restated Articles of Incorporation dated May 19, 2010 — filed as Exhibit 3.1 to the Company's Current Report on Form 8-K on May 19, 2010, is hereby incorporated by reference.       |
| EXHIBIT 3.2      | Amended and Restated Bylaws — filed as Exhibit 3.2 to the Company's Form 10-Q for the quarter ended September 30, 2013, as filed on November 12, 2013, is hereby incorporated by reference.      |
| EXHIBIT 4.1      | Form of Common Stock Certificate — filed as Exhibit 4.1 to the Company's Form 10-Q for the quarter ended September 30, 2014, as filed on November 10, 2014, is hereby incorporated by reference. |
| EXHIBIT 4.2      | Form of Subordinated Note — filed as Exhibit 4.1 to the Company's Current Report on Form 8-K dated August 28, 2009, is hereby incorporated by reference.   |
| EXHIBIT 31.1*    | Certification of Chief Executive Officer   |
| EXHIBIT 31.2*    | Certification of Chief Financial Officer   |
| EXHIBIT 32.1**   | Section 1350 Certification —Chief Executive Officer and Chief Financial Officer  |
| EXHIBIT 101.INS* | XBRL INSTANCE DOCUMENT   |
| EXHIBIT 101.SCH* | XBRL TAXONOMY EXTENSION SCHEMA   |
| EXHIBIT 101.CAL* | XBRL TAXONOMY EXTENSION CALCULATION LINKBASE   |
| EXHIBIT 101.DEF* | XBRL TAXONOMY EXTENSION DEFINITION LINKBASE  |
| EXHIBIT 101.LAB* | XBRL TAXONOMY EXTENSION LABEL LINKBASE   |
| EXHIBIT 101.PRE* | XBRL TAXONOMY EXTENSION PRESENTATION LINKBASE  |

\* Filed herewith

\*\* Furnished herewith

+ Management contract, compensatory plan or arrangement

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## SIGNATURES

Pursuant to the requirements 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.

Registrant: FIRST NATIONAL COMMUNITY BANCORP, INC.

Date: May 8, 2015      By:    /s/ Steven R.  
  Tokach  
  Steven R. Tokach  
  President and Chief  
  Executive Officer

Date: May 8, 2015      By:    /s/ James M. Bone,  
  Jr.  
  James M. Bone, Jr., CPA  
  Executive Vice President  
  and Chief Financial Officer  
  Principal Financial Officer

Date: May 8, 2015      By:    /s/ Stephanie A.  
  Westington  
  Stephanie A. Westington,  
  CPA  
  Senior Vice President and  
  Controller  
  Principal Accounting  
  Officer