

DNB FINANCIAL CORP /PA/  
Form 10-Q  
November 05, 2018  
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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FORM 10-Q

☒ Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended: September 30, 2018

or

☐ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-34242

DNB Financial Corporation

(Exact name of registrant as specified in its charter)

Pennsylvania

23-2222567

Pennsylvania

23-2222567

(State or other jurisdiction of (I.R.S. Employer Identification No.)

incorporation or organization)

4 Brandywine Avenue - Downingtown, PA 19335

(Address of principal executive offices and Zip Code)

(610) 269-1040

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
Emerging growth company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes    No

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

Common Stock (\$1.00 Par Value)

(Class)	4,315,518 (Shares Outstanding as of November 5, 2018)
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DNB FINANCIAL CORPORATION AND SUBSIDIARY

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## PART I – FINANCIAL INFORMATION

## ITEM 1 – FINANCIAL STATEMENTS

## DNB Financial Corporation and Subsidiary

## Consolidated Statements of Financial Condition (Unaudited)

	September 30, 2018	December 31, 2017
(Dollars in thousands, except share and per share data)		
Assets		
Cash and due from banks	\$ 10,702	\$ 10,917
Cash and cash equivalents	10,702	10,917
Available-for-sale investment securities at fair value (amortized cost of \$102,345 and \$113,555)	99,161	111,783
Held-to-maturity investment securities (fair value of \$60,303 and \$62,420)	62,069	62,390
Total investment securities	161,230	174,173
Loans held for sale	-	651
Loans	908,293	845,897
Allowance for credit losses	(6,559)	(5,843)
Net loans	901,734	840,054
Restricted stock	5,864	7,641
Office property and equipment, net	7,881	8,649
Accrued interest receivable	4,210	3,822
Other real estate owned & other repossessed property	5,077	5,012
Bank owned life insurance (BOLI)	9,472	9,314
Core deposit intangible	364	435
Goodwill	15,525	15,525
Net deferred taxes	3,084	2,980
Other assets	2,972	2,742
Total assets	\$ 1,128,115	\$ 1,081,915
Liabilities and Stockholders' Equity		
Liabilities		
Non-interest-bearing deposits	\$ 168,311	\$ 176,815
Interest-bearing deposits:		
NOW	213,707	199,310
Money market	227,797	221,726
Savings	78,996	81,050

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Time	154,021	140,490
Brokered deposits	97,049	41,812
Total deposits	939,881	861,203
Federal Home Loan Bank of Pittsburgh (FHLBP) advances	36,952	79,013
Repurchase agreements	4,089	12,023
Junior subordinated debentures	9,279	9,279
Subordinated debt	9,750	9,750
Other borrowings	13,554	2,738
Total borrowings	73,624	112,803
Accrued interest payable	557	554
Other liabilities	5,994	5,413
Total liabilities	1,020,056	979,973
Stockholders' Equity		
Common stock, \$1.00 par value; 20,000,000 shares authorized; 4,375,645 and 4,362,939 issued, respectively; 4,311,860 and 4,286,117 outstanding, respectively	4,393	4,379
Treasury stock, at cost; 63,785 and 76,822 shares, respectively	(1,196)	(1,429)
Surplus	69,316	69,110
Retained earnings	39,523	32,272
Accumulated other comprehensive loss	(3,977)	(2,390)
Total stockholders' equity	108,059	101,942
Total liabilities and stockholders' equity	\$ 1,128,115	\$ 1,081,915
See accompanying notes to unaudited consolidated financial statements.		

## DNB Financial Corporation and Subsidiary

## Consolidated Statements of Income (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands, except share and per share data)	2018	2017	2018	2017
Interest Income:				
Interest and fees on loans	\$ 10,588	\$ 9,994	\$ 30,634	\$ 29,089
Interest and dividends on investment securities:				
Taxable	754	721	2,409	2,175
Exempt from federal taxes	219	236	654	714
Interest on cash and cash equivalents	74	38	140	166
Total interest and dividend income	11,635	10,989	33,837	32,144
Interest Expense:				
Interest on NOW, money market and savings	998	606	2,822	1,678
Interest on time deposits	579	307	1,237	921
Interest on brokered deposits	457	160	1,070	346
Interest on FHLB advances	199	185	739	522
Interest on repurchase agreements	2	8	14	21
Interest on junior subordinated debentures	122	99	340	286
Interest on subordinated debt	104	104	311	311
Interest on other borrowings	23	14	58	42
Total interest expense	2,484	1,483	6,591	4,127
Net interest income	9,151	9,506	27,246	28,017
Provision for credit losses	100	375	850	1,285
Net interest income after provision for credit losses	9,051	9,131	26,396	26,732
Non-interest Income:				
Service charges	274	282	848	936
Wealth management	542	411	1,489	1,256
Mortgage banking	56	62	193	112
Increase in cash surrender value of BOLI	54	55	158	165
Gain on sale of investment securities, net	-	-	-	25
Gain on sale of loans	27	35	37	132
Gains from insurance proceeds	8	-	8	80
Other fees	410	426	1,243	1,293
Total non-interest income	1,371	1,271	3,976	3,999
Non-interest Expense:				
Salaries and employee benefits	3,709	3,926	11,742	11,291
Furniture and equipment	564	525	1,603	1,526
Occupancy	656	631	1,987	2,006
Professional and consulting	484	485	1,311	1,334
Advertising and marketing	182	135	568	575
FDIC insurance	123	161	363	506



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PA shares tax	242	219	727	677
Telecommunications	89	87	254	265
Loss on sale or write down of OREO, net	11	7	151	121
Due diligence and merger expense	-	-	-	77
Other expenses	713	814	2,337	2,441
Total non-interest expense	6,773	6,990	21,043	20,819
Income before income tax expense	3,649	3,412	9,329	9,912
Income tax expense	629	1,001	1,647	2,774
Net income	\$ 3,020	\$ 2,411	\$ 7,682	\$ 7,138
Earnings per common share:				
Basic	\$ 0.70	\$ 0.57	\$ 1.79	\$ 1.68
Diluted	\$ 0.70	\$ 0.56	\$ 1.78	\$ 1.66
Cash dividends per common share	\$ 0.07	\$ 0.07	\$ 0.21	\$ 0.21
Weighted average common shares outstanding:				
Basic	4,307,402	4,262,165	4,298,987	4,255,520
Diluted	4,317,553	4,296,371	4,313,638	4,287,745
See accompanying notes to unaudited consolidated financial statements.				

## DNB Financial Corporation and Subsidiary

## Consolidated Statements of Comprehensive Income (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2018	2017	2018	2017
Net income	\$ 3,020	\$ 2,411	\$ 7,682	\$ 7,138
Other Comprehensive (Loss) Income:				
Unrealized holding gains arising during the period				
Before tax amount	(163)	165	(1,412)	401
Tax effect	34	(56)	296	(136)
	(129)	109	(1,116)	265
Accretion of discount on AFS to HTM reclassification				
Before tax amount(1)	-	1	-	8
Tax effect(2)	-	-	-	(3)
	-	1	-	5
Less reclassification for gains on sales of AFS investment securities included in net income				
Before tax amount(3)	-	-	-	(9)
Tax effect(2)	-	-	-	3
	-	-	-	(6)
Total other comprehensive (loss) income	(129)	110	(1,116)	264
Total comprehensive income	\$ 2,891	\$ 2,521	\$ 6,566	\$ 7,402

(1) Amounts are included in "Interest and dividends on investment securities" in the consolidated statements of income.

(2) Amounts are included in "Income tax expense" in the consolidated statements of income.

(3) Amounts are included in "Gains on sale of investment securities, net" in the consolidated statements of income.

See accompanying notes to unaudited consolidated financial statements.

## DNB Financial Corporation and Subsidiary

## Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

	Common Treasury			Retained Earnings		Accumulated Other Comprehensive Loss	Total
(Dollars in thousands)	Stock	Stock	Surplus	Earnings	Loss		
Balance at January 1, 2018	\$ 4,379	\$ (1,429)	\$ 69,110	\$ 32,272	\$ (2,390)		\$ 101,942
Net income for nine months ended September 30, 2018	-	-	-	7,682	-		7,682
Other comprehensive loss	-	-	-	-	(1,116)		(1,116)
Restricted stock compensation expense (4,908 shares vested)	10	-	260	-	-		270
Exercise of stock options (7,798 shares)	8	-	(8)	-	-		-
Taxes on exercise of stock options	(4)	-	(262)	-	-		(266)
Cash dividends - common (\$0.21 per share)	-	-	-	(902)	-		(902)
Sale of treasury shares to 401(k) (8,828 shares)	-	159	145	-	-		304
Sale of treasury shares to deferred comp. plan (4,209 shares)	-	74	71	-	-		145
Adoption impact - ASU 2018-02	-	-	-	471	(471)		-
Balance at September 30, 2018	\$ 4,393	\$ (1,196)	\$ 69,316	\$ 39,523	\$ (3,977)		\$ 108,059

	Common Treasury			Retained Earnings		Accumulated Other Comprehensive Loss	Total
(Dollars in thousands)	Stock	Stock	Surplus	Earnings	Loss		
Balance at January 1, 2017	\$ 4,351	\$ (1,730)	\$ 68,973	\$ 25,520	\$ (2,274)		\$ 94,840
Net income for nine months ended September 30, 2017	-	-	-	7,138	-		7,138
Other comprehensive income	-	-	-	-	264		264
Restricted stock compensation expense	13	-	308	-	-		321
Exercise of stock options (9,264 shares)	9	-	(9)	-	-		-
Taxes on exercise of stock options	-	-	(189)	-	-		(189)
Cash dividends - common (\$0.21 per share)	-	-	-	(895)	-		(895)
Sale of treasury shares to 401(k) (8,366 shares)	-	151	62	-	-		213
Sale of treasury shares to deferred comp. plan (4,313 shares)	-	77	115	-	-		192
Balance at September 30, 2017	\$ 4,373	\$ (1,502)	\$ 69,260	\$ 31,763	\$ (2,010)		\$ 101,884

See accompanying notes to unaudited consolidated financial statements.



## DNB Financial Corporation and Subsidiary

## Consolidated Statements of Cash Flows (Unaudited)

(Dollars in thousands)	Nine Months Ended September 30, 2018	2017
Cash Flows From Operating Activities:		
Net income	\$ 7,682	\$ 7,138
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	1,144	1,253
Provision for credit losses	850	1,285
Stock based compensation	270	321
Net gain on sale of securities	-	(25)
Net loss on sale or write down of OREO and other repossessed property	151	121
Gain on insurance proceeds	(8)	(80)
Earnings from investment in BOLI	(158)	(165)
Deferred tax expense	193	260
Proceeds from sales of mortgage loans	11,088	3,698
Mortgage loans originated for sale	(10,244)	(3,936)
Gain on sale of mortgage loans	(193)	(112)
Proceeds from sales of loans	805	2,142
Loans originated for sale	(768)	(2,010)
Gain on sale of loans	(37)	(132)
Increase in accrued interest receivable	(388)	(224)
(Increase) decrease in other assets	(230)	101
Increase (decrease) in accrued interest payable	3	(73)
Increase in other liabilities	581	2,716
Net Cash Provided by Operating Activities	10,741	12,278
Cash Flows From Investing Activities:		

Activity in available-for-sale securities:		
Sales	-	3,030
Maturities, repayments and calls	10,976	19,318
Purchases	-	(15,093)
Activity in held-to-maturity securities:		
Sales	-	737
Maturities, repayments and calls	413	641
Purchases	-	(1,407)
Net decrease (increase) in restricted stock	1,777	(990)
Net increase in loans	(62,848)	(6,074)
Death benefit proceeds	8	310
Purchases of property and equipment	(164)	(576)
Expenses capitalized in OREO	-	(15)
Proceeds from sale of OREO and other repossessed property	102	596
Net Cash (Used in) Provided by Investing Activities	(49,736)	477
Cash Flows From Financing Activities:		
Net increase (decrease) in deposits	78,678	(13,859)
Repayment of FHLBP advances	(226,661)	(24,133)
Funding of FHLBP advances	184,600	19,848
Net (decrease) increase in repurchase agreements	(7,934)	3,494
Proceeds from (repayment of) other borrowings	10,816	(39)
Dividends paid	(902)	(895)
Payment of employee taxes on stock option exercise and share award vest	(266)	(189)
Tax benefit for restricted stock vesting	-	-
Sale of treasury stock	449	405
Net Cash Provided By (Used In) Financing Activities	38,780	(15,368)
Net Change in Cash and Cash Equivalents	(215)	(2,613)
Cash and Cash Equivalents at Beginning of Period	10,917	22,103
Cash and Cash Equivalents at End of Period	\$ 10,702	\$ 19,490

Supplemental Disclosure of  
Cash Flow Information:

Cash paid during the period  
for:

Interest	\$	6,588	\$	4,200
Income taxes		975		2,536

Supplemental Disclosure of  
Non-cash Flow Information:

Net decrease in goodwill	-	65
Transfers from loans to real estate owned and other repossessed property	318	2,851

See accompanying notes to unaudited consolidated financial statements.

## NOTE 1: BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements of DNB Financial Corporation (referred to herein as the "Corporation" or "DNB") and its subsidiary, DNB First, National Association (the "Bank") have been prepared in accordance with the instructions for Form 10-Q and therefore do not include certain information or footnotes necessary for the presentation of financial condition, statement of operations and statement of cash flows required by generally accepted accounting principles. However, in the opinion of management, the consolidated financial statements reflect all adjustments (which consist of normal recurring adjustments) necessary for a fair presentation of the results for the unaudited periods. Prior amounts not affecting net income are reclassified when necessary to conform to current period classifications. The results of operations for the three and nine months ended September 30, 2018 are not necessarily indicative of the results which may be expected for the entire year. The consolidated financial statements should be read in conjunction with the Annual Report and report on Form 10-K for the year ended December 31, 2017.

Subsequent Events-- Management has evaluated events and transactions occurring subsequent to September 30, 2018 for items that should potentially be recognized or disclosed in these Consolidated Financial Statements. The evaluation was conducted through the date these financial statements were issued.

### Recent Accounting Pronouncements-

#### Accounting Developments Affecting DNB

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." The updated standard is a new comprehensive revenue recognition model that requires revenue to be recognized in a manner that depicts the transfer of goods or services to a customer at an amount that reflects the consideration expected to be received in exchange for those goods or services. In August 2015, the FASB issued ASU 2015-14 which deferred the effective date of ASU 2014-09 by one year. During 2016 and 2017, the FASB issued ASU Nos. 2016-10, 2016-12, 2016-20, and 2017-13 that provided additional guidance related to the identification of performance obligations within a contract, assessing collectability, contract costs, and other technical corrections and improvements.

DNB adopted the new standards discussed above effective January 1, 2018 using the modified retrospective approach. A significant majority of DNB's revenues are explicitly excluded from the scope of the new guidance including interest, dividend income, BOLI, gain/loss on sale of loans and investments on the Consolidated Statements of Income. The adoption of ASU 2014-09 did not require a cumulative adjustment to the opening balance of retained earnings as of January 1, 2018 and is not expected to have a material impact on DNB's Consolidated Statements of Financial Condition, Comprehensive Income, Stockholders' Equity or Cash Flows for the year ended December 31, 2018. Non-interest income components in the scope of Topic 606 continue to be recognized when DNB's performance obligations are complete or at the time of sale after a customer's transaction posts in the account. Disclosures required



for DNB's revenue streams in the scope of ASU 2014-09 are included in Non-Interest Income in the following table.

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Non-interest Income Non-interest income includes revenue from contracts with customers in the scope of ASU 2014-09 as follows:

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
(Dollars in thousands)	2017		2017	
Non-interest Income:				
Service charges:				
Non-sufficient funds charges	\$ 157	\$ 173	\$ 458	\$ 538
Business analysis charges	42	39	127	120
Cycle charges	24	23	69	69
Lockbox fees	2	2	54	57
Stop payment fees	5	4	12	14
Wire transfer fees	23	20	66	64
Other service charges	21	21	62	74
Total service charges	274	282	848	936
Wealth management:				
DNB Investments & Insurance	185	115	423	361
DNB First Investment Management & Trust	357	296	1,066	895
Total wealth management	542	411	1,489	1,256
Other fee income:				
Cardholder interchange fees	257	245	771	733
Safe deposit box	24	27	74	77
Check printing	14	15	49	54
Merchant card processing	44	48	134	145
ATM surcharges for non-DNB customers	19	22	56	62
Other fee income	13	28	40	85
Total other fee income	371	385	1,124	1,156
Total Revenue from contracts with customers	1,187	1,078	3,461	3,348
Total Revenue not within the scope of ASC 606	184	193	515	651
Total non-interest income	\$ 1,371	\$ 1,271	\$ 3,976	\$ 3,999

Service charges on deposit accounts are recorded monthly when DNB's performance obligations are complete. Deposit balances are disclosed in the Consolidated Statement of Condition. For transaction-based service charges such as non-sufficient funds charges, wire transfer fees, stop payment fees, ATM fees, and other transaction-based fees, revenue is recognized at the time of sale after the transaction posts in the customer's account.

Wealth management revenue includes non-deposit products and services offered under the names "DNB Investment & Insurance" and "DNB First Investment Management & Trust".

Through a third-party marketing agreement with Cetera Investment Services, LLC ("Cetera"), DNB Investment & Insurance offers a complete line of investment and insurance products. DNB's performance obligation as an agent is to arrange for the sale of products by Cetera. Monthly, DNB recognizes commission fees in the amounts to which it is entitled in accordance with the terms of the marketing agreement for products sold. Shortly after a sale, the product

provided remits the commission payment through Cetera to the Company, and the Company recognizes the revenue.

DNB First Investment Management & Trust offers a full line of investment and fiduciary services. DNB's performance obligation is to manage investments, estates and trusts. Investment management and trust income is primarily comprised of fees earned from the management and administration of trusts, estates and investment agency portfolios. The Company's performance obligation is generally satisfied over time and the resulting fees are recognized quarterly, based upon the quarter-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after quarter end through a direct charge to customers' accounts. While managing estates and trusts, DNB contracts with a third-party tax preparation service. For tax preparation services, DNB's obligation as an agent is to arrange for the performance of services by the third party. As tax services are rendered, DNB records revenue net of the cost of the services.

Cardholder interchange fees consist of revenue DNB is entitled per agreements with third party debit and credit card providers. DNB's performance obligation as an agent is to arrange for cardholder services with its customers in accordance with fees and terms offered by the third-party service providers. Based on cardholder transactions reported by third party service providers, DNB recognizes fees for the amount it is contractually entitled.

DNB also contracts with third party providers for check printing, merchant card services, and ATM services. DNB's performance obligation as an agent is to arrange for the services with its customers in accordance with fees and terms offered by the third-party service providers. Monthly, DNB recognizes fees for the amount it is contractually entitled.

DNB adopted ASU 2015-16, Business Combinations (Topic 805), in 2016: Simplifying the Accounting for Measurement Period Adjustments on a prospective basis. This amendment eliminates the requirement to account for adjustments to provisional amounts recognized in a business combination retrospectively. Instead, the acquirer will recognize the adjustments to provisional amounts during the period in which the adjustments are determined, including the effect on earnings of any amounts the acquirer would have recorded in previous periods if the accounting had been completed at the acquisition date. DNB evaluated the impact of this guidance and it does not have a material impact to the consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities. The guidance addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. In particular, the guidance revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The guidance also amends certain disclosure requirements associated with fair value of financial instruments. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Entities should apply the amendments by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. As of September 30, 2018, DNB did not hold any equity investments (excluding restricted investments in bank stocks). DNB does not expect to make significant purchases of equity investments; therefore, the adoption of this ASU is not expected to be material to DNB's consolidated financial statements. Adoption of the standard on January 1, 2018 also resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis in the consolidated balance sheets.

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, Leases. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. DNB has determined that upon the adoption of ASU 2016-02 we will be required to recognize a right-of-use asset and a corresponding liability based on the then present value of such obligation. DNB is preparing an inventory of its leases and evaluating the impact of this ASU on these leases. Upon adoption of the guidance, DNB expects to report increased assets and increased liabilities as a result of recognizing right-of-use assets and lease liabilities on its consolidated statement of condition. DNB is currently evaluating the extent of the impact that the adoption of this ASU will have on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting." This ASU simplifies several aspects of the accounting for employee share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. For public business entities, this ASU is effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods therein. Accordingly, effective January of 2017, DNB adopted the pronouncement. During the three and nine month periods ended September 30, 2018, DNB had \$51,000 and \$93,000

of tax benefits for stock option exercises and restricted stock vesting, respectively. In accordance with ASU 2016-09, forfeitures are recognized as they occur instead of applying an estimated forfeiture rate to each grant. For purposes of the determination of stock-based compensation expense for the three and nine month periods ended September 30, 2018, we recognized actual forfeitures of 0 and 4,345 shares of restricted stock awards that were granted to officers and other employees.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments," (ASU 2016-13), which addresses concerns regarding the perceived delay in recognition of credit losses under the existing incurred loss model. The amendment introduces a new, single model for recognizing credit losses on all financial instruments presented on cost basis. Under the new model, entities must estimate current expected credit losses by considering all available relevant information, including historical and current information, as well as reasonable and supportable forecasts of future events. The update also requires additional qualitative and quantitative information to allow users to better understand the credit risk within the portfolio and the methodologies for determining allowance. ASU 2016-13 is effective for DNB on January 1, 2020 and must be applied using the modified retrospective approach with limited exceptions. Early adoption is permitted. Although early adoption is permitted for fiscal years beginning after December 15, 2018, DNB does not plan to early adopt. DNB has established a CECL Implementation Team to assess the impact of this ASU on its consolidated financial position, results of operations, and cash flows. DNB has been preserving certain historical loan information from its core processing system in anticipation of adopting the standard and will be evaluating control and process framework, data, model, and resource requirements and areas where modifications will be required. The team continues to assess the impact of the standard; however, DNB expects adopting this ASU will result in an increase in its allowance for credit losses. The amount of the increase in the allowance for credit losses upon adoption will be dependent upon the characteristics of the portfolio at the adoption date, as well as macroeconomic conditions and forecasts at that date. A cumulative effect adjustment will be made to retained earnings for the impact of the standard at the beginning of the period the standard is adopted.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230). The amendments in this update provide guidance for eight specific cash flow classification issues for which current guidance is unclear or does not exist, thereby reducing diversity in practice. For public companies, the update is effective for annual periods beginning after December 15, 2017.

Accordingly, effective January 1, 2018, DNB adopted the pronouncement and it did not have a material impact to DNB's consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805), Clarifying the Definition of a Business. The new guidance narrows the existing definition of a business and provides a framework for evaluating whether a transaction should be accounted for as an acquisition (or disposal) of assets or a business. The guidance requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets; if so, the set of transferred assets and activities (collectively, the set) is not a business. To be considered a business, the set would need to include an input and a substantive process that together significantly contribute to the ability to create outputs, as defined by the ASU. The guidance is effective for annual reporting periods beginning after December 15, 2017, including interim periods within those annual reporting periods, and should be applied prospectively. Early adoption is permitted. DNB will apply this guidance to applicable transactions after the adoption date.

In January 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. The ASU simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Instead, under the amendments, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value with its carrying amount. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount when measuring the goodwill impairment loss, if applicable. The update also eliminated the requirements for zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. The amendments are effective for public business entities for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. DNB will not early adopt this ASU for its annual goodwill impairment test, and conducted a qualitative test (step zero) as of October 1, 2017 and determined that its Goodwill has not been impaired. The adoption of this ASU is not expected to have a material impact on DNB's consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-07, "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." Under the new guidance, employers will present the service cost component of the net periodic benefit cost in the same income statement line item (e.g., Salaries and Benefits) as other employee compensation costs arising from services rendered during the period. In addition, only the service cost component will be eligible for capitalization in assets. Employers will present the other components separately (e.g., Other Noninterest Expense) from the line item that includes the service cost. ASU No. 2017-07 is effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is permitted, however, DNB has decided not to early adopt. Employers will apply the guidance on the presentation of the components of net periodic benefit cost in the income statement retrospectively. ASU No. 2017-07 will not have a material impact on DNB Consolidated Financial Statements because the Pension plan has been frozen to new accruals since December 31, 2003, and thus, generated no service cost in any subsequent year.

In March of 2017, the FASB issued ASU No. 2017-08, “Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities” (“ASU 2017-08”). This guidance shortens the amortization period for premiums on certain callable debt securities to the earliest call date (with an explicit, non-contingent call feature that is callable at a fixed price and on a preset dates), rather than contractual maturity date as currently required under GAAP. The ASU does not impact instruments without preset call dates such as mortgage-backed securities. For instruments with contingent call features, once the contingency is resolved and the security is callable at a fixed price and preset date, the security is within the scope of the ASU. ASU 2017-08 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, and early adoption is permitted. Accordingly, effective January of 2017, DNB early adopted the pronouncement. The adoption of the ASU did not have a material impact to the consolidated financial statements.

In May 2017, the FASB issued ASU No. 2017-09, Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting; (“ASU 2017-09”). ASU 2017-09 provides clarity by offering guidance on the scope of modification accounting for share-based payment awards and gives direction on which changes to the terms or conditions of these awards require an entity to apply modification accounting. Under the new guidance, modification accounting is required only if the fair value, the vesting conditions, or the classification of the award (as equity or liability) changes as a result of the change in terms or conditions. The guidance is effective prospectively for all companies for annual periods beginning on or after December 15, 2017. Early adoption is permitted. DNB adopted the ASU on January 1, 2018 and the effects were immaterial.

In February 2018, the FASB issued ASU No. 2018-02, Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income; (“ASU 2018-02”). This ASU allows a reclassification from accumulated other comprehensive income (“AOCI”) to retained earnings for certain income tax effects stranded in AOCI as a result of the Tax Act. Consequently, the reclassification eliminates the stranded tax effects resulting from the Tax Act and is intended to improve the usefulness of information reported to financial statement users. However, because the ASU only relates to the reclassification of the income tax effects of the Tax Act, the underlying guidance that requires the effect of a change in tax laws or rates to be included in income from continuing operations is not affected. The amendments in this update are effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. DNB adopted this ASU on January 1, 2018. The amount of this reclassification is \$471,000.

## NOTE 2: INVESTMENT SECURITIES

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

(Dollars in thousands)	September 30, 2018			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Held To Maturity				
US Government agency obligations	\$ 8,682	\$ 34	\$ -	\$ 8,716
Government Sponsored Entities (GSE) mortgage-backed securities	413	-	(4)	409
Corporate bonds	13,882	84	(95)	13,871
Collateralized mortgage obligations GSE	1,211	-	(55)	1,156
State and municipal taxable	362	-	(10)	352
State and municipal tax-exempt	37,519	2	(1,722)	35,799
Total	\$ 62,069	\$ 120	\$ (1,886)	\$ 60,303
Available For Sale				
US Government agency obligations	\$ 50,077	\$ -	\$ (622)	\$ 49,455
GSE mortgage-backed securities	28,762	-	(1,431)	27,331
Collateralized mortgage obligations GSE	10,610	-	(669)	9,941
Corporate bonds	10,913	-	(275)	10,638
State and municipal tax-exempt	1,983	-	(187)	1,796
Total	\$ 102,345	\$ -	\$ (3,184)	\$ 99,161

(Dollars in thousands)	December 31, 2017			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Held To Maturity				
US Government agency obligations	\$ 8,483	\$ 163	\$ -	\$ 8,646
Government Sponsored Entities (GSE) mortgage-backed securities	496	9	-	505
Corporate bonds	14,047	243	(2)	14,288
Collateralized mortgage obligations GSE	1,471	-	(29)	1,442



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State and municipal taxable	363	-	(8)	355
State and municipal tax-exempt	37,530	59	(405)	37,184
Total	\$ 62,390	\$ 474	\$ (444)	\$ 62,420

Available For Sale

US Government agency obligations	\$ 53,279	\$ -	\$ (386)	\$ 52,893
GSE mortgage-backed securities	33,203	-	(715)	32,488
Collateralized mortgage obligations GSE	12,101	-	(447)	11,654
Corporate bonds	12,981	12	(173)	12,820
State and municipal tax-exempt	1,991	-	(63)	1,928
Total	\$ 113,555	\$ 12	\$ (1,784)	\$ 111,783

Included in unrealized losses are market losses on securities that have been in a continuous unrealized loss position for twelve months or more and those securities that have been in a continuous unrealized loss position for less than twelve months. The following table details the aggregate unrealized losses and aggregate fair value of the underlying securities whose fair values are below their amortized cost at September 30, 2018 and December 31, 2017.

September 30, 2018						
	Total	Total	Fair Value	Unrealized	Fair Value	Unrealized
(Dollars in thousands)	Fair Value	Unrealized	Impaired	Loss	Impaired	Loss
Held To Maturity		Loss	Less Than	Less Than	More Than	More Than
			12 Months	12 Months	12 Months	12 Months
GSE mortgage-backed securities	\$ 409	\$ (4)	\$ 409	\$ (4)	\$ -	\$ -
Corporate bonds	5,137	(95)	5,137	(95)	-	-
Collateralized mortgage obligations	1,156	(55)	-	-	1,156	(55)
GSE						
State and municipal taxable	352	(10)	-	-	352	(10)
State and municipal tax-exempt	33,969	(1,722)	17,644	(327)	16,325	(1,395)
Total	\$ 41,023	\$ (1,886)	\$ 23,190	\$ (426)	\$ 17,833	\$ (1,460)
Available For Sale						
US Government agency obligations	\$ 49,455	\$ (622)	\$ 8,839	\$ (138)	\$ 40,616	\$ (484)
GSE mortgage-backed securities	27,331	(1,431)	2,500	(91)	24,831	(1,340)
Collateralized mortgage obligations	9,941	(669)	-	-	9,941	(669)
GSE						
Corporate bonds	10,638	(275)	4,529	(68)	6,109	(207)
State and municipal tax-exempt	1,796	(187)	-	-	1,796	(187)
Total	\$ 99,161	\$ (3,184)	\$ 15,868	\$ (297)	\$ 83,293	\$ (2,887)

December 31, 2017						
	Total	Total	Fair Value	Unrealized	Fair Value	Unrealized
(Dollars in thousands)	Fair Value	Unrealized	Impaired	Loss	Impaired	Loss
Held To Maturity		Loss	Less Than	Less Than	More Than	More Than
			12 Months	12 Months	12 Months	12 Months
Corporate bonds	\$ 498	\$ (2)	\$ 498	\$ (2)	\$ -	\$ -
Collateralized mortgage obligations	1,442	(29)	620	(5)	822	(24)
GSE						
State and municipal taxable	355	(8)	355	(8)	-	-
State and municipal tax-exempt	20,240	(405)	6,775	(67)	13,465	(338)
Total	\$ 22,535	\$ (444)	\$ 8,248	\$ (82)	\$ 14,287	\$ (362)
Available For Sale						
US Government agency obligations	\$ 52,893	\$ (386)	\$ 30,894	\$ (185)	\$ 21,999	\$ (201)
GSE mortgage-backed securities	32,488	(715)	9,055	(133)	23,433	(582)
Collateralized mortgage obligations	11,654	(447)	2,132	(56)	9,522	(391)
GSE						
Corporate bonds	10,759	(173)	4,572	(43)	6,187	(130)

State and municipal tax-exempt	1,928	(63)	288	(2)	1,640	(61)
Total	\$ 109,722	\$ (1,784)	\$ 46,941	\$ (419)	\$ 62,781	\$ (1,365)

As of September 30, 2018, there were nineteen collateralized mortgage obligations GSE, twenty GSE mortgage-backed securities, nine U.S. agency obligations, fifty-six tax-exempt municipalities, one taxable municipality, and twelve corporate bonds which were in an unrealized loss position. DNB does not intend to sell these securities and management of DNB does not expect to be required to sell any of these securities prior to a recovery of their cost basis. Management has reviewed all of these securities and believes that DNB will collect all principal and interest that is due on debt securities on a timely basis. Management does not believe any individual unrealized loss as of September 30, 2018 represents an other-than-temporary impairment (OTTI). DNB reviews its investment portfolio on a quarterly basis, reviewing each investment for OTTI. The OTTI analysis focuses on condition of the issuers as well as duration and severity of impairment in determining OTTI. As of September 30, 2018, the following securities were reviewed:

**Collateralized mortgage obligations GSE** There are nineteen impaired securities classified as collateralized mortgage obligations, all of which have been impaired for more than 12 months. The largest unrealized loss of a security in this group is 9.50% of its carrying value. All of these securities were issued and insured by FNMA, FHLMC or GNMA. DNB receives monthly principal and interest payments on all of these securities on a timely basis and none of these agencies have ever defaulted on mortgage-backed principal or interest. DNB anticipates a recovery in the market value as the securities approach their maturity dates or if interest rates decline from September 30, 2018 levels. Management concluded that these securities were not other-than-temporarily impaired at September 30, 2018.

**GSE mortgage-backed securities** There are twenty impaired securities classified as GSE mortgage-backed securities, eighteen of which have been impaired for more than 12 months. The largest unrealized loss of a security in this group is 6.06% of its carrying value. These securities were issued and insured by FNMA, FHLMC or GNMA. DNB receives monthly principal and interest payments on these securities on a timely basis and none of these have ever defaulted on mortgage-backed principal or interest. DNB anticipates a

recovery in the market value as the securities approach their maturity dates or if interest rates decline from September 30, 2018 levels. Management concluded that these securities were not other-than-temporarily impaired at September 30, 2018.

**US Government agency obligations** There are nine impaired securities classified as agencies, eight of which have been impaired for more than 12 months. The largest unrealized loss of a security in this group is 6.68% of its carrying value. All of these securities were issued and insured by FHLB, FNMA, or FHLMC. DNB has received timely interest payments on all of these securities and none of these agencies have ever defaulted on their bonds. DNB anticipates a recovery in the market value as the securities approach their maturity dates. Management concluded that these securities were not other-than-temporarily impaired at September 30, 2018.

**State and municipal tax-exempt** There are fifty-six impaired securities in this category, which are comprised of intermediate to long-term municipal bonds, twenty-nine of which have been impaired for more than 12 months. The largest unrealized loss of a security in this group is 12.29% of its carrying value. All of the issues carry a "BBB-" or better underlying credit rating and/or have strong underlying fundamentals; included but not limited to annual financial reports, geographic location, population, and debt ratios. In certain cases, options for calls reduce the effective duration and in turn, future market value fluctuations. All issues are performing and are expected to continue to perform in accordance with their respective contractual terms and conditions. There have not been disruptions of any payments associated with any of these municipal securities. These bonds are investment grade and the value decline is related to the changes in interest rates. Of the fifty-six municipal securities, there are twenty-three insured school districts, seventeen uninsured school districts, nine insured townships, and seven uninsured townships, all of which have strong underlying ratings. Management concluded that these securities were not other-than-temporarily impaired at September 30, 2018.

**State and municipal taxable** There is one impaired security in this category, which has been impaired for more than 12 months. The unrealized loss of this security is 2.78% of its carrying value. This security is an insured township and carries a "BBB+" underlying credit. It is performing and is expected to continue to perform in accordance with its contractual terms and conditions. There have not been disruptions of any payments associated with this municipal security. Management concluded that this security was not other-than-temporarily impaired at September 30, 2018.

**Corporate bonds** There are twelve impaired bonds classified as corporate bonds, four of which have been impaired for more than 12 months. The largest unrealized loss of a security in this group is 6.14% of its carrying value. The bonds are investment grade and the value decline is related to the changes in interest rates that occurred since the time of purchase and subsequent changes in spreads affecting the market prices. All of the issues carry a "BBB+" or better underlying credit support and were evaluated on the basis on their underlying fundamentals; included but not limited to annual financial reports, rating agency reports, capital strength and debt ratios. DNB anticipates a recovery in the market value as the securities approach their maturity dates or if interest rates decline from September 30, 2018 levels. Management concluded that these securities were not other-than-temporarily impaired at September 30, 2018.

The amortized cost and fair value of investment securities as of September 30, 2018, by final contractual maturity, are shown below. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid without penalties.

(Dollars in thousands)	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 1,000	\$ 999	\$ 32,757	\$ 32,609
Due after one year through five years	22,277	22,264	24,443	23,925
Due after five years through ten years	29,384	28,449	20,482	19,498
Due after ten years	9,408	8,591	24,663	23,129
Total investment securities	\$ 62,069	\$ 60,303	\$ 102,345	\$ 99,161

The HTM security sold during the nine months ended September 30, 2017 was sold in accordance with GAAP, as DNB collected greater than 85% of the original recorded investment on the HTM security prior to the sale. As a result, it is appropriate to continue to carry the remaining HTM portfolio as currently classified. Gains and losses resulting from investment sales, redemptions or calls were as follows:

(Dollars in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Gross realized gains-AFS	\$ -	\$ -	\$ -	\$ 10
Gross realized gains-HTM	-	-	-	16
Gross realized losses-AFS	-	-	-	(1)
Net realized gain	\$ -	\$ -	\$ -	\$ 25

At September 30, 2018 and December 31, 2017, investment securities with a carrying value of approximately \$90.4 million and \$105.9 million, respectively, were pledged to secure public funds, repurchase agreements and for other purposes as required by law.

## NOTE 3: LOANS

The following table sets forth information concerning the composition of total loans outstanding, as of the dates indicated.

(Dollars in thousands)	September 30, 2018	December 31, 2017
Residential mortgage	\$ 103,093	\$ 93,959
Commercial mortgage	524,672	484,868
Commercial:		
Commercial term	140,810	129,535
Commercial construction	81,297	75,014
Consumer:		
Home equity	53,210	56,844
Other	5,211	5,677
Total loans	\$ 908,293	\$ 845,897
Less allowance for credit losses	(6,559)	(5,843)
Net loans	\$ 901,734	\$ 840,054

Information concerning non-accrual loans is shown in the following tables:

(Dollars in thousands)	Three Months Ended September 30, 2018					Nine Months Ended September 30, 2018				
	Interest income that would have been recorded under		Interest income that would have been recorded under		Net interest income on the period	Interest income that would have been recorded under		Interest income that would have been recorded under		Net interest income on the period
	September 30, 2018	December 31, 2017	original terms	the period	interest income	September 30, 2018	December 31, 2017	original terms	the period	interest income
Non-accrual loans:										
Residential mortgage	\$ 1,005	\$ 1,915	\$ 9	\$ -	\$ 9	\$ 52	\$ -	\$ 52		
Commercial mortgage	1,561	2,259	30	-	30	88	-	88		
Commercial:										
Commercial term	2,624	2,100	50	-	50	140	-	140		

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Commercial construction	479	514	9	-	9	29	-	29
Consumer:								
Home equity	631	466	9	-	9	17	-	17
Other	171	245	3	-	3	14	-	14
Total non-accrual loans	\$ 6,471	\$ 7,499	\$ 110	\$ -	\$ 110	\$ 340	\$ -	\$ 340
Loans 90 days past due and accruing	-	54	-	-	-	-	-	-
Total non-performing loans	\$ 6,471	\$ 7,553	\$ 110	\$ -	\$ 110	\$ 340	\$ -	\$ 340

	Three Months Ended September 30, 2017				Nine Months Ended September 30, 2017			
	Interest income that would have Interest been income Net recorded recorded impact under during on September original the interest original the interest 30, 2017 terms period income terms period income							
(Dollars in thousands)								
Non-accrual loans:								
Residential mortgage	\$ 2,070	\$ 23	\$ -	\$ 23	\$ 65	\$ -	\$ 65	
Commercial mortgage	2,311	33	-	33	110	-	110	
Commercial:								
Commercial term	1,506	27	-	27	93	-	93	
Commercial construction	447	46	-	46	137	-	137	
Consumer:								
Home equity	468	5	-	5	17	-	17	
Other	308	9	-	9	21	-	21	
Total non-accrual loans	\$ 7,110	\$ 143	\$ -	\$ 143	\$ 443	\$ -	\$ 443	
Loans 90 days past due and accruing	-	-	-	-	-	-	-	
Total non-performing loans	\$ 7,110	\$ 143	\$ -	\$ 143	\$ 443	\$ -	\$ 443	

## NOTE 4: ALLOWANCE FOR CREDIT LOSSES

The performance and credit quality of the loan portfolio is also monitored by analyzing the age of the loans receivable as determined by the length of time a scheduled payment is past due. The following tables present the classes of the loan portfolio summarized by the past due status as of September 30, 2018 and December 31, 2017.

## Age Analysis of Past Due Loans Receivable

	September 30, 2018					Total Loans Receivable	Loans Receivable > 90 Days and Accruing
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current		
(Dollars in thousands)							
Residential mortgage	\$ 1,063	\$ 261	\$ 585	\$ 1,909	\$ 101,184	\$ 103,093	\$ -
Commercial mortgage (less acquired with credit deterioration)	177	-	960	1,137	522,861	523,998	-
Acquired commercial mortgage with credit deterioration	-	-	-	-	674	674	-
Commercial:							
Commercial term	354	172	1,094	1,620	139,190	140,810	-
Commercial construction	-	-	-	-	81,297	81,297	-
Consumer:							
Home equity	152	-	481	633	52,577	53,210	-
Other	5	-	109	114	5,097	5,211	-
Total	\$ 1,751	\$ 433	\$ 3,229	\$ 5,413	\$ 902,880	\$ 908,293	\$ -

	December 31, 2017					Total Loans Receivable	Loans Receivable > 90 Days and Accruing
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total	Current		
(Dollars in thousands)							



	Past Due						
Residential mortgage (less acquired with credit deterioration)	\$ 887	\$ 349	\$ 1,148	\$ 2,384	\$ 91,568	\$ 93,952	\$ -
Acquired residential mortgage with credit deterioration	-	-	7	7	-	7	-
Commercial mortgage (less acquired with credit deterioration)	221	-	1,126	1,347	483,105	484,452	-
Acquired commercial mortgage with credit deterioration	-	-	416	416	-	416	-
Commercial:							
Commercial term	381	13	1,654	2,048	127,487	129,535	-
Commercial construction	514	-	-	514	74,500	75,014	-
Consumer:							
Home equity	15	-	386	401	56,443	56,844	-
Other	13	139	156	308	5,369	5,677	54
Total	\$ 2,031	\$ 501	\$ 4,893	\$ 7,425	\$ 838,472	\$ 845,897	\$ 54

DNB had \$64,000 of residential mortgage loans in the process of foreclosure and no residential mortgage loans in other real estate owned as of September 30, 2018. DNB had \$638,000 residential mortgage loans in the process of foreclosure and \$149,000 of residential mortgage loans in other real estate owned as of December 31, 2017.

The following tables summarize information in regards to impaired loans by loan portfolio class as of September 30, 2018 and December 31, 2017, and for the three and nine months ended September 30, 2018 and 2017.

### Impaired Loans

	September 30, 2018			December 31, 2017		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
(Dollars in thousands)						
With no related allowance recorded:						
Residential mortgage	\$ 1,573	\$ 1,909	\$ -	\$ 1,908	\$ 2,210	\$ -
Commercial mortgage	2,406	2,706	-	2,809	3,207	-
Acquired commercial mortgage with credit deterioration	521	535	-	936	950	-
Commercial:						
Commercial term	1,367	1,848	-	1,743	2,253	-
Commercial construction	479	514	-	514	514	-
Consumer:						
Home equity	772	776	-	612	632	-
Other	159	207	-	117	117	-
Total	\$ 7,277	\$ 8,495	\$ -	\$ 8,639	\$ 9,883	\$ -
With allowance recorded:						
Residential mortgage	74	74	1	-	-	-
Acquired residential mortgage with credit deterioration	-	-	-	7	26	3
Commercial mortgage	122	237	18	19	93	19
Commercial:						
Commercial term	1,257	1,379	319	337	343	123
Consumer:						
Other	42	42	3	128	129	12
Total	\$ 1,495	\$ 1,732	\$ 341	\$ 491	\$ 591	\$ 157
Total:						
Residential mortgage	1,647	1,983	1	1,908	2,210	-
Acquired residential mortgage with credit deterioration	-	-	-	7	26	3
Commercial mortgage	2,528	2,943	18	2,828	3,300	19
Acquired commercial mortgage with credit deterioration	521	535	-	936	950	-
Commercial:						
Commercial term	2,624	3,227	319	2,080	2,596	123
Commercial construction	479	514	-	514	514	-
Consumer:						
Home equity	772	776	-	612	632	-

Other	201	249	3	245	246	12
Total	\$ 8,772	\$ 10,227	\$ 341	\$ 9,130	\$ 10,474	\$ 157

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	Three Months Ended September 30, 2018		Three Months Ended September 30, 2017		Nine Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
(Dollars in thousands)								
With no related allowance recorded:								
Residential mortgage	\$ 1,748	\$ 6	\$ 1,758	\$ -	\$ 1,925	\$ 12	\$ 1,448	\$ -
Acquired residential mortgage with credit deterioration	-	-	6	-	-	-	8	-
Commercial mortgage	2,446	13	2,210	3	2,602	37	2,023	3
Acquired commercial mortgage with credit deterioration	521	9	1,141	-	691	24	1,272	-
Commercial:								
Commercial term	1,662	-	1,508	-	1,790	-	978	-
Commercial construction	484	-	447	-	495	-	734	-
Consumer:								
Home equity	706	1	584	3	658	5	580	7
Other	182	1	94	-	173	1	103	-
Total	\$ 7,749	\$ 30	\$ 7,748	\$ 6	\$ 8,334	\$ 79	\$ 7,146	\$ 10
With allowance recorded:								
Residential mortgage	74	1	174	-	37	1	416	-
Acquired residential mortgage with credit deterioration	-	-	6	-	2	-	3	-
Commercial mortgage	100	-	11	-	76	-	6	-
Acquired commercial mortgage with credit deterioration	-	-	-	-	-	-	-	-
Commercial:								
Commercial term	941	-	-	-	786	-	322	-
Commercial construction	-	-	-	-	-	-	112	-
Consumer:								
Other	42	-	216	-	78	-	179	-
Total	\$ 1,157	\$ 1	\$ 407	\$ -	\$ 979	\$ 1	\$ 1,038	\$ -
Total:								
Residential mortgage	1,822	7	1,932	-	1,962	13	1,864	-
Acquired residential mortgage with credit deterioration	-	-	12	-	2	-	11	-
Commercial mortgage	2,546	13	2,221	3	2,678	37	2,029	3
Acquired commercial mortgage with credit deterioration	521	9	1,141	-	691	24	1,272	-

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Commercial:								
Commercial term	2,603	-	1,508	-	2,576	-	1,300	-
Commercial construction	484	-	447	-	495	-	846	-
Consumer:								
Home equity	706	1	584	3	658	5	580	7
Other	224	1	310	-	251	1	282	-
Total	\$ 8,906	\$ 31	\$ 8,155	\$ 6	\$ 9,313	\$ 80	\$ 8,184	\$ 10

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The following tables present the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within DNB's internal risk rating system as of September 30, 2018 and December 31, 2017.

#### Credit Quality Indicators

(Dollars in thousands)	September 30, 2018				
	Pass	Special Mention	Substandard	Doubtful	Total
Residential mortgage	\$ 102,002	\$ -	\$ 1,091	\$ -	\$ 103,093
Commercial mortgage	517,742	1,959	4,971	-	524,672
Commercial:					
Commercial term	137,170	346	3,294	-	140,810
Commercial construction	77,171	3,605	521	-	81,297
Consumer:					
Home equity	52,420	144	646	-	53,210
Other	5,002	-	209	-	5,211
Total	\$ 891,507	\$ 6,054	\$ 10,732	\$ -	\$ 908,293

(Dollars in thousands)	December 31, 2017				
	Pass	Special Mention	Substandard	Doubtful	Total
Residential mortgage	\$ 91,993	\$ -	\$ 1,966	\$ -	\$ 93,959
Commercial mortgage	479,308	125	5,435	-	484,868
Commercial:					
Commercial term	125,926	115	3,494	-	129,535
Commercial construction	73,902	-	1,112	-	75,014
Consumer:					
Home equity	56,085	-	759	-	56,844
Other	5,432	-	245	-	5,677
Total	\$ 832,646	\$ 240	\$ 13,011	\$ -	\$ 845,897

Troubled Debt Restructurings Loans whose terms are modified are classified as troubled debt restructurings ("TDR") if DNB grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate or an

extension of a loan's stated maturity date. Non-accrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. During the nine month period ended September 30, 2018 DNB classified one residential mortgage loan totaling \$73,000 as TDR. The loan's rate was changed but the term was not extended. During the nine month period ended September 30, 2017, DNB classified three commercial mortgage loans totaling \$987,000 as TDRs, all of which had rate changes and extensions to their maturity dates, but their balances were unmodified. Loans classified as troubled debt restructurings are designated as impaired. The recorded investments in troubled debt restructured loans at September 30, 2018 and December 31, 2017 are as follows:

(Dollars in thousands)	September 30, 2018		
	Pre-Modification	Post-Modification	Recorded Investment
	Outstanding	Outstanding	
	Recorded Investment	Recorded Investment	
Residential mortgage	\$ 676	\$ 805	\$ 643
Commercial mortgage	992	992	967
Consumer:			
Home equity	148	148	141
Other	40	42	30
Total	\$ 1,856	\$ 1,987	\$ 1,781

(Dollars in thousands)	December 31, 2017		
	Pre-Modification	Post-Modification	Recorded Investment
	Outstanding	Outstanding	
	Recorded Investment	Recorded Investment	
Residential mortgage	\$ 603	\$ 732	\$ 690
Commercial mortgage	992	992	982
Consumer:			
Home equity	148	148	146
Other	40	42	39
Total	\$ 1,783	\$ 1,914	\$ 1,857

At September 30, 2018, DNB had nine TDRs with recorded investment totaling \$1,781,000, all of which are accruing loans in compliance with the terms of the modifications. As a result of collateral evaluations, specific reserves and charge-offs have been taken where appropriate. DNB recognized partial charge-offs totaling \$151,000 on two residential loans prior to their restructuring and \$2,000 on one consumer installment loan after its restructuring. As of September 30, 2018, there were no defaulted TDRs as all TDRs were

current with respect to their associated forbearance agreements. There were no defaults on TDRs during the nine months ended September 30, 2018.

At December 31, 2017, DNB had eight TDRs with recorded investment totaling \$1,857,000, five of which, totaling \$1,128,000, were accruing loans in compliance with the terms of the modifications. The remaining \$729,000 represents three loans that were nonaccrual impaired loans and resulted in collateral evaluations. As a result of the evaluations, specific reserves and charge-offs have been taken where appropriate. As of December 31, 2017, DNB recognized partial charge-offs totaling \$151,000 on two residential loans prior to their restructuring and \$2,000 on one consumer installment loan after its restructuring. As of December 31, 2017, there were no defaulted TDRs as all TDRs were current with respect to their associated forbearance agreements. There were no defaults on TDRs within twelve months of restructure during 2017. DNB classified three commercial mortgage loans totaling \$992,000 as TDRs during the year ended December 31, 2017.

The following tables set forth the composition of DNB's allowance for credit losses as of September 30, 2018 and December 31, 2017, the activity for the three and nine months ended September 30, 2018 and 2017 and as of and for the year ended December 31, 2017.

#### Allowance for Credit Losses and Recorded Investment in Loans Receivables

(Dollars in thousands)	Residential Mortgage	Commercial Mortgage	Commercial Term	Commercial Construction	Lease Financing	Consumer Home Equity	Consumer Other	Unallocated	Total
Allowance for credit losses:									
Beginning balance - July 1, 2018	\$ 207	\$ 3,076	\$ 889	\$ 1,355	\$ -	\$ 196	\$ 49	\$ 416	\$ 6,188
Charge-offs	-	-	(15)	-	-	-	(23)	-	(38)
Recoveries	308	-	-	-	-	-	1	-	309
Provisions	(352)	213	113	(287)	-	-	21	392	100
Ending balance - September 30, 2018	\$ 163	\$ 3,289	\$ 987	\$ 1,068	\$ -	\$ 196	\$ 48	\$ 808	\$ 6,559



	Residential	Commercial	Commercial	Commercial	Lease	Consumer	Consumer		
(Dollars in thousands)	Mortgage	Mortgage	Term	Construction	Financing	Home Equity	Other	Unallocated	Total
Allowance for credit losses:									
Beginning balance - January 1, 2018	\$ 221	\$ 2,856	\$ 845	\$ 1,128	\$ -	\$ 183	\$ 63	\$ 547	\$ 5,843
Charge-offs	(137)	(184)	(79)	-	-	-	(72)	-	(472)
Recoveries	334	-	2	-	-	-	2	-	338
Provisions	(255)	617	219	(60)	-	13	55	261	850
Ending balance - September 30, 2018	\$ 163	\$ 3,289	\$ 987	\$ 1,068	\$ -	\$ 196	\$ 48	\$ 808	\$ 6,559
Ending balance: individually evaluated for impairment	\$ 1	\$ 18	\$ 319	\$ -	\$ -	\$ -	\$ 3	\$ -	\$ 341
Ending balance: collectively evaluated for impairment	\$ 162	\$ 3,271	\$ 668	\$ 1,068	\$ -	\$ 196	\$ 45	\$ 808	\$ 6,218
Loans receivables:									
Ending balance	\$ 103,093	\$ 524,672	\$ 140,810	\$ 81,297	\$ -	\$ 53,210	\$ 5,211		\$ 908,293
Ending balance: individually evaluated for impairment	\$ 1,647	\$ 2,528	\$ 2,624	\$ 479	\$ -	\$ 772	\$ 201		\$ 8,251
Ending balance: acquired with credit deterioration	\$ -	\$ 521	\$ -	\$ -	\$ -	\$ -	\$ -		\$ 521
Ending balance: collectively evaluated for impairment	\$ 101,446	\$ 521,623	\$ 138,186	\$ 80,818	\$ -	\$ 52,438	\$ 5,010		\$ 899,521
Reserve for unfunded loan commitments included in other liabilities	\$ -	\$ 3	\$ 176	\$ 186	\$ -	\$ 21	\$ -		\$ 386

(Dollars in thousands)	Residential Mortgage	Commercial Mortgage	Commercial Term	Commercial Construction	Lease Financing	Consumer Home Equity	Consumer Other	Unallocated	Total
Allowance for credit losses:									
Beginning balance - July 1, 2017	\$ 245	\$ 2,634	\$ 625	\$ 1,208	\$ -	\$ 189	\$ 84	\$ 282	\$ 5,267
Charge-offs	-	(36)	(14)	-	-	-	-	-	(50)
Recoveries	-	-	1	-	-	-	1	-	2
Provisions	1	200	36	(102)	-	(3)	(4)	247	375
Ending balance - September 30, 2017	\$ 246	\$ 2,798	\$ 648	\$ 1,106	\$ -	\$ 186	\$ 81	\$ 529	\$ 5,594

(Dollars in thousands)	Residential Mortgage	Commercial Mortgage	Commercial Term	Commercial Construction	Lease Financing	Consumer Home Equity	Consumer Other	Unallocated	Total
Allowance for credit losses:									
Beginning balance - January 1, 2017	\$ 349	\$ 2,531	\$ 709	\$ 969	\$ -	\$ 196	\$ 61	\$ 558	\$ 5,373
Charge-offs	-	(519)	(610)	-	-	-	(10)	-	(1,139)
Recoveries	2	50	20	-	1	-	2	-	75
Provisions	(105)	736	529	137	(1)	(10)	28	(29)	1,285
Ending balance - September 30, 2017	\$ 246	\$ 2,798	\$ 648	\$ 1,106	\$ -	\$ 186	\$ 81	\$ 529	\$ 5,594
Reserve for unfunded loan commitments included in other liabilities	\$ -	\$ 3	\$ 150	\$ 139	\$ -	\$ 17	\$ -		\$ 309

(Dollars in thousands)	Residential Mortgage	Commercial Mortgage	Commercial Term	Commercial Construction	Lease Financing	Consumer Other	Consumer Unallocated	Total
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	Home Equity								
Allowance for credit losses:									
Ending balance - December 31, 2017	\$ 221	\$ 2,856	\$ 845	\$ 1,128	\$ -	\$ 183	\$ 63	\$ 547	\$ 5,843
Ending balance: individually evaluated for impairment	\$ 3	\$ 19	\$ 123	\$ -	\$ -	\$ -	\$ 12	\$ -	\$ 157
Ending balance: collectively evaluated for impairment	\$ 218	\$ 2,837	\$ 722	\$ 1,128	\$ -	\$ 183	\$ 51	\$ 547	\$ 5,686
Loans receivables:									
Ending balance	\$ 93,959	\$ 484,868	\$ 129,535	\$ 75,014	\$ -	\$ 56,844	\$ 5,677		\$ 845,897
Ending balance: individually evaluated for impairment	\$ 1,908	\$ 2,828	\$ 2,080	\$ 514	\$ -	\$ 612	\$ 245		\$ 8,187
Ending balance: acquired with credit deterioration	\$ 7	\$ 936	\$ -	\$ -	\$ -	\$ -	\$ -		\$ 943
Ending balance: collectively evaluated for impairment	\$ 92,044	\$ 481,104	\$ 127,455	\$ 74,500	\$ -	\$ 56,232	\$ 5,432		\$ 836,767
Reserve for unfunded loan commitments included in other liabilities	\$ -	\$ 2	\$ 155	\$ 173	\$ -	\$ 18	\$ -		\$ 348

## NOTE 5: EARNINGS PER SHARE

Basic earnings per share (“EPS”) is computed based on the weighted average number of common shares outstanding during the period. Diluted EPS is computed using the treasury stock method and reflects the potential dilution that could occur from the exercise of stock options, and warrants and the amortized portion of unvested stock awards. Stock options and unvested stock awards for which the exercise or the grant price exceeds the average market price over the period have an anti-dilutive effect on EPS and, accordingly, are excluded from the calculation. Treasury shares are not deemed outstanding for calculations. There were no outstanding stock warrants, no anti-dilutive stock options outstanding, and no anti-dilutive stock awards outstanding at September 30, 2018 and September 30, 2017. The following table sets forth the computation of basic and diluted earnings per share:

(In thousands, except per-share data)	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Income	Shares	Amount	Income	Shares	Amount
Basic EPS						
Income available to common stockholders	\$ 3,020	4,307	\$ 0.70	\$ 7,682	4,299	\$ 1.79
Effect of potential dilutive common stock equivalents – stock options and restricted shares	-	11	-	-	15	(0.01)
Diluted EPS						
Income available to common stockholders after assumed conversions	\$ 3,020	4,318	\$ 0.70	\$ 7,682	4,314	\$ 1.78

(In thousands, except per-share data)	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	Income	Shares	Amount	Income	Shares	Amount
Basic EPS						
Income available to common stockholders	\$ 2,411	4,262	\$ 0.57	\$ 7,138	4,256	\$ 1.68
	-	34	(0.01)	-	32	(0.02)

Effect of potential dilutive common stock equivalents –  
stock options and restricted shares

Diluted EPS

Income available to common stockholders after assumed conversions	\$ 2,411	4,296	\$ 0.56	\$ 7,138	4,288	\$ 1.66
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#### NOTE 6: ACCUMULATED OTHER COMPREHENSIVE LOSS

The components of accumulated other comprehensive loss included in stockholders' equity are as follows:

Accumulated Other Comprehensive Loss (Dollars in thousands)	Before-Tax Amount	Tax Effect	Net-of-Tax Amount
September 30, 2018			
Net unrealized loss on AFS securities	\$ (3,184)	\$ 668	\$ (2,516)
Unrealized actuarial losses-pension	(1,849)	388	(1,461)
	\$ (5,033)	\$ 1,056	\$ (3,977)
December 31, 2017			
Net unrealized loss on AFS securities	\$ (1,772)	\$ 603	\$ (1,169)
Unrealized actuarial losses-pension	(1,849)	628	(1,221)
	\$ (3,621)	\$ 1,231	\$ (2,390)



## NOTE 7: SUBORDINATED DEBENTURES, NOTES, AND OTHER BORROWINGS

DNB has two issuances of junior subordinated debentures (the “debentures”) as follows. The majority of the proceeds of each issuance were invested in DNB’s subsidiary, DNB First, National Association, to increase the Bank’s capital levels. The junior subordinated debentures issued in each case qualify as a component of capital for regulatory purposes. DNB Capital Trust I and II are special purpose Delaware business trusts, which are not consolidated.

### DNB Capital Trust I

DNB’s first issuance of junior subordinated debentures was on July 20, 2001. These debentures are floating rate and were issued to DNB Capital Trust I, a Delaware business trust in which DNB owns all of the common equity. DNB Capital Trust I issued \$5.0 million of floating rate (6 month Libor plus 3.75%, with a cap of 12%) capital preferred securities to a qualified institutional buyer. The proceeds of these securities were used by the Trust, along with DNB’s capital contribution, to purchase \$5.2 million principal amount of DNB’s floating rate junior subordinated debentures. The preferred securities have been redeemable since July 25, 2006 and must be redeemed upon maturity of the debentures on July 25, 2031.

### DNB Capital Trust II

DNB’s second issuance of junior subordinated debentures was on March 30, 2005. These are floating rate and were issued to DNB Capital Trust II, a Delaware business trust in which DNB owns all of the common equity. DNB Capital Trust II issued \$4.0 million of floating rate (the rate was fixed at 6.56% for the first 5 years and is now adjusting at a rate of 3-month LIBOR plus 1.77%) capital preferred securities. The proceeds of these securities were used by the Trust, along with DNB’s capital contribution, to purchase \$4.1 million principal amount of DNB’s floating rate junior subordinated debentures. The preferred securities have been redeemable since May 23, 2010. The preferred securities must be redeemed upon maturity of the debentures on May 23, 2035.

### Subordinated Note

On March 5, 2015, DNB Financial Corporation entered into a Subordinated Note Purchase Agreement (the “Agreement”) with an accredited investor under which DNB issued a \$9.75 million subordinated note (the “Note”) to the investor. The Note has a maturity date of March 6, 2025, and bears interest at a fixed rate of 4.25% per annum for the first 5 years and then will float at the Wall Street Journal Prime rate plus 1.00%, provided that the interest rate applicable to the outstanding principal balance will at no time be less than 3.0% and more than 5.75% per annum.

DNB may, at its option, beginning with the first interest payment date after March 6, 2019, and on any interest payment date thereafter, redeem the Note, in whole or in part, at par plus accrued and unpaid interest to the date of redemption. The Note is not subject to repayment at the option of the noteholder.

The Note is unsecured and ranks junior in right of payment to DNB’s senior indebtedness and to DNB’s obligations to its general creditors and qualifies as Tier 2 capital for regulatory purposes.

## Repurchase Agreements Accounted for as Secured Borrowings

Repurchase agreements accounted for as secured borrowings are shown in the following table.

(Dollars in thousands)	Overnight and Continuous	Up to 30 days	30 - 90 days	Greater than 90 days	Total
September 30, 2018					
Repurchase agreements and repurchase-to-maturity transactions	\$ 4,089	\$ -	\$ -	\$ -	\$ 4,089
Gross amount of recognized liabilities for repurchase agreements in statement of financial condition	\$ 4,089				\$ 4,089
December 31, 2017					
Repurchase agreements and repurchase-to-maturity transactions	\$ 12,023	\$ -	\$ -	\$ -	\$ 12,023
Gross amount of recognized liabilities for repurchase agreements in statement of financial condition	\$ 12,023				\$ 12,023

As of September 30, 2018 and December 31, 2017, DNB had \$4.1 million and \$12.0 million of repurchase agreements, respectively. In conjunction with these repurchase agreements, \$4.2 million and \$12.3 million of state and municipal securities were sold on an overnight basis as of September 30, 2018 and December 31, 2017, respectively, which represents 102% of the repurchase agreement amounts.



## NOTE 8: STOCK-BASED COMPENSATION

## Stock Option Plan

DNB has a Stock Option Plan for employees and directors. Under the plan, options (both qualified and non-qualified) to purchase a maximum of 793,368 (as adjusted for subsequent stock dividends) shares of DNB's common stock could be issued to employees and directors. Under the plan, option exercise prices must equal the fair market value of the shares on the date of option grant and the option exercise period may not exceed ten years. Vesting of options under the plan is determined by the Plan Committee. There were 354,090 shares available for grant at September 30, 2018. All options are immediately exercisable. During the three and nine months ended September 30, 2018 and 2017, DNB had no expenses related to the plan and anticipates no additional expense related to the plan. Under the Stock Option Plan, 16,450 shares were exercised during the nine months ended September 30, 2018. The shares awarded from the non-qualified cashless exercises resulted in an increase in shares outstanding of 7,798 shares. There was a cash equivalent of 8,652 shares used to pay all applicable taxes on the transactions. Under the Stock Option Plan, 19,150 shares were exercised during the nine months ended September 30, 2017. The shares awarded from the non-qualified cashless exercises resulted in an increase in shares outstanding of 9,264 shares. There was a cash equivalent of 9,886 shares used to pay all applicable taxes on the transactions. Stock option activity is indicated below.

	Number Outstanding	Weighted Average Exercise Price
Outstanding January 1, 2018	16,450	\$ 10.31
Issued	-	-
Exercised	16,450	10.31
Forfeited	-	-
Expired	-	-
Outstanding September 30, 2018	-	\$ -

	Number Outstanding	Weighted Average Exercise Price
Outstanding January 1, 2017	49,700	\$ 9.18

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Issued	-	-
Exercised	19,150	7.39
Forfeited	-	-
Expired	-	-
Outstanding September 30, 2017	30,550	\$ 10.31

The weighted-average price and weighted average remaining contractual life for the outstanding options are listed in the following table for the dates indicated.

December 31, 2017

Range of Exercise Prices	Number Outstanding	Number Exercisable	Weighted Average Exercise Price	Remaining Contractual Life	Intrinsic Value
\$ 6.93-10.99	16,450	16,450	\$ 10.31	0.95 years	\$ 385,000

#### Other Stock-Based Compensation

DNB maintains an Incentive Equity and Deferred Compensation Plan (the "Plan"). The Plan provides that up to 493,101 (as adjusted for subsequent stock dividends) shares of common stock may be granted, at the discretion of the Board, to individuals of the Corporation. Shares already granted are issuable on the earlier of three or four years (cliff vesting period) after the date of the grant or a change in control of DNB if the recipients are then employed by DNB ("Vest Date"). Upon issuance of the shares, resale of the shares is restricted for an additional one year, during which the shares may not be sold, pledged or otherwise disposed of. Prior to the Vest Date and in the event the recipient terminates association with DNB for reasons other than death, disability or change in control, the recipient forfeits all rights to the shares that would otherwise be issued under the grant.

Share awards granted by the Plan were recorded at the date of award based on the market value of shares. Awards are being amortized to expense over a three or four year cliff-vesting period. DNB records compensation expense equal to the value of the shares being amortized. For the three and nine month periods ended September 30, 2018, \$66,000 and \$270,000 was amortized to expense. For the three and nine month periods ended September 30, 2017, \$106,000 and \$321,000 was amortized to expense.

DNB issued 3,000 restricted stock awards during the first quarter of 2016 and 26,595 restricted stock awards in December 2015 that required the award recipient to hold the shares for one additional year after vesting. These awards

cliff vest in three years. For these shares, DNB adopted the Chaffee Model to measure the fair value by applying a 9.1% discount due to the lack of marketability when these transactions took place. The input assumptions used and resulting fair values were an expected life of 5 years, volatility of 19.37%,

annual rate of quarterly dividends of 1.01%, and bond equivalent yield of 1.742%.

As of September 30, 2018, there was approximately \$373,000 in additional compensation that will be recognized over the remaining service period of approximately 1.24 years. At September 30, 2018, 308,254 shares were reserved for future grants under the Plan.

There were 8,500 restricted shares that vested during the nine months ended September 30, 2018. The shares awarded from the cashless exercises resulted in an increase in shares outstanding of 4,908 shares. There was a cash equivalent of 3,492 shares used to pay all applicable taxes on the transactions. There were no such transaction during the nine months ended September 30, 2017. Stock grant activity is indicated below:

	Shares	Weighted Average Stock Price
Non-vested stock awards—January 1, 2018	31,130	\$ 26.53
Granted	10,750	33.98
Forfeited	4,345	28.92
Vested	8,500	26.69
Non-vested stock awards—September 30, 2018	29,035	\$ 28.88

	Shares	Weighted Average Stock Price
Non-vested stock awards—January 1, 2017	55,775	\$ 25.63
Granted	500	34.00
Forfeited	230	22.92
Vested	-	-
Non-vested stock awards—September 30, 2017	56,045	\$ 25.71

NOTE 9: INCOME TAXES

As of September 30, 2018, DNB had no material unrecognized tax benefits or accrued interest and penalties. It is DNB's policy to account for interest and penalties accrued relative to unrecognized tax benefits as a component of income tax expense. Federal and state tax years 2015 through 2017 were open for examination as of September 30, 2018.

## NOTE 10: FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy based on the nature of data inputs for fair value determinations, under which DNB is required to value each asset within its scope using assumptions that market participations would utilize to value that asset. When DNB uses its own assumptions, it is required to disclose additional information about the assumptions used and the effect of the measurement on earnings or the net change in assets for the period.

The three levels of the fair value hierarchy under FASB ASC Topic 820 are as follows:

Level 1—Quoted prices in active markets for identical securities.

Level 2—Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active and model derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3—Instruments whose significant value drivers are unobservable.

A description of the valuation methodologies used for assets measured at fair value is set forth below:

DNB's available-for-sale investment securities, which generally include U.S. government agencies and mortgage backed securities, collateralized mortgage obligations, corporate bonds and equity securities are reported at fair value. These securities are valued by an independent third party ("preparer"). The preparer's evaluations are based on market data. They utilize evaluated pricing models that vary by asset and incorporate available trade, bid and other market information. For securities that do not trade on a daily basis, their evaluated pricing applications apply available information such as benchmarking and matrix pricing. The market inputs normally sought in the evaluation of securities include benchmark yields, reported trades, broker/dealer quotes (only obtained from market makers or broker/dealers recognized as market participants), issuer spreads, two-sided markets, benchmark securities, bid, offers and reference data. For certain securities additional inputs may be used or some market inputs may not be applicable. Inputs are prioritized differently on any given day based on market conditions.

U.S. Government agencies are evaluated and priced using multi dimensional relational models and option adjusted spreads. State and municipal securities are evaluated on a series of matrices including reported trades and material event notices. Mortgage backed securities are evaluated using matrix correlation to treasury or floating index benchmarks, prepayment speeds, monthly payment information and other benchmarks. Other securities are evaluated using a broker-quote based application, including quotes from issuers.

Impaired loans are those loans that the Bank has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements.

OREO assets are adjusted to fair value less estimated selling costs upon transfer of the loans to OREO establishing a new cost basis. Subsequently, OREO assets are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the

collateral. When recorded at fair value, these assets are included as Level 3 fair values.

The following tables present assets measured at fair value on a recurring basis as of September 30, 2018 and December 31, 2017:

## September 30, 2018

(Dollars in thousands)	Level 1	Level 2	Level 3	Fair Value
Assets Measured at Fair Value on a Recurring Basis				
AFS Investment Securities:				
US Government agency obligations	\$ -	\$ 49,455	\$ -	\$ 49,455
GSE mortgage-backed securities	-	27,331	-	27,331
Collateralized mortgage obligations GSE	-	9,941	-	9,941
Corporate bonds	-	10,638	-	10,638
State and municipal tax-exempt	-	1,796	-	1,796
Total	\$ -	\$ 99,161	\$ -	\$ 99,161

## Assets Measured at Fair Value on a Nonrecurring Basis

Impaired loans	\$ -	\$ -	\$ 1,891	\$ 1,891
OREO and other repossessed property	-	-	1,240	1,240
Total	\$ -	\$ -	\$ 3,131	\$ 3,131

## December 31, 2017

(Dollars in thousands)	Level 1	Level 2	Level 3	Fair Value
Assets Measured at Fair Value on a Recurring Basis				
AFS Investment Securities:				
US Government agency obligations	\$ -	\$ 52,893	\$ -	\$ 52,893
GSE mortgage-backed securities	-	32,488	-	32,488
Collateralized mortgage obligations GSE	-	11,654	-	11,654
Corporate bonds	-	12,820	-	12,820
State and municipal tax-exempt	-	1,928	-	1,928
Total	\$ -	\$ 111,783	\$ -	\$ 111,783

## Assets Measured at Fair Value on a Nonrecurring Basis

Impaired loans	\$ -	\$ -	\$ 1,814	\$ 1,814
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OREO and other repossessed property	-	-	817	817
Total	\$ -	\$ -	\$ 2,631	\$ 2,631

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The following table presents additional information about assets measured at fair value on a nonrecurring basis and for which DNB has utilized Level 3 inputs to determine fair value:

September 30, 2018

Quantitative Information about Level 3 Fair Value Measurement

(Dollars in thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
Impaired loans - Residential mortgage	\$ 73	Appraisal of collateral (1)	Appraisal adj. (2) Disposal costs (2)	0% to 0% (0%) -8% to -8% (-8%)
Impaired loans - Commercial mortgage	841	Appraisal of collateral (1)	Appraisal adj. (2) Disposal costs (2)	0% to 0% (0%) -7% to -8% (-8%)
Impaired loans - Commercial term	938	Appraisal of collateral (1)	Appraisal adj. (2) Disposal costs (2)	0% to 0% (0%) -7% to -31% (-17%)
Impaired loans - Consumer other	39	Appraisal of collateral (1)	Appraisal adj. (2) Disposal costs (2)	0% to 0% (0%) -8% to -8% (-8%)
Impaired loan total	\$ 1,891			
Other real estate owned	\$ 1,240		Disposal costs (2)	8% to 8% (-8%)
(1)				
(2)				

December 31, 2017

Quantitative Information about Level 3 Fair Value Measurement

(Dollars in thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
Impaired loans - Residential mortgage	\$ 4	Appraisal of collateral (1)	Appraisal adj. (2) Disposal costs (2)	0% to 0% (0%) -8% to -8% (-8%)
Impaired loans - Commercial mortgage	46	Appraisal of collateral (1)	Appraisal adj. (2) Disposal costs (2)	0% to 0% (0%) -8% to -8% (-8%)
Impaired loans - Commercial term	1,648	Appraisal of collateral (1)	Appraisal adj. (2) Disposal costs (2)	0% to -50% (-6%) 0% to -9% (-8%)
Impaired loans - Consumer other	116	Appraisal of collateral (1)	Appraisal adj. (2) Disposal costs (2)	0% to 0% (0%) -8% to -8% (-8%)
Impaired loan total	\$ 1,814			
Other real estate owned	\$ 817		Disposal costs (2)	-8% to -8% (-8%)

(1) Fair value is generally determined through independent appraisals or sales contracts of the underlying collateral, which generally include various level 3 inputs which are not identifiable.

(2) Appraisals are adjusted by management for qualitative factors and disposal costs.

Impaired loans. Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$8.8 million at September 30, 2018. Of this, \$1.5 million had specific valuation allowances of \$341,000, leaving a fair value of \$1.2 million as of September 30, 2018. In addition, DNB had

\$594,000 in impaired loans that were partially charged down by \$39,000, leaving \$555,000 at fair value as of September 30, 2018. The total fair value of impaired loans at September 30, 2018 was \$1.8 million. Impaired loans had a carrying amount of \$9.1 million at December 31, 2017. Of this, \$491,000 had specific valuation allowances of \$157,000, leaving a fair value of \$334,000 at December 31, 2017. In addition, DNB had \$1.9 million in impaired loans that were partially charged down by \$442,000, leaving \$1.5 million at fair value as of December 31, 2017. The total fair value of impaired loans at December 31, 2017 was \$1.8 million.

Other Real Estate Owned & other repossessed property. Other real estate owned (“OREO”) consists of properties acquired as a result of, or in-lieu-of, foreclosure. Properties or other assets are classified as OREO and other repossessed property are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying value or fair value, less estimated costs to sell. Costs relating to the development or improvement of the assets are capitalized and costs relating to holding the assets are charged to expense. DNB had \$5.1 million of such assets at September 30, 2018, \$4.9 million of which was OREO and \$224,000 was in other repossessed property. DNB had \$5.0 million of such assets at December 31, 2017, which consisted of \$4.8 million in OREO and \$177,000 in other repossessed property. DNB wrote down the carrying values of two OREO properties by \$147,000 to \$922,000 during the nine month period ended September 30, 2018. DNB wrote down the carrying value of two OREO properties by \$121,000 to \$817,000 during the nine month period ended September 30, 2017.

DNB's policy is to recognize transfer between levels as of the actual date of the event or change in circumstances that caused the transfer. There were no transfers between Level 1 and 2 for the nine months ended September 30, 2018.

Below is management's estimate of the fair value of all financial instruments, whether carried at cost or fair value on the Company's consolidated statement of financial condition. The carrying amounts and fair values of financial instruments at September 30, 2018 and December 31, 2017 are as follows:

	September 30, 2018				
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets					
Cash and cash equivalents	\$ 10,702	\$ 10,702	\$ 10,702	\$ -	\$ -
AFS investment securities	99,161	99,161	-	99,161	-
HTM investment securities	62,069	60,303	-	58,303	2,000
Restricted stock	5,864	5,864	-	5,864	-
Loans held-for-sale	-	-	-	-	-
Loans, net of allowance, including impaired	901,734	887,443	-	-	887,443
Accrued interest receivable	4,210	4,210	-	4,210	-
Financial liabilities					
Deposits:					
Non-interest-bearing	168,311	168,311	-	168,311	-
NOW, Money market, and Savings	520,500	520,500	-	520,500	-
Time	154,021	152,617	-	152,617	-
Brokered	97,049	95,391	-	95,391	-
Repurchase agreements	4,089	4,089	-	4,089	-
FHLBP advances	36,952	36,187	-	36,187	-
Junior subordinated debentures and other borrowings	9,279	9,998	-	9,998	-
Subordinated debt	9,750	9,644	-	9,644	-
Accrued interest payable	557	557	-	557	-
Off-balance sheet instruments	-	-	-	-	-

December 31, 2017

(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets					
Cash and cash equivalents	\$ 10,917	\$ 10,917	\$ 10,917	\$ -	\$ -
AFS investment securities	111,783	111,783	-	111,783	-
HTM investment securities	62,390	62,420	-	60,420	2,000
Restricted stock	7,641	7,641	-	7,641	-
Loans held-for-sale	651	657	-	-	657
Loans, net of allowance, including impaired	840,054	821,672	-	-	821,672
Accrued interest receivable	3,822	3,822	-	3,822	-
Financial liabilities					
Deposits:					
Non-interest-bearing	176,815	176,815	-	176,815	-
NOW, Money market, and Savings	502,086	502,086	-	502,086	-
Time	140,490	139,406	-	139,406	-
Brokered	41,812	42,304	-	42,304	-
Repurchase agreements	12,023	12,023	-	12,023	-
FHLBP advances	79,013	78,531	-	78,531	-
Junior subordinated debentures and other borrowings	9,279	9,373	-	9,373	-
Subordinated debt	9,750	9,577	-	9,577	-
Accrued interest payable	554	554	-	554	-
Off-balance sheet instruments	-	-	-	-	-

The specific estimation methods and assumptions used can have a substantial impact on the resulting fair values of financial instruments. Following is a brief summary of the significant assumptions, methods, and estimates used in estimating fair value.

**Limitations** Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time DNB's entire holdings of a particular financial instrument. Because no market exists for a significant portion of DNB's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of

various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

**Investment Securities** The fair value of investment securities are determined by an independent third party (“preparer”). The preparer’s evaluations are based on market data. They utilize evaluated pricing models that vary by asset and incorporate available trade, bid and other market information. For securities that do not trade on a daily basis, their evaluated pricing applications apply available information such as benchmarking and matrix pricing. The market inputs normally sought in the evaluation of securities include benchmark yields, reported trades, broker/dealer quotes (only obtained from market makers or broker/dealers recognized as market participants), issuer spreads, two-sided markets, benchmark securities, bid, offers and reference data. For certain securities additional inputs may be used or some market inputs may not be applicable. Inputs are prioritized differently on any given day based on market conditions.

U.S. Government agencies are evaluated and priced using multi dimensional relational models and option adjusted spreads. State and municipal securities are evaluated on a series of matrices including reported trades and material event notices. Mortgage backed securities are evaluated using matrix correlation to treasury or floating index benchmarks, prepayment speeds, monthly payment information and other benchmarks. Other investments are evaluated using a broker quote based application, including quotes from issuers. The carrying amount of non-readily marketable equity securities approximates liquidation value.

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

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

The fair value for non-accrual loans not based on fair value of collateral is derived through a discounted cash flow analysis, which includes the opportunity costs of carrying a non-performing asset. An estimated discount rate was used for these non-accrual loans, based on the probability of loss and the expected time to recovery.



## ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### FORWARD-LOOKING STATEMENTS

DNB Financial Corporation (the "Registrant", "Corporation" or "DNB"), may from time to time make written or oral "forward-looking statements," including statements contained in the Corporation's filings with the Securities and Exchange Commission (including this Quarterly Report on Form 10-Q and the exhibits hereto and thereto), in its reports to stockholders and in other communications by the Corporation, which are made in good faith by the Corporation pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended.

These forward-looking statements include statements with respect to the Corporation'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 Corporation's control). The words "may," "could," "should," "would," "will," "believe," "anticipate," "estimate," "expect," "intend," "plan" and similar expressions are identify forward-looking statements. The following factors, among others, could cause the Corporation'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 which the Corporation conducts operations; 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; the downgrade, and any future downgrades, in the credit rating of the U.S. Government and federal agencies; inflation, interest rate, market and monetary fluctuations; the timely development of and acceptance of new products and services of the Corporation and the perceived overall value of these products and services by users, including the features, pricing and quality compared to competitors' products and services; the willingness of users to substitute competitors' products and services for the Corporation's products and services; the success of the Corporation in gaining regulatory approval of its products and services, when required; the impact of changes in laws and regulations applicable to financial institutions (including laws concerning taxes, banking, securities and insurance); technological changes; acquisitions; changes in consumer spending and saving habits; the nature, extent, and timing of governmental actions and reforms the implementation of Basel III, which may be changed unilaterally and retroactively by legislative or regulatory actions; and the success of the Corporation at managing the risks involved in the foregoing.

The Corporation cautions that the foregoing list of important factors is not exclusive. Readers are also cautioned not to place undue reliance on these forward-looking statements, which reflect management's analysis only as of the date of this report, even if subsequently made available by the Corporation on its website or otherwise. The Corporation 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 Corporation to reflect events or circumstances occurring after the date of this report.



For a complete discussion of the assumptions, risks and uncertainties related to our business, you are encouraged to review our filings with the Securities and Exchange Commission, including this Form 10-Q, as well as any changes in risk factors or other risks that we may identify in our quarterly or other reports subsequently filed with the SEC.

## DESCRIPTION OF DNB'S BUSINESS AND BUSINESS STRATEGY

DNB Financial Corporation, a Pennsylvania business corporation, is a bank holding company registered with and supervised by the Board of Governors of the Federal Reserve System (Federal Reserve Board). The Registrant was incorporated on October 28, 1982 and commenced operations on July 1, 1983 upon consummation of the acquisition of all of the outstanding stock of Downingtown National Bank, now known as DNB First, National Association (the "Bank"). Since commencing operations, DNB's business has consisted primarily of managing and supervising the Bank, and its principal source of income has been derived from the Bank.

The Bank was organized in 1860. The Bank is a national banking association that is a member of the Federal Reserve System, the deposits of which are insured by the Federal Deposit Insurance Corporation ("FDIC"). The Bank is a full service commercial bank providing a wide range of services to individuals and small to medium sized businesses in the southeastern Pennsylvania market area, including accepting time, demand, and savings deposits and making secured and unsecured commercial, real estate and consumer loans. In addition, the Bank has fifteen (15) full service branches and a full-service wealth management group known as "DNB First Wealth Management." The Bank's financial subsidiary, DNB Financial Services, Inc., (also known as "DNB Investments & Insurance") is a Pennsylvania licensed insurance agency, which, through a third party marketing agreement with Cetera Investment Services, LLC, sells a broad variety of insurance and investment products. The Bank's other subsidiaries are Downco, Inc. and DN Acquisition Company, Inc. which were incorporated in December 1995 and December 2008, respectively, for the purpose of acquiring and holding Other Real Estate Owned acquired through foreclosure or deed in-lieu-of foreclosure, as well as Bank-occupied real estate.

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

To ensure we remain well positioned to meet the growing needs of our customers and communities and to meet the challenges of the 21st century, we've worked to build awareness of our full-service capabilities and ability to meet the needs of a wide range of customers. To that end, DNB continues to make appropriate investments in all areas of our business, including people, technology, facilities and marketing.

**Comprehensive 5-Year Plan.** During the third quarter of 2017, management updated the 5-year strategic plan that was designed to reposition its balance sheet and improve core earnings. Through the plan, management will endeavor to expand its loan portfolio through new originations, increased loan participations, as well as strategic loan and lease purchases. Management also plans to reduce the absolute level of borrowings with cash flows from existing loans and investments as well as from new core deposit growth. A discussion on DNB's Key Strategies follows:

- Focus on penetrating existing markets to maximize profitability;
- Grow loans and diversify the mix;
- Improve asset quality;
- Focus on profitable customer segments;
- Grow and diversify non-interest income, primarily wealth management, origination and sales of SBA guaranteed loans and mortgage banking;
- Continue to grow core deposits to maintain low funding costs;
- Focus on cost containment and improving operational efficiencies; and
- Continue to engage employees to help them become more effective and successful.

**Strategic Plan Update.** DNB reported net income available to common shareholders of \$3.0 million, or \$0.70 per diluted share, for the quarter ending September 30, 2018, compared with \$2.4 million, or \$0.56 per diluted share, for the same quarter, last year. For the nine months ending September 30, 2018, the Company reported net income of \$7.7 million, or \$1.78 per diluted share, compared with \$7.1 million, or \$1.66 per diluted share, for the same period last year.

- As of September 30, 2018, total assets were \$1.1 billion. Since December 31, 2017, total assets increased \$46.2 million, or 4.3% (not annualized). Total loan growth of \$62.4 million, or 7.4% (not annualized) was partially offset by a \$12.9 million, or 7.4% (not annualized) decrease in total investment securities. Total deposits increased \$78.7 million, or 9.1% (not annualized) since December 31, 2017, mainly due to growth in NOW, time, and brokered deposits. As of September 30, 2018, total shareholders' equity was \$108.1 million, compared with \$101.9 million as of December 31, 2017.
- Total loans were \$908.3 million, or 80.5% of total assets, as of September 30, 2018. As of September 30, 2018, commercial loans, a key strategic emphasis, totaled \$746.8 million and represented 82.2% of total loans. Total commercial loans increased \$57.4 million, or 8.3% (not annualized) since December 31, 2017. Of this total, commercial mortgage loans increased \$39.8 million, or 8.2%, commercial business loans increased \$11.3 million, or 8.7%, and commercial construction loans increased \$6.3 million, or 8.4%. Residential mortgage loans increased nearly 10% or \$9.1 million since January 1, 2018. Consumer loans, however, declined \$4.1 million, or 6.6%, over the same time period.

- On a sequential quarter basis, total core deposits were relatively stable and were 73.3% of total deposits as of September 30, 2018. As of the same date, non-interest bearing deposits were 17.9% of total deposits. The amount of time deposits increased \$39.3 million, or 34.2%, through the third quarter of 2018. The Company used these deposits to help fund loan growth due to their more favorable rates and maturities compared with other funding sources. As of September 30, 2018, the loan-to-deposit ratio was 96.6%.
- Asset quality remained strong as net recoveries were 0.12% (annualized) of total average loans for the quarter ending September 30, 2018. (Net charge-offs include recoveries of \$309,000). Total non-performing assets, including loans and other real estate property, were \$11.5 million as of September 30, 2018, compared with \$11.9 million as of June 30, 2018, and \$12.6 million as of December 31, 2017. The ratio of non-performing loans to total loans was 0.71% compared with 0.76% as of June 30, 2018 and 0.89% as of December 31, 2017.

DNB's most significant revenue source continues to be net interest income, defined as total interest income less total interest expense, which accounted for approximately 87% of total revenue during the second quarter of 2018. To produce net interest income and consistent earnings growth over the long-term, DNB must generate loan and deposit growth at acceptable economic spreads within its market area. To generate and grow loans and deposits, DNB must focus on a number of areas including, but not limited to, the

economy, branch expansion, sales practices, customer satisfaction and retention, competition, customer behavior, technology, product innovation and credit performance of its customers.

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

## MATERIAL CHALLENGES, RISKS AND OPPORTUNITIES

The following is a summary of material challenges, risks and opportunities DNB has faced during the nine month period ended September 30, 2018:

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

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

The largest component of DNB's total income is net interest income, and the majority of DNB's financial instruments are comprised of interest rate-sensitive assets and liabilities with various terms and maturities. The primary objective of management is to maximize net interest income while minimizing interest rate risk. Interest rate risk is derived from timing differences in the re-pricing of assets and liabilities, loan prepayments, deposit withdrawals, and differences in lending and funding rates. The ALCO actively seeks to monitor and control the mix of interest rate-sensitive assets and interest rate-sensitive liabilities. One measure of interest rate risk is net interest income simulation analysis. The ALCO utilizes simulation analysis, whereby the model estimates the variance in net interest income with a change in interest rates. Simulation model results continue to show moderate liability sensitivity to rising rates in 100, 200, 300 and 400 basis point shock scenarios over a 12 month period. Rate changes ramped in over 24 months also show moderate liability sensitivity.

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

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

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

assessments of the quality of underwriting, documentation, risk grading and charge-off procedures, as well as an assessment of the allowance for credit loss reserve analysis process.

**Competition.** In addition to the challenges related to the interest rate environment, community banks in Chester, Philadelphia and Delaware Counties have been experiencing increased competition from large regional and international banks entering DNB's marketplace through mergers and acquisitions. Competition for loans and deposits has negatively affected DNB's net interest margin. To compensate for the increased competition, DNB, along with other area community banks, has aggressively sought and marketed customers who have been disenfranchised by these mergers.

To attract these customers, DNB offers deposit products and services, such as Choice Checking relationship products, and Online Banking with bill payment, external transfer and account aggregation functionality. DNB also offers a complete package of cash management services including automated clearing house services, remote deposit, payroll services, merchant services, and account payment solutions. Our broad range of Business Checking products provides solutions to meet the needs of a variety of businesses and non-profit organizations.

**FDIC Insurance and Assessments.** The Bank's deposits are insured to applicable limits by the FDIC. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the maximum deposit insurance amount was permanently increased from \$100,000 to \$250,000.

The FDIC has adopted a risk-based premium system that provides for quarterly assessments based on an insured institution's ranking in one of four risk categories based on their examination ratings and capital ratios. Within its risk category, an institution is assigned an initial base assessment which is then adjusted to determine its final assessment rate based on its level of brokered deposits, secured liabilities and unsecured debt.

The Dodd-Frank Act required the FDIC to take such steps as necessary to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020. In setting the assessments, the FDIC is required to offset the effect of the higher reserve ratio against insured depository institutions with total consolidated assets of less than \$10 billion. The Dodd-Frank Act also broadened the base for FDIC insurance assessments so that assessments will be based on the average consolidated total assets less average tangible equity capital of a financial institution rather than on its insured deposits. The FDIC has adopted a restoration plan to increase the reserve ratio to 1.15% by September 30, 2020 with additional rulemaking scheduled regarding the method to be used to achieve a 1.35% reserve ratio by that date and offset the effect on institutions with less than \$10 billion in assets.

Pursuant to these requirements, the FDIC adopted new assessment regulations effective April 1, 2011 that redefined the assessment base as average consolidated assets less average tangible equity. Insured banks with more than \$1.0 billion in assets must calculate quarterly average assets based on daily balances while smaller banks and newly chartered banks may use weekly averages. Average assets would be reduced by goodwill and other intangibles. Average tangible equity equals Tier 1 capital. For institutions with more than \$1.0 billion in assets, average tangible equity is calculated on a weekly basis while smaller institutions may use the quarter-end balance. The base assessment rate for insured institutions in Risk Category I will range between 5 to 9 basis points and for institutions in Risk

Categories II, III, and IV will be 14, 23 and 35 basis points. An institution's assessment rate will be reduced based on the amount of its outstanding unsecured long-term debt and for institutions in Risk Categories II, III and IV may be increased based on their brokered deposits.

In addition to deposit insurance assessments, banks are subject to assessments to pay the interest on Financing Corporation bonds. The Financing Corporation was created by Congress to issue bonds to finance the resolution of failed thrift institutions. The FDIC sets the Financing Corporation assessment rate every quarter. The current annual Financing Corporation assessment rate is 32 basis points on the deposit insurance assessment base, as defined above, which we anticipate will result in an aggregate estimated FICO assessment payment by the Bank of \$35,000 in 2018.

#### Material Trends and Uncertainties.

DNB reported net income available to common shareholders of \$3.0 million, or \$0.70 per diluted share, for the quarter ending September 30, 2018, compared with \$2.4 million, or \$0.56 per share, for the same quarter, last year. For the nine months ending September 30, 2018, the Company reported net income of \$7.7 million, or \$1.78 per share, compared with \$7.1 million, or \$1.66 per share, for the same period last year.

There are many aspects of the economy and the Federal Reserve's monetary policy that influence DNB's ability to grow revenues and net income. In general, the U.S. economy is growing at a moderate pace. The unemployment rate declined by 0.2 percentage point to 3.7 percent in September, and the number of unemployed persons decreased by 270,000 to 6.0 million. Over the year, the unemployment rate and the number of unemployed persons declined by 0.5 percentage point and 795,000, respectively. The number of long-term unemployed (those jobless for 27 weeks or more) was little changed at 1.4 million over the month. In September, the labor force participation rate remained at 62.7 percent. Activity in the housing market continues at a moderate pace. Short-term interest rates are expected to continue to gradually rise. One of the most significant factors is that US economic growth is strengthening to about 3%, largely due to a substantial fiscal boost. Employment growth remains robust which, coupled with buoyant asset prices and

strong consumer confidence, is sustaining income and consumption growth. Business investment is projected to strengthen as a result of major tax reform and supportive financial conditions. A pick-up in the world economy is underpinning export growth, although tensions have emerged on how best to reduce barriers to trade.

Although the national and international economies influence DNB's Results, economic conditions in southeastern Pennsylvania are more germane, as the majority of DNB's loan and deposits relationships are with businesses and individuals within the Third Federal Reserve District. The Federal Reserve's September 12, 2018 Beige Book summarizes the economic climate which impacts DNB's operating environment.

Aggregate business activity in the Third District continued at a modest pace of growth during the September 12, 2018 Beige Book period. Likewise, employment sustained modest growth, but wages continued to grow moderately as the labor market remained tight. While manufacturers reported paying higher prices, other Federal Reserve Bank contacts reported no current shift in inflation trends, but many worried that tariffs would trigger future inflation. Nonfinancial services maintained a moderate pace of growth, but manufacturers reported a more modest pace than last period. Most consumer sectors continued at a modest pace. The construction and real estate sectors continued to issue mixed reports with declines in residential real estate sales and nonresidential construction, while contacts from new home construction and nonresidential leasing noted some growth. The growth outlook over the next six months remained positive, with over half of all firms anticipating increases in general activity.

Homebuilders reported a slight growth in new contracts but little change in construction activity. Sales of existing homes continued to decline moderately compared with the same period last year. However, as the period progressed, sales began to rise a bit in a few markets, despite ongoing low inventories.

The Federal Reserve's nonresidential real estate contacts reported that rents continued to rise in the slowly growing nonresidential real estate market, especially for offices and industrial warehouses. Higher office rents have been driven, in part, by outside investors, then partially offset by concessions, while underlying demand continued to support new construction and rising rates for warehouses. On balance, nonresidential construction activity continued to slowly wane in most markets.

Third District financial firms reported modest growth in overall loan volumes (excluding credit cards)--a slightly slower pace than during the same period last year. Volumes grew moderately in mortgages and in other consumer loans and grew modestly in commercial real estate lending and in auto loans. However, these gains were offset by slight declines in home equity lines and in commercial and industrial lending. Compared with one year earlier, loans grew modestly and in all categories except for home equity lines. During the current period, credit card lending grew at a modest pace--comparable with the same period last year for this highly seasonal measure. Credit card lending has also grown modestly over the entire year. The Federal Reserve's banking contacts noted ongoing challenges from "overly" competitive loan terms and bank deposit rates but generally cited greater business optimism and growing loan demand. The bankers also reported no signs of credit quality deterioration.

Third District manufacturing activity slowed to a modest pace of growth--nearer to non-recession averages than the moderate pace of the September 12, 2018 Beige Book period. About 35 percent of the firms reported an increase in shipments and new orders, while over 20 percent of the firms reported decreases.

The makers of lumber products, chemicals, primary metals, and fabricated metal products tended to note gains in new orders and shipments; the makers of electronic machinery and industrial machinery reported mixed results. Nearly



two-thirds of the firms that offered general comments noted that price hikes and/or supply disruptions had already occurred or were anticipated because of tariffs and the threat of tariffs. For those firms already impacted, contacts often cited double-digit price increases.

On balance, the Federal Reserve's manufacturing contacts continued to expect general activity to increase over the next six months. The percentage of firms expecting future increases edged above 50 percent; however, the percentage of firms expecting decreases also edged upward. The firms' outlook for future employment and future capital expenditures remained nearly the same, with just under 40 percent expecting increases.

These and other factors have impacted DNB's operations. We continue to focus on the consistency and stability of core earnings and balance sheet strength which are critical success factors in today's challenging economic environment.

**Regulatory Reform and Legislation.** From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of DNB in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions and other financial institutions. DNB cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on its financial condition or results of operations. A change in statutes, regulations or regulatory policies applicable to DNB or our subsidiaries could have a material effect on our business, financial condition and results of operations.

**Capital Rules.** On July 2, 2013, the Federal Reserve approved final rules that substantially amend the regulatory risk-based capital rules applicable to the Corporation and the Bank. The FDIC and the OCC have subsequently approved these rules. The final

rules were adopted following the issuance of proposed rules by the Federal Reserve in June 2012, and implement the “Basel III” regulatory capital reforms and changes required by the Dodd-Frank Act. “Basel III” refers to two consultative documents released by the Basel Committee on Banking Supervision in December 2009, the rules text released in December 2010, and loss absorbency rules issued in January 2011, which include significant changes to bank capital, leverage and liquidity requirements.

The rules include new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019, and refine the definition of what constitutes “capital” for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Corporation and the Bank under the final rules effective as of January 1, 2015: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The final rules also establish a “capital conservation buffer” above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The capital conservation buffer will be phased-in over four years beginning on January 1, 2016, as follows: the maximum buffer was 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. Under the final rules, institutions are 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 establish a maximum percentage of eligible retained income that could be utilized for such actions.

The final rules implemented revisions and clarifications consistent with Basel III regarding the various components of Tier 1 capital, including common equity, unrealized gains and losses, as well as certain instruments that no longer qualify as Tier 1 capital, some of which will be phased out over time. However, the final rules provided that small depository institution holding companies with less than \$15 billion in total assets as of December 31, 2009 (which includes the Corporation) were able to permanently include non-qualifying instruments that were issued and included in Tier 1 or Tier 2 capital prior to May 19, 2010 until they redeem such instruments or until the instruments mature.

The final rules also contained revisions to 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 are required to meet the following increased capital level requirements in order to qualify as “well capitalized:” (i) a new common equity Tier 1 capital ratio of 6.5%; (ii) a Tier 1 capital ratio of 8% (increased from 6%); (iii) a total capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (increased from 4%).

The final rules set forth certain changes for the calculation of risk-weighted assets, which have been required to be utilized since January 1, 2015. The standardized approach final rule utilizes an increased number of credit risk exposure categories and risk weights, and also addresses: (i) an alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; (iv) revised capital treatment for derivatives and repo-style transactions; and (v) disclosure requirements for top-tier banking organizations with \$50 billion or more in total assets

that are not subject to the “advance approach rules” that apply to banks with greater than \$250 billion in consolidated assets. Based on our current capital composition and levels, we believe that we are in compliance with the requirements as set forth in the final rules presently in effect.

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

## CRITICAL ACCOUNTING POLICIES

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

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the Consolidated Statements of Financial Condition, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. Amounts subject to significant estimates are items such as the allowance for credit losses and lending related commitments, the fair value of repossessed assets, pension and post-retirement obligations, the fair value of financial instruments, other-

than-temporary impairments of investment securities, the valuation of assets acquired and liabilities assumed in business combinations, and the valuations of goodwill for impairment. Among other effects, such changes could result in future impairments of investment securities, and establishment of allowances for credit losses and lending related commitments as well as increased benefit plans' expenses.

The notes to DNB's most recent Consolidated Financial Statements as set forth in DNB's Annual Report 10-K identify other significant accounting policies used in the development and presentation of its financial statements. This discussion and analysis, the significant accounting policies, and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for an understanding and evaluation of DNB and its results of operations.

## FINANCIAL CONDITION

DNB's total assets were \$1.13 billion at September 30, 2018, compared to \$1.08 billion at December 31, 2017. The \$46.2 million increase in total assets was primarily attributable to a \$61.7 million increase in net loans offset by a \$215,000 decrease in cash and cash equivalents and a \$12.9 million decrease in investment securities.

**Investment Securities.** Investment securities, including restricted stock, at September 30, 2018 were \$167.1 million, compared to \$181.8 million at December 31, 2017. The \$14.7 million decrease in investment securities and restricted stock was primarily due to \$11.4 million in principal pay-downs, calls and maturities, a \$1.8 million decrease in restricted stock, and a \$1.4 million increase in unrealized loss of the AFS portfolio.

**Gross Loans.** DNB's loans held for investment increased \$62.4 million to \$908.3 million at September 30, 2018, compared to \$845.9 million at December 31, 2017. Total commercial loans increased \$57.4 million and residential loans increased \$9.1 million, while consumer loans decreased \$4.1 million.

**Deposits.** Deposits were \$939.9 million at September 30, 2018, compared to \$861.2 million at December 31, 2017. Deposits increased \$78.7 million or 9.14% during the nine month period ended September 30, 2018. Core deposits, which are comprised of demand, NOW, money markets and savings accounts, increased by \$9.9 million, time deposits increased by \$13.5 million and brokered deposits increased by \$55.2 million.

**Borrowings.** Borrowings were \$73.6 million at September 30, 2018, compared to \$112.8 million at December 31, 2017. The decrease of \$39.2 million or 34.73% was primarily due to a \$42.1 million decrease in FHLBP advances and a \$7.9 million decrease in repurchase agreements offset by a \$10.8 million increase in other borrowings.

Stockholders' Equity. Stockholders' equity was \$108.1 million at September 30, 2018, compared to \$101.9 million at December 31, 2017. The increase in stockholders' equity was primarily a result of year-to-date earnings of \$7.7 million, sales of treasury shares totaling \$449,000, and restricted stock compensation expense of \$270,000. These additions to stockholders' equity were partially offset by other comprehensive loss of \$1.1 million, taxes on the exercise of stock options of \$266,000 and \$902,000 of dividends paid on DNB's common stock.

## RESULTS OF OPERATIONS

### SUMMARY

Net income for the three and nine month periods ended September 30, 2018 was \$3.0 million and \$7.7 million, respectively, compared to \$2.4 million and \$7.1 million for the same periods in 2017. Diluted earnings per share for the three and nine month periods ended September 30, 2018 was \$0.70 and \$1.78, compared to \$0.56 and \$1.66 for the same periods in 2017. The \$609,000 increase in net income in the third quarter of 2018 compared to the third quarter of 2017 was primarily attributable to a \$372,000 decrease in income tax expense (primarily due to a decreased effective tax rate as a result of the Tax Cuts and Jobs Act of 2017), a \$275,000 decrease in provision for credit losses, a \$217,000 decrease in non-interest expense (primarily due to decreased salaries and employee benefits expense), and a \$100,000 increase in non-interest income (primarily due to increased wealth management income), offset by a \$355,000 decrease in net interest income before provision (primarily due to increased interest expense on deposits). The \$544,000 increase in net income during the nine month period ended September 30, 2018 compared to the nine month period ended September 30, 2017 was primarily attributable to a \$1.1 million decrease in income tax expense (primarily due to a decreased effective tax rate as a result of the Tax Cuts and Jobs Act of 2017) and a \$435,000 decrease in provision for credit losses, offset by a \$771,000 decrease in net interest income before provision (primarily due to increased interest expense on deposits), a \$224,000 increase in non-interest expense (primarily due to increased salary and employee benefits expense from a previously disclosed one-time internal restructuring expense), and a \$23,000 decrease in non-interest income (primarily due to decreases in gains on sale of loans and service charges on deposits).

### NET INTEREST INCOME

DNB's earnings performance is primarily dependent upon its level of net interest income, which is the excess of interest income over interest expense. Interest income includes interest earned on loans, investments and federal funds sold and interest-earning cash,

as well as loan fees and dividend income earned on investment securities. Interest expense includes interest on deposits, Federal Home Loan Bank of Pittsburgh ("FHLBP") advances, repurchase agreements, Federal funds purchased, subordinated debentures and notes, and other borrowings.

Net interest income for the three and nine month periods ended September 30, 2018 was \$9.2 million and \$27.2 million, compared to \$9.5 million and \$28.0 million for the same periods in 2017. Interest income for the three and nine month periods ended September 30, 2018 was \$11.6 million and \$33.8 million, compared to \$11.0 million and \$32.1 million for the same periods in 2017. The \$646,000 increase in interest income in the third quarter of 2018, compared to the third quarter of 2017, was primarily due to increases of \$594,000 in interest and fees on loans and \$16,000 in interest and dividends on investment securities and \$36,000 in interest on cash and cash equivalents. The \$1.7 million increase in interest income in the nine month period ended September 30, 2018, compared to the nine month period ended September 30, 2017, was primarily due to increases of \$1.5 million in interest and fees on loans and \$174,000 in interest and dividends on investment securities, offset by a decrease of \$26,000 in interest on cash and cash equivalents. The weighted average yield on total interest-earning assets was 4.30% and 4.28% for the three and nine month periods ended September 30, 2018, compared to 4.30% and 4.20% for the same periods in 2017. Interest expense for the three and nine month periods ended September 30, 2018 was \$2.5 million and \$6.6 million, compared to \$1.5 million and \$4.1 million for the same periods in 2017. The \$1.0 million increase in interest expense in the third quarter of 2018, compared to the third quarter of 2017, was primarily due to increases of \$961,000 in interest on deposits and \$40,000 in interest on borrowings. The \$2.5 million increase in interest expense in the nine month period ended September 30, 2018, compared to the nine month period ended September 30, 2017, was primarily due to increases of \$2.2 million in interest on deposits and \$280,000 in interest on borrowings. The composite cost of funds for the three and nine month periods ended September 30, 2018 was 0.98% and 0.88%, compared to 0.61% and 0.57% for the same periods in 2017.

Interest on loans was \$10.6 million and \$30.6 million for the three and nine month periods ended September 30, 2018, compared to \$10.0 million and \$29.1 million for the same periods in 2017. The average balance of loans was \$889.1 million, with a tax equivalent average yield of 4.74% (a non-GAAP measure) for the third quarter of 2018, compared to \$818.8 million, with a tax equivalent average yield of 4.82% (a non-GAAP measure) for the same period in 2017.

The average balance of loans was \$870.1 million, with a tax equivalent average yield of 4.72% (a non-GAAP measure) for the nine month period ended September 30, 2018, compared to \$817.0 million, with a tax equivalent average yield of 4.73% (a non-GAAP measure) for the same period in 2017. See the following table for a reconciliation of the non-GAAP measure "tax equivalent average yield on loans."

#### Tax equivalent average yield on loans (Non-GAAP)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2018	2017	2018	2017
Interest and fees on loans (GAAP)	\$ 10,588	\$ 9,994	\$ 30,634	\$ 29,089
Tax adjustment	26	59	85	191
Tax equivalent interest and fees on loans (Non-GAAP)	\$ 10,614	\$ 10,053	\$ 30,719	\$ 29,280

Average balance of loans	\$ 889,113		\$ 818,800		\$ 870,105		\$ 817,006	
Tax equivalent average yield on loans (Non-GAAP)	4.74	%	4.82	%	4.72	%	4.73	%

Interest and dividends on investment securities was \$973,000 and \$3.1 million for the three and nine month periods ended September 30, 2018, compared to \$957,000 and \$2.9 million for the same periods in 2017. The average balance of investment securities was \$173.1 million with a tax equivalent average yield of 2.37% (a non-GAAP measure) for the third quarter of 2018, compared to \$184.1 million with a tax equivalent average yield of 2.33% (a non-GAAP measure) for the same period in 2017. The average balance of investment securities was \$178.1 million with a tax equivalent average yield of 2.43% (a non-GAAP measure) for the nine month period ended September 30, 2018, compared to \$184.9 million with a tax equivalent average yield of 2.37% (a non-GAAP measure) for the same period in 2017. See the following table for a reconciliation of the non-GAAP measure “tax equivalent average yield on investment securities.”

Tax equivalent average yield on investment securities (Non-GAAP)

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Interest on tax exempt investment securities (GAAP)	\$ 973	\$ 957	\$ 3,063	\$ 2,889
Tax adjustment	52	115	168	361
Tax equivalent interest on tax-exempt investment securities (Non-GAAP)	\$ 1,025	\$ 1,072	\$ 3,231	\$ 3,250
Average balance of investment securities	\$ 173,080	\$ 184,089	\$ 178,091	\$ 184,875
Tax equivalent average yield on investment securities (Non-GAAP)	2.37	% 2.33	% 2.43	% 2.37

Interest on deposits was \$2.0 million and \$5.1 million for the three and nine month periods ended September 30, 2018, compared to \$1.1 million and \$2.9 million for the same periods in 2017. The average balance of deposits was \$935.7 million, with an average rate of 0.86% for the third quarter of 2018, compared to \$872.9 million, with an average rate of 0.49% for the same period in 2017. The average balance of deposits was \$905.7 million, with an average rate of 0.75% for the nine month period ended September 30, 2018, compared to \$886.6 million, with an average rate of 0.44% for the same period in 2017. The increases in average rate were attributable to a 75 basis points increase in the federal funds rate, which has impacted the rates DNB pays on the majority of interest-bearing deposit accounts.

Interest on borrowings was \$450,000 and \$1.5 million for the three and nine month periods ended September 30, 2018, compared to \$410,000 and \$1.2 million for the same periods in 2017. The average balance of borrowings was \$73.0 million, with an average rate of 2.45% for the third quarter of 2018, compared to \$86.6 million, with an average rate of 1.88% for the same period in 2017. The average balance of borrowings was \$89.4 million, with an average rate of 2.18% for the nine month period ended September 30, 2018, compared to \$85.7 million, with an average rate of 1.84% for the same period in 2017.

#### PROVISION FOR CREDIT LOSSES

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

Management reviews and establishes the adequacy of the allowance for credit losses in accordance with U.S. generally accepted accounting principles, guidance provided by the Securities and Exchange Commission and as prescribed in OCC Bulletin 2006-47. Its methodology for assessing the appropriateness of the allowance consists of several key elements which include: specific allowances for identified impaired loans; and allowances by loan type for pooled homogenous loans. In considering national and local economic trends, we review a variety of information including Federal Reserve publications, general economic statistics, foreclosure rates and housing statistics published by third parties. We believe this improves the measure of inherent loss over a complete economic cycle and reduces the impact for qualitative adjustments. The unallocated portion of the allowance is intended to provide for probable losses not otherwise accounted for in management's other elements of its overall estimate. An unallocated component is maintained to cover uncertainties such as changes in the national and local economy, concentrations of credit, expansion into new markets and other factors 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.

In addition, DNB reviews historical loss experience for the residential mortgage, commercial mortgage, commercial term, commercial construction, home equity and consumer installment loan pools to determine a historical loss factor.



The historical loss factors are then applied to the current portfolio balances to determine the required reserve percentage for each loan pool. A historical loss ratio is determined for each group over a five year period. The five year average loss ratio by type is then used to calculate the estimated loss based on the current balance of each group. This five year time period is appropriate given DNB's historical level of losses and, more importantly, represents the current economic environment.

This analysis is intended to assess the potential for loss within the loan portfolio and to substantiate the adequacy of the allowance. Should the analysis indicate that the allowance is not adequate, management will recommend a provision expense be made in an amount equal to the shortfall derived. In establishing and reviewing the allowance for adequacy, emphasis has been placed on utilizing the methodology prescribed in OCC Bulletin 2006-47. Management believes that the following factors create a comprehensive system of controls in which management can monitor the quality of the loan portfolio. Consideration has been given to the following factors and variables which may influence the risk of loss within the loan portfolio:

- Changes in the nature and volume of the portfolio and in the terms of loans;
- Changes in the volume and severity of past due loans, the volume of non-accrual loans, and the volume and severity of adversely classified or graded loans;
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations;
- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses;
  - Changes in the experience, ability, and depth of lending management and other relevant staff;
- Changes in loan review methodology and degree of oversight by DNB's Board of Directors;
- Changes in international, national, regional, and local economic and business conditions and developments that affect the collectability of the portfolio, including the condition of various market segments;

- The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's existing portfolio; and
- Changes in the value of underlying collateral for collateral dependent loans.

Portfolio risk includes the levels and trends in delinquencies, impaired loans, changes in the loan rating matrix and trends in volume and terms of loans. Management is satisfied with the stability of the past due and non-performing loans and believes there has been no further decline in the quality of the loan portfolio due to any trend in delinquent or adversely classified loans. New appraisal values we have obtained for existing loans have generally been consistent with trends indicated by Case-Schiller and other indices.

DNB closely monitors the loan to value ratios of all classified assets and requires periodic current appraisals to monitor underlying collateral values. Management also reviews borrower, sponsorship and guarantor's financial strength along with their ability and willingness to provide financial support of their obligations on an immediate and continuing basis.

There was a \$100,000 and \$850,000 provision made during the three and nine month periods ended September 30, 2018, compared to \$375,000 and \$1.3 million for the same periods in 2017. DNB's percentage of allowance for credit losses to total loans was 0.72% at September 30, 2018 compared to 0.69% and 0.68% at December 31, 2017 and September 30, 2017, respectively. Net charge-offs were \$135,000, \$1.2 million, and \$1.1 million during the nine months ended September 30, 2018, year ended December 31, 2017, and nine months ended September 30, 2017, respectively. The percentage of net charge-offs to total average loans were 0.02%, 0.15%, and 0.13% for those same respective periods. Management believes that the allowance for credit losses is adequate, but continues to monitor it along with other performance metrics including those ratios related to non-performing loans. Management is not aware of any potential problem loans, which were accruing and current at September 30, 2018, where serious doubt exists as to the ability of the borrower to comply with the present repayment terms and that would result in a significant loss to DNB. Non-performing loans decreased \$1.1 million during the nine month period ended September 30, 2018. The ratio of the allowance for credit losses as a percentage of loans reflects management's estimate of the level of inherent losses in the portfolio.

We typically establish a general valuation allowance on classified loans which are not individually impaired. In establishing the general valuation allowance, we segregate these loans by category. The categories used by DNB include "doubtful," "substandard," "special mention," "watch list" and "pass." For commercial mortgage, commercial and construction loans, the determination of the category for each loan is based on periodic reviews of each loan by our lending and credit officers as well as an independent, third-party consultant. The reviews include a consideration of such factors as recent payment history, current financial data, cash flow, financial projections, collateral evaluations, guarantor or sponsorship financial strength and current economic and business conditions. Categories for residential mortgage and consumer loans are determined through a similar review. Classification of a loan within a category is based on identified weaknesses that increase the credit risk of loss on the loan. Each category carries a loss factor for the allowance percentage to be assigned to the loans within that category. The allowance percentage, is determined based on inherent losses associated with each type of lending as determined through consideration of our loss history with each type of loan, trends in credit quality and collateral values, and an evaluation of current economic and business conditions.

We establish a general allowance on non-classified loans to recognize the inherent losses associated with lending activities, but which, unlike specific allowances, have not been allocated to particular problem loans. This general valuation allowance is determined by segregating the loans by loan category and assigning allowance percentages to each category. An evaluation of each category is made to determine the need to further segregate the loans within each category by type. For our residential mortgage and consumer loan portfolios, we identify similar characteristics

throughout the portfolio including credit scores, loan-to-value ratios and collateral. For our commercial mortgage and construction loan portfolios, a further analysis is made in which we segregated the loans by type based on the purpose of the loan and the collateral properties securing the loan. Various risk factors for each type of loan are considered, including the impact of general economic and business conditions, collateral value trends, credit quality trends and historical loss experience.

As of September 30, 2018, DNB had \$11.5 million of non-performing assets, which included \$6.5 million of non-performing loans and \$5.1 million of OREO and other repossessed assets. This compares to \$12.6 million of non-performing assets at December 31, 2017 which included \$7.6 million of non-performing loans and \$5.0 million of OREO and other repossessed assets. Loans are reviewed for impairment in accordance with FASB ASC 310-10-35. Impaired loans can either be secured or unsecured, not including large groups of smaller balance loans that are collectively evaluated. Impairment is measured by the difference between the loan amount and the present value of the future cash flow discounted at the loan's effective interest rate. Management measures loans for impairment by using the fair value of collateral for collateral dependent loans. In general, management reduces the amount of the appraisal by the estimated cost of acquisition and disposition of the underlying collateral and compares that adjusted value with DNB's carrying value. DNB establishes a specific valuation allowance on impaired loans that have a collateral shortfall and/or cashflow shortfalls, including estimated costs to sell in comparison to the carrying value of the loan. Of the \$8.8 million of impaired loans (\$6.5 million of non-performing loans, \$1.8 million of performing TDRs, and a \$521,000 performing ASC 310-30 loan) at September 30, 2018, \$1.5 million had valuation allowances of \$341,000 and \$7.3 million had no specific allowance. Of the \$9.1 million of impaired loans (\$7.6 million of non-performing loans, \$1.0 million of performing TDRs, and a \$520,000 performing ASC 310-30 loan) at December 31, 2017, \$491,000 had valuation allowances of \$157,000 and \$8.6 million had no specific allowance. For those impaired loans that management determined that no specific valuation allowance was necessary, management has reviewed the present value of the future cash flows or the appraisal for each loan and determined that no valuation was necessary. During the quarter ended September 30, 2018, DNB

recognized \$38,000 in total charge-offs, \$23,000 of which related to impaired loans. An impaired loan may not represent an expected loss.

We typically order new third-party appraisals or collateral valuations when a loan becomes impaired or is transferred to OREO. This is done within two weeks of a loan becoming impaired or a loan moving to OREO. It generally takes two to eight weeks to receive the appraisals, depending on the type of property being appraised. We recognize any provision or related charge-off within two weeks of receiving the appraisal, after the appraisal has been reviewed by DNB. We generally order a new appraisal for all impaired real estate loans having a balance of \$250,000 or higher, every twelve to twenty-four months, dependent upon management's assessment of trends in relevant markets and property types. We use updated valuations when time constraints do not permit a full appraisal process, to reflect rapidly changing market conditions. Because appraisals and updated valuations utilize historical data in reaching valuation conclusions, the appraised or updated value may or may not reflect the actual sales price that we will receive at the time of sale. Management uses the qualitative factor "Changes in the value of underlying collateral for collateral-dependent loans" to calculate any required reserve to mitigate this risk.

Real estate appraisals typically include up to three approaches to value: the sales comparison approach, the income approach (for income-producing property) and the cost approach. Not all appraisals utilize all three approaches to value. Depending on the nature of the collateral and market conditions, the appraiser may emphasize one approach over another in determining the fair value of collateral.

Appraisals may also contain different estimates of value based on the level of occupancy or future improvements. "As-is" valuations represent an estimate of value based on current market conditions with no changes to the collateral's use or condition. "As-stabilized" or "as-completed" valuations assume that the collateral is improved to a stated standard or achieves its highest and best use in terms of occupancy. "As-stabilized" valuations may be subject to a present value adjustment for market conditions or the schedule for improvements.

In connection with the valuation process, we will typically develop an exit strategy for the collateral by assessing overall market conditions, the current condition and use of the asset and its highest and best use. For most income-producing real estate, investors value most highly a stable income stream from the asset; consequently, we conduct a comparative evaluation to determine whether conducting a sale on an "as-is" basis or on an "as-stabilized" basis is most likely to produce the highest net realizable value and compare these values with the costs incurred and the holding period necessary to achieve the "as stabilized" value.

Our estimates of the net realizable value of collateral include a deduction for the expected costs to sell the collateral or such other deductions as deemed appropriate. For most real estate collateral, we apply a seven to ten percent deduction to the value of real estate collateral to determine our expected costs to sell the asset.

## Analysis of Allowance for Credit Losses

(Dollars in thousands)

	Nine Months Ended September 30, 2018	Year Ended December 31, 2017	Nine Months Ended September 30, 2017
Beginning balance	\$ 5,843	\$ 5,373	\$ 5,373
Provisions	850	1,660	1,285
Loans charged off:			
Residential mortgage	(137)	(85)	-
Commercial mortgage	(184)	(519)	(519)
Commercial:			
Commercial term	(79)	(683)	(610)
Commercial construction	-	-	-
Lease financing	-	-	-
Consumer:			
Home equity	-	-	-
Other	(72)	(38)	(10)
Total charged off	(472)	(1,325)	(1,139)
Recoveries:			
Residential mortgage	334	16	2
Commercial mortgage	-	51	50
Commercial:			
Commercial term	2	23	20
Commercial construction	-	42	-
Lease financing	-	1	1
Consumer:			
Home Equity	-	-	-
Other	2	2	2
Total recoveries	338	135	75
Ending balance	\$ 6,559	\$ 5,843	\$ 5,594

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

## Composition of Allowance for Credit Losses

(Dollars in thousands)

	September 30, 2018			December 31, 2017			September 30, 2017		
	Percent of Loan Type to Total			Percent of Loan Type to Total			Percent of Loan Type to Total		
	Amount	Loans		Amount	Loans		Amount	Loans	
Residential mortgage	\$ 163	11 %		\$ 221	11 %		\$ 246	11 %	
Commercial mortgage	3,289	58		2,856	57		2,798	56	
Commercial:									
Commercial term	987	15		845	15		648	15	
Commercial construction	1,068	9		1,128	9		1,106	10	
Consumer:									
Home equity	196	6		183	7		186	7	
Other	48	1		63	1		81	1	
Unallocated	808	-		547	-		529	-	
Total	\$ 6,559	100 %		\$ 5,843	100 %		\$ 5,594	100 %	
Reserve for unfunded loan commitments	\$ 386			\$ 348			\$ 309		

## NON-INTEREST INCOME

Non-interest income includes service charges on deposit products; fees received in connection with the sale of non-depository products and services, including fiduciary and investment advisory services offered through DNB First Investment Management and Trust; securities brokerage products and services and insurance products and services offered through DNB Investments & Insurance; and other sources of income such as increases in the cash surrender value of Bank Owned Life Insurance (“BOLI”), net gains on sales of investment securities, mortgage loans, SBA loans and OREO properties. In addition, DNB receives fees for cash management, mortgage banking, remote capture, merchant services, debit cards, safe deposit box rentals and similar activities.

Non-interest income for the three and nine month periods ended September 30, 2018 was \$1.4 million and \$4.0 million,

compared to \$1.3 million and \$4.0 million for the same periods in 2017. The \$100,000 increase during the three months ended September 30, 2018 was mainly attributable to increases of \$131,000 in wealth management and \$8,000 in gains from insurance proceeds. These increases were offset by decreases of \$16,000 in other fees (mostly servicing fees), \$8,000 in service charges (mostly NSF fees), \$8,000 in gain on sale of loans, and \$6,000 in mortgage banking. The \$23,000 decrease during the nine months ended September 30, 2018 was mainly attributable to decreases of \$95,000 in gain on sale of loans, \$88,000 in service charges (mostly NSF fees), \$72,000 in gains from insurance proceeds, \$50,000 in other fees (mostly servicing fees), \$25,000 in gain on sale of investment securities, and \$7,000 in increase in cash surrender value of BOLI. These decreases were offset by increases of \$233,000 in wealth management and \$81,000 in mortgage banking.

## NON-INTEREST EXPENSE

Non-interest expense for the three and nine month periods ended September 30, 2018 was \$6.8 million and \$21.0 million, compared to \$7.0 million and \$20.8 million for the same periods in 2017. During the three months ended September 30, 2018, total non-interest expense decreased by \$217,000. The decrease was primarily due to decreases of \$217,000 in salaries and employee benefits (primarily due to open positions), \$101,000 in other expenses (mostly decreased OREO expenses), and \$38,000 in FDIC insurance (assessment rate decreased due to improved leverage ratio and increase in income over the last 12 months). These decreases were partially offset by increases of \$47,000 in advertising and marketing, \$39,000 in furniture and equipment (increased maintenance agreement expenses), \$25,000 in occupancy (mostly office building security expenses), and \$23,000 in PA shares tax. During the nine months ended September 30, 2018, total non-interest expense increased by \$224,000. The increase was primarily due to increases of \$451,000 in salary and employee benefits (compensation expense for the second quarter of 2018 included a one-time severance payment of \$434,000 and other related costs of \$79,000 associated with an internal restructuring), \$77,000 in furniture and equipment (increased maintenance agreement expenses), \$50,000 in PA shares tax, and \$30,000 in loss on sale or write down of OREO. These increases were partially offset by decreases of \$143,000 in FDIC insurance (assessment rate decreased due to improved leverage ratio and increase in income over the last 12 months), \$104,000 in other expenses (mostly decreased OREO expenses), \$77,000 in due diligence and merger expense (no expense in 2018), \$23,000 in professional and consulting (mostly decreased audit and accounting fees and consulting fees), \$19,000 in occupancy (mostly repairs and maintenance), \$11,000 in telecommunications, and \$7,000 in advertising and marketing.

## INCOME TAXES

Income tax expense for the three and nine month periods ended September 30, 2018 was \$629,000 and \$1.6 million, respectively, compared to \$1.0 million and \$2.8 million for the same periods in 2017. The effective tax rate for the three and nine month periods ended September 30, 2018 was 17.2% and 17.7% compared to 29.3% and 28.0% for the same periods in 2017. The decrease in effective tax rate was mainly attributable to adoption of the Tax Cuts and Jobs Act of 2017 which reduced the statutory rate from 34% to 21%. Income tax expense for each period differs from the amount determined at the statutory rate, due to tax-exempt income on loans and investment securities and DNB's ownership of BOLI policies.

## ASSET QUALITY

DNB works diligently to improve asset quality by adhering to strict underwriting standards and improving lending policies and procedures. Non-performing assets totaled \$11.5 million at September 30, 2018 compared to \$12.6 million at December 31, 2017 and \$12.0 million at September 30, 2017. Loans acquired in connection with the purchase of ERB have been recorded at fair value, in accordance with GAAP, and are based on an initial estimate of the expected cash flows, including a reduction for estimated credit losses, and without carryover of the respective portfolio's historical allowance for credit losses. DNB will continually evaluate the loans acquired from ERB for additional impairment as part of our normal allowance review process. Non-performing assets have, and will continue to have, an impact on earnings; therefore management intends to continue working aggressively to reduce the level of such assets.

Non-performing assets are comprised of non-accrual loans, loans delinquent over ninety days and still accruing, as well as OREO and other repossessed assets. Non-accrual loans are loans for which the accrual of interest ceases when the collection of principal or interest payments is determined to be doubtful by management. It is the policy of DNB to discontinue the accrual of interest when principal or interest payments are delinquent 90 days or more (unless the loan principal and interest are determined by management to be fully secured and in the process of collection), or earlier if considered prudent. Interest received on such loans is applied to the principal balance, or may, in some instances, be recognized as income on a cash basis. A non-accrual loan may be restored to accrual status when management expects to collect all contractual principal and interest due and the borrower has demonstrated a sustained period of repayment performance in accordance with the contractual terms. OREO consists of real estate acquired by foreclosure or deed-in-lieu of foreclosure. Other repossessed assets are primarily assets from DNB's consumer purchased chattel portfolio that were repossessed. OREO and other repossessed assets are carried at the lower of carrying value or estimated fair value, less estimated disposition costs. Any significant change in the level of non-performing assets is dependent, to a large extent, on the economic climate within DNB's market area.

DNB's Credit Policy Committee monitors the performance of the loan portfolio to identify potential problem assets on a timely basis. Committee members meet to design, implement and review asset recovery strategies, which serve to maximize the recovery of each troubled asset. As of September 30, 2018, DNB had \$10.7 million of substandard loans. Of the \$10.7 million, \$3.7 million are performing and are believed to require supervision and review greater than loans rated pass or special mention; and may, depending on the economic environment and other factors, become non-performing assets in future periods. The amount of performing substandard loans at December 31, 2017 was \$4.5 million. DNB had \$6.1 million of special mention loans at September 30, 2018 compared to \$240,000 at



December 31, 2017. The increase in special mention loans during the nine months ended September 30, 2018 was primarily due to rating downgrades in the portfolio, specifically \$3.6 million of commercial construction loans, \$1.8 million of commercial mortgages, \$231,000 in commercial term loans, and \$144,000 in home equity loans. The majority of the loans are secured by commercial real estate, with lesser amounts being secured by residential real estate, inventory and receivables.

The following table sets forth those assets that are: (i) placed on non-accrual status, (ii) contractually delinquent by 90 days or more and still accruing, and (iii) OREO as a result of foreclosure or voluntary transfer to DNB as well as other repossessed assets. In addition, the table sets forth DNB's asset quality and allowance coverage ratios at the dates indicated:

# Non-Performing Assets

(Dollars in thousands)

	September 30, 2018	December 31, 2017	September 30, 2017
Non-accrual loans:			
Residential mortgage	\$ 1,005	\$ 1,915	\$ 2,070
Commercial mortgage	1,561	2,259	2,311
Commercial:			
Commercial term	2,624	2,100	1,506
Commercial construction	479	514	447
Consumer:			
Home equity	631	466	468
Other	171	245	308
Total non-accrual loans	6,471	7,499	7,110
Loans 90 days past due and still accruing	-	54	-
Total non-performing loans	6,471	7,553	7,110
Other real estate owned & other repossessed property	5,077	5,012	4,916
Total non-performing assets	\$ 11,548	\$ 12,565	\$ 12,026
Asset quality ratios:			
Non-performing loans to total loans	0.71 %	0.89 %	0.87 %
Non-performing assets to total assets	1.02	1.16	1.13
Allowance for credit losses to:			
Total loans	0.72	0.69	0.68
Non-performing loans	101.4	77.4	78.7

Troubled Debt Restructurings Loans whose terms are modified are classified as troubled debt restructurings ("TDR") if DNB grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate or an extension of a loan's stated maturity date. Non-accrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired. The recorded investments in troubled debt restructured loans at September 30, 2018 and December 31, 2017 are as follows:

(Dollars in thousands)	September 30, 2018		
	Pre-Modification	Post-Modification	Recorded Investment
	Outstanding	Outstanding	
	Recorded Investment	Recorded Investment	
Residential mortgage	\$ 676	\$ 805	\$ 643
Commercial mortgage	992	992	967
Consumer:			
Home equity	148	148	141
Other	40	42	30
Total	\$ 1,856	\$ 1,987	\$ 1,781

(Dollars in thousands)	December 31, 2017		
	Pre-Modification	Post-Modification	Recorded Investment
	Outstanding	Outstanding	
	Recorded Investment	Recorded Investment	
Residential mortgage	\$ 603	\$ 732	\$ 690
Commercial mortgage	992	992	982
Consumer:			
Home equity	148	148	146
Other	40	42	39
Total	\$ 1,783	\$ 1,914	\$ 1,857

At September 30, 2018, DNB had nine TDRs with recorded investment totaling \$1,781,000, all of which are accruing loans in compliance with the terms of the modifications. As a result of collateral evaluations, specific reserves and charge-offs have been taken where appropriate. DNB recognized partial charge-offs totaling \$151,000 on two residential loans prior to their restructuring and \$2,000 on one consumer installment loan after its restructuring. As of September 30, 2018, there were no defaulted TDRs as all TDRs were

current with respect to their associated forbearance agreements. There were no defaults on TDRs during the nine months ended September 30, 2018.

At December 31, 2017, DNB had eight TDRs with recorded investment totaling \$1,857,000, five of which, totaling \$1,128,000, were accruing loans in compliance with the terms of the modifications. The remaining \$729,000 represents three loans that were nonaccrual impaired loans and resulted in collateral evaluations. As a result of the evaluations, specific reserves and charge-offs have been taken where appropriate. As of December 31, 2017, DNB recognized partial charge-offs totaling \$151,000 on two residential loans prior to their restructuring and \$2,000 on one consumer installment loan after its restructuring. As of December 31, 2017, there were no defaulted TDRs as all TDRs were current with respect to their associated forbearance agreements. There were no defaults on TDRs within twelve months of restructure during 2017. DNB classified three commercial mortgage loans totaling \$992,000 as TDRs during the year ended December 31, 2017.

Impaired loans are measured for impairment using the fair value of the collateral for collateral dependent loans. Information regarding impaired loans is presented as follows:

	At and For the Nine Months Ended September 30, 2018	At and For the Year Ended December 31, 2017	At and For the Nine Months Ended September 30, 2017
(Dollars in thousands)			
Total recorded investment	\$ 8,772	\$ 9,130	\$ 8,776
Impaired loans with a specific allowance	1,495	491	367
Impaired loans without a specific allowance	7,277	8,639	8,409
Average recorded investment	9,313	8,373	8,184
Specific allowance allocation	341	157	95
Total principal and interest collected	526	1,409	427
Interest income recorded	80	24	10

## LIQUIDITY AND CAPITAL RESOURCES

Management maintains liquidity to meet depositors' needs for funds, to satisfy or fund loan commitments, and for other operating purposes. DNB's foundation for liquidity is a stable and loyal customer deposit base, cash and cash equivalents, and a marketable investment portfolio that provides periodic cash flow through regular maturities and amortization, or that can be used as collateral to secure funding. As part of its liquidity management, DNB maintains assets that comprise its liquidity, which totaled \$96.5 million at September 30, 2018 compared to \$109.3 million at

December 31, 2017. Liquidity includes investments and restricted stock, Federal funds sold and cash and due from banks, less the amount of securities required to be pledged for certain liabilities. DNB also anticipates scheduled payments and prepayments on its loan and mortgage-backed securities portfolios.

In addition, DNB maintains borrowing arrangements with various correspondent banks, the Federal Home Loan Bank of Pittsburgh and the Federal Reserve Bank of Philadelphia to meet short-term liquidity needs. Through these relationships, DNB had available credit of approximately \$558.6 million at September 30, 2018. As a member of the FHLB, we are eligible to borrow up to a specific credit limit which is determined by the amount of our residential mortgages, commercial mortgages and other loans that have been pledged as collateral. As of September 30, 2018, DNB's Maximum Borrowing Capacity with the FHLBP was \$498.6 million. At September 30, 2018, DNB had borrowed \$37.0 million and the FHLB had issued letters of credit, on DNB's behalf, totaling \$40.0 million against its available credit lines. At September 30, 2018, DNB also had available \$60.0 million of unsecured federal funds lines of credit with other financial institutions as well as \$485.0 million of available short or long term funding through several agreements and programs with brokers. Management believes that DNB has adequate resources to meet its short-term and long-term funding requirements.

At September 30, 2018, DNB had \$187.0 million in un-funded loan commitments. Management anticipates these commitments will be funded by means of normal cash flows. Certificates of deposit greater than or equal to \$250,000 scheduled to mature in one year or less from September 30, 2018 totaled \$38.0 million. Management believes that the majority of such deposits will be reinvested with DNB and that certificates that are not renewed will be funded by a reduction in cash and cash equivalents or by pay-downs and maturities of loans and investments.

The Bank has met the definition of "well capitalized" for regulatory purposes on September 30, 2018. The Bank's capital category is determined for the purposes of applying the bank regulators' "prompt corrective action" regulations and for determining levels of deposit insurance assessments and may not constitute an accurate representation of the Corporation's or the Bank's overall financial condition or prospects. The Corporation's capital exceeds the FRB's minimum leverage ratio requirements for bank holding companies and meets other requirements to be considered "well capitalized" (see additional discussion included in Note 18 of DNB's December 31, 2017 Form 10-K).

Under federal banking laws and regulations, DNB and the Bank are required to maintain minimum capital as determined by certain regulatory ratios. Capital adequacy for regulatory purposes, and the capital category assigned to an institution by its regulators,

may be determinative of an institution's overall financial condition. Under the final capital rules that became effective on January 1, 2015, there was a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. DNB must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% to 2.50% by 2019. The capital conservation buffer is 1.875% and 1.25% for 2018 and 2017, respectively.

The following table summarizes data and ratios pertaining to the Corporation and the Bank's capital structure.

	Actual		For Capital Adequacy Purposes*			To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio		Amount	Ratio
(Dollars in thousands)							
DNB Financial Corporation							
September 30, 2018							
Total risk-based capital	\$ 121,842	13.83 %	\$ 70,492	8.00 %		N/A	N/A
Common Equity Tier 1 capital	96,147	10.91	39,652	4.50		N/A	N/A
Tier 1 risk-based capital	105,147	11.93	52,869	6.00		N/A	N/A
Tier 1 (leverage) capital	105,147	9.48	44,374	4.00		N/A	N/A
December 31, 2017							
Total risk-based capital	\$ 113,400	13.73 %	\$ 66,083	8.00 %		N/A	N/A
Common equity tier 1 capital	88,459	10.71	37,172	4.50		N/A	N/A
Tier 1 risk-based capital	97,459	11.80	49,562	6.00		N/A	N/A
Tier 1 (leverage) capital	97,459	9.19	42,426	4.00		N/A	N/A
DNB First, N.A.							
September 30, 2018							
Total risk-based capital	\$ 120,275	13.68 %	\$ 70,354	8.00 %	\$ 87,942	10.00 %	
Common Equity Tier 1 capital	113,330	12.89	39,574	4.50	57,163	6.50	
Tier 1 risk-based capital	113,330	12.89	52,765	6.00	70,354	8.00	
Tier 1 (leverage) capital	113,330	10.23	44,321	4.00	55,401	5.00	
December 31, 2017							
Total risk-based capital	\$ 112,050	13.59 %	\$ 65,953	8.00 %	\$ 82,441	10.00 %	
Common equity tier 1 capital	105,859	12.84	37,098	4.50	53,587	6.50	
Tier 1 risk-based capital	105,859	12.84	49,465	6.00	65,953	8.00	
Tier 1 (leverage) capital	105,859	9.99	42,378	4.00	52,972	5.00	

\*Does not include capital conservation buffer of 1.875% and 1.25% for June 30, 2018 and December 31, 2017, respectively.

In addition, the Federal Reserve Bank (the "FRB") leverage ratio rules require bank holding companies to maintain a minimum level of "primary capital" to total assets of 5.5% and a minimum level of "total capital" to total assets of 6%. For this purpose, (i) "primary capital" includes, among other items, common stock, certain perpetual debt instruments such as eligible Trust preferred securities, contingency and other capital reserves, and the allowance for loan losses, (ii) "total capital" includes, among other things, certain subordinated debt, and "total assets" is increased by the allowance for loan losses. DNB's primary capital ratio and its total capital ratio are both well in excess of FRB requirements.

## REGULATORY MATTERS

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

## ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

To measure the impacts of longer-term asset and liability mismatches beyond two years, DNB utilizes an Economic Value of Equity ("EVE") model. The EVE model measures the potential price risk of equity to changes in interest rates and factors in the optionality included on the balance sheet. EVE analysis is used to dynamically model the present value of asset and liability cash flows, with rates ranging up or down 200 basis points. The EVE is likely to be different if rates change. Results falling outside prescribed ranges may require action by management. At September 30, 2018 and December 31, 2017, DNB's variance in the EVE as a percentage of assets with an instantaneous and sustained parallel shift of 200 basis points was within its negative 3% guideline, as shown in the following table. The change as a percentage of the present value of equity with a 200 basis point increase was within DNB's negative 25% guideline at September 30, 2018 and December 31, 2017.

(Dollars in thousands)	September 30, 2018			December 31, 2017		
Change in rates	Flat	-200bp	+200bp	Flat	-200bp	+200bp
EVE	\$ 161,731	\$ 157,337	\$ 155,427	\$ 129,535	\$ 120,945	\$ 123,710
Change		(4,394)	(6,304)		(8,590)	(5,825)
Change as % of assets		(0.4%)	(0.6%)		(0.8%)	(0.5%)
Change as % of PV equity		(2.7%)	(3.9%)		(6.6%)	(4.5%)

## ITEM 4- CONTROLS AND PROCEDURES

DNB's Management, with the participation of our Chief Executive Officer and Chief Financial Officer, has reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of September 30, 2018, the end of the period covered by this report, in accordance with the requirements of Exchange Act Rule 240.13a-15(b). Based on that evaluation, Management has concluded that DNB's current disclosure controls and procedures are effective.

Management of DNB is responsible for establishing and maintaining adequate internal control over financial reporting for DNB, as such term is defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. There was no change in DNB's "internal control over financial reporting" (as such term is defined in Rule 13a-15(f) under the Exchange Act) that occurred during the fiscal quarter ended September 30, 2018, that has materially affected, or is reasonably likely to materially affect, DNB's internal control over financial reporting.

## PART II - OTHER INFORMATION



## ITEM 1. LEGAL PROCEEDINGS

Neither DNB nor any of its subsidiaries is a party to, nor is any of their property the subject of, any material legal proceedings other than ordinary routine litigation incident to their businesses.

## ITEM 1A. RISK FACTORS

In addition to the other information set forth in this Quarterly Report, you should carefully consider the factors discussed in “Risk Factors” included within the 2017 Form 10-K. The risks described therein are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently believe to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

There were no unregistered sales of equity securities during the quarter ended September 30, 2018. The following table provides information on repurchases by DNB of its common stock in each month of the quarter ended September 30, 2018:

Period	Total Number Of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (a)
July 1, 2018 – July 31, 2018	-	\$ -	-	\$ 63,016
August 1, 2018 – August 31, 2018	-	-	-	\$ 63,016
September 1, 2018 – September 30, 2018	-	-	-	\$ 63,016
Total	-	\$ -	-	\$ 63,016

On July 25, 2001, DNB authorized the buyback of up to 175,000 shares of its common stock over an indefinite period. On August 27, 2004, DNB increased the buyback from 175,000 to 325,000 shares of its common stock over an

indefinite period.

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### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

### ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable.

### ITEM 5. OTHER INFORMATION

None.

### ITEM 6. EXHIBITS

a) The following exhibits are filed or furnished herewith:

Exhibit Number	Description
2.1	<u>Agreement and Plan of Merger by and between DNB Financial Corporation and East River Bank, dated as of April 4, 2016, filed as Exhibit 2.1 to Form 8-K on April 5, 2016 and incorporated herein by reference.</u>
3.1	<u>Amended and Restated Articles of Incorporation, as amended effective June 30, 2017, filed as Exhibit 3.1 to Form 8-K on July 3, 2017 and incorporated herein by reference.</u>
3.2	<u>Bylaws of the Registrant as amended January 27, 2016, filed as Exhibit 3.1 to Form 8-K on January 29, 2016 and incorporated herein by reference.</u>
31.1	<u>Rule 13a-14(a)/15d-14 (a) Certification of Chief Executive Officer, filed herewith.</u>
31.2	<u>Rule 13a-14(a)/15d-14 (a) Certification of Chief Financial Officer, filed herewith.</u>
32.1	<u>Section 1350 Certification of Chief Executive Officer, filed herewith.</u>
32.2	<u>Section 1350 Certification of Chief Financial Officer, filed herewith.</u>
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document

101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

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

November

DNB FINANCIAL CORPORATION

November 5, 2018

/s/ William J. Hieb  
William J. Hieb, Chief Executive Officer, President and Director

November 5, 2018

/s/ Gerald F. Sopp  
Gerald F. Sopp, Chief Financial Officer and Executive Vice President

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Exhibit Index

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101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document