DNB FINANCIAL CORP /PA/
Form 10-Q
November 14, 2006

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

FORM 10-Q

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

For the quarterly period ended: September 30, 2006
or

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

For the transition period from ________________ to _____________

Commission File Number: 0-16667
DNB Financial Corporation
(Exact name of registrant as specified in its charter)

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

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 x No o

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

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

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

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)	**2,392,285**
(Class)	(Shares Outstanding as of November 14, 2006)

DNB FINANCIAL CORPORATION AND SUBSIDIARY

INDEX

PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

DNB Financial Corporation and Subsidiary
Consolidated Statements of Financial Condition (Unaudited)

(Dollars in thousands except share data)	**September 30 2006**	**December 31 2005**
Assets		
Cash and due from banks	**$ 12,484**	$ 14,421
Federal funds sold	**6,913**	7,762
Cash and cash equivalents	**19,397**	22,183
AFS investment securities, at fair value (amortized cost of $113,660 and $117,580)	**112,130**	116,074
HTM investment securities (fair value of $18,720 and $26,214)	**19,383**	26,933
Other investment securities	**3,402**	3,367
Total investment securities	**134,915**	146,374
Loans and leases	**334,784**	288,130
Allowance for credit losses	**(4,287)**	(4,420)
Net loans and leases	**330,497**	283,710
Office property and equipment	**7,296**	6,733
Accrued interest receivable	**2,547**	2,134
Bank owned life insurance	**6,830**	6,642
Net deferred taxes	**2,390**	2,326
Other assets	**2,877**	2,944
Total assets	**$ 506,749**	$ 473,046
Liabilities and Stockholders' Equity		
Liabilities		
Non-interest-bearing deposits	**$ 52,434**	$ 51,407
Interest-bearing deposits:		
NOW	**80,515**	78,664
Money market	**67,431**	45,390
Savings	**57,884**	77,216
Time	**111,664**	86,950
Total deposits	**369,928**	339,627
FHLB advances	**49,550**	53,850
Repurchase agreements	**42,864**	36,050
Junior subordinated debentures	**9,279**	9,279
Other borrowings	**692**	701
Total borrowings	**102,385**	99,880
Accrued interest payable	**922**	939
Other liabilities	**2,596**	2,414
Total liabilities	**475,831**	442,860
Stockholders' Equity		
Preferred stock, $10.00 par value; 1,000,000 shares authorized; none issued	—	—
Common stock, $1.00 par value;		
	2,582	2,572

10,000,000 shares authorized; 2,582,379 and 2,572,419 issued				
Treasury stock, at cost; 194,960 and 201,865 shares, respectively		**(4,109)**		(4,253)
Surplus		**34,954**		34,802
Accumulated deficit		**(754)**		(1,196)
Accumulated other comprehensive loss, net		**(1,755)**		(1,739)
Total stockholders' equity		**30,918**		30,186
Total liabilities and stockholders' equity	**$**	**506,749**	$	473,046

See accompanying notes to consolidated financial statements.

3

DNB Financial Corporation and Subsidiary
Consolidated Statements of Operations (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands except share data)	**2006**	**2005**	**2006**	**2005**
Interest Income:				
Interest and fees on loans	**$ 5,765**	$ 4,540	**$ 16,011**	$ 12,218
Interest and dividends on investment securities:				
Taxable	**1,161**	1,283	**3,544**	3,857
Exempt from federal taxes	**311**	302	**932**	793
Tax-preferred DRD	**—**	—	**—**	57
Interest on cash and cash equivalents	**71**	55	**309**	177
Total interest income	**7,308**	6,180	**20,796**	17,102
Interest Expense:				
Interest on NOW, money market and savings	**1,171**	716	**3,219**	1,695
Interest on time deposits	**983**	549	**2,491**	1,451
Interest on FHLB advances	**796**	815	**2,211**	2,479
Interest on repurchase agreements	**390**	227	**1,131**	525
Interest on junior subordinated debentures	**177**	154	**523**	388
Interest on other borrowings	**40**	26	**102**	85
Total interest expense	**3,557**	2,487	**9,677**	6,623
Net interest income	**3,751**	3,693	**11,119**	10,479
Provision for credit losses	**—**	75	**—**	120
Net interest income after provision for credit losses	**3,751**	3,618	**11,119**	10,359
Non-interest Income:				
Service charges on deposits	**418**	365	**1,253**	966
Wealth management fees	**174**	159	**553**	559
Increase in cash surrender value of BOLI	**87**	47	**188**	161
Net (losses) gains on sales of available for sale securities	**—**	(2)	**13**	(662)
Other fees	**192**	192	**578**	552
Total non-interest income	**871**	761	**2,585**	1,576
Non-interest Expense:				
Salaries and employee benefits	**2,345**	2,125	**6,843**	6,035
Furniture and equipment	**341**	320	**1,010**	923
Occupancy	**335**	241	**927**	701
Professional and consulting	**447**	310	**1,082**	885
Advertising and marketing	**82**	76	**365**	371
Printing and supplies	**75**	68	**306**	228
Other expenses	**562**	538	**1,665**	1,514
Total non-interest expense	**4,187**	3,678	**12,198**	10,657
Income before income taxes	**435**	701	**1,506**	1,278

Income tax expense (benefit)		**18**		114		**139**		(25)
Net Income	**$**	**417**	$	587	**$**	**1,367**	$	1,303
Earnings per share:								
Basic	**$**	**0.18**	$	0.28	**$**	**0.57**	$	0.63
Diluted	**$**	**0.17**	$	0.28	**$**	**0.57**	$	0.62
Cash dividends per share	**$**	**0.13**	$	0.12	**$**	**0.39**	$	0.37
Weighted average common shares outstanding:								
Basic		**2,385,292**		2,080,690		**2,378,125**		2,075,289
Diluted		**2,401,773**		2,101,438		**2,395,197**		2,106,455

See accompanying notes to consolidated financial statements.

DNB Financial Corporation and Subsidiary

Consolidated Statements of Stockholders' Equity and Comprehensive Income (Unaudited)

(Dollars in thousands)	Common Stock	Treasury Stock	Surplus	Retained Earnings (Accumulated deficit)	Accumulated Other Compre-hensive Loss	Total
Balance at January 1, 2005	$ 2,170	$ (4,488)	$ 29,388	$ (2,273)	$ (59)	$ 24,738
Net income	—	—	—	2,148	—	2,148
Other comprehensive loss, net of tax:						
Unrealized losses on investments	—	—	—	—	(935)	(935)
Unrealized actuarial losses - pension	—	—	—	—	(745)	(745)
Release of restricted stock	3	—	88	—	—	91
Common stock issued	266	—	5,259	—	—	5,525
Cash dividends	—	—	—	(1,064)	—	(1,064)
Issuance of stock dividends	122	—	(122)	—	—	—
Purchase of treasury shares	—	(5)	—	—	—	(5)
Issuance of treasury shares to 401(k) plan	—	240	9	—	—	249
Cash payment for fractional shares	—	—	—	(7)	—	(7)
Exercise of stock options	11	—	180	—	—	191
Balance at December 31, 2005	2,572	(4,253)	34,802	(1,196)	(1,739)	30,186
Net income	—	—	—	1,367	—	1,367
Other comprehensive loss, net of tax:						
Unrealized losses on investments	—	—	—	—	(16)	(16)
Release of restricted stock	3	—	98	—	—	101
Cash dividends	—	—	—	(925)	—	(925)
Purchase of treasury shares	—	(128)	—	—	—	(128)
Issuance of treasury shares to 401(k) plan	—	272	(7)	—	—	265
Exercise of stock options	7	—	61	—	—	68
Balance at September 30, 2006	**$ 2,582**	**$ (4,109)**	**$ 34,954**	**$ (754)**	**$ (1,755)**	**$ 30,918**

See accompanying notes to consolidated financial statements.

DNB Financial Corporation and Subsidiary
Consolidated Statements of Cash Flows (Unaudited)

	Nine Months Ended September 30,	
(Dollars in thousands)	**2006**	**2005**
Cash Flows From Operating Activities:		
Net income	**$ 1,367**	$ 1,303
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	**889**	933
Restricted stock amortization	**101**	-
Provision for credit losses	**-**	120
Net (gain) loss on sale of securities	**(13)**	662
Increase in interest receivable	**(413)**	(349)
Decrease (increase) in other assets	**67**	(494)
Increase in investment in BOLI	**(188)**	(144)
Decrease in interest payable	**(17)**	(102)
Increase in deferred tax benefit	**(56)**	(41)
Increase (decrease) in other liabilities	**182**	(14)
Net Cash Provided By Operating Activities	**1,919**	1,874
Cash Flows From Investing Activities:		
Activity in available-for-sale securities:		
Sales	**-**	95,780
Maturities, repayments and calls	**9,652**	17,399
Purchases	**(5,856)**	(103,847)
Activity in held-to-maturity securities:		
Maturities, repayments and calls	**7,512**	5,078
Net (increase) decrease in other investments	**(35)**	439
Net increase in loans and leases	**(46,787)**	(43,995)
Purchase of bank property and equipment, net	**(1,277)**	(495)
Net Cash Used By Investing Activities	**(36,791)**	(29,641)
Cash Flows From Financing Activities:		
Net increase (decrease) in deposits	**30,301**	(1,094)
Decrease in FHLB advances	**(4,300)**	(3,500)
Increase in junior subordinated debentures	**-**	4,124
Increase in short term repurchase agreements	**6,814**	16,064
Decrease in lease obligations	**(9)**	(7)
Dividends paid	**(925)**	(771)
Proceeds from issuance of stock under stock option plan	**68**	160
Issuance of treasury stock, net	**137**	139
Net Cash Provided By Financing Activities	**32,086**	15,115
Net Change in Cash and Cash Equivalents	**(2,786)**	(12,652)
Cash and Cash Equivalents at Beginning of Period	**22,183**	24,121
Cash and Cash Equivalents at End of Period	**$ 19,397**	$ 11,469
Supplemental Disclosure of Cash Flow Information:		
Cash paid during the period for:		
Interest	**$ 9,694**	$ 6,725
Income taxes	**1**	101
Supplemental Disclosure of Non-cash Flow Information:		
Change in unrealized losses on AFS securities	**$ (24)**	$ (171)

Change in deferred taxes due to change in unrealized losses on AFS securities	**8**	54

See accompanying notes to consolidated financial statements.

DNB FINANCIAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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 with current period classifications. The results of operations for the nine-month period ended September 30, 2006, 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, 2005. Included among such items was the reclassification of certain investments from held-to-maturity securities to other investment securities.

Stock-based compensation

Prior to January 1, 2006, SFAS Statement No. 123 ("SFAS 123"), *Accounting for Stock-Based Compensation*, permitted entities to recognize as expense over the vesting period, the fair value of all stock-based awards on the date of grant. Alternatively, SFAS 123 also allowed entities to continue to apply the provisions of the Accounting Principles Board Opinion No. 25 ("APB Opinion No. 25"), *Accounting for Stock Issued to Employees*, and related interpretations and provide pro-forma net income and pro-forma earnings per share disclosures for employee stock option grants made in 1995 and subsequent years as if the fair-value-based method defined in SFAS 123 had been applied. DNB elected to apply the provisions of APB Opinion No. 25 and provide the pro-forma disclosure provisions of SFAS 123. As such, there was no compensation expense recorded prior to 2006. Additionally, all options were granted at the then current market price.

Effective January 1, 2006, DNB adopted SFAS 123 (revised 2004), Share-Based Payment ("SFAS 123R"), which requires DNB to measure the cost of employee services received in exchange for all equity awards granted including stock options based on the fair market value of the award as of the grant date. SFAS 123R supersedes SFAS 123 and APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123R requires DNB to record compensation expense related to unvested stock awards as of December 31, 2005 by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards. DNB had no unamortized stock option awards at December 31, 2005 as all stock options issued prior to December 31, 2005 were fully vested. Additionally, DNB did not issue any stock awards during the nine-month period ended September 30, 2006. As a result, there was no compensation expense recorded during the three-month or nine-month periods ended September 30, 2006. DNB issued 5,250 and 48,825 stock option awards for the three and nine-month periods ended September 30, 2005. The pro-forma disclosure of stock- based compensation expense related to 2005 is presented below:

(Dollars in thousands, except per-share data)	**Three Months Ended September 30, 2005**	**Nine Months Ended September 30, 2005**
Net income as reported	$ 587	$ 1,303
Add: Stock-based compensation recorded as expense, net of tax	—	—
Deduct: Total stock-based employee compensation expense, net of tax	27	282

Net income - pro-forma	$	560	$	1,021
Earnings per share:				
Basic - as reported	$	0.28	$	0.63
Basic - pro-forma	$	0.27	$	0.48
Diluted - as reported	$	0.28	$	0.62
Diluted - pro-forma	$	0.27	$	0.48

For additional information on stock-based compensation, refer to Footnote 7 on page 11.

DNB FINANCIAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 2: EARNINGS PER SHARE

Basic earnings per share ("EPS") is computed based on the weighted average number of common shares outstanding during the period. Diluted EPS reflects the potential dilution that could occur from the conversion of common stock equivalents and is computed using the treasury stock method. The difference between basic and diluted EPS, for DNB, is attributable to stock options and restricted stock awards. Stock options and restricted stock awards for which the exercise price exceeds the average market price over the period have an anti-dilutive effect on EPS and, accordingly, are excluded from the calculation. At September 30, 2006, there were 119,182 anti-dilutive stock options outstanding as well as 15,089 anti-dilutive stock awards. At September 30, 2005, there were 120,000 anti-dilutive stock options outstanding as well as 17,000 anti-dilutive stock awards. EPS, dividends per share, and weighted average shares outstanding have been adjusted to reflect the effect of the 5% stock dividend in 2005. The dilutive effect of stock options on basic earnings per share is presented below.

	Three Months Ended September 30, 2006			**Nine Months Ended September 30, 2006**		
(In thousands, except per-share data)	**Income**	**Shares**	**Amount**	**Income**	**Shares**	**Amount**
Basic EPS						
Income available to common stockholders	**$ 417**	**2,385**	**$0.18**	$ 1,367	2,378	$0.57
Effect of dilutive common stock equivalents - stock options	**—**	**17**	**(.01)**	—	17	—
Diluted EPS						
Income available to common stockholders after assumed conversions	**$ 417**	**2,402**	**$0.17**	$ 1,367	2,395	$0.57

	Three Months Ended September 30, 2005			**Nine Months Ended September 30, 2005**		
(In thousands, except per-share data)	**Income**	**Shares**	**Amount**	**Income**	**Shares**	**Amount**
Basic EPS						
Income available to common stockholders	**$ 587**	**2,081**	**$0.28**	$ 1,303	2,075	$0.63
Effect of dilutive common stock equivalents - stock options	**—**	**20**	**—**	—	31	(.01)
Diluted EPS						
Income available to common stockholders after assumed conversions	**$ 587**	**2,101**	**$0.28**	$ 1,303	2,106	$0.62

NOTE 3: COMPREHENSIVE INCOME (LOSS)

Comprehensive income includes all changes in stockholders' equity during the period, except those resulting from investments by owners and distributions to owners. Comprehensive income for all periods consisted of net income and other comprehensive income relating to the change in unrealized losses on investment securities available for sale. Comprehensive income (loss), net of tax, is disclosed in the following table.

(Dollars in thousands)	**Three Months Ended September 30, 2006 Net-of-Tax Amount**	**Three Months Ended September 30, 2005 Net-of-Tax Amount**
Net Income	$ 417	$ 587

Other Comprehensive Income:		
Unrealized holding gains (losses) arising during the period	1,129	(476)
Reclassification for losses included in net income	—	1
Total Comprehensive Income	**$ 1,546**	**$ 112**

(Dollars in thousands)	**Nine Months Ended September 30, 2006 Net-of-Tax Amount**	**Nine Months Ended September 30, 2005 Net-of-Tax Amount**
Net Income	$ 1,367	$ 1,303
Other Comprehensive Income:		
Unrealized holding losses arising during the period	(7)	(555)
Reclassification for (gains) losses included in net income	(9)	437
Total Comprehensive Income	**$ 1,351**	**$ 1,185**

8

DNB FINANCIAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 4: COMPOSITION OF LOAN AND LEASE PORTFOLIO

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

(Dollars in thousands)	**September 30, 2006**	December 31, 2005
Commercial mortgage	**$ 94,455**	$ 88,921
Commercial term and lines of credit	**103,357**	83,156
Consumer	**56,120**	48,381
Residential mortgage	**56,786**	43,738
Commercial leases	**24,066**	23,934
Gross loans and leases	**334,784**	288,130
Allowance for credit losses	**(4,287)**	(4,420)
Net loans and leases	**$ 330,497**	$ 283,710

NOTE 5: JUNIOR SUBORDINATED DEBENTURES

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

DNB Capital Trust I

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

DNB Capital Trust II

DNB's second issuance of junior subordinated debentures was on March 30, 2005. This issuance of debentures are floating rate and were issued to DNB Capital Trust II, a Delaware business trust in which DNB owns all of the common equity. DNB Capital Trust II issued $4.0 million of floating rate (the rate is fixed at 6.56% for the first 5 years and will adjust at a rate of 3-month LIBOR plus 1.77% thereafter) capital preferred securities. The proceeds of these securities were used by the Trust, along with DNB's capital contribution, to purchase $4.1 million principal amount of DNB's floating rate junior subordinated debentures. The preferred securities are redeemable by DNB on or after May 23, 2010, or earlier in the event of certain adverse tax or bank regulatory developments. The preferred securities must be redeemed upon maturity of the debentures on May 23, 2035.

NOTE 6: RECENT ACCOUNTING PRONOUNCEMENTS

In February 2006, the FASB issued SFAS No. 155, "*Accounting for Certain Hybrid Financial Instruments.*" This Statement amends FASB Statements No. 133 and No. 140. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, *"Application of Statement 133 to Beneficial Interests in Securitized Financial Assets."* This Statement: a) permits fair value

9

DNB FINANCIAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; b) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133; c) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; d) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and e) amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period for that fiscal year. Provisions of this Statement may be applied to instruments that an entity holds at the date of adoption on an instrument-by-instrument basis. The Company has not yet determined whether this Statement will have a material impact on their consolidated financial statements upon adoption.

In July 2006, the FASB issued FASB Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes" - an interpretation of FASB Statement No. 109 (FIN 48).* This interpretation of SFAS No. 109 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The interpretation is effective for fiscal years beginning after December 15, 2006. The Corporation has reserves related to certain of its tax positions, which would be subject to analysis under FIN 48. The Corporation has not yet determined the impact on its Consolidated Financial Statements, if any, that would result as a consequence of adopting this interpretation in 2007.

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

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plan" ("SFAS 158"). SFAS 158 requires an employer to recognize on their balance sheet the funded status of its defined pension plans and other post-retirement plans as of December 31, 2006. An under-funded position would create a liability and an over-funded position would create an asset, with a correlating deferred tax asset or liability. The net impact would be an adjustment to equity as accumulated other comprehensive income (loss.) Employers must also recognize as a component of other comprehensive income (loss), net of tax, the actuarial gains and losses and the prior service costs and credits that arise during the period. The Corporation has not completed its assessment of SFAS 158 but anticipates recording a reduction to Shareholders' Equity in Net Other Comprehensive Loss during the fourth quarter of 2006.

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

DNB FINANCIAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 7: 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 583,554 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 90,187 and 82,406 options available for grant at September 30, 2006 and December 31, 2005, respectively.

Prior to January 1, 2006, DNB applied APB Opinion No. 25 in accounting for its Stock Option Plan, and accordingly, no compensation cost has been recognized for its stock options in the financial statements. All stock options issued by DNB prior to January 1, 2006 vested immediately and the related expense was reported in the period issued as a pro-forma disclosure of stock-based compensation expense. Because all options issued prior to January 1, 2006 vested immediately, DNB had no unamortized stock option awards at December 31, 2005. Additionally, DNB did not issue any stock awards during the nine-month period ended September 30, 2006. As a result, there was no compensation expense recorded during the period. DNB issued 5,250 and 48,825 stock option awards for the three and nine-month periods ended September 30, 2005. For periods where stock options have been issued, DNB utilizes a Black-Scholes option valuation model.

Stock option activity for the nine-month period ended September 30, 2006 is indicated below.

	Number Outstanding		Weighted Average Exercise Price
Outstanding January 1, 2006	289,046	$	20.96
Granted	-		-
Exercised	(6,671)		(10.07)
Expired	-		-
Forfeited	(7,781)		(23.93)
Outstanding September 30, 2006	274,594	$	21.14

For the nine-month period ended September 30, 2006, there were 6,671 stock options exercised. The total amount of proceeds received on these stock option exercises was $68,000. The fair market value of the stock options on the date of exercise was $141,000 and the related tax benefit to DNB was $25,000.

The weighted-average price and weighted average remaining contractual life for the outstanding options are listed below for the dates indicated. The aggregate intrinsic value of outstanding options is $546,000 as of September 30, 2006. All outstanding options are exercisable.

		September 30, 2006	
Range of Exercise Prices	Number Outstanding	Weighted Average Exercise Price	Remaining Contractual Life
$ 8.44-10.99	10,252	$10.17	3.75 years
11.00-13.99	15,607	12.56	3.38 years
14.00-19.99	122,117	19.12	7.11 years

20.00-23.99	40,780	23.26	2.66 years
24.00-26.76	85,838	25.89	8.43 years
Total	**274,594**	**$21.14**	**6.52 years**

DNB FINANCIAL CORPORATION AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Restricted Stock Awards

DNB maintains an Incentive Equity and Deferred Compensation Plan. The plan provides that up to 220,500 (as adjusted for subsequent stock dividends) shares of common stock may be granted, at the discretion of the Board, to individuals of the Company. DNB did not grant any shares of restricted stock during the nine-month period ended September 30, 2006. Shares already granted are issuable on the earlier of three years after the date of the grant or a change in control of DNB if the recipients are then employed by DNB (“Vest Date”). Upon issuance of the shares, resale of the shares is restricted for an additional two years, during which the shares may not be sold, pledged or otherwise disposed of. Prior to the Vest Date and in the event the recipient terminates association with DNB for reasons other than death, disability or change in control, the recipient forfeits all rights to the shares that would otherwise be issued under the grant.

Share awards granted by the plan were recorded at the date of award based on the market value of shares. Awards are being amortized to expense over the three-year cliff-vesting period. DNB records compensation expense equal to the value of the shares being amortized. For the three and nine-month periods ended September 30, 2006, $33,000 and $101,000 was amortized to expense. As of September 30, 2006 the $218,000 unrecognized compensation expense related to restricted stock awards and the expense is expected to be recognized over 1.67 years. There were 17,514 stock awards granted in May 2005. At September 30, 2006, 205,412 shares were reserved for future grants under the plan.

The table below summarizes the activity for the nine-month period ended September 30, 2006:

	Shares	Weighted-Average Grant Date Fair Value
Outstanding - January 1, 2006	16,884	$ 26.26
Granted	-	-
Forfeited	(1,796)	(26.26)
Vested	-	-
Outstanding - September 30, 2006	**15,088**	**$ 26.26**

NOTE 8: SUBSEQUENT EVENTS

As discussed in the Company’s S-8 filed on October 25, 2006, the Company established, the Deferred Compensation Plan for Directors of DNB Financial Corporation adopted effective October 1, 2006 (the “Directors Plan”) and the DNB Financial Corporation Deferred Compensation Plan adopted effective October 1, 2006 (the “Officers Plan”) (individually, a “Plan” and collectively, “Plans”).

The Directors Plan permits a non-employee director of DNB or any of its direct or indirect subsidiaries to defer all or a portion of the compensation payable to the director for his or her services as a member of the board of DNB or a subsidiary and committees thereof. The Officers Plan permits an eligible officer to elect to defer up to fifty percent (50%) of the regular salary otherwise payable to the eligible officer and all or a portion of any annual or other periodic bonus otherwise payable to the eligible officer. Upon receiving a director’s or officer’s qualifying election to defer compensation, DNB will allocate to a deferred compensation account for the participant that number of shares of DNB common stock having a fair market value, on the last day of the month in which such compensation would have been paid in absence of the deferral election, equal to 110% of the amount of compensation the participant has elected to defer.

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

DESCRIPTION OF DNB'S BUSINESS AND BUSINESS STRATEGY

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

DNB earns revenues and generates cash flows by lending funds to commercial and consumer customers in its marketplace. DNB generates its largest source of interest income through its lending function. Another source of interest income is derived from DNB's investment portfolio, which provides liquidity and cash flows for future lending needs.

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

To implement the culture changes necessary at DNB First to become an innovative community bank capable of meeting challenges of the 21st century, we embarked on a strategy called "Loyalty, Bank On It." In recognizing the importance of loyalty in our everyday lives, we have embraced this concept as the cornerstone of DNB First's new culture. 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 2003, management developed a strategic 5-year plan designed to reposition its balance sheet and improve core earnings. As part of the plan, management announced its intentions to substantially reduce the size of its investment portfolio and expand its loan portfolio through new originations, increased loan participations, as well as strategic loan and lease receivable purchases. Management also planned a reduction in the absolute level of borrowings with cash flows from existing loans and investments as well as from new core deposit growth. A detailed discussion on DNB's progress follows below.

Investment Portfolio Restructure. As part of its previously announced balance sheet repositioning, DNB took advantage of the rate environment to restructure a significant portion of its investment securities portfolio. In March 2005, DNB sold $73.3 million of structured securities, government agency preferred stock, longer-term municipal securities, as well as corporate securities. The majority of the proceeds received on the sale of these investments were re-invested into higher yielding agency mortgage-backed securities, agency bonds and municipal securities. Management believed that the restructured portfolio would result in more stable earnings and cash flow, as well as improved value metrics.

Continued Progress in Balance Sheet Repositioning. DNB decreased its investment portfolio, grew its loan portfolio and increased deposits in a continuing effort to strengthen its balance sheet during the first nine months in 2006. During this time, the investment portfolio decreased $11.5 million or by 8.0% and loans increased $46.7 million or by 16.2%. Commercial loans increased $25.7 million, residential loans increased $13.1 million, and consumer loans increases $7.7 million. In addition, DNB increased its deposit base by $30.3 million and added $6.8 million in customer repurchase agreements.

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

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

Management’s strategies are designed to direct DNB’s tactical investment decisions and support financial objectives. DNB’s most significant revenue source continues to be net interest income, defined as total interest income less interest expense, which through the nine months ended September 30, 2006 accounted for approximately 81% of total revenue. To produce net interest income and consistent earnings growth over the long-term, DNB must generate loan and deposit growth at acceptable economic spreads within its market area. To generate and grow loans and deposits, DNB must focus on a number of areas including, but not limited to, the economy, branch expansion, sales practices, customer satisfaction and retention, competition, customer behavior, technology, product innovation and credit performance of its customers.

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

RECENT ECONOMIC DEVELOPMENTS

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

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

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

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

MATERIAL CHALLENGES, RISKS AND OPPORTUNITIES

The following is a summary of changes to material challenges, risks and opportunities DNB has faced during the nine-month period ended September 30, 2006.

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 approved guidelines. 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 Asset/Liability Committee ("ALCO") actively seeks to monitor and control the mix of in-terest 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 of plus or minus 300 basis points over a twelve-month period. Given today's rising interest rate environment, our simulation model measures the effect that a 100 through 300 basis point increase in rates or the effect a 100 basis point decline would have on earnings. As of September 30, 2006, simulations indicate that net interest income would be within policy guidelines regardless of the direction of market rates.

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

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

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

Competition. In addition to the challenges related to the interest rate environment, community banks in Chester County have been experiencing increased competition from large regional and international banks entering DNB's marketplace through mergers and acquisitions. Competition for loans and deposits has negatively affected DNB's net interest margin. To compensate for the increased competition, DNB, like other area community banks, has aggressively sought and marketed customers who have been disenfranchised by these mergers. To attract these customers, DNB has introduced new deposit products, such as the Partnership Banking Program, the "Platinum" Account, the Executive and employee package as well as the Business Package. In addition, DNB has introduced Market Managers and Personal Bankers to serve the special banking needs of its clients. DNB is dedicated to implementing the culture changes necessary to become an innovative community bank capable of meeting challenges of the 21st century. As such, we embarked on a strategy called "Loyalty, Bank On It." To recognize the importance of loyalty in our everyday lives, we have embraced this concept as the cornerstone of DNB First's new culture. To that end, DNB continues to make appropriate investments in all areas of our business, including people, technology, facilities and marketing.

Bank Secrecy Act/OFAC/Patriot Act Implementation. Management of the Bank had previously determined that its BSA compliance program needed to be improved to a level commensurate with BSA, OFAC and Patriot Act related risks to which the Bank is exposed. An action plan was developed to strengthen the Bank's compliance with the goal of completing it by the end of the third quarter of 2006. The action plan includes assessing the Bank's customer base for high-risk activity, and expanding and augmenting policies and procedures to establish protocols with respect to identification, evaluation and compliance responses to certain types of potentially high-risk individuals. Additionally, the Bank has strengthened training and now further involves its front-line personnel in this process. The Bank's management has increased the frequency with which it reports BSA compliance program activity to its board of directors and continues to focus its board of directors more frequently and more thoroughly on BSA compliance program requirements, including the identification of high-risk customers and the processes the Bank uses to evaluate and monitor them. The Bank has and will continue to formalize, structure and document compliance in a more disciplined way, including more stringent policies and formal periodic review. The Bank has taken a more aggressive posture in identifying customers and transactions that are potentially subject to the filing of Suspicious Activity Reports ("SARs") and in appropriate cases expects to file SARs. The Bank has and will continue to improve its management information systems to improve identification, evaluation and reporting of certain types of high risk or suspicious transactions and activities. The Bank will be augmenting its BSA compliance staff. Management has and

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will continue to strengthen its day-to-day audit processes to more effectively validate and test the Bank’s BSA compliance program procedures and records. It is management’s goal that the planned improvements to the BSA compliance program will be completed in 2006 and will address the Bank’s BSA compliance needs, in order to establish the Bank as an institution that will not pose a target to those who would use the U.S. financial system to further criminal or terroristic ends.

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

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

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

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

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

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 economics in which we operate. For example, an economic downturn, increase in unemployment, or other events that negatively impact household and/or corporate incomes could decrease the demand for DNB's loan and non-loan products and services and increase the number of customers who fail to pay interest or principal on their loans. Geopolitical conditions can also affect DNB's earnings. Acts or threats of terrorism, actions taken by the United States or other governments in response to acts or threats of terrorism and our military conflicts including the aftermath of the war with Iraq, could impact business conditions in the United States.

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 accounting principals generally accepted in the United States of America. Generally accepted accounting principles are complex and require management to apply significant judgment to various accounting, reporting and disclosure matters. Management must use assumptions and estimates to apply these principles where actual measurement is not possible or practical. Actual results may differ from these estimates under different assumptions or conditions.

In management's opinion, the most critical accounting policies and estimates impacting DNB's consolidated financial statements are listed below. These policies are critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. For a complete discussion of DNB's significant accounting policies, see the footnotes to the Consolidated Financial Statements for the fiscal year ended December 31, 2005, included in DNB's 10-K for the year ended December 31, 2005.

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

Management uses significant estimates to determine the allowance for credit losses. Because the allowance for credit losses is dependent, to a great extent, on conditions that may be beyond DNB's control, management's estimate of the amount necessary to absorb credit losses and actual credit losses could differ. DNB's current judgment is that the valuation of the allowance for credit losses remains adequate at September 30, 2006. For a description of DNB's accounting policies in connection with its allowance for credit losses, see, "Allowance for Credit Losses", in Management's Discussion and Analysis.

Realization of deferred income tax items. Estimates of deferred tax assets and deferred tax liabilities make up the asset category titled "net deferred taxes". These estimates involve significant judgments and assumptions by management, which may have a material impact on the carrying value of net deferred tax assets for financial reporting purposes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis, as well as operating loss carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance would be established against deferred tax assets when in the judgment of management, it is more likely than not that such deferred tax assets will not become available. For a more detailed description of these items, refer to Footnote 11 (Federal Income Taxes) to DNB's audited consolidated financial statements for the fiscal year ended December 31, 2005.

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

- Fair value is significantly below cost and the decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area, the decline has existed for an extended period of time or Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.

- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

The Footnotes 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 $506.7 million at September 30, 2006 compared to $473.0 million at December 31, 2005. The growth in total assets was primarily attributable to strong loan growth offset by a decrease in investment securities as discussed below.

Investment Securities. Investment securities at September 30, 2006 were $134.9 million compared to $146.4 million at December 31, 2005. The decrease in investment securities was primarily due to $17.1 million in principal pay-downs and maturities offset by the purchase of $5.9 million in investment securities.

Gross Loans and Leases. Loans and leases were $334.8 million at September 30, 2006 compared to $288.1 million at December 31, 2005. DNB continued to grow its loan portfolio, which increased by $46.7 million or 16.2%. Commercial loans grew $25.7 million, residential real estate loans, primarily hybrid adjustable rate mortgages, grew $13.1 million, consumer loans grew $7.7 million, and commercial leases grew $132,000. The increase in the commercial loans and residential mortgages continues to reflect DNB’s commitment to commercial and residential development in Chester and Delaware counties in Pennsylvania as well as northern Delaware.

Deposits. Deposits were $369.9 million at September 30, 2006 compared to $339.6 million at December 31, 2005. Deposits increased $30.3 million or 8.9% during the nine-month period ended September 30, 2006. A significant portion of this increase was attributable to the opening of a new branch in West Chester, Pennsylvania during the fourth quarter of 2005. At September 30, 2006 the West Chester branch had approximately $25 million in deposits.

Borrowings. Borrowings were $102.4 million at September 30, 2006 compared to $99.9 million at December 31, 2005. The increase of $2.5 million, or 2.5% was primarily due to growth in repurchase agreements offset by a decrease in FHLB borrowings. The increase in repurchase agreements was the result of expanding DNB’s cash management services by focusing on commercial customers and providing them with the ability to sell excess funds to DNB through repurchase agreements. Repurchase agreements have helped to compliment DNB’s existing funding sources.

Stockholders’ Equity. Stockholders' equity was $30.9 million at September 30, 2006 compared to $30.2 million at December 31, 2005. The increase in stockholders’ equity was primarily a result of year-to-date earnings offset by cash dividends paid.

RESULTS OF OPERATIONS

SUMMARY

Net income for the three and nine-month periods ended September 30, 2006 was $417,000 and $1.4 million compared to $587,000 and $1.3 million for the same periods in 2005. Diluted earnings per share for the three and nine-month periods ended September 30, 2006 was $0.17 and $0.57 compared to $0.28 and $0.62 for the same periods in 2005. Earnings per share in 2005 have been adjusted to reflect the effect of the 5% stock dividend paid in December 2005.

The decrease in net income for the latest three-month period compared to the same period in 2005 was primarily attributable to a a $509,000 increase in non-interest expense offset by a $133,000 increase in net interest income and a $110,000 increase in non-interest income. The increases in non-interest income and non-interest expense are discussed in detail below on page 20. The increase in net interest income was a result of growth in interest-earning assets offset by net interest margin compression. The net interest margin compression was a result of a rising interest rate environment, a flat yield curve, and intense competition in DNB's marketplace. The increase in net income for the latest nine-month period compared to the same period in 2005 was primarily attributable to a $1.0 million increase in non-interest income and a $760,000 increase in net interest income, offset by a $1.5 million increase in non-interest expense. The increases in non-interest income and non-interest expense are discussed in detail below on page 20. The increase in net interest income was a result of growth of interest-earning assets offset by net interest margin compression. The compression in DNB's net interest margin was a result of a rising interest rate environment, which is discussed in more detail below.

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, FHLB advances, repurchase agreements, Federal funds purchased and other borrowings.

Net interest income for the three and nine-month periods ended September 30, 2006 was $3.8 million and $11.1 million, compared to $3.7 million and $10.5 million for the same periods in 2005. Interest income for the three and nine-month periods ended September 30, 2006 was $7.3 million and $20.8 million compared to $6.2 million and $17.1 million for the same periods in 2005. The increase in interest income was primarily attributable to an increase of interest on loans and leases, which was a result of strong growth in the loan and lease portfolio. The yield on interest-earning assets for the third quarter in 2006 was 6.1%, compared to 5.7% for the same period in 2005. Interest expense for the three and nine-month periods ended September 30, 2006 was $3.6 million and $9.7 million compared to $2.5 million and $6.6 million for the same periods in 2005. The increase in interest expense was primarily attributable to deposit and repurchase agreement account growth as well as higher rates on interest-bearing liabilities. The costs of deposits increased to 2.36% for the third quarter in 2006, compared to 1.52% for the same period in 2005. The net interest margin for the three-month period ended September 30, 2006 was 3.20%, compared to 3.49% for the same period in 2005.

Interest on loans and leases was $5.8 million and $16.0 million for the three and nine-month periods ended September 30, 2006, compared to $4.5 million and $12.2 million for the same periods in 2005. The average balance of loans and leases was $317.1 million with an average yield of 6.71% for the nine-month period ended September 30, 2006 compared to an average balance of $251.3 million with an average yield of 6.49% for the same period in 2005. The increase in the average balance is the result of management’s increased efforts towards growing DNB’s loan and lease portfolio as DNB has added additional commercial loan officers and business bankers to accomplish this growth. The increase in yield was primarily the result of a rising interest rate environment.

Interest and dividends on investment securities was $1.5 million and $4.5 million for the three and nine-month periods ended September 30, 2006, compared to $1.6 million and $4.7 million for the same periods in 2005. The average balance on investment securities was $142.0 million with an average yield of 4.65% for the nine-month period ended September 30, 2006 compared to $161.2 million with an average yield of 4.25% for the same period in 2005. The decrease in the average balance was part of DNB’s strategic plan to reduce the size of its investment portfolio. The increase in yield was primarily due to the investment portfolio restructuring which occurred during the first quarter of 2005, which is discussed in more detail on page 13 under “Investment Portfolio Restructure”.

Interest on deposits was $2.2 million and $5.7 million for the three and nine-month periods ended September 30, 2006, compared to $1.3 million and $3.1 million for the same periods in 2005. The average balance on interest-bearing deposits was $355.5 million with an average rate of 2.15% for the nine-month period ended September 30, 2006 compared to $317.6 million with an average rate of 1.32% for the same period in 2005. The increase in the average balance was primarily the result of year-over-year increased deposit relationships through aggressive marketing efforts and the opening of a new branch in West Chester, which had approximately $25 million in deposits at September 30, 2006. The increase in rate was primarily attributable to an increase in market rates resulting from a 150 basis point increase in the federal funds rate over the last twelve months in addition to intense competition for deposits in the Chester County marketplace.

Interest on borrowings was $1.4 million and $4.0 million for the three and nine-month periods ended September 30, 2006, compared to $1.2 million and $3.5 million for the same periods in 2005. The average balance on borrowings was $102.4 million with an average rate of 5.18% for the nine-month period ended September 30, 2006 compared to $98.6 million with an average rate of 4.71% for the same period in 2005. The increase in the average balance was attributable to growth in customer repurchase agreements and FHLB borrowings. The increase in rate was attributable to an increase in market rates resulting from a 150 basis point increase in the federal funds rate over the last twelve months.

ALLOWANCE FOR CREDIT LOSSES

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

In establishing and reviewing the allowance for adequacy, management establishes the allowance for credit losses in accordance with generally accepted accounting principles in the United States and the guidance provided in the Securities and Exchange Commission's

Staff Accounting Bulletin 102 (SAB 102). Its methodology for assessing the appropriateness of the allowance consists of several key elements which include: specific allowances for identified problem loans; formula based allowances for commercial and commercial real estate loans; and allowances for pooled, homogenous loans. As a result, management has taken into consideration factors and variables which may influence the risk of loss within the loan portfolio, including: (i) trends in delinquency and non-accrual loans; (ii) changes in the nature and volume of the loan portfolio; (iii) effects of any changes in lending policies; (iv) experience, ability, and depth of management; (v) quality of loan review; (vi) national and local economic trends and conditions; (vii) concentrations of credit; and (viii) effect of external factors on estimated credit losses. In addition, DNB reviews historical loss experience for the commercial real estate, commercial, residential real estate, home equity and consumer installment loan pools to determine a historical loss factor. The historical loss factors are then applied to the current portfolio balances to determine the required reserve percentage for each loan pool based on risk rating.

DNB's percentage of allowance for credit losses to total loans and leases was 1.28% at September 30, 2006 compared to 1.53% at December 31, 2005. Management believes that the allowance for credit losses was adequate and provided for known and inherent credit losses.

The following table summarizes the changes in the allowance for credit losses for the periods indicated.

(Dollars in thousands)	**Nine Months Ended September 30, 2006**	**Year Ended December 31, 2005**	**Nine Months Ended September 30, 2005**
Beginning balance	**$ 4,420**	$ 4,436	$ 4,436
Provisions	**¾**	—	120
Charge-offs	**(196)**	(46)	(10)
Recoveries	**63**	30	17
Ending balance	**$ 4,287**	$ 4,420	$ 4,563

NON-INTEREST INCOME

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

Non-interest income for the three and nine-month periods ended September 30, 2006 was $871,000 and $2.6 million, compared to $761,000 and $1.6 million for the same periods in 2005. The $110,000 increase for the three-month period was primarily attributable to an increase in service charges on deposits of $53,000 and an increase in the cash surrender value of BOLI of $40,000. The $1.0 million increase for the nine-month period was primarily attributable to a $699,000 loss recognized on the sale of investment securities during 2005 in addition to a $287,000 increase for the nine-month period ended September 30, 2006 related to service charges on deposits.

NON-INTEREST EXPENSE

Non-interest expense includes salaries & employee benefits, furniture & equipment, occupancy, professional & consulting fees as well as printing & supplies, marketing and other less significant expense items. Non-interest expense for the three and nine-month periods ended September 30, 2006 was $4.2 million and $12.2 million compared to $3.7 million and $10.7 million for the same periods in 2005. The increases in both periods were primarily attributable to an increase in salaries and employee benefits, which is related to DNB's substantial investment during

2005 in hiring experienced personnel in revenue producing lines of business. There were additional increases in occupancy costs as well as furniture and equipment expenses as a result of adding a new loan origination office in Newtown Square, Pennsylvania and a new retail branch in West Chester, Pennsylvania during 2005 along with additional expenses during the third quarter of 2006 related to a new retail branch in Chadds Ford, Pennsylvania that is scheduled to open in 2007. Professional and consulting expense also increased during the second and third quarters relating to the efficiency project started in the second quarter. This project has helped to streamline many processes throughout the bank, which will help to decrease non-interest expense in the future along with a reduction of 14 full time equivalent employees.

INCOME TAXES

Income tax expense (benefit) for the three and nine-month periods ended September 30, 2006 was $18,000 and $139,000 compared to $114,000 and ($25,000) for the same periods in 2005. Income tax expense (benefit) for each period differs from the amount determined at the statutory rate of 34% due to tax-exempt income on loans and investment securities, DNB's ownership of BOLI policies, and tax credits recognized on a low-income housing limited partnership. An additional reason for the change in income tax expense (benefit) in 2006 as compared to comparable periods in 2005 is due to the fact that during the period ended September 30, 2005 DNB reversed a portion of a previously recorded valuation allowance for deferred tax assets and recognized related income tax benefits in the amounts of $0 and $102,000 for the three and nine-month periods ended September 30, 2005, respectively, in connection with the sale of agency preferred securities.

ASSET QUALITY

Non-performing assets are comprised of non-accrual loans and leases, loans and leases delinquent over ninety days and still accruing and Other Real Estate Owned ("OREO"). Non-accrual loans and leases are loans and leases 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 or lease may be restored to accrual status when management expects to collect all contractual principal and interest due and the borrower has demonstrated a sustained period of repayment performance in accordance with the contractual terms. OREO consists of real estate acquired by foreclosure. OREO is carried at the lower of cost 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.

The following table sets forth those assets that are: (i) placed on non-accrual status, (ii) contractually delinquent by 90 days or more and still accruing, (iii) troubled debt restructurings other than those included in items (i) and (ii), and (iv) OREO as a result of foreclosure or voluntary transfer to DNB. DNB did not have any OREO at the end of all reported periods.

Non-Performing Assets

(Dollars in thousands)	**September 30, 2006**	**December 31, 2005**	**September 30, 2005**
Loans and leases:			
Non-accrual	**$ 1,465**	$ 1,105	$ 1,387
90 days past due and still accruing	**689**	245	140
Troubled debt restructurings	**—**	—	—
Total non-performing loans and leases	**2,154**	1,350	1,527
Other real estate owned	**—**	—	—
Total non-performing assets	**$ 2,154**	$ 1,350	$ 1,527

The following table sets forth DNB's asset quality and allowance coverage ratios at the dates indicated:

	September 30, 2006	**December 31, 2005**	**September 30, 2005**
Asset quality ratios:			
Non-performing loans to total loans	**0.6%**	0.5%	0.6%
Non-performing assets to total assets	**0.4**	0.3	0.3
Allowance for credit losses to:			

Total loans and leases	**1.3**	1.5	1.7
Non-performing loans and leases	**199.1**	327.3	298.8

Included in the loan and lease portfolio are loans for which DNB has ceased the accrual of interest. If contractual interest income had been recorded on non-accrual loans, interest would have been increased as shown in the following table:

(Dollars in thousands)	**Nine Months Ended September 30, 2006**	Year Ended December 31, 2005	Nine Months Ended September 30, 2005
Interest income which would have been recorded under original terms	**$ 86**	$ 87	$ 87
Interest income recorded during the period	**(28)**	(8)	(7)
Net impact on interest income	**$ 58**	$ 79	$ 80

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

(Dollars in thousands)	**September 30, 2006**	December 31, 2005	September 30, 2005
Total recorded investment	**$ 1,353**	$ 916	$ 1,110
Average recorded investment	**1,070**	1,118	1,185
Specific allowance allocation	**497**	442	488

(Dollars in thousands)	**Nine Months Ended September 30, 2006**	Year Ended December 31, 2005	Nine Months Ended September 30, 2005
Total cash collected	**$ 257**	$ 564	$ 280
Interest income recorded	**4**	18	6

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 primary liquidity, which totaled $51.4 million at September 30, 2006. Primary liquidity includes investments, Federal funds sold, and interest-bearing cash balances, less pledged securities. DNB also anticipates scheduled payments and prepayments on its loan and mortgage-backed securities portfolios. In addition, DNB maintains borrowing arrangements with various correspondent banks, the Federal Home Loan Bank of Pittsburgh and the Federal Reserve Bank of Philadelphia to meet short-term liquidity needs. Through these relationships, DNB has available credit of approximately $138.4 million. Management believes that DNB has adequate resources to meet its short-term and long-term funding requirements.

At September 30, 2006, DNB had $73.2 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 $100,000 scheduled to mature in one year or less from September 30, 2006 totaled $36.1 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 Federal funds sold or by pay-downs and maturities of loans and investments.

In March of 2005, DNB completed a private offering of $4 million Trust Preferred Securities, and in November 2005, DNB completed a private offering of 265,730 shares of its common stock to 53 accredited investors at a price of $21.00 per share, realizing total offering proceeds of $5.6 million. DNB invested the majority of the proceeds of each of these securities issuances into the Bank to increase the Bank's capital levels and legal lending limit.

Management believes that the Corporation and the Bank have each met the definition of "well capitalized" for regulatory purposes on September 30, 2006. The Bank's capital category is determined for the purposes of applying the bank regulators' "prompt corrective action" regulations and for determining levels of deposit insurance assessments and may not constitute an accurate representation of the Corporation's or the Bank's overall financial condition or prospects. The Corporation's capital exceeds the FRB's minimum lever-age ratio requirements for bank holding companies (see additional discussion included in Footnote 17 of DNB's 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.

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	
(Dollars in thousands)	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
DNB Financial Corporation						
September 30, 2006:						
Total risk-based capital	$ 44,764	13.31%	$ 26,909	8.00%	$ 33,636	10.00%
Tier 1 capital	40,558	12.06	13,454	4.00	20,182	6.00
Tier 1 (leverage) capital	40,558	8.11	20,003	4.00	25,004	5.00
December 31, 2005:						
Total risk-based capital	$ 43,752	13.77%	$ 25,422	8.00%	$ 31,778	10.00%
Tier 1 capital	39,773	12.52	12,711	4.00	19,067	6.00
Tier 1 (leverage) capital	39,773	8.61	18,468	4.00	23,085	5.00
DNB First, N.A.						
September 30, 2006:						
Total risk-based capital	$ 44,621	13.21%	$ 27,016	8.00%	$ 33,770	10.00%
Tier 1 capital	40,399	11.96	13,508	4.00	20,262	6.00
Tier 1 (leverage) capital	40,399	8.09	19,983	4.00	24,979	5.00
December 31, 2005:						
Total risk-based capital	$ 43,770	13.79%	$ 25,389	8.00%	$ 31,736	10.00%
Tier 1 capital	39,797	12.54	12,695	4.00	19,042	6.00
Tier 1 (leverage) capital	39,797	8.63	18,450	4.00	23,063	5.00

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.

FORWARD-LOOKING STATEMENTS

This report may contain statements that are not of historical facts and may pertain to future operating results or events or management's expectations regarding those results or events. These are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities and Exchange Act of 1934. These forward-looking statements may include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements contained in this report that are not historical facts. When used in this report, the words "expects", "anticipates", "intends", "plans", "believes", "seeks", "estimates", or words of similar meaning, or future or conditional verbs, such as "will", "would", "should", "could", or "may" are generally intended to identify forward-looking statements. Forward-looking statements involve certain risks and uncertainties, and actual results may differ materially from those contemplated by such statements. For example, actual results may be adversely affected by the following possibilities: (1) competitive pressures among financial institutions may increase; (2) changes in interest rates may reduce banking interest margins; (3) general economic conditions and real estate values may be less favorable than contemplated; (4)

adverse legislation or regulatory requirements may be adopted; (5) other unexpected contingencies may arise; (6) DNB may change one or more strategies described in this document; or (7) management's evaluation of certain facts, circumstances or trends and the appropriate responses to them may change. These forward-looking statements are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are either beyond our control or not reasonably capable of predicting at this time. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. Actual results may differ materially from the results discussed in these forward-looking statements. Readers of this report are accordingly cautioned not to place undue reliance on forward-looking statements. DNB disclaims any intent or obligation to update publicly any of the forward-looking statements herein, whether in response to new information, future events or otherwise.

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 Modified Duration of Equity and Economic Value of Equity ("EVE") models. The modified duration of equity measures the potential price risk of equity to changes in interest rates. A longer modified duration of equity indicates a greater degree of risk to rising interest rates. Because of balance sheet optionality, an EVE analysis is also used to dynamically model the present value of asset and liability cash flows, with rates ranging up or down 200 basis points. The economic value of equity is likely to be different if rates change. Results falling outside prescribed ranges require action by management. At September 30, 2006 and December 31, 2005, DNB's variance in the economic value of equity as a percentage of assets with an instantaneous and sustained parallel shift of 200 basis points was within its negative 3% guideline, as shown in the table below. The change as a percentage of the present value of equity with a 200 basis point increase or decrease at September 30, 2006 and December 31, 2005, was within DNB's negative 25% guideline. DNB’s EVE has decreased by $15.2 million during 2006. This decrease is mostly attributable to a decrease in the EVE on deposits resulting from an increase in DNB’s cost of funds during the year. DNB’s cost of deposits increased to 2.50% at September 30, 2006 compared to 1.75% at December 31, 2005.

	September 30, 2006			**December 31, 2005**		
Change in rates	**Flat**	**-200bp**	**+200bp**	**Flat**	**-200bp**	**+200bp**
EVE	**$45,343**	**$43,498**	**$38,852**	$60,579	$55,559	$54,967
Change		**(1,845)**	**(6,491)**		(5,020)	(5,612)
Change as a % of assets		**(0.4%)**	**(1.3%)**		(1.1%)	(1.2%)
Change as a % of PV equity		**(4.1%)**	**(14.3%)**		(8.3%)	(9.3%)

ITEM 4 - CONTROLS AND PROCEDURES

DNB’s Chief Executive Officer and Chief Financial Officer have reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of September 30, 2006, the end of the period covered by this report, in accordance with the requirements of Exchange Act Rule 240.13a-15(b). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that DNB’s current disclosure controls and procedures are effective and timely, providing them with material information relating to DNB and its subsidiaries required to be disclosed in the report DNB files under the Exchange Act.

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 the 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 quarter ended September 30, 2006, that has materially affected, or is reasonably likely to materially affect, DNB’s internal control over financial reporting.

24

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Not Applicable

ITEM 1A. RISK FACTORS

There have been no material changes to the Risk Factors previously disclosed in Registrant's Annual Report on Form 10-K for its fiscal year ended December 31, 2005, filed with the Commission on March 23, 2006 (File No. 000-16667).

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

The following table provides information on repurchases by DNB of its common stock in each month of the quarter ended September 30, 2006:

Period	Total Number Of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (a)
July 1, 2006 - July 31, 2006	500	$21.25	500	139,570
August 1, 2006 - August 31, 2006	500	21.15	500	139,070
September 1, 2006 - September 30, 2006	—	—	—	—
Total	**1,000**	**$21.20**	**1,000**	**139,070**

(a) On July 25, 2001, DNB authorized the buyback of up to 183,750 shares of its common stock over an indefinite period. On August 27, 2004, DNB increased the buyback from 183,750 to 358,313 shares of its common stock over an indefinite period. This number has been adjusted to reflect the 5% stock dividend issued in December 2005.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not Applicable

ITEM 5. OTHER INFORMATION

Not Applicable

ITEM 6. EXHIBITS

Exhibits required by Item 601 of Regulation S-K.

The exhibits listed on the Index to Exhibits on pages 27 - 29 of this report are incorporated by reference or filed or furnished herewith in response to this Item.

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

	DNB FINANCIAL CORPORATION
November 14, 2006	BY:/s/ William S. Latoff William S. Latoff, Chairman of the Board and Chief Executive Officer
November 14, 2006	BY:/s/ Bruce E. Moroney Bruce E. Moroney, Chief Financial Officer and Executive Vice President

Index to Exhibits

Exhibit No.		Description of Exhibit and Filing Information
3	(i)	Amended and Restated Articles of Incorporation, as amended effective June 15, 2001, filed on August 14, 2001, as Item 6(a) to Form 10Q (No. 0-16667) and incorporated herein by reference.
	(ii)	By-laws of the Registrant as amended December 19, 2001, filed on March 24, 2002 at Item 3b to Form 10-K for the fiscal year ended December 31, 2001 (No. 0-16667) and incorporated herein by reference.
4		Registrant has certain debt obligations outstanding, for none of which do the instruments defining holders rights authorize an amount of securities in excess of 10% of the total assets of the Registrant and its subsidiaries on a consolidated basis. Registrant agrees to furnish copies of such agreements to the Commission on request.
10	(a)*	Employment Agreement between DNB First, N.A. and Henry F. Thorne dated December 31, 1996 filed on March 26, 1999 at Item 10.1 to Form 10-K for the fiscal year ended December 31, 1998 (No. 0-16667) and incorporated herein by reference.
	(b)*	Change of Control Agreements between DNB Financial Corporation and DNB First, N.A. and the following executive officers each in the form filed on March 29, 1999 at Item 10.2 to Form 10-K for the fiscal year ended December 31, 1998 (No. 0-16667), and incorporated herein by reference: (i) dated May 5, 1998 with Ronald K. Dankanich; and Bruce E. Moroney, (ii) dated April 28, 2003 with William J. Hieb, and (iii) dated October 18, 2004 with C. Tomlinson Kline III, (iv) dated December 3, 2004 with Thomas M. Miller, (v) dated January 26, 2006 with Richard J. Hartmann.
	(c)**	1995 Stock Option Plan of DNB Financial Corporation (as amended and restated, effective as of April 27, 2004), filed on March 29, 2004 as Appendix A to Registrant's Proxy Statement for its Annual Meeting of Stockholders held April 27, 2004, and incorporated herein by reference.
	(d)*	Death Benefit Agreement between DNB First, N.A. and Henry F. Thorne dated November 24, 1999, filed March 20, 2002 as Item 10(d) to Form 10-K for the fiscal year ended December 31, 2001 (No. 0-16667) and incorporated herein by reference.
	(e)*	Form of Change of Control Agreements, as amended November 10, 2003, filed on November 14, 2003 as Item 10(e) to Form 8-K (No. 0-16667) and incorporated herein by reference between DNB Financial Corporation and DNB First, N.A. and each of the following Directors:

(i) dated November 10, 2005 with James H. Thornton, James J. Koegel and Eli Silberman, and (ii) dated February 23, 2005 with Mildred C. Joyner, and dated February 22, 2006 with Thomas Fillippo.

(f)* First Amendment to Employment Agreement of Henry F. Thorne dated December 23, 2003 filed March 29, 2004 as Item 10(g) to Form 10-K for the fiscal year ended December 31, 2003 (No. 0-16667) and incorporated herein by reference.

(g)* Retirement and Death Benefit Agreement between DNB First, N.A. and Henry F. Thorne dated December 23, 2003 filed March 29, 2004 as Item 10(h) to Form 10-K for the fiscal year ended December 31, 2003 (No. 0-16667) and incorporated herein by reference.

(h)*** DNB Financial Corp. Incentive Equity and Deferred Compensation Plan, filed March 10, 2005 as item 10(i) to Form 10-K for the fiscal year-ended December 31, 2004 (No. 0-16667) and incorporated herein by reference.

(i)* Retirement Agreement among DNB Financial Corporation, DNB First, N.A. and Henry F. Thorne, dated December 17, 2004, filed March 10, 2005 as Item 10(i) to Form 10-K for the fiscal year ended December 31, 2004 (No. 0-16667) and incorporated herein by reference.

(j)* Change of Control Agreement among DNB Financial Corporation, DNB First, N.A. and William S. Latoff, dated December 17, 2004, filed March 10, 2005 as Item 10(i) to Form 10-K for the fiscal year ended December 31, 2004 (No. 0-16667) and incorporated herein by reference.

(k) Agreement of Lease dated February 10, 2005 between Headwaters Associates, a Pennsylvania general partnership, as Lessor, and DNB First, National Association as Lessee for a portion of premises at 2 North Church Street, West Chester, Pennsylvania, filed March 10, 2005 as Item 10(l) to Form 10-K for the fiscal year ended December 31, 2004 (No. 0-16667) and incorporated herein by reference, as amended by Addendum to Agreement of Lease dated as of November 15, 2005, filed March 23, 2006 as Item 10(l) to Form 10-K for the fiscal year ended December 31, 2005 (No. 0-16667) and incorporated herein by reference, and as further amended by Second Addendum to Agreement of Lease dated as of May 25, 2006, filed August 14, 2006 as Item 10(l) to Form 10-K for the fiscal quarter ended June 30, 2006 (No. 0-16667) and incorporated herein by reference.

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

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

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

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

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

(q)* Form of First Amendments dated January 26, 2006 to Change of Control Agreements with William J. Hieb, the Company's President and COO, and Thomas M. Miller, the Company's First Executive Vice President and Chief Lending Officer, filed March 23, 2006 as Item 10(r) to Form 10-K for the fiscal year ended December 31, 2005 (No. 0-16667) and incorporated herein by reference.

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

(s)*** Deferred Compensation Plan For Directors of DNB Financial Corporation (adopted effective October 1, 2006), filed herewith.

(t)*** DNB Financial Corporation Deferred Compensation Plan (adopted effective October 1, 2006), filed herewith.

(u)*** Trust Agreement, effective as of October 1, 2006, between DNB Financial Corporation and DNB First, National Association, filed herewith.

11 Registrant's Statement of Computation of Earnings Per Share. The information for this Exhibit is incorporated by reference to page 8 of this Form 10-Q.

14 Code of Ethics as amended and restated effective February 23, 2005, filed March 10, 2005 as Item 10(m) to Form 10-K for the fiscal year ended December 31, 2004 (No. 0-16667) and incorporated herein by reference.

31.1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for the Chief Executive Officer, and filed herewith.

31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for the Chief Financial Officer, and filed herewith.

32.1 Certification of Chief Executive Officer pursuant to Section 906, and filed herewith.

32.2 Certification of Chief Financial Officer pursuant to Section 906, and filed herewith.

* Management contract or compensatory plan arrangement.

** Shareholder approved compensatory plan pursuant to which the Registrant's Common Stock may be issued to employees of the Corporation.

*** Non-shareholder approved compensatory plan pursuant to which the Registrant's Common Stock may be issued to employees of the Corporation.