

NORWOOD FINANCIAL CORP  
Form 10-Q  
August 06, 2010

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2010

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 0-28366

Norwood Financial Corp.  
(Exact name of Registrant as specified in its charter)

Pennsylvania  
(State or other jurisdiction of  
Incorporation or organization)

23-2828306  
(I.R.S. employer identification no.)

717 Main Street, Honesdale, Pennsylvania  
(Address of principal executive offices)

18431  
(Zip Code)

(570) 253-1455  
(Registrant's telephone number, including area code)

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

Indicate by check (x) whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

(Do not check if a smaller reporting company)

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

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

| Class                                    | Outstanding as of August 2, 2010 |
|--|----------------------------------|
| Common stock, par value \$0.10 per share | 2,760,166                        |

NORWOOD FINANCIAL CORP.  
FORM 10-Q  
FOR THE QUARTER ENDED JUNE 30, 2010

|   | Page<br>Number |
|---|----------------|
| PART I - CONSOLIDATED FINANCIAL INFORMATION OF NORWOOD FINANCIAL CORP.                        |                |
| Item 1. Financial Statements  | 3              |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | 8              |
| Item 3. Quantitative and Qualitative Disclosures about Market Risk                            | 33             |
| Item 4. Controls and Procedures   | 34             |
| PART II - OTHER INFORMATION   |                |
| Item 1. Legal Proceedings   | 35             |
| Item 1A. Risk Factors   | 35             |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds                           | 35             |
| Item 3. Defaults upon Senior Securities   | 35             |
| Item 4. Reserved  | 35             |
| Item 5. Other Information   | 35             |
| Item 6. Exhibits  | 35             |
| Signatures  | 37             |

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## NORWOOD FINANCIAL CORP.

## Consolidated Balance Sheets (unaudited)

(dollars in thousands, except per share data)

|  | June 30,<br>2010 | December<br>31,<br>2009 |
|--|------------------|-------------------------|
| <b>ASSETS</b>  |                  |                         |
| Cash and due from banks  | \$6,168          | \$6,498                 |
| Interest bearing deposits with banks   | 25,374           | 7,857                   |
| Federal funds sold   | 3,000            | 3,000                   |
| Cash and cash equivalents  | 34,542           | 17,355                  |
| Securities available for sale  | 141,245          | 130,577                 |
| Securities held to maturity, fair value 2010:<br>\$179, 2009: \$722                        | 169              | 708                     |
| Loans receivable (net of unearned income)  | 353,933          | 363,474                 |
| Less: Allowance for loan losses  | 5,421            | 5,453                   |
| Net loans receivable   | 348,512          | 358,021                 |
| Investment in FHLB Stock, at cost  | 3,538            | 3,538                   |
| Bank premises and equipment, net   | 5,061            | 5,189                   |
| Bank owned life insurance  | 8,074            | 7,889                   |
| Accrued interest receivable  | 2,113            | 2,200                   |
| Foreclosed real estate owned   | 382              | 392                     |
| Other assets   | 2,944            | 3,827                   |
| <b>TOTAL ASSETS</b>  | <b>\$546,580</b> | <b>\$529,696</b>        |
| <b>LIABILITIES</b>   |                  |                         |
| Deposits:  |                  |                         |
| Non-interest bearing demand  | \$63,408         | \$59,820                |
| Interest-bearing   | 344,355          | 331,653                 |
| Total deposits   | 407,763          | 391,473                 |
| Short-term borrowings  | 24,378           | 25,803                  |
| Other borrowings   | 43,000           | 43,000                  |
| Accrued interest payable   | 1,617            | 2,057                   |
| Other liabilities  | 3,056            | 2,892                   |
| <b>TOTAL LIABILITIES</b>   | <b>479,814</b>   | <b>465,225</b>          |
| <b>STOCKHOLDERS' EQUITY</b>  |                  |                         |
| Common stock, \$.10 par value per share, authorized<br>10,000,000; shares issued 2,840,872 | 284              | 284                     |
| Surplus  | 9,777            | 9,764                   |
| Retained earnings  | 56,526           | 54,455                  |
| Treasury stock at cost: 2010: 80,977 shares, 2009: 68,436                                  | (2,467 )         | (2,122 )                |
| Accumulated other comprehensive income   | 2,646            | 2,090                   |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>  | <b>66,766</b>    | <b>64,471</b>           |
| <b>TOTAL LIABILITIES AND</b>   | <b>\$546,580</b> | <b>\$529,696</b>        |

STOCKHOLDERS' EQUITY

See accompanying notes to the unaudited consolidated financial statements.

3

---

NORWOOD FINANCIAL CORP.  
Consolidated Statements of Income (unaudited)  
(dollars in thousands, except per share data)

|  | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |          |
|--|--------------------------------|---------|------------------------------|----------|
|  | 2010                           | 2009    | 2010                         | 2009     |
| <b>INTEREST INCOME</b>                                 |                                |         |                              |          |
| Loans receivable, including fees                       | \$5,218                        | \$5,426 | \$10,628                     | \$10,713 |
| Securities   | 1,141                          | 1,316   | 2,362                        | 2,713    |
| Other  | 18                             | 1       | 29                           | 7        |
| Total interest income                                  | 6,377                          | 6,743   | 13,019                       | 13,433   |
| <b>INTEREST EXPENSE</b>                                |                                |         |                              |          |
| Deposits   | 1,102                          | 1,420   | 2,301                        | 2,921    |
| Short-term borrowings                                  | 27                             | 73      | 61                           | 169      |
| Other borrowings                                       | 416                            | 415     | 828                          | 827      |
| Total interest expense                                 | 1,545                          | 1,908   | 3,190                        | 3,917    |
| NET INTEREST INCOME                                    | 4,832                          | 4,835   | 9,829                        | 9,516    |
| PROVISION FOR LOAN LOSSES                              | 150                            | 220     | 480                          | 445      |
| NET INTEREST INCOME AFTER<br>PROVISION FOR LOAN LOSSES | 4,682                          | 4,615   | 9,349                        | 9,071    |
| <b>OTHER INCOME</b>                                    |                                |         |                              |          |
| Service charges and fees                               | 570                            | 642     | 1,093                        | 1,240    |
| Income from fiduciary activities                       | 93                             | 82      | 179                          | 164      |
| Net realized gains on sales of securities              | 64                             | 172     | 219                          | 333      |
| Gains on sale of loans and servicing rights            | 130                            | 121     | 205                          | 254      |
| Gains on sale of deposits                              | -                              | -       | -                            | 150      |
| Other  | 159                            | 151     | 322                          | 308      |
| Total other income                                     | 1,016                          | 1,168   | 2,018                        | 2,449    |
| <b>OTHER EXPENSES</b>                                  |                                |         |                              |          |
| Salaries and employee benefits                         | 1,572                          | 1,595   | 3,187                        | 3,209    |
| Occupancy, furniture & equipment, net                  | 408                            | 379     | 802                          | 864      |
| Data processing related                                | 216                            | 203     | 412                          | 399      |
| Taxes, other than income                               | 150                            | 139     | 297                          | 275      |
| Professional fees                                      | 138                            | 104     | 277                          | 202      |
| FDIC Insurance assessment                              | 118                            | 358     | 236                          | 484      |
| Other  | 574                            | 542     | 1,125                        | 1,162    |
| Total other expenses                                   | 3,176                          | 3,320   | 6,336                        | 6,595    |
| INCOME BEFORE INCOME TAXES                             | 2,522                          | 2,463   | 5,031                        | 4,925    |
| INCOME TAX EXPENSE                                     | 704                            | 714     | 1,416                        | 1,439    |
| NET INCOME   | \$1,818                        | \$1,749 | \$3,615                      | \$3,486  |
| BASIC EARNINGS PER SHARE                               | \$0.66                         | \$0.64  | \$1.31                       | \$1.27   |
| DILUTED EARNINGS PER SHARE                             | \$0.66                         | \$0.63  | \$1.31                       | \$1.26   |

See accompanying notes to the unaudited consolidated financial statements.

## NORWOOD FINANCIAL CORP.

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

Six months ended June 30, 2010

(dollars in thousands, except share data)

|   | Common Stock |        |          | Retained  | Treasury Stock |             | Accumulated<br>Other<br>Comprehensive | Total     |
|---|--------------|--------|----------|-----------|----------------|-------------|---------------------------------------|-----------|
|   | Shares       | Amount | Surplus  | Earnings  | Shares         | Amount      | Income                                |           |
| Balance December 31, 2009   | 2,840,872    | \$ 284 | \$ 9,764 | \$ 54,455 | 68,436         | \$ (2,122 ) | \$ 2,090                              | \$ 64,471 |
| Comprehensive Income:   |              |        |          |           |                |             |                                       |           |
| Net Income  |              |        |          | 3,615     |                |             |                                       | 3,615     |
| Change in unrealized gains on securities available or sale, net of reclassification adjustments and tax effects |              |        |          |           |                |             | 556                                   | 556       |
| Total comprehensive income  |              |        |          |           |                |             |                                       | \$ 4,171  |
| Cash dividends declared \$.56 per share   |              |        |          | (1,544 )  |                |             |                                       | (1,544 )  |
| Acquisition of treasury stock   |              |        |          |           | 18,571         | (529 )      |                                       | (529 )    |
| Stock options exercised   |              |        | (95 )    |           | (6,030 )       | 184         |                                       | 89        |
| Tax benefit on stock options exercised  |              |        | 30       |           |                |             |                                       | 30        |
| Compensation expense related to stock options   |              |        | 78       |           |                |             |                                       | 78        |
| Balance, June 30, 2010  | 2,840,872    | \$ 284 | \$ 9,777 | \$ 56,526 | 80,977         | \$ (2,467 ) | \$ 2,646                              | \$ 66,766 |

See accompanying notes to the unaudited consolidated financial statements.



NORWOOD FINANCIAL CORP.  
Consolidated Statements of Cash Flows (Unaudited)  
(dollars in thousands)

|   | Six Months Ended June |                |
|---|-----------------------|----------------|
|   | 30,                   |                |
|   | 2010                  | 2009           |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                       |                |
| Net Income  | \$3,615               | \$3,486        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                       |                |
| Provision for loan losses   | 480                   | 445            |
| Depreciation  | 233                   | 290            |
| Amortization of intangible assets   | 26                    | 26             |
| Deferred income taxes   | 10                    | 144            |
| Net amortization of securities premiums and discounts                             | 141                   | 60             |
| Net realized gain on sales of securities  | (219)                 | (333)          |
| Gain on sale of deposits  | -                     | (150)          |
| Earnings on life insurance  | (182)                 | (166)          |
| Net gain on sale of mortgage loans and servicing rights                           | (205)                 | (254)          |
| Mortgage loans originated for sale  | (10,451)              | (15,674)       |
| Proceeds from sale of mortgage loans originated for sale                          | 10,656                | 15,928         |
| Compensation expense related to stock options                                     | 78                    | 65             |
| Decrease in accrued interest receivable and other assets                          | 755                   | 145            |
| Increase (decrease) in accrued interest payable and other liabilities             | (273)                 | 800            |
| Net cash provided by operating activities   | 4,664                 | 4,812          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                       |                |
| Securities available for sale:  |                       |                |
| Proceeds from sales   | 12,611                | 11,141         |
| Proceeds from maturities and principal reductions on mortgage-backed securities   | 32,567                | 25,278         |
| Purchases   | (54,926)              | (28,428)       |
| Securities held to maturity, proceeds from maturities                             | 540                   | -              |
| Net (increase) decrease in loans  | 8,928                 | (11,506)       |
| Purchase of bank premises and equipment   | (105)                 | (100)          |
| Proceeds from sale of bank premises and equipment and foreclosed real estate      | -                     | 2              |
| Net cash used in investing activities   | (385)                 | (3,613)        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                       |                |
| Net increase in deposits  | 16,290                | 18,274         |
| Deposits sold   | -                     | (3,606)        |
| Net decrease in short-term borrowings   | (1,425)               | (13,530)       |
| Stock options exercised   | 89                    | 215            |
| Tax benefit of stock options exercised  | 30                    | 67             |
| Acquisition of treasury stock   | (529)                 | (68)           |
| Cash dividends paid   | (1,547)               | (1,477)        |
| Net cash provided by (used in) financing activities                               | 12,908                | (125)          |
| Increase in cash and cash equivalents   | 17,187                | 1,074          |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                             | <b>17,355</b>         | <b>6,480</b>   |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>                                   | <b>\$34,542</b>       | <b>\$7,554</b> |

See accompanying notes to the unaudited consolidated financial statements.

6

---

## Notes to the Unaudited Consolidated Financial Statements

## 1. Basis of Presentation

The unaudited consolidated financial statements include the accounts of Norwood Financial Corp. (Company) and its wholly-owned subsidiary, Wayne Bank (Bank) and the Bank's wholly-owned subsidiaries, WCB Realty Corp., Norwood Investment Corp. and WTRO Properties. All significant intercompany transactions have been eliminated in consolidation.

The accompanying unaudited consolidated financial statements have been prepared in conformity with generally accepted accounting principles for interim financial statements and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ from those estimates. The financial statements reflect, in the opinion of management, all normal, recurring adjustments necessary to present fairly the financial position and results of operations of the Company. The operating results for the three and six month periods ended June 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010 or any other future interim period.

These statements should be read in conjunction with the consolidated financial statements and related notes which are incorporated by reference in the Company's Annual Report on Form 10-K for the year-ended December 31, 2009.

## 2. Earnings Per Share

Basic earnings per share represents income available to common stockholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options and are determined using the treasury stock method.

The following table sets forth the weighted average shares outstanding used in the computations of basic and diluted earnings per share:

(in thousands)

|   | Three Months Ended |       | Six Months Ended |       |
|---|--------------------|-------|------------------|-------|
|   | June 30,<br>2010   | 2009  | June 30,<br>2010 | 2009  |
| Basic EPS weighted average shares outstanding   | 2,758              | 2,741 | 2,763            | 2,739 |
| Dilutive effect of stock options                | 4                  | 19    | 4                | 19    |
| Diluted EPS weighted average shares outstanding | 2,762              | 2,760 | 2,767            | 2,758 |

Stock options which had no intrinsic value, because their effect would be anti-dilutive and therefore would not be included in the diluted EPS calculation were 138,150 and 114,150 as of June 30, 2010 and 2009, respectively.



### 3. Stock-Based Compensation

The Company's shareholders approved the Norwood Financial Corp 2006 Stock Option Plan at the annual meeting on April 25, 2006 and the Company awarded 47,700 options in 2006, 22,000 options in 2007, 24,000 options in 2008, 27,000 options in 2009 and 1,000 options in 2010, all of which have a twelve month vesting period. As of June 30, 2010, there was \$78,000 of total unrecognized compensation cost related to non-vested options granted in 2009 and 2010 under the plan, which will be fully amortized by December 31, 2010.

A summary of stock options from all plans, adjusted for stock dividends declared, is shown below.

|                                | Options | Weighted<br>Average Exercise<br>Price<br>Per Share | Weighted Average<br>Remaining<br>Contractual Term | Aggregate<br>Intrinsic Value<br>(\$000) |
|--------------------------------|---------|--|---|---|
| Outstanding at January 1, 2010 | 170,915 | \$ 28.07   | 6.8 Yrs.  | \$ 286                                  |
| Granted                        | 1,000   | 26.88  | 9.7 Yrs.  | -                                       |
| Exercised                      | (6,030) | 14.83  | 1.3 Yrs.  | 74                                      |
| Outstanding at June 30, 2010   | 165,885 | \$ 28.55   | 6.4 Yrs.  | \$ 85                                   |
| Exercisable at June 30, 2010   | 141,900 | \$ 28.33   | 5.0 Yrs.  | \$ 85                                   |

Intrinsic value represents the amount by which the market price of the stock on the measurement date exceeded the exercise price of the option. The stock price was \$25.25 as of June 30, 2010 and \$28.59 as of December 31, 2009. The intrinsic value of options exercised during the six months ended June 30, 2010 was \$74,000, cash received from such exercises was \$89,000 and the tax benefit recognized was \$25,000.

### 4. Cash Flow Information

For the purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing deposits with banks all of which mature within 90 days and federal funds sold.

Cash payments for interest for the six months ended June 30, 2010 and 2009 were \$3,629,000 and \$3,954,000, respectively. Cash payments for income taxes for the periods ending June 30, 2010 and 2009 were \$1,307,000 and \$1,153,000, respectively. Non-cash investing activity for 2010 and 2009 included repossession of other assets and foreclosed mortgage loans transferred to real estate owned of \$101,000 and \$213,000, respectively.

### 5. Comprehensive Income

Accounting principles generally accepted in the United States of America require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income. The components of other comprehensive income and related tax effects are as follows.

|  | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |       |
|--|--------------------------------|---------|------------------------------|-------|
|  | 2010                           | 2009    | 2010                         | 2009  |
| Unrealized holding gains<br>on available for sale securities | \$783                          | \$(368) | ) \$1,062                    | \$533 |
| Reclassification adjustment for gains<br>realized in income  | 64                             | (172)   | ) 219                        | (333) |
| Net unrealized gains   | 719                            | (540)   | ) 843                        | 200   |
| Income tax expense   | 244                            | (182)   | ) 287                        | 72    |
| Other comprehensive income                                   | \$475                          | \$(358) | ) \$556                      | \$128 |

#### 6. Off-Balance Sheet Financial Instruments and Guarantees

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

A summary of the Bank's financial instrument commitments is as follows:

|  | June 30,<br>2010 | 2009     |
|--|------------------|----------|
| Commitments to grant loans                 | \$15,908         | \$15,991 |
| Unfunded commitments under lines of credit | 33,915           | 41,482   |
| Standby letters of credit                  | 3,269            | 2,079    |
|  | \$53,092         | \$59,522 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the customer and generally consists of real estate.

The Bank does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit written are conditional commitments issued by the Bank to guarantee the

performance of a customer to a third party. Generally, all letters of credit, when issued, have

expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank, generally, holds collateral and/or personal guarantees supporting these commitments. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of June 30, 2010 for guarantees under standby letters of credit issued is not material.

## 7. Securities

The amortized cost and fair value of securities were as follows:

|                                   | June 30, 2010  |                        |                         | Fair Value     |
|-----------------------------------|----------------|------------------------|-------------------------|----------------|
|                                   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses |                |
|                                   |                |                        |                         |                |
|                                   |                |                        |                         | (In Thousands) |
| Available for Sale:               |                |                        |                         |                |
| U.S. Government agencies          | \$46,602       | \$615                  | \$(1 )                  | \$47,216       |
| States and political subdivisions | 40,203         | 1,015                  | (83 )                   | 41,135         |
| Corporate obligations             | 5,031          | 215                    | -                       | 5,246          |
| Mortgage-backed securities        | 45,065         | 1,760                  | (2 )                    | 46,823         |
|                                   | 136,901        | 3,605                  | (86 )                   | 140,420        |
| Equity securities                 | 330            | 498                    | (3 )                    | 825            |
|                                   | \$137,231      | \$4,103                | \$(89 )                 | \$141,245      |
| Held to Maturity:                 |                |                        |                         |                |
| States and political subdivisions | \$169          | \$10                   | \$-                     | \$179          |

|                                   | December 31, 2009 |                        |                         | Fair Value     |
|-----------------------------------|-------------------|------------------------|-------------------------|----------------|
|                                   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses |                |
|                                   |                   |                        |                         |                |
|                                   |                   |                        |                         | (In Thousands) |
| Available for Sale:               |                   |                        |                         |                |
| U.S. Government agencies          | \$39,607          | \$295                  | \$(130 )                | \$39,772       |
| States and political subdivisions | 30,872            | 780                    | (17 )                   | 31,635         |
| Corporate obligations             | 5,043             | 200                    | (3 )                    | 5,240          |
| Mortgage-backed securities        | 51,554            | 1,618                  | (18 )                   | 53,154         |
|                                   | 127,076           | 2,893                  | (168 )                  | 129,801        |
| Equity securities                 | 330               | 451                    | (5 )                    | 776            |
|                                   | \$127,406         | \$3,344                | \$(173 )                | \$130,577      |
| Held to Maturity:                 |                   |                        |                         |                |
| States and political subdivisions | \$708             | \$14                   | \$-                     | \$722          |





The following tables show the Company's investments' gross unrealized losses and fair value aggregated by length of time that individual securities have been in a continuous unrealized loss position (in thousands):

|                                   | June 30, 2010       |                   |                   |                   |            |                   |
|-----------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                                   | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|                                   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government agencies          | \$999               | \$(1 )            | \$-               | \$-               | \$999      | \$(1 )            |
| States and political subdivisions | 7,420               | (83 )             | -                 | -                 | 7,420      | (83 )             |
| Mortgage-backed securities        | 758                 | (2 )              | -                 | -                 | 758        | (2 )              |
| Equity securities                 | 15                  | (1 )              | 5                 | (2 )              | 20         | (3 )              |
|                                   | \$9,192             | \$(87 )           | \$5               | \$(2 )            | \$9,197    | \$(89 )           |

The Company has twenty securities in an unrealized loss position in the less than twelve months category and one security in the twelve months or more category. In Management's opinion the unrealized losses less than twelve months principally reflect changes in interest rates subsequent to the acquisition of specific securities. The Company holds a small amount of equity securities in other financial institutions. The value of these equity securities has been impacted by the overall weakness in the financial sector, one of which has been in a loss position for greater than one year. During the fourth quarter of 2009, the Company recorded an other-than-temporary impairment charge on two equity holdings totaling \$31,000. Management believes that all other unrealized losses represent temporary impairment of the securities as the Company does not have the intent to sell these securities and it is more likely than not that it will not have to sell the securities before recovery of their cost basis.

|                                   | December 31, 2009   |                   |                   |                   |            |                   |
|-----------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                                   | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|                                   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government agencies          | \$15,366            | \$(130 )          | \$-               | \$-               | \$15,366   | \$(130 )          |
| States and political subdivisions | 1,413               | (17 )             | -                 | -                 | 1,413      | (17 )             |
| Corporate obligations             | 997                 | (3 )              | -                 | -                 | 997        | (3 )              |
| Mortgage-backed securities        | 3,655               | (18 )             | -                 | -                 | 3,655      | (18 )             |
| Equity securities                 | 49                  | (3 )              | 5                 | (2 )              | 54         | (5 )              |
|                                   | \$21,480            | \$(171 )          | \$5               | \$(2 )            | \$21,485   | \$(173 )          |

The amortized cost and fair value of debt securities as of June 30, 2010 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties.

|  | Available for Sale<br>Amortized |            | Held to Maturity<br>Amortized |            |
|--|---------------------------------|------------|-------------------------------|------------|
|  | Cost                            | Fair Value | Cost                          | Fair Value |
|  | (In Thousands)                  |            |                               |            |
| Due in one year or less                | \$2,010                         | \$2,032    | \$-                           | \$-        |
| Due after one year through five years  | 42,756                          | 43,532     | 169                           | 179        |
| Due after five years through ten years | 26,659                          | 27,268     | -                             | -          |
| Due after ten years                    | 20,411                          | 20,765     | -                             | -          |
|  | 91,836                          | 93,597     | 169                           | 179        |
| Mortgage-backed securities             | 45,065                          | 46,823     | -                             | -          |
|  | \$136,901                       | \$140,420  | \$169                         | \$179      |

Gross realized gains and gross realized losses on sales of securities available for sale were as follows (in thousands):

|                                   | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |          |
|-----------------------------------|--------------------------------|---------|------------------------------|----------|
|                                   | 2010                           | 2009    | 2010                         | 2009     |
| Gross realized gains              | \$64                           | \$172   | \$219                        | \$436    |
| Gross realized losses             | -                              | -       | -                            | (103)    |
| Net realized gain/(loss)          | \$64                           | \$172   | \$219                        | \$333    |
| Proceeds from sales of securities | \$3,774                        | \$6,168 | \$12,611                     | \$11,141 |

## 8. Fair Value Measurements

Generally accepted accounting principles in the United States of America established a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.



For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2010 and December 31, 2009 are as follows:

| Description                       | Fair Value Measurement Reporting Date Using |   |   |  |
|-----------------------------------|---|---|---|--|
|                                   | Total                                       | (Level 1)<br>Quoted<br>Prices in<br>Active<br>Markets<br>For<br>Identical<br>Assets | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Unobservable<br>Inputs |
| June 30, 2010                     |   |   |   |  |
| Available for Sale:               |   |   |   |  |
| US Government agencies            | \$47,216                                    |   | \$47,216  | \$ -   |
| States and political subdivisions | 41,135                                      |   | 41,135  | -  |
| Corporate securities              | 5,246                                       |   | 5,246   | -  |
| Mortgage-backed securities        | 46,823                                      |   | 46,823  | -  |
| Equity securities                 | 825   | \$825   |   | -  |
| Total                             | \$141,245                                   | \$825   | \$140,420   | \$ -   |
| December 31, 2009                 |   |   |   |  |
| Available for Sale:               |   |   |   |  |
| US Government agencies            | \$39,772                                    |   | \$39,772  | \$ -   |
| States and political subdivisions | 31,635                                      |   | 31,635  | -  |
| Corporate securities              | 5,240                                       |   | 5,240   | -  |
| Mortgage-backed securities        | 53,154                                      |   | 53,154  | -  |
| Equity securities                 | 776   | \$776   |   | -  |
| Total                             | \$130,577                                   | \$776   | \$129,801   | \$ -   |

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2010 and December 31, 2009 are as follows:

| (In thousands) | Description                  | Total    | Fair Value Measurement Reporting Date using   |   |
|----------------|------------------------------|----------|---|---|
|                |                              |          | (Level 1)<br>Quoted<br>Prices in<br>Active<br>Markets<br>For<br>Identical<br>Assets | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs |
| June 30, 2010  |                              |          |   |   |
|                | Impaired Loans               | \$ 7,115 |   | \$ 7,115  |
|                | Foreclosed Real Estate Owned | 382      |   | 382   |
|                |                              | \$ 7,497 | \$ -  | \$ 7,497  |

December 31, 2009

|                              |          |      |          |      |
|------------------------------|----------|------|----------|------|
| Impaired Loans               | \$ 7,991 |      | \$ 7,991 | \$ - |
| Foreclosed Real Estate Owned | 392      | \$ - | 392      | \$ - |
|                              | \$ 8,383 | \$ - | \$ 8,383 | \$ - |

13

---

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at June 30, 2010 and December 31, 2009.

Cash and cash equivalents (carried at cost):

The carrying amounts reported in the consolidated balance sheet for cash and short-term instruments approximate those assets' fair values.

Securities:

The fair value of securities available for sale (carried at fair value) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 2). Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) are used to support fair values of certain (Level 3) investments, if applicable.

Loans receivable (Carried at cost):

The fair values of loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

The Company measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as either Level 2 or Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements.

As of June 30, 2010, the fair value investment in impaired loans totaled \$7,115,000 which includes three loans for \$2.4 million for which a valuation allowance has been provided based on current collateral values and five loans for \$4.7 million which do not require a valuation allowance since the current collateral value exceeds the loan value. As of June 30, 2010, the Company has recognized charge-offs against the allowance for loan losses on impaired loans in the amount of \$775,000 over the life of the loans.

As of December 31, 2009, the fair value investment in impaired loans was \$7,991,000 which included two loans for \$1.0 million for which a valuation allowance had been provided based on the estimated value of the collateral and five loans for \$7.0 million which did not require a valuation allowance since the estimated realizable value of the collateral exceeded the recorded investment in the loan. As of December 31, 2009, the Company had recognized a cumulative charge-off against the allowance for loans losses in the amount of \$634,000 on impaired loans.

|  | June 30, 2010  |                     |                                   |
|--|----------------|---------------------|-----------------------------------|
|  | Carrying Value | Valuation Allowance | Cumulative Charge-offs Recognized |
| Impaired loans requiring a valuation allowance     | \$2,434,000    | \$313,000           | \$565,000                         |
| Impaired loans not requiring a valuation allowance | 4,681,000      | -                   | 210,000                           |
| Total  | \$7,115,000    | \$313,000           | \$775,000                         |

|  | December 31, 2009 |                     |                                   |
|--|-------------------|---------------------|-----------------------------------|
|  | Carrying Value    | Valuation Allowance | Cumulative Charge-offs Recognized |
| Impaired loans requiring a valuation allowance     | \$1,029,000       | \$36,000            | \$480,000                         |
| Impaired loans not requiring a valuation allowance | 6,962,000         | -                   | 154,000                           |
| Total  | \$7,991,000       | \$36,000            | \$634,000                         |

#### Foreclosed real estate owned

Real estate properties acquired through, or in lieu of loan foreclosure are to be sold and are carried at fair value less cost to sell. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. These assets are included in Level 2 fair value based upon the lowest level of input that is significant to the fair value measurement.

#### Restricted investment in Federal Home Loan Bank stock (carried at cost):

Restricted stock which represents required investment in the common stock of correspondent banks is carried at cost and as of June 30, 2010 and December 31, 2009, consists of the common stock of the Federal Home Loan Bank of Pittsburgh. In December 2008, the FHLB of Pittsburgh notified member banks that it was suspending dividend payments and the repurchase of excess capital stock.

Management evaluates the restricted stock for impairment. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. Management believes no impairment charge is necessary related to FHLB stock as of June 30, 2010.

#### Accrued interest receivable and payable (carried at cost):

The carrying amount of accrued interest receivable and accrued interest payable approximates its fair value.





## Deposit liabilities (carried at cost):

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

## Short-term borrowings (carried at cost):

The carrying amounts of short-term borrowings approximate their fair values.

## Other borrowings (carried at cost):

Fair values of FHLB advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

## Off-balance sheet financial instruments (disclosed at cost):

Fair values for the Company's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

The estimated fair values of the Bank's financial instruments were as follows at June 30, 2010 and December 31, 2009.

|  | June 30, 2010      |               | December 31, 2009  |               |
|--|--------------------|---------------|--------------------|---------------|
|  | Carrying<br>Amount | Fair<br>Value | Carrying<br>Amount | Fair<br>Value |
|  | (In Thousands)     |               |                    |               |
| <b>Financial assets:</b>   |                    |               |                    |               |
| Cash and due from banks, interest-bearing deposits with banks and federal funds sold | \$34,542           | \$34,542      | \$17,355           | \$17,355      |
| Securities   | 141,414            | 141,424       | 131,285            | 131,299       |
| Loans receivable, net  | 348,512            | 357,850       | 358,021            | 368,180       |
| Investment in FHLB stock   | 3,538              | 3,538         | 3,538              | 3,538         |
| Accrued interest receivable  | 2,113              | 2,113         | 2,200              | 2,200         |
| <b>Financial liabilities:</b>  |                    |               |                    |               |
| Deposits   | 407,763            | 409,145       | 391,473            | 392,445       |
| Short-term borrowings  | 24,378             | 24,378        | 25,803             | 25,803        |
| Other borrowings   | 43,000             | 45,781        | 43,000             | 45,591        |
| Accrued interest payable   | 1,617              | 1,617         | 2,057              | 2,057         |
| <b>Off-balance sheet financial instruments:</b>                                      |                    |               |                    |               |
| Commitments to extend credit and outstanding letters of credit                       | -                  | -             | -                  | -             |



9. New and Recently Adopted Accounting Pronouncements

In December 2009, the FASB issued Accounting Standards Update (“ASU”) 2009-16, Accounting for Transfer of Financial Assets. ASU 2009-16 provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor’s continuing involvement, if any, in transferred financial assets. ASU 2009-16 is effective for annual periods beginning after November 15, 2009 and for interim periods within those fiscal years. The adoption of this guidance is not expected to have a significant impact on the Company’s financial statements.

In January 2010, the FASB issued ASU 2010-01, Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash – a consensus of the FASB Emerging Issues Task Force. ASU 2010-01 clarifies that the stock portion of a distribution to shareholders that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in EPS prospectively and is not a stock dividend. ASU 2010-01 is effective for interim and annual periods ending on or after December 15, 2009 and should be applied on a retrospective basis. The adoption of this guidance did not have a material impact on the Company’s financial position or results of operation.

In January 2010, the FASB issued ASU 2010-05, Compensation – Stock Compensation (Topic 718): Escrowed Share Arrangements and the Presumption of Compensation. ASU 2010-05 updates existing guidance to address the SEC staff’s views on overcoming the presumption that for certain shareholders escrowed share arrangements represent compensation. ASU 2010-05 is effective January 15, 2010. The adoption of this guidance did not have a material impact on the Company’s financial position or results of operation.

In January 2010, the FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers’ disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The Company has presented the necessary disclosures in Note 8 herein.

In February 2010, the FASB issued ASU 2010-08, Technical Corrections to Various Topics. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. The adoption of this guidance did not have a material impact on the Company’s financial position or results of operation.

In March 2010, the FASB issued ASU 2010-11, Derivatives and Hedging. ASU 2010-11 provides clarification and related additional examples to improve financial reporting by resolving potential ambiguity about the breadth of the embedded credit derivative scope exception in ASC 815-15-15-8. ASU 2010-11 is effective at the beginning of the first fiscal quarter beginning after June 15, 2010. The adoption of this guidance is not expected to have a significant impact on the Company’s financial statements.

In April 2010, the FASB issued ASU 2010-18, Receivables (Topic 310): Effect of a Loan Modification When the Loan is a Part of a Pool That is Accounted for as a Single Asset – a consensus of the FASB Emerging



Issues Task Force. ASU 2010-18 clarifies the treatment for a modified loan that was acquired as part of a pool of assets. Refinancing or restructuring the loan does not make it eligible for removal from the pool, the FASB said. The amendment will be effective for loans that are part of an asset pool and are modified during financial reporting periods that end July 15, 2010 or later and is not expected to have a significant impact on the Company's financial statements.

In July 2010, FASB issued ASU No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The Company is currently evaluating the impact the adoption of this guidance will have on the Company's financial position or results of operations.

#### 10. Branch Closure

On December 26, 2008, the Company filed notifications with the Pennsylvania Department of Banking and the FDIC, requesting authorization to discontinue branch operations at its Hamlin Office, as the lease for the location expires in 2009, with no renewal options available. The Company entered into an agreement with NBT Bank to assume the deposits of the Hamlin location and the office was closed. The Company recorded a net payable to NBT Bank of \$3,607,000, which was paid subsequent to March 31, 2009. The gain on the transaction was \$150,000 with expense related to the closing, including final lease payments, of \$46,000, included in other expense in the consolidated income statement.

#### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

##### Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 contains safe harbor provisions regarding forward-looking statements. When used in this discussion, the words believes, anticipates, contemplates, expects, and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected. Those risks and uncertainties include changes in federal and state laws, changes in interest rates, risks associated with the effect of opening a new branch, the ability to control costs and expenses, demand for real estate and general economic conditions. The Company undertakes no obligation to publicly release the results of any revisions to those forward-looking statements which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

##### Critical Accounting Policies

Note 2 to the Company's consolidated financial statements for the year ended December 31, 2009 (incorporated by reference in Item 8 of the Form 10-K) lists 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 the Company and its results of operations.



Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, potential impairment of restricted stock, accounting for stock options, the valuation of deferred tax assets and the determination of other-than-temporary impairment losses on securities. Please refer to the discussion of the allowance for loan losses calculation under "Allowance for Loan Losses and Non-performing Assets" in the "Changes in Financial Condition" section.

The Company uses the modified prospective transition method to account for stock based compensation. Under this method companies are required to record compensation expense, based on the fair value of options over the vesting period.

The Deferred income taxes reflect temporary differences in the recognition of the revenue and expenses for tax reporting and financial statement purposes, principally because certain items are recognized in different periods for financial reporting and tax return purposes. Although realization is not assured, the Company believes that it is more likely than not that all deferred tax assets will be realized.

Restricted stock which represents required investment in the common stock of correspondent banks is carried at cost and as of June 30, 2010 and December 31, 2009, consists of the common stock of the Federal Home Loan Bank of Pittsburgh. In December 2008, the FHLB of Pittsburgh notified member banks that it was suspending dividend payments and the repurchase of excess capital stock.

Management evaluates the restricted stock for impairment. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary decline in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. Management believes no impairment charge is necessary related to the restricted stock as of June 30, 2010 and December 31, 2009

In estimating other-than-temporary impairment losses on securities, the Company considers 1) the length of time and extent to which the fair value has been less than cost 2) the financial condition of the issuer and 3) the intent and ability of the Company to hold the security to allow for a recovery to fair value. During the fourth quarter of 2009, the Company recorded an other-than-temporary impairment charge on two equity holdings totaling \$31,000. The Company believes that the unrealized losses on all other securities at June 30, 2010 and December 31, 2009 represent temporary impairment of the securities, related to changes in interest rates.

## Changes in Financial Condition

### General

Total assets as of June 30, 2010 were \$546.6 million compared to \$529.7 million as of December 31, 2009 an increase of \$16.9 million. The increase was due primarily to a \$16.3 million increase in total deposits which contributed to an increase in cash and cash equivalents and securities available for sale.

### Cash and Cash Equivalents

Cash and cash equivalents totaled \$34.5 million compared to \$17.4 million as of December 31, 2009, an increase of \$17.2 million, or 99%. The increase in cash and cash equivalents was driven by an increase in deposits and proceeds from the sale and maturity of loans.





### Securities

The fair value of securities available for sale as of June 30, 2010 was \$141.2 million compared to \$130.6 million as of December 31, 2009. The Company purchased \$54.9 million of securities using the proceeds from \$45.2 million of securities sold, called, maturities and principal reductions as well as cash received from an increase in total deposits and from the sale of residential mortgage loans.

U.S. Government Agency securities increased \$7.4 million to \$47.2 million and obligations of States and political subdivisions increased \$9.0 million to \$41.3 million which offset a \$6.3 million decline in mortgage-backed securities.

The carrying value of the Company's securities portfolio (Available-for Sale and Held-to Maturity) consisted of the following:

| (dollars in thousands)            | June 30, 2010 |                | December 31, 2009 |                |   |
|-----------------------------------|---------------|----------------|-------------------|----------------|---|
|                                   | Amount        | % of portfolio | Amount            | % of portfolio |   |
| US Government agencies            | \$47,216      | 33.4           | % \$39,772        | 30.3           | % |
| States and political subdivisions | 41,304        | 29.2           | 32,343            | 24.6           |   |
| Corporate securities              | 5,246         | 3.7            | 5,240             | 4.0            |   |
| Mortgage-backed securities        | 46,823        | 33.1           | 53,154            | 40.5           |   |
| Equity securities                 | 825           | 0.6            | 776               | 0.6            |   |
| Total                             | \$141,414     | 100.0          | % \$131,285       | 100.0          | % |

The Company has securities in an unrealized loss position. In management's opinion, the unrealized losses in the mortgage-backed securities reflect changes in interest rates subsequent to the acquisition of specific securities. The unrealized losses in the State and Political Subdivisions also reflect a widening of spreads due to liquidity and credit concerns in the financial markets. The Company holds a small amount of equity securities in other financial institutions, the value of which has been impacted by the weakening conditions of the financial markets. During the fourth quarter of 2009, the Company recorded an other-than-temporary impairment charge on two equity holdings totaling \$31,000. Management believes that all other unrealized losses represent temporary impairment of the securities as the Company does not have the intent to sell these securities and it is more likely than not that it will not have to sell the securities before recovery of their cost basis.

### Loans Receivable

Loans receivable totaled \$353.9 million compared to \$363.5 million as of December 31, 2009. Residential real estate loans, including construction financing, decreased \$7.5 million due to the sale of \$10.5 million of residential mortgages and principal repayments. The loans were sold for interest rate risk management to shorten the average life of the mortgage loan portfolio and to reduce the risk to rising interest rates. Commercial loans including commercial real estate loans decreased \$700,000 during the period while all other loans decreased \$1.4 million.

Set forth below is selected data relating to the composition of the loan portfolio at the dates indicated:

| Types of loans<br>(dollars in thousands) | June 30, 2010 |       | December 31, 2009 |           |       |   |
|--|---------------|-------|-------------------|-----------|-------|---|
| Real Estate-Residential                  | \$125,803     | 35.5  | %                 | \$130,318 | 35.8  | % |
| Commercial                               | 179,599       | 50.7  |                   | 180,266   | 49.5  |   |
| Construction                             | 11,376        | 3.2   |                   | 14,405    | 4.0   |   |
| Commercial, financial and agricultural   | 24,087        | 6.8   |                   | 24,116    | 6.6   |   |
| Consumer loans to individuals            | 13,484        | 3.8   |                   | 14,850    | 4.1   |   |
| Total loans                              | 354,349       | 100.0 | %                 | 363,955   | 100.0 | % |
| Deferred fees (net)                      | (416          | )     |                   | (481      | )     |   |
|  | 353,933       |       |                   | 363,474   |       |   |
| Allowance for loan losses                | (5,421        | )     |                   | (5,453    | )     |   |
| Net loans receivable                     | \$348,512     |       |                   | \$358,021 |       |   |

#### Allowance for Loan Losses and Non-performing Assets

Following is a summary of changes in the allowance for loan losses for the periods indicated:

| (dollars in thousands)  | Three Months Ended |         | Six Months Ended |         |
|---|--------------------|---------|------------------|---------|
|   | June 30,           | 2009    | June 30,         | 2009    |
|   | 2010               |         | 2010             |         |
| Balance, beginning  | \$5,362            | \$4,413 | \$5,453          | \$4,233 |
| Provision for loan losses                                     | 150                | 220     | 480              | 445     |
| Charge-offs   | (95                | ) (80   | ) (524           | ) (142  |
| Recoveries  | 4                  | 21      | 12               | 38      |
| Net charge-offs   | (91                | ) (59   | ) (512           | ) (104  |
| Balance, ending   | \$5,421            | \$4,574 | \$5,421          | \$4,574 |
| Allowance to total loans                                      | 1.53               | % 1.27  | % 1.53           | % 1.27  |
| Net (charge-offs) recoveries to average loans<br>(annualized) | .10                | % .07   | % .29            | % .06   |

The allowance for loan losses totaled \$5,421,000 as of June 30, 2010 and represented 1.53% of total loans, compared to \$5,453,000 and 1.50% of total loans at year end, and \$4,574,000 or 1.27% of total loans, as of June 30, 2009. The Company had net charge-offs for the six months ended June 30, 2010 of \$512,000 compared to \$104,000 in the comparable period in 2009. The charge-offs during the six months ended June 30, 2010 included \$472,000 of losses on loans that were previously carried in nonaccrual status. The Company's loan review process assesses the adequacy of the allowance for loan losses on a quarterly basis. The process includes an analysis of the risks inherent in the loan portfolio. It includes an analysis of impaired loans and a historical review of credit losses by loan type. Other factors considered include: concentration of credit in specific industries; economic and industry conditions; trends in delinquencies and loan classifications, large dollar exposures and loan growth. Management considers the allowance adequate at June 30, 2010 based on the Company's criteria. However, there can be no assurance that the allowance for loan losses will be adequate to cover significant losses, if any, that might be incurred in the future.



As of June 30, 2010, non-performing loans totaled \$3,754,000, which is 1.06% of total loans. Included in the total are four commercial real estate loans for \$2.6 million; four consumer loans for \$658,000; two commercial loans for \$413,000 and three residential mortgage loans for \$76,000. At December 31, 2009, non-performing loans totaled \$5,015,000, or 1.38% of total loans. Included in this total was five commercial real estate loans for \$3.1 million; six consumer loans totaling \$996,000; two commercial loans for \$695,000 and three residential mortgage loans totaling \$87,000. The decrease was principally due to the resolution and payoff of two commercial credits. The following table sets forth information regarding non-performing loans and foreclosed real estate at the dates indicated:

| (dollars in thousands)   | June 30,<br>2010 | December<br>31, 2009 |      |   |
|--|------------------|----------------------|------|---|
| Loans accounted for on a non-accrual basis:                        |                  |                      |      |   |
| Commercial and all other   | \$ -             | \$ -                 |      |   |
| Real Estate-Commercial   | 3,019            | 3,833                |      |   |
| Residential  | 735              | 1,083                |      |   |
| Consumer   | -                | -                    |      |   |
| Total  | 3,754            | 4,916                |      |   |
| Accruing loans which are contractually<br>past due 90 days or more | 0                | 99                   |      |   |
| Total non-performing loans   | 3,754            | 5,015                |      |   |
| Foreclosed real estate   | 382              | 392                  |      |   |
| Total non-performing assets  | \$ 4,136         | \$ 5,407             |      |   |
| Allowance for loans losses   | \$ 5,421         | \$ 5,453             |      |   |
| Coverage of non-performing loans                                   | 1.44x            | 1.09x                |      |   |
| Non-performing loans to total loans                                | 1.06             | %                    | 1.38 | % |
| Non-performing loans to total assets                               | .69              | %                    | .95  | % |
| Non-performing assets to total assets                              | .76              | %                    | 1.02 | % |

#### Deposits

Total deposits as of June 30, 2010 were \$407.8 million compared to \$391.5 million as of December 31, 2009, an increase of \$16.3 million. During the period, interest bearing demand deposits, including money market deposits, increased \$20.4 million, savings deposits increased \$4.8 million and non-interest bearing demand balances increased \$3.6 million to offset a \$12.5 million reduction in certificates of deposit. The decrease in certificates includes \$4.2 million of certificates of deposit over \$100,000 due to the seasonality of municipal deposits and \$8.3 million of retail certificates due to the maturity of certificates which were generated through deposit promotions.

The following table sets forth deposit balances as of the dates indicated:

| (dollars in thousands)        | June 30,<br>2010 | December<br>31, 2009 |
|-------------------------------|------------------|----------------------|
| Non-interest bearing demand   | \$63,408         | \$59,820             |
| Interest bearing demand       | 41,314           | 34,410               |
| Money market deposit accounts | 73,510           | 60,035               |
| Savings                       | 49,274           | 44,423               |
| Time deposits <\$100,000      | 117,864          | 126,154              |
| Time deposits >\$100,000      | 62,393           | 66,631               |
| <br>Total                     | <br>\$407,763    | <br>\$391,473        |

#### Borrowings

Short-term borrowings as of June 30, 2010 totaled \$24.4 million compared to \$25.8 million as of December 31, 2009. Securities sold under agreements to repurchase declined \$1.3 million principally due to the seasonality of municipal cash management accounts. Short-term borrowings consist of the following:

| (dollars in thousands)                         | June 30,<br>2010 | December<br>31, 2009 |
|--|------------------|----------------------|
| Securities sold under agreements to repurchase | \$24,291         | \$25,606             |
| U.S. Treasury demand notes                     | 87               | 197                  |
|  | \$24,378         | \$25,803             |

Other borrowings consisted of the following:

| (dollars in thousands)                      | June 30,<br>2010 | December<br>31, 2009 |
|---|------------------|----------------------|
| Notes with the FHLB:                        |                  |                      |
| Fixed rate note due September 2010 at 3.53% | \$5,000          | \$5,000              |
| Convertible note due January 2011 at 5.24%  | 3,000            | 3,000                |
| Convertible note due August 2011 at 2.69%   | 10,000           | 10,000               |
| Fixed rate note due September 2011 at 4.06% | 5,000            | 5,000                |
| Convertible note due October 2012 at 4.37%  | 5,000            | 5,000                |
| Convertible note due May 2013 at 3.015%     | 5,000            | 5,000                |
| Convertible note due January 2017 at 4.71%  | 10,000           | 10,000               |
|   | \$43,000         | \$43,000             |

The convertible notes contain an option which allows the FHLB, at quarterly intervals to change the note to an adjustable-rate advance at three month LIBOR plus 11 to 19 basis points. If the notes are converted, the option allows the Bank to put the funds back to the FHLB at no charge.

Off-Balance Sheet Arrangements

The Bank is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Commitments to grant loans totaled \$15.9 million as of June 30, 2010 compared to \$17.7 million as of December 31, 2009.

A summary of the contractual amount of the Company's financial instrument commitments is as follows:

|  | June<br>30, 2010 | December<br>31, 2009 |
|--|------------------|----------------------|
|  | (in thousands)   |                      |
| Commitments to grant loans                 | \$15,908         | \$17,713             |
| Unfunded commitments under lines of credit | 33,915           | 36,809               |
| Standby letters of credit                  | 3,269            | 3,679                |
|  | \$53,092         | \$58,201             |

#### Stockholders' Equity and Capital Ratios

As of June 30, 2010, stockholders' equity totaled \$66.8 million, compared to \$64.5 million as of December 31, 2009. The net change in stockholders' equity included \$3,615,000 in net income, that was partially offset by \$1,544,000 of dividends declared and a \$529,000 reduction due to an increase in Treasury Stock. In addition, accumulated other comprehensive income increased \$556,000 due to an increase in fair value of securities in the available for sale portfolio, net of tax. This increase in fair value is the result of a change in interest rates, which may impact the value of the securities. Because of interest rate volatility, the Company's accumulated other comprehensive income could materially fluctuate for each interim and year-end period.

A comparison of the Company's regulatory capital ratios is as follows:

|   | June 30,<br>2010 |   | December<br>31, 2009 |   |
|---|------------------|---|----------------------|---|
| Tier 1 Capital<br>(To average assets)       | 12.05            | % | 11.53                | % |
| Tier 1 Capital<br>(To risk-weighted assets) | 17.86            | % | 16.55                | % |
| Total Capital<br>(To risk-weighted assets)  | 19.18            | % | 17.85                | % |

The minimum capital requirements imposed by the FDIC on the Bank for leverage, Tier 1 and Total Capital are 4%, 4% and 8%, respectively. The Company has similar capital requirements imposed by the Board of Governors of the Federal Reserve System (FRB). The Bank is also subject to more stringent Pennsylvania Department of Banking (PDB) guidelines. The Bank's capital ratios do not differ significantly from the Company's ratios. Although not adopted in regulation form, the PDB utilizes capital standards requiring a minimum of 6.5% leverage capital and 10% total capital. The Company and the Bank were in compliance with FRB, FDIC and PDB capital requirements as of June 30, 2010 and December 31, 2009.





### Liquidity

As of June 30, 2010, the Company had cash and cash equivalents of \$34.5 million in the form of cash, due from banks, Federal Funds sold and short-term deposits with other institutions. In addition, the Company had total securities available for sale of \$141.2 million which could be used for liquidity needs. This totals \$175.7 million and represents 32.1% of total assets compared to \$147.9 million and 27.9% of total assets as of December 31, 2009. The Company also monitors other liquidity measures, all of which were within the Company's policy guidelines as of June 30, 2010 and December 31, 2009. Based upon these measures, the Company believes its liquidity is adequate.

### Capital Resources

The Company has a line of credit commitment available from the Federal Home Loan Bank (FHLB) of Pittsburgh for borrowings of up to \$20,000,000 which expires in December 2011. There were no borrowings under this line at June 30, 2010 and December 31, 2009.

The Company has a line of credit commitment from Atlantic Central Bankers Bank for \$7,000,000 which expires on June 30, 2011. There were no borrowings under this line as of June 30, 2010 and December 31, 2009.

The Company has a line of credit commitment available which has no stated expiration date from PNC for \$16,000,000. Borrowings under this line were \$-0- as of June 30, 2010 and December 31, 2009.

The Bank's maximum borrowing capacity with the FHLB was approximately \$186,000,000 as of June 30, 2010, of which \$43,000,000 was outstanding at June 30, 2010 and at December 31, 2009. Advances from the FHLB are secured by qualifying assets of the Bank.

### Non-GAAP Financial Measures

This report contains or references fully taxable-equivalent (fte) interest income and net interest income, which are non-GAAP financial measures. Interest income (fte) and net interest income (fte) are derived from GAAP interest income and net interest income using an assumed tax rate of 34%. We believe the presentation of interest income (fte) and net interest income (fte) ensures comparability of interest income and net interest income arising from both taxable and tax-exempt sources and is consistent with industry practice. Net interest income (fte) is reconciled to GAAP net interest income on page 26 and 30. Although the Company believes that these non-GAAP financial measures enhance investors' understanding of our business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP measures.

## Results of Operations

## NORWOOD FINANCIAL CORP.

## Consolidated Average Balance Sheets with Resultant Interest and Rates

(Tax-Equivalent Basis, dollars

in thousands)

|   | Three Months Ended June 30, |          |         | 2009      |          |         |   |
|---|-----------------------------|----------|---------|-----------|----------|---------|---|
|   | 2010                        |          |         | 2009      |          |         |   |
|   | Average                     | Interest | Average | Average   | Interest | Average |   |
|   | Balance                     | (1)      | Rate    | Balance   | (1)      | Rate    |   |
|   | (2)                         | (1)      | (3)     | (2)       | (1)      | (3)     |   |
| <b>Assets</b>                                   |                             |          |         |           |          |         |   |
| <b>Interest-earning assets:</b>                 |                             |          |         |           |          |         |   |
| Federal funds sold                              | \$3,000                     | \$2      | 0.33    | % \$1,082 | \$1      | 0.37    | % |
| Interest bearing deposits with banks            | 22,263                      | 15       | 0.27    | 512       | -        | -       |   |
| Securities held-to-maturity                     | 169                         | 3        | 8.12    | 707       | 16       | 9.05    |   |
| <b>Securities available for sale:</b>           |                             |          |         |           |          |         |   |
| Taxable   | 95,367                      | 782      | 3.28    | 99,290    | 1,032    | 4.16    |   |
| Tax-exempt(1)                                   | 36,795                      | 541      | 5.88    | 28,589    | 398      | 5.57    |   |
| Total securities available for sale (1)         | 132,162                     | 1,323    | 4.00    | 127,879   | 1,430    | 4.47    |   |
| Loans receivable (4) (5)                        | 353,468                     | 5,267    | 5.96    | 354,284   | 5,466    | 6.17    |   |
| Total interest earning assets                   | 511,062                     | 6,610    | 5.17    | 484,464   | 6,913    | 5.71    |   |
| <b>Non-interest earning assets:</b>             |                             |          |         |           |          |         |   |
| Cash and due from banks                         | 7,295                       |          |         | 6,932     |          |         |   |
| Allowance for loan losses                       | (5,414                      | )        |         | (4,483    | )        |         |   |
| Other assets                                    | 22,129                      |          |         | 17,263    |          |         |   |
| Total non-interest earning assets               | 24,010                      |          |         | 19,712    |          |         |   |
| Total Assets                                    | \$535,072                   |          |         | \$504,176 |          |         |   |
| <b>Liabilities and Stockholders' Equity</b>     |                             |          |         |           |          |         |   |
| <b>Interest bearing liabilities:</b>            |                             |          |         |           |          |         |   |
| <b>Interest bearing demand and money market</b> |                             |          |         |           |          |         |   |
| Savings   | \$108,011                   | 97       | 0.36    | \$100,663 | 183      | 0.73    |   |
| Time  | 48,355                      | 29       | 0.24    | 45,053    | 42       | 0.37    |   |
| Total interest bearing deposits                 | 181,163                     | 921      | 2.03    | 167,474   | 1,195    | 2.85    |   |
| Short-term borrowings                           | 337,529                     | 1,047    | 1.24    | 313,190   | 1,420    | 1.81    |   |
| Other borrowings                                | 22,605                      | 81       | 1.43    | 23,558    | 73       | 1.24    |   |
| Total interest bearing liabilities              | 43,000                      | 416      | 3.87    | 43,000    | 415      | 3.86    |   |
| Non-interest bearing liabilities                | 403,134                     | 1,544    | 1.53    | 379,748   | 1,908    | 2.01    |   |
| <b>Non-interest bearing liabilities:</b>        |                             |          |         |           |          |         |   |
| Demand deposits                                 | 61,528                      |          |         | 58,710    |          |         |   |
| Other liabilities                               | 4,306                       |          |         | 4,631     |          |         |   |
| Total non-interest bearing liabilities          | 65,834                      |          |         | 63,341    |          |         |   |

Edgar Filing: NORWOOD FINANCIAL CORP - Form 10-Q

|  |           |           |
|--|-----------|-----------|
| Stockholders' equity                       | 66,104    | 61,087    |
| Total Liabilities and Stockholders' Equity | \$535,072 | \$504,176 |

|  |         |      |   |         |      |   |
|--|---------|------|---|---------|------|---|
| Net interest income (tax equivalent basis) | 5,066   | 3.64 | % | 5,005   | 3.70 | % |
| Tax-equivalent basis adjustment            | (234 )  |      |   | (170 )  |      |   |
| Net interest income                        | \$4,832 |      |   | \$4,835 |      |   |
| Net interest margin (tax equivalent basis) |         | 3.96 | % |         | 4.13 | % |

(1) Interest and yields are presented on a tax-equivalent basis using a marginal tax rate of 34%.

(2) Average balances have been calculated based on daily balances.

(3) Annualized

(4) Loan balances include non-accrual loans and are net of unearned income.

(5) Loan yields include the effect of amortization of deferred fees, net of costs.

Rate/Volume Analysis. The following table shows the fully taxable equivalent effect of changes in volumes and rates on interest income and interest expense.

|   | Increase/(Decrease)              |         |        |
|---|----------------------------------|---------|--------|
|   | Three months ended June 30, 2010 |         |        |
|   | Compared to                      |         |        |
|   | Three months ended June 30, 2009 |         |        |
|   | Variance due to                  |         |        |
|   | Volume                           | Rate    | Net    |
|   | (dollars in thousands)           |         |        |
| Interest earning assets:                        |                                  |         |        |
| Federal funds sold.....                         | \$2                              | \$(1    | ) \$1  |
| Interest bearing deposits with banks.....       | 14                               | 1       | 15     |
| Securities held to maturity.....                | (11                              | ) (2    | ) (13  |
| Securities available for sale:                  |                                  |         |        |
| Taxable.....                                    | (39                              | ) (211  | ) (250 |
| Tax-exempt securities.....                      | 120                              | 23      | 143    |
| Total securities.....                           | 81                               | (188    | ) (107 |
| Loans receivable.....                           | (13                              | ) (186  | ) (199 |
| Total interest earning assets.....              | 73                               | (376    | ) (303 |
| Interest bearing liabilities:                   |                                  |         |        |
| Interest-bearing demand and money market....    | 83                               | (169    | ) (86  |
| Savings.....                                    | 18                               | (31     | ) (13  |
| Time.....                                       | 548                              | (822    | ) (274 |
| Total interest bearing deposits.....            | 649                              | (1,022  | ) (373 |
| Short-term borrowings.....                      | (17                              | ) 25    | 8      |
| Other borrowings.....                           | -                                | 1       | 1      |
| Total interest bearing liabilities.....         | 632                              | (996    | ) (364 |
| Net interest income (tax-equivalent basis)..... | \$(559                           | ) \$620 | \$61   |

Changes in net interest income that could not be specifically identified as either a rate or volume change were allocated proportionately to changes in volume and changes in rate.

## Comparison of Operating Results for The Three Months Ended June 30, 2010 to June 30, 2009

## General

For the three months ended June 30, 2010, net income totaled \$1,818,000 compared to \$1,749,000 earned in the similar period in 2009. Earnings per share for the current period were \$.66 for basic and fully diluted compared to \$.64 per share for basic and \$.63 on a fully diluted basis for the three months ended June 30, 2009. The resulting annualized return on average assets and annualized return on average equity for the three months ended June 30, 2010 was 1.36% and 11.03%, respectively, compared to 1.39% and 11.49%, respectively, for the similar period in 2009.

The following table sets forth changes in net income:

| (dollars in thousands)                        | Three months<br>ended<br>June 30, 2010 to<br>June 30, 2009 |
|---|--|
| Net income three months ended June 30, 2009   | \$ 1,749   |
| Change due to:                                |  |
| Net interest income                           | (3 )   |
| Provision for loan losses                     | 70   |
| Gain on sales of loans, securities & deposits | (99 )  |
| Other income                                  | (53 )  |
| Salaries and employee benefits                | 23   |
| Occupancy, furniture and equipment            | (29 )  |
| FDIC insurance assessment                     | 240  |
| Professional fees                             | (34 )  |
| All other expenses                            | (56 )  |
| Income tax expense                            | 10   |
| Net income three months ended June 30, 2010   | \$ 1,818   |

## Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the three months ended June 30, 2010, totaled \$5,066,000, an increase of \$61,000 or 1.2% over the similar period in 2009. The fte net interest spread and net interest margin were 3.64% and 3.96%, respectively, for the three months ended June 30, 2010 compared to 3.70% and 4.13%, respectively, for the similar period in 2009.

Interest income (fte) totaled \$6,610,000 with a yield on average earning assets of 5.17% compared to \$6,913,000 and 5.71% for the 2009 period. The decrease in yield was due to the reinvestment of securities cash flow and new purchases of securities at lower than historical rates, resulting in an 88 basis point decrease in the yield earned on taxable securities. The yields earned on money market investments, tax-free securities and loans were comparable to the second three months of 2009. The total yield earned was also impacted by a \$21.7 million increase in interest bearing deposits with banks at an average return of .27%. Average earning assets totaled \$511.1 million for the three months ended June 30, 2010, an increase of \$26.6 million over the average for the similar period in 2009. This increase in average earning assets helped offset the decline in asset yields.

Interest expense for the three months ended June 30, 2010 totaled \$1,544,000 at an average cost of 1.53% compared to \$1,908,000 and 2.01% for the similar period in 2009. As a result of the continued low rate environment, the Company further reduced rates paid on most deposit products. The cost of time deposits,

which is the most significant component of funding, declined to 2.03% from 2.85% for the similar period in the prior year. As time deposits matured, they repriced at the current lower rates resulting in the decrease.

#### Other Income

Other income totaled \$1,016,000 for the three months ended June 30, 2010 compared to \$1,168,000 for the similar period in 2009. The current period includes \$130,000 of gains and servicing rights on the sale of \$6.2 million of fixed residential mortgages compared to \$121,000 in gains on the sale of \$4.3 million of mortgages in the similar period of 2009. The current period also includes a \$64,000 gain on the sale of investment securities compared to a \$172,000 gain in the second quarter of 2009. Service charges and fees decreased \$72,000 compared to the same quarter of last year due primarily to a reduction in overdraft fees.

#### Other Expense

Other expense for the three months ended June 30, 2010 totaled \$3,176,000, a decrease of \$144,000 from \$3,320,000 for the similar period in 2009. In 2010, the decrease in costs is due primarily to a \$240,000 reduction in FDIC insurance assessments related to the special assessment of \$225,000 recognized in the second quarter of 2009.

#### Income Tax Expense

Income tax expense totaled \$704,000 for an effective tax rate of 27.9% for the three month period ending June 30, 2010 compared to \$714,000 for an effective tax rate of 29.0% for the similar period in 2009.



## Results of Operations

## NORWOOD FINANCIAL CORP.

## Consolidated Average Balance Sheets with Resultant Interest and Rates

(Tax-Equivalent Basis, dollars

in thousands)

|   | Six Months Ended June 30, |                 |                        |                           |                 |                        |   |
|---|---------------------------|-----------------|------------------------|---------------------------|-----------------|------------------------|---|
|   | 2010                      |                 | 2009                   |                           |                 |                        |   |
|   | Average<br>Balance<br>(2) | Interest<br>(1) | Average<br>Rate<br>(3) | Average<br>Balance<br>(2) | Interest<br>(1) | Average<br>Rate<br>(3) |   |
| <b>Assets</b>                                   |                           |                 |                        |                           |                 |                        |   |
| Interest-earning assets:                        |                           |                 |                        |                           |                 |                        |   |
| Federal funds sold                              | \$3,000                   | \$5             | 0.33                   | % \$2,048                 | \$3             | 0.29                   | % |
| Interest bearing deposits with<br>banks         | 16,805                    | 24              | 0.28                   | 3,067                     | 4               | 0.26                   |   |
| Securities<br>held-to-maturity (1)              | 392                       | 17              | 8.61                   | 707                       | 31              | 8.77                   |   |
| Securities available for sale:                  |                           |                 |                        |                           |                 |                        |   |
| Taxable   | 96,425                    | 1,685           | 3.49                   | 100,847                   | 2,174           | 4.31                   |   |
| Tax-exempt(1)                                   | 34,384                    | 1,009           | 5.87                   | 27,039                    | 770             | 5.70                   |   |
| Total securities available<br>for sale (1)      | 130,809                   | 2,694           | 4.12                   | 127,886                   | 2,944           | 4.60                   |   |
| Loans receivable (4) (5)                        | 356,088                   | 10,718          | 6.02                   | 352,807                   | 10,782          | 6.11                   |   |
| Total interest earning<br>assets                | 507,094                   | 13,458          | 5.31                   | 486,515                   | 13,764          | 5.66                   |   |
| Non-interest earning assets:                    |                           |                 |                        |                           |                 |                        |   |
| Cash and due from banks                         | 7,027                     |                 |                        | 6,804                     |                 |                        |   |
| Allowance for loan losses                       | (5,426                    | )               |                        | (4,400                    | )               |                        |   |
| Other assets                                    | 22,176                    |                 |                        | 17,458                    |                 |                        |   |
| Total non-interest earning<br>assets            | 23,777                    |                 |                        | 19,862                    |                 |                        |   |
| Total Assets                                    | \$530,871                 |                 |                        | \$506,377                 |                 |                        |   |
| <b>Liabilities and Stockholders'<br/>Equity</b> |                           |                 |                        |                           |                 |                        |   |
| Interest bearing liabilities:                   |                           |                 |                        |                           |                 |                        |   |
| Interest bearing demand and<br>money            |                           |                 |                        |                           |                 |                        |   |
| market  | \$102,643                 | 297             | 0.58                   | \$99,281                  | 383             | 0.77                   |   |
| Savings   | 47,218                    | 57              | 0.24                   | 44,880                    | 83              | 0.37                   |   |
| Time  | 184,047                   | 1,947           | 2.12                   | 167,467                   | 2,455           | 2.93                   |   |
| Total interest bearing<br>deposits              | 333,908                   | 2,301           | 1.38                   | 311,628                   | 2,921           | 1.87                   |   |
| Short-term borrowings                           | 23,717                    | 61              | .51                    | 29,396                    | 169             | 1.15                   |   |
| Other borrowings                                | 43,000                    | 827             | 3.85                   | 43,000                    | 827             | 3.85                   |   |
| Total interest bearing<br>liabilities           | 400,625                   | 3,189           | 1.59                   | 384,024                   | 3,917           | 2.04                   |   |
| Non-interest bearing liabilities:               |                           |                 |                        |                           |                 |                        |   |
| Demand deposits                                 | 60,057                    |                 |                        | 57,507                    |                 |                        |   |

Edgar Filing: NORWOOD FINANCIAL CORP - Form 10-Q

|  |           |      |   |           |      |   |
|--|-----------|------|---|-----------|------|---|
| Other liabilities                          | 4,289     |      |   | 4,459     |      |   |
| Total non-interest bearing liabilities     | 64,346    |      |   | 61,966    |      |   |
| Stockholders' equity                       | 65,900    |      |   | 60,387    |      |   |
| Total Liabilities and Stockholders' Equity | \$530,871 |      |   | \$506,377 |      |   |
| Net interest income (tax equivalent basis) | 10,269    | 3.72 | % | 9,847     | 3.62 | % |
| Tax-equivalent basis adjustment            | (440 )    |      |   | (331 )    |      |   |
| Net interest income                        | \$9,829   |      |   | \$9,516   |      |   |
| Net interest margin (tax equivalent basis) |           | 4.05 | % |           | 4.05 | % |

(1) Interest and yields are presented on a tax-equivalent basis using a marginal tax rate of 34%.

(2) Average balances have been calculated based on daily balances.

(3) Annualized

(4) Loan balances include non-accrual loans and are net of unearned income.

(5) Loan yields include the effect of amortization of deferred fees, net of costs.

## Rate/Volume Analysis

The following table shows the fully taxable equivalent effect of changes in volumes and rates on interest income and interest expense. Changes in net interest income that could not be specifically identified as either a rate or volume change were allocated proportionately to changes in volume and changes in rate.

|  | Increase/(Decrease)   |         |        |
|--|---|---------|--------|
|  | Six Months Ended June 30, 2010<br>Compared to<br>Six Months Ended June 30, 2009 |         |        |
|  | Variance due to   |         |        |
|  | Volume  | Rate    | Net    |
|  | (dollars in thousands)  |         |        |
| Interest earning assets:                   |   |         |        |
| Federal funds sold                         | \$2   | \$0     | \$2    |
| Interest bearing deposits with banks       | 19  | 1       | 20     |
| Securities held to maturity                | (14   | ) 0     | (14    |
| Securities available for sale:             |   |         |        |
| Taxable                                    | (92   | ) (397  | ) (489 |
| Tax-exempt securities                      | 215   | 24      | 239    |
| Total securities                           | 123   | (373    | ) (250 |
| Loans receivable                           | 224   | (288    | ) (64  |
| Total interest earning assets              | 354   | (660    | ) (306 |
| Interest bearing liabilities:              |   |         |        |
| Interest-bearing demand and money market   | 35  | (122    | ) (87  |
| Savings                                    | 12  | (38     | ) (26  |
| Time                                       | 584   | (1,091  | ) (507 |
| Total interest bearing deposits            | 631   | (1,251  | ) (620 |
| Short-term borrowings                      | (28   | ) (80   | ) (108 |
| Other borrowings                           | 0   | 0       | 0      |
| Total interest bearing liabilities         | 603   | (1,331  | ) (728 |
| Net interest income (tax-equivalent basis) | \$(249  | ) \$671 | \$422  |

## Comparison of Operating Results for Six Months Ended June 30, 2010 and June 30, 2009

## General

For the six months ended June 30, 2010, net income totaled \$3,615,000 compared to \$3,486,000 earned in the similar period of 2009. Earnings per share for the current period were \$1.31 per share for both basic and diluted compared to \$1.27 per share basic and \$1.26 per share diluted for the six months ended June 30, 2009. The resulting annualized return on average assets and annualized return on average equity for the six months ended June 30, 2010 was 1.37% and 11.06% and 1.39% and 11.64%, respectively, for the similar period in 2009.



The following table sets forth changes in net income:

|   | Six Months<br>Ended<br>June 30, 2010 to<br>June 30, 2009 |
|---|--|
| (dollars in thousands)                          |  |
| Net income six months ended June 30, 2009       | \$ 3,486   |
| Change due to:                                  |  |
| Net interest income                             | 313  |
| Provision for loan losses                       | (35 )  |
| Gain on sales of loans, securities & deposits   | (313 )   |
| Other income                                    | (118 )   |
| Salaries and employee benefits                  | 22   |
| Occupancy, furniture and equipment expense, net | 62   |
| FDIC insurance assessment                       | 248  |
| All other expenses                              | (73 )  |
| Income tax expense                              | 23   |
| Net income six months ended June 30, 2010       | \$ 3,615   |

#### Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the six months ended June 30, 2010 totaled \$10,269,000, an increase of \$422,000, or 4.3% over the similar period in 2009. The fte net interest spread and net interest margin were 3.72% and 4.05% respectively, compared to 3.62% and 4.05% respectively for the similar period in 2009.

Interest income (fte) totaled \$13,458,000 with a yield on average earning assets of 5.31% compared to \$13,764,000 and 5.66% for the similar period in 2009. The decrease in yield was due to a \$13.7 million increase in interest bearing deposits with banks at an average yield of .28%. In addition, residential mortgage rates have declined causing a portion of the portfolio to refinance at lower rates. As a result, the fte yield on average loans in the current period was 6.02% down from 6.11% in the 2009 period. The yield on investment securities also declined 48 basis points reflecting the reinvestment of cash flow, maturities and calls at the current lower rate. Average earning assets totaled \$507.1 million for the six months ended June 30, 2010 an increase of \$20.6 million over the similar period in 2009. The growth in average earning assets helped offset the decline in asset yields.

Interest expense for the six months ended June 30, 2010 totaled \$3,189,000 with an average cost of 1.59% compared to \$3,917,000 and 2.04% for the 2009 period. The Company reduced rates paid on its deposits by 49 basis points and short-term borrowings by 64 basis points. The cost of time deposits which is the largest component of interest expense was 2.12% for the 2010 period decreasing from 2.93% in 2009. This reflects time deposits maturing and repricing at the current lower rates.



#### Other Income

Other income totaled \$2,018,000 for the six months ended June 30, 2010 compared to \$2,449,000 for the similar period in 2009. The current period includes \$205,000 in gains and servicing rights on the sale of \$10.5 million of residential mortgage loans compared to \$254,000 in similar gains on the sales of \$15.7 million of mortgage loans in the 2009 period. Gains on the sale investment securities totaled \$219,000 on sales of \$12.6 million for the 2010 period compared to \$333,000 of gains on sales of \$11.1 million in the similar 2009 period. The proceeds from investment securities sales were reinvested. The Company also had a gain of \$150,000 on the sale of deposits related to a branch closure in 2009 period.

#### Other Expenses

Other expense totaled \$6,336,000 for the six months ended June 30, 2010 a decrease of \$259,000 compared to \$6,595,000 for the similar period in 2009. Higher FDIC insurance assessments, including a \$225,000 special assessment was included in the 2009 costs. The efficiency ratio for the 2010 period was 53.4% compared to 53.6% in the 2009 period.

#### Income Tax Expense

Income tax expense totaled \$1,416,000 for an effective tax rate of 28.1% in the 2010 period compared to \$1,439,000 and 29.2% in 2009. The decrease in the effective tax rate was principally due to a higher level of tax-exempt income related to purchases of municipal obligations held in the available-for-sale portfolio.

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

#### Market Risk

Interest rate sensitivity and the repricing characteristics of assets and liabilities are managed by the Asset and Liability Management Committee (ALCO). The principal objective of ALCO is to maximize net interest income within acceptable levels of risk, which are established by policy. Interest rate risk is monitored and managed by using financial modeling techniques to measure the impact of changes in interest rates.

Net interest income, which is the primary source of the Company's earnings, is impacted by changes in interest rates and the relationship of different interest rates. To manage the impact of the rate changes, the balance sheet must be structured so that repricing opportunities exist for both assets and liabilities at approximately the same time intervals. The Company uses net interest simulation to assist in interest rate risk management. The process includes simulating various interest rate environments and their impact on net interest income. As of June 30, 2010, the level of net interest income at risk in a 200 basis points change in interest rates was within the Company's policy limits. The Company's policy allows for a decline of no more than 8% of net interest income.

Imbalance in repricing opportunities at a given point in time reflects interest-sensitivity gaps measured as the difference between rate-sensitive assets (RSA) and rate-sensitive liabilities (RSL). These are static gap measurements that do not take into account any future activity, and as such are principally used as early indications of potential interest rate exposures over specific intervals.

As of June 30, 2010, the Bank had a positive 90 day interest sensitivity gap of \$44.0 million or 8.0% of total assets, increasing from \$26.3 million or 5.0% of total assets as of December 31, 2009. The change was principally due to a lower level of time deposits maturing in the 90 day time frame in the amount of \$20 million and a higher level of overnight investments of \$17 million as of June 30, 2010. A positive gap means that rate-sensitive assets are greater than rate-sensitive liabilities at the time interval. This would indicate that in a rising rate environment, the yield on interest-earning assets could increase faster than the cost of interest-bearing liabilities in the 90 day time frame. The repricing intervals are managed by ALCO strategies, including adjusting the average life of the investment portfolio,

pricing of deposit liabilities to attract longer term time

33

---



deposits, loan pricing to encourage variable rate products and evaluation of loan sales of long-term fixed rate mortgages.

June 30, 2010

Rate Sensitivity Table

(dollars in thousands)

|  | 3 Months | 3-12<br>Months | 1 to 3<br>Years | Over<br>3 Years | Total     |
|--|----------|----------------|-----------------|-----------------|-----------|
| Federal funds sold and interest bearing deposits | \$28,113 | \$--           | \$250           | \$--            | \$28,363  |
| Securities                                       | 16,382   | 33,922         | 41,445          | 49,189          | 140,938   |
| Loans Receivable                                 | 79,187   | 61,406         | 94,000          | 119,340         | 353,933   |
| Total RSA  | 123,682  | 95,328         | 135,695         | 168,529         | 523,234   |
| Non-maturity interest-bearing deposits           | 25,938   | 29,089         | 76,591          | 32,479          | 164,097   |
| Time Deposits                                    | 43,093   | 73,718         | 47,849          | 15,598          | 180,258   |
| Other  | 10,660   | 11,193         | 35,525          | 10,000          | 67,378    |
| Total RSL  | 79,691   | 114,000        | 159,965         | 58,077          | 411,733   |
| Interest Sensitivity Gap                         | \$43,991 | \$(18,672)     | \$(24,270)      | \$110,452       | \$111,501 |
| Cumulative Gap                                   | 43,991   | 25,319         | 1,049           | 111,501         |           |
| RSA/RSL-cumulative                               | 155.2    | % 113.1        | % 100.3         | % 127.1         | %         |

December 31, 2009

|                          |          |            |            |           |           |
|--------------------------|----------|------------|------------|-----------|-----------|
| Interest Sensitivity Gap | \$26,256 | \$(35,423) | \$(20,986) | \$135,313 | \$105,160 |
| Cumulative Gap           | 26,256   | (9,167)    | (30,153)   | 105,160   |           |
| RSA/RSL-cumulative       | 128.9    | % 95.5     | % 91.2     | % 126.3   | %         |

Item 4. Controls and Procedures

The Company's management evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures, as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

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

## Part II. OTHER INFORMATION

### Item 1. Legal Proceedings

Not applicable

### Item 1A. Risk Factors

There have been no material changes in the risk factors affecting the Company that were identified in Item 1A of Part 1 of the Company's Form 10-K for the year ended December 31, 2009.

### Item 2. Unregistered Sales of Equity Sales and Use of Proceeds

Not applicable

### Item 3. Defaults Upon Senior Securities

Not applicable

### Item 4. Reserved

### Item 5. Other Information

None

### Item 6. Exhibits

| No. | Description |
|-----|-------------|
|-----|-------------|

|        |  |
|--------|--|
| 3(i)   | Articles of Incorporation of Norwood Financial Corp.(1)                      |
| 3(ii)  | Bylaws of Norwood Financial Corp. (2)  |
| 4.0    | Specimen Stock Certificate of Norwood Financial Corp. (1)                    |
| 10.1†  | Employment Agreement with Lewis J. Critelli (2)                              |
| 10.2†  | Change in Control Severance Agreement with William S. Lance (2)              |
| 10.3†  | Norwood Financial Corp. Stock Option Plan (4)                                |
| 10.4†  | Salary Continuation Agreement between the Bank and William W. Davis, Jr. (3) |
| 10.5†  | Salary Continuation Agreement between the Bank and Lewis J. Critelli (3)     |
| 10.6†  | Salary Continuation Agreement between the Bank and Edward C. Kasper (3)      |
| 10.7†  | 1999 Directors Stock Compensation Plan (3)                                   |
| 10.8†  | Salary Continuation Agreement between the Bank and Joseph A. Kneller (4)     |
| 10.9†  | Salary Continuation Agreement between the Bank and John H. Sanders (4)       |
| 10.10† | 2006 Stock Option Plan (5)   |
| 10.11† |  |

Edgar Filing: NORWOOD FINANCIAL CORP - Form 10-Q

First and Second Amendments to Salary Continuation Agreement with William W. Davis, Jr. (6)

10.12† First and Second Amendments to Salary Continuation Agreement with Lewis J. Critelli (6)

10.13† First and Second Amendments to Salary Continuation Agreement with Edward C. Kasper (6)

10.14† First and Second Amendments to Salary Continuation Agreement with Joseph A. Kneller (6)

10.15† First and Second Amendments to Salary Continuation Agreement with John H. Sanders (6)  
31 Rule 13a-14(a)/15d-14(a) Certification of CEO and CFO  
32 Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of Sarbanes-Oxley  
Act of 2002

---

- (1) Incorporated herein by reference to the identically numbered exhibits of the Registrant's Form 10 Registration Statement initially filed with the Commission on April 29, 1996.
- (2) Incorporated herein by reference to the identically numbered exhibit to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2009 filed with the Commission on March 15, 2010.
- (3) Incorporated herein by reference to the identically numbered exhibits of the Registrant's Form 10-K filed with the Commission on March 23, 2000.
- (4) Incorporated herein by reference to the identically numbered exhibit to the Registrants Form 10-K filed with the Commission on March 22, 2004.
- (5) Incorporated herein by reference to the Registrant's Form 8-K filed with the Commission on April 25, 2006.
- (6) Incorporated herein by reference from the Exhibits to the Registrant's Current Report on Form 8-K filed on April 4, 2006.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NORWOOD FINANCIAL CORP.

Date: August 6, 2010

By: /s/ Lewis J. Critelli  
Lewis J. Critelli  
President and Chief Executive  
Officer  
(Principal Executive Officer)

Date: August 6, 2010

By: /s/ William S. Lance  
William S. Lance  
Senior Vice President, and  
Chief Financial Officer  
(Principal Financial Officer)