

NORWOOD FINANCIAL CORP  
Form 10-Q  
May 09, 2014

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2014

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

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Non-accelerated filer   
(Do not check if a smaller reporting company)

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 May 1, 2014 |
|--|-------------------------------|
| Common stock, par value \$0.10 per share | 3,637,971                     |

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NORWOOD FINANCIAL CORP.  
FORM 10-Q  
FOR THE QUARTER ENDED MARCH 31, 2014

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## NORWOOD FINANCIAL CORP.

## Consolidated Balance Sheets (unaudited)

(dollars in thousands, except share and per share data)

|   | March 31,<br>2014 | December<br>31,<br>2013 |
|---|-------------------|-------------------------|
| <b>ASSETS</b>   |                   |                         |
| Cash and due from banks   | \$8,607           | \$7,528                 |
| Interest bearing deposits with banks  | 142               | 335                     |
| Cash and cash equivalents   | 8,749             | 7,863                   |
| Securities available for sale, at fair value  | 156,165           | 158,132                 |
| Securities held to maturity, fair value 2014: \$176<br>2013: \$177                                | 175               | 174                     |
| Loans receivable (net of unearned income)   | 496,016           | 503,097                 |
| Less: Allowance for loan losses   | 5,727             | 5,708                   |
| Net loans receivable  | 490,289           | 497,389                 |
| Regulatory stock, at cost   | 2,741             | 2,877                   |
| Bank premises and equipment, net  | 7,031             | 7,125                   |
| Bank owned life insurance   | 17,930            | 17,790                  |
| Accrued interest receivable   | 2,330             | 2,422                   |
| Foreclosed real estate owned  | 1,364             | 1,009                   |
| Goodwill  | 9,715             | 9,715                   |
| Other intangibles   | 477               | 510                     |
| Deferred tax asset  | 4,294             | 4,819                   |
| Other assets  | 1,974             | 1,409                   |
| <b>TOTAL ASSETS</b>   | <b>\$703,234</b>  | <b>\$711,234</b>        |
| <b>LIABILITIES</b>  |                   |                         |
| Deposits:   |                   |                         |
| Non-interest bearing demand   | \$93,400          | \$92,684                |
| Interest-bearing  | 446,676           | 448,498                 |
| Total deposits  | 540,076           | 541,182                 |
| Short-term borrowings   | 40,373            | 49,914                  |
| Other borrowings  | 23,373            | 23,761                  |
| Accrued interest payable  | 973               | 1,022                   |
| Other liabilities   | 4,239             | 3,491                   |
| <b>TOTAL LIABILITIES</b>  | <b>609,034</b>    | <b>619,370</b>          |
| <b>STOCKHOLDERS' EQUITY</b>   |                   |                         |
| Common stock, \$.10 par value per share,<br>authorized 10,000,000 shares; issued 3,708,718 shares | 371               | 371                     |
| Surplus   | 35,050            | 35,010                  |
| Retained earnings   | 61,671            | 60,798                  |

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|   |           |           |
|---|-----------|-----------|
| Treasury stock at cost: 2014: 71,297 shares,<br>2013: 64,628 shares | (1,892 )  | (1,713 )  |
| Accumulated other comprehensive loss                                | (1,000 )  | (2,602 )  |
| TOTAL STOCKHOLDERS' EQUITY  | 94,200    | 91,864    |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY                          | \$703,234 | \$711,234 |

See accompanying notes to the unaudited consolidated financial statements.

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

|  | Three Months Ended<br>March 31, |         |
|--|---------------------------------|---------|
|  | 2014                            | 2013    |
| <b>INTEREST INCOME</b>                                     |                                 |         |
| Loans receivable, including fees                           | \$5,980                         | \$6,186 |
| Securities   | 987                             | 868     |
| Other  | 1                               | 3       |
| Total interest income                                      | 6,968                           | 7,057   |
| <b>INTEREST EXPENSE</b>                                    |                                 |         |
| Deposits   | 635                             | 754     |
| Short-term borrowings                                      | 22                              | 12      |
| Other borrowings   | 166                             | 190     |
| Total interest expense                                     | 823                             | 956     |
| NET INTEREST INCOME  | 6,145                           | 6,101   |
| PROVISION FOR LOAN LOSSES                                  | 420                             | 800     |
| NET INTEREST INCOME AFTER<br>PROVISION FOR LOAN LOSSES     | 5,725                           | 5,301   |
| <b>OTHER INCOME</b>  |                                 |         |
| Service charges and fees                                   | 576                             | 592     |
| Income from fiduciary activities                           | 104                             | 85      |
| Net realized gains on sales of securities                  | 95                              | 138     |
| Gains on sale of loans and servicing rights                | 39                              | 11      |
| Earnings and proceeds on bank owned life insurance         | 168                             | 925     |
| Other  | 71                              | 126     |
| Total other income   | 1,053                           | 1,877   |
| <b>OTHER EXPENSES</b>                                      |                                 |         |
| Salaries and employee benefits                             | 2,165                           | 2,211   |
| Occupancy, furniture & equipment, net                      | 578                             | 529     |
| Data processing related                                    | 212                             | 221     |
| Taxes, other than income                                   | 165                             | 174     |
| Professional fees  | 165                             | 187     |
| Federal Deposit Insurance Corporation insurance assessment | 114                             | 111     |
| Foreclosed real estate owned                               | 65                              | 191     |
| Other  | 668                             | 677     |
| Total other expenses                                       | 4,132                           | 4,301   |
| INCOME BEFORE INCOME TAXES                                 | 2,646                           | 2,877   |
| INCOME TAX EXPENSE   | 682                             | 569     |
| NET INCOME   | \$1,964                         | \$2,308 |
| BASIC EARNINGS PER SHARE                                   | \$0.54                          | \$0.64  |

|                            |        |        |
|----------------------------|--------|--------|
| DILUTED EARNINGS PER SHARE | \$0.54 | \$0.63 |
|----------------------------|--------|--------|

See accompanying notes to the unaudited consolidated financial statements.

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NORWOOD FINANCIAL CORP  
 Consolidated Statements of Comprehensive Income (unaudited)  
 (dollars in thousands)

|  | Three Months Ended<br>March 31, 2014 | Three Months Ended<br>March 31, 2013 |      |
|--|--------------------------------------|--------------------------------------|------|
| Net income   | \$ 1,964                             | \$ 2,308                             |      |
| Other comprehensive income (loss):                 |                                      |                                      |      |
| Investment securities available for sale:          |                                      |                                      |      |
| Unrealized holding gains (losses)                  | 2,525                                | (864                                 | )    |
| Tax effect   | (860                                 | )                                    | 293  |
| Reclassification of gains recognized in net income | (95                                  | )                                    | (138 |
| Tax effect   | 32                                   | )                                    | 47   |
| Other comprehensive income (loss)                  | 1,602                                | (662                                 | )    |
| Comprehensive Income                               | \$ 3,566                             | \$ 1,646                             |      |

See accompanying notes to the unaudited consolidated financial statements.



## NORWOOD FINANCIAL CORP.

Consolidated Statements of Changes in Stockholders' Equity (unaudited)

Three Months Ended March 31, 2014

(dollars in thousands, except share and per share data)

|   | Common Stock |        | Surplus   | Retained Earnings | Treasury Stock |            | Accumulated Other Comprehensive | Total     |
|---|--------------|--------|-----------|-------------------|----------------|------------|---------------------------------|-----------|
|   | Shares       | Amount |           |                   | Shares         | Amount     | (Loss)                          |           |
| Balance December 31, 2013                     | 3,708,718    | \$ 371 | \$ 35,010 | \$ 60,798         | 64,628         | \$ (1,713) | \$ (2,602)                      | \$ 91,864 |
| Net Income                                    |              |        |           | 1,964             |                |            |                                 | 1,964     |
| Other comprehensive income                    |              |        |           |                   |                |            | 1,602                           | 1,602     |
| Cash dividends declared (\$.30 per share)     |              |        |           | (1,091)           |                |            |                                 | (1,091)   |
| Acquisition of treasury stock                 |              |        |           |                   | 6,669          | (179)      |                                 | (179)     |
| Compensation expense related to stock options |              |        | 40        |                   |                |            |                                 | 40        |
| Balance, March 31, 2014                       | 3,708,718    | \$ 371 | \$ 35,050 | \$ 61,671         | 71,297         | \$ (1,892) | \$ (1,000)                      | \$ 94,200 |

See accompanying notes to the unaudited consolidated financial statements.

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

| (dollars in thousands)  | Three Months Ended<br>March 31 |          |
|---|--------------------------------|----------|
|   | 2014                           | 2013     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                                |          |
| Net Income  | \$1,964                        | \$2,308  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                |          |
| Provision for loan losses   | 420                            | 800      |
| Depreciation  | 147                            | 149      |
| Amortization of intangible assets   | 33                             | 37       |
| Deferred income taxes   | (303)                          | 12       |
| Net amortization of securities premiums and discounts                             | 211                            | 298      |
| Net realized gain on sales of securities  | (95)                           | (138)    |
| Gain on life insurance policy   | -                              | (770)    |
| Net increase in value of life insurance   | (168)                          | (155)    |
| Loss on sale of bank premises and equipment and foreclosed real estate            | 19                             | 97       |
| Net gain on sale of mortgage loans  | (41)                           | (11)     |
| Mortgage loans originated for sale  | (1,110)                        | (1,101)  |
| Proceeds from sale of mortgage loans originated for sale                          | 1,151                          | 1,112    |
| Compensation expense related to stock options                                     | 40                             | 39       |
| Decrease in accrued interest receivable and other assets                          | (445)                          | (530)    |
| Increase in accrued interest payable and other liabilities                        | 701                            | 732      |
| Net cash provided by operating activities   | 2,524                          | 2,879    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                                |          |
| Securities available for sale:  |                                |          |
| Proceeds from sales   | 12,080                         | 7,403    |
| Proceeds from maturities and principal reductions on mortgage-backed securities   | 3,150                          | 5,093    |
| Purchases   | (10,950)                       | (16,867) |
| Purchase of FHLB stock  | (504)                          | -        |
| Redemption of FHLB stock  | 640                            | 97       |
| Net decrease (increase) in loans  | 6,297                          | (2,964)  |
| Proceeds from life insurance policy   | -                              | 1,859    |
| Purchase of bank premises and equipment   | (53)                           | (14)     |
| Proceeds from sale of bank premises and equipment and foreclosed real estate      | 9                              | 127      |
| Net cash provided by (used in) investing activities                               | 10,669                         | (5,266)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                                |          |
| Net (decrease) increase in deposits   | (1,106)                        | 11,207   |
| Net decrease in short-term borrowings   | (9,541)                        | (6,838)  |
| Repayments of other borrowings  | (388)                          | (144)    |
| Proceeds from other borrowings  | -                              | 3,000    |
| Stock options exercised   | -                              | 142      |

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|   |           |          |
|---|-----------|----------|
| Tax benefit of stock options exercised              | -         | 11       |
| Acquisition of treasury stock                       | (179 )    | (319 )   |
| Cash dividends paid                                 | (1,093 )  | (1,022 ) |
| Net cash (used in) provided by financing activities | (12,307 ) | 6,037    |
| Increase in cash and cash equivalents               | 886       | 3,650    |
| <br>  |           |          |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD      | 7,863     | 12,295   |
| CASH AND CASH EQUIVALENTS, END OF PERIOD            | \$8,749   | \$15,945 |

See accompanying notes to the unaudited consolidated financial statements.

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NORWOOD FINANCIAL CORP.  
 Consolidated Statements of Cash Flows (Unaudited) (continued)

| (dollars in thousands)  | Three Months Ended |                   |
|---|--------------------|-------------------|
|   | 2014               | March 31,<br>2013 |
| <b>Supplemental Disclosures of Cash Flow Information</b>                      |                    |                   |
| Cash payments for:  |                    |                   |
| Interest on deposits and borrowings   | \$872              | \$1,116           |
| Income taxes paid, net of refunds   | 204                | (3 )              |
| Supplemental Schedule of Noncash Investing Activities                         |                    |                   |
| Transfers of loans to foreclosed real estate and repossession of other assets | 383                | 486               |

See accompanying notes to the unaudited consolidated financial statements.

## 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., Norwood Settlement Services, LLC, 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 month period ended March 31, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014 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, 2013.

## 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 reflect 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 |       |
|---|--------------------|-------|
|   | March 31,          |       |
|   | 2014               | 2013  |
| Basic EPS weighted average shares outstanding   | 3,643              | 3,628 |
| Dilutive effect of stock options                | 10                 | 9     |
| Diluted EPS weighted average shares outstanding | 3,653              | 3,637 |

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 20,700 and 40,700 as of March 31, 2014 and 2013, respectively, based upon the closing prices of Norwood common stock of \$28.60 and \$27.82 per share on March 31, 2014 and 2013, 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. No awards were granted during the three month period ending March 31, 2014. As of March 31, 2014, there was \$117,000 of total unrecognized compensation cost related to non-vested options granted in 2013 under the plan, which will be fully amortized by December 31, 2014.

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,<br>2014 | 219,540 | \$ 26.64   | 6.1 Yrs.  | \$ 147                                  |
| Granted                           | -       | -  | - Yrs.  | -                                       |
| Exercised                         | -       | -  | - Yrs.  | -                                       |
| Forfeited                         | -       | -  | - Yrs.  | -                                       |
| Outstanding at March 31,<br>2014  | 219,540 | \$ 26.64   | 5.8 Yrs.  | \$ 431                                  |
| Exercisable at March 31,<br>2014  | 192,040 | \$ 26.58   | 5.2 Yrs.  | \$ 388                                  |

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 \$28.60 as of March 31, 2014 and \$26.90 as of December 31, 2013.

### 4. Accumulated Other Comprehensive Income

The following table presents the changes in accumulated other comprehensive income (in thousands) by component net of tax for the three months ended March 31, 2014 and 2013:

|  |  |   |
|--|--|---|
|  | Unrealized gains (losses) on<br>available for sale<br>securities (a) |   |
| Balance as of December 31, 2013  | \$ (2,602  | ) |
| Other comprehensive loss before reclassification                       | 1,665  |   |
| Amount reclassified from accumulated other comprehensive income (loss) | (63  | ) |
| Total other comprehensive loss   | 1,602  |   |
| Balance as of March 31, 2014   | \$ (1,000  | ) |
|  | Unrealized gains (losses) on<br>available for sale<br>securities (a) |   |
| Balance as of December 31, 2012  | \$ 2,797   |   |
| Other comprehensive loss before reclassification                       | (571   | ) |

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|  |          |   |
|--|----------|---|
| Amount reclassified from accumulated other comprehensive income (loss) | (91      | ) |
| Total other comprehensive loss   | (662     | ) |
| Balance as of March 31, 2013   | \$ 2,135 |   |

(a) All amounts are net of tax. Amounts in parentheses indicate debits.

The following table presents significant amounts reclassified out of each component of accumulated other comprehensive income (loss) (in thousands) for the three months ended March 31, 2014 and 2013:

| Details about other comprehensive income          | From Accumulated Other Comprehensive Income (a) |                                   | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|-----------------------------------|---|
|   | Three months ended March 31, 2014               | Three months ended March 31, 2013 |   |
| Unrealized gains on available for sale securities | \$ 95   | \$ 138                            | Net realized gains on sales of securities                         |
|   | (32)  | (47)                              | Income tax expense  |
|   | \$ 63   | \$ 91                             | Net of tax  |

(a) Amounts in parentheses indicate debits to net income

#### 5. 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:

| (in thousands)                               | March 31, |          |
|--|-----------|----------|
|  | 2014      | 2013     |
| Unfunded availability under loan commitments | \$24,728  | \$22,836 |
| Unfunded commitments under lines of credit   | 46,360    | 49,433   |
| Standby letters of credit                    | 5,700     | 6,128    |
|  | \$76,788  | \$78,397 |

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 March 31, 2014 for guarantees under standby letters of credit issued is not material.

## 6. Securities

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

|  | Amortized<br>Cost | March 31, 2014               |                               | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
|  |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
| (In Thousands)   |                   |                              |                               |               |
| Available for Sale:  |                   |                              |                               |               |
| U.S. Government agencies                                     | \$27,762          | \$5                          | \$(675)                       | \$27,092      |
| States and political subdivisions                            | 62,177            | 1,239                        | (833)                         | 62,583        |
| Corporate obligations  | 3,646             | 81                           | (27)                          | 3,700         |
| Mortgage-backed securities-<br>government sponsored entities | 63,798            | 132                          | (1,485)                       | 62,445        |
| Equity securities-financial services                         | 292               | 53                           | -                             | 345           |
|  | \$157,675         | \$1,510                      | \$(3,020)                     | \$156,165     |
| Held to Maturity:  |                   |                              |                               |               |
| States and political subdivisions                            | \$175             | \$1                          | \$-                           | \$176         |

|   | Amortized<br>Cost | December 31, 2013            |                               | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
|   |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
| (In Thousands)  |                   |                              |                               |               |
| Available for Sale:   |                   |                              |                               |               |
| U.S. Government agencies                                    | \$34,471          | \$-                          | \$(1,058)                     | \$33,413      |
| States and political subdivisions                           | 60,174            | 650                          | (1,794)                       | 59,030        |
| Corporate obligations                                       | 3,667             | 84                           | (40)                          | 3,711         |
| Mortgage-backed securities-government<br>sponsored entities | 63,467            | 81                           | (1,898)                       | 61,650        |
| Equity securities-financial services                        | 293               | 50                           | (15)                          | 328           |
|   | \$162,072         | \$865                        | \$(4,805)                     | \$158,132     |
| Held to Maturity:   |                   |                              |                               |               |

|                                   |       |     |     |       |
|-----------------------------------|-------|-----|-----|-------|
| States and political subdivisions | \$174 | \$3 | \$- | \$177 |
|-----------------------------------|-------|-----|-----|-------|

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):

|  | Less than 12 Months |             | March 31, 2014<br>12 Months or More |             | Total      |             |
|--|---------------------|-------------|-------------------------------------|-------------|------------|-------------|
|  | Unrealized          |             | Unrealized                          |             | Unrealized |             |
|  | Fair Value          | Losses      | Fair Value                          | Losses      | Fair Value | Losses      |
| U.S. government agencies                                 | \$ 23,010           | \$ (622 )   | \$ 947                              | \$ (53 )    | \$ 23,957  | \$ (675 )   |
| States and political subdivisions                        | 15,113              | (506 )      | 5,406                               | (327 )      | 20,519     | (833 )      |
| Corporate Obligations                                    | 1,151               | (27 )       | -                                   | -           | 1,151      | (27 )       |
| Mortgage-backed securities-government sponsored agencies | 31,166              | (632 )      | 16,545                              | (853 )      | 47,711     | (1,485 )    |
|  | \$ 70,440           | \$ (1,787 ) | \$ 22,898                           | \$ (1,233 ) | \$ 93,338  | \$ (3,020 ) |

|  | Less than 12 Months |             | December 31, 2013<br>12 Months or More |           | Total      |             |
|--|---------------------|-------------|--|-----------|------------|-------------|
|  | Unrealized          |             | Unrealized                             |           | Unrealized |             |
|  | Fair Value          | Losses      | Fair Value                             | Losses    | Fair Value | Losses      |
| U.S. government agencies                                 | \$ 32,481           | \$ (990 )   | \$ 932                                 | \$ (68 )  | \$ 33,413  | \$ (1,058 ) |
| States and political subdivisions                        | 26,281              | (1,415 )    | 4,228                                  | (379 )    | 30,509     | (1,794 )    |
| Corporate obligations                                    | 1,145               | (40 )       | -                                      | -         | 1,145      | (40 )       |
| Mortgage-backed securities-government sponsored agencies | 47,014              | (1,524 )    | 7,478                                  | (374 )    | 54,492     | (1,898 )    |
| Equity securities - financial services                   | 170                 | (15 )       | -                                      | -         | 170        | (15 )       |
|  | \$ 107,091          | \$ (3,984 ) | \$ 12,638                              | \$ (821 ) | \$ 119,729 | \$ (4,805 ) |

At March 31, 2014, the Company has 80 debt securities in an unrealized loss position in the less than twelve months category and 24 debt securities in the twelve months or more category. In Management's opinion the unrealized losses reflect changes in interest rates subsequent to the acquisition of specific securities. No other-than-temporary-impairment charges were recorded in 2014. Management believes that all unrealized losses represent temporary impairment of the securities as the Company does not have the intent to sell the securities and it is more likely than not that it will not have to sell the securities before recovery of its cost basis.

The amortized cost and fair value of debt securities as of March 31, 2014 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 |                              | Held to Maturity  |            |
|--|--------------------|------------------------------|-------------------|------------|
|  | Amortized<br>Cost  | Fair Value<br>(In Thousands) | Amortized<br>Cost | Fair Value |
| Due in one year or less                                  | \$-                | \$-                          | \$175             | \$176      |
| Due after one year through five years                    | 16,825             | 16,692                       | -                 | -          |
| Due after five years through ten years                   | 28,352             | 28,041                       | -                 | -          |
| Due after ten years                                      | 48,408             | 48,642                       | -                 | -          |
| Mortgage-backed securities-government sponsored agencies | 63,798             | 62,445                       | -                 | -          |
|  | \$157,383          | \$155,820                    | \$175             | \$176      |

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

|                                   | Three Months<br>Ended March 31, |          |
|-----------------------------------|---------------------------------|----------|
|                                   | 2014                            | 2013     |
| Gross realized gains              | \$ 95                           | \$ 156   |
| Gross realized losses             | -                               | (18 )    |
| Net realized gain                 | \$ 95                           | \$ 138   |
| Proceeds from sales of securities | \$ 12,080                       | \$ 7,403 |

#### 7. Loans Receivable and Allowance for Loan Losses

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) |       |                   |           |       |   |
|--|--|-------|-------------------|-----------|-------|---|
|  | March 31, 2014                           |       | December 31, 2013 |           |       |   |
| Real Estate-Residential                | \$156,651                                | 31.5  | %                 | \$158,842 | 31.6  | % |
| Commercial                             | 265,571                                  | 53.5  |                   | 273,144   | 54.2  |   |
| Construction                           | 21,400                                   | 4.3   |                   | 20,551    | 4.1   |   |
| Commercial, financial and agricultural | 37,606                                   | 7.6   |                   | 35,745    | 7.1   |   |
| Consumer loans to individuals          | 15,245                                   | 3.1   |                   | 15,295    | 3.0   |   |
| Total loans                            | 496,473                                  | 100.0 | %                 | 503,577   | 100.0 | % |
| Deferred fees, net                     | (457 )                                   |       |                   | (480 )    |       |   |
| Total loans receivable                 | 496,016                                  |       |                   | 503,097   |       |   |
| Allowance for loan losses              | (5,727 )                                 |       |                   | (5,708 )  |       |   |
| Net loans receivable                   | \$490,289                                |       |                   | \$497,389 |       |   |



Changes in the accretable yield for purchased credit-impaired loans were as follows for the three months ended March 31 (in thousands):

|                                | 2014  | 2013  |
|--------------------------------|-------|-------|
| Balance at beginning of period | \$ 20 | \$ 76 |
| Accretion                      | (7 )  | (23 ) |
| Reclassification and other     | -     | -     |
| Balance at end of period       | \$ 13 | \$ 53 |

The following table presents additional information regarding loans acquired and accounted for in accordance with ASC 310-30 (in thousands):

|                     | March 31, 2014 | December 31, 2013 |
|---------------------|----------------|-------------------|
| Outstanding Balance | \$ 1,098       | \$ 1,110          |
| Carrying Amount     | \$ 1,085       | \$ 1,090          |

There were no material increases or decreases in the expected cash flows of these loans between May 31, 2011 (the “acquisition date”) and March 31, 2014. There has been no allowance for loan losses recorded for acquired loans with specific evidence of deterioration in credit quality as of May 31, 2011. In addition, there has been no allowance for loan losses on these loans reversed. For loans that were acquired without specific evidence of deterioration in credit quality, adjustments to the allowance for loan losses have been accounted for through the allowance for loan loss adequacy calculation.

The Company maintains a loan review system, which allows for a periodic review of our loan portfolio and the early identification of potential impaired loans. Such system takes into consideration, among other things, delinquency status, size of loans, type and market value of collateral and financial condition of the borrowers. Specific loan loss allowances are established for identified losses based on a review of such information. A loan evaluated for impairment is considered to be impaired when, based on current information and events, it is probably that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. All loans identified as impaired are evaluated independently. We do not aggregate such loans for evaluation purposes. Impairment is measured on a loan-by-loan basis for commercial and construction loans by the present value of expected future cash flows discounted at the loan’s effective interest rate, the loan’s obtainable market price, or the fair value of the collateral if the loan is collateral-dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential mortgage loans for impairment disclosures, unless such loans are part of a larger relationship that is impaired, or are classified as a troubled debt restructuring.

A loan is considered to be a troubled debt restructuring (“TDR”) loan when the Company grants a concession to the borrower because of the borrower’s financial condition that it would not otherwise consider. Such concessions include the reduction of interest rates, forgiveness of principal or interest, or other modifications of interest rates that are less than the current market rate for new obligations with similar risk.

The following table shows the amount of loans in each category that were individually and collectively evaluated for impairment at the dates indicated:

|  | Real Estate Loans |            |                                | Commercial<br>Loans | Consumer<br>Loans | Total      |
|--|-------------------|------------|--------------------------------|---------------------|-------------------|------------|
|  | Residential       | Commercial | Construction<br>(In thousands) |                     |                   |            |
| March 31, 2014                                     |                   |            |                                |                     |                   |            |
| Individually evaluated<br>for impairment           | \$ -              | \$ 10,634  | \$ -                           | \$ -                | \$ -              | \$ 10,634  |
| Loans acquired with<br>deteriorated credit quality | 237               | 848        | -                              | -                   | -                 | 1,085      |
| Collectively evaluated<br>for impairment           | 156,414           | 254,089    | 21,400                         | 37,606              | 15,245            | 484,754    |
| Total Loans  | \$ 156,651        | \$ 265,571 | \$ 21,400                      | \$ 37,606           | \$ 15,245         | \$ 496,473 |

|   | Real Estate Loans |            |                                | Commercial<br>Loans | Consumer<br>Loans | Total      |
|---|-------------------|------------|--------------------------------|---------------------|-------------------|------------|
|   | Residential       | Commercial | Construction<br>(In thousands) |                     |                   |            |
| December 31, 2013                                     |                   |            |                                |                     |                   |            |
| Individually evaluated<br>for impairment              | \$ -              | \$ 11,519  | \$ -                           | \$ -                | \$ -              | \$ 11,519  |
| Loans acquired with<br>deteriorated credit<br>quality | 242               | 848        | -                              | -                   | -                 | 1,090      |
| Collectively evaluated<br>for impairment              | 158,600           | 260,777    | 20,551                         | 35,745              | 15,295            | 490,968    |
| Total Loans   | \$ 158,842        | \$ 273,144 | \$ 20,551                      | \$ 35,745           | \$ 15,295         | \$ 503,577 |



The following table includes the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable. Also presented are the average recorded investments in the impaired loans and the related amount of interest recognized during the time within the period that the impaired loans were impaired.

|                                     | Recorded<br>Investment | Unpaid Principal<br>Principal<br>Balance<br>(in thousands) | Associated<br>Allowance |
|-------------------------------------|------------------------|--|-------------------------|
| March 31, 2014                      |                        |  |                         |
| With no related allowance recorded: |                        |  |                         |
| Real Estate Loans                   |                        |  |                         |
| Residential                         | \$ 237                 | \$ 245   | \$ -                    |
| Commercial                          | 9,310                  | 12,631   | -                       |
| Subtotal                            | 9,547                  | 12,876   | -                       |
| With an allowance recorded:         |                        |  |                         |
| Real Estate Loans                   |                        |  |                         |
| Commercial                          | 2,172                  | 2,882  | 203                     |
| Subtotal                            | 2,172                  | 2,882  | -                       |
| Total:                              |                        |  |                         |
| Real Estate Loans                   |                        |  |                         |
| Residential                         | 237                    | 245  | -                       |
| Commercial                          | 11,482                 | 15,513   | 203                     |
| Total Impaired Loans                | \$ 11,719              | \$ 15,758  | \$ 203                  |

|                                     | Recorded<br>Investment | Unpaid Principal<br>Principal<br>Balance<br>(in thousands) | Associated<br>Allowance |
|-------------------------------------|------------------------|--|-------------------------|
| December 31, 2013                   |                        |  |                         |
| With no related allowance recorded: |                        |  |                         |
| Real Estate Loans                   |                        |  |                         |
| Residential                         | \$ 242                 | \$ 251   | \$ -                    |
| Commercial                          | 10,644                 | 14,400   | -                       |
| Subtotal                            | 10,886                 | 14,651   | -                       |
| With an allowance recorded:         |                        |  |                         |
| Real Estate Loans                   |                        |  |                         |
| Commercial                          | 1,723                  | 1,723  | 53                      |
| Subtotal                            | 1,723                  | 1,723  | 53                      |
| Total:                              |                        |  |                         |
| Real Estate Loans                   |                        |  |                         |
| Residential                         | 242                    | 251  | -                       |
| Commercial                          | 12,367                 | 16,123   | 53                      |
| Total Impaired Loans                | \$ 12,609              | \$ 16,374  | \$ 53                   |

The following information for impaired loans is presented (in thousands) for the three months ended March 31, 2014 and 2013:

|                   | Average Recorded<br>Investment |          | Interest Income<br>Recognized |      |
|-------------------|--------------------------------|----------|-------------------------------|------|
|                   | 2014                           | 2013     | 2014                          | 2013 |
| Total:            |                                |          |                               |      |
| Real Estate Loans |                                |          |                               |      |
| Residential       | \$240                          | \$262    | \$1                           | \$1  |
| Commercial        | 11,754                         | 10,839   | 57                            | 19   |
| Total Loans       | \$11,994                       | \$11,101 | \$58                          | \$20 |

Troubled debt restructured loans are those loans whose terms have been renegotiated to provide a reduction or deferral of principal or interest as a result of financial difficulties experienced by the borrower, who could not obtain comparable terms from alternate financing sources. As of March 31, 2014, troubled debt restructured loans totaled \$9.1 million and resulted in specific reserves of \$203,000. As of December 31, 2013, troubled debt restructured loans totaled \$9.2 million and resulted in specific reserves of \$53,000. For the periods ended March 31, 2014 and 2013, there were no new loans identified as troubled debt restructurings, nor were there any loan modifications classified as troubled debt restructurings that subsequently defaulted during the period.

Management uses an eight point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first four categories are considered not criticized, and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The Special Mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a Substandard classification. Loans in the Substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are considered Substandard. Any portion of a loan that has been charged off is placed in the Loss category.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Bank has a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as non performance, repossession, or death occurs to raise awareness of a possible credit event. The Company's Loan Review Department is responsible for the timely and accurate risk rating of the loans on an ongoing basis. Every credit which must be approved by Loan Committee or the Board of Directors is assigned a risk rating at time of consideration. Loan Review also annually reviews relationships of \$500,000 and over to assign or re-affirm risk ratings. Loans in the Substandard categories that are collectively evaluated for impairment are given separate consideration in the determination of the allowance.

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard, Doubtful and Loss within the internal risk rating system as of March 31, 2014 and December 31, 2013 (in thousands):

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|                              | Pass      | Special<br>Mention | Substandard | Doubtful<br>and Loss | Total     |
|------------------------------|-----------|--------------------|-------------|----------------------|-----------|
| March 31, 2014               |           |                    |             |                      |           |
| Commercial real estate loans | \$244,455 | \$3,752            | \$17,364    | \$-                  | \$265,571 |
| Commercial loans             | 37,606    | -                  | -           | -                    | 37,606    |
| Total                        | \$282,061 | \$3,752            | \$17,364    | \$-                  | \$303,177 |

|                              | Pass      | Special<br>Mention | Substandard | Doubtful<br>and Loss | Total     |
|------------------------------|-----------|--------------------|-------------|----------------------|-----------|
| December 31, 2013            |           |                    |             |                      |           |
| Commercial real estate loans | \$250,566 | \$3,651            | \$18,927    | \$-                  | \$273,144 |
| Commercial loans             | 35,745    | -                  | -           | -                    | 35,745    |
| Total                        | \$286,311 | \$3,651            | \$18,927    | \$-                  | \$308,889 |

For residential real estate loans, construction loans and consumer loans, the Company evaluates credit quality based on the performance of the individual credits. The following table presents the recorded investment in the loan classes based on payment activity as of March 31, 2014 and December 31, 2013 (in thousands):

|                               | Performing | Nonperforming | Total     |
|-------------------------------|------------|---------------|-----------|
| March 31, 2014                |            |               |           |
| Residential real estate loans | \$155,022  | \$1,629       | \$156,651 |
| Construction                  | 21,400     | -             | 21,400    |
| Consumer loans                | 15,245     | -             | 15,245    |
| Total                         | \$191,667  | \$1,629       | \$193,296 |

|                               | Performing | Nonperforming | Total     |
|-------------------------------|------------|---------------|-----------|
| December 31, 2013             |            |               |           |
| Residential real estate loans | \$157,138  | \$1,704       | \$158,842 |
| Construction                  | 20,551     | -             | 20,551    |
| Consumer loans                | 15,295     | -             | 15,295    |
| Total                         | \$192,984  | \$1,704       | \$194,688 |

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans as of March 31, 2014 and December 31, 2013 (in thousands):

|                   | Current   | 31-60 Days<br>Past Due | 61-90 Days<br>Past Due | Greater<br>than<br>90 Days<br>Past<br>Due and<br>still<br>accruing | Non-Accrual | Total Past<br>Due<br>and Non-<br>Accrual | Total<br>Loans |
|-------------------|-----------|------------------------|------------------------|--|-------------|--|----------------|
| March 31, 2014    |           |                        |                        |  |             |  |                |
| Real Estate loans |           |                        |                        |  |             |  |                |
| Residential       | \$154,518 | \$377                  | \$127                  | \$-  | \$1,629     | \$2,133                                  | \$156,651      |

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|                  |           |       |       |     |          |          |           |
|------------------|-----------|-------|-------|-----|----------|----------|-----------|
| Commercial       | 257,381   | 287   | -     | -   | 7,903    | 8,190    | 265,571   |
| Construction     | 21,400    | -     | -     | -   | -        | -        | 21,400    |
| Commercial loans | 37,584    | 22    | -     | -   | -        | 22       | 37,606    |
| Consumer loans   | 15,134    | 96    | 15    | -   | -        | 111      | 15,245    |
| Total            | \$486,017 | \$782 | \$142 | \$- | \$ 9,532 | \$10,456 | \$496,473 |

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|                      | Current    | 31-60 Days<br>Past Due | 61-90 Days<br>Past Due | Greater<br>than<br>90 Days<br>Past<br>Due and<br>still<br>accruing | Non-Accrual | Total Past<br>Due<br>and Non-<br>Accrual | Total<br>Loans |
|----------------------|------------|------------------------|------------------------|--|-------------|--|----------------|
| December 31,<br>2013 |            |                        |                        |  |             |  |                |
| Real Estate loans    |            |                        |                        |  |             |  |                |
| Residential          | \$ 156,066 | \$ 1,018               | \$ 54                  | \$ -   | \$ 1,704    | \$ 2,776                                 | \$ 158,842     |
| Commercial           | 263,837    | 977                    | 487                    | -  | 7,843       | 9,307                                    | 273,144        |
| Construction         | 20,551     | -                      | -                      | -  | -           | -  | 20,551         |
| Commercial loans     | 35,717     | 28                     | -                      | -  | -           | 28                                       | 35,745         |
| Consumer loans       | 15,228     | 57                     | 10                     | -  | -           | 67                                       | 15,295         |
| Total                | \$ 491,399 | \$ 2,080               | \$ 551                 | \$ -   | \$ 9,547    | \$ 12,178                                | \$ 503,577     |

The following table presents the allowance for loan losses by the classes of the loan portfolio:

| (In thousands)   | Residential<br>Real Estate | Commercial<br>Real Estate | Construction | Commercial | Consumer | Total    |
|--|----------------------------|---------------------------|--------------|------------|----------|----------|
| Beginning balance, December<br>31, 2013                    | \$ 1,441                   | \$ 3,025                  | \$ 898       | \$ 184     | \$ 160   | \$ 5,708 |
| Charge Offs  | (75 )                      | (329 )                    | -            | -          | (11 )    | (415 )   |
| Recoveries   | -                          | -                         | -            | -          | 14       | 14       |
| Provision Expense  | (34 )                      | 1,146                     | (667 )       | -          | (25 )    | 420      |
| Ending balance, March 31,<br>2014                          | \$ 1,332                   | \$ 3,842                  | \$ 231       | \$ 184     | \$ 138   | \$ 5,727 |
| Ending balance individually<br>evaluated<br>for impairment | \$ -                       | \$ 203                    | \$ -         | \$ -       | \$ -     | \$ 203   |
| Ending balance collectively<br>evaluated<br>for impairment | \$ 1,332                   | \$ 3,639                  | \$ 231       | \$ 184     | \$ 138   | \$ 5,524 |

| (In thousands)                           | Residential<br>Real Estate | Commercial<br>Real Estate | Construction | Commercial | Consumer | Total    |
|--|----------------------------|---------------------------|--------------|------------|----------|----------|
| Beginning balance, December<br>31, 2012  | \$ 1,797                   | \$ 3,183                  | \$ 119       | \$ 223     | \$ 180   | \$ 5,502 |
| Charge Offs                              | (250 )                     | (313 )                    | -            | -          | (19 )    | (582 )   |
| Recoveries                               | -                          | -                         | -            | -          | 6        | 6        |
| Provision Expense                        | 427                        | 420                       | 5            | (47 )      | (5 )     | 800      |
| Ending balance, March 31,<br>2013        | \$ 1,974                   | \$ 3,290                  | \$ 124       | \$ 176     | \$ 162   | \$ 5,726 |
| Ending balance individually<br>evaluated | \$ -                       | \$ -                      | \$ -         | \$ -       | \$ -     | \$ -     |

for impairment

Ending balance collectively

evaluated

|                |          |          |        |        |        |          |
|----------------|----------|----------|--------|--------|--------|----------|
| for impairment | \$ 1,974 | \$ 3,290 | \$ 124 | \$ 176 | \$ 162 | \$ 5,726 |
|----------------|----------|----------|--------|--------|--------|----------|

The Company's primary business activity as of March 31, 2014 and December 31, 2013 is with customers located in northeastern Pennsylvania. Accordingly, the Company has extended credit primarily to commercial entities and individuals in this area whose ability to honor their contracts is influenced by the region's economy.

As of March 31, 2014, the Company considered its concentration of credit risk to be acceptable. The highest concentrations are in the hospitality lodging industry, automobile dealers, property owners associations and resorts with loans outstanding of \$37.2 million, or 42.8% of capital, to the hospitality lodging industry,

\$14.3 million, or 16.5% of capital to automobile dealers, \$12.1 million, or 13.9% of capital, to property owners associations and \$9.1 million, or 10.6% of capital, to the resort industry. During the current period, the Company recorded a write down of \$300,000 on a motel property.

Gross realized gains and gross realized losses on sales of residential mortgage loans were \$42,000 and \$0, respectively, in the first three months of 2014 compared to \$18,000 and \$7,000, respectively, in the same period in 2013. The proceeds from the sales of residential mortgage loans totaled \$1.1 million for each of the three month periods ended March 31, 2014 and 2013, respectively.

#### 8. Fair Value Measurements

Fair value estimates are based on quoted market prices, if available, quoted market prices of similar assets or liabilities, or the present value of expected future cash flows and other valuation techniques. These valuations are significantly affected by discount rates, cash flow assumptions and risk assumptions used. Therefore, fair value estimates may not be substantiated by comparison to independent markets and are not intended to reflect the proceeds that may be realizable in an immediate settlement of the instruments.

Fair value is determined at one point in time and is not representative of future value. These amounts do not reflect the total value of a going concern organization. Management does not have the intention to dispose of a significant portion of its assets and liabilities and therefore, the unrealized gains or losses should not be interpreted as a forecast of future earnings and cash flows.

The following is a discussion of assets and liabilities measured at fair value on a recurring basis and valuation techniques applied:

##### Securities:

The fair value of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) 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 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. 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.

##### Impaired loans (generally carried at fair value):

The Company measures 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 lowest level of input that is significant to the fair value measurements.

Foreclosed real estate owned (carried at fair value):

Real estate properties acquired through, or in lieu of loan foreclosure are to be sold and are carried at fair value less estimated 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 3 fair value based upon 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 March 31, 2014 and December 31, 2013 are as follows:

| Description  | Total     | Fair Value Measurement Using Reporting Date |           |         |
|--|-----------|---|-----------|---------|
|  |           | Level 1<br>(In thousands)                   | Level 2   | Level 3 |
| March 31, 2014   |           |   |           |         |
| Available for Sale:                                      |           |   |           |         |
| US Government agencies                                   | \$27,092  | \$-   | \$27,092  | \$-     |
| States and political subdivisions                        | 62,583    | -   | 62,583    | -       |
| Corporate obligations                                    | 3,700     | -   | 3,700     | -       |
| Mortgage-backed securities-government sponsored agencies | 62,445    | -   | 62,445    | -       |
| Equity securities-financial services                     | 345       | 345   | -         | -       |
| Total  | \$156,165 | \$345                                       | \$155,820 | \$-     |
| December 31, 2013  |           |   |           |         |
| Available for Sale:                                      |           |   |           |         |
| US Government agencies                                   | \$33,413  | \$-   | \$33,413  | \$-     |
| States and political subdivisions                        | 59,030    | -   | 59,030    | -       |
| Corporate obligations                                    | 3,711     | -   | 3,711     | -       |
| Mortgage-backed securities-government sponsored agencies | 61,650    | -   | 61,650    | -       |
| Equity securities-financial services                     | 328       | 328   | -         | -       |
| Total  | \$158,132 | \$328                                       | \$157,804 | \$-     |

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at March 31, 2014 and December 31, 2013 are as follows:

| Description    | Total    | Fair Value Measurement Reporting Date using |         |          |
|----------------|----------|---|---------|----------|
|                |          | Level 1                                     | Level 2 | Level 3  |
| (In thousands) |          |   |         |          |
| March 31, 2014 |          |   |         |          |
| Impaired Loans | \$11,516 | \$-   | \$-     | \$11,516 |



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|                              |          |     |     |          |
|------------------------------|----------|-----|-----|----------|
| Foreclosed Real Estate Owned | 1,364    | -   | -   | 1,364    |
| December 31, 2013            |          |     |     |          |
| Impaired Loans               | \$12,556 | \$- | \$- | \$12,556 |
| Foreclosed Real Estate Owned | 1,009    | -   | -   | 1,009    |

The following tables present additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Company has utilized Level 3 inputs to determine fair value:

| Quantitative Information about Level 3 Fair Value Measurements |                     |                            |                          |                          |   |
|--|---------------------|----------------------------|--------------------------|--------------------------|---|
| (In thousands)   | Fair Value Estimate | Valuation Techniques       | Unobservable Input       | Range (Weighted Average) |   |
| March 31, 2014   |                     |                            |                          |                          |   |
| Impaired loans   | \$11,516            | Appraisal of collateral(1) | Appraisal adjustments(2) | 10% (10.0)               | % |
| Foreclosed real estate owned                                   | \$1,364             | Appraisal of collateral(1) | Liquidation Expenses(2)  | 10                       | % |

| Quantitative Information about Level 3 Fair Value Measurements |                     |                            |                          |                          |   |
|--|---------------------|----------------------------|--------------------------|--------------------------|---|
| (In thousands)   | Fair Value Estimate | Valuation Techniques       | Unobservable Input       | Range (Weighted Average) |   |
| December 31, 2013  |                     |                            |                          |                          |   |
| Impaired loans   | \$12,556            | Appraisal of collateral(1) | Appraisal adjustments(2) | 10-15% (10.67)           | % |
| Foreclosed real estate owned                                   | \$1,009             | Appraisal of collateral(1) | Liquidation Expenses(2)  | 10                       | % |

- (1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable, less any associated allowance.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

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 March 31, 2014 and December 31, 2013.

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) and held to maturity (carried at amortized cost) 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 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. 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.

Impaired loans (generally carried at fair value):

The Company measures 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 lowest level of input that is significant to the fair value measurements.

As of March 31, 2014, the fair value investment in impaired loans totaled \$11,516,000 which included two loans for \$2,172,000 for which a valuation allowance of \$203,000 had been provided based on the estimated value of the collateral or the present value of estimated cash flows, and fifteen loans for \$9,547,000 which did not require a valuation allowance since the estimated realizable value of the collateral exceeded the recorded investment in the loan. As of March 31, 2014, the Company has recognized charge-offs against the allowance for loan losses on these impaired loans in the amount of \$3,847,000 over the life of the loans.

As of December 31, 2013, the fair value investment in impaired loans totaled \$12,556,000 which included one loan for \$1,723,000 for which a valuation allowance of \$53,000 had been provided based on the estimated value of the collateral or the present value of estimated cash flows, and twenty loans for \$10,886,000 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, 2013, the Company has recognized charge-offs against the allowance for loan losses on these impaired loans in the amount of \$3,714,000 over the life of the loans.

Mortgage servicing rights (generally carried at cost)

The Company utilizes a third party provider to estimate the fair value of certain loan servicing rights. Fair value for the purpose of this measurement is defined as the amount at which the asset could be exchanged in a current transaction between willing parties, other than in a forced liquidation.

Foreclosed real estate owned (carried at fair value):

Real estate properties acquired through, or in lieu of loan foreclosure are to be sold and are carried at fair value less estimated 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 3 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):

The Company, as a member of the Federal Home Loan Bank (FHLB) system is required to maintain an investment in capital stock of its district FHLB according to a predetermined formula. This regulatory stock has no quoted market value and is carried at cost.

Bank owned life insurance (carried at cost):

The fair value is equal to the cash surrender value of the Bank owned life insurance.

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 except certificates of deposit which are at fair value):

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 March 31, 2014 and December 31, 2013. (In thousands)

|  | Carrying<br>Amount | Fair Value Measurements at March 31, 2014 |          |         |         |
|--|--------------------|---|----------|---------|---------|
|  |                    | Fair Value                                | Level 1  | Level 2 | Level 3 |
| Financial assets:  |                    |   |          |         |         |
| Cash and cash equivalents                                      | \$ 8,749           | \$ 8,749                                  | \$ 8,749 | \$ -    | \$ -    |
| Securities   | 156,340            | 156,341                                   | 345      | 155,996 | -       |
| Loans receivable, net  | 490,289            | 505,518                                   | -        | -       | 505,518 |
| Mortgage servicing rights                                      | 286                | 286                                       | 286      | -       | -       |
| Regulatory Stock   | 2,741              | 2,741                                     | 2,741    | -       | -       |
| Bank owned life insurance                                      | 17,930             | 17,930                                    | 17,930   | -       | -       |
| Accrued interest receivable                                    | 2,330              | 2,330                                     | 2,330    | -       | -       |
| Financial liabilities:   |                    |   |          |         |         |
| Deposits   | 540,076            | 540,858                                   | 331,722  | -       | 209,136 |
| Short-term borrowings  | 40,373             | 40,373                                    | 40,373   | -       | -       |
| Other borrowings   | 23,373             | 25,181                                    | -        | -       | 25,181  |
| Accrued interest payable                                       | 973                | 973                                       | 973      | -       | -       |
| Off-balance sheet financial instruments:                       |                    |   |          |         |         |
| Commitments to extend credit and outstanding letters of credit | -                  | -   | -        | -       | -       |

|  | Carrying<br>Amount | Fair Value Measurements at December 31, 2013 |          |         |         |
|--|--------------------|--|----------|---------|---------|
|  |                    | Fair Value                                   | Level 1  | Level 2 | Level 3 |
| Financial assets:  |                    |  |          |         |         |
| Cash and cash equivalents                                      | \$ 7,863           | \$ 7,863                                     | \$ 7,863 | \$ -    | \$ -    |
| Securities   | 158,306            | 158,309                                      | 328      | 157,981 | -       |
| Loans receivable, net  | 497,389            | 506,113                                      | -        | -       | 506,113 |
| Mortgage servicing rights                                      | 289                | 289  | -        | 289     | -       |
| Regulatory stock   | 2,877              | 2,877  | 2,877    | -       | -       |
| Bank owned life insurance                                      | 17,790             | 17,790                                       | 17,790   | -       | -       |
| Accrued interest receivable                                    | 2,422              | 2,422  | 2,422    | -       | -       |
| Financial liabilities:   |                    |  |          |         |         |
| Deposits   | 541,182            | 542,123                                      | 329,753  | -       | 212,370 |
| Short-term borrowings  | 49,914             | 49,914                                       | 49,914   | -       | -       |
| Other borrowings   | 23,761             | 25,923                                       | -        | -       | 25,923  |
| Accrued interest payable                                       | 1,022              | 1,022  | 1,022    | -       | -       |
| Off-balance sheet financial instruments:                       |                    |  |          |         |         |
| Commitments to extend credit and outstanding letters of credit | -                  | -  | -        | -       | -       |

## 9. New and Recently Adopted Accounting Pronouncements

In June 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2013-08, Financial Services – Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements. The amendments in this Update affect the scope, measurement, and disclosure requirements for investment companies under U.S. GAAP. The amendments do all of the following: 1. Change the approach to the investment company assessment in Topic 946, clarify the characteristics of an investment company, and provide comprehensive guidance for assessing whether an entity is an investment Company. 2. Require an investment company to measure non-controlling ownership interests in other investment companies at fair value rather than using the equity method of accounting. 3. Require the following additional disclosures: (a) the fact that the entity is an investment company and is applying the guidance in Topic 946, (b) information about changes, if any, in an entity’s status as an investment company, and (c) information about financial support provided or contractually required to be provided by an investment company to any of its investees. The amendments in this Update are effective for an entity’s interim and annual reporting periods in fiscal years that begin after December 15, 2013. Earlier application is prohibited. This ASU is not expected to have a significant impact on the Company’s financial statements.

In July 2013, the FASB issued ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carry forward, a Similar Tax Loss, or a Tax Credit Carry forward Exists. This Update applies to all entities that have unrecognized tax benefits when a net operating loss carry forward, a similar tax loss, or a tax credit carry forward exists at the reporting date. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carry forward, a similar tax loss, or a



tax credit carry forward, except as follows. To the extent a net operating loss carry forward, a similar tax loss, or a tax credit carry forward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In January 2014, FASB issued ASU 2014-01, Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. The amendments in this Update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this Update should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In January 2014, the FASB issued ASU 2014-04, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amendments in this Update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this Update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in this Update using either a modified retrospective transition method or a prospective transition method. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

## 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 are as follows:

- our ability to realize the anticipated benefits from our acquisition of North Penn Bancorp, Inc.
- possible future impairment of intangible assets
- our ability to effectively manage future growth
- loan losses in excess of our allowance
- risks inherent in commercial lending
- real estate collateral which is subject to declines in value
- potential other-than-temporary impairments
- higher deposit insurance premiums
- soundness of other financial institutions
- increased compliance burden under new financial reform legislation
- current market volatility
- potential liquidity risk
- availability of capital
- regional economic factors
- loss of senior officers
- comparatively low legal lending limits
- risks of new capital requirements
- limited market for the Company's stock
- restrictions on ability to pay dividends
- common stock may lose value
- competitive environment
- issuing additional shares may dilute ownership
- extensive and complex governmental regulation and associated cost
- interest rate risks

Norwood Financial Corp. 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, 2013 (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, the valuation of deferred tax assets, the fair value of financial instruments, the determination of goodwill impairment and the determination of other-than-temporary impairment 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.

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.

Bonds, notes and debentures for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the term of the security.

Management determines the appropriate classification of debt securities at the time of purchase and re-evaluates such designation as of each Consolidated Balance Sheet date.

Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, the Company considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent of the Company to not sell the securities and it is more likely than not that it will not have to sell the securities before recovery of their cost basis. The Company believes that the unrealized loss on all other securities at March 31, 2014 and December 31, 2013 represent temporary impairment of the securities, related to changes in interest rates.

The Company, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in capital stock of its district FHLB according to a predetermined formula. This restricted stock has no quoted market value and is carried at cost.

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 considered that the FHLB's regulatory capital ratios have increased from the prior year, liquidity appears adequate, and the new shares of FHLB stock continue to change hands at the \$100 par value. Management believes no impairment charge is necessary related to FHLB stock as of March 31, 2014.

In connection with the acquisition of North Penn Bancorp, Inc. ("North Penn"), we recorded goodwill in the amount of \$9.7 million, representing the excess of amounts paid over the fair value of net assets of the institutions acquired in purchase transactions, at its fair value at the date of acquisition. Goodwill is tested and deemed impaired when the carrying value of goodwill exceeds its implied fair value. The value of the goodwill can change in the future. We expect the value of the goodwill to decrease if there is a significant decrease in the franchise value of the Bank. If an impairment loss is determined in the future, we will reflect the loss as an expense for the period in which the impairment is determined, leading to a reduction of our net income for that period by the amount of the impairment loss.



## Changes in Financial Condition

## General

Total assets as of March 31, 2014 were \$703.2 million compared to \$711.2 million as of December 31, 2013, a decrease of \$8.0 million due to a \$7.1 million reduction in loans outstanding.

## Securities

The fair value of securities available for sale as of March 31, 2014 was \$156.2 million compared to \$158.1 million as of December 31, 2013. The Company purchased \$10.9 million of securities principally using the proceeds from \$15.2 million of sales, calls, maturities and principal reductions of securities.

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

| (dollars in thousands)               | March 31, 2014 |                | December 31, 2013 |                |   |
|--------------------------------------|----------------|----------------|-------------------|----------------|---|
|                                      | Amount         | % of portfolio | Amount            | % of portfolio |   |
| US Government agencies               | \$27,092       | 17.3           | % \$33,413        | 21.1           | % |
| States and political subdivisions    | 62,758         | 40.1           | 59,204            | 37.4           |   |
| Corporate obligations                | 3,700          | 2.4            | 3,711             | 2.3            |   |
| Mortgage-backed securities-          |                |                |                   |                |   |
| government sponsored entities        | 62,445         | 39.9           | 61,650            | 39.0           |   |
| Equity securities-financial services | 345            | 0.2            | 328               | 0.2            |   |
| Total                                | \$156,340      | 100.0          | % \$158,306       | 100.0          | % |

The Company has securities in an unrealized loss position. In management's opinion, the unrealized losses 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 which has been impacted by the weakening conditions of the financial markets. Management believes that the unrealized losses on all holdings represent temporary impairment of the securities, as the Company has the intent and ability to hold these investments until maturity or market price recovery.

## Loans

Loans receivable totaled \$496.0 million at March 31, 2014 compared to \$503.1 million as of December 31, 2013. The \$7.1 million decrease recorded in the three month period ending March 31, 2014 was attributed to a \$7.6 million decrease in commercial real estate loans and a \$2.2 million decrease in residential mortgage loans. Commercial loans increased \$1.9 million during the period while other loans increased \$800,000.

The allowance for loan losses totaled \$5,727,000 as of March 31, 2014 and represented 1.15% of total loans, compared to \$5,708,000, or 1.13% of total loans, at December 31, 2013, and \$5,726,000, or 1.20% of total loans, as of March 31, 2013. The Company had net charge-offs for the three months ended March 31, 2014 of \$401,000 compared to \$576,000 in the comparable period in 2013. 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 March 31, 2014 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 March 31, 2014, non-performing loans totaled \$9.5 million, or 1.92% of total loans compared to \$9.5 million, or 1.90% of total loans at December 31, 2013. At March 31, 2014, non-performing assets totaled \$10.9 million, or 1.55%, of total assets compared to \$10.6 million, or 1.48%, of total assets at December 31, 2013. The increase reflects the transfer of four properties into foreclosed real estate owned with a carrying value of \$383,000.

The following table sets forth information regarding non-performing loans and foreclosed real estate at the dates indicated:

| (dollars in thousands)  | March 31, 2014 | December 31, 2013 |
|---|----------------|-------------------|
| Loans accounted for on a non-accrual basis:                     |                |                   |
| Commercial and all other  | \$ -           | \$ -              |
| Real Estate   | 9,532          | 9,547             |
| Total non-accrual loans *                                       | 9,532          | 9,547             |
| Accruing loans which are contractually past due 90 days or more | -              | -                 |
| Total non-performing loans                                      | 9,532          | 9,547             |
| Foreclosed real estate  | 1,364          | 1,009             |
| Total non-performing assets                                     | \$ 10,896      | \$ 10,556         |
| Allowance for loans losses                                      | \$ 5,727       | \$ 5,708          |
| Coverage of non-performing loans                                | 0.60x          | 0.60x             |
| Non-performing loans to total loans                             | 1.92%          | 1.90%             |
| Non-performing loans to total assets                            | 1.36%          | 1.34%             |
| Non-performing assets to total assets                           | 1.55%          | 1.48%             |

\*Includes non-accrual TDRs of \$6.2 million as of March 31, 2014 and December 31, 2013. The Company also had \$3.0 million of accruing TDRs on those dates.

## Deposits

During the period, total deposits decreased \$1.1 million due primarily to a \$3.7 million decrease in certificates of deposit over \$100,000 as municipalities utilized funds to meet cash flow needs. All other deposit products increased \$2.6 million, net.

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

| (dollars in thousands)        | March 31, 2014 | December 31, 2013 |
|-------------------------------|----------------|-------------------|
| Non-interest bearing demand   | \$ 93,400      | \$ 92,684         |
| Interest bearing demand       | 46,059         | 45,444            |
| Money market deposit accounts | 120,907        | 122,423           |
| Savings                       | 71,356         | 69,202            |
| Time deposits <\$100,000      | 132,382        | 131,793           |

|                          |            |            |
|--------------------------|------------|------------|
| Time deposits >\$100,000 | 75,972     | 79,636     |
| Total                    | \$ 540,076 | \$ 541,182 |



## Borrowings

Short-term borrowings as of March 31, 2014 totaled \$40.4 million compared to \$49.9 million as of December 31, 2013. Short-term borrowings, which consisted of securities sold under agreements to repurchase and overnight borrowings from the FHLB, decreased \$9.5 million principally due to the seasonality of municipal cash management accounts and a reduced level of overnight borrowings due to loan payoffs.

Other borrowings consisted of the following:

(dollars in thousands)

|  | March 31, 2014 | December 31, 2013 |
|--|----------------|-------------------|
| Notes with the FHLB:   |                |                   |
| Fixed rate note due July 2015 at 4.34%                       | \$ 7,254       | \$ 7,301          |
| Convertible note due January 2017 at 4.71%                   | 10,000         | 10,000            |
| Amortizing fixed rate borrowing due January, 2018 at 0.91%   | 2,312          | 2,460             |
| Amortizing fixed rate borrowing due December, 2018 at 1.425% | 3,807          | 4,000             |
|  | \$ 23,373      | \$ 23,761         |

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 19 to 22 basis points. If the notes are converted, the option allows the Bank to put the funds back to the FHLB at no charge. The fixed rate borrowing due July 2015 includes a \$254,000 fair value adjustment recorded at the time of the North Penn acquisition.

## 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 \$24.7 million as of March 31, 2014 compared to \$22.8 million as of December 31, 2013.

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

|  | March 31, 2014<br>(in thousands) | December 31, 2013 |
|--|----------------------------------|-------------------|
| Unfunded availability under loan commitments | \$ 24,728                        | \$ 22,845         |
| Unfunded commitments under lines of credit   | 46,360                           | 42,575            |
| Standby letters of credit                    | 5,700                            | 5,701             |
|  | \$ 76,788                        | \$ 71,121         |



## Stockholders' Equity and Capital Ratios

As of March 31, 2014, stockholders' equity totaled \$94.2 million, compared to \$91.9 million as of December 31, 2013. The net change in stockholders' equity included \$2.0 million of net income that was partially offset by \$1.1 million of dividends declared, a \$179,000 reduction due to an increase in Treasury Stock, and a \$40,000 increase due to the exercise and vesting of stock options. In addition, total equity increased \$1.6 million due to an increase in the 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 and spreads, 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:

|   | March 31, 2014 |   | December 31, 2013 |   |
|---|----------------|---|-------------------|---|
| Tier 1 Capital<br>(To average assets)       | 12.19          | % | 12.09             | % |
| Tier 1 Capital<br>(To risk-weighted assets) | 16.86          | % | 16.53             | % |
| Total Capital<br>(To risk-weighted assets)  | 18.00          | % | 17.66             | % |

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 and Securities (PDB&S) guidelines. The Bank's capital ratios do not differ significantly from the Company's ratios. Although not adopted in regulation form, the PDB&S 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&S capital requirements as of March 31, 2014 and December 31, 2013.

## Liquidity

As of March 31, 2014, the Company had cash and cash equivalents of \$8.7 million in the form of cash, due from banks and short-term deposits with other institutions. In addition, the Company had total securities available for sale of \$156.2 million which could be used for liquidity needs. This totals \$164.9 million of liquidity and represents 23.4% of total assets compared to \$166.0 million and 23.3% of total assets as of December 31, 2013. The Company also monitors other liquidity measures, all of which were within the Company's policy guidelines as of March 31, 2014 and December 31, 2013. 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 2016. Borrowings under this line were \$5.9 million and \$13.4 million at March 31, 2014 and December 31, 2013, respectively.

The Company has a line of credit commitment from Atlantic Central Bankers Bank for \$7,000,000 which expires June 30, 2014. There were no borrowings under this line as of March 31, 2014 and December 31, 2013.

The Company has a line of credit commitment available which has no stated expiration date from PNC Bank for \$16,000,000. There were no borrowings under this line as of March 31, 2014 and December 31, 2013.

The Bank's maximum borrowing capacity with the Federal Home Loan Bank was approximately \$287,228,000 as of March 31, 2014, of which \$29,300,000 and \$37,200,000 was outstanding at March 31, 2014 and December 31, 2013 respectively. Advances from the Federal Home Loan Bank 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 36. 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,<br>dollars in thousands) | Three Months Ended March 31, |                         |                        |                           |                         |                        |
|---|------------------------------|-------------------------|------------------------|---------------------------|-------------------------|------------------------|
|   | Average<br>Balance<br>(2)    | 2014<br>Interest<br>(1) | Average<br>Rate<br>(3) | Average<br>Balance<br>(2) | 2013<br>Interest<br>(1) | Average<br>Rate<br>(3) |
| <b>Assets</b>                                   |                              |                         |                        |                           |                         |                        |
| Interest-earning assets:                        |                              |                         |                        |                           |                         |                        |
| Interest bearing deposits<br>with banks         | \$ 854                       | \$ 1                    | 0.47 %                 | \$ 3,983                  | \$ 3                    | 0.30 %                 |
| Securities<br>held-to-maturity                  | 175                          | 3                       | 6.86                   | 173                       | 3                       | 6.94                   |
| Securities available for<br>sale:               |                              |                         |                        |                           |                         |                        |
| Taxable   | 99,840                       | 488                     | 1.96                   | 89,946                    | 400                     | 1.78                   |
| Tax-exempt (1)                                  | 59,990                       | 753                     | 5.02                   | 54,973                    | 706                     | 5.14                   |
| Total securities<br>available for sale (1)      | 159,830                      | 1,241                   | 3.11                   | 144,919                   | 1,106                   | 3.05                   |
| Loans receivable (1) (4)<br>(5)                 | 500,182                      | 6,040                   | 4.83                   | 478,170                   | 6,231                   | 5.21                   |
| Total interest earning<br>assets                | 661,041                      | 7,285                   | 4.41                   | 627,245                   | 7,343                   | 4.68                   |
| Non-interest earning assets:                    |                              |                         |                        |                           |                         |                        |
| Cash and due from banks                         | 7,638                        |                         |                        | 8,835                     |                         |                        |
| Allowance for loan losses                       | (5,886 )                     |                         |                        | (5,580 )                  |                         |                        |
| Other assets                                    | 42,204                       |                         |                        | 44,199                    |                         |                        |
| Total non-interest<br>earning assets            | 43,956                       |                         |                        | 47,454                    |                         |                        |
| Total Assets                                    | \$ 704,997                   |                         |                        | \$ 674,699                |                         |                        |
| <b>Liabilities and<br/>Stockholders' Equity</b> |                              |                         |                        |                           |                         |                        |
| Interest bearing liabilities:                   |                              |                         |                        |                           |                         |                        |
| Interest bearing demand<br>and money market     | \$ 168,265                   | \$ 79                   | 0.19                   | \$ 167,514                | \$ 111                  | 0.27                   |
| Savings   | 69,963                       | 9                       | 0.05                   | 69,178                    | 17                      | 0.10                   |
| Time  | 210,543                      | 547                     | 1.04                   | 210,035                   | 626                     | 1.19                   |
| Total interest bearing<br>deposits              | 448,771                      | 635                     | 0.57                   | 446,727                   | 754                     | 0.68                   |
| Short-term borrowings                           | 41,929                       | 22                      | 0.21                   | 22,137                    | 12                      | 0.22                   |
| Other borrowings                                | 23,575                       | 166                     | 2.82                   | 24,734                    | 190                     | 3.07                   |
| Total interest bearing<br>liabilities           | 514,275                      | 823                     | 0.64                   | 493,598                   | 956                     | 0.77                   |
| Non-interest bearing<br>liabilities:            |                              |                         |                        |                           |                         |                        |

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|  |            |            |
|--|------------|------------|
| Demand deposits                            | 92,593     | 83,618     |
| Other liabilities                          | 3,995      | 4,073      |
| Total non-interest bearing liabilities     | 96,588     | 87,691     |
| Stockholders' equity                       | 94,134     | 93,410     |
| Total Liabilities and Stockholders' Equity | \$ 704,997 | \$ 674,699 |

|  |          |        |          |        |
|--|----------|--------|----------|--------|
| Net interest income (tax equivalent basis) | 6,462    | 3.77 % | 6,387    | 3.91 % |
| Tax-equivalent basis adjustment            | (317 )   |        | (286 )   |        |
| Net interest income                        | \$ 6,145 |        | \$ 6,101 |        |
| Net interest margin (tax equivalent basis) |          | 3.91 % |          | 4.07 % |

(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 March 31,<br>2014 Compared to<br>Three months ended March 31, 2013 |             |         |
|  | Variance due to   |             | Net     |
|  | Volume  | Rate        |         |
|  | (dollars in thousands)  |             |         |
| Interest earning assets:                   |   |             |         |
| Interest bearing deposits with banks       | \$ (9 )   | \$ 7        | \$ (2 ) |
| Securities held to maturity                | -   | -           | -       |
| Securities available for sale:             |   |             |         |
| Taxable                                    | 46  | 42          | 88      |
| Tax-exempt securities                      | 140   | (93 )       | 47      |
| Total securities                           | 186   | (51 )       | 135     |
| Loans receivable                           | 1,336   | (1,527 )    | (191 )  |
| Total interest earning assets              | 1,513   | (1,571 )    | (58 )   |
| Interest bearing liabilities:              |   |             |         |
| Interest-bearing demand and money market   | 3   | (35 )       | (32 )   |
| Savings                                    | 1   | (9 )        | (8 )    |
| Time                                       | 10  | (89 )       | (79 )   |
| Total interest bearing deposits            | 14  | (133 )      | (119 )  |
| Short-term borrowings                      | 13  | (3 )        | 10      |
| Other borrowings                           | (9 )  | (15 )       | (24 )   |
| Total interest bearing liabilities         | 18  | (151 )      | (133 )  |
| Net interest income (tax-equivalent basis) | \$ 1,495  | \$ (1,420 ) | \$ 75   |

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 March 31, 2014 to March 31, 2013

## General

For the three months ended March 31, 2014, net income totaled \$1,964,000 compared to \$2,308,000 earned in the similar period in 2013. The decrease in net income for the three months ended March 31, 2014 was due primarily to \$770,000 of proceeds from a bank-owned life insurance policy that was recorded in the first quarter of 2013, some of which was offset by higher core earnings and a reduced provision for loan losses in the current year. Earnings per share for the current period were \$.54 for basic and fully diluted compared to \$.64 per share basic and \$.63 fully diluted for the three months ended March 31, 2013. The resulting annualized return on average assets and annualized return on average equity for the three months ended March 31, 2014 were 1.13% and 8.46%, respectively, compared to 1.39% and 10.02%, respectively, for the similar period in 2013.

The following table sets forth changes in net income:

| (dollars in thousands)                             | Three months ended<br>March 31, 2014 to March 31, 2013 |        |
|--|--|--------|
| Net income three months ended March 31, 2013       | \$   | 2,308  |
| Change due to:                                     |  |        |
| Net interest income                                |  | 44     |
| Provision for loan losses                          |  | 380    |
| Gain on sales of loans and securities              |  | (15 )  |
| Earnings and proceeds on bank-owned life insurance |  | (757 ) |
| Other income                                       |  | (52 )  |
| Salaries and employee benefits                     |  | 46     |
| Occupancy, furniture and equipment                 |  | (49 )  |
| Foreclosed real estate owned                       |  | 126    |
| All other expenses                                 |  | 46     |
| Income tax expense                                 |  | (113 ) |
| Net income three months ended March 31, 2014       | \$   | 1,964  |

## Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the three months ended March 31, 2014 totaled \$6,462,000 which was \$75,000 higher than the comparable period in 2013. The increase in net interest income largely reflects the improved mix and growth of the balance sheet which offset the reduced earnings on loans and investments due to repricing in the current low interest rate environment. The fte net interest spread and net interest margin were 3.77% and 3.91%, respectively, for the three months ended March 31, 2014 compared to 3.91% and 4.07%, respectively, for the similar period in 2013.

Interest income (fte) totaled \$7,285,000 with a yield on average earning assets of 4.41% compared to \$7,343,000 and 4.68% for the 2013 period. Average loans increased \$22.0 million over the comparable period of last year but resulted in a 38 basis point reduction in the yield earned, resulting in a \$191,000 reduction in fte loan income. Reduced yields on tax-free securities were offset by higher yields on taxable securities and increased balances, resulting in a \$135,000 increase in earnings on securities. Average earning assets totaled \$661.0 million for the three months ended March 31, 2014, an increase of \$33.8 million over the average for the similar period in 2013. This increase in average earning assets helped offset the decline in asset yields.





Interest expense for the three months ended March 31, 2014 totaled \$823,000 at an average cost of 0.64% compared to \$956,000 and 0.77% for the similar period in 2013. As a result of the continued low interest rate environment, the Company further reduced rates paid on its money market and savings accounts. The cost of time deposits, which is the most significant component of funding, declined to 1.04% from 1.19% for the similar period in the prior year. As time deposits matured, they repriced at the current lower rates resulting in the decrease.

#### Provision for Loan Losses

The Company's provision for loan losses for the three months ended March 31, 2014 was \$420,000 compared to \$800,000 for the three months ended March 31, 2013. The Company makes provisions for loan losses in an amount necessary to maintain the allowance for loan losses at an acceptable level. Net charge-offs were \$401,000 for the quarter ended March 31, 2014 compared to \$576,000 for the similar period in 2013.

#### Other Income

Other income totaled \$1,053,000 for the three months ended March 31, 2014 compared to \$1,877,000 for the similar period in 2013. Earnings and proceeds from bank-owned life insurance policies decreased due to a non-recurring gain of \$770,000 recognized in the first quarter of 2013. Net gains from the sale of loans and securities decreased \$15,000 compared to the same period of 2013 due to reduced activity. All other items of other income decreased \$52,000, net, compared to the first quarter of last year.

#### Other Expense

Other expense for the three months ended March 31, 2014 totaled \$4,132,000 or \$169,000 lower than the same period of 2013. Costs associated with foreclosed real estate properties decreased \$126,000 while all other operating expenses decreased \$43,000, net.

#### Income Tax Expense

Income tax expense totaled \$682,000 for an effective tax rate of 25.8% for the period ending March 31, 2014 compared to \$569,000 for an effective tax rate of 19.8% for the similar period in 2013. The 2013 period included a non-recurring tax-free gain.

### 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 March 31, 2014, the level of net interest income at risk in a 200 basis point increase in interest rates was within the Company's policy limits, while a 200 basis point decrease in rates would result in a net interest fluctuation that exceeds the policy limit. The Company's policy allows for a decline of no more than 8% of net interest income for a  $\pm$  200 basis point shift in interest rates. Based on the current level of interest rates, the risk in the declining 200 basis point scenario is considered acceptable.

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 March 31, 2014, the Company had a positive 90 day interest sensitivity gap of \$54.9 million or 7.8% of total assets, compared to the \$51.9 million or 7.3% of total assets as of December 31, 2013. Rate sensitive assets repricing within 90 days decreased \$3.8 million due primarily to a \$7.8 million decrease in borrowed funds and a \$5.1 million decrease in loans repricing within the period. 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 deposits, loan pricing to encourage variable rate products and evaluation of loan sales of long-term fixed rate mortgages.

March 31, 2014  
Rate Sensitivity Table  
(dollars in thousands)

|  | 3 Months   | 3-12<br>Months | 1 to 3<br>Years | Over 3<br>Years | Total      |
|--|------------|----------------|-----------------|-----------------|------------|
| Federal funds sold and interest bearing deposits | \$ 142     | \$-            | \$-             | \$-             | \$ 142     |
| Securities                                       | 9,407      | 21,362         | 40,307          | 85,264          | 156,340    |
| Loans Receivable                                 | 129,346    | 119,613        | 138,163         | 108,894         | 496,016    |
| Total RSA  | \$ 138,895 | \$ 140,975     | \$ 178,470      | \$ 194,158      | \$ 652,498 |
| Non-maturity interest-bearing deposits           | \$ 38,185  | \$ 43,264      | \$ 114,714      | \$ 42,159       | \$ 238,322 |
| Time Deposits                                    | 31,877     | 64,802         | 86,532          | 25,143          | 208,354    |
| Other  | 13,895     | 12,831         | 34,572          | 2,448           | 63,746     |
| Total RSL  | \$ 83,957  | \$ 120,897     | \$ 235,818      | \$ 69,750       | \$ 510,422 |
| Interest Sensitivity Gap                         | \$ 54,938  | \$ 20,078      | \$ (57,348 )    | \$ 124,408      | \$ 142,076 |
| Cumulative Gap                                   | 54,938     | 75,016         | 17,668          | 142,076         |            |
| RSA/RSL-cumulative                               | 165.4 %    | 136.6 %        | 104.0 %         | 127.8 %         |            |

December 31, 2013

|                          |           |           |              |            |            |
|--------------------------|-----------|-----------|--------------|------------|------------|
| Interest Sensitivity Gap | \$ 51,870 | \$ 11,886 | \$ (48,607 ) | \$ 124,416 | \$ 139,565 |
| Cumulative Gap           | 51,870    | 63,756    | 15,149       | 139,565    |            |
| RSA/RSL-cumulative       | 157.1 %   | 128.7 %   | 103.4 %      | 126.7 %    |            |

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, 2013.

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

None

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Mine Safety Disclosures

Not applicable

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 (3)  |
| 10.4  | Change in Control Severance Agreement with Robert J. Mancuso(4)                                      |
| 10.5  | Salary Continuation Agreement between the Bank and William W. Davis, Jr. (5)                         |
| 10.6  | Salary Continuation Agreement between the Bank and Lewis J. Critelli (5)                             |
| 10.7  | 1999 Directors Stock Compensation Plan (3)   |
| 10.8  | Salary Continuation Agreement between the Bank and John H. Sanders (6)                               |
| 10.9  | 2006 Stock Option Plan (7)   |
| 10.10 | First and Second Amendments to Salary Continuation Agreement with William W. Davis, Jr. (8)          |
| 10.11 | First and Second Amendments to Salary Continuation Agreement with Lewis J. Critelli (8)              |
| 10.12 | First and Second Amendments to Salary Continuation Agreement with John H. Sanders (8)                |
| 10.13 | Change In Control Severance Agreement with James F. Burke(9)   |
| 10.14 | 2014 Equity Incentive Plan(10)   |
| 31.1  | Rule 13a-14(a)/15d-14(a) Certification of CEO  |
| 31.2  | Rule 13a-14(a)/15d-14(a) Certification of 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 into this document from the Exhibits to Form 10, Registration Statement initially filed with the Commission on April 29, 1996, Registration No. 0-28364

(2)

Incorporated by reference into this document from the identically numbered exhibits to the Registrant's Form 10-K 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 by reference into this document from the identically numbered exhibit to the Registrant's Form 10-K filed with the Commission on March 14, 2013, File No. 0-28364.

- (5) Incorporated by reference into this document from the Exhibits to Form S-8 filed with the Commission on August 14, 1998, File No. 333-61487.
- (6) Incorporated herein by reference to the identically numbered exhibit to the Registrant's Form 10-K filed with the Commission on March 22, 2004.
- (7) Incorporated by reference to this document from Exhibit 4.1 to Registrant's Registration Statement on Form S-8 (File No. 333-134831) filed with the Commission on June 8, 2006.
- (8) Incorporated herein by reference from the Exhibits to the Registrant's Current Report on Form 8-K filed on April 4, 2006.
- (9) Incorporated by reference from the identically numbered exhibit to the Registrant's Form 10-Q filed with the Commission on November 7, 2013.
- (10) Incorporated by reference to Exhibit 10.1 to the Registrant's Registration Statement on Form S-8 (File No. 333-195643) filed with the Commission on May 2, 2014.



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: May 9, 2014

By:

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

Date: May 9, 2014

By:

/s/ William S. Lance  
William S. Lance  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial Officer)