

NORWOOD FINANCIAL CORP
Form 10-Q
August 10, 2009
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2009

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

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

Incorporation or organization)

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))

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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 xNo o

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 o No o

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 O

Accelerated filer X

Non-accelerated filer O

Smaller reporting company O

(Do not check if a smaller reporting company)

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

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

Class
Common stock, par value \$0.10 per share

Outstanding as of August 7, 2009
2,748,206

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NORWOOD FINANCIAL CORP.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2009

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PART I. FINANCIAL INFORMATION**Item 1. Financial Statements**

NORWOOD FINANCIAL CORP.

Consolidated Balance Sheets (unaudited)

(dollars in thousands, except per share data)

| | June 30, 2009 | December 31, 2008 |
|---|-------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 7,548 | \$ 6,463 |
| Interest bearing deposits with banks | 6 | 17 |
| Cash and cash equivalents | 7,554 | 6,480 |
| Securities available for sale | 122,601 | 130,120 |
| Securities held to maturity, fair value 2009 \$721, 2008: \$720 | 708 | 707 |
| Loans receivable (net of unearned income) | 360,593 | 349,404 |
| Less: Allowance for loan losses | 4,574 | 4,233 |
| Net loans receivable | 356,019 | 345,171 |
| Investment in FHLB Stock, at cost | 3,538 | 3,538 |
| Bank premises and equipment, net | 5,297 | 5,490 |
| Bank owned life insurance | 8,234 | 8,068 |
| Foreclosed real estate owned | 798 | 660 |
| Accrued interest receivable | 2,117 | 2,179 |
| Other assets | 1,629 | 1,883 |
| TOTAL ASSETS | \$ 508,495 | \$ 504,296 |
| LIABILITIES | | |
| Deposits: | | |
| Non-interest bearing demand | \$ 60,444 | \$ 56,839 |
| Interest bearing | 313,709 | 302,796 |
| Total deposits | 374,153 | 359,635 |
| Short-term borrowings | 24,596 | 38,126 |
| Other borrowings | 43,000 | 43,000 |
| Accrued interest payable | 2,210 | 2,247 |
| Other liabilities | 3,435 | 2,598 |
| TOTAL LIABILITIES | 447,394 | 445,606 |
| STOCKHOLDERS' EQUITY | | |
| Common stock, \$.10 par value, authorized 10,000,000 shares, issued: 2,840,872 | 284 | 284 |
| Surplus | 9,879 | 9,972 |
| Retained earnings | 52,402 | 50,398 |
| Treasury stock at cost: 2009: 92,666 shares, 2008: 104,310 shares | (2,871) | (3,243) |
| Accumulated other comprehensive income | 1,407 | 1,279 |

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| | | |
|---|------------|------------|
| TOTAL STOCKHOLDERS' EQUITY | 61,101 | 58,690 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 508,495 | \$ 504,296 |

See accompanying notes to the unaudited consolidated financial statements

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NORWOOD FINANCIAL CORP.

Consolidated Statements of Income (unaudited)

(dollars in thousands, except per share data)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|----------|------------------|-----------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| INTEREST INCOME | | | | |
| Loans receivable, including fees | \$ 5,426 | \$ 5,410 | \$ 10,713 | \$ 11,051 |
| Securities | 1,316 | 1,537 | 2,713 | 3,026 |
| Other | 1 | 6 | 7 | 25 |
| Total interest income | 6,743 | 6,953 | 13,433 | 14,102 |
| INTEREST EXPENSE | | | | |
| Deposits | 1,420 | 1,963 | 2,921 | 4,334 |
| Short-term borrowings | 73 | 178 | 169 | 365 |
| Other borrowings | 415 | 238 | 827 | 505 |
| Total interest expense | 1,908 | 2,379 | 3,917 | 5,204 |
| NET INTEREST INCOME | 4,835 | 4,574 | 9,516 | 8,898 |
| PROVISION FOR LOAN LOSSES | 220 | 110 | 445 | 185 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 4,615 | 4,464 | 9,071 | 8,713 |
| OTHER INCOME | | | | |
| Service charges and fees | 642 | 670 | 1,240 | 1,308 |
| Income from fiduciary activities | 82 | 110 | 164 | 202 |
| Net realized gains on sales of securities | 172 | 9 | 333 | 9 |
| Gain on sale of loans and servicing rights | 121 | 8 | 254 | 396 |
| Gain on sale of deposits | — | — | 150 | — |
| Other | 151 | 165 | 308 | 309 |
| Total other income | 1,168 | 962 | 2,449 | 2,224 |
| OTHER EXPENSES | | | | |
| Salaries and employee benefits | 1,595 | 1,498 | 3,209 | 3,044 |
| Occupancy, furniture & equipment, net | 379 | 414 | 864 | 844 |
| Data processing related | 203 | 180 | 399 | 368 |
| Taxes, other than income | 139 | 131 | 275 | 257 |
| Professional fees | 104 | 88 | 202 | 178 |
| FDIC Insurance assessment | 358 | 12 | 484 | 13 |
| Foreclosed real estate owned | 6 | 52 | 18 | 52 |
| Other | 536 | 597 | 1,144 | 1,177 |
| Total other expenses | 3,320 | 2,972 | 6,595 | 5,933 |
| INCOME BEFORE INCOME TAXES | 2,463 | 2,454 | 4,925 | 5,004 |
| INCOME TAX EXPENSE | 714 | 733 | 1,439 | 1,504 |

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| | | | | |
|----------------------------|----------|----------|----------|----------|
| NET INCOME | \$ 1,749 | \$ 1,721 | \$ 3,486 | \$ 3,500 |
| BASIC EARNINGS PER SHARE | \$ 0.64 | \$ 0.63 | \$ 1.27 | \$ 1.28 |
| DILUTED EARNINGS PER SHARE | \$ 0.63 | \$ 0.62 | \$ 1.26 | \$ 1.26 |

See accompanying notes to the unaudited consolidated financial statements

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NORWOOD FINANCIAL CORP.

Consolidated Statements of Changes in Stockholders' Equity (unaudited)

Six Months Ended June 30, 2009 and 2008

| | Common Stock | | Surplus | Retained Earnings | Treasury Stock | | Accumulated Other Comprehensive Income (Loss) | Total |
|--|--------------|--------|-----------|-------------------|----------------|-----------|---|-----------|
| | Shares | Amount | | | Shares | Stock | | |
| Balance December 31, 2007 | 2,840,872 | \$ 284 | \$ 10,159 | \$ 47,030 | 87,256 | (\$2,708) | \$ 1,054 | \$ 55,819 |
| Comprehensive Income: | | | | | | | | |
| Net Income | | | | 3,500 | | | | 3,500 |
| Change in unrealized gains on securities available for sale, net of reclassification adjustment and tax effects | | | | | | | (842) | (842) |
| Total comprehensive income | | | | | | | | 2,658 |
| Cash dividends declared \$.50 per share | | | | (1,368) | | | | (1,368) |
| Acquisition of treasury stock | | | | | 34,338 | (1,072) | | (1,072) |
| Stock options exercised | | | (276) | | (16,953) | 530 | | 254 |
| Tax benefit of stock options exercised | | | 83 | | | | | 83 |
| Compensation expense related to stock options | | | 77 | | | | | 77 |
| Cumulative effect of periodic Net periodic postretirement Benefit | | | | (520) | | | | (520) |
| Balance, June 30, 2008 | 2,840,872 | \$ 284 | \$ 10,043 | \$ 48,642 | 104,641 | (\$3,250) | \$ 212 | \$ 55,931 |
| Balance December 31, 2008 | 2,840,872 | \$ 284 | \$ 9,972 | \$ 50,938 | 104,310 | (\$3,243) | \$ 1,279 | \$ 59,690 |
| Comprehensive Income: | | | | | | | | |
| Net Income | | | | 3,486 | | | | 3,486 |
| Change in unrealized gains on securities available for sale, Net of reclassification adjustments and tax effects | | | | | | | 128 | 128 |
| Total comprehensive income | | | | | | | | 3,614 |
| Cash dividends declared \$.54 per share | | | | (1,482) | | | | (1,482) |
| Acquisition of treasury stock | | | | | 2,519 | (68) | | (68) |
| Stock options exercised | | | (225) | | (14,163) | 440 | | 215 |

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| | | | | | | | | |
|---|-----------|-------|---------|----------|--------|----------|-----------|----------|
| Tax benefit on stock options exercised | | | 67 | | | | | 67 |
| Compensation expense related to stock options | | | 65 | | | | | 65 |
| Balance, June 30, 2009 | 2,840,872 | \$284 | \$9,879 | \$52,402 | 92,666 | (\$3,871 |)\$ 1,407 | \$61,101 |

See accompanying notes to the unaudited consolidated financial statements

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NORWOOD FINANCIAL CORP.

Consolidated Statements of Cash Flows (unaudited)

(dollars in thousands)

| | Six Months Ended | |
|---|------------------|-----------|
| | June 30, | |
| | 2009 | 2008 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net Income | | |
| Adjustments to reconcile net income to net cash provided by operating activities: | \$ 3,486 | \$ 3,500 |
| Provision for loan losses | 445 | 185 |
| Depreciation | 290 | 283 |
| Amortization of intangible assets | 26 | 26 |
| Deferred income taxes | 144 | (59) |
| Net amortization of securities premiums and discounts | 60 | 26 |
| Net realized gain on sales of securities | (333) | (9) |
| Gain on sale of deposits | (150) | — |
| Net increase in investment in life insurance | (166) | (149) |
| Net gain on sale of mortgage loans and servicing rights | (254) | (396) |
| Loss on sale of bank premises and equipment and foreclosed real estate | 1 | 0 |
| Mortgage loans originated for sale | (15,674) | (866) |
| Proceeds from sale of mortgage loans originated for sale | 15,928 | 881 |
| Compensation expense related to stock options | 65 | 77 |
| Decrease (increase) in accrued interest receivable and other assets | 144 | (130) |
| Increase in accrued interest payable and other liabilities | 800 | 26 |
| Net cash provided by operating activities | 4,812 | 3,395 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Securities available for sale: | | |
| Proceeds from sales | 11,141 | 59 |
| Proceeds from maturities and principal reductions on mortgage-backed securities | 25,278 | 26,234 |
| Purchases | (28,428) | (34,416) |
| Increase in investment in FHLB stock | 0 | (585) |
| Net increase in loans | (11,506) | (16,214) |
| Proceeds from sale of mortgage loans | 0 | 13,885 |
| Purchase of bank premises and equipment | (100) | (243) |
| Proceeds from sale of bank premises and equipment and foreclosed real estate | 2 | — |
| Net cash used in investing activities | (3,613) | (11,280) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Net increase (decrease) in deposits | 18,274 | (4,729) |
| Deposits sold | (3,606) | — |
| Net increase (decrease) in short-term borrowings | (13,530) | 15,374 |
| Repayments of long- term debt | — | (5,000) |
| Proceeds from other borrowings | — | 5,000 |
| Tax benefit of stock options exercised | 67 | 83 |

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| | | |
|---|----------|----------|
| Stock options exercised | 215 | 254 |
| Acquisition of treasury stock | (68) | (1,072) |
| Cash dividends paid | (1,477) | (1,374) |
| Net cash provided by (used in) financing activities | (125) | 8,536 |
| Increase in cash and cash equivalents | 1,074 | 651 |
| | | |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 6,480 | 9,064 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 7,554 | \$ 9,715 |

See accompanying notes to the unaudited consolidated financial statements

Notes to Unaudited Consolidated Financial Statements

1. Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in conformity with generally accepted accounting principles for interim financial statements and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted 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 of the Company. The operating results for the three and six month periods ended June 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009 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, 2008.

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of June 30, 2009 for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through August 10, 2009, the date these financial statements were issued.

2. Earnings Per Share

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

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

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-------|------------------|-------|
| | June 30, 2009 | 2008 | June 30, 2009 | 2008 |
| Basic EPS weighted average shares outstanding | 2,741 | 2,736 | 2,739 | 2,744 |

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| | | | | |
|---|-------|-------|-------|-------|
| Dilutive effect of stock options | 19 | 35 | 19 | 35 |
| Diluted EPS weighted average shares outstanding | 2,760 | 2,771 | 2,758 | 2,779 |

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 114,150 and 44,000 as of June 30, 2009 and 2008, respectively.

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3. Stock-Based Compensation

The Company's shareholders approved the Norwood Financial Corp 2006 Stock Option Plan at the annual meeting on April 25, 2006 and the Company awarded 47,700 options in 2006, and 22,000 options in 2007, 24,000 options in 2008 and 1,000 options in 2009, all of which have a twelve-month vesting period. As of June 30, 2009, there was approximately \$65,000 of total unrecognized compensation cost related to nonvested options under the plan, which will be fully amortized by December 31, 2009.

There were 1,000 stock options granted for the six months ended June 30, 2009. A summary of stock options from all plans, adjusted for stock dividends declared, is shown below.

| | | Weighted | Weighted | | |
|--------------------------------|----------|----------------|-------------------|------|---------------|
| | | Average | Average Remaining | | Aggregate |
| | | Exercise Price | Contractual | | Intrinsic |
| | Options | Per Share | Term | | Value (\$000) |
| Outstanding at January 1, 2009 | 176,443 | \$25.95 | 6.5 | Yrs. | \$273 |
| Exercised | (14,163) | 15.09 | | | |
| Granted | 1,000 | 28.90 | 9.7 | | |
| Outstanding at June 30, 2009 | 163,280 | \$26.91 | 6.1 | | \$727 |
| Exercisable at June 30, 2009 | 138,280 | \$26.79 | 4.7 | | \$632 |

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 intrinsic value of options exercised during the six months ended June 30, 2009 was \$199,000, cash received from such exercises was \$215,000 and the tax benefit recognized was \$67,000.

4. Cash Flow Information

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

Cash payments for interest for the six months ended June 30, 2009 and 2008 were \$3,954,000 and \$5,717,000 respectively. Cash payments for income taxes in 2009 were \$1,153,000 compared to \$1,583,000 in 2008. Non-cash investing activity for 2009 and 2008 included foreclosed mortgage loans transferred to real estate owned and repossession of other assets of \$213,000 and \$1,223,000, respectively.

5. Comprehensive Income

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

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(in thousands)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|-------------|------------------|-------------|
| | June 30, 2009 | 2008 | June 30, 2009 | 2008 |
| Unrealized holding gains (losses) on available for sale securities | \$ (368) | \$ (2,279) | \$ 533 | \$ (1,272) |
| Reclassification adjustment for gains realized in net income | (172) | (9) | (333) | (9) |
| Net unrealized gains (losses) | (540) | (2,288) | 200 | (1,281) |
| Income tax (benefit), expense | (182) | (780) | 72 | (439) |
| Other comprehensive income (loss) | \$ (358) | \$ (1,508) | \$ 128 | \$ (842) |

6. Off-Balance Sheet Financial Instruments and Guarantees

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

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

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

(in thousands)

| | June 30, 2009 | 2008 |
|--|------------------|-----------|
| Commitments to grant loans | \$ 15,991 | \$ 12,507 |
| Unfunded commitments under lines of credit | 41,482 | 36,067 |
| Standby letters of credit | 2,079 | 2,677 |
| | \$ 59,522 | \$ 51,251 |

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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.

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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 payment required under the corresponding guarantees. The current amount of the liability as of June 30, 2009 for guarantees under standby letters of credit issued is not material.

7. Securities

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

| | June 30, 2009 | | | |
|-----------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In Thousands) | | | |
| Available for Sale: | | | | |
| U.S. Government agencies | \$ 25,126 | \$ 409 | \$ (52) | \$ 25,483 |
| States and political subdivisions | 30,185 | 176 | (523) | 29,838 |
| Corporate obligations | 5,054 | 44 | (12) | 5,086 |
| Mortgage-backed securities | 59,743 | 1,651 | (23) | 61,371 |
| | 120,108 | 2,280 | (610) | 121,778 |
| Equity securities | 361 | 507 | (45) | 823 |
| | \$ 120,469 | \$ 2,787 | \$ (655) | \$ 122,601 |
| Held to Maturity: | | | | |
| States and political subdivisions | \$ 708 | \$ 13 | \$ — | \$ 721 |
| | | | | |
| | December 31, 2008 | | | |
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In Thousands) | | | |
| Available for Sale: | | | | |
| U.S. Government agencies | \$ 34,989 | \$ 836 | \$ (12) | \$ 35,813 |
| States and political subdivisions | 25,436 | 110 | (337) | 25,209 |
| Corporate obligations | 6,065 | — | (440) | 5,625 |
| Mortgage-backed securities | 61,198 | 1,340 | (220) | 62,318 |
| | 127,688 | 2,286 | (1,009) | 128,965 |
| Equity securities | 500 | 754 | (99) | 1,155 |
| | \$ 128,188 | \$ 3,040 | \$ (1,108) | \$ 130,120 |
| Held to Maturity: | | | | |
| States and political subdivisions | \$ 707 | \$ 13 | \$ — | \$ 720 |

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

| | June 30, 2009 | | | | | |
|-----------------------------------|---------------------|------------|-------------------|------------|-------------|----------|
| | Less than 12 Months | | 12 Months or More | | Fair | Total |
| | Fair | Unrealized | Fair | Unrealized | | |
| Value | Losses | Value | Losses | Value | Losses | |
| U.S. Government agencies | \$ 4,958 | \$ (52) | \$ — | \$ — | \$ 4,958 | \$ (52) |
| States and political subdivisions | 15,853 | (523) |) — | — | 15,853 | (523) |
| Corporate obligations | — | — | 2,998 | (12) | 2,998 | (12) |
| Mortgage-backed securities | 5,132 | (23) |) — | — | 5,132 | (23) |
| Equity securities | 8 | (16) |) 19 | (29) | 27 | (45) |
| | \$ 25,951 | \$ (614) |)\$ 3,017 | \$ (41) |) \$ 28,968 | \$ (655) |

The Company has 42 securities in the less than twelve month category and 5 securities in the twelve or more category. In Management's opinion the unrealized losses principally reflect changes in interest rates subsequent to the acquisition of specific securities. The unrealized losses in the state and political subdivisions portfolio (municipals) also reflect a widening of spreads due to liquidity and credit concerns. The majority of the Company's municipal portfolio consists of debt obligations of Pennsylvania school districts. The Company holds a small amount of equity securities in other financial institutions, the value of which has been impacted by the overall weakness in the financial sector. Management believes that the unrealized losses represent temporary impairment of the the securities as the Company has the intent and ability to hold these investments until maturity or market price recovery.

| | December 31, 2008 | | | | | |
|-----------------------------------|---------------------|------------|-------------------|------------|-------------|------------|
| | Less than 12 Months | | 12 Months or More | | Fair | Total |
| | Fair | Unrealized | Fair | Unrealized | | |
| Value | Losses | Value | Losses | Value | Losses | |
| U.S. Government agencies | \$ 988 | \$ (12) |)\$ — | \$ — | \$ 988 | \$ (12) |
| States and political subdivisions | 13,653 | (337) |) — | — | 13,653 | (337) |
| Corporate obligations | 3,886 | (180) |) 1,739 | (260) | 5,625 | (440) |
| Mortgage-backed securities | 13,610 | (220) |) — | — | 13,610 | (220) |
| Equity securities | 20 | (3) |) 69 | (96) | 89 | (99) |
| | \$ 32,157 | \$ (752) |)\$ 1,808 | \$ (356) |) \$ 33,965 | \$ (1,108) |

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The amortized cost and fair value of debt securities as of June 30, 2009 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to prepay obligations with our without call or prepayment penalties.

| | Available for Sale | | Held to Maturity | |
|--|---------------------------|-------------------|-------------------------|-------------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (In Thousands) | | | |
| Due in one year or less | \$ 2,431 | \$ 2,441 | \$ — | \$ — |
| Due after one year through five years | 25,310 | 25,661 | — | — |
| Due after five years through ten years | 18,241 | 18,335 | 708 | 721 |
| Due after ten years | 14,383 | 13,970 | — | — |
| | 60,365 | 60,407 | 708 | 721 |
| Mortgage-backed securities | 59,743 | 61,371 | — | — |
| | \$ 120,108 | \$ 121,778 | \$ 708 | \$ 721 |

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

| | Three months | | Six Months | |
|-----------------------|----------------------|-------------|----------------------|-------------|
| | Ended June 30 | | Ended June 30 | |
| | 2009 | 2008 | 2009 | 2008 |
| Gross realized gains | \$ 172 | \$ 44 | \$ 436 | \$ 44 |
| Gross realized losses | - | 35 | 103 | 35 |
| Net realized gains | \$ 172 | \$ 9 | \$ 333 | \$ 9 |

8. Fair Value Measurements

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

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

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

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

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

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2009 and December 31, 2008 are as follows:

| Description | Fair Value Measurement Reporting Date Using | | | |
|-------------------------------|---|--|---|--|
| | Total (In thousands) | (Level 1) Quoted Prices in Active Markets For Identical Assets | (Level 2) Significant Other Observable Inputs | (Level 3) Significant Unobservable Inputs |
| June 30, 2009 | | | | |
| Securities available for sale | \$ 122,601 | \$ 823 | \$ 121,778 | \$ — |
| December 31, 2008 | | | | |
| Securities available for sale | \$ 130,120 | \$ 1,155 | \$ 128,965 | \$ — |

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2009 and December 31, 2008 are as follows:

| (In Thousands) | Fair Value Measurement Reporting Date Using | | | |
|------------------------------|---|--|---|--|
| | Total | (Level 1) Quoted Prices in Active Markets For Identical Assets | (Level 2) Significant Other Observable Inputs | (Level 3) Significant Unobservable Inputs |
| June 30, 2009 | | | | |
| Impaired Loans | \$ 2,602 | \$ - | \$ - | \$ 2,602 |
| Foreclosed real estate owned | 798 | - | - | 798 |
| | \$ 3,400 | \$ - | \$ - | \$ 3,400 |
| December 31, 2008 | | | | |
| Impaired Loans | \$ 2,976 | \$ - | \$ - | \$ 2,976 |

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at June 30, 2009 and December 31, 2008.

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.

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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):

Impaired loans are those that are accounted for under FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan ("SFAS 114"), in which the Bank has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the property or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value investment in impaired loans requiring an allowance for loan losses was \$1,235,000 net of a valuation allowance of \$50,000 and \$1,367,000 not requiring an allowance for loan losses as of June 30, 2009. The fair value investment in impaired loans not requiring an allowance for loan losses was \$2,976,000, net of a charge-off against the allowance for loan losses of \$380,000 at December 31, 2008.

Foreclosed real estate owned:

Real estate properties acquired through, or in lieu of loan foreclosure are to be sold and are carried at fair value less cost to sell. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. These assets are included in Level 3 fair value based upon the lowest level of input that is significant to the fair value measurement. For the six months ended June 30, 2009, a property consisting of a residential one family residence was acquired through foreclosure and is carried at its net realizable value of \$108,000, based on a current appraisal and a residential building lot is carried at its net realizable value of \$30,000 based on an appraisal. At June 30, 2009 the Company was also carrying a property it acquired in the previous year with a net realizable value of \$660,000 based on an appraisal at the time the property was acquired.

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

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

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Management evaluates the restricted stock for impairment in accordance with Statement of Position (SOP) 01-6, Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. Management believes no impairment charge is necessary related to FHLB stock as of June 30, 2009.

Accrued interest receivable and payable (carried at cost):

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

Deposit liabilities (carried at cost):

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

Short-term borrowings (carried at cost):

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

Other borrowings (carried at cost):

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

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

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

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The estimated fair values of the Bank's financial instruments were as follows at June 30, 2009 and December 31, 2008.

| | June 30, 2009 | | December 31, 2008 | |
|--|--------------------|---------------|--------------------|---------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| (In Thousands) | | | | |
| Financial assets: | | | | |
| Cash and due from banks, interest-bearing | | | | |
| deposits with banks and federal funds sold | \$ 7,554 | \$ 7,554 | \$ 6,480 | \$ 6,480 |
| Securities | 123,309 | 123,322 | 130,827 | 130,840 |
| Loans receivable, net | 356,019 | 374,050 | 345,171 | 363,219 |
| Investment in FHLB stock | 3,538 | 3,538 | 3,538 | 3,538 |
| Accrued interest receivable | 2,117 | 2,117 | 2,179 | 2,179 |
| Financial liabilities: | | | | |
| Deposits | 374,153 | 375,657 | 359,635 | 361,223 |
| Short-term borrowings | 24,596 | 24,596 | 38,126 | 38,126 |
| Other borrowings | 43,000 | 45,479 | 43,000 | 46,281 |
| Accrued interest payable | 2,210 | 2,210 | 2,247 | 2,247 |
| Off-balance sheet financial instruments: | | | | |
| Commitments to extend credit and outstanding letters of credit | — | — | — | — |

9. New Accounting Pronouncements

In April 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (FSP FAS 157-4). FASB Statement 157, Fair Value Measurements, defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FSP FAS 157-4 provides additional guidance on determining when the volume and level of activity for the asset or liability has significantly decreased. The FSP also includes guidance on identifying circumstances when a transaction may not be considered orderly.

FSP FAS 157-4 provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with Statement 157.

This FSP clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. The FSP provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

This FSP is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. An entity early adopting FSP FAS 157-4 must also early adopt FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments. The adoption of this pronouncement did not have a material impact on the Company's Consolidated Financial Statements.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (FSP FAS 115-2 and FAS 124-2). FSP FAS 115-2 and FAS 124-2 clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are done before assessing whether the entity will recover the cost basis of the investment. Previously, this assessment required management to assert it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in fair value to avoid recognizing an other-than-temporary impairment. This change does not affect the need to forecast recovery of the value of the security through either cash flows or market price.

In instances when a determination is made that an other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, FSP FAS 115-2 and FAS 124-2 changes the presentation and amount of the other-than-temporary impairment recognized in the income statement. The other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

This FSP is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. An entity early adopting FSP FAS 115-2 and FAS 124-2 must also early adopt FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly. The adoption of this pronouncement did not have a material impact on the Company's Financial Statements.

In June 2009, the FASB issued SFAS No. 166, Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140. This statement prescribes the information that a reporting entity must provide in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a transferor's continuing involvement in transferred financial assets. Specifically, among other aspects, SFAS 166 amends Statement of Financial Standard No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, or SFAS 140, by removing the concept of a qualifying special-purpose entity from SFAS 140 and removes the exception from applying FIN 46(R) to variable interest entities that are qualifying special-purpose entities. It also modifies the financial-components approach used in SFAS 140. SFAS 166 is effective for fiscal years beginning after November 15, 2009. We have not determined the effect that the adoption of SFAS 166 will have on our financial position or results of operations.

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In June 2009, the FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R). This statement amends FASB Interpretation No. 46, Consolidation of Variable Interest Entities (revised December 2003) — an interpretation of ARB No. 51, or FIN 46(R), to require an enterprise to determine whether its variable interest or interests give it a controlling financial interest in a variable interest entity. The primary beneficiary of a variable interest entity is the enterprise that has both (1) the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (2) the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. SFAS 167 also amends FIN 46(R) to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. SFAS 167 is effective for fiscal years beginning after November 15, 2009. We have not determined the effect that the adoption of SFAS 167 will have on our financial position or results of operations.

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162. SFAS 168 replaces SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles, to establish the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in preparation of financial statements in conformity with generally accepted accounting principles in the United States. SFAS 168 is effective for interim and annual periods ending after September 15, 2009. We do not expect the adoption of this standard to have an impact on our financial position or results of operations.

10. Branch Closure

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

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

Forward-Looking Statements

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

Critical Accounting Policies

Note 2 to the Company's consolidated financial statements for the year ended December 31, 2008 (incorporated by reference in Item 8 of the Form 10-K) lists significant accounting policies used in the development and presentation of its financial statements. This discussion and analysis, the significant accounting policies, and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for an understanding and evaluation of the Company and its results of operations.

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

The Company adopted SFAS No. 123(R), "Share-Based Payment" as of January 1, 2006, using the modified prospective transition method. 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.

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

Management evaluates the restricted stock for impairment in accordance with Statement of Position (SOP) 01-6, Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary decline in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. Management believes no impairment charge is necessary related to the restricted stock as of June 30, 2009 and December 31, 2008.

In estimating other-than-temporary impairment losses on securities, the Company considers 1) the length of time and extent to which the fair value has been less than cost 2) the financial condition of the issuer and 3) the intent and ability of the Company to hold the security to allow for a recovery to fair value. The Company believes that the unrealized losses in certain specific securities at June 30, 2009 and December 31, 2008 represent temporary impairment of the securities, related to changes in interest rates.

Changes in Financial Condition**General**

Total assets as of June 30, 2009 were \$508.5 million compared to \$504.3 million as of December 31, 2008, an increase of \$4.2 million. The increase reflects a \$11.2 million increase in loans funded by a \$14.5 million increase in deposits.

Securities

The fair value of securities available for sale as of June 30, 2009 was \$122.6 million compared to \$130.1 million as of December 31, 2008. The Company purchased \$28.4 million of securities using the proceeds from \$25.3 million of securities called, maturities and principal reductions and from short-term borrowings.

Securities with a carrying value of \$49,720,000 and \$51,444,000 at June 30, 2009 and at December 31, 2008 respectively, were pledged to secure public deposits, U.S. Treasury demand notes, securities sold under agreements to repurchase and for other purposes as required or permitted by law.

Loans Receivable

Loans receivable totaled \$360.6 million compared to \$349.7 million as of December 31, 2008. Commercial real estate loans increased \$8.5 million during the period, reflecting new activity principally centered in the Monroe County, Pennsylvania market area. Commercial loans increased \$4.4 million principally due to tax-exempt financing of a municipal sewer authority.

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

| Types of loans | June 30, 2009 | | December 31, 2008 | |
|--|----------------------|---------|--------------------------|---------|
| (dollars in thousands) | | | | |
| Real Estate-Residential | \$ 133,237 | 36.9 % | \$ 133,417 | 38.1 % |
| Commercial | 167,947 | 46.5 | 159,476 | 45.6 |
| Construction | 14,291 | 4.0 | 14,856 | 4.2 |
| Commercial, financial and agricultural | 30,242 | 8.4 | 25,886 | 7.4 |
| Consumer loans to individuals | 15,258 | 4.2 | 16,087 | 4.6 |
| Total loans | 360,975 | 100.0 % | 349,722 | 100.0 % |
| Deferred fees (net) | (382) | | (318) | |
| | 360,593 | | 349,404 | |
| Allowance for loan losses | (4,574) | | (4,233) | |

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| | | |
|----------------------|------------|------------|
| Net loans receivable | \$ 356,019 | \$ 345,171 |
|----------------------|------------|------------|

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Allowance for Loan Losses and Non-performing Assets

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

| | Three Months | | Six Months | |
|---|----------------------|-------------|----------------------|-------------|
| | Ended June 30 | | Ended June 30 | |
| (dollars in thousands) | 2009 | 2008 | 2009 | 2008 |
| Balance, beginning | \$ 4,413 | \$ 4,137 | \$ 4,233 | \$ 4,081 |
| Provision for loan losses | 220 | 110 | 445 | 185 |
| Charge-offs | (80) | (36) | (142) | (71) |
| Recoveries | 21 | 26 | 38 | 42 |
| Net charge-offs | (59) | (10) | (104) | (29) |
| Balance, ending | \$ 4,574 | \$ 4,237 | \$ 4,574 | \$ 4,237 |
| Allowance to total loans | 1.27 % | 1.27 % | 1.27 % | 1.27 % |
| Net charge-offs to average loans (annualized) | .07 % | .01 % | .06 % | .02 % |

The allowance for loan losses totaled \$4,574,000 as of June 30, 2009 and represented 1.27% of total loans compared to \$4,233,000 at the prior year end, and \$4,237,000 as of June 30, 2008. The Company had net charge-offs for the six months of \$104,000 compared to \$29,000 in the comparable period in 2008. The Company's loan review process assesses the adequacy of the allowance for loan losses on a quarterly basis. The process includes an analysis of the risks inherent in the loan portfolio. It includes an analysis of impaired loans and a historical review of credit losses by loan type. Other factors considered include: concentration of credit in specific industries; economic and industry conditions; trends in delinquencies and loan classifications, large dollar exposures and loan growth. Management considers the allowance adequate at June 30, 2009 based on the Company's criteria. However, there can be no assurance that the allowance for loan losses will be adequate to cover significant losses, if any, that might be incurred in the future.

As of June 30, 2009, non-performing loans totaled \$1,800,000, which is .50% of total loans compared to \$2,087,000, or 0.60% of total loans at December 31, 2008. The decrease was principally due to a pay down as a result of a third party refinance on a portion of a land development loan. The recorded investment for impaired loans requiring a specific allowance for loan losses was \$1,235,000 of which \$50,000 was specifically reserved due to a shortfall in the collateral. Foreclosed real estate totals \$798,000 as of June 30, 2009 compared to \$660,000 as of year-end. The balance principally consists of undeveloped residential building lots in Monroe County, PA.

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

| (dollars in thousands) | June 30, 2009 | December 31, 2008 | |
|--|---------------|-------------------|------|
| Loans accounted for on a non-accrual basis: | | | |
| Commercial and all other | \$ — | \$ — | |
| Real Estate | 1,781 | 2,087 | |
| Consumer | — | — | |
| Total | 1,781 | 2,087 | |
| Accruing loans which are contractually past due 90 days or more | 19 | — | |
| Total non-performing loans | 1,800 | 2,087 | |
| Foreclosed real estate | 798 | 660 | |
| Total non-performing assets | \$ 2,598 | \$ 2,747 | |
| Allowance for loan losses | \$ 4,574 | \$ 4,233 | |
| Coverage of non-performing loans | 2.54 | x | 2.03 |
| Non-performing loans to total loans | .50 | % | .60 |
| Non-performing assets to total assets | .51 | % | .54 |

Deposits

Total deposits as of June 30, 2009 were \$374.2 million increasing from \$359.6 million as of December 31, 2008, an increase of \$14.6 million. The growth in deposits is net of the sale of \$3.6 million in deposits related to a branch closure as described in Note 9. Non-interest bearing demand deposits increased \$3.6 million to \$60.4 million reflecting seasonal growth in certain commercial and municipal accounts. Time deposits less than \$100,000 totaled \$123.2 million as of June 30, 2009, an increase of \$6.0 million. The increase was principally due to the results of a 13 month CD product. The growth in deposits was used to fund loan growth and pay down short-term borrowings.

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

| (dollars in thousands) | June 30, 2009 | December 31, 2008 |
|-------------------------------|---------------|-------------------|
| Non-interest bearing demand | \$ 60,444 | \$ 56,839 |
| Interest bearing demand | 36,999 | 35,322 |
| Money Market Deposit Accounts | 62,699 | 60,623 |
| Savings | 44,565 | 44,577 |
| Time deposits <\$100,000 | 123,212 | 117,179 |
| Time deposits >\$100,000 | 46,234 | 45,095 |
| Total | \$ 374,153 | \$ 359,635 |

Borrowings

Short-term borrowings as of June 30, 2009 totaled \$24.6 million compared to \$38.1 million as of December 31, 2008. Securities sold under agreements to repurchase declined \$4.8 million principally due to the seasonality of school district cash management accounts. Short-term borrowings consist of the following:

(dollars in thousands)

| | June 30, 2009 | December 31, 2008 |
|--|----------------------|--------------------------|
| Securities sold under agreements to repurchase | \$ 18,599 | \$ 23,404 |
| Federal Funds Purchased | — | 3,600 |
| Federal Reserve Discount Window | 5,800 | — |
| Short-term FHLB advances | — | 11,000 |
| U.S. Treasury demand notes | 197 | 122 |
| | \$ 24,596 | \$ 38,126 |

Other borrowings consisted of the following:

| (dollars in thousands) | June 30, 2009 | December 31, 2008 |
|---|----------------------|--------------------------|
| Notes with the FHLB: | | |
| Fixed rate note due September 2010 at 3.53% | \$ 5,000 | \$ 5,000 |
| Convertible note due January 2011 at 5.24% | 3,000 | 3,000 |
| Convertible note due August 2011 at 2.69% | 10,000 | 10,000 |
| Fixed rate note due September 2011 at 4.06% | 5,000 | 5,000 |
| Convertible note due October 2012 at 4.37% | 5,000 | 5,000 |
| Convertible note due May 2013 at 3.015% | 5,000 | 5,000 |
| Convertible note due January 2017 at 4.71% | 10,000 | 10,000 |
| | \$ 43,000 | \$ 43,000 |

The convertible notes contain an option that allows the FHLB, at quarterly intervals to change the note to an adjustable-rate advance at three-month LIBOR plus 11 to 17 basis points. If the notes are converted, the option allows the Bank to put the funds back to the FHLB at no charge.

Off- Balance Sheet Arrangements

The Bank is 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 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.

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

| | June 30, 2009 | December 31, 2008 |
|--|------------------|----------------------|
| | (in thousands) | |
| Commitments to grant loans | \$ 15,991 | \$ 19,254 |
| Unfunded commitments under lines of credit | 41,482 | 36,980 |
| Standby letters of credit | 2,079 | 1,897 |
| | \$ 59,522 | \$ 58,131 |

Stockholders' Equity and Capital Ratios

At June 30, 2009, total stockholders' equity totaled \$61.1 million, compared to \$58.7 million as of December 31, 2008. The net change in stockholders' equity included \$3,486,000 in net income, that was partially offset by \$1,482,000 of dividends declared. In addition, accumulated other comprehensive income increased \$128,000 due to an increase in fair value of securities in the available for sale portfolio, net of tax. This increase in fair value is the result of a change in interest rates, which may impact the value of the securities. Because of interest rate volatility, the Company's accumulated other comprehensive income could materially fluctuate for each interim and year-end period.

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

| | June 30, 2009 | | December 31, 2008 | |
|---|---------------|---|-------------------|---|
| Tier 1 Capital (To average assets) | 11.89 | % | 11.45 | % |
| Tier 1 Capital (To risk-weighted assets) | 16.41 | % | 16.22 | % |
| Tier 1 Capital (To risk-weighted assets) | 17.72 | % | 17.50 | % |

The minimum capital requirements imposed by the FDIC on the Bank for leverage, Tier 1 and Total Capital are 4%, 4% and 8%, respectively. The Company has similar capital requirements imposed by the Board of Governors of the Federal Reserve System (FRB). The Bank is also subject to more stringent Pennsylvania Department of Banking (PDB) guidelines. The Bank's capital ratios do not differ significantly from the Company's ratios. Although not adopted in regulation form, the PDB utilizes capital standards requiring a minimum of 6.5% leverage capital and 10% total capital. The Company and the Bank were in compliance with the FRB, FDIC and PDB capital requirements as of June 30, 2009 and December 31, 2008.

Liquidity

As of June 30, 2009, the Company had cash and cash equivalents of \$7.6 million in the form of cash and due from banks, and short-term deposits with other institutions. In addition, the Company had total securities available for sale of \$122.6 million which could be used for liquidity needs. This totals \$130.2 million and represents 25.6% of total assets compared to \$136.6 million and 27.1% of total assets as of December 31, 2008. The Company also monitors other liquidity measures, all of which were within the Company's policy guidelines as of June 30, 2009 and December 31, 2008. Based upon these measures, the Company believes its liquidity is adequate.

Capital Resources

The Company has a line of credit commitment available from the Federal Home Loan Bank (FHLB) of Pittsburgh for borrowings of up to \$20,000,000 which expires in December 2011. There were no borrowings under this line at June 30, 2009 and December 31, 2008.

The Company has a line of credit commitment from Atlantic Central Bankers Bank for \$7,000,000 which expires in May 2010. There were no borrowings under these lines as of June 30, 2009 and December 31, 2008. The Company has a line of credit commitment available which has no stated expiration date from PNC for \$12,000,000. Borrowings under this line were \$-0- as of June 30, 2009 and \$3,600,000 as of December 31, 2008. The Bank has access to the Federal Reserve Discount Window with total availability of \$8,000,000 based upon qualifying collateral held by the Federal Reserve Bank. There was \$5,800,000 outstanding as of June 30, 2009 and -0- as of December 31, 2008.

The Bank's maximum borrowing capacity with the Federal Home Loan Bank was approximately \$235,056,000 of which \$43,000,000 was outstanding at June 30, 2009 and \$54,000,000 at December 31, 2008. 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 26 and page 30. Although the Company believes that these non-GAAP financial measures enhance investors' understanding of our business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP measures.

Results of Operations

NORWOOD FINANCIAL CORP.

Consolidated Average Balance Sheets with Resultant Interest and Rates

(Tax-Equivalent Basis, dollars in thousands)

| | Three Months Ended June 30, | | | | | | |
|--|-----------------------------|-------|---------|------------|-------|---------|---|
| | 2009 | | | 2008 | | | |
| | Average | | Average | Average | | Average | |
| Balance | Interest | Rate | Balance | Interest | Rate | | |
| (2) | (1) | (3) | (2) | (1) | (3) | | |
| Assets | | | | | | | |
| Interest-earning assets: | | | | | | | |
| Federal funds sold | \$ 1,082 | \$ 1 | 0.37 | % \$ 1,146 | \$ 6 | 2.09 | % |
| Interest bearing deposits with banks | 512 | — | — | 97 | 1 | 4.12 | |
| Securities held-to-maturity(1) | 707 | 16 | 9.05 | 706 | 15 | 8.50 | |
| Securities available for sale: | | | | | | | |
| Taxable | 99,290 | 1,032 | 4.16 | 110,352 | 1,318 | 4.78 | |
| Tax-exempt | 28,589 | 398 | 5.57 | 22,570 | 318 | 5.64 | |
| Total securities available for sale (1) | 127,879 | 1,430 | 4.47 | 132,922 | 1,636 | 4.92 | |
| Loans receivable (4) (5) | 354,284 | 5,466 | 6.17 | 331,509 | 5,458 | 6.59 | |
| Total interest earning assets | 484,464 | 6,913 | 5.71 | 466,380 | 7,116 | 6.10 | |
| Non-interest earning assets: | | | | | | | |
| Cash and due from banks | 6,932 | | | 8,051 | | | |
| Allowance for loan losses | (4,483 |) | | (4,184 |) | | |
| Other assets | 17,263 | | | 17,176 | | | |
| Total non-interest earning assets | 19,712 | | | 21,043 | | | |
| Total Assets | \$ 504,176 | | | \$ 487,423 | | | |
| Liabilities and Stockholders' Equity | | | | | | | |
| Interest bearing liabilities: | | | | | | | |
| Interest bearing demand and money market | \$ 100,663 | 183 | 0.73 | \$ 105,965 | 371 | 1.40 | |
| Savings | 45,053 | 42 | 0.37 | 43,715 | 52 | 0.48 | |
| Time | 167,474 | 1,195 | 2.85 | 161,209 | 1,540 | 3.82 | |
| Total interest bearing deposits | 313,190 | 1,420 | 1.81 | 310,889 | 1,963 | 2.53 | |
| Short-term borrowings | 23,558 | 73 | 1.24 | 33,764 | 178 | 2.11 | |
| Other borrowings | 43,000 | 415 | 3.86 | 20,912 | 238 | 4.55 | |
| Total interest bearing liabilities | 379,748 | 1,908 | 2.01 | 365,565 | 2,379 | 2.60 | |
| Non-interest bearing liabilities: | | | | | | | |
| Demand deposits | 58,710 | | | 60,431 | | | |
| Other liabilities | 4,631 | | | 4,812 | | | |
| Total non-interest bearing liabilities | 63,341 | | | 65,243 | | | |

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| | | |
|--|------------|------------|
| Stockholders' equity | 61,087 | 56,615 |
| Total Liabilities and Stockholders' Equity | \$ 504,176 | \$ 487,423 |

| | | | | | | |
|--|----------|------|---|----------|------|---|
| Net interest income (tax equivalent basis) | 5,005 | 3.70 | % | 4,737 | 3.50 | % |
| Tax-equivalent basis adjustment | (170) | | | (163) | | |
| Net interest income | \$ 4,835 | | | \$ 4,574 | | |
| Net interest margin (tax equivalent basis) | | 4.13 | % | | 4.06 | % |

- (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
- (5) Loan balances include non-accrual loans and are net of unearned income.
- (6) Loan yields include the effect of amortization of deferred fees, net of costs.

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

Increase/(Decrease)

Three Months Ended June 30, 2009 Compared to

Three Months Ended June 30, 2008

Variance due to

| | Volume | Rate | Net |
|--|-------------------------------|-------------|------------|
| | (dollars in thousands) | | |
| Interest earning assets: | | | |
| Federal funds sold | \$ — | \$ (5 |) \$ (5) |
| Interest bearing deposits with banks | 6 | (7 |) (1) |
| Securities held to maturity | — | 1 | 1 |
| Securities available for sale: | | | |
| Taxable | (125) | (161 |) (286) |
| Tax-exempt securities | 106 | (26 |) 80 |
| Total securities | (19) | (187 |) (206) |
| Loans receivable | 1,438 | (1,430 |) 8 |
| Total interest earning assets | 1,424 | (1,627 |) (203) |
| Interest bearing liabilities: | | | |
| Interest-bearing demand and money market | | | |
| Savings | (18) | (170 |) (188) |
| Time | 10 | (20 |) (10) |
| Total interest bearing deposits | 369 | (714 |) (345) |
| Short-term borrowings | 361 | (904 |) (543) |
| Other borrowings | (44) | (61 |) (105) |
| Total interest bearing liabilities | 408 | (231 |) 177 |
| Total interest bearing liabilities | 725 | (1,196 |) (471) |
| Net interest income (tax-equivalent basis) | \$ 700 | \$ (432 |) \$ 268 |

Comparison of Operating Results for Three Months Ended June 30, 2009 and June 30, 2008**General**

For the three months ended June 30, 2009, net income totaled \$1,749,000, compared to \$1,721,000 earned in the similar period in 2008. Earnings per share for the current period were \$.64 for basic and \$.63 fully diluted compared to \$.63 per share basic and \$.62 per share on a fully diluted basis for the three months ended June 30, 2008. The resulting annualized return on average assets and annualized return on average equity for the three months ended June 30, 2009 were 1.39% and 11.49%, respectively, compared to 1.42% and 12.19%, respectively, for the similar period in 2008.

The following table sets forth changes in net income:

| (dollars in thousands) | Three Months Ended | |
|---|---------------------------------------|-------|
| | June 30, 2009 to June 30, 2008 | |
| Net income three months ended June 30, 2008 | \$ | 1,721 |
| Change due to: | | |
| Net interest income | | 261 |
| Provision for loan losses | | (110) |
| Gain on sales of loans, securities & deposits | | 276 |
| Other income | | (70) |
| Salaries and employee benefits | | (97) |
| FDIC insurance assessment | | (346) |
| All other expenses | | 95 |
| Income tax expense | | 19 |
| Net income three months ended June 30, 2009 | \$ | 1,749 |

Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the three months ended June 30, 2009 totaled \$5,005,000, an increase of \$268,000 or 5.7%, over the similar period in 2008. The fte net interest spread and net interest margin were 3.70% and 4.13%, respectively for the three months ended June 30, 2009 compared to 3.50% and 4.06% respectively, for the similar period in 2008.

Interest income (fte) totaled \$6,913,000 with a yield on average earning assets of 5.71% compared to \$7,116,000 and 6.10% for the 2008 period. The decrease in yield was due in part to lower prime interest rate which was 3.25% as of June 30, 2009 compared to 5.00% as of June 30, 2008. The Company has \$69 million of floating rate loans tied to prime rate. In addition, residential mortgage rates have declined causing a portion of the portfolio to refinance at lower rates. As a result, the fte yield on loans declined to 6.17% in the current period from 6.59% for the same period in the prior year. The yield on investment securities also declined 45 basis points reflecting the reinvestment of cash flow, maturities and calls at the current lower rates. Average earning assets totaled \$484.5 million for the three months ended June 30, 2009, an increase of \$18.1 million over the average for the similar period in 2008. This increase in average earning assets helped offset the decline in asset yields. In addition, the mix of earning assets improved, with loans receivable reflecting 73.1% of average earning assets compared to 71.1% for the similar period in 2008.

Interest expense for the three months ended June 30, 2009 totaled \$1,908,000 at an average cost of 2.01% compared to \$2,379,000 at an average cost of 2.60% for the similar period in 2008. As a result of the decrease in short-term interest rates, the Company reduced rates paid on its

money market accounts and cash management products, which are included in short-term borrowings. The cost of time deposits, which

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is the most significant component of funding, declined to 2.85% from 3.82% for the similar period in the prior year. As time deposits matured, they repriced at the current lower rates resulting in the decrease.

Other Income

Other income totaled \$1,168,000 for the three months ended June 30, 2009 compared to \$962,000 for the similar period in 2008. The increase was principally due to a \$172,000 gain on the sales of investment securities and \$121,000 in gains on the sales of mortgage loans compared to \$9,000 and \$8,000, respectively, in similar gains for the same period in 2008.

Other Expenses

Other expense for the three months ended June 30, 2009 totaled \$3,320,000, an increase of \$348,000 from \$2,972,000 for the similar period in 2008. FDIC insurance assessments increased \$346,000 which includes a special assessment of \$225,000. The FDIC has doubled the assessment rate for the majority of banks in the current year. The efficiency ratio, which is other expense as a percentage of net interest income (fte) plus other income was 53.8% for the three months ended June 30, 2009, compared to 52.2% for the similar period in 2008.

Income Tax Expense

Income tax expense totaled \$714,000 for an effective tax rate of 29.0% for the period ending June 30, 2009 compared to \$733,000 for an effective tax rate of 29.9% for the similar period in 2008. The decrease in the effective tax rate was principally due to a higher level of tax-exempt income related to purchases of municipal obligations in the available-for-sale investment portfolio.

Results of Operations

NORWOOD FINANCIAL CORP.

Consolidated Average Balance Sheets with Resultant Interest and Rates

(Tax-Equivalent Basis, dollars in thousands)

| | Six Months Ended June 30, | | | | | |
|--|---------------------------|----------|---------|------------|----------|---------|
| | 2009 | | | 2008 | | |
| | Average | | Average | Average | Interest | Average |
| Balance | Interest | Rate | Balance | Interest | Rate | |
| | (2) | (1) | (3) | (2) | (1) | (3) |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Federal funds sold | \$ 2,048 | \$ 3 | 0.29 | % \$ 1,774 | \$ 24 | 2.71 % |
| Interest bearing deposits with banks | 3,067 | 4 | 0.26 | 90 | 1 | 2.22 |
| Securities held-to-maturity(1) | 707 | 31 | 8.77 | 706 | 30 | 8.50 |
| Securities available for sale: | | | | | | |
| Taxable | 100,847 | 2,174 | 4.31 | 107,920 | 2,595 | 4.81 |
| Tax-exempt | 27,039 | 770 | 5.70 | 22,329 | 624 | 5.59 |
| Total securities available for sale (1) | 127,886 | 2,944 | 4.60 | 130,249 | 3,219 | 4.94 |
| Loans receivable (4) (5) | 352,807 | 10,782 | 6.11 | 329,927 | 11,147 | 6.76 |
| Total interest earning assets | 486,515 | 13,764 | 5.66 | 462,746 | 14,421 | 6.23 |
| Non-interest earning assets: | | | | | | |
| Cash and due from banks | 6,804 | | | 7,576 | | |
| Allowance for loan losses | (4,400 |) | | (4,152 |) | |
| Other assets | 17,458 | | | 17,020 | | |
| Total non-interest earning assets | 19,862 | | | 20,444 | | |
| Total Assets | \$ 506,377 | | | \$ 483,190 | | |
| Liabilities and Stockholders' Equity | | | | | | |
| Interest bearing liabilities: | | | | | | |
| Interest bearing demand and money market | \$ 99,281 | 383 | 0.77 | \$ 100,738 | 803 | 1.59 |
| Savings | 44,880 | 83 | 0.37 | 43,135 | 101 | 0.47 |
| Time | 167,467 | 2,455 | 2.93 | 168,230 | 3,430 | 4.08 |
| Total interest bearing deposits | 311,628 | 2,921 | 1.87 | 312,103 | 4,334 | 2.78 |
| Short-term borrowings | 29,396 | 169 | 1.15 | 29,770 | 365 | 2.45 |
| Other borrowings | 43,000 | 827 | 3.85 | 21,956 | 505 | 4.60 |
| Total interest bearing liabilities | 384,024 | 3,917 | 2.04 | 363,829 | 5,204 | 2.86 |
| Non-interest bearing liabilities: | | | | | | |
| Demand deposits | 57,507 | | | 58,055 | | |
| Other liabilities | 4,459 | | | 4,862 | | |
| Total non-interest bearing liabilities | 61,966 | | | 62,917 | | |
| Stockholders' equity | 60,387 | | | 56,444 | | |
| Total Liabilities and Stockholders' Equity | \$ 506,377 | | | \$ 483,190 | | |
| Net interest income (tax equivalent basis) | | 9,847 | 3.62 % | | 9,217 | 3.37 % |
| Tax-equivalent basis adjustment | | (331 |) | | (319 |) |
| Net interest income | | \$ 9,516 | | | \$ 8,898 | |

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| | | | | |
|--|------|---|------|---|
| Net interest margin (tax equivalent basis) | 4.05 | % | 3.98 | % |
|--|------|---|------|---|

- (1) Interest and yields are presented on a tax-equivalent basis using a marginal tax rate of 34%.
- (2) Average balances have been calculated based on daily balances.
- (3) Annualized
- (4) Loan balances include non-accrual loans and are net of unearned income.
- (5) Loan yields include the effect of amortization of deferred fees, net of costs.

Rate/Volume Analysis

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

Increase/(Decrease)Six Months Ended June 30, 2009 Compared toSix Months Ended June 30, 2008Variance due to

| | Volume | | Rate | | Net |
|--|-------------------------------|---|-------------|---|------------|
| | (dollars in thousands) | | | | |
| Interest earning assets: | | | | | |
| Federal funds sold | \$ 10 | | \$ (31 |) | \$ (21) |
| Interest bearing deposits with banks | 6 | | (3 |) | 3 |
| Securities held to maturity | — | | 1 | | 1 |
| Securities available for sale: | | | | | |
| Taxable | (163 |) | (258 |) | (421) |
| Tax-exempt securities | 134 | | 12 | | 146 |
| Total securities | (29 |) | (246 |) | (275) |
| Loans receivable | 1,638 | | (2,003 |) | (365) |
| Total interest earning assets | 1,624 | | (2,281 |) | (657) |
| Interest bearing liabilities: | | | | | |
| Interest-bearing demand and money market | | | | | |
| Savings | 11 |) | (29 |) | (18) |
| Time | (15 |) | (960 |) | (975) |
| Total interest bearing deposits | (16 |) | (1,397 |) | (1,413) |
| Short-term borrowings | (5 |) | (191 |) | (196) |
| Other borrowings | 558 | | (236 |) | 322 |
| Total interest bearing liabilities | 538 | | (1,825 |) | (1,288) |
| Net interest income (tax-equivalent basis) | \$ 1,087 | | \$ (457 |) | \$ 630 |

Comparison of Operating Results for Six Months Ended June 30, 2009 and June 30, 2008

General

For the six months ended June 30, 2009, net-income totaled \$3,486,000 compared to \$3,500,000 earned in the similar period of 2008. Earnings per share for the current period were \$1.27 per share basic and a \$1.26 per share fully diluted compared to \$1.28 per share basic and \$1.26 per share diluted for the six months ended June 30, 2008. The resulting annualized return on average assets and annualized return on average equity for the six months ended June 30, 2009 was 1.39% and 11.64% and 1.45% and 12.44%, respectively, for the similar period in 2008.

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The following table sets forth changes in net income:

| | Six Months Ended June 30, 2009 to June 30, 2008 |
|---|---|
| (dollars in thousands) | |
| Net income six months ended June 30, 2008 | \$ 3,500 |
| Change due to: | |
| Net interest income | 618 |
| Provision for loan losses | (250) |
| Gain on sales of loans, securities & deposits | 332 |
| Other income | (107) |
| Salaries and employee benefits | (165) |
| FDIC insurance assessment | (471) |
| All other expenses | (26) |
| Income tax expense | 65 |
| Net income six months ended June 30, 2009 | \$ 3,486 |

Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the six months ended June 30, 2009 totaled \$9,847,000, an increase of \$630,000, or 6.8% over the similar period in 2008. The fte net interest spread and net interest margin were 3.62% and 4.05% respectively, increasing from 3.37% and 3.98% respectively for the similar period in 2008.

Interest income (fte) totaled \$13,764,000 with a yield on average earning assets of 5.66% compared to \$14,421,000 and 6.23% for the similar period in 2008. The decrease in yield was due in part to the lower prime interest rate which was 3.25% as of June 30, 2009 declining from 5.00% as of June 30, 2008. The Company has \$69 million of floating rate loans tied to prime rate. In addition, residential mortgage rates have declined causing a portion of the portfolio to refinance at lower rates. As a result, the fte yield on average loans in the current period was 6.11% down from 6.76% in the 2008 period. The yield on investment securities also declined 34 basis points reflecting the reinvestment of cash flow, maturities and calls at the current lower rate. Average earning assets totaled \$486.5 million for the six months ended June 30, 2009 an increase of \$23.8 million over the similar period in 2008. The growth in average earning assets helped offset the decline in asset yields. The mix in earning assets also improved as higher yielding loans receivable represented 72.5% of average earning assets compared to 71.3% for the similar period in 2008.

Interest expense for the six months ended June 30, 2009 totaled \$3,917,000 with an average cost of 2.04% compared to \$5,204,000 and 2.86% for the 2008 period, with the decrease in short-term interest rates the Company reduced rates paid on its money-market accounts by 82 basis points and short-term borrowings by 130 basis points. The cost of time deposits which is the largest component of interest expense was 2.93% for the 2009 period decreasing from 4.08% in 2008. This reflects time deposits maturing and repricing at the current lower rates.

Other Income

Other income totaled \$2,449,000 for the six months ended June 30, 2009 compared to \$2,224,000 for the similar period in 2008. The current period includes \$254,000 in gains on the sale of \$15.7 million of residential mortgage loans compared to \$396,000 in similar gains on the sales of \$14.4 million of mortgage loans in the 2008 period. Gains on the sale investment securities totaled \$333,000 on sales of \$11.1 million for the 2009 period compared to \$9,000 in gains in the similar 2008 period. The proceeds from investment securities sales were used to fund loan growth. The Company also had a gain of \$150,000 on the sale of deposits related to a branch closure in 2009 period.

Other Expenses

Other expense totaled \$6,595,000 for the six months ended June 30, 2009 an increase of \$662,000 compared to \$5,933,000 for the similar period in 2008. Higher FDIC insurance assessments, including a \$225,000 special assessment accounted for \$471,000 of the increase. The FDIC has doubled the assessment rate for the majority of banks in the current year. Salaries and employee benefits increased \$165,000 or 5.4% reflecting staff increases and higher health insurance expense. The efficiency ratio for the 2009 period was 53.6% compared to 51.9% in the 2008 period.

Income Tax Expense

Income tax expense totaled \$1,439,000 for an effective tax rate of 29.2% in the 2009 period compared to \$1,504,000 and 30.1% in 2008. The decrease in the effective tax rate was principally due to a higher level of tax-exempt income related to purchases of municipal obligations held in the available-for-sale portfolio.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market Risk

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

Net interest income, which is the primary source of the Company's earnings, is impacted by changes in interest rates and the relationship of different interest rates. To manage the impact of the rate changes, the balance sheet must be structured so that repricing opportunities exist for both assets and liabilities at approximately the same time intervals. The Company uses net interest simulation to assist in interest rate risk management. The process includes simulating various interest rate environments and their impact on net interest income. As of June 30, 2009, the level of net interest income at risk in a 200 basis points change in interest rates was within the Company's policy limits. The Company's policy allows for a decline of no more than 8% of net interest income.

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

As of June 30, 2009, the Bank had a positive 90 day interest sensitivity gap of \$35.1 million or 6.9% of total assets, increasing from \$20.4 million, 4.0% of total assets as of December 31, 2008. The change was principally due to a decrease in time deposits maturing in 90 days. A positive gap means that rate-sensitive assets are greater than rate-sensitive liabilities at the time interval. This would indicate that in



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a falling rate environment, the yield on interest-earning assets would decrease 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 or shorter term time deposits, loan pricing to encourage variable or fixed rate products and evaluation of loan sales of long-term fixed rate mortgages.

June 30, 2009

Rate Sensitivity Table

(dollars in thousands)

| | 3 Months | 3-12 Months | 1 to 3 Years | 3 Years | Total |
|---------------------------------|-----------------|--------------------|---------------------|----------------|--------------|
| Federal funds sold and interest | | | | | |
| bearing deposits | \$ 6 | \$ — | \$ — | \$ — | \$ 6 |
| Securities | 16,027 | 33,055 | 27,864 | 46,363 | 123,309 |
| Loans Receivable | 81,723 | 57,188 | 89,788 | 131,894 | 360,593 |
| Total RSA | 97,756 | 90,243 | 117,652 | 178,257 | 483,908 |
| Non-maturity interest-bearing | | | | | |
| deposits | 22,734 | 25,452 | 66,850 | 29,227 | 144,263 |
| Time deposits | 29,721 | 88,455 | 32,346 | 18,924 | 169,446 |
| Other | 10,214 | 6,733 | 30,649 | 20,000 | 67,596 |
| Total RSL | 62,669 | 120,640 | 129,845 | 68,151 | 381,305 |
| Interest Sensitivity Gap | \$ 35,087 | (\$30,397 |) \$ (12,193 |) \$ 110,106 | \$ 102,603 |
| Cumulative gap | 35,087 | 4,690 | (7,503 |) 102,603 | |
| RSA/RSL-Cumulative | 156.0 | % 102.6 | % 97.6 | % 126.9 | % |
| December 31, 2008 | | | | | |
| Interest Sensitivity Gap | \$ 20,390 | \$ (10,272 |) \$ (16,051 |) \$ 102,259 | \$ 96,326 |
| Cumulative gap | 20,390 | 10,118 | (5,933 |) 96,326 | |
| RSA/RSL-Cumulative | 123.1 | % 105.5 | % 98.1 | % 125.1 | % |

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.

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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 I of the Company's Form 10-K for the year ended December 31, 2008.

Item 2. Unregistered Sales of Securities and Use of Proceeds

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of Shareholders of the Company was held on April 28, 2009. The following incumbent directors were nominated and duly elected to the Board of Directors for a three-year term expiring in 2012.

| | FOR | WITHHELD |
|-----------------------|------------|-----------------|
| William W. Davis, Jr. | 2,227,801 | 69,876 |
| John E. Marshall | 2,236,970 | 60,707 |
| Susan Gumble-Cottell | 2,281,446 | 16,231 |

There were no abstentions or broker non-votes.

Ratify the appointment of Beard Miller Company LLP as independent accountant of the Company for the fiscal year ending December 31, 2009.

| FOR | AGAINST | ASTAIN |
|------------|----------------|---------------|
| 2,282,078 | 3,499 | 12,100 |

There were no broker non-votes.

Item 5. Other Information

None

Item 6. Exhibits

- (a) 3(i) Articles of Incorporation of Norwood Financial Corp.*
- 3(ii) Bylaws of Norwood Financial Corp.**
- 4.0 Specimen Stock Certificate of Norwood Financial Corp.*
- 10.1 Amended Employment Agreement with William W. Davis, Jr.***
- 10.2 Amended Employment Agreement with Lewis J. Critelli ***
- 10.3 Form of Change-In-Control Severance Agreement with seven key employees of the Bank****
- 10.4 Wayne Bank Stock Option Plan*
- 10.5 Salary Continuation Agreement between the Bank and William W. Davis, Jr.****
- 10.6 Salary Continuation Agreement between the Bank and Lewis J. Critelli****
- 10.7 Salary Continuation Agreement between the Bank and Edward C. Kasper****
- 10.8 1999 Directors Stock Compensation Plan****
- 10.9 Salary Continuation Agreement between the Bank and Joseph A. Kneller****
- 10.10 Salary Continuation Agreement between the Bank and John H. Sanders****
- 10.11 2006 Stock Option Plan*****
- 10.12 First and Second Amendments to Salary Continuation Agreement with William W. Davis, Jr.*****
- 10.13 First and Second Amendments to Salary Continuation Agreement with Lewis J. Critelli*****
- 10.14 First and Second Amendments to Salary Continuation Agreement with Edward C. Kasper*****
- 10.15 First and Second Amendments to Salary Continuation Agreement with Joseph A. Kneller*****
- 10.16 First and Second Amendments to Salary Continuation Agreement with John H. Sanders*****
- 31.1 Rule 13a-14(a)/15d-14(a) Certification (Chief Executive Officer)
- 31.2 Rule 13a-14(a)/15d-14(a) Certification (Chief Financial Officer)
- 32.1 Section 1350 Certification (Chief Executive Officer)
- 32.2 Section 1350 Certification (Chief Financial Officer)

- * Incorporated herein by reference to the identically numbered exhibits of the Registrant's Form 10 Registration Statement initially filed with the Commission on April 29, 1996.

- ** Incorporated by reference to the identically numbered exhibit to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2007 filed with the Commission on March 14, 2008.

- *** Incorporated herein by reference to the identically numbered exhibits of the Registrant's Form 8-K filed with the Commission on March 6, 2006.

- **** Incorporated herein by reference to the identically numbered exhibits of the Registrant's Form 10-K filed with the Commission on March 23, 2000.

- ***** Incorporated herein by reference to the identically numbered exhibits of Registrant's Form 10-K filed with the Commission on March 22, 2004.

- ***** Incorporated herein by reference to the Registrant's Form 8-K filed with the Commission on April 25, 2006.

- ***** Incorporated herein by reference from the Exhibits to the Registrant's Current Report on Form 8-K filed April 4, 2006.

Signatures

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

NORWOOD FINANCIAL CORP.

Date: August 10, 2009

By: /s/ William W. Davis, Jr.
William W. Davis, Jr.
President and Chief Executive Officer
(Principal Executive Officer)

Date: August 10, 2009

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