

NORWOOD FINANCIAL CORP  
Form 10-Q  
August 09, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2011

OR

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

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

Commission file number 0-28366

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

Pennsylvania  
(State or other jurisdiction of  
Incorporation or organization)

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

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

18431  
(Zip Code)

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

NA

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

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

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

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

Large accelerated filer   
Non-accelerated filer

Accelerated filer   
Smaller reporting company

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(Do not check if a smaller reporting company)

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

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

| Class                                    | Outstanding as of August 5, 2011 |
|--|----------------------------------|
| Common stock, par value \$0.10 per share | 3,292,366                        |

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NORWOOD FINANCIAL CORP.  
FORM 10-Q  
FOR THE QUARTER ENDED JUNE 30, 2011

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## NORWOOD FINANCIAL CORP.

## Consolidated Balance Sheets (unaudited)

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

|  | June 30,<br>2011  | December 31,<br>2010 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Cash and due from banks  | \$ 9,269          | \$ 5,782             |
| Interest bearing deposits with banks   | 34,213            | 7,843                |
| Federal funds sold   | 1,729             | 3,000                |
| Cash and cash equivalents  | 45,211            | 16,625               |
| Securities available for sale, at fair value   | 152,275           | 145,815              |
| Securities held to maturity, fair value 2011:<br>\$178, 2010: \$179  | 170               | 170                  |
| Loans receivable (net of unearned income)  | 464,646           | 356,855              |
| Less: Allowance for loan losses  | 5,267             | 5,616                |
| Net loans receivable   | 459,379           | 351,239              |
| Investment in Federal Home Loan Bank Stock, at cost  | 3,981             | 3,361                |
| Bank premises and equipment, net   | 7,672             | 4,904                |
| Bank owned life insurance  | 11,648            | 8,249                |
| Accrued interest receivable  | 2,539             | 2,166                |
| Foreclosed real estate owned   | 1,755             | 748                  |
| Goodwill   | 9,483             | 13                   |
| Other intangibles  | 881               | -                    |
| Other assets   | 8,801             | 3,715                |
| <b>TOTAL ASSETS</b>  | <b>\$ 703,795</b> | <b>\$ 537,005</b>    |
| <b>LIABILITIES</b>   |                   |                      |
| Deposits:  |                   |                      |
| Non-interest bearing demand  | \$ 73,718         | \$ 62,238            |
| Interest-bearing   | 464,571           | 331,627              |
| Total deposits   | 538,289           | 393,865              |
| Short-term borrowings  | 32,181            | 33,309               |
| Other borrowings   | 42,761            | 38,000               |
| Accrued interest payable   | 1,473             | 1,536                |
| Other liabilities  | 4,456             | 2,597                |
| <b>TOTAL LIABILITIES</b>   | <b>619,160</b>    | <b>469,307</b>       |
| <b>STOCKHOLDERS' EQUITY</b>  |                   |                      |
| Common stock, \$.10 par value per share, authorized<br>10,000,000; shares issued 2011: 3,371,866 shares,<br>2010: 2,840,872 shares | 337               | 284                  |
| Surplus  | 24,603            | 9,826                |
| Retained earnings  | 60,036            | 58,648               |
| Treasury stock at cost: 2011: 79,500 shares,   | (2,404 )          | (2,197 )             |

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2010: 72,068 shares

|   |            |            |
|---|------------|------------|
| Accumulated other comprehensive income        | 2,063      | 1,137      |
| TOTAL STOCKHOLDERS' EQUITY                    | 84,635     | 67,698     |
| TOTAL LIABILITIES AND<br>STOCKHOLDERS' EQUITY | \$ 703,795 | \$ 537,005 |

See accompanying notes to the unaudited consolidated financial statements.

## NORWOOD FINANCIAL CORP.

Consolidated Statements of Income (unaudited)

(dollars in thousands, except per share data)

|   | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |          |
|---|--------------------------------|---------|------------------------------|----------|
|   | 2011                           | 2010    | 2011                         | 2010     |
| <b>INTEREST INCOME</b>  |                                |         |                              |          |
| Loans receivable, including fees                              | \$5,468                        | \$5,218 | \$10,396                     | \$10,628 |
| Securities  | 1,135                          | 1,141   | 2,225                        | 2,362    |
| Other   | 16                             | 18      | 24                           | 29       |
| Total interest income   | 6,619                          | 6,377   | 12,645                       | 13,019   |
| <b>INTEREST EXPENSE</b>                                       |                                |         |                              |          |
| Deposits  | 932                            | 1,102   | 1,817                        | 2,301    |
| Short-term borrowings   | 27                             | 27      | 51                           | 61       |
| Other borrowings  | 342                            | 416     | 678                          | 828      |
| Total interest expense  | 1,301                          | 1,545   | 2,546                        | 3,190    |
| NET INTEREST INCOME   | 5,318                          | 4,832   | 10,099                       | 9,829    |
| PROVISION FOR LOAN LOSSES                                     | 430                            | 150     | 650                          | 480      |
| NET INTEREST INCOME AFTER<br>PROVISION FOR LOAN LOSSES        | 4,888                          | 4,682   | 9,449                        | 9,349    |
| <b>OTHER INCOME</b>   |                                |         |                              |          |
| Service charges and fees                                      | 592                            | 570     | 1,141                        | 1,093    |
| Income from fiduciary activities                              | 105                            | 93      | 218                          | 179      |
| Net realized gains on sales of securities                     | 12                             | 64      | 224                          | 219      |
| Gains on sale of loans and servicing rights                   | 98                             | 130     | 241                          | 205      |
| Other   | 186                            | 159     | 377                          | 322      |
| Total other income  | 993                            | 1,016   | 2,201                        | 2,018    |
| <b>OTHER EXPENSES</b>   |                                |         |                              |          |
| Salaries and employee benefits                                | 1,832                          | 1,572   | 3,533                        | 3,187    |
| Occupancy, furniture & equipment, net                         | 408                            | 408     | 806                          | 802      |
| Data processing related                                       | 187                            | 216     | 402                          | 412      |
| Taxes, other than income                                      | 143                            | 150     | 272                          | 297      |
| Professional fees   | 126                            | 138     | 281                          | 277      |
| Merger related expenses                                       | 488                            | -       | 755                          | -        |
| Federal Deposit Insurance Corporation Insurance<br>assessment | 95                             | 118     | 215                          | 236      |
| Foreclosed real estate owned                                  | 17                             | 13      | 36                           | 29       |
| Other   | 640                            | 561     | 1,170                        | 1,096    |
| Total other expenses  | 3,936                          | 3,176   | 7,470                        | 6,336    |
| INCOME BEFORE INCOME TAXES                                    | 1,945                          | 2,522   | 4,180                        | 5,031    |
| INCOME TAX EXPENSE  | 461                            | 704     | 1,036                        | 1,416    |
| NET INCOME  | \$1,484                        | \$1,818 | \$3,144                      | \$3,615  |

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|                            |        |        |         |         |
|----------------------------|--------|--------|---------|---------|
| BASIC EARNINGS PER SHARE   | \$ .50 | \$ .66 | \$ 1.10 | \$ 1.31 |
| DILUTED EARNINGS PER SHARE | \$ .50 | \$ .66 | \$ 1.10 | \$ 1.31 |

See accompanying notes to the unaudited consolidated financial statements.

## NORWOOD FINANCIAL CORP.

Consolidated Statements of Changes in Stockholders' Equity (unaudited)

Six Months ended June 30, 2011

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

|  | Common Stock |        | Retained Earnings | Treasury Stock |        | Accumulated Other Comprehensive Income |          | Total     |
|--|--------------|--------|-------------------|----------------|--------|--|----------|-----------|
|  | Shares       | Amount |                   | Surplus        | Shares | Amount                                 |          |           |
| Balance December 31, 2010  | 2,840,872    | \$ 284 | \$ 9,826          | \$ 58,648      | 72,068 | \$ (2,197 )                            | \$ 1,137 | \$ 67,698 |
| Comprehensive Income:  |              |        |                   |                |        |  |          |           |
| Net Income   |              |        |                   | 3,144          |        |  |          | 3,144     |
| Change in unrealized gains on securities available for sale, net of reclassification adjustments and tax effects |              |        |                   |                |        |  | 926      | 926       |
| Total comprehensive income   |              |        |                   |                |        |  |          | 4,070     |
| Cash dividends declared \$.29 per share  |              |        |                   | (1,756 )       |        |  |          | (1,756 )  |
| Acquisition of treasury stock  |              |        |                   |                | 7,432  | (207 )                                 |          | (207 )    |
| Compensation expense related to stock options  |              |        | 82                |                |        |  |          | 82        |
| Effect of North Penn acquisition   | 530,994      | 53     | 14,695            |                |        |  |          | 14,748    |
| Balance, June 30, 2011   | 3,371,866    | \$ 337 | \$ 24,603         | \$ 60,036      | 79,500 | \$ (2,404 )                            | \$ 2,063 | \$ 84,635 |

See accompanying notes to the unaudited consolidated financial statements.



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

|   | Six Months Ended<br>June 30, |               |
|---|------------------------------|---------------|
|   | 2011                         | 2010          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                              |               |
| Net Income  | \$3,144                      | \$3,615       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |               |
| Provision for loan losses   | 650                          | 480           |
| Depreciation  | 226                          | 233           |
| Amortization of intangible assets   | 27                           | 26            |
| Deferred income taxes   | (8                           | ) 10          |
| Net amortization of securities premiums and discounts                             | 345                          | 141           |
| Net realized gain on sales of securities  | (224                         | ) (219        |
| Net increase in investment in life insurance                                      | (180                         | ) (182        |
| Loss on sale of bank premises and equipment and foreclosed real estate            | -                            | 10            |
| Net gain on sale of mortgage loans and servicing rights                           | (241                         | ) (205        |
| Mortgage loans originated for sale  | (6,530                       | ) (10,451     |
| Proceeds from sale of mortgage loans originated for sale                          | 6,771                        | 10,656        |
| Compensation expense related to stock options                                     | 82                           | 78            |
| Decrease (increase) in accrued interest receivable and other assets               | (182                         | ) 745         |
| Increase (decrease) in accrued interest payable and other liabilities             | 841                          | (273          |
| Net cash provided by operating activities   | 4,721                        | 4,664         |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |                              |               |
| Securities available for sale:  |                              |               |
| Proceeds from sales   | 10,344                       | 12,611        |
| Proceeds from maturities and principal reductions on mortgage-backed securities   | 15,918                       | 32,567        |
| Purchases   | (18,769                      | ) (54,926     |
| Securities held to maturity, proceeds from maturities                             | -                            | 540           |
| Redemption of FHLB stock  | 328                          | -             |
| Net decrease in loans   | 8,527                        | 8,928         |
| Purchase of bank premises and equipment   | (63                          | ) (105        |
| Acquisition, net of cash and cash equivalents acquired                            | 4,544                        | -             |
| Net cash provided by (used in) investing activities                               | 20,829                       | (385          |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                              |               |
| Net increase in deposits  | 8,990                        | 16,290        |
| Net decrease in short-term borrowings   | (1,128                       | ) (1,425      |
| Repayments of other borrowings  | (3,015                       | ) -           |
| Stock options exercised   | -                            | 89            |
| Tax benefit of stock options exercised  | -                            | 30            |
| Acquisition of treasury stock   | (207                         | ) (529        |
| Cash dividends paid   | (1,604                       | ) (1,547      |
| Net cash used in financing activities   | 3,036                        | 12,908        |
| Increase in cash and cash equivalents   | 28,586                       | 17,187        |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                             | <b>16,625</b>                | <b>17,355</b> |

|  |          |          |
|--|----------|----------|
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$45,211 | \$34,542 |
|--|----------|----------|

See accompanying notes to the unaudited consolidated financial statements.

## Notes to the Unaudited Consolidated Financial Statements

## 1. Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in conformity with generally accepted accounting principles for interim financial statements and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ from those estimates. The financial statements reflect, in the opinion of management, all normal, recurring adjustments necessary to present fairly the financial position and results of operations of the Company. The operating results for the six month period ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011 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, 2010.

## 2. Earnings Per Share

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

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

(in thousands)

|   | Three Months Ended |       | Six Months Ended |       |
|---|--------------------|-------|------------------|-------|
|   | June 30,           |       | June 30,         |       |
|   | 2011               | 2010  | 2011             | 2010  |
| Basic EPS weighted average shares outstanding   | 2,937              | 2,758 | 2,852            | 2,763 |
| Dilutive effect of stock options                | 2                  | 4     | 3                | 4     |
| Diluted EPS weighted average shares outstanding | 2,939              | 2,762 | 2,855            | 2,767 |

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 165,150 and 138,150 as of June 30, 2011 and 2010, respectively, based upon the closing price of Norwood stock of \$26.15 and \$25.25 per share on June 30, 2011 and 2010, respectively.

### 3. Stock-Based Compensation

The Company's shareholders approved the Norwood Financial Corp 2006 Stock Option Plan at the annual meeting on April 25, 2006 and the Company awarded 47,700 options in 2006, 22,000 options in 2007, 24,000 options in 2008, 27,000 options in 2009, 28,000 options in 2010 and 1,000 in 2011, all of which have a twelve month vesting period. As of June 30, 2011, there was \$88,000 of total unrecognized compensation cost related to non-vested options granted in 2010 and 2011 under the plan, which will be fully amortized by December 31, 2011.

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

|                                | Options | Weighted<br>Average<br>Exercise<br>Price<br>Per Share | Weighted Average<br>Remaining<br>Contractual Term | Aggregate<br>Intrinsic<br>Value<br>(\$000) |
|--------------------------------|---------|---|---|--|
| Outstanding at January 1, 2011 | 189,639 | \$ 28.52  | 6.6 Yrs.  | \$ 146                                     |
| Granted                        | 1,000   | 26.27   | 10.0 Yrs.   | -  |
| Exercised                      | -       | -   | -   | -  |
| Outstanding at June 30, 2011   | 190,639 | \$ 28.51  | 6.0 Yrs.  | \$ 98                                      |
| Exercisable at June 30, 2011   | 162,639 | \$ 28.65  | 4.6 Yrs.  | \$ 98                                      |

Intrinsic value represents the amount by which the market price of the stock on the measurement date exceeded the exercise price of the option. The stock price was \$26.15 as of June 30, 2011 and \$27.77 as of December 31, 2010. During the six months ended June 30, 2011, no stock options were exercised.

### 4. Cash Flow Information

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

Cash payments for interest for the periods ended June 30, 2011 and 2010 were \$2,610,000 and \$3,629,000, respectively. Cash payments for income taxes for the periods ending June 30, 2011 and 2010 were \$1,407,000 and \$1,307,000, respectively. Non-cash investing activity for 2011 and 2010 included repossession of other assets and foreclosed mortgage loans transferred to real estate owned of \$1,036,000 and \$101,000, 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.

| (in thousands)                        | Three Months Ended |       | Six Months Ended |         |
|---------------------------------------|--------------------|-------|------------------|---------|
|                                       | June 30,           |       | June 30,         |         |
|                                       | 2011               | 2010  | 2011             | 2010    |
| Unrealized holding gains              |                    |       |                  |         |
| on available for sale securities      | \$1,161            | \$783 | \$1,627          | \$1,062 |
| Reclassification adjustment for gains |                    |       |                  |         |
| realized in income                    | (12 )              | (64 ) | (224 )           | (219 )  |
| Net unrealized gains                  | 1,149              | 719   | 1,403            | 843     |
| Income tax expense                    | 391                | 244   | 477              | 287     |
| Other comprehensive income            | \$758              | \$475 | \$926            | \$556   |

#### 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  |          |
|--|----------|----------|
|  | 2011     | 2010     |
| Commitments to grant loans                 | \$43,395 | \$15,908 |
| Unfunded commitments under lines of credit | 28,910   | 33,915   |
| Standby letters of credit                  | 5,586    | 3,269    |
|  | \$77,891 | \$53,092 |

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

The Bank does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank, generally, holds collateral and/or personal guarantees supporting these commitments. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of



future payments required under the corresponding guarantees. The current amount of the liability as of June 30, 2011 for guarantees under standby letters of credit issued is not material.

## 7. Securities

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

|  | Amortized<br>Cost | June 30, 2011                |                               | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
|  |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
| (In Thousands)   |                   |                              |                               |               |
| Available for Sale:  |                   |                              |                               |               |
| U.S. Government agencies                                     | \$31,254          | \$393                        | \$(175)                       | ) \$31,472    |
| States and political subdivisions                            | 50,590            | 970                          | (252)                         | ) 51,308      |
| Corporate obligations  | 7,747             | 251                          | -                             | 7,998         |
| Mortgage-backed securities-<br>government sponsored entities | 59,252            | 1,673                        | (15)                          | ) 60,910      |
|  | \$148,843         | \$3,287                      | \$(442)                       | ) 151,688     |
| Equity securities-financial services                         | 300               | 288                          | (1)                           | ) 587         |
|  | \$149,143         | \$3,575                      | \$(443)                       | ) 152,275     |
| Held to Maturity:  |                   |                              |                               |               |
| States and political subdivisions                            | \$170             | \$8                          | \$-                           | \$178         |
|  |                   |                              |                               |               |
|  | Amortized<br>Cost | December 31, 2010            |                               | Fair<br>Value |
|  |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |               |
| (In Thousands)   |                   |                              |                               |               |
| Available for Sale:  |                   |                              |                               |               |
| U.S. Government agencies                                     | \$30,194          | \$392                        | \$(318)                       | ) \$30,268    |
| States and political subdivisions                            | 49,880            | 510                          | (624)                         | ) 49,766      |
| Corporate obligations  | 4,018             | 231                          | -                             | 4,249         |
| Mortgage-backed securities-government<br>sponsored entities  | 59,770            | 1,398                        | (240)                         | ) 60,928      |
|  | 143,862           | 2,531                        | (1,182)                       | ) 145,211     |
| Equity securities-financial services                         | 224               | 381                          | (1)                           | ) 604         |
|  | \$144,086         | \$2,912                      | \$(1,183)                     | ) \$145,815   |
| Held to Maturity:  |                   |                              |                               |               |
| States and political subdivisions                            | \$170             | \$9                          | \$-                           | \$179         |

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, 2011       |                      |                   |                      |            |                      |
|--|---------------------|----------------------|-------------------|----------------------|------------|----------------------|
|  | Less than 12 Months |                      | 12 Months or More |                      | Total      | Unrealized<br>Losses |
|  | Fair Value          | Unrealized<br>Losses | Fair Value        | Unrealized<br>Losses | Fair Value |                      |
| U.S. Government agencies                                 | \$8,835             | \$(175 )             | \$-               | \$-                  | \$8,835    | \$(175 )             |
| States and political subdivisions                        | 13,294              | (252 )               | -                 | -                    | 13,294     | (252 )               |
| Mortgage-backed securities-government sponsored agencies | 5,181               | (15 )                | -                 | -                    | 5,181      | (15 )                |
| Equity securities-financial services                     | \$-                 | \$0                  | 16                | (1 )                 | 16         | (1 )                 |
|  | \$27,310            | \$(442 )             | \$16              | \$(1 )               | \$27,326   | \$(443 )             |

|  | December 31, 2010   |                      |                   |                      |            |                      |
|--|---------------------|----------------------|-------------------|----------------------|------------|----------------------|
|  | Less than 12 Months |                      | 12 Months or More |                      | Total      | Unrealized<br>Losses |
|  | Fair Value          | Unrealized<br>Losses | Fair Value        | Unrealized<br>Losses | Fair Value |                      |
| U.S. Government agencies                                 | \$8,696             | \$(318 )             | \$-               | \$-                  | \$8,696    | \$(318 )             |
| States and political subdivisions                        | 21,829              | (624 )               | -                 | -                    | 21,829     | (624 )               |
| Mortgage-backed securities-government sponsored agencies | 20,113              | (240 )               | -                 | -                    | 20,113     | (240 )               |
| Equity securities-financial services                     | 15                  | (1 )                 | -                 | -                    | 15         | (1 )                 |
|  | \$50,653            | \$(1,183 )           | \$-               | \$-                  | \$50,653   | \$(1,183 )           |

At June 30, 2011, the Company has 36 securities in an unrealized loss position in the less than twelve months category and no securities in the twelve months or more category. In Management's opinion the unrealized losses less than twelve months principally reflect changes in interest rates subsequent to the acquisition of specific securities. The Company holds a small amount of equity securities in other financial institutions. The value of these equity securities has been impacted by the overall weakness in the financial sector, one of which has been in a loss position for greater than one year. Management believes that the other unrealized loss represents temporary impairment of the security as the Company does not have the intent to sell the security and it is more likely than not that it will not have to sell the security before recovery of its cost basis.



The amortized cost and fair value of debt securities as of June 30, 2011 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties.

|  | Available for Sale<br>Amortized |            | Held to Maturity<br>Amortized |            |
|--|---------------------------------|------------|-------------------------------|------------|
|  | Cost                            | Fair Value | Cost                          | Fair Value |
|  | (In Thousands)                  |            |                               |            |
| Due in one year or less                                  | \$996                           | \$1,001    | \$-                           | \$-        |
| Due after one year through five years                    | 32,796                          | 33,445     | 170                           | 178        |
| Due after five years through ten years                   | 27,013                          | 27,432     | -                             | -          |
| Due after ten years                                      | 28,786                          | 28,900     | -                             | -          |
| Mortgage-backed securities-government sponsored agencies | 59,252                          | 60,910     | -                             | -          |
|  | \$148,843                       | \$151,688  | \$170                         | \$178      |

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

|                                   | Three Months<br>Ended June 30, |         | Six Months<br>Ended June 30, |          |
|-----------------------------------|--------------------------------|---------|------------------------------|----------|
|                                   | 2011                           | 2010    | 2011                         | 2010     |
| Gross realized gains              | \$15                           | \$64    | \$228                        | \$219    |
| Gross realized losses             | (3 )                           | —       | (4 )                         | -        |
| Net realized gain                 | \$12                           | \$64    | \$224                        | \$219    |
| Proceeds from sales of securities | \$4,157                        | \$3,774 | \$10,344                     | \$12,611 |

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

Included in the 2011 growth are balances acquired from North Penn as follows (in thousands):

|  |           |
|--|-----------|
| Real Estate – Residential              | \$36,221  |
| Commercial                             | 70,789    |
| Construction                           | 358       |
| Commercial, financial and agricultural | 10,499    |
| Consumer loans to individuals          | 1,831     |
| Total loans                            | \$119,698 |

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

## Types of loans

(dollars in thousands)

|  | June 30, 2011 |       |   | December 31, 2010 |       |   |
|--|---------------|-------|---|-------------------|-------|---|
| Real Estate-Residential                | \$ 152,772    | 32.9  | % | \$ 124,562        | 34.9  | % |
| Commercial                             | 258,719       | 55.6  |   | 184,094           | 51.5  |   |
| Construction                           | 11,832        | 2.6   |   | 12,638            | 3.5   |   |
| Commercial, financial and agricultural | 27,215        | 5.8   |   | 22,386            | 6.3   |   |
| Consumer loans to individuals          | 14,544        | 3.1   |   | 13,668            | 3.8   |   |
| Total loans                            | 465,082       | 100.0 | % | 357,348           | 100.0 | % |
| Deferred fees (net)                    | (436 )        |       |   | (493 )            |       |   |
|  | 464,646       |       |   | 356,855           |       |   |
| Allowance for loan losses              | (5,267 )      |       |   | (5,616 )          |       |   |
| Net loans receivable                   | \$ 459,379    |       |   | \$ 351,239        |       |   |

Purchased loans acquired in a business combination are recorded at estimated fair value on their purchase date without a carryover of the related allowance for loan losses.

Upon acquisition, the Company evaluated whether each acquired loan (regardless of size) was within the scope of ASC 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased credit-impaired loans are loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. The carrying value of purchased loans acquired with deteriorated credit quality was \$1.5 million at June 30, 2011. There were no material increases or decreases in the expected cash flows of covered loans between May 31, 2011 (the "acquisition date") and June 30, 2011. The fair value of purchased credit-impaired loans, on the acquisition date, was determined, primarily based on the fair value of loan collateral.

U.S. generally accepted accounting principles prohibits carrying over an allowance for loan losses for impaired loans purchased in the North Penn acquisition. On the acquisition date, the preliminary estimate of the unpaid principal balance for all loans evidencing credit impairment acquired in the North Penn acquisition was \$1.9 million and the estimated fair value of the loans was \$1.5 million. Total contractually required payments on these loans, including interest, at the acquisition date was \$3.6 million. However, the Company's preliminary estimate of expected cash flows was \$1.9 million. At such date, the Company established a credit risk related non-accretable discount (a discount representing amounts which are not expected to be collected from the customer nor liquidation of collateral) of \$1.7 million relating to these impaired loans, reflected in the recorded net fair value. Such amount is reflected as a non-accretable fair value adjustment to loans. The Company further estimated the timing and amount of expected cash flows in excess of the estimated fair value and established an accretable discount of \$329,000 on the acquisition date relating to these impaired loans.

The carrying value of covered loans acquired and accounted for in accordance with ASC Subtopic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, was determined by projecting discounted contractual cash flows. The table below presents the components of the purchase accounting adjustments related to the purchased impaired loans acquired in the North Penn acquisition:



|                          | 2011     |
|--------------------------|----------|
| (In thousands)           |          |
| Unpaid principal balance | \$1,936  |
| Interest                 | 1,669    |
| Contractual cash flows   | 3,605    |
| Non-accretable discount  | (1,724 ) |
| Expected cash flows      | 1,881    |
| Accretable discount      | (329 )   |
| Estimated fair value     | \$1,552  |

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

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

A loan is considered to be a troubled debt restructuring ("TDR") loan when the Company grants a concession to the borrower because of the borrower's financial condition that it would not otherwise consider. Such concessions include the reduction of interest rates, forgiveness of principal or interest, or other modifications of interest rates that are less than the current market rate for new obligations with similar risk. TDR loans that are in compliance with their modified terms and that yield a market rate may be removed from the TDR status after a period of performance.

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

|   | Real Estate Loans |            |                                | Commercial<br>Loans | Consumer<br>Loans | Total      |
|---|-------------------|------------|--------------------------------|---------------------|-------------------|------------|
|   | Residential       | Commercial | Construction<br>(In thousands) |                     |                   |            |
| June 30, 2011                               |                   |            |                                |                     |                   |            |
| Total Loans                                 | \$ 152,772        | \$ 258,719 | \$ 11,832                      | \$ 27,215           | \$ 14,544         | \$ 465,082 |
| Individually<br>evaluated for<br>impairment | \$-               | \$ 15,782  | \$-                            | \$ 508              | \$-               | \$ 16,290  |
| Collectively<br>evaluated for<br>impairment | \$ 152,772        | \$ 242,937 | \$ 11,832                      | \$ 26,707           | \$ 14,544         | \$ 448,792 |
|   |                   |            |                                |                     |                   |            |
|   | Real Estate Loans |            |                                | Commercial<br>Loans | Consumer<br>Loans | Total      |
|   | Residential       | Commercial | Construction<br>(In thousands) |                     |                   |            |
| December 31, 2010                           |                   |            |                                |                     |                   |            |
| Total Loans                                 | \$ 124,562        | \$ 184,094 | \$ 12,638                      | \$ 22,386           | \$ 13,668         | \$ 357,348 |
| Individually<br>evaluated for<br>impairment | \$-               | \$ 14,239  | \$-                            | \$ 513              | \$-               | \$ 14,752  |
| Collectively<br>evaluated for<br>impairment | \$ 124,562        | \$ 169,855 | \$ 12,638                      | \$ 21,873           | \$ 13,668         | \$ 342,596 |

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

|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Associated<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|------------------------|--------------------------------|-------------------------|-----------------------------------|----------------------------------|
| June 30, 2011                       |                        |                                |                         |                                   |                                  |
| With no related allowance recorded: | (In thousands)         |                                |                         |                                   |                                  |
| Real Estate Loans                   |                        |                                |                         |                                   |                                  |
| Residential                         | \$-                    | \$-                            | \$-                     | \$-                               | \$-                              |
| Construction                        | -                      | -                              | -                       | -                                 | -                                |
| Commercial                          | 4,981                  | 4,981                          | -                       | 4,135                             | 135                              |
| Commercial Loans                    | 508                    | 508                            | -                       | 511                               | -                                |
| Consumer Loans                      | -                      | -                              | -                       | -                                 | -                                |
| Total                               | 5,489                  | 5,489                          | -                       | 4,646                             | 135                              |
| With an allowance recorded:         |                        |                                |                         |                                   |                                  |
| Real Estate Loans                   |                        |                                |                         |                                   |                                  |
| Residential                         | -                      | -                              | -                       | -                                 | -                                |
| Construction                        | -                      | -                              | -                       | -                                 | -                                |
| Commercial                          | 10,801                 | 10,801                         | 1,678                   | 11,370                            | 92                               |
| Commercial Loans                    | -                      | -                              | -                       | -                                 | -                                |
| Consumer Loans                      | -                      | -                              | -                       | -                                 | -                                |
| Total                               | 10,801                 | 10,801                         | 1,678                   | 11,370                            | 92                               |
| Total:                              |                        |                                |                         |                                   |                                  |
| Real Estate loans                   |                        |                                |                         |                                   |                                  |
| Residential                         | -                      | -                              | -                       | -                                 | -                                |
| Construction                        | -                      | -                              | -                       | -                                 | -                                |
| Commercial                          | 15,782                 | 15,782                         | 1,678                   | 15,505                            | 227                              |
| Commercial Loans                    | 508                    | 508                            | -                       | 511                               | -                                |
| Consumer Loans                      | -                      | -                              | -                       | -                                 | -                                |
| Total Impaired Loans                | \$16,290               | \$16,290                       | \$1,678                 | \$16,016                          | \$227                            |

|  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Associated<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|--|------------------------|--------------------------------|-------------------------|-----------------------------------|----------------------------------|
| December 31, 2010                                  |                        |                                |                         |                                   |                                  |
| With no related allowance recorded: (In thousands) |                        |                                |                         |                                   |                                  |
| Real Estate Loans                                  |                        |                                |                         |                                   |                                  |
| Residential  | \$-                    | \$-                            | \$-                     | \$-                               | \$-                              |
| Construction                                       | -                      | -                              | -                       | -                                 | -                                |
| Commercial   | 5,598                  | 5,598                          | -                       | 5,088                             | 266                              |
| Commercial Loans                                   | 513                    | 513                            | -                       | 115                               | -                                |
| Consumer Loans                                     | -                      | -                              | -                       | -                                 | -                                |
| Total  | 6,111                  | 6,111                          | -                       | 5,203                             | 266                              |
| With an allowance recorded:                        |                        |                                |                         |                                   |                                  |
| Real Estate Loans                                  |                        |                                |                         |                                   |                                  |
| Residential  | -                      | -                              | -                       | -                                 | -                                |
| Construction                                       | -                      | -                              | -                       | -                                 | -                                |
| Commercial   | 8,641                  | 8,548                          | 1,648                   | 4,734                             | 119                              |
| Commercial Loans                                   | -                      | -                              | -                       | 159                               | -                                |
| Consumer Loans                                     | -                      | -                              | -                       | -                                 | -                                |
| Total  | 8,641                  | 8,548                          | 1,648                   | 4,893                             | 119                              |
| Total:   |                        |                                |                         |                                   |                                  |
| Real Estate loans                                  |                        |                                |                         |                                   |                                  |
| Residential  | -                      | -                              | -                       | -                                 | -                                |
| Construction                                       | -                      | -                              | -                       | -                                 | -                                |
| Commercial   | 14,239                 | 14,146                         | 1,648                   | 9,822                             | 385                              |
| Commercial Loans                                   | 513                    | 513                            | -                       | 274                               | -                                |
| Consumer Loans                                     | -                      | -                              | -                       | -                                 | -                                |
| Total Impaired Loans                               | \$14,752               | \$14,659                       | \$1,648                 | \$10,096                          | \$385                            |

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

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





The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard, Doubtful and Loss within the internal risk rating system as of June 30, 2011 and December 31, 2010 (in thousands):

|                              | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total     |
|------------------------------|-----------|--------------------|-------------|----------|------|-----------|
| June 30, 2011                |           |                    |             |          |      |           |
| Commercial real estate loans | \$233,564 | \$3,859            | \$21,296    | \$-      | \$-  | \$258,719 |
| Commercial loans             | 27,207    | -                  | 8           | -        | -    | 27,215    |
| Total                        | \$260,771 | \$3,859            | \$21,304    | \$-      | \$-  | \$285,934 |

|                              | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total     |
|------------------------------|-----------|--------------------|-------------|----------|------|-----------|
| December 31, 2010            |           |                    |             |          |      |           |
| Commercial real estate loans | \$165,226 | \$1,780            | \$17,088    | \$-      | \$-  | \$184,094 |
| Commercial loans             | 21,759    | 75                 | 552         | -        | -    | 22,386    |
| Total                        | \$186,985 | \$1,855            | \$17,640    | \$-      | \$-  | \$206,480 |

For residential real estate loans, construction loans and consumer loans, the Company evaluates credit quality based on the performance of the individual credits. The following table presents the recorded investment in the loan classes based on payment activity as of June 30, 2011 and December 31, 2010 (in thousands):

| June 30, 2011                 | Performing | Nonperforming | Total     |
|-------------------------------|------------|---------------|-----------|
| Residential real estate loans | \$150,907  | \$ 1,865      | \$152,772 |
| Construction                  | 11,832     | -             | \$11,832  |
| Consumer loans                | 14,511     | 33            | \$14,544  |
| Total                         | \$177,250  | \$ 1,898      | \$179,148 |

| December 31, 2010             | Performing | Nonperforming | Total     |
|-------------------------------|------------|---------------|-----------|
| Residential real estate loans | \$123,623  | \$ 939        | \$124,562 |
| Construction                  | 12,638     | -             | \$12,638  |
| Consumer loans                | 13,668     | -             | \$13,668  |
| Total                         | \$149,929  | \$ 939        | \$150,868 |

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans as of June 30, 2011 and December 31, 2010 (in thousands):

|                   | Current    | 31-60 Days<br>Past Due | 61-90<br>Days<br>Past Due | Greater<br>than 90<br>Days<br>Past Due<br>and still<br>accruing | Non-Accrual | Total Past<br>Due and<br>Non-Accrual | Total Loans |
|-------------------|------------|------------------------|---------------------------|---|-------------|--------------------------------------|-------------|
| June 30, 2011     |            |                        |                           |   |             |                                      |             |
| Real Estate loans |            |                        |                           |   |             |                                      |             |
| Residential       | \$ 150,300 | \$ 461                 | \$ 146                    | \$ -  | \$ 1,865    | \$ 2,472                             | \$ 152,772  |
| Construction      | 11,566     | 266                    | -                         | -   | -           | 266                                  | 11,832      |
| Commercial        | 251,068    | 1,224                  | -                         | -   | 6,427       | 7,651                                | 258,719     |
| Commercial loans  | 26,536     | 171                    | -                         | -   | 508         | 679                                  | 27,215      |
| Consumer loans    | 14,402     | 80                     | 29                        | -   | 33          | 142                                  | 14,544      |
| Total             | \$ 453,872 | \$ 2,202               | \$ 175                    | \$ -  | \$ 8,833    | \$ 11,210                            | \$ 465,082  |

|                   | Current    | 31-60<br>Days<br>Past Due | 61-90<br>Days<br>Past Due | Greater<br>than 90<br>Days Past<br>Due and<br>still<br>accruing | Non-Accrual | Total Past<br>Due and<br>Non-Accrual | Total Loans |
|-------------------|------------|---------------------------|---------------------------|---|-------------|--------------------------------------|-------------|
| December 31, 2010 |            |                           |                           |   |             |                                      |             |
| Real Estate loans |            |                           |                           |   |             |                                      |             |
| Residential       | \$ 123,177 | \$ 407                    | \$ -                      | \$ 39   | \$ 939      | \$ 1,385                             | \$ 124,562  |
| Construction      | 12,622     | 16                        | -                         | -   | -           | 16                                   | 12,638      |
| Commercial        | 176,981    | 3,047                     | 1,478                     | -   | 2,588       | 7,113                                | 184,094     |
| Commercial loans  | 21,858     | 15                        | -                         | -   | 513         | 528                                  | 22,386      |
| Consumer loans    | 13,642     | 24                        | 2                         | -   | -           | 26                                   | 13,668      |
| Total             | \$ 348,280 | \$ 3,509                  | \$ 1,480                  | \$ 39   | \$ 4,040    | \$ 9,068                             | \$ 357,348  |

The following table presents changes in the allowance for loan losses:

|  | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |         |
|--|--------------------------------|----------|------------------------------|---------|
|  | 2011                           | 2010     | 2011                         | 2010    |
|  | (dollars in thousands)         |          |                              |         |
| Allowance balance at beginning of period | \$ 5,780                       | \$ 5,362 | \$ 5,616                     | \$5,453 |
| Charge-offs:                             | (958)                          | (95)     | (1,033)                      | (524)   |
| Recoveries:                              | 15                             | 4        | 34                           | 12      |
| Provision expense                        | 430                            | 150      | 650                          | 480     |
| Allowance balance at end of period       | \$ 5,267                       | \$ 5,421 | \$ 5,267                     | \$5,421 |

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

| (In thousands)  | Residential | Commercial  | Construction | Commercial | Consumer | Total    |
|---|-------------|-------------|--------------|------------|----------|----------|
|   | Real Estate | Real Estate |              |            |          |          |
| Beginning balance,<br>December 31, 2010                 | \$1,167     | \$3,976     | \$110        | \$171      | \$192    | \$5,616  |
| Charge Offs   | (226 )      | (764 )      | -            | (2 )       | (41 )    | (1,033 ) |
| Recoveries  | 7           | -           | -            | 5          | 22       | 34       |
| Provision Expense                                       | 148         | 463         | (19 )        | 84         | (26 )    | 650      |
| Ending balance, June 30, 2011                           | \$1,096     | \$3,675     | \$91         | \$258      | \$147    | \$5,267  |
| Ending balance individually<br>evaluated for impairment | \$-         | \$1,678     | \$-          | \$-        | \$-      | \$1,678  |
| Ending balance collectively<br>evaluated for impairment | \$1,096     | \$1,997     | \$91         | \$258      | \$147    | \$3,589  |

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

As of June 30, 2011, the Company considered its concentration of credit risk to be acceptable. The highest concentrations are in the hospitality lodging industry, builders/contractors and summer camps, with loans outstanding of \$57.9 million, or 69.2% of capital, to the hospitality lodging industry; \$18.2 million, or 21.8% of capital, to builders/contractors; and \$14.6 million, or 17.5% of capital, to summer camps. As of June 30, 2011, one motel loan with an outstanding balance of \$2.2 million was on nonaccrual status and considered impaired. During the second quarter, the Company recognized a write-down of \$750,000 on the loan based on the receipt of a current appraisal. There were no losses recognized on loans to builders/contractors or summer camps in 2011.

Gross realized gains and gross realized losses on sales of residential mortgage loans were \$94,000 and \$0 respectively, in the first six months of 2011 compared to \$150,000 and \$11,000, respectively, in the same period in 2010. The proceeds from the sales of residential mortgage loans totaled \$6.7 million and \$10.6 million for the six months ended June 30, 2011 and 2010, respectively.



## 9. Fair Value Measurements

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

- Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
- Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.
- Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

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

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2011 and December 31, 2010 are as follows:

| Description  | Total<br>(In thousands) | Fair Value Measurement Reporting Date Using<br>(Level 1)<br>Quoted Prices<br>in<br>Active<br>Markets<br>For Identical<br>Assets |            |      | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Unobservable<br>Inputs |
|--|-------------------------|---|------------|------|---|--|
|  |                         |   |            |      |   |  |
| June 30, 2011  |                         |   |            |      |   |  |
| Available for Sale:                                      |                         |   |            |      |   |  |
| US Government agencies                                   | \$ 31,472               | \$ -  | \$ 31,472  | \$ - |   |  |
| States and political subdivisions                        | 51,308                  | -   | 51,308     | -    |   |  |
| Corporate obligations                                    | 7,998                   | -   | 7,998      | -    |   |  |
| Mortgage-backed securities-government sponsored agencies |                         |   |            |      |   |  |
|  | 60,910                  | -   | 60,910     | -    |   |  |
| Equity securities-financial services                     | 587                     | 587   | -          | -    |   |  |
| Total  | \$ 152,275              | \$ 587  | \$ 151,688 | \$ - |   |  |
| December 31, 2010  |                         |   |            |      |   |  |
| Available for Sale:                                      |                         |   |            |      |   |  |
| US Government agencies                                   | \$ 30,268               | \$ -  | \$ 30,268  | \$ - |   |  |
| States and political subdivisions                        | 49,766                  | -   | 49,766     | -    |   |  |
| Corporate obligations                                    | 4,249                   | -   | 4,249      | -    |   |  |
| Mortgage-backed securities-government                    | 60,928                  | -   | 60,928     | -    |   |  |

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|                                      |            |        |            |      |   |
|--------------------------------------|------------|--------|------------|------|---|
| sponsored agencies                   |            |        |            |      |   |
| Equity securities-financial services | 604        | 604    | -          | -    | - |
| Total                                | \$ 145,815 | \$ 604 | \$ 145,211 | \$ - | - |

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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, 2011 and December 31, 2010 are as follows:

| (In thousands)               | Fair Value Measurement Reporting Date using | Reporting Date using   |   |  |
|------------------------------|---|--|---|--|
|                              |   | (Level 1)<br>Quoted Prices<br>in<br>Active<br>Markets<br>For Identical<br>Assets | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Unobservable<br>Inputs |
| Description                  | Total                                       |  |   |  |
| June 30, 2011                |   |  |   |  |
| Impaired Loans               | \$ 14,612                                   | \$ -   | \$ -  | \$ 14,612  |
| Foreclosed Real Estate Owned | 1,755                                       | -  | -   | 1,755  |
|                              | \$ 16,367                                   | \$ -   | \$ -  | \$ 16,367  |
| December 31, 2010            |   |  |   |  |
| Impaired Loans               | \$ 13,104                                   | \$ -   | \$ 7,038  | \$ 6,066   |
| Foreclosed Real Estate Owned | 748   | -  | 748   | -  |
|                              | \$ 13,852                                   | \$ -   | \$ 7,786  | \$ 6,066   |

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, 2011 and December 31, 2010.

Cash and cash equivalents (carried at cost):

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

Securities:

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

Loans receivable (carried at cost):

The fair values of loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate

loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.



Impaired loans (generally carried at fair value):

The Company measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as either Level 2 or Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. As of June 30, 2011, the fair value investment in impaired loans totaled \$14.6 million which includes four loans for \$10.8 million for which a valuation allowance has been provided based on current collateral values and ten loans for \$5.5 million which do not require a valuation allowance since the current collateral value exceeds the loan value. As of June 30, 2011, the Company has recognized charge-offs against the allowance for loan losses on impaired loans in the amount of \$1,450,000 over the life of the loans.

Mortgage servicing rights (generally carried at cost)

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

Foreclosed real estate owned (carried at fair value):

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

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

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

In December 2008, the FHLB of Pittsburgh notified member banks that it was suspending dividend payments and the repurchase of excess capital stock. In October, 2010, the FHLB of Pittsburgh repurchased a portion of member bank's excess stock, but notified member banks that decisions regarding future capital stock repurchases will be made on a quarterly basis. Subsequent repurchases have been executed in the first and second quarters of 2011.

Management evaluates the restricted stock for impairment. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. Management believes no impairment charge is necessary related to FHLB stock as of June 30, 2011.

Accrued interest receivable and payable (carried at cost):

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



## Deposit liabilities (carried at cost):

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

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

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

## Other borrowings (carried at cost):

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

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

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

The estimated fair values of the Bank's financial instruments were as follows at June 30, 2011 and December 31, 2010.

|  | June 30, 2011      |               | December 31, 2010  |               |
|--|--------------------|---------------|--------------------|---------------|
|  | Carrying<br>Amount | Fair<br>Value | Carrying<br>Amount | Fair<br>Value |
|  | (In Thousands)     |               |                    |               |
| Financial assets:  |                    |               |                    |               |
| Cash and due from banks, interest-bearing deposits with banks and federal funds sold | \$45,211           | \$45,211      | \$16,625           | \$16,625      |
| Securities   | 152,445            | 152,453       | 145,985            | 145,994       |
| Loans receivable, net  | 459,379            | 472,687       | 351,239            | 358,873       |
| Mortgage servicing rights  | 301                | 314           | 250                | 274           |
| Investment in FHLB stock   | 3,981              | 3,981         | 3,361              | 3,361         |
| Accrued interest receivable  | 2,539              | 2,539         | 2,166              | 2,166         |
| Financial liabilities:   |                    |               |                    |               |
| Deposits   | 538,289            | 541,633       | 393,865            | 395,157       |
| Short-term borrowings  | 32,181             | 32,181        | 33,309             | 33,309        |
| Other borrowings   | 42,761             | 44,911        | 38,000             | 40,413        |
| Accrued interest payable   | 1,473              | 1,473         | 1,536              | 1,536         |
| Off-balance sheet financial instruments:   | -                  | -             | -                  | -             |
| Commitments to extend credit and   |                    |               |                    |               |

outstanding letters of credit

10. New and Recently Adopted Accounting Pronouncements

In July 2010, FASB issued ASU No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses. The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The Company has presented the necessary disclosures in Note 8 herein.

In October, 2010, the FASB issued ASU 2010-26, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts. This ASU addresses the diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The amendments are effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2011 and are not expected to have a significant impact on the Company's financial statements.

In December, 2010, the FASB issued ASU 2010-28, When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts. This ASU modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating an impairment may exist. The qualitative factors are consistent with the existing guidance, which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. For public entities, the amendments in this Update are effective for fiscal year, and interim periods within those years, beginning after December 15, 2010. Early adoption is not permitted. For nonpublic entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Nonpublic entities may early adopt the amendments using the effective date for public entities. This ASU is not expected to have a significant impact on the Company's financial statements.

In December 2010, the FASB issued ASU 2010-29, Disclosure of Supplementary Pro Forma Information for Business Combinations. The amendments in this update specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments also expand the supplemental pro forma disclosures under Topic 805 to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The amendments in this Update are effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In January 2011, the FASB issued ASU 2011-01, Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20. The amendments in this Update temporarily delay the effective date of the disclosures about troubled debt restructurings in Update 2010-20, enabling public-entity creditors to provide those disclosures after the FASB clarifies the guidance for



determining what constitutes a troubled debt restructuring. The deferral in this Update will result in more consistent disclosures about troubled debt restructurings. This amendment does not defer the effective date of the other disclosure requirements in Update 2010-20. In the proposed Update for determining what constitutes a troubled debt restructuring, the FASB proposed that the clarifications would be effective for interim and annual periods ending after June 15, 2011. For the new disclosures about troubled debt restructurings in Update 2010-20, those clarifications would be applied retrospectively to the beginning of the fiscal year in which the proposal is adopted. The adoption of this guidance is not expected to have a significant impact on the Company's financial statements.

In April 2011, the FASB issued ASU 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. The amendments in this Update provide additional guidance or clarification to help creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. The amendments in this Update are effective for the first interim or annual reporting period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning annual period of adoption. As a result of applying these amendments, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In April 2011, the FASB issued ASU 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*. The main objective in developing this Update is to improve the accounting for repurchase agreements (repos) and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The amendments in this Update remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this Update apply to all entities, both public and nonpublic. The amendments affect all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The guidance in this Update is effective for the first interim or annual period beginning on or after December 15, 2011 and should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In May 2011, the FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this Update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments in this Update are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. For nonpublic entities, the amendments are effective for annual periods beginning after December 15, 2011. Early application by public entities is not permitted. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income*. The amendments in this Update improve the comparability, clarity, consistency, and transparency of financial reporting and increase the prominence of items reported in other comprehensive income. To increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. GAAP and IFRS, the option to present components of other comprehensive income as part of the statement of changes in





stockholders' equity was eliminated. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. All entities that report items of comprehensive income, in any period presented, will be affected by the changes in this Update. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2012, and interim and annual periods thereafter. The amendments in this Update should be applied retrospectively, and early adoption is permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

#### 11. Acquisition of North Penn Bancorp, Inc.

On May 31, 2011, the Company closed on a merger transaction pursuant to which Norwood Financial Corp acquired North Penn Bancorp, Inc. in a stock and cash transaction. The acquisition is an in-market transaction that will expand the Company's existing footprint in Monroe County, Pennsylvania and extends its footprint into Lackawanna County, Pennsylvania.

North Penn Bancorp, Inc. was the holding company for North Penn Bank, a Pennsylvania savings bank that conducted its business from a main office in Scranton, Pennsylvania and four branch offices in the northeastern Pennsylvania counties of Lackawanna and Monroe.

Under the terms of the merger agreement, the Company acquired all of the outstanding shares of North Penn Bancorp, Inc. for a total purchase price of approximately \$25.4 million. North Penn Bank has been merged into Wayne Bank, with Wayne as the surviving entity.

The acquired assets and assumed liabilities were measured at estimated fair values. Management made significant estimates and exercised significant judgment in accounting for the acquisition. Management measured loan fair values based on loan file reviews (including borrower financial statements or tax returns), appraised collateral values, expected cash flows and historical loss factors of North Penn Bank. Real estate acquired through foreclosure was primarily valued based on appraised collateral values. The Company also recorded an identifiable intangible asset representing the core deposit base of North Penn Bank based on management's evaluation of the cost of such deposits relative to alternative funding sources. Management used significant estimates including the average lives of depository accounts, future interest rate levels and the cost of servicing various depository products. Management used market quotations to fair value investment securities and FHLB advances.

The business combination resulted in the acquisition of loans with and without evidence of credit quality deterioration. North Penn Bank's loans were deemed impaired at the acquisition date if the Company did not expect to receive all contractually required cash flows due to concerns about credit quality. Such loans were fair valued and the difference between contractually required payments at the acquisition date and cash flows expected to be collected was recorded as a nonaccretable difference. At the acquisition date, the Company recorded \$1.9 million of purchased credit-impaired loans subject to a nonaccretable difference of \$1.7 million. The method of measuring carrying value of purchased loans differs from loans originated by the Company (originated loans), and as such, the Company identifies purchased loans and purchased loans with a credit quality discount and originated loans at amortized cost.

North Penn Bank's loans without evidence of credit deterioration were fair valued by discounting both expected principal and interest cash flows using an observable discount rate for similar instruments that a market participant would consider in determining fair value. Additionally, consideration was given to management's



best estimates of default rates and payment speeds. At acquisition, North Penn's loan portfolio without evidence of deterioration totaled \$119.8 million and was recorded at a fair value of \$116.7 million.

The following table summarizes the purchase of North Penn Bancorp, Inc. as of May 31, 2011:

(\$ In thousands except per share data)

|   |          |          |
|---|----------|----------|
| Purchase Price Consideration in Common Stock (1)                                |          |          |
| North Penn common shares settled for stock                                      | 777,927  |          |
| Exchange Ratio  | 0.6829   |          |
| Norwood shares issued   | 531,246  |          |
| Value assigned to Norwood common share  | \$27.76  |          |
| Purchase price assigned to North Penn common shares exchanged for Norwood stock |          | \$14,748 |
| Purchase Price Consideration-Cash for Common Stock (1)                          |          |          |
| North Penn shares exchanged for cash  | 471,446  |          |
| Purchase price paid to each North Penn common share exchanged for cash          | \$19.12  |          |
| Purchase price assigned to North Penn common shares exchanged for cash          |          | 9,014    |
| Purchase Price Consideration-Cash for Unallocated ESOP Shares (1)               |          |          |
| North Penn Unallocated ESOP Shares Outstanding                                  | 85,471   |          |
| Unallocated ESOP Shares settlement price per share                              | \$19.12  |          |
| Purchase price assigned to North Penn unallocated ESOP shares settled for cash  |          | 1,634    |
| Total Purchase Price  |          | 25,396   |
| Net Assets Acquired:  |          |          |
| North Penn shareholders' equity   | \$18,195 |          |
| North Penn goodwill and intangibles   | -        |          |
| Adjustments to reflect assets acquired at fair value:                           |          |          |
| Investments   | -        |          |
| Loans   | (3,525   | )        |
| Allowance for loan losses   | 1,570    |          |
| Core deposit intangible   | 895      |          |
| Premises & equipment  | (783     | )        |
| Deferred tax assets   | 1,152    |          |
| Adjustments to reflect liabilities acquired at fair value:                      |          |          |
| Time deposits   | (815     | )        |
| Borrowings  | (776     | )        |
|   |          | 15,913   |
| Goodwill resulting from merger  |          | \$9,483  |

The following condensed statement reflects the values assigned to North Penn Bancorp's net assets as of the acquisition date:

|   |          |          |
|---|----------|----------|
| Total purchase price                      |          | \$25,396 |
| Net Assets Acquired:                      |          |          |
| Cash                                      | \$15,192 |          |
| Securities held to maturity               | -        |          |
| Securities available for sale             | 12,671   |          |
| Restricted investments                    | 985      |          |
| Loans                                     | 118,336  |          |
| Accrued interest receivable               | 566      |          |
| Premises & equipment, net                 | 2,931    |          |
| Core deposit intangible                   | 895      |          |
| Deferred tax assets                       | 2,947    |          |
| Other assets                              | 5,403    |          |
| Time deposits                             | (51,936) | )        |
| Deposits other than time deposits         | (83,498) | )        |
| Borrowings                                | (7,776)  | )        |
| Accrued interest payable                  | (203)    | )        |
| Other liabilities                         | (600)    | )        |
|   |          | 15,913   |
| Goodwill resulting from North Penn Merger |          | \$9,483  |

The Company recorded goodwill and other intangibles associated with the purchase of North Penn Bancorp, Inc. totaling \$10.4 million. Goodwill is not amortized, but is periodically evaluated for impairment. The Company did not recognize any impairment during the quarter ended June 30, 2011. The carrying amount of the goodwill at June 30, 2011 was \$9.5 million.

Identifiable intangibles are amortized to their estimated residual values over the expected useful lives. Such lives are also periodically reassessed to determine if any amortization period adjustments are required. During the quarter ended June 30, 2011, no such adjustments were recorded. The identifiable intangible asset consists of a core deposit intangible which is being amortized on an accelerated basis over the useful life of such asset. The gross carrying amount of the core deposit intangible at June 30, 2011 was \$895,000 with \$13,000 accumulated amortization as of that date.

As of June 30, 2011, the current year and estimated future amortization expense for the core deposit intangible was:

|      |           |
|------|-----------|
| 2011 | \$ 95,000 |
| 2012 | 153,000   |
| 2013 | 137,000   |
| 2014 | 121,000   |
| 2015 | 104,000   |
| 2016 | 88,000    |
| 2017 | 72,000    |
| 2018 | 56,000    |
| 2019 | 39,000    |
| 2020 | 23,000    |
| 2021 | 7,000     |

\$ 895,000

Results of operations for North Penn prior to the acquisition date are not included in the Consolidated Statement of Income for the three and six month periods ended June 30, 2011. Due to the significant amount of fair value adjustments historical results of North Penn are not relevant to the Company's results of operations. Therefore, no pro forma information is presented.

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

### Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 contains safe harbor provisions regarding forward-looking statements. When used in this discussion, the words "believes," "anticipates," "contemplates," "expects," and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected. Those risks and uncertainties are as follows:

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

Norwood Financial Corp. undertakes no obligation to publicly release the results of any revisions to those forward-looking statements which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

### Critical Accounting Policies

Note 2 to the Company's consolidated financial statements for the year ended December 31, 2010 (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, the fair value of financial instruments, valuation of impaired loans, and the determination of other-than-temporary impairment losses on securities. Please refer to the discussion of the allowance for loan losses calculation under "Allowance for Loan Losses and Non-performing Assets" in the "Changes in Financial Condition" section.

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

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

Restricted stock which represents required investment in the common stock of correspondent banks is carried at cost and as of June 30, 2011 and December 31, 2010, consists of the common stock of the Federal Home Loan Bank of Pittsburgh. In December 2008, the FHLB of Pittsburgh notified member banks that it was suspending dividend payments and the repurchase of excess capital stock. In October, 2010, the FHLB of Pittsburgh repurchased a portion of member bank's excess stock, but notified member banks that decisions regarding future capital stock repurchases will be made on a quarterly basis. Subsequent stock repurchases have been executed in each quarter since October 2010.

Management evaluates the restricted stock for impairment. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary decline in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. Management believes no impairment charge is necessary related to the restricted stock as of June 30, 2011 and December 31, 2010.

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 loss on all other securities at June 30, 2011 and December 31, 2010 represent temporary impairment of the securities, related to changes in interest rates.

In connection with the acquisition of North Penn, we recorded goodwill in the amount of \$9.5 million, representing the excess of amounts paid over the fair value of net assets of the institutions acquired in purchase transactions, at its fair value at the date of acquisition. Goodwill is tested and deemed impaired when the carrying value of goodwill exceeds its implied fair value. The value of the goodwill can change in the future. We expect the value of the goodwill to decrease if there is a significant decrease in the franchise value of the Bank. If an impairment loss is determined in the future, we will reflect the loss as an expense for the period in which the impairment is determined, leading to a reduction of our net income for that period by the amount of the impairment loss.





## Changes in Financial Condition

## General

Total assets as of June 30, 2011 were \$703.8 million compared to \$537.0 million as of December 31, 2010, an increase of \$166.8 million. The increase includes \$168.3 million of assets acquired as a result of the North Penn transaction.

## Securities

The fair value of securities available for sale as of June 30, 2011 was \$152.3 million compared to \$145.8 million as of December 31, 2010. The Company purchased \$31.4 million of securities principally using the proceeds from \$26.2 million of securities sold, called, maturities and principal reductions. Additionally, the Company acquired \$12.6 million of securities from North Penn.

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

| (dollars in thousands)               | June 30, 2011 |                | December 31, 2010 |                |   |
|--------------------------------------|---------------|----------------|-------------------|----------------|---|
|                                      | Amount        | % of portfolio | Amount            | % of portfolio |   |
| US Government agencies               | \$31,472      | 20.6           | % \$30,268        | 20.7           | % |
| States and political subdivisions    | 51,478        | 33.8           | 49,936            | 34.2           |   |
| Corporate obligations                | 7,998         | 5.2            | 4,249             | 2.9            |   |
| Mortgage-backed securities-          |               |                |                   |                |   |
| government sponsored entities        | 60,910        | 40.0           | 60,928            | 41.8           |   |
| Equity securities-financial services | 587           | 0.4            | 604               | 0.4            |   |
| Total                                | \$152,445     | 100.0          | % \$145,985       | 100.0          | % |

The Company has securities in an unrealized loss position. In management's opinion, the unrealized losses in U.S. Government agencies and mortgage-backed securities reflect changes in interest rates subsequent to the acquisition of specific securities. The unrealized losses in the State and Political Subdivisions also reflect a widening of spreads due to liquidity and credit concerns in the financial markets. The Company holds a small amount of equity securities in other financial institutions, the value of which has been impacted by the weakening conditions of the financial markets. Management believes that the unrealized losses on all other equity holdings represent temporary impairment of the securities, as the Company has the intent and ability to hold these investments until maturity or market price recovery.

## Loans

Loans receivable totaled \$464.6 million at June 30, 2011 compared to \$356.9 million as of December 31, 2010. The majority of the growth recorded in 2011 is a result of the acquisition of North Penn Bancorp. Residential real estate loans increased \$28.2 million after the sale of \$6.5 million of residential mortgages. The loans were sold for interest rate risk management to shorten the average life of the mortgage loan portfolio. Commercial loans including commercial real estate loans increased \$79.5 million during the period.

The allowance for loan losses totaled \$5,267,000 as of June 30, 2011 and represented 1.13% of total loans, compared to \$5,616,000 at December 31, 2010, and \$5,421,000 as of June 30, 2010. The Company had net charge-offs for the

six months ended June 30, 2011 of \$999,000 compared to \$512,000 in the comparable period in 2010. 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, 2011 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, 2011, non-performing loans totaled \$8.8 million, which is 1.90% of total loans compared to \$4,079,000, or 1.14% of total loans at December 31, 2010. The increase was principally due to the transfer of one credit to nonaccrual status due to the borrower's inability to make scheduled payments and the acquisition of \$2.0 million of non-performing loans from North Penn.

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

| (dollars in thousands)   | June 30,<br>2011 |   | December 31,<br>2010 |   |
|--|------------------|---|----------------------|---|
| Loans accounted for on a non-accrual basis:                        |                  |   |                      |   |
| Commercial and all other   | \$ 508           |   | \$ 513               |   |
| Real Estate  | 8,287            |   | 3,527                |   |
| Consumer   | 38               |   | -                    |   |
| Total  | 8,833            |   | 4,040                |   |
| Accruing loans which are contractually<br>past due 90 days or more | -                |   | 39                   |   |
| Total non-performing loans   | 8,833            |   | 4,079                |   |
| Foreclosed real estate   | 1,755            |   | 748                  |   |
| Total non-performing assets  | \$ 10,588        |   | \$ 4,827             |   |
| Allowance for loans losses   | \$ 5,267         |   | \$ 5,616             |   |
| Coverage of non-performing loans                                   | .60              | x | 1.38                 | x |
| Non-performing loans to total loans                                | 1.90             | % | 1.14                 | % |
| Non-performing loans to total assets                               | 1.26             | % | .76                  | % |
| Non-performing assets to total assets                              | 1.50             | % | .90                  | % |

#### Deposits

During the period, total deposits increased \$144.4 million which includes growth of \$135.4 million due to the acquisition. Other variances include a \$2.9 million increase in non-interest bearing demand deposits, a \$15.5 million increase in money market and NOW accounts, and a \$2.8 million increase in savings deposits. Certificates of deposit declined \$12.2 million due primarily to the seasonality of jumbo certificates.

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

| (dollars in thousands)        | June 30,<br>2011 | December<br>31, 2010 |
|-------------------------------|------------------|----------------------|
| Non-interest bearing demand   | \$73,718         | \$62,238             |
| Interest bearing demand       | 56,610           | 38,168               |
| Money market deposit accounts | 95,628           | 70,812               |
| Savings                       | 100,497          | 50,341               |
| Time deposits <\$100,000      | 143,474          | 112,291              |
| Time deposits >\$100,000      | 68,362           | 60,015               |

|       |           |           |
|-------|-----------|-----------|
| Total | \$538,289 | \$393,865 |
|-------|-----------|-----------|

## Borrowings

Short-term borrowings as of June 30, 2011 totaled \$32.2 million compared to \$33.3 million as of December 31, 2010. Securities sold under agreements to repurchase declined \$1.1 million principally due to the seasonality of municipal cash management accounts. Short-term borrowings consist of the following:

|  | June 30,<br>2011 | December<br>31,<br>2010 |
|--|------------------|-------------------------|
| (dollars in thousands)                         |                  |                         |
| Securities sold under agreements to repurchase | \$31,983         | \$33,110                |
| U.S. Treasury demand notes                     | 198              | 199                     |
|  | \$32,181         | \$33,309                |

Other borrowings consisted of the following:

(dollars in thousands)

|   | June 30,<br>2011 | December<br>31,<br>2010 |
|---|------------------|-------------------------|
| Notes with the FHLB:                        |                  |                         |
| Convertible note due January 2011 at 5.24%  | \$-              | \$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                   |
| Fixed rate note due July 2015 at 4.34%      | 7,761            | -                       |
| Convertible note due January 2017 at 4.71%  | 10,000           | 10,000                  |
|   | \$42,761         | \$38,000                |

The convertible notes contain an option which allows the FHLB, at quarterly intervals to change the note to an adjustable-rate advance at three month LIBOR plus 11 to 19 basis points. If the notes are converted, the option allows the Bank to put the funds back to the FHLB at no charge. The fixed rate borrowing due July 2015 includes a \$761,000 fair value adjustment recorded at the time of the acquisition.

## Off-Balance Sheet Arrangements

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

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Commitments to grant loans totaled \$43.4 million as of June 30, 2011 compared to \$21.4 million as of December 31, 2010. The increase is due to commercial real estate transactions and the North Penn acquisition.



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

|  | June 30,<br>2011 | December<br>31,<br>2010 |
|--|------------------|-------------------------|
|  | (in thousands)   |                         |
| Commitments to grant loans                 | \$43,395         | \$21,448                |
| Unfunded commitments under lines of credit | 28,910           | 30,311                  |
| Standby letters of credit                  | 5,586            | 3,605                   |
|  | \$77,891         | \$55,364                |

#### Stockholders' Equity and Capital Ratios

As of June 30, 2011, stockholders' equity totaled \$84.6 million, compared to \$67.7 million as of December 31, 2010. The net change in stockholders' equity included \$3.1 million of net income, that was partially offset by \$1.8 million of dividends declared and a \$200,000 reduction due to an increase in Treasury Stock. Total equity also increased \$14.7 million due to the capital assumed from North Penn. In addition, accumulated other comprehensive income increased \$900,000 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 and spreads, which may impact the value of the securities. Because of interest rate volatility, the Company's accumulated other comprehensive income could materially fluctuate for each interim and year-end period.

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

|   | June 30,<br>2011 | December<br>31,<br>2010 |
|---|------------------|-------------------------|
| Tier 1 Capital<br>(To average assets)       | 12.37%           | 12.41%                  |
| Tier 1 Capital<br>(To risk-weighted assets) | 15.18%           | 18.44%                  |
| Total Capital<br>(To risk-weighted assets)  | 16.31%           | 19.74%                  |

The minimum capital requirements imposed by the FDIC on the Bank for leverage, Tier 1 and Total Capital are 4%, 4% and 8%, respectively. The Company has similar capital requirements imposed by the Board of Governors of the Federal Reserve System (FRB). The Bank is also subject to more stringent Pennsylvania Department of Banking (PDB) guidelines. The Bank's capital ratios do not differ significantly from the Company's ratios. Although not adopted in regulation form, the PDB utilizes capital standards requiring a minimum of 6.5% leverage capital and 10% total capital. The Company and the Bank were in compliance with FRB, FDIC and PDB capital requirements as of June 30, 2011 and December 31, 2010.

#### Liquidity

As of June 30, 2011, the Company had cash and cash equivalents of \$45.2 million in the form of cash, due from banks, Federal Funds sold and short-term deposits with other institutions. In addition, the Company had total securities available for sale of \$152.3 million which could be used for liquidity needs. This totals \$197.5 million and



represents 28.1% of total assets compared to \$162.4 million and 30.2% of total assets as of December 31, 2010. The Company also monitors other liquidity measures, all of which were within the Company's policy guidelines as of June 30, 2011 and December 31, 2010. 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, 2011 and December 31, 2010.

The Company has a line of credit commitment from Atlantic Central Bankers Bank for \$7,000,000 which expires June 30, 2012. There were no borrowings under this line as of June 30, 2011 and December 31, 2010.

The Company has a line of credit commitment available which has no stated expiration date from PNC Bank for \$16,000,000. Borrowings under this line were \$-0- as of June 30, 2011 and December 31, 2010.

The Bank's maximum borrowing capacity with the Federal Home Loan Bank was approximately \$174,000,000 as of June 30, 2011, of which \$35,000,000 and \$38,000,000 was outstanding at June 30, 2011 and December 31, 2010 respectively. Advances from the Federal Home Loan Bank are secured by qualifying assets of the Bank.

### Non-GAAP Financial Measures

This report contains or references fully taxable-equivalent (fte) interest income and net interest income, which are non-GAAP financial measures. Interest income (fte) and net interest income (fte) are derived from GAAP interest income and net interest income using an assumed tax rate of 34%. We believe the presentation of interest income (fte) and net interest income (fte) ensures comparability of interest income and net interest income arising from both taxable and tax-exempt sources and is consistent with industry practice. Net interest income (fte) is reconciled to GAAP net interest income on pages 37 and 41. 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,<br>2011 |                 |                        | 2010                      |                 |                        |   |
|--|-------------------------------------|-----------------|------------------------|---------------------------|-----------------|------------------------|---|
|  | Average<br>Balance<br>(2)           | Interest<br>(1) | Average<br>Rate<br>(3) | Average<br>Balance<br>(2) | Interest<br>(1) | Average<br>Rate<br>(3) |   |
| Assets                                     |                                     |                 |                        |                           |                 |                        |   |
| Interest-earning assets:                   |                                     |                 |                        |                           |                 |                        |   |
| Federal funds sold                         | \$615                               | \$-             | 0.07                   | % \$3,000                 | \$2             | 0.33                   | % |
| Interest bearing deposits with<br>banks    | 25,136                              | 16              | 0.25                   | 22,263                    | 15              | 0.27                   |   |
| Securities held-to-maturity                | 170                                 | 4               | 9.41                   | 169                       | 3               | 8.12                   |   |
| Securities available for sale:             |                                     |                 |                        |                           |                 |                        |   |
| Taxable                                    | 101,963                             | 695             | 2.73                   | 95,367                    | 782             | 3.28                   |   |
| Tax-exempt(1)                              | 46,847                              | 662             | 5.65                   | 36,795                    | 541             | 5.88                   |   |
| Total securities available<br>for sale (1) | 148,810                             | 1,357           | 3.65                   | 132,162                   | 1,323           | 4.00                   |   |
| Loans receivable (1) (4) (5)               | 387,203                             | 5,517           | 5.70                   | 353,468                   | 5,267           | 5.96                   |   |
| Total interest earning<br>assets           | 561,934                             | 6,894           | 4.91                   | 511,062                   | 6,610           | 5.17                   |   |
| Non-interest earning assets:               |                                     |                 |                        |                           |                 |                        |   |
| Cash and due from banks                    | 7,443                               |                 |                        | 7,295                     |                 |                        |   |
| Allowance for loan losses                  | (5,753                              | )               |                        | (5,414                    | )               |                        |   |
| Other assets                               | 33,047                              |                 |                        | 22,129                    |                 |                        |   |
| Total non-interest earning<br>assets       | 34,737                              |                 |                        | 24,010                    |                 |                        |   |
| Total Assets                               | \$596,671                           |                 |                        | \$535,072                 |                 |                        |   |
| Liabilities and Stockholders'<br>Equity    |                                     |                 |                        |                           |                 |                        |   |
| Interest bearing liabilities:              |                                     |                 |                        |                           |                 |                        |   |
| Interest bearing demand and<br>money       |                                     |                 |                        |                           |                 |                        |   |
| market                                     | \$126,053                           | 132             | 0.42                   | \$108,011                 | 97              | 0.36                   |   |
| Savings                                    | 68,622                              | 53              | 0.31                   | 48,355                    | 29              | 0.24                   |   |
| Time                                       | 185,475                             | 747             | 1.61                   | 181,163                   | 921             | 2.03                   |   |
| Total interest bearing<br>deposits         | 380,150                             | 932             | 0.98                   | 337,529                   | 1,047           | 1.24                   |   |
| Short-term borrowings                      | 30,634                              | 27              | 0.35                   | 22,605                    | 81              | 1.43                   |   |
| Other borrowings                           | 37,563                              | 342             | 3.64                   | 43,000                    | 416             | 3.87                   |   |
| Total interest bearing<br>liabilities      | 448,347                             | 1,301           | 1.16                   | 403,134                   | 1,544           | 1.53                   |   |
| Non-interest bearing liabilities:          |                                     |                 |                        |                           |                 |                        |   |
| Demand deposits                            | 67,922                              |                 |                        | 61,528                    |                 |                        |   |
| Other liabilities                          | 4,881                               |                 |                        | 4,306                     |                 |                        |   |
| Total non-interest bearing<br>liabilities  | 72,803                              |                 |                        | 65,834                    |                 |                        |   |

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|  |           |           |
|--|-----------|-----------|
| Stockholders' equity                       | 75,521    | 66,104    |
| Total Liabilities and Stockholders' Equity | \$596,671 | \$535,072 |

|  |         |      |   |         |      |   |
|--|---------|------|---|---------|------|---|
| Net interest income (tax equivalent basis) | 5,593   | 3.75 | % | 5,066   | 3.64 | % |
| Tax-equivalent basis adjustment            | (275 )  |      |   | (234 )  |      |   |
| Net interest income                        | \$5,318 |      |   | \$4,832 |      |   |
| Net interest margin (tax equivalent basis) |         | 3.98 | % |         | 3.96 | % |

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

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

(3) Annualized

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

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

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

|  | Increase/(Decrease)              |            |        |
|--|----------------------------------|------------|--------|
|  | Three months ended June 30, 2011 |            |        |
|  | Compared to                      |            |        |
|  | Three months ended June 30, 2010 |            |        |
|  | Variance due to                  |            |        |
|  | Volume                           | Rate       | Net    |
|  | (dollars in thousands)           |            |        |
| Interest earning assets:                   |                                  |            |        |
| Federal funds sold                         | \$(1 )                           | \$(1 )     | \$(2 ) |
| Interest bearing deposits with banks       | 6                                | (5 )       | 1      |
| Securities held to maturity                | -                                | 1          | 1      |
| Securities available for sale:             |                                  |            |        |
| Taxable                                    | 282                              | (369 )     | (87 )  |
| Tax-exempt securities                      | 254                              | (133 )     | 121    |
| Total securities                           | 536                              | (502 )     | 34     |
| Loans receivable                           | 1,432                            | (1,181 )   | 251    |
| Total interest earning assets              | 1,973                            | (1,688 )   | 284    |
| Interest bearing liabilities:              |                                  |            |        |
| Interest-bearing demand and money market   | 18                               | 17         | 35     |
| Savings                                    | 14                               | 10         | 24     |
| Time                                       | 139                              | (314 )     | (174 ) |
| Total interest bearing deposits            | 171                              | (287 )     | (115 ) |
| Short-term borrowings                      | 138                              | (192 )     | (54 )  |
| Other borrowings                           | (50 )                            | (24 )      | (74 )  |
| Total interest bearing liabilities         | 259                              | (503 )     | (243 ) |
| Net interest income (tax-equivalent basis) | \$1,713                          | \$(1,186 ) | \$527  |

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

## Comparison of Operating Results for The Three Months Ended June 30, 2011 to June 30, 2010

## General

For the three months ended June 30, 2011, net income totaled \$1,484,000 compared to \$1,818,000 earned in the similar period in 2010. Earnings per share for the current period were \$.50 for basic and fully diluted compared to \$.66 per share for the three months ended June 30, 2010. The resulting annualized return on average assets and annualized return on average equity for the three months ended June 30, 2011 was 1.00% and 7.88%, respectively, compared to 1.36% and 11.03%, respectively, for the similar period in 2010.

The following table sets forth changes in net income:

| (dollars in thousands)                      | Three months ended<br>June 30, 2011 to June 30, 2010 |       |
|---|--|-------|
| Net income three months ended June 30, 2010 | \$   | 1,818 |
| Change due to:                              |  |       |
| Net interest income                         |  | 486   |
| Provision for loan losses                   |  | (280) |
| Gain on sales of loans and securities       |  | (84)  |
| Other income                                |  | 61    |
| Salaries and employee benefits              |  | (260) |
| Occupancy, furniture and equipment          |  | -     |
| Merger related expenses                     |  | (488) |
| All other expenses                          |  | (12)  |
| Income tax expense                          |  | 243   |
| Net income three months ended June 30, 2011 | \$   | 1,484 |

## Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the three months ended June 30, 2011, totaled \$5,593,000, an increase of \$527,000 or 10.4% from the similar period in 2010. The fte net interest spread and net interest margin were 3.75% and 3.98%, respectively, for the three months ended June 30, 2011 compared to 3.64% and 3.96%, respectively, for the similar period in 2010.

Interest income (fte) totaled \$6,894,000 with a yield on average earning assets of 4.91% compared to \$6,610,000 and 5.17% for the 2010 period. The decrease in yield was due to the reinvestment of securities cash flow and new purchases of securities at lower than historical rates, resulting in a 55 basis point decrease in the yield earned on taxable securities. The yields earned on money market investments and tax-free securities were comparable to the second three months of 2010, while the yield on loans receivable decreased 26 basis points due to a higher level of non-performing assets. Average earning assets totaled \$561.9 million for the three months ended June 30, 2011, an increase of \$50.9 million over the average for the similar period in 2010. This increase in average earning assets helped offset the decline in asset yields.

Interest expense for the three months ended June 30, 2011 totaled \$1,301,000 at an average cost of 1.16% compared to \$1,544,000 and 1.53% for the similar period in 2010. As a result of the continued low interest rate environment, the Company further 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 is the most significant component of funding, declined to 1.61% from 2.03% for the similar period in the prior year. As time deposits matured, they repriced at the current lower rates resulting in the decrease.

#### Provision for Loan Losses

The Company's provision for loan losses for the three months ended June 30, 2011 was \$430,000 compared to \$150,000 for the three months ended June 30, 2010. The Company makes provisions for loan losses in an amount necessary to maintain the allowance for loan losses at an acceptable level. The increase in the provision reflects an increase in net charge-offs during the quarter. Net charge-offs were \$943,000 for the quarter ended June 30, 2011 compared to \$91,000 for the similar period in 2010. The increase in charge-offs during the second quarter is due primarily to one credit which has been carried in nonaccrual status.

#### Other Income

Other income totaled \$993,000 for the three months ended June 30, 2011 compared to \$1,016,000 for the similar period in 2010. The current period includes a \$98,000 gain on the sale of \$1.8 million of fixed residential mortgages compared to \$130,000 in gains on the sale of \$6.1 million of mortgages in the similar period of 2010. The current period also includes a \$12,000 gain on the sale of investment securities compared to a \$64,000 gain in the second quarter of 2010. All other service charges and fees increased \$61,000 compared to the second quarter of last year including a \$12,000 increase in earnings from fiduciary activities and a \$22,000 improvement in service charges on deposits.

#### Other Expense

Other expense for the three months ended June 30, 2011 totaled \$3,936,000, or an increase of \$760,000 from \$3,176,000 for the similar period in 2010. Merger related expenses totaled \$488,000 in the second quarter while salary and benefit costs increased \$260,000 or 16.5% due to staffing increases related to the acquisition.

#### Income Tax Expense

Income tax expense totaled \$461,000 for an effective tax rate of 23.7% for the period ending June 30, 2011 compared to \$704,000 for an effective tax rate of 27.9% for the similar period in 2010 due primarily to the \$10 million increase in average tax-exempt securities.



## 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, |                 |                        |                           |                 |                        |
|--|---------------------------|-----------------|------------------------|---------------------------|-----------------|------------------------|
|  | 2011                      |                 | 2010                   |                           |                 |                        |
|  | Average<br>Balance<br>(2) | Interest<br>(1) | Average<br>Rate<br>(3) | Average<br>Balance<br>(2) | Interest<br>(1) | Average<br>Rate<br>(3) |
| Assets   |                           |                 |                        |                           |                 |                        |
| Interest-earning assets:                       |                           |                 |                        |                           |                 |                        |
| Federal funds sold                             | \$392                     | \$-             | 0.12                   | % \$3,000                 | \$5             | 0.33                   |
| Interest bearing deposits with<br>banks        | 17,890                    | 24              | 0.27                   | 16,805                    | 24              | 0.28                   |
| Securities held-to-maturity<br>(1)             | 170                       | 7               | 8.24                   | 392                       | 17              | 8.61                   |
| Securities available for sale:                 |                           |                 |                        |                           |                 |                        |
| Taxable  | 99,738                    | 1,345           | 2.70                   | 96,425                    | 1,685           | 3.49                   |
| Tax-exempt (1)                                 | 46,739                    | 1,326           | 5.67                   | 34,384                    | 1,009           | 5.87                   |
| Total securities available<br>for sale (1)     | 146,477                   | 2,671           | 3.65                   | 130,809                   | 2,694           | 4.12                   |
| Loans receivable (4) (5)                       | 370,255                   | 10,487          | 5.66                   | 356,088                   | 10,718          | 6.02                   |
| Total interest earning<br>assets               | 535,184                   | 13,189          | 4.93                   | 507,094                   | 13,458          | 5.31                   |
| Non-interest earning assets:                   |                           |                 |                        |                           |                 |                        |
| Cash and due from banks                        | 7,122                     |                 |                        | 7,027                     |                 |                        |
| Allowance for loan losses                      | (5,747                    | )               |                        | (5,426                    | )               |                        |
| Other assets                                   | 27,365                    |                 |                        | 22,176                    |                 |                        |
| Total non-interest earning<br>assets           | 28,740                    |                 |                        | 23,777                    |                 |                        |
| Total Assets                                   | \$563,924                 |                 |                        | \$530,871                 |                 |                        |
| Liabilities and Stockholders'<br>Equity        |                           |                 |                        |                           |                 |                        |
| Interest bearing liabilities:                  |                           |                 |                        |                           |                 |                        |
| Interest bearing demand and<br>money<br>market | \$117,545                 | 240             | 0.41                   | \$102,643                 | 297             | 0.58                   |
| Savings  | 60,022                    | 78              | 0.26                   | 47,218                    | 57              | 0.24                   |
| Time   | 179,234                   | 1,499           | 1.67                   | 184,047                   | 1,947           | 2.12                   |
| Total interest bearing<br>deposits             | 356,801                   | 1,817           | 1.02                   | 333,908                   | 2,301           | 1.38                   |
| Short-term borrowings                          | 29,234                    | 51              | 0.35                   | 23,717                    | 61              | 0.51                   |
| Other borrowings                               | 36,588                    | 678             | 3.71                   | 43,000                    | 827             | 3.85                   |
| Total interest bearing<br>liabilities          | 422,623                   | 2,546           | 1.20                   | 400,625                   | 3,189           | 1.59                   |
| Non-interest bearing liabilities:              |                           |                 |                        |                           |                 |                        |
| Demand deposits                                | 64,907                    |                 |                        | 60,057                    |                 |                        |
| Other liabilities                              | 4,750                     |                 |                        | 4,289                     |                 |                        |

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|  |           |           |
|--|-----------|-----------|
| Total non-interest bearing liabilities     | 69,657    | 64,346    |
| Stockholders' equity                       | 71,644    | 65,900    |
| Total Liabilities and Stockholders' Equity | \$563,924 | \$530,871 |

|  |          |      |   |         |      |   |
|--|----------|------|---|---------|------|---|
| Net interest income (tax equivalent basis) | 10,643   | 3.72 | % | 10,269  | 3.72 | % |
| Tax-equivalent basis adjustment            | (544 )   |      |   | (440 )  |      |   |
| Net interest income                        | \$10,099 |      |   | \$9,829 |      |   |
| Net interest margin (tax equivalent basis) |          | 3.98 | % |         | 4.05 | % |

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

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

(3) Annualized

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

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

## Rate/Volume Analysis

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

|  | Increase/(Decrease)            |            |        |
|--|--------------------------------|------------|--------|
|  | Six Months Ended June 30, 2011 |            |        |
|  | Compared to                    |            |        |
|  | Six Months Ended June 30, 2010 |            |        |
|  | Variance due to                |            |        |
|  | Volume                         | Rate       | Net    |
|  | (dollars in thousands)         |            |        |
| Interest earning assets:                   |                                |            |        |
| Federal funds sold                         | \$(3 )                         | \$(2 )     | \$(5 ) |
| Interest bearing deposits with banks       | 3                              | (3 )       | -      |
| Securities held to maturity                | (9 )                           | (1 )       | (10 )  |
| Securities available for sale:             |                                |            |        |
| Taxable                                    | 157                            | (497 )     | (340 ) |
| Tax-exempt securities                      | 413                            | (96 )      | 317    |
| Total securities                           | 570                            | (593 )     | (23 )  |
| Loans receivable                           | 926                            | (1,157 )   | (231 ) |
| Total interest earning assets              | 1,487                          | (1,756 )   | (269 ) |
| Interest bearing liabilities:              |                                |            |        |
| Interest-bearing demand and money market   | 97                             | (154 )     | (57 )  |
| Savings                                    | 16                             | 5          | 21     |
| Time                                       | (50 )                          | (398 )     | (448 ) |
| Total interest bearing deposits            | 63                             | (547 )     | (484 ) |
| Short-term borrowings                      | 28                             | (38 )      | (10 )  |
| Other borrowings                           | (120 )                         | (29 )      | (149 ) |
| Total interest bearing liabilities         | (29 )                          | (614 )     | (643 ) |
| Net interest income (tax-equivalent basis) | \$1,516                        | \$(1,142 ) | \$374  |

## Comparison of Operating Results for Six Months Ended June 30, 2011 and June 30, 2010

## General

For the six months ended June 30, 2011, net income totaled \$3,144,000 compared to \$3,615,000 earned in the similar period of 2010. Earnings per share for the current period were \$1.10 per share for both basic and diluted per share compared to \$1.31 per share for the six months ended June 30, 2010. The resulting annualized return on average assets and annualized return on average equity for the six months ended June 30, 2011 was 1.12% and 8.85% and 1.37% and 11.06%, respectively, for the similar period in 2010.

The following table sets forth changes in net income:

| (dollars in thousands)                          | Six Months Ended<br>June 30, 2011 to<br>June 30, 2010 |        |
|---|---|--------|
| Net income six months ended June 30, 2010       | \$  | 3,615  |
| Change due to:                                  |   |        |
| Net interest income                             |   | 270    |
| Provision for loan losses                       |   | (170 ) |
| Gain on sales of loans and securities           |   | 41     |
| Other income                                    |   | 142    |
| Salaries and employee benefits                  |   | (346 ) |
| Occupancy, furniture and equipment expense, net |   | (4 )   |
| Merger related expenses                         |   | (755 ) |
| All other expenses                              |   | (29 )  |
| Income tax expense                              |   | 380    |
| Net income six months ended June 30, 2011       | \$  | 3,144  |

## Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the six months ended June 30, 2011 totaled \$10,643,000, an increase of \$374,000, or 3.6% over the similar period in 2010. The fte net interest spread and net interest margin were 3.72% and 3.98% respectively, compared to 3.72% and 4.05% respectively for the similar period in 2010.

Interest income (fte) totaled \$13,189,000 with a yield on average earning assets of 4.93% compared to \$13,458,000 and 5.31% for the similar period in 2010. 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 5.66% down from 6.02% in the 2010 period. The yield on investment securities also declined 47 basis points reflecting the reinvestment of cash flow, maturities and calls at the current lower rate. Average earning assets totaled \$535.2 million for the six months ended June 30, 2011 an increase of \$28.1 million over the similar period in 2010. The growth in average earning assets helped offset the decline in asset yields.

Interest expense for the six months ended June 30, 2011 totaled \$2,546,000 with an average cost of 1.20% compared to \$3,189,000 and 1.59% for the 2010 period. The Company reduced rates paid on its deposits by 36 basis points and short-term borrowings by 16 basis points. The cost of time deposits which is the largest component of

interest expense was 1.67% for the 2011 period decreasing from 2.12% in 2010. This reflects time deposits maturing and repricing at the current lower rates.

#### Provision for Loan Losses

The Company's provision for loan losses for the six months ended June 30, 2011 was \$650,000 compared to \$480,000 for the six months ended June 30, 2010. The Company makes provisions for loan losses in an amount necessary to maintain the allowance for loan losses at an acceptable level. The increase in the provision reflects an increase in net charge-offs during the six months ended June 30, 2011. Net charge-offs were \$1.0 million for the six months ended June 30, 2011 compared to \$512,000 for the similar period in 2010. The increase in charge-offs during the 2011 period is due primarily to one credit which has been carried in nonaccrual status.

#### Other Income

Other income totaled \$2,201,000 for the six months ended June 30, 2011 compared to \$2,018,000 for the similar period in 2010. The current period includes \$241,000 in gains on the sale of \$6.5 million of residential mortgage loans compared to \$205,000 in similar gains on the sales of \$10.5 million of mortgage loans in the 2010 period. Gains on the sale investment securities totaled \$224,000 on sales of \$10.3 million for the 2011 period compared to \$219,000 of gains on sales of \$12.6 million in the similar 2010 period. The proceeds from investment securities sales were reinvested to improve credit quality in the Company's municipal bond portfolio.

#### Other Expenses

Other expense totaled \$7,470,000 for the six months ended June 30, 2011 an increase of \$1,134,000 compared to \$6,336,000 for the similar period in 2010. The majority of the increase was related to the \$755,000 of merger related costs incurred in 2011. Salary and benefit costs also increased due to new hires and merit increases. The efficiency ratio for the 2011 period was 60.7% compared to 53.4% in the 2010 period due to the acquisition costs recorded in 2011.

#### Income Tax Expense

Income tax expense totaled \$1,036,000 for an effective tax rate of 24.8% in the 2011 period compared to \$1,416,000 and 28.1% in 2010. 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, 2011, the level of net interest income at risk in a 200 basis point 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 for a  $\pm$  200 basis point shift in interest rates.



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

As of June 30, 2011, the Company had a positive 90 day interest sensitivity gap of \$67.5 million or 9.6% of total assets, an increase from the \$41.3 million or 7.7% of total assets as of December 31, 2010. Rate sensitive assets repricing within 90 days increased \$57.9 million due to loans acquired and a higher level of overnight liquidity. Time deposits repricing within 90 days increased \$5.6 million, while non-maturity interest bearing balances increased \$14.2 million and other borrowings increased \$11.9 million due primarily to the acquisition. A positive gap means that rate-sensitive assets are greater than rate-sensitive liabilities at the time interval. This would indicate that in a rising rate environment, the yield on interest-earning assets could increase faster than the cost of interest-bearing liabilities in the 90 day time frame. The repricing intervals are managed by ALCO strategies, including adjusting the average life of the investment portfolio, pricing of deposit liabilities to attract longer term time deposits, loan pricing to encourage variable rate products and evaluation of loan sales of long-term fixed rate mortgages.

June 30, 2011

Rate Sensitivity Table

(dollars in thousands)

|  | 3 Months | 3-12<br>Months | 1 to 3<br>Years | Over<br>3 Years | Total     |
|--|----------|----------------|-----------------|-----------------|-----------|
| Federal funds sold and interest bearing deposits | \$35,692 | \$250          | \$-             | \$-             | \$35,942  |
| Securities                                       | 9,171    | 24,849         | 46,739          | 71,686          | 152,445   |
| Loans Receivable                                 | 120,098  | 87,355         | 142,539         | 114,654         | 464,646   |
| Total RSA  | 164,961  | 112,454        | 189,278         | 186,340         | 653,033   |
| Non-maturity interest-bearing deposits           | 39,435   | 43,139         | 113,772         | 56,389          | 252,735   |
| Time Deposits                                    | 35,581   | 80,619         | 66,986          | 26,650          | 211,836   |
| Other  | 22,403   | 10,793         | 23,986          | 17,760          | 74,942    |
| Total RSL  | 97,419   | 134,551        | 206,744         | 100,799         | 539,513   |
| Interest Sensitivity Gap                         | \$67,542 | \$(22,097)     | \$(17,466)      | \$85,541        | \$113,520 |
| Cumulative Gap                                   | 67,542   | 45,445         | 27,979          | 113,520         |           |
| RSA/RSL-cumulative                               | 169.3    | % 119.6        | % 106.4         | % 121.0         | %         |

December 31, 2010

|                          |          |            |          |          |           |
|--------------------------|----------|------------|----------|----------|-----------|
| Interest Sensitivity Gap | \$41,341 | \$(33,613) | \$10,969 | \$92,050 | \$110,747 |
| Cumulative Gap           | 41,341   | 7,728      | 18,697   | 110,747  |           |
| RSA/RSL-cumulative       | 162.9    | % 103.9    | % 105.5  | % 127.5  | %         |

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 1 of the Company's Form 10-K for the year ended December 31, 2010.

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

|                           | Issuer Purchases of Equity Securities |                              |  | Maximum number of shares (or approximate dollar value) that may yet be purchased under the plans or programs (2) |
|---------------------------|---------------------------------------|------------------------------|--|--|
|                           | Total number of shares purchased      | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs |  |
| April 1–April 30, 2011(1) | 468                                   | \$27.77                      | 0  | 85,532   |
| May 1–May 31, 2011        | 0                                     | 0                            | 0  | 0  |
| June 1 – June 30, 2011(1) | 72                                    | 27.77                        | 0  | 85,460   |
|                           | 540                                   | \$27.77                      | 0  | 85,460   |

(1) Purchases related to the Company's Employee Stock Ownership Plan (ESOP) related to purchases of shares from terminated employees and voluntary diversification.

(2) On March 19, 2008 the Company announced its intention to repurchase up to 5% of its outstanding common stock (approximately 137,000 shares) in the open market.

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Removed and Reserved

Item 5. Other Information

None

Item 6. Exhibits

| No.   | Description  |
|-------|--|
| 3(i)  | Articles of Incorporation of Norwood Financial Corp.(1)  |
| 3(ii) | Bylaws of Norwood Financial Corp. (2)  |
| 4.0   | Specimen Stock Certificate of Norwood Financial Corp. (1)  |
| 10.1  | Employment Agreement with Lewis J. Critelli (2)  |
| 10.2  | Change in Control Severance Agreement with William S. Lance(2)                                       |
| 10.3  | Norwood Financial Corp. Stock Option Plan (4)  |
| 10.4  | Salary Continuation Agreement between the Bank and William W. Davis, Jr. (3)                         |
| 10.5  | Salary Continuation Agreement between the Bank and Lewis J. Critelli (3)                             |
| 10.6  | Salary Continuation Agreement between the Bank and Edward C. Kasper (3)                              |
| 10.7  | 1999 Directors Stock Compensation Plan (3)   |
| 10.8  | Salary Continuation Agreement between the Bank and Joseph A. Kneller (5)                             |
| 10.9  | Salary Continuation Agreement between the Bank and John H. Sanders (5)                               |
| 10.10 | 2006 Stock Option Plan (6)   |
| 10.11 | First and Second Amendments to Salary Continuation Agreement with William W. Davis, Jr. (7)          |
| 10.12 | First and Second Amendments to Salary Continuation Agreement with Lewis J. Critelli (7)              |
| 10.13 | First and Second Amendments to Salary Continuation Agreement with Edward C. Kasper (7)               |
| 10.14 | First and Second Amendments to Salary Continuation Agreement with Joseph A. Kneller (7)              |
| 10.15 | First and Second Amendments to Salary Continuation Agreement with John H. Sanders (7)                |
| 31    | Rule 13a-14(a)/15d-14(a) Certification of CEO and CFO  |
| 32    | Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of Sarbanes Oxley Act of 2002 |
| 101   | Interactive Data Files (to be filed by Amendment)  |

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(1) Incorporated herein by reference into this document from the Exhibits to Form 10, Registration Statement initially filed with the Commission on April 29, 1996, Registration No. 0-28364

(2) Incorporated by reference into this document from the identically numbered exhibits to the Registrant's Form 10-K filed with the Commission on March 15, 2010.

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- (3) Incorporated herein by reference to the identically numbered exhibits of the Registrant's Form 10-K filed with the Commission on March 23, 2000.
- (4) Incorporated by reference into this document from the Exhibits to Form S-8 filed with the Commission on August 14, 1998, File No. 333-61487.
- (5) Incorporated herein by reference to the identically numbered exhibit to the Registrant's Form 10-K filed with the Commission on March 22, 2004.
- (6) Incorporated by reference to this document from Exhibit 4.1 to Registrant's Registration Statement on Form S-8 (File No. 333-134831) filed with the Commission on June 8, 2006.
- (7) Incorporated herein by reference from the Exhibits to the Registrant's Current Report on Form 8-K filed on April 4, 2006.

- (6) Incorporated by reference to this document from Exhibit 4.1 to Registrant's Registration Statement on Form S-8 (File No. 333-134831) filed with the Commission on June 8, 2006.
- (7) Incorporated herein by reference from the Exhibits to the Registrant's Current Report on Form 8-K filed on April 4, 2006.

Signatures

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

NORWOOD FINANCIAL CORP.

Date: August 9, 2011

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

Date: August 9, 2011

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