

NORWOOD FINANCIAL CORP
Form 10-Q
May 09, 2011

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 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.

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

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

| Class | Outstanding as of May 3, 2011 |
|--|-------------------------------|
| Common stock, par value \$0.10 per share | 2,761,444 |

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

| | March 31, 2011 | December 31, 2010 |
|--|-------------------|-------------------------|
| ASSETS | | |
| Cash and due from banks | \$5,670 | \$5,782 |
| Interest bearing deposits with banks | 13,864 | 7,843 |
| Federal funds sold | 0 | 3,000 |
| Cash and cash equivalents | 19,534 | 16,625 |
| Securities available for sale | 143,104 | 145,815 |
| Securities held to maturity, fair value 2011: \$177, 2010: \$179 | 170 | 170 |
| Loans receivable (net of unearned income) | 350,128 | 356,855 |
| Less: Allowance for loan losses | 5,780 | 5,616 |
| Net loans receivable | 344,348 | 351,239 |
| Investment in Federal Home Loan Bank Stock, at cost | 3,193 | 3,361 |
| Bank premises and equipment, net | 4,798 | 4,904 |
| Bank owned life insurance | 8,333 | 8,249 |
| Accrued interest receivable | 2,191 | 2,166 |
| Foreclosed real estate owned | 948 | 748 |
| Other assets | 4,307 | 3,728 |
| TOTAL ASSETS | \$530,926 | \$537,005 |
| LIABILITIES | | |
| Deposits: | | |
| Non-interest bearing demand | \$62,736 | \$62,238 |
| Interest-bearing | 334,384 | 331,627 |
| Total deposits | 397,120 | 393,865 |
| Short-term borrowings | 25,465 | 33,309 |
| Other borrowings | 35,000 | 38,000 |
| Accrued interest payable | 1,342 | 1,536 |
| Other liabilities | 3,424 | 2,597 |
| TOTAL LIABILITIES | 462,351 | 469,307 |
| STOCKHOLDERS' EQUITY | | |
| Common stock, \$.10 par value per share, authorized 10,000,000; shares issued 2,840,872 | 284 | 284 |
| Surplus | 9,867 | 9,826 |
| Retained earnings | 59,507 | 58,648 |
| Treasury stock at cost: 2011: 78,960 shares, 2010: 72,068 | (2,388) | (2,197) |
| Accumulated other comprehensive income | 1,305 | 1,137 |
| TOTAL STOCKHOLDERS' EQUITY | 68,575 | 67,698 |

| | | |
|---|-----------|-----------|
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$530,926 | \$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 March 31, | |
|--|---------------------------------|---------|
| | 2011 | 2010 |
| INTEREST INCOME | | |
| Loans receivable, including fees | \$4,928 | \$5,410 |
| Securities | 1,090 | 1,221 |
| Other | 8 | 11 |
| Total interest income | 6,026 | 6,642 |
| INTEREST EXPENSE | | |
| Deposits | 885 | 1,199 |
| Short-term borrowings | 24 | 34 |
| Other borrowings | 336 | 412 |
| Total interest expense | 1,245 | 1,645 |
| NET INTEREST INCOME | 4,781 | 4,997 |
| PROVISION FOR LOAN LOSSES | 220 | 330 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 4,561 | 4,667 |
| OTHER INCOME | | |
| Service charges and fees | 549 | 523 |
| Income from fiduciary activities | 113 | 86 |
| Net realized gains on sales of securities | 212 | 155 |
| Gains on sale of loans and servicing rights | 143 | 75 |
| Other | 191 | 163 |
| Total other income | 1,208 | 1,002 |
| OTHER EXPENSES | | |
| Salaries and employee benefits | 1,701 | 1,615 |
| Occupancy, furniture & equipment, net | 398 | 394 |
| Data processing related | 215 | 196 |
| Taxes, other than income | 129 | 147 |
| Professional fees | 134 | 139 |
| Merger related expenses | 267 | - |
| Federal Deposit Insurance Corporation Insurance assessment | 120 | 118 |
| Foreclosed real estate owned | 19 | 16 |
| Other | 551 | 535 |
| Total other expenses | 3,534 | 3,160 |
| INCOME BEFORE INCOME TAXES | 2,235 | 2,509 |
| INCOME TAX EXPENSE | 575 | 712 |
| NET INCOME | \$1,660 | \$1,797 |
| BASIC EARNINGS PER SHARE | \$0.60 | \$0.65 |

| | | |
|----------------------------|--------|--------|
| DILUTED EARNINGS PER SHARE | \$0.60 | \$0.65 |
|----------------------------|--------|--------|

See accompanying notes to the unaudited consolidated financial statements.

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NORWOOD FINANCIAL CORP.

Consolidated Statements of Changes in Stockholders' Equity (unaudited)

Three Months ended March 31, 2011

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

| | Common Stock | | | Retained | Treasury Stock | | Accumulated Other Comprehensive | |
|--|--------------|--------|----------|-----------|----------------|-------------|---------------------------------------|-----------|
| | Shares | Amount | Surplus | Earnings | Shares | Amount | Income | Total |
| Balance December 31, 2010 | 2,840,872 | \$ 284 | \$ 9,826 | \$ 58,648 | 72,068 | \$ (2,197) | \$ 1,137 | \$ 67,698 |
| Comprehensive Income: | | | | | | | | |
| Net Income | | | | 1,660 | | | | 1,660 |
| Change in unrealized gains on securities available for sale, net of reclassification adjustments and tax effects | | | | | | | 168 | 168 |
| Total comprehensive income | | | | | | | | \$ 1,828 |
| Cash dividends declared \$.29 per share | | | | (801) | | | | (801) |
| Acquisition of treasury stock | | | | | 6,892 | (191) | | (191) |
| Compensation expense related to stock options | | | 41 | | | | | 41 |
| Balance, March 31, 2011 | 2,840,872 | \$ 284 | \$ 9,867 | \$ 59,507 | 78,960 | \$ (2,388) | \$ 1,305 | \$ 68,575 |

See accompanying notes to the unaudited consolidated financial statements.

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

| | Three Months Ended March 31, | |
|---|---------------------------------|------------|
| | 2011 | 2010 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net Income | \$1,660 | \$1,797 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 220 | 330 |
| Depreciation | 110 | 117 |
| Amortization of intangible assets | 13 | 13 |
| Deferred income taxes | (84) |) 28 |
| Net amortization of securities premiums and discounts | 179 | 59 |
| Net realized gain on sales of securities | (212) |) (155) |
| Net increase in investment in life insurance | (84) |) (95) |
| Net gain on sale of mortgage loans and servicing rights | (143) |) (75) |
| Mortgage loans originated for sale | (4,692) |) (4,300) |
| Proceeds from sale of mortgage loans originated for sale | 4,835 | 4,375 |
| Compensation expense related to stock options | 41 | 39 |
| Decrease (increase) in accrued interest receivable and other assets | (615) |) 199 |
| Increase in accrued interest payable and other liabilities | 635 | 33 |
| Net cash provided by operating activities | 1,863 | 2,365 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Securities available for sale: | | |
| Proceeds from sales | 6,187 | 8,837 |
| Proceeds from maturities and principal reductions on mortgage-backed securities | 7,113 | 15,055 |
| Purchases | (10,302) |) (18,748) |
| Securities held to maturity, proceeds from maturities | - | 540 |
| Redemption of FHLB stock | 168 | - |
| Net decrease in loans | 6,467 | 5,396 |
| Purchase of bank premises and equipment | (4) |) (54) |
| Net cash provided by investing activities | 9,629 | 11,026 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Net increase in deposits | 3,255 | 183 |
| Net decrease in short-term borrowings | (7,844) |) (4,022) |
| Repayments of other borrowings | (3,000) |) - |
| Stock options exercised | - | 10 |
| Tax benefit of stock options exercised | - | 5 |
| Acquisition of treasury stock | (191) |) (529) |
| Cash dividends paid | (803) |) (776) |
| Net cash used in financing activities | (8,583) |) (5,129) |
| Increase in cash and cash equivalents | 2,909 | 8,262 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 16,625 | 17,355 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$19,534 | \$25,617 |

See accompanying notes to the unaudited consolidated financial statements.

Notes to the Unaudited Consolidated Financial Statements

1. Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in conformity with generally accepted accounting principles for interim financial statements and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ from those estimates. The financial statements reflect, in the opinion of management, all normal, recurring adjustments necessary to present fairly the financial position and results of operations of the Company. The operating results for the three month period ended March 31, 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 March 31, | |
|---|---------------------------------|-------|
| | 2011 | 2010 |
| Basic EPS weighted average shares outstanding | 2,767 | 2,768 |
| Dilutive effect of stock options | 3 | 7 |
| Diluted EPS weighted average shares outstanding | 2,770 | 2,775 |

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 163,150 and 137,150 as of March 31, 2011 and 2010, respectively based upon the closing price of Norwood stock of \$27.25 and \$27.00 per share on March 31, 2011 and 2010.

3. Stock-Based Compensation

The Company's shareholders approved the Norwood Financial Corp 2006 Stock Option Plan at the annual meeting on April 25, 2006 and the Company awarded 47,700 options in 2006, 22,000 options in 2007, 24,000 options in 2008, 27,000 options in 2009 and 28,000 options in 2010, all of which have a twelve month vesting period. As of March 31, 2011, there was \$123,000 of total unrecognized compensation cost related to non-vested options granted in 2010 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 Average Exercise Price Per Share | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value (\$000) |
|--------------------------------|---------|--|---|---|
| Outstanding at January 1, 2011 | 189,639 | \$ 28.52 | 6.6 Yrs. | \$ 146 |
| Granted | - | - | - | - |
| Exercised | - | - | - | - |
| Outstanding at March 31, 2011 | 189,639 | \$ 28.52 | 6.3Yrs. | \$ 126 |
| Exercisable at March 31, 2011 | 162,639 | \$ 28.65 | 4.9Yrs. | \$ 126 |

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 \$27.25 as of March 31, 2011 and \$27.77 as of December 31, 2010. During the three months ended March 31, 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 March 31, 2011 and 2010 were \$1,440,000 and \$2,121,000, respectively. Cash payments for income taxes for the periods ending March 31, 2011 and 2010 were \$3,000 and \$3,000, respectively. Non-cash investing activity for 2011 and 2010 included repossession of other assets and foreclosed mortgage loans transferred to real estate owned of \$204,000 and \$70,000, 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 | |
|---------------------------------------|--------------------|--------|
| | March 31, 2011 | 2010 |
| Unrealized holding gains | | |
| on available for sale securities | \$466 | \$279 |
| Reclassification adjustment for gains | | |
| Realized in income | (212) | (155) |
| Net unrealized gains | 254 | 124 |
| Income tax expense | 86 | 43 |
| Other comprehensive income | \$168 | \$81 |

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) | March 31, | |
|--|-----------|----------|
| | 2011 | 2010 |
| Commitments to grant loans | \$23,466 | \$16,473 |
| Unfunded commitments under lines of credit | 29,809 | 37,020 |
| Standby letters of credit | 3,636 | 3,438 |
| | \$56,911 | \$56,931 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of

the commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the customer and generally consists of real estate.

The Bank does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank, generally, holds collateral and/or personal guarantees supporting these commitments. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of March 31, 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 Cost | March 31, 2011 | | Fair Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| | | | | |
| | | (In Thousands) | | |
| Available for Sale: | | | | |
| U.S. Government agencies | \$32,278 | \$281 | \$(369) | \$32,190 |
| States and political subdivisions | 45,423 | 751 | (159) | 46,015 |
| Corporate obligations | 3,016 | 221 | - | 3,237 |
| Mortgage-backed securities- government sponsored entities | 60,189 | 1,276 | (301) | 61,164 |
| | 140,906 | 2,529 | (829) | 142,606 |
| Equity securities-financial services | 215 | 284 | (1) | 498 |
| | \$141,121 | \$2,813 | \$(830) | \$143,104 |
| Held to Maturity: | | | | |
| States and political subdivisions | \$170 | \$7 | - | \$177 |

| | | December 31, 2010 | | | |
|---|-------------------|------------------------------|-------------------------------|---------------|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | |
| | (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 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):

| | March 31, 2011 | | | | | |
|--|---------------------|----------------------|-------------------|----------------------|---------------|------------|
| | Less than 12 Months | | 12 Months or More | | Total | Unrealized |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Losses |
| U.S. Government agencies | \$12,730 | \$(369) | \$- | \$- | \$12,730 | \$(369) |
| States and political subdivisions | 10,051 | (159) | - | - | 10,051 | (159) |
| Mortgage-backed securities-government sponsored agencies | 21,874 | (301) | - | - | 21,874 | (301) |
| Equity securities-financial services | - | - | 16 | (1) | 16 | (1) |
| | \$44,655 | \$(829) | \$16 | \$(1) | \$44,671 | \$(830) |

| | Less than 12 Months | | December 31, 2010 12 Months or More | | Total | |
|--|---------------------|-------------------|--|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| 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 March 31, 2011, the Company has 42 securities in an unrealized loss position in the less than twelve months category and one security in the twelve months or more category. In Management's opinion the unrealized losses less than twelve months principally reflect changes in interest rates subsequent to the acquisition of specific securities. The Company holds a small amount of equity securities in other financial institutions. The value of these equity securities has been impacted by the overall weakness in the financial sector, one of which has been in a loss position for greater than one year. 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 March 31, 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 | | Held to Maturity | |
|--|--------------------|------------|------------------|------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (In Thousands) | | | |
| Due after one year through five years | \$30,859 | \$31,346 | \$170 | \$177 |
| Due after five years through ten years | 23,089 | 23,213 | - | - |
| Due after ten years | 26,769 | 26,883 | - | - |
| Mortgage-backed securities-government sponsored agencies | 60,189 | 61,164 | - | - |
| | \$140,906 | \$142,606 | \$170 | \$177 |

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

| | Three Months Ended March 31, | |
|-----------------------------------|---------------------------------|---------|
| | 2011 | 2010 |
| Gross realized gains | \$212 | \$155 |
| Gross realized losses | - | - |
| Net realized gain | \$212 | \$155 |
| Proceeds from sales of securities | \$6,187 | \$8,837 |

8. Loans Receivable and Allowance for Loan Losses

Loans receivable totaled \$350.1 million at March 31, 2011 compared to \$356.9 million as of December 31, 2010. Residential real estate loans decreased \$6.2 million principally due to the sale of \$4.7 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 \$900,000 during the period while all other commercial and retail loans decreased \$1.4 million due primarily to a reduction in home equity loans as borrowers took advantage of a continued low interest rate environment to convert balances to permanent financing.

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

Types of loans

(dollars in thousands)

| | March 31, 2011 | | December 31, 2010 | | | |
|--|----------------|-------|-------------------|-----------|-------|---|
| Real Estate-Residential | \$118,382 | 33.8 | % | \$124,562 | 34.9 | % |
| Commercial | 186,195 | 53.1 | | 184,094 | 51.5 | |
| Construction | 11,894 | 3.4 | | 12,638 | 3.5 | |
| Commercial, financial and agricultural | 21,194 | 6.0 | | 22,386 | 6.3 | |
| Consumer loans to individuals | 12,963 | 3.7 | | 13,668 | 3.8 | |
| Total loans | 350,628 | 100.0 | % | 357,348 | 100.0 | % |
| Deferred fees (net) | (500) | | | (493) | | |
| | 350,128 | | | 356,855 | | |
| Allowance for loan losses | (5,780) | | | (5,616) | | |
| Net loans receivable | \$344,348 | | | \$351,239 | | |

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 Loans | Consumer Loans | Total |
|---|-------------------|------------|-----------------------------------|---------------------|-------------------|------------|
| | Residential | Commercial | Construction (In thousands) | | | |
| March 31, 2011 | | | | | | |
| Total Loans | \$ 118,382 | \$ 186,195 | \$ 11,894 | \$ 21,194 | \$ 12,963 | \$ 350,628 |
| Individually evaluated for impairment | \$ — | \$ 16,498 | \$ — | \$ 511 | \$ — | \$ 17,009 |
| Collectively evaluated for impairment | \$ 118,382 | \$ 169,697 | \$ 11,894 | \$ 20,683 | \$ 12,963 | \$ 336,619 |
| | | | | | | |
| | Real Estate Loans | | | Commercial Loans | Consumer Loans | Total |
| | Residential | Commercial | Construction (In thousands) | | | |
| December 31, 2010 | | | | | | |
| Total Loans | \$ 124,562 | \$ 184,094 | \$ 12,638 | \$ 22,386 | \$ 13,668 | \$ 357,348 |
| Individually evaluated for impairment | \$ — | \$ 14,239 | \$ — | \$ 513 | \$ — | \$ 14,752 |
| Collectively evaluated for 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 Investment | Unpaid Principal Balance | Associated Allowance | Average Recorded Investment | Interest Income Recognized |
|--|------------------------|--------------------------------|-------------------------|-----------------------------------|----------------------------------|
| March 31, 2011 | | | | | |
| With no related allowance recorded: | | | (In thousands) | | |
| Real Estate Loans | | | | | |
| Residential | \$— | \$— | \$— | \$— | \$— |
| Construction | — | — | — | — | — |
| Commercial | 4,875 | 4,875 | — | 3,714 | 15 |
| Commercial Loans | 511 | 511 | — | 512 | — |
| Consumer Loans | — | — | — | — | — |
| Total | 5,386 | 5,386 | — | 4,226 | 15 |
| With an allowance recorded: | | | | | |
| Real Estate Loans | | | | | |
| Residential | — | — | — | — | — |
| Construction | — | — | — | — | — |
| Commercial | 11,623 | 11,531 | 2,153 | 11,654 | 103 |
| Commercial Loans | — | — | — | — | — |
| Consumer Loans | — | — | — | — | — |
| Total | 11,623 | 11,531 | 2,153 | 11,654 | 103 |
| Total: | | | | | |
| Real Estate loans | | | | | |
| Residential | — | — | — | — | — |
| Construction | — | — | — | — | — |
| Commercial | 16,498 | 16,406 | 2,153 | 15,368 | 118 |
| Commercial Loans | 511 | 511 | — | 512 | — |
| Consumer Loans | — | — | — | — | — |
| Total Impaired Loans | \$17,009 | \$16,917 | \$2,153 | \$15,880 | \$118 |

| | Recorded Investment | Unpaid Principal Balance | Associated Allowance | Average Recorded Investment | Interest Income 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 March 31, 2011 and December 31, 2010 (in thousands):

| | Pass | Special Mention | Substandard | Doubtful | Loss | Total |
|------------------------------|------------|--------------------|-------------|----------|------|------------|
| March 31, 2011 | | | | | | |
| Commercial real estate loans | \$ 167,696 | \$ 1,601 | \$ 16,898 | \$— | \$— | \$ 186,195 |
| Commercial loans | 20,586 | 75 | 533 | — | — | 21,194 |
| Total | \$ 188,282 | \$ 1,676 | \$ 17,431 | \$— | \$— | \$ 207,389 |

| | Pass | Special 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 March 31, 2011 and December 31, 2010 (in thousands):

| March 31, 2011 | Performing | Nonperforming | Total |
|-------------------------------|------------|---------------|------------|
| Residential real estate loans | \$ 117,490 | \$ 892 | \$ 118,382 |
| Construction | 11,894 | — | 11,894 |
| Consumer loans | 12,963 | — | 12,963 |
| Total | \$ 142,347 | \$ 892 | \$ 143,239 |

| 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 March 31, 2011 and December 31, 2010 (in thousands):

| | Current | 31-60 Days Past Due | 61-90 Days Past Due | Greater than 90 Days Past Due and still accruing | Non- Accrual | Total Past Due and Non-Accrual | Total Loans |
|-------------------|------------|---------------------------|---------------------------|---|-----------------|--------------------------------------|----------------|
| March 31, 2011 | | | | | | | |
| Real Estate loans | | | | | | | |
| Residential | \$ 117,227 | \$ 263 | \$— | \$— | \$ 892 | \$ 1,155 | \$ 118,382 |
| Construction | 11,783 | 111 | — | — | — | 111 | 11,894 |
| Commercial | 180,035 | 176 | — | — | 5,984 | 6,160 | 186,195 |
| Commercial loans | 20,683 | — | — | — | 511 | 511 | 21,194 |
| Consumer loans | 12,948 | 7 | 8 | — | — | 15 | 12,963 |
| Total | \$ 342,676 | \$ 557 | \$ 8 | \$— | \$ 7,387 | \$ 7,952 | \$ 350,628 |

| | Current | 31-60 Days Past Due | 61-90 Days Past Due | Greater than 90 Days Past Due and still accruing | Non- Accrual | Total Past Due and 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 March 31, | |
|--|---------------------------------|----------|
| | 2011 | 2010 |
| | (dollars in thousands) | |
| Allowance balance at beginning of period | \$ 5,616 | \$ 5,453 |

| | | | | |
|------------------------------------|---------|---|---------|---|
| Charge-offs: | (75 |) | (429 |) |
| Recoveries: | 19 | | 8 | |
| Provision expense | 220 | | 330 | |
| Allowance balance at end of period | \$5,780 | | \$5,362 | |

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

| (In thousands) | Residential Real Estate | Commercial Real Estate | Construction | Commercial | Consumer | Total |
|--|----------------------------|---------------------------|--------------|------------|----------|----------|
| Beginning balance, December 31, 2010 | \$1,167 | \$3,976 | \$ 110 | \$ 171 | \$192 | \$5,616 |
| Charge Offs | (37) | (14) | — | (2) | (22) | (75) |
| Recoveries | 2 | — | — | 5 | 12 | 19 |
| Provision Expense | (14) | 124 | 1 | 139 | (30) | 220 |
| Ending balance | \$1,118 | \$4,086 | \$ 111 | \$ 313 | \$152 | \$5,780 |
| Ending balance individually evaluated for impairment | \$ — | \$ 2,153 | \$ — | \$ — | \$ — | \$ 2,153 |
| Ending balance collectively evaluated for impairment | \$ 1,118 | \$ 1,933 | \$ 111 | \$ 313 | \$ 152 | \$ 3,627 |

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 March 31, 2011, the Company considered its concentration of credit risk to be acceptable. The two highest concentrations are in the hospitality lodging industry and summer camps, with loans outstanding of \$42.3 million, or 59.0% of capital, to the hospitality lodging industry and \$21.7 million, or 31.0% of capital, to summer camps. In 2011, there were no losses in either portfolio. As of March 31, 2011, one motel loan with an outstanding balance of \$3,028,000 was on nonaccrual status and considered impaired.

Gross realized gains and gross realized losses on sales of residential mortgage loans were \$96,000 and \$0, respectively, in the first quarter of 2011 compared to \$54,000 and \$5,000, respectively, in the same period in 2010. The proceeds from the sales of residential mortgage loans totaled \$4.7 million and \$4.3 million for the three months ended March 31, 2011 and 2010, respectively.

The allowance for loan losses totaled \$5,780,000 as of March 31, 2011 and represented 1.65% of total loans, compared to \$5,616,000 at December 31, 2010, and \$5,362,000 as of March 31, 2010. The Company had net charge-offs for the three months ended March 31, 2011 of \$56,000 compared to \$421,000 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 March 31, 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 March 31, 2011, non-performing loans totaled \$7.4 million, which is 2.11% 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.

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

| (dollars in thousands) | March 31, 2011 | December 31, 2010 | | |
|--|----------------|-------------------|---|--|
| Loans accounted for on a non-accrual basis: | | | | |
| Commercial and all other | \$ - | \$ 513 | | |
| Real Estate | 6,786 | 3,527 | | |
| Consumer | 601 | - | | |
| Total | 7,387 | 4,040 | | |
| Accruing loans which are contractually past due 90 days or more | - | 39 | | |
| Total non-performing loans | 7,387 | 4,079 | | |
| Foreclosed real estate | 948 | 748 | | |
| Total non-performing assets | \$ 8,335 | \$ 4,827 | | |
| Allowance for loans losses | \$ 5,780 | \$ 5,616 | | |
| Coverage of non-performing loans | .78 | x 1.38 | x | |
| Non-performing loans to total loans | 2.11 | % 1.14 | % | |
| Non-performing loans to total assets | 1.39 | % .76 | % | |
| Non-performing assets to total assets | 1.57 | % .90 | % | |

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 March 31, 2011 and December 31, 2010 are as follows:

| Description | Fair Value Measurement Reporting Date Using | | | |
|--|---|---|--|------|
| | (Level 1) Quoted Prices in Active Markets For Identical Assets | (Level 2) Significant Other Observable Inputs | (Level 3) Significant Unobservable Inputs | |
| | Total (In thousands) | | | |
| March 31, 2011 | | | | |
| Available for Sale: | | | | |
| US Government agencies | \$32,190 | \$- | \$32,190 | \$ - |
| States and political subdivisions | 46,015 | - | 46,015 | - |
| Corporate obligations | 3,237 | - | 3,237 | - |
| Mortgage-backed securities-government sponsored agencies | 61,164 | - | 61,164 | - |
| Equity securities-financial services | 498 | 498 | - | -- |
| Total | \$143,104 | \$498 | \$142,606 | \$ - |
| 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 sponsored agencies | 60,928 | - | 60,928 | - |
| Equity securities-financial services | 604 | 604 | - | -- |
| Total | \$145,815 | \$604 | \$145,211 | \$ - |

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

| (In thousands) | Fair Value Measurement Reporting Date using | Fair Value Measurement Reporting Date using | | |
|------------------------------|---|---|---|--|
| | | (Level 1) Quoted Prices in Active Markets For Identical Assets | (Level 2) Significant Other Observable Inputs | (Level 3) Significant Unobservable Inputs |
| Description | Total | | | |
| March 31, 2011 | | | | |
| Impaired Loans | \$14,856 | \$- | \$- | \$ 14,856 |
| Foreclosed Real Estate Owned | 948 | - | - | 948 |
| | \$15,804 | \$- | \$- | \$ 15,804 |
| 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 March 31, 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 March 31, 2011, the fair value investment in impaired loans totaled \$14,856,000 which includes four loans for \$11.6 million for which a valuation allowance has been provided based on current collateral values and nine loans for \$5.4 million which do not require a valuation allowance since the current collateral value exceeds the loan value. As of March 31, 2011, the Company has recognized charge-offs against the allowance for loan losses on impaired loans in the amount of \$700,000 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.

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 March 31, 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 March 31, 2011 and December 31, 2010.

| | March 31, 2011 | | December 31, 2010 | |
|--|--------------------|---------------|--------------------|---------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| | (In Thousands) | | | |
| Financial assets: | | | | |
| Cash and due from banks, interest-bearing deposits with banks and federal funds sold | \$19,534 | \$19,534 | \$16,625 | \$16,625 |
| Securities | 143,274 | 143,281 | 145,985 | 145,994 |
| Loans receivable, net | 344,348 | 357,701 | 351,239 | 358,873 |
| Mortgage servicing rights | 298 | 298 | 250 | 274 |
| Investment in FHLB stock | 3,193 | 3,193 | 3,361 | 3,361 |
| Accrued interest receivable | 2,191 | 2,191 | 2,166 | 2,166 |
| Financial liabilities: | | | | |
| Deposits | 397,120 | 398,190 | 393,865 | 395,157 |
| Short-term borrowings | 25,465 | 25,465 | 33,309 | 33,309 |
| Other borrowings | 35,000 | 37,037 | 38,000 | 40,413 |
| Accrued interest payable | 1,342 | 1,342 | 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.

11. Proposed Acquisition of North Penn Bancorp, Inc.

On December 15, 2010, the Company announced the signing of a definitive merger agreement pursuant to which Norwood Financial Corp would acquire North Penn Bancorp, Inc. in a stock and cash transaction. The proposed 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. is the holding company for North Penn Bank, a Pennsylvania savings bank that conducts its business from its main office in Scranton, Pennsylvania and four branch offices in the northeastern Pennsylvania counties of Lackawanna and Monroe. As of December 31, 2010, North Penn Bancorp, Inc. had total assets of \$164.0 million, total net loans of \$121.9 million, total deposits of \$136.3 million and total stockholders' equity of \$19.6 million.

Under the terms of the agreement, the Company will acquire all of the outstanding shares of North Penn Bancorp, Inc. for a total purchase price of approximately \$27.1 million. North Penn Bank will be merged into Wayne Bank, with Wayne as the surviving entity. It is expected that the merger will be consummated in the second quarter of 2011.

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 March 31, 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 banks excess stock, but notified member banks that decisions regarding future capital stock repurchases will be made on a quarterly basis.

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 March 31, 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 March 31, 2011 and December 31, 2010 represent temporary impairment of the securities, related to changes in interest rates.

Changes in Financial Condition

General

Total assets as of March 31, 2011 were \$530.9 million compared to \$537.0 million as of December 31, 2010, a decrease of \$6.1 million. The decrease was due to a \$10.8 million reduction in short-term and other borrowings, including repurchase agreements and FHLB borrowings.

Securities

The fair value of securities available for sale as of March 31, 2011 was \$143.1 million compared to \$145.8 million as of December 31, 2010. The Company purchased \$10.3 million of securities principally using the proceeds from \$13.3 million of securities sold, called, maturities and principal reductions.

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

| (dollars in thousands) | March 31, 2011 | | December 31, 2010 | | |
|--------------------------------------|----------------|----------------|-------------------|----------------|---|
| | Amount | % of portfolio | Amount | % of portfolio | |
| US Government agencies | \$32,190 | 22.5 | % \$30,268 | 20.7 | % |
| States and political subdivisions | 46,185 | 32.2 | 49,936 | 34.2 | |
| Corporate obligations | 3,237 | 2.3 | 4,249 | 2.9 | |
| Mortgage-backed securities- | | | | | |
| government sponsored entities | 61,164 | 42.7 | 60,928 | 41.8 | |
| Equity securities-financial services | 498 | 0.3 | 604 | 0.4 | |
| Total | \$143,274 | 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.

Deposits

During the period, both savings deposits and certificates of deposit increased \$1.9 million while interest-bearing demand deposits decreased \$1.0 million.

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

| (dollars in thousands) | March 31, 2011 | December 31, 2010 |
|-------------------------------|----------------|-------------------|
| Non-interest bearing demand | \$ 62,736 | \$ 62,238 |
| Interest bearing demand | 37,851 | 38,168 |
| Money market deposit accounts | 70,093 | 70,812 |
| Savings | 52,200 | 50,341 |
| Time deposits <\$100,000 | 112,436 | 112,291 |
| Time deposits >\$100,000 | 61,804 | 60,015 |
| Total | \$ 397,120 | \$ 393,865 |

Borrowings

Short-term borrowings as of March 31, 2011 totaled \$25.5 million compared to \$33.3 million as of December 31, 2010. Securities sold under agreements to repurchase declined \$7.8 million principally due to the seasonality of municipal cash management accounts. Short-term borrowings consist of the following:

| (dollars in thousands) | March 31, 2011 | December 31, 2010 |
|--|----------------|-------------------|
| Securities sold under agreements to repurchase | \$ 25,267 | \$ 33,110 |
| U.S. Treasury demand notes | 198 | 199 |
| | \$ 25,465 | \$ 33,309 |

Other borrowings consisted of the following:

| (dollars in thousands) | March 31, 2011 | December 31, 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 |
| Convertible note due January 2017 at 4.71% | 10,000 | 10,000 |
| | \$ 35,000 | \$ 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.

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 \$23.5 million as of March 31, 2011 compared to \$21.4 million as of December 31, 2010.

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

| | March 31, 2011 (in thousands) | December 31, 2010 |
|--|-------------------------------------|----------------------|
| Commitments to grant loans | \$ 23,466 | \$ 21,448 |
| Unfunded commitments under lines of credit | 29,809 | 30,311 |
| Standby letters of credit | 3,636 | 3,605 |
| | \$ 56,911 | \$ 55,364 |

Stockholders' Equity and Capital Ratios

As of March 31, 2011, stockholders' equity totaled \$68.6 million, compared to \$67.7 million as of December 31, 2010. The net change in stockholders' equity included \$1.7 million of net income, that was partially offset by \$801,000 of dividends declared and a \$191,000 reduction due to an increase in Treasury Stock. In addition, accumulated other comprehensive income increased \$168,000 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:

| | March 31, 2011 | | December 31, 2010 | |
|---|-------------------|---|-------------------|---|
| Tier 1 Capital (To average assets) | 12.71 | % | 12.41 | % |
| Tier 1 Capital (To risk-weighted assets) | 18.94 | % | 18.44 | % |
| Total Capital (To risk-weighted assets) | 20.23 | % | 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 March 31, 2011 and December 31, 2010.

Liquidity

As of March 31, 2011, the Company had cash and cash equivalents of \$19.5 million in the form of cash, due from banks, Federal Funds sold and short-term deposits with other institutions. In addition, the Company had total securities available for sale of \$143.1 million which could be used for liquidity needs. This totals \$162.6 million and represents 30.6% 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 March 31, 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 March 31, 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, 2011. There were no borrowings under this line as of March 31, 2011 and December 31, 2010.

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

The Bank's maximum borrowing capacity with the Federal Home Loan Bank was approximately \$183,000,000 as of March 31, 2011, of which \$35,000,000 and \$38,000,000 was outstanding at March 31, 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 page 35. 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 March 31, | | | 2010 | | | | |
|--|------------------------------|-----------------|------------------------|---------------------------|-----------------|------------------------|---|--|
| | 2011 | | Average Rate (3) | 2010 | | Average Rate (3) | | |
| | Average Balance (2) | Interest (1) | | Average Balance (2) | Interest (1) | | | |
| Assets | | | | | | | | |
| Interest-earning assets: | | | | | | | | |
| Federal funds sold | \$ 167 | \$- | 0.24 | % \$ 3,000 | \$ 2 | 0.27 | % | |
| Interest bearing deposits with banks | 10,564 | 8 | 0.30 | 11,128 | 9 | 0.32 | | |
| Securities held-to-maturity | 170 | 3 | 7.06 | 618 | 13 | 8.41 | | |
| Securities available for sale: | | | | | | | | |
| Taxable | 97,489 | 650 | 2.67 | 97,496 | 903 | 3.70 | | |
| Tax-exempt(1) | 46,629 | 664 | 5.70 | 31,946 | 468 | 5.86 | | |
| Total securities available for sale (1) | 144,118 | 1,314 | 3.65 | 129,442 | 1,371 | 4.24 | | |
| Loans receivable (1) (4) (5) | 353,118 | 4,970 | 5.63 | 358,737 | 5,453 | 6.08 | | |
| Total interest earning assets | 508,137 | 6,295 | 4.96 | 502,925 | 6,848 | 5.45 | | |
| Non-interest earning assets: | | | | | | | | |
| Cash and due from banks | 6,798 | | | 6,915 | | | | |
| Allowance for loan losses | (5,742 |) | | (5,439 |) | | | |
| Other assets | 21,619 | | | 22,223 | | | | |
| Total non-interest earning assets | 22,675 | | | 23,699 | | | | |
| Total Assets | \$ 530,812 | | | \$ 526,624 | | | | |
| Liabilities and Stockholders' Equity | | | | | | | | |
| Interest bearing liabilities: | | | | | | | | |
| Interest bearing demand and money market | \$ 108,944 | 108 | 0.40 | \$ 97,214 | 145 | 0.60 | | |
| Savings | 51,326 | 25 | 0.19 | 46,069 | 28 | 0.24 | | |
| Time | 172,924 | 752 | 1.74 | 186,963 | 1,026 | 2.20 | | |
| Total interest bearing deposits | 333,194 | 885 | 1.06 | 330,246 | 1,199 | 1.45 | | |
| Short-term borrowings | 27,819 | 24 | 0.35 | 25,010 | 34 | 0.54 | | |
| Other borrowings | 35,600 | 336 | 3.78 | 43,000 | 412 | 3.83 | | |
| Total interest bearing liabilities | 396,613 | 1,245 | 1.26 | 398,256 | 1,645 | 1.65 | | |
| Non-interest bearing liabilities: | | | | | | | | |
| Demand deposits | 61,858 | | | 58,570 | | | | |
| Other liabilities | 3,723 | | | 4,105 | | | | |
| Total non-interest bearing liabilities | 65,581 | | | 62,675 | | | | |

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| | | |
|--|-----------|-----------|
| Stockholders' equity | 68,618 | 65,693 |
| Total Liabilities and Stockholders' Equity | \$530,812 | \$526,624 |

| | | | | | | |
|--|---------|------|---|---------|------|---|
| Net interest income (tax equivalent basis) | 5,050 | 3.70 | % | 5,203 | 3.79 | % |
| Tax-equivalent basis adjustment | (269) | | | (206) | | |
| Net interest income | \$4,781 | | | \$4,997 | | |
| Net interest margin (tax equivalent basis) | | 3.98 | % | | 4.14 | % |

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

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

| | Increase/(Decrease) | | |
|---|-----------------------------------|----------|----------|
| | Three months ended March 31, 2011 | | |
| | Compared to | | |
| | Three months ended March 31, 2010 | | |
| | Variance due to | | |
| | Volume | Rate | Net |
| Interest earning assets: | | | |
| Federal funds sold..... | \$(2 |) \$- | \$(2) |
| Interest bearing deposits with banks..... | - | (1) | (1) |
| Securities held to maturity..... | (8 |) (2 |) (10) |
| Securities available for sale: | | | |
| Taxable..... | - | (253) | (253) |
| Tax-exempt securities..... | 283 | (87) | 196 |
| Total securities..... | 275 | (342) | (67) |
| Loans receivable..... | (84 |) (399 |) (483) |
| Total interest earning assets..... | 189 | (742) | (553) |
| Interest bearing liabilities: | | | |
| Interest-bearing demand and money market.... | 93 | (130) | (37) |
| Savings..... | 15 | (18) | (3) |
| Time..... | (73 |) (201 |) (274) |
| Total interest bearing deposits..... | 35 | (349) | (314) |
| Short-term borrowings..... | 21 | (31) | (10) |
| Other borrowings..... | (70 |) (6 |) (76) |
| Total interest bearing liabilities..... | (14 |) (386 |) (400) |
| Net interest income (tax-equivalent basis)..... | \$203 | \$(356) | \$(153) |

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

Comparison of Operating Results for The Three Months Ended March 31, 2011 to March 31, 2010

General

For the three months ended March 31, 2011, net income totaled \$1,660,000 compared to \$1,797,000 earned in the similar period in 2010. Earnings per share for the current period were \$.60 for basic and fully diluted compared to \$.65 per share for both basic and a fully diluted basis for the three months ended March 31, 2010. The resulting annualized return on average assets and annualized return on average equity for the three months ended March 31, 2011 was 1.27% and 9.76%, respectively, compared to 1.38% and 11.10%, respectively, for the similar period in 2010.

The following table sets forth changes in net income:

| (dollars in thousands) | Three months ended March 31, 2011 to March 31, 2010 | |
|--|--|--------|
| Net income three months ended March 31, 2010 | \$ | 1,797 |
| Change due to: | | |
| Net interest income | | (216) |
| Provision for loan losses | | 110 |
| Gain on sales of loans and securities | | 125 |
| Other income | | 81 |
| Salaries and employee benefits | | (86) |
| Occupancy, furniture and equipment | | (4) |
| Merger related expenses | | (267) |
| All other expenses | | (17) |
| Income tax expense | | 137 |
| Net income three months ended March 31, 2011 | \$ | 1,660 |

Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the three months ended March 31, 2011, totaled \$5,050,000, a decrease of \$153,000 or 2.9% from the similar period in 2010. The fte net interest spread and net interest margin were 3.70% and 3.98%, respectively, for the three months ended March 31, 2011 compared to 3.79% and 4.14%, respectively, for the similar period in 2010.

Interest income (fte) totaled \$6,295,000 with a yield on average earning assets of 4.96% compared to \$6,848,000 and 5.45% 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 103 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 first three months of 2010, while the yield on loans receivable decreased 45 basis points due to a higher level of non-performing assets. Average earning assets totaled \$508.1 million for the three months ended March 31, 2011, an increase of \$5.2 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 March 31, 2011 totaled \$1,245,000 at an average cost of 1.26% compared to \$1,645,000 and 1.65% for the similar period in 2010. As a result of the continued low interest rate environment, the Company reduced rates paid on its money market accounts and cash management products, which are included in short-term borrowings. The cost of time deposits, which is the most significant component of funding, declined to 1.74% from 2.20% for the similar period in the prior year. As time deposits matured, they repriced at the current lower rates resulting in the decrease.

Other Income

Other income totaled \$1,208,000 for the three months ended March 31, 2011 compared to \$1,002,000 for the similar period in 2010. The current period includes a \$143,000 gain on the sale of \$4.7 million of fixed residential mortgages compared to \$75,000 in gains on the sale of \$4.3 million of mortgages in the similar period of 2010. The current period also includes a \$212,000 gain on the sale of investment securities compared to a \$155,000 gain in the first quarter of 2010. All other service charges and fees increased \$81,000 compared to the first quarter of last year including a \$27,000 increase in earnings from fiduciary activities and a \$26,000 improvement in service charges on deposits.

Other Expense

Other expense for the three months ended March 31, 2011 totaled \$3,534,000, or an increase of \$374,000 from \$3,160,000 for the similar period in 2010. Merger related expenses totaled \$267,000 in the first quarter while salary and benefit costs increased \$86,000 or 5.3%.

Income Tax Expense

Income tax expense totaled \$575,000 for an effective tax rate of 25.7% for the period ending March 31, 2011 compared to \$712,000 for an effective tax rate of 28.4% for the similar period in 2010 due to the \$14.7 million increase in average tax-exempt securities.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market Risk

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

Net interest income, which is the primary source of the Company's earnings, is impacted by changes in interest rates and the relationship of different interest rates. To manage the impact of the rate changes, the balance sheet must be structured so that repricing opportunities exist for both assets and liabilities at approximately the same time intervals. The Company uses net interest simulation to assist in interest rate risk management. The process includes simulating various interest rate environments and their impact on net interest income. As of March 31, 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 March 31, 2011, the Company had a positive 90 day interest sensitivity gap of \$38.9 million or 7.8% of total assets, similar to the \$41.3 million or 7.7% of total assets as of December 31, 2010. Rate sensitive assets repricing within 90 days increased \$6.5 million due primarily to loans. Time deposits repricing within 90 days increased \$13.6 million, but the increase was offset by a \$4.8 million reduction in other borrowings. A positive gap means that rate-sensitive assets are greater than rate-sensitive liabilities at the time interval. This would indicate that in a rising rate environment, the yield on interest-earning assets could increase faster than the cost of interest-bearing liabilities in the 90 day time frame. The repricing intervals are managed by ALCO strategies, including adjusting the average life of the investment portfolio, pricing of deposit liabilities to attract longer term time deposits, loan pricing to encourage variable rate products and evaluation of loan sales of long-term fixed rate mortgages.

March 31, 2011
Rate Sensitivity Table
(dollars in thousands)

| | 3 Months | 3-12 Months | 1 to 3 Years | Over 3 Years | Total |
|--|----------|----------------|-----------------|-----------------|-----------|
| Federal funds sold and interest bearing deposits | \$13,614 | \$250 | \$- | \$- | \$13,864 |
| Securities | 9,901 | 21,885 | 44,670 | 66,818 | 143,274 |
| Loans Receivable | 90,059 | 61,036 | 104,949 | 94,084 | 350,128 |
| Total RSA | 113,574 | 83,171 | 149,619 | 160,902 | 507,266 |
| Non-maturity interest-bearing deposits | 25,332 | 28,129 | 74,373 | 32,311 | 160,145 |
| Time Deposits | 43,628 | 65,989 | 47,829 | 16,793 | 174,239 |
| Other | 5,697 | 23,762 | 21,006 | 10,000 | 60,465 |
| Total RSL | 74,657 | 117,880 | 143,208 | 59,104 | 394,849 |
| Interest Sensitivity Gap | 38,917 | (34,709) | 6,411 | 101,798 | \$112,417 |
| Cumulative Gap | 38,917 | 4,208 | 10,619 | 112,417 | |
| RSA/RSL-cumulative | 152.1 % | 102.2 % | 103.2 % | 128.5 % | |

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.

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 | |
| January 1–January 31, 2011 | - | \$- | - | - |
| February 1–February 28, 2011 | - | - | - | - |
| March 1 – March 31, 2011(1) | 6,892 | 27.77 | - | 86,000 |
| | 6,892 | \$27.77 | - | 86,000 |

(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 |
|-------|--|
| 2.1 | Agreement and Plan of Merger, dated December 14, 2010, by and among Norwood Financial Corp., Wayne Bank, North Penn Bancorp, Inc. and North Penn Bank. (1) |
| 3(i) | Articles of Incorporation of Norwood Financial Corp.(2) |
| 3(ii) | Bylaws of Norwood Financial Corp. (3) |
| 4.0 | Specimen Stock Certificate of Norwood Financial Corp. (2) |
| 10.1 | Employment Agreement with Lewis J. Critelli (3) |
| 10.2 | Change in Control Severance Agreement with William S. Lance(3) |
| 10.3 | Norwood Financial Corp. Stock Option Plan (5) |
| 10.4 | Salary Continuation Agreement between the Bank and William W. Davis, Jr. (4) |
| 10.5 | Salary Continuation Agreement between the Bank and Lewis J. Critelli (4) |
| 10.6 | Salary Continuation Agreement between the Bank and Edward C. Kasper (4) |
| 10.7 | 1999 Directors Stock Compensation Plan (4) |
| 10.8 | Salary Continuation Agreement between the Bank and Joseph A. Kneller (6) |
| 10.9 | Salary Continuation Agreement between the Bank and John H. Sanders (6) |
| 10.10 | 2006 Stock Option Plan (7) |
| 10.11 | First and Second Amendments to Salary Continuation Agreement with William W. Davis, Jr. (8) |
| 10.12 | First and Second Amendments to Salary Continuation Agreement with Lewis J. Critelli (8) |
| 10.13 | First and Second Amendments to Salary Continuation Agreement with Edward C. Kasper (8) |
| 10.14 | First and Second Amendments to Salary Continuation Agreement with Joseph A. Kneller (8) |
| 10.15 | First and Second Amendments to Salary Continuation Agreement with John H. Sanders (8) |
| 31 | Rule 13a-14(a)/15d-14(a) Certification of CEO and CFO |
| 32 | Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of Sarbanes Oxley Act of 2002 |

(1)Incorporated by reference into this document from the identically numbered exhibit to the Registrant's Current Report on Form 8-K filed with the Commission on December 17, 2010.

(2)

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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

(3) 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.

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

Signatures

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

NORWOOD FINANCIAL CORP.

Date: May 9, 2011

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

Date: May 9, 2011

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