NORWOOD FINANCIAL CORP
Form 10-Q
August 10, 2009

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2009

OR

o 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	23-2828306
(State or other jurisdiction of Incorporation or organization)	(I.R.S. employer identification no.)
717 Main Street, Honesdale, Pennsylvania	18431
(Address of principal executive offices)	(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 xNo o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes o No o

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

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

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

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

Class	Outstanding as of August 7, 2009
Common stock, par value $0.10 per share	2,748,206

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NORWOOD FINANCIAL CORP.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2009

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NORWOOD FINANCIAL CORP.

Consolidated Balance Sheets (unaudited)

(dollars in thousands, except per share data)

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

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

See accompanying notes to the unaudited consolidated financial statements

NORWOOD FINANCIAL CORP.

Consolidated Statements of Income (unaudited)

(dollars in thousands, except per share data)

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

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

See accompanying notes to the unaudited consolidated financial statements

NORWOOD FINANCIAL CORP.

Consolidated Statements of Changes in Stockholders' Equity (unaudited)

Six Months Ended June 30, 2009 and 2008

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

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

See accompanying notes to the unaudited consolidated financial statements

NORWOOD FINANCIAL CORP.

Consolidated Statements of Cash Flows (unaudited)

(dollars in thousands)

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

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

See accompanying notes to the unaudited consolidated financial statements

Notes to Unaudited Consolidated Financial Statements

1. Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in conformity with generally accepted accounting principles for interim financial statements and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted principles for complete financial statements. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ from those estimates. The financial statements reflect, in the opinion of management all normal, recurring adjustments necessary to present fairly the financial position of the Company. The operating results for the three and six month periods ended June 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009 or any other future interim period.

These statements should be read in conjunction with the consolidated financial statements and related notes which are incorporated by reference in the Company's Annual Report on Form 10-K for the year-ended December 31, 2008.

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

2. Earnings Per Share

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

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

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

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

Stock options which had no intrinsic value because their effect would be anti-dilutive and therefore would not be included in the diluted EPS calculation were 114,150 and 44,000 as of June 30, 2009 and 2008, respectively.

3. Stock-Based Compensation

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

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

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

Intrinsic value represents the amount by which the market price of the stock on the measurement date exceeded the exercise price of the option. The intrinsic value of options exercised during the six months ended June 30, 2009 was $199,000, cash received from such exercises was $215,000 and the tax benefit recognized was $67,000.

4. Cash Flow Information

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

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

5. Comprehensive Income

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

(in thousands)

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

6. <u>Off-Balance Sheet Financial Instruments and Guarantees</u>

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

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

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

(in thousands)

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

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

7. Securities

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

	June 30, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available for Sale:				
U.S. Government agencies	$ 25,126	$ 409	$ (52)	$ 25,483
States and political subdivisions	30,185	176	(523)	29,838
Corporate obligations	5,054	44	(12)	5,086
Mortgage-backed securities	59,743	1,651	(23)	61,371
	120,108	2,280	(610)	121,778
Equity securities	361	507	(45)	823
	$ 120,469	$ 2,787	$ (655)	$ 122,601
Held to Maturity:				
States and political subdivisions	$ 708	$ 13	$ —	$ 721

	December 31, 2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available for Sale:				
U.S. Government agencies	$ 34,989	$ 836	$ (12)	$ 35,813
States and political subdivisions	25,436	110	(337)	25,209
Corporate obligations	6,065	—	(440)	5,625
Mortgage-backed securities	61,198	1,340	(220)	62,318
	127,688	2,286	(1,009)	128,965
Equity securities	500	754	(99)	1,155
	$ 128,188	$ 3,040	$ (1,108)	$ 130,120
Held to Maturity:				
States and political subdivisions	$ 707	$ 13	$ —	$ 720

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

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

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

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

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

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

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

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

8. <u>Fair Value Measurements</u>

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

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

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

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

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

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

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

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

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

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

Cash and cash equivalents (carried at cost):

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

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Securities:

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

Loans receivable (carried at cost):

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

Impaired loans (generally carried at fair value):

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

Foreclosed real estate owned:

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

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

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

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

Accrued interest receivable and payable (carried at cost):

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

Deposit liabilities (carried at cost):

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

Short-term borrowings (carried at cost):

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

Other borrowings (carried at cost):

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

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

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

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

	June 30, 2009		December31,2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In Thousands)			
Financial assets:				
Cash and due from banks, interest-bearing deposits with banks and federal funds sold	$ 7,554	$ 7,554	$ 6,480	$ 6,480
Securities	123,309	123,322	130,827	130,840
Loans receivable, net	356,019	374,050	345,171	363,219
Investment in FHLB stock	3,538	3,538	3,538	3,538
Accrued interest receivable	2,117	2,117	2,179	2,179
Financial liabilities:				
Deposits	374,153	375,657	359,635	361,223
Short-term borrowings	24,596	24,596	38,126	38,126
Other borrowings	43,000	45,479	43,000	46,281
Accrued interest payable	2,210	2,210	2,247	2,247
Off-balance sheet financial instruments:				
Commitments to extend credit and outstanding letters of credit	—	—	—	—

9. New Accounting Pronouncements

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

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

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

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

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

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

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

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

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

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

10. Branch Closure

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

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

Forward-Looking Statements

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

Critical Accounting Policies

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

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

The Company adopted SFAS No. 123(R), "Share-Based Payment" as of January 1, 2006, using the modified prospective transition method. Under this method companies are required to record compensation expense, based on the fair value of options over the vesting period.

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

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

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

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

Changes in Financial Condition

General

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

Securities

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

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

Loans Receivable

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

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

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

Net loans receivable	$ 356,019	$ 345,171

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Allowance for Loan Losses and Non-performing Assets

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

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

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

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

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

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

Deposits

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

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

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

Borrowings

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