

NORWOOD FINANCIAL CORP  
Form 10-Q  
May 11, 2009  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended March 31, 2009

OR

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

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

Commission file number 0-28366

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

Pennsylvania  
(State or other jurisdiction of

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

Incorporation or organization)

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

18431  
(Zip Code)

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

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

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

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

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

Large accelerated filer O

Accelerated filer X

Non-accelerated filer O

Smaller reporting company O

(Do not check if a smaller reporting company)

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

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

Class  
Common stock, par value \$0.10 per share

Outstanding as of May 8, 2009  
2,739,446

**NORWOOD FINANCIAL CORP.**

**FORM 10-Q**

**FOR THE QUARTER ENDED MARCH 31, 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)

	March 31, 2009	December 31, 2008
<b>ASSETS</b>		
Cash and due from banks	\$ 5,682	\$ 6,463
Interest bearing deposits with banks	9,329	17
Federal funds sold	3,000	—
Cash and cash equivalents	18,011	6,480
Securities available for sale	124,222	130,120
Securities held to maturity, fair value 2009: \$724, 2008: \$720	707	707
Loans receivable (net of unearned income)	351,433	349,404
Less: Allowance for loan losses	4,413	4,233
Net loans receivable	347,020	345,171
Investment in FHLB Stock, at cost	3,538	3,538
Bank premises and equipment, net	5,413	5,490
Bank owned life insurance	8,149	8,068
Foreclosed real estate owned	768	660
Accrued interest receivable	2,314	2,179
Other assets	1,282	1,883
<b>TOTAL ASSETS</b>	<b>\$ 511,424</b>	<b>\$ 504,296</b>
<b>LIABILITIES</b>		
Deposits:		
Non-interest bearing demand	\$ 57,270	\$ 56,839
Interest-bearing	313,146	302,796
Total deposits	370,416	359,635
Short-term borrowings	29,412	38,126
Other borrowings	43,000	43,000
Payable on sale of deposits	3,607	—
Accrued interest payable	1,944	2,247
Other liabilities	2,895	2,598
<b>TOTAL LIABILITIES</b>	<b>451,274</b>	<b>445,606</b>
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, \$.10 par value per share, authorized 10,000,000; shares issued 2,840,872	284	284
Surplus	9,993	9,972

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Retained earnings	51,394		50,398	
Treasury stock at cost: 2009: 106,041 shares, 2008: 104,310	(3,286	)	(3,243	)
Accumulated other comprehensive income	1,765		1,279	
TOTAL STOCKHOLDERS' EQUITY	60,150		58,690	
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 511,424		\$ 504,296	

See accompanying notes to the unaudited consolidated financial statements.

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NORWOOD FINANCIAL CORP. Consolidated Statements of Income (unaudited)

(dollars in thousands, except per share data)

	Three Months Ended	
	2009	2008
<b>INTEREST INCOME</b>		
Loans receivable, including fees	\$ 5,287	\$ 5,641
Securities	1,397	1,489
Other	6	19
Total interest income	6,690	7,149
<b>INTEREST EXPENSE</b>		
Deposits	1,501	2,371
Short-term borrowings	96	187
Long-term debt	412	267
Total interest expense	2,009	2,825
NET INTEREST INCOME	4,681	4,324
PROVISION FOR LOAN LOSSES	225	75
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	4,456	4,249
<b>OTHER INCOME</b>		
Service charges and fees	598	638
Income from fiduciary activities	82	92
Net realized gains on sales of securities	161	—
Gains on sale of loans	133	388
Gains on sale of deposits	150	—
Other	157	144
Total other income	1,281	1,262
<b>OTHER EXPENSES</b>		
Salaries and employee benefits	1,614	1,546
Occupancy, furniture & equipment, net	485	430
Data processing related	196	188
Taxes, other than income	136	126
Professional fees	98	90
FDIC Insurance assessment	126	12
Foreclosed real estate owned	12	—
Other	608	569
Total other expenses	3,275	2,961
INCOME BEFORE INCOME TAXES	2,462	2,550
INCOME TAX EXPENSE	725	771
NET INCOME	\$ 1,737	\$ 1,779
BASIC EARNINGS PER SHARE	\$ 0.63	\$ 0.65
DILUTED EARNINGS PER SHARE	\$ 0.63	\$ 0.64

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, 2009 and 2008

(dollars in thousands, except per share data)

	Common Stock		Retained	Treasury Stock		Accumulated		
	Shares	Amount	Earnings	Shares	Amount	Other	Total	
			Surplus			Comprehensive		
						Income		
Balance December 31, 2007	2,840,872	\$ 284	\$ 10,159	\$ 47,030	87,256	(\$2,708 )	\$ 1,054	\$ 55,819
Comprehensive Income:								
Net Income				1,779				1,779
Change in unrealized gains on securities available for sale, net of reclassification adjustment and tax effects							666	666
Total comprehensive income								2,445
Cash dividends declared \$.25 per share				(686 )				(686 )
Acquisition of treasury stock					20,000	(630 )		(630 )
Stock options exercised			(95 )		(5,928 )	186		91
Tax benefit of stock options exercised			17					17
Compensation expense related to stock options			38					38
Cumulative effect of net periodic postretirement benefit				(520 )				(520 )
Balance, March 31, 2008	2,840,872	\$ 284	\$ 10,119	\$ 47,603	101,328	(\$3,152 )	\$ 1,720	\$ 56,574
Balance December 31, 2008	2,840,872	\$ 284	\$ 9,972	\$ 50,938	104,310	(\$3,243 )	\$ 1,279	\$ 58,690
Comprehensive Income:								
Net Income				1,737				1,737
Change in unrealized gains on securities available for sale, net of reclassification adjustments and tax effects							486	486
Total comprehensive income								2,223
Cash dividends declared \$.27 per								



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share						(741)		(741)	)
Acquisition of treasury stock						2,519	(68	)	(68
Stock options exercised	(16	)				(788	)	25	9
Tax benefit on stock options exercised	5								5
Compensation expense related to stock options			32						32
Balance, March 31, 2009	2,840,872	\$ 284	\$ 9,993	\$ 51,394	106,041	(\$3,286	)	\$ 1,765	\$ 60,150

See accompanying notes to the unaudited consolidated financial statements.

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NORWOOD FINANCIAL CORP.

Consolidated Statements of Cash Flows (Unaudited)

(dollars in thousands)

	Three Months Ended	
	March 31,	
	2009	2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income	\$ 1,737	\$ 1,779
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	225	75
Depreciation	148	138
Amortization of intangible assets	13	13
Deferred income taxes	94	(38 )
Net amortization of securities premiums and discounts	19	16
Net realized gain on sales of securities	(161 )	—
Gain on sale of deposits	(150 )	—
Net increase in investment in life insurance	(81 )	(74 )
Net gain on sale of mortgage loans	(133 )	(388 )
Mortgage loans originated for sale	(9,795 )	—
Proceeds from sale of mortgage loans originated for sale	9,928	—
Compensation expense related to stock options	32	38
Decrease in accrued interest receivable and other assets	127	314
Decrease in accrued interest payable and other liabilities	(6 )	(389 )
Net cash provided by operating activities	1,997	1,484
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Securities available for sale:		
Proceeds from sales	4,973	—
Proceeds from maturities and principal reductions on mortgage-backed securities	16,950	15,286
Purchases	(15,143 )	(20,942 )
Increase in investment in FHLB stock	—	(52 )
Net increase in loans	(2,206 )	(11,705 )
Proceeds from sale of mortgage loans	—	13,982
Purchase of bank premises and equipment	(71 )	(64 )
Net cash provided by (used in) investing activities	4,503	(3,495 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	14,538	1,153
Net increase (decrease) in short-term borrowings	(8,714 )	1,320
Stock options exercised	9	91
Tax benefit of stock options exercised	5	17
Acquisition of treasury stock	(68 )	(630 )
Cash dividends paid	(739 )	(688 )
Net cash provided by financing activities	5,031	1,263
Increase (decrease) in cash and cash equivalents	11,531	(748 )

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CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	6,480	9,064
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 18,011	\$ 8,316

See accompanying notes to the unaudited consolidated financial statements.

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**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 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, 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.

**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,	
	2009	2008
Basic EPS weighted average shares outstanding	2,737	2,753
Dilutive effect of stock options	18	37
Diluted EPS weighted average shares outstanding	2,755	2,790

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 113,150 and 40,000 as of March 31, 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, 22,000 options in 2007 and 24,000 options in 2008, all of which have a twelve month vesting period. As of March 31, 2009, there was \$98,000 of total unrecognized compensation cost related to nonvested options granted in 2008 under the plan, which will be fully amortized by December 31, 2009.

No stock options were granted during the three months ended March 31, 2009. A summary of stock options from all plans 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	<u>(788)</u>	10.36			
Outstanding at March 31, 2009	175,655	\$ 26.02	6.4	Yrs.	\$ -
Exercisable at March 31, 2009	151,655	\$ 25.78	5.0	Yrs.	\$ -

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 three months ended March 31, 2009 was \$14,000, cash received from such exercises was \$9,000 and the tax benefit recognized was \$5,000.

**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 all of which mature within 90 days and federal funds sold.

Cash payments for interest for the periods ended March 31, 2009 and 2008 were \$2,312,000 and \$3,401,000 respectively. Cash payments for income taxes for the periods ending March 31, 2009 and 2008 were \$2,000 and \$4,000 respectively. Non-cash investing activity for 2009 and 2008 included repossession of other assets and foreclosed mortgage loans transferred to real estate owned of \$132,000 and \$11,000, respectively. Non-cash financing activity for 2009 includes \$3,607,000 relating to the payable on the sale of deposits.

**5. Comprehensive Income**

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



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(in thousands)	Three Months Ended	
	March 31, 2009	2008
Unrealized holding gains on available for sale securities	\$ 901	\$ 1,007
Reclassification adjustment for gains realized in income	161	-
Net unrealized gains	740	1,007
Income tax expense	254	341
Other comprehensive income	\$ 486	\$ 666

**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	
	2009	2008
Commitments to grant loans	\$ 15,441	\$ 10,311
Unfunded commitments under lines of credit	37,527	32,920
Standby letters of credit	1,695	2,214
	\$ 54,663	\$ 45,445

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.





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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, 2009 for guarantees under standby letters of credit issued is not material.

### 7. Fair Value Measurements

Financial Accounting Board Statement No. 157, *Fair Value Measurements* ("SFAS 157") establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS 157 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, 2009 and December 31, 2008 are as follows:

(In Thousands)	Fair Value Measurement Reporting Date using	(Level 1) (Level 2) (Level 3)		
		Total	Quoted Prices in Active Markets For Identical Assets	Significant Other Observable Inputs
<u>Description</u>				
March 31, 2009				
Securities available for sale	\$124,222	\$781	\$123,441	\$ -
December 31, 2008				
Securities available for sale	\$130,120	\$1,155	\$128,965	\$ -



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

(In Thousands)	Fair Value Measurement Reporting Date using	(Level 1) (Level 2) (Level 3)		
		Quoted Prices in Active Markets For Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
<u>Description</u>	Total			
March 31, 2009				
Impaired Loans	\$3,078	\$-	\$-	\$3,078
Foreclosed real estate owned	768	-	-	768
	\$3,846	\$-	\$-	\$3,846
December 31, 2008				
Impaired Loans	\$2,976	\$-	\$-	\$2,976

### 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). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) are used to support fair values of certain Level 3 investments, if applicable.

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

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 Company 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 properties, 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 was \$3,078,000 as of March 31, 2009 and \$2,976,000 as of 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. A property consisting of a residential one family residence was acquired through foreclosure in the period ending March 31, 2009 and is carried at its net realizable value of \$108,000, based on a current appraisal. At March 31, 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.

## **8. New and Recently Adopted Accounting Pronouncements**

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

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

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

This FSP is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. An entity early adopting FSP FAS 157-4 must also early adopt FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments. The Company is currently reviewing the effect this new pronouncement will have on its 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.



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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 Company is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1 amends FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This FSP also amends APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in summarized financial information at interim reporting periods.

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 107-1 and APB 28-1 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 and FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments. The Company is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

### **9. 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. The Company recorded a net payable to NBT Bank of \$3,607,000, which was paid subsequent to 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 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 March 31, 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 decline in

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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

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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, 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 March 31, 2009 and December 31, 2008 represent temporary impairment of the securities.

### **Changes in Financial Condition**

#### **General**

Total assets as of March 31, 2009 were \$511.4 million compared to \$504.3 million as of December 31, 2008 an increase of \$7.1 million. The increase reflects a \$11.5 million increase in the cash and cash equivalents and a \$2.0 million increase in loans receivable partially offset by a \$5.9 million decrease in securities available for sale.

#### **Securities**

The fair value of securities available for sale as of March 31, 2009 was \$124.2 million compared to \$130.1 million as of December 31, 2008. The Company purchased \$15.1 million of securities principally using the proceeds from \$16.9 million of securities 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, 2009		December 31, 2008		
	Amount	% of portfolio	Amount	% of portfolio	
US Government agencies	\$ 30,886	24.8	% \$ 35,813	27.5	%
States and political subdivisions	26,831	21.4	25,916	19.8	
Corporate securities	4,742	3.8	5,625	4.3	
Mortgage-backed securities	61,689	49.4	62,318	47.5	
Equity securities	781	0.6	1,155	0.9	
Total	\$ 124,929	100.0	% \$ 130,827	100.0	%

The Company has securities in an unrealized loss position. In management's opinion, the unrealized losses in the mortgage-backed securities reflect changes in interest rates subsequent to the acquisition of specific securities. The unrealized losses in the State and Political Subdivisions and Corporate Obligations 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 represent temporary impairment of the securities, as the Company has the intent and ability to hold these investments until maturity or market price recovery.



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**Loans Receivable**

Loans receivable totaled \$351.4 million compared to \$349.4 million as of December 31, 2008. Residential real estate loans decreased \$4.2 million principally due to the sale of \$9.7 million of residential mortgages. The loans were sold for interest rate risk management to shorten the average life of the mortgage loan portfolio. Commercial real estate loans increased \$7.2 million during the period as a result of continued activity in the Monroe and Pike area.

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, 2009		December 31, 2008		
Real Estate-Residential	\$ 129,235	36.7	% \$ 133,417	38.1	%
Commercial	166,668	47.4	159,476	45.7	
Construction	13,230	3.8	14,856	4.2	
Commercial, financial and agricultural	27,246	7.7	25,886	7.4	
Consumer loans to individuals	15,438	4.4	16,087	4.6	
Total loans	351,817	100.0	% 349,722	100.0	%
Deferred fees (net)	(384 )		(318 )		
	351,433		349,404		
Allowance for loan losses	(4,413 )		(4,233 )		
Net loans receivable	\$ 347,020		\$ 345,171		

**Allowance for Loan Losses and Non-performing Assets**

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

(dollars in thousands)	Three Months Ended March 31,	
	2009	2008
Balance, beginning	\$ 4,233	\$ 4,081
Provision for loan losses	225	75
Charge-offs	(62 )	(35 )
Recoveries	17	16
Net charge-offs	(45 )	(19 )
Balance, ending	\$ 4,413	\$ 4,137
Allowance to total loans	1.26	% 1.26
Net (charge-offs) recoveries to average loans (annualized)	.05	% .02

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The allowance for loan losses totaled \$4,413,000 as of March 31, 2009 and represented 1.26% of total loans, compared to \$4,233,000 at year end, and \$4,137,000 as of March 31, 2008. The Company had net charge-offs for the three months ended March 31, 2009 of \$45,000 compared to \$19,000 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 March 31, 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.

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As of March 31, 2009, non-performing loans totaled \$1,692,000, which is .48% 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 following table sets forth information regarding non-performing loans and foreclosed real estate at the dates indicated:

(dollars in thousands)	March 31, 2009	December 31, 2008
Loans accounted for on a non-accrual basis:		
Commercial and all other	\$ —	\$ —
Real Estate	1,641	2,087
Consumer	—	—
Total	1,641	2,087
Accruing loans which are contractually past due 90 days or more	51	—
Total non-performing loans	1,692	2,087
Foreclosed real estate	768	660
Total non-performing assets	\$ 2,460	\$ 2,747
Allowance for loans losses	\$ 4,413	\$ 4,233
Coverage of non-performing loans	2.61	2.03
Non-performing loans to total loans	.48	.60
Non-performing assets to total assets	.48	.54

**Deposits**

Total deposits as of March 31, 2009 were \$370.4 million compared to \$359.6 million as of December 31, 2008, an increase of \$10.8 million. This growth in deposits was after the sale of \$3.6 million related to a branch closure as described in Note 9. Deposit growth was attributable to a \$4.7 million increase in money market deposit accounts and \$4.6 million increase in time deposits under \$100,000. The increase in time deposits was due to a promotional 13 month product. The growth in deposits was used to reduce short-term borrowings with the remaining portion temporarily invested in Federal Funds sold.

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

(dollars in thousands)	March 31, 2009	December 31, 2008
Non-interest bearing demand	\$ 57,270	\$ 56,839
Interest bearing demand	35,757	35,322
Money market deposit accounts	65,274	60,623
Savings	44,714	44,577
Time deposits <\$100,000	121,753	117,179

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Time deposits >\$100,000	45,648	45,095
Total	\$ 370,416	\$ 359,635

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**Borrowings**

Short-term borrowings as of March 31, 2009 totaled \$29.4 million compared to \$38.1 million as of December 31, 2008. Securities sold under agreements to repurchase declined \$5.2 million principally due to the seasonality of municipal cash management accounts. Short-term borrowings consist of the following:

	March 31, 2009	December 31, 2008
(dollars in thousands)		
Securities sold under agreements to repurchase	\$ 18,214	\$ 23,404
Federal Funds Purchased	—	3,600
Short-term FHLB advances	11,000	11,000
U.S. Treasury demand notes	198	122
	\$ 29,412	\$ 38,126

Other borrowings consisted of the following:

(dollars in thousands)

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

The convertible notes contain an option 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.

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

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

	March 31, 2009	December 31, 2008
	(in thousands)	
Commitments to grant loans	\$ 15,441	\$ 19,254
Unfunded commitments under lines of credit	37,527	36,980
Standby letters of credit	1,695	1,897
	\$ 54,663	\$ 58,131

### **Stockholders' Equity and Capital Ratios**

As of March 31, 2009, stockholders' equity totaled \$60.2 million, compared to \$58.7 million as of December 31, 2008. The net change in stockholders' equity included \$1,737,000 in net income, that was partially offset by \$741,000 of dividends declared. In addition, accumulated other comprehensive income increased \$486,000 due to an increase in fair value of securities in the available for sale portfolio, net of tax. This increase in fair value is the result of a change in interest rates, which may impact the value of the securities. Because of interest rate volatility, the Company's accumulated other comprehensive income could materially fluctuate for each interim and year-end period.

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

	March 31, 2009	December 31, 2008
Tier 1 Capital (To average assets)	11.51%	11.45%
Tier 1 Capital (To average-weighted assets)	16.47%	16.22%
Total Capital (To risk-weighted assets)	17.77%	17.50%

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

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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, 2009 and December 31, 2008.

### **Liquidity**

As of March 31, 2009, the Company had cash and cash equivalents of \$18.0 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 \$124.2 million which could be used for liquidity needs. This totals \$142.2 million and represents 27.8% of total assets compared to \$136.6 million and 27.1% of total assets as of December 31, 2008. The Company also monitors other liquidity measures, all of which were within the Company's policy guidelines as of March 31, 2009 and December 31, 2008. Based upon these measures, the Company believes its liquidity is adequate.

### **Capital Resources**

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

The Company has a line of credit commitment from Atlantic Central Bankers Bank for \$7,000,000 which expires in May 2009. There were no borrowings under these lines as of March 31, 2009 and December 31, 2008. The Company has a line of credit commitment available which has no stated expiration date from PNC for \$12,000,000. Borrowings under this line were \$-0- as of March 31, 2009 and \$3,600,000 as of December 31, 2008.

The Bank's maximum borrowing capacity with the Federal Home Loan Bank was approximately \$235,056,000 of which \$54,000,000 was outstanding at March 31, 2009 and at December 31, 2008. Advances from the Federal Home Loan Bank are secured by qualifying assets of the Bank.

### **Non-GAAP Financial Measures**

This report contains or references fully taxable-equivalent (fte) interest income and net interest income, which are non-GAAP financial measures. Interest income (fte) and net interest income (fte) are derived from GAAP interest income and net interest income using an assumed tax rate of 34%. We believe the presentation of interest income (fte) and net interest income (fte) ensures comparability of interest income and net interest income arising from both taxable and tax-exempt sources and is consistent with industry practice. Net interest income (fte) is reconciled to GAAP net interest income on page 21. 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,						
	2009			2008			
	Average Balance (2)	Interest (1)	Average Rate (3)	Average Balance (2)	Interest (1)	Average Rate (3)	
<b>Assets</b>							
Interest-earning assets:							
Federal funds sold	\$ 3,024	\$ 2	0.26	% \$ 2,403	\$ 18	3.00	%
Interest bearing deposits with banks	5,725	4	0.28	82	1	4.88	
Securities held-to-maturity	707	15	8.49	706	15	8.50	
Securities available for sale:							
Taxable	102,422	1,142	4.46	105,489	1,277	4.84	
Tax-exempt	25,471	372	5.84	22,087	306	5.54	
Total securities available for sale (1)	127,893	1,514	4.74	127,576	1,583	4.96	
Loans receivable (4) (5)	351,315	5,316	6.05	328,347	5,689	6.93	
Total interest earning assets	488,664	6,851	5.61	459,114	7,306	6.37	
Non-interest earning assets:							
Cash and due from banks	6,599			7,103			
Allowance for loan losses	(4,317 )			(4,121 )			
Other assets	17,657			16,861			
Total non-interest earning assets	19,939			19,843			
Total Assets	\$ 508,603			\$ 478,957			
<b>Liabilities and Stockholders' Equity</b>							
Interest bearing liabilities:							
Interest bearing demand and money market	\$ 97,883	200	0.82	\$ 95,512	432	1.81	
Savings	44,707	41	0.37	42,555	49	0.46	
Time	167,461	1,260	3.01	175,250	1,890	4.31	
Total interest bearing deposits	310,051	1,501	1.94	313,317	2,371	3.03	
Short-term borrowings	35,299	96	1.09	25,776	187	2.90	
Other borrowings	43,000	412	3.83	23,000	267	4.64	
Total interest bearing liabilities	388,350	2,009	2.07	362,093	2,825	3.12	
Non-interest bearing liabilities:							
Demand deposits	56,290			55,679			
Other liabilities	4,284			4,911			
Total non-interest bearing liabilities	60,574			60,590			
Stockholders' equity	59,679			56,274			
Total Liabilities and Stockholders' Equity	\$ 508,603			\$ 478,957			
<b>Net interest income (tax equivalent basis)</b>							
		4,842	3.54	%	4,481	3.25	%
Tax-equivalent basis adjustment		(161 )			(157 )		
Net interest income		\$ 4,681			\$ 4,324		

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Net interest margin (tax equivalent basis)	3.96	%	3.90	%
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- (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.

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**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, 2009 Compared to Three Months ended March 31, 2008		
	Variance due to		
	Volume	Rate	Net
	(dollars in thousands)		
Assets			
Interest earning assets:			
Federal funds sold.....	\$ 25	\$ (41 )	\$ (16 )
Interest bearing deposits with banks.....	10	(7 )	3
Securities held to maturity.....	—	—	—
Securities available for sale:			
Taxable.....	(36 )	(99 )	(135 )
Tax-exempt securities.....	49	17	66
Total securities.....	13	(82 )	(69 )
Loans receivable.....	1,918	(2,291 )	(373 )
Total interest earning assets.....	1,966	(2,421 )	(455 )
Interest bearing liabilities:			
Interest-bearing demand and money market....	72	(304 )	(232 )
Savings.....	14	(22 )	(8 )
Time.....	(81 )	(549 )	(630 )
Total interest bearing deposits.....	5	(875 )	(870 )
Short-term borrowings.....	314	(405 )	(91 )
Other borrowings.....	431	(286 )	145
Total interest bearing liabilities.....	750	(1,566 )	(816 )
Net interest income (tax-equivalent basis).....	\$ 1,217	\$ (856 )	\$ 361

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, 2009 to March 31, 2008****General**

For the three months ended March 31, 2009, net income totaled \$1,737,000 compared to \$1,779,000 earned in the similar period in 2008. Earnings per share for the current period were \$.63 for basic and fully diluted compared to \$.65 per share basic and \$.64 per share on a fully diluted basis for the three months ended March 31, 2008. The resulting annualized return on average assets and annualized return on average equity for the three months ended March 31, 2009 was 1.39% and 11.80%, respectively, compared to 1.49% and 12.71%, respectively, for the similar period in 2008.

The following table sets forth changes in net income:

(dollars in thousands)	Three months ended March 31, 2009 to March 31, 2008	
Net income three months ended March 31, 2008	\$	1,779
Change due to:		
Net interest income		357
Provision for loan losses		(150 )
Gain on sales of loans, securities & deposits		56
Other income		(37 )
Salaries and employee benefits		(68 )
FDIC insurance assessment		(114 )
All other expenses		(132 )
Income tax expense		46
Net income three months ended March 31, 2009	\$	1,737

**Net Interest Income**

Net interest income on a fully taxable equivalent basis (fte) for the three months ended March 31, 2009, totaled \$4,842,000, an increase of \$361,000 or 8.1% over the similar period in 2008. The fte net interest spread and net interest margin were 3.54% and 3.96%, respectively, for the three months ended March 31, 2009 compared to 3.25% and 3.90%, respectively for the similar period in 2008.

Interest income (fte) totaled \$6,851,000 with a yield on average earning assets of 5.61% compared to \$7,306,000 and 6.37% for the 2008 period. The decrease in yield was due in part to the lower prime interest rate which was 3.25% as of March 31, 2009 compared to 5.25% at March 31, 2008. The Company has \$69 million of floating rate loans tied to prime rate. In addition, residential mortgage rates have declined causing a portion of the portfolio to refinance at lower rates. As a result, the fte yield on loans declined to 6.05% in the current period from 6.93% for the same period in the prior year. The yield on investment securities also declined 22 basis points reflecting the reinvestment of cash flow, maturities and calls at the current lower rates. The yield on earning assets was also adversely impacted by a higher level of Fed Funds and interest-bearing deposits, \$8.7 million on average at .27% for the current period compared to \$2.5 million at 3.06% for the prior-year period. Average earning assets totaled \$488.7 million for the three months ended March 31, 2009, an increase of \$29.6 million over the average for the similar period in 2008. This increase in average earning assets helped offset the decline in asset yields.



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Interest expense for the three months ended March 31, 2009 totaled \$2,009,000 at an average cost of 2.07% compared to \$2,825,000 and 3.12% for the similar period in 2008. As a result of the decrease in short-term interest rates, the Company reduced rates paid on its money market accounts and cash management products, which are included in short-term borrowings. The cost of time deposits, which is the most significant component of funding, declined to 3.01% from 4.31% 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 \$1,281,000 for the three months ended March 31, 2009 compared to \$1,262,000 for the similar period in 2008. The current period includes \$133,000 gain on the sale of \$9.7 million of fixed residential mortgages compared to \$388,000 in gains on the sale of \$13.9 million of mortgages in the similar period of 2008. The current period includes a \$161,000 gain on the sale of investment securities with no such gains in the 2008 period. The Company closed its branch office in Hamlin, PA and recorded a gain of \$150,000 on the sale of deposits to another financial institution.

### **Other Expense**

Other expense for the three months ended March 31, 2009 totaled \$3,275,000, an increase of \$314,000 from \$2,961,000 for the similar period in 2008. FDIC insurance assessments increased \$114,000 as a result of an increase in the assessment rates and utilization of credits in the prior period. Expense related to the Hamlin branch closing totaled \$46,000.

The FDIC has additionally announced that it will impose a special assessment equal to 20 basis points on deposits as of June 30, 2009 to be paid on September 30, 2009. The FDIC has indicated that it may decrease the special assessment to 10 basis points if its line of credit from the U.S. Treasury is increased to \$100 million.

### **Income Tax Expense**

Income tax expense totaled \$725,000 for an effective tax rate of 29.5% for the period ending March 31, 2009 compared to \$771,000 for an effective tax rate of 30.2% for the similar period in 2008.

## **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.

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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, 2009, the level of net interest income at risk in a 200 basis points change in interest rates was within the Company's policy limits. The Company's policy allows for a decline of no more than 8% of net interest income.

Imbalance in repricing opportunities at a given point in time 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.

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As of March 31, 2009, the Bank had a positive 90 day interest sensitivity gap of \$44.2 million or 8.6% of total assets, increasing from \$20.4 million or 4% of total assets as of December 31, 2008. The change was principally due to a lower level of time deposits maturing in the 90 day time frame \$16.8 million and a higher level of overnight investments, \$12.3 million as of March 31, 2009. A positive gap means that rate-sensitive assets are greater than rate-sensitive liabilities at the time interval. This would indicate that in a declining rate environment, the yield on interest-earning assets could decrease faster than the cost of interest-bearing liabilities in the 90 day time frame. The repricing intervals are managed by ALCO strategies, including adjusting the average life of the investment portfolio, pricing of deposit liabilities to attract longer term time deposits, loan pricing to encourage variable rate products and evaluation of loan sales of long-term fixed rate mortgages.

### March 31, 2009

#### 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	\$ 12,329	\$ —	\$ —	\$ —	\$ 12,329
Securities	18,993	31,007	29,929	45,000	124,929
Loans Receivable	83,208	56,914	84,395	126,916	351,433
Total RSA	114,530	87,921	114,324	171,916	488,691
Non-maturity interest-bearing deposits	25,751	25,751	68,035	28,861	148,398
Time Deposits	29,509	85,157	33,689	19,046	167,401
Other	15,118	6,413	30,881	20,000	72,412
Total RSL	70,378	117,321	132,605	67,907	388,211
Interest Sensitivity Gap	\$ 44,152	(\$29,400 )	(\$18,281 )	\$ 104,009	\$ 100,480
Cumulative Gap	44,152	14,752	(3,529 )	100,480	
RSA/RSL-cumulative	162.7	% 107.9	% 98.9	% 125.9	%

### December 31, 2008

Interest Sensitivity Gap	\$ 20,390	(\$10,272 )	(\$16,051 )	\$ 102,259	\$ 96,326
Cumulative Gap	20,390	10,118	(5,933 )	96,326	
RSA/RSL-cumulative	123.1	% 105.5	% 98.1	% 125.1	%

#### **Item 4. Controls and Procedures**

The Company's management evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures, as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

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.

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**Part II. OTHER INFORMATION****Item 1. Legal Proceedings**

Not applicable

**Item 1A. Risk Factors**

No material changes from those disclosed in the Form 10-K for the year ended December 31, 2008.

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

On January 14, 2009, the Registrant issued 788 shares of common stock pursuant to the exercise of options by a director under the 1999 Directors Stock Option Plan in a transaction that was exempt from registration pursuant to section 4(2) of the Securities Act of 1933. Such shares were sold for cash at an exercise price equal to the fair market value of the common stock on the date that the option was granted.

	Issuer Purchases of Equity Securities		Total number of shares purchased as part of announced plans or programs	Maximum number (or approximate dollar value that may yet be purchased under the plans or programs (2))
	Total number of shares purchased	Average price per share		
January 1–January 31, 2009	—	\$ —	—	—
February 1–February 28, 2009	—	—	—	—
March 1 – March 31, 2009(1)	2,519	27.50	—	112,000
	2,519	\$ 27.50	—	112,000

(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. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

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



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- \* Incorporated herein by reference to the identically numbered exhibits of the Registrant's Form 10 Registration Statement initially filed with the Commission on April 29, 1996.
- \*\* Incorporated herein by reference to the identically numbered exhibit to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2009 filed with the Commission on March 11, 2009.
- \*\*\* Incorporated herein by reference to the identically numbered exhibits to the Registrant's Form 8-K filed with the Commission on March 6, 2006.
- \*\*\*\* Incorporated herein by reference to the identically numbered exhibits of the Registrant's Form 10-K filed with the Commission on March 20, 2000.
- \*\*\*\*\* Incorporated herein by reference to the identically numbered exhibit to the Registrant's Form 10-K filed with the Commission on March 22, 2004.
- \*\*\*\*\* Incorporated herein by reference to the Registrant's Form 8-K filed with the Commission on April 25, 2006.
- \*\*\*\*\* Incorporated herein by reference from the Exhibits to the Registrant's Current Report on Form 8-K filed 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 11, 2009

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

Date May 11, 2009

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