NORWOOD FINANCIAL CORP
Form 10-Q
November 13, 2007

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 September 30, 2007

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	(I.R.S. Employer Identification No.)
Incorporation or organization)	

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 x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

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 November 13, 2007
Common stock, par value $0.10 per share	2,767,959

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NORWOOD FINANCIAL CORP.

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2007

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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)	**September 30, 2007**	**December 31, 2006**
ASSETS		
Cash and due from banks	$ 8,656	$ 9,450
Interest bearing deposits with banks	218	67
Cash and cash equivalents	8,874	9,517
Securities available for sale	118,736	112,912
Securities held to maturity, fair value 2007: $723, 2006: $971	705	954
Loans receivable (net of unearned income)	328,582	315,567
Less: Allowance for loan losses	3,979	3,828
Net loans receivable	324,603	311,739
Investment in FHLB Stock, at cost	1,989	1,687
Bank premises and equipment, net	5,764	6,020
Bank owned life insurance	7,694	7,479
Accrued interest receivable	2,417	2,129
Other assets	2,084	1,919
TOTAL ASSETS	$ 472,866	$ 454,356
LIABILITIES		
Deposits:		
Non-interest bearing demand	$ 60,880	$ 53,856
Interest bearing	306,673	304,247
Total deposits	367,553	358,103
Short-term borrowings	22,628	22,736
Other borrowings	23,000	13,000
Accrued interest payable	2,590	2,894
Other liabilities	2,375	5,392
TOTAL LIABILITIES	418,146	402,125
STOCKHOLDERS' EQUITY		
Common stock, $.10 par value, authorized 10,000,000 shares, issued: 2,840,872	284	284
Surplus	10,203	10,149
Retained earnings	46,046	43,125
Treasury stock at cost: 2007: 72,913 shares, 2006: 43,721 shares	(2,237)	(1,283)
Accumulated other comprehensive income (loss)	424	(44)
TOTAL STOCKHOLDERS' EQUITY	54,720	52,231

TOTAL LIABILITIES AND		
STOCKHOLDERS' EQUITY	$ 472,866	$ 454,356

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 September 30,**		**Nine Months Ended September 30,**	
	2007	**2006**	**2007**	**2006**
INTEREST INCOME				
Loans receivable, including fees	$ 6,054	$ 5,506	$ 17,772	$ 15,651
Securities	1,370	1,105	3,866	3,221
Other	33	36	144	121
Total interest income	7,457	6,647	21,782	18,993
INTEREST EXPENSE				
Deposits	2,489	2,032	7,449	5,360
Short-term borrowings	195	235	656	585
Other borrowings	281	278	808	991
Total interest expense	2,965	2,545	8,913	6,936
NET INTEREST INCOME	4,492	4,102	12,869	12,057
PROVISION FOR LOAN LOSSES	90	45	195	170
NET INTEREST INCOME AFTER PROVSION FOR LOAN LOSSES	4,402	4,057	12,674	11,887
OTHER INCOME				
Service charges and fees	635	616	1,876	1,850
Income from fiduciary activities	117	89	335	261
Net realized gains on sales of securities	--	45	15	66
Gain on sale of loans and servicing rights	8	3	16	110
Other	153	141	422	434
Total other income	913	894	2,664	2,721
OTHER EXPENSES				
Salaries and employee benefits	1,432	1,482	4,367	4,344
Occupancy, furniture & equipment, net	400	329	1,231	1,078
Data processing related	173	185	515	511
Taxes, other than income	54	110	293	334
Professional fees	75	62	258	279
Other	653	562	1,831	1,791
Total other expenses	2,787	2,730	8,495	8,337
INCOME BEFORE INCOME TAXES	2,528	2,221	6,843	6,271
INCOME TAX EXPENSE	722	699	2,004	1,940
NET INCOME	$ 1,806	$ 1,522	$ 4,839	$ 4,331
BASIC EARNINGS PER SHARE	$ 0.65	$ 0.54	$ 1.74	$ 1.55
DILUTED EARNINGS PER SHARE	$ 0.64	$ 0.53	$ 1.71	$ 1.52

See accompanying notes to the unaudited consolidated financial statements

NORWOOD FINANCIAL CORP.

Consolidated Statements of Changes in Stockholders' Equity (unaudited)

(dollars in thousands, except per share data)	Number of shares issued	Common Stock	Surplus	Retained Earnings	Treasury Stock	Unearned ESOP Shares	Accumulated Other Comprehensive (Loss) Income	Total
Balance December 31, 2005	2,705,715	$ 270	$ 5,648	$ 43,722	$ (633)	$ (127)	$ (772)	$ 48,108
Comprehensive Income:								
Net Income				4,331				4,331
Change in unrealized losses on securities available for sale, net of reclassification adjustment and tax effects							483	483
Total comprehensive income								4,814
Cash dividends declared, $.62 per share				(1,727)				(1,727)
5% Stock dividend	135,157	14	4,121	(4,139)				(4)
Acquisition of treasury stock					(671)			(671)
Stock options exercised			(26)		58			32
Tax benefit of stock options exercised			1					1
Compensation expense related to stock options			85					85
Release of earned ESOP shares			294			127		421
Balance, September 30, 2006	2,840,872	$ 284	$ 10,123	$ 42,187	$ (1,246)	$ -	$ (289)	$ 51,059

(dollars in thousands, except per share data)	Number of shares issued	Common Stock	Surplus	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive (Loss) Income	Total
	2,840,872	$ 284	$ 10,149	$ 43,125	$ (1,283)	$ (44)	$ 52,231

Balance December 31, 2006							
Comprehensive Income:							
Net Income				4,839			4,839
Change in unrealized gains on securities available for sale, net of reclassification adjustment and tax effects						468	468
Total comprehensive income							5,307
Cash dividends declared, $.69 per share				(1,918)			(1,918)
Acquisition of treasury stock					(1,385)		(1,385)
Stock options exercised			(243)		431		188
Tax benefit of stock options exercised			98				98
Compensation expense related to stock options			199				199
Balance September 30, 2007	2,840,872	$ 284	$ 10,203	$ 46,046	$ (2,237)	$ 424	$ 54,720

See accompanying notes to the unaudited consolidated financial statements

NORWOOD FINANCIAL CORP.

Consolidated Statements of Cash Flows (unaudited)

(dollars in thousands)	Nine Months Ended September 30, 2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income	$ 4,839	$ 4,331
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	195	170
Depreciation	425	372
Amortization of intangible assets	39	39
Deferred income taxes	207	145
Net amortization of securities premiums and discounts	101	243
Net realized gain on sales of securities	(15)	(66)
Earnings on life insurance policies	(215)	(197)
Net gain on sale of mortgage loans and servicing rights	(16)	(110)
Gain on sale of bank premises and equipment and foreclosed real estate	—	(5)
Mortgage loans originated for sale	(801)	(572)
Proceeds from sale of mortgage loans and servicing rights	817	682
Release of ESOP shares	—	421
Compensation expense related to stock options	199	85
Decrease (increase) in accrued interest receivable and other assets	(651)	613
Increase (decrease) in accrued interest payable and other liabilities	(3,549)	676
Net cash provided by operating activities	1,575	6,828
CASH FLOWS FROM INVESTING ACTIVITIES		
Securities available for sale:		
Proceeds from sales	74	96
Proceeds from maturities and principal reductions on mortgage-backed securities	37,761	20,616
Purchases	(43,046)	(16,750)
Securities held to maturity- proceeds from calls	250	505
Net increase in investment in FHLB stock	(302)	(14)
Net increase in loans	(13,107)	(22,910)
Purchase of bank premises and equipment	(169)	(468)
Proceeds from sale of bank premises and equipment and foreclosed real estate	—	29
Net cash used in investing activities	(18,539)	(18,896)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	9,450	24,003
Net decrease in short-term borrowings	(108)	(3,294)
Proceeds from (repayments of) other borrowings	10,000	(5,000)
Tax benefit of stock options exercised	98	1
Stock options exercised	188	32
Acquisition of treasury stock	(1,385)	(671)
Cash dividends paid	(1,922)	(1,704)
Net cash provided by financing activities	16,321	13,366
Increase (decrease) in cash and cash equivalents	(643)	1,298

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	9,517	9,816
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 8,874	$ 11,114

See accompanying notes to the unaudited consolidated financial statements

Notes to Unaudited Consolidated Financial Statements

1. Basis of Presentation

The 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 results of operations and financial position of the Company. The operating results for the three and nine month periods ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007 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, 2006.

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:

(in thousands)	**Three Months Ended September 30,**		**Nine Months Ended September 30,**	
	2007	**2006**	**2007**	**2006**
Basic EPS weighted average shares outstanding	2,773	2,794	2,783	2,794
Dilutive effect of stock options	46	59	52	58
Diluted EPS weighted average shares outstanding	2,819	2,853	2,835	2,852

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3. Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123(R), "Share-Based Payment." Statement No. 123(R) replaces Statement No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." Statement No. 123(R) requires that the fair value of share-based payment transactions be recognized as compensation costs in the financial statements over the period that an employee provides service in exchange for the award. The fair value of the share-based payments is estimated using the Black-Scholes option-pricing model. The Company adopted Statement No. 123(R) effective January 1, 2006, using the modified-prospective transition method. Under the modified prospective method, companies are required to record compensation cost for new and modified awards over the related vesting period of such awards and record compensation cost prospectively for the unvested portion, at the date of adoption, of previously issued and outstanding awards over the remaining vesting period of such awards. No change to prior periods presented is permitted under the modified prospective method. All outstanding options as of December 31, 2005 were fully vested. 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, all of which have a twelve month vesting period. As of September 30, 2007, there was approximately $48,000 of total unrecognized compensation cost related to nonvested options under the plan, which will be fully amortized by December 31, 2007.

No stock options were granted during the nine months ended September 30, 2007. 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, 2007	183,645	$ 21.81	6.0	Yrs.	$ 1,780
Exercised	(14,384)	12.91			
Outstanding at September 30, 2007	169,261	$ 22.57	5.8		$ 1,723
Exerciseable at September 30, 2007	146,761	$ 21.19	6.0		$ 1,697

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 nine months ended September 30, 2007 was $284,000, cash received from such exercises was $188,000 and the tax benefit recognized was $98,000.

4. New Borrowings

In January 2007 the company borrowed $10 million in the form of a convertible note from the Federal Home Loan Bank of Pittsburgh (FHLB). The note has a ten year term and has a fixed interest rate of 4.71% for three years. The convertible note contains an option that allows the FHLB, at quarterly intervals to change the note to an adjustable-rate advance at three-month LIBOR plus 16 basis points. If the note is converted, the Company has the option to put the funds back to the FHLB without penalty.

5. 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, all of which mature within 90 days.

Cash payments for interest for the nine months ended September 30, 2007 and 2006 were $9,218,000 and $6,340,000 respectively. Cash payments for income taxes in 2007 were $1,966,000 compared to $1,873,000 in 2006. Non-cash investing activities for 2007 and 2006 included foreclosed mortgage loans and repossession of other assets of $47,000 and $111,000, respectively.

6. 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 consolidated 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 September 30,**		**Nine Months Ended September 30,**	
	2007	**2006**	**2007**	**2006**
Unrealized holding gains on available for sale securities	$ 1,123	$ 1,285	$ 715	$ 799
Reclassification adjustment for gains realized in net income	-	(45)	(15)	(66)
Net unrealized gains	1,123	1,240	700	733
Income tax	380	423	232	250
Other comprehensive income	$ 743	$ 817	$ 468	$ 483

7. 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

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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)	September 30, 2007	2006
Commitments to grant loans	$ 15,687	$ 15,993
Unfunded commitments under lines of credit	31,911	34,507
Standby letters of credit	2,751	7,290
	$ 50,349	$ 57,790

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 September 30, 2007 for guarantees under standby letters of credit issued is not material.

8. New Accounting Pronouncements

In April 2007, the FASB directed the FASB Staff to issue FSP No. FIN 39-1, "Amendment of FASB Interpretation No. 39" ("FSP FIN 39-1"). FSP FIN 39-1 modifies FIN No. 39, "Offsetting of Amounts Related to Certain Contracts"and permits companies to offset cash collateral receivables or payables with net derivative positions under certain circumstances. FSP FIN 39-1 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. We are evaluating the effect of adopting FSP FIN 39-1 on our Consolidated Financial Statements.

In May 2007, the FASB issued FASB Staff Position ("FSP") FIN 48-1, "Definition of Settlement in FASB Interpretation No. 48" (FSP FIN 48-1). FSP FIN 48-1 provides guidance on how to determine whether a tax position is effectively settled for the purpose of recognizing

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previously unrecognized tax benefits. FSP FIN 48-1 is effective retroactively to January 1, 2007. The implementation of this standard did not have a material impact on our consolidated financial position or results of operations.

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board (FASB) Statement No. 156, "Accounting for Servicing of Financial Assets – An Amendment of FASB Statement No. 140" (SFAS "156"). SFAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. The statement permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. The adoption of SFAS 156 did not have a significant effect on the consolidated financial statements.

Effective January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes".* The Interpretation provides clarification on accounting for uncertainty in income taxes recognized in an enterprises's financial statements in accordance with FASB Statement of Financial Accounting Standard (SFAS) No. 109, *"Accounting for Income Taxes".* The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As a result of the Company's evaluation of the implementation of FIN 48, no significant income tax uncertainties were identified. Therefore, the Company recognized no adjustment for unrecognized income tax benefits during the nine months ended September 30, 2007. Our policy is to recognize interest and penalties on unrecognized tax benefits in "Federal income taxes" in the Consolidated Statements of Income. The amount of interest and penalties for the three months ended September 30, 2007 was immaterial. The tax years subject to examination by the taxing authorities are the years ending December 31, 2006, 2005, 2004 and 2003.

In March 2007, the FASB ratified EITF Issue No. 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards." EITF 06-11 requires companies to recognize the income tax benefit realized from dividends or dividend equivalents that are charged to retained earnings and paid to employees for nonvested equity-classified employee share-based payment awards as an increase to additional paid-in capital. EITF 06-11 is effective for fiscal years beginning after September 15, 2007. The Company does not expect EITF 06-11 will have a material impact on its consolidated financial position, results of operations or cash flows.

In March 2007, the FASB ratified Emerging Issues Task Force Issue No. 06-10 "Accounting for Collateral Assignment Split-Dollar Life Insurance Agreements" (EITF 06-10). EITF 06-10 provides guidance for determining a liability for the postretirement benefit obligation as well as recognition and measurement of the associated asset on the basis of the terms of the collateral assignment agreement. EITF 06-10 is effective for fiscal years beginning after December 15, 2007. The Company is currently assessing the impact of EITF 06-10 on its consolidated financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115". SFAS

No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective for our Company January 1, 2008. The Company is evaluating the impact that the adoption of SFAS No. 159 will have on our consolidated financial statements.

On September 7, 2006, the Task Force reached a conclusion on EITF Issue No. 06-5, “Accounting for Purchases of Life Insurance – Determining the Amount that Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance” (“EITF 06-5”). The Scope of EITF 06-5 consists of six separate issues relating to accounting for life insurance policies purchased by entities protecting against the loss of “key persons.” The six issues are clarifications of previously issued guidance on FASB Technical Bulletin No. 85-4. EITF 06-5 is effective for fiscal years beginning after December 15, 2006. The adoption of EITC 06-5 did not have a material impact on the Company’s consolidated financial statements.

In September 2006, the FASB’s Emerging Issues Task Force (EITF) issued EITF Issue No. 06-4, “Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements” (“EITF 06-4). EITF 06-4 requires the recognition of a liability related to the postretirement benefits covered by an endorsement split-dollar life insurance arrangement. The consensus highlights that the employer (who is also the policyholder) has a liability for the benefit it is providing to its employee. As such, if the policyholder has agreed to maintain the insurance policy in force for the employee’s benefit during his or her retirement, then the liability recognized during the employee’s active service period should be based on the future cost of insurance to be incurred during the employee’s retirement. Alternatively if the policy holder has agreed to provide the employee with a death benefit, then the liability for the future death benefit should be recognized by following the guidance in SFAS No. 106 or Accounting Principles Board (APB) Opinion No. 12, as appropriate. For transition, an entity can choose to apply the guidance using either of the following approaches: (a) a change in accounting principle through retrospective application to all periods presented or (b) a change in accounting principle through a cumulative-effect adjustment to the balance in retained earnings at the beginning of the year of adoption. The EITF is effective for fiscal years beginning after December 15, 2007, with early adoption permitted. The Company is evaluating the potential impact of this guidance on the Company’s consolidated financial statements.

In September 2006, the FASB issued FASB Statement No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. FASB Statement 157 applies to all accounting pronouncements that require or permit fair value measurements. The new guidance is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years. We are currently evaluating the potential impact, if any, of the adoption of FASB Statement No. 157 on our consolidated financial position, results of operations and cash flows.

In June 2007, the Emerging Issues Task Force (“EITF”) reached a final consensus on EITF Issue No. 07-3, “Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities” (“EITF 07-3”). EITF 07-3 is effective for fiscal years beginning after December 15, 2007. EITF 07-3 requires that non-refundable advance payments for future research and development activities should be capitalized until the goods have been delivered or related services have been performed. Adoption is on a prospective basis and could impact the timing of expense recognitions for agreements entered into after December 31, 2007. We do not expect the adoption of EITF 07-3 to have a significant impact on our consolidated financial statements.

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, 2006 (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, 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, which requires that transactions be recognized as compensation cost in the income statement based on their fair values on the measurement date, which, for the Company is the grant date. The Norwood Financial Corp 2006 Stock Option Plan was approved on April 25, 2006 and the Company granted 47,700 options during 2006. For the three and nine months ended September 30, 2007, salaries and employee benefit expense includes $48,000 and $199,000 related to the adoption of Statement No. 123(R) and $51,000 and $85,000 for the three and nine months ended September 30, 2006.

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

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 at September 30, 2007 and December 31, 2006 represent temporary impairment of the securities, related to changes in interest rates.

Changes in Financial Condition

General

Total assets as of September 30, 2007 were $472.9 million compared to $454.4 million as of December 31, 2006, an increase of $18.5 million, or 4.1%. The increase reflects a $13.0 million increase in loans receivable and a $5.8 million increase in securities available for sale, funded by a $9.5 million increase in deposits and a $10 million increase in other borrowings.

Securities

The fair value of securities available for sale as of September 30, 2007 was $118.7 million compared to $112.9 million as of December 31, 2006. The Company purchased $43.0 million of securities principally using the proceeds from $38.0 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)	**September 30, 2007** Amount	% of portfolio		**December 31, 2006** Amount	% of portfolio	
US Government agencies	$ 43,555	36.5	%	$ 47,581	41.8	%
States and political subdivisions	21,766	18.2		17,419	15.3	
Corporate securities	2,978	2.5		8,439	7.4	
Mortgage-backed securities	49,591	41.5		38,652	33.9	
Equity securities	1,551	1.3		1,775	1.6	
Total	$ 119,441	100.0	%	$ 113,866	100.0	%

The Company has securities in an unrealized loss position. In Management's opinion, the unrealized losses reflect changes in interest rates subsequent to the acquisition of specific securities. The Company's available-for-sale portfolio has an average repricing term of 2.9 years.

Interest rates in the two to four year section of the treasury yield curve decreased during the nine months ended September 30, 2007, favorably impacting the fair value of individual securities. Management believes that the unrealized losses represent temporary impairment of the securities

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and are the result of changes in interest rates. The Company has the intent and ability to hold these investments until maturity or market price recovery.

Loans Receivable

Loans receivable totaled $328.6 million compared to $315.6 million as of December 31, 2006. Commercial real estate loans increased $6.3 million reflecting continued commercial growth in the Company's market area. Commercial, financial and agricultural decreased $3.5 million principally due to seasonal pay downs in various lines of credit. The growth in residential real estate loans of $13.3 million has principally been in fixed rate first lien residential mortgages and home equity loans. The Company does not originate any non-traditional mortgage products such as interest-only loans or option adjustable-rate mortgages, does not participate in the sub-prime mortgage lending market, nor offer any terms over 30 years.

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

Types of loans (dollars in thousands)	**September 30, 2007**		**December 31, 2006**	
Real Estate-Residential	$ 127,131	38.7 %	$ 113,783	36.0 %
Commercial	133,970	40.7	127,640	40.4
Construction	18,126	5.5	18,955	6.0
Commercial, financial and agricultural	30,540	9.3	34,019	10.8
Consumer loans to individuals	19,087	5.8	21,520	6.8
Total loans	328,854	100.0 %	315,917	100.0 %
Deferred fees (net)	(272)		(350)	
	328,582		315,567	
Allowance for loan losses	(3,979)		(3,828)	
Net loans receivable	$ 324,603		$ 311,739	

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 September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Balance, beginning	$ 3,900	$ 3,794	$ 3,828	$ 3,669
Provision for loan losses	90	45	195	170
Charge-offs	(16)	(34)	(83)	(84)
Recoveries	5	23	39	73
Net charge-offs	(11)	(11)	(44)	(11)
Balance, ending	$ 3,979	$ 3,828	$ 3,979	$ 3,828
Allowance to total loans	1.21 %	1.22 %	1.21 %	1.22 %
Net charge-offs to average loans (annualized)	.01 %	.01 %	.02 %	—

The allowance for loan losses totaled $3,979,000 as of September 30, 2007 and represented 1.21% of total loans compared to $3,828,000 and 1.21% as of December 31, 2006. The Company had net charge-offs of $44,000 for the nine months ended September 30, 2007 compared to $11,000 for the similar period in 2006. The charge-offs in 2007 were principally due to losses on repossessed automobiles. The provision for loan losses for the nine months ended September 30, 2007 was $195,000, compared to $170,000 for the similar period in 2006.

The Company 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 risk-rated classifications; large dollar exposures and loan growth. Management considers the allowance adequate at September 30, 2007 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 September 30, 2007, non-performing loans totaled $119,000, which is .04% of total loans compared to $409,000, or .13% of total loans at December 31, 2006. The Company resolved its largest non-performing loan in the third quarter of 2007 with full collection of principal, interest and fees. The following table sets forth information regarding non-performing loans and foreclosed real estate at the dates indicated:

	September 30, 2007		**December 31, 2006**	
(dollars in thousands)				
Loans accounted for on a non accrual basis:				
Commercial and all other	$ —		$ —	
Real Estate	114		392	
Consumer	2		17	
Total	116		409	
Accruing loans which are contractually past due 90 days or more	3		—	
Total non-performing loans	119		409	
Foreclosed real estate	—		—	
Total non-performing assets	$ 119		$ 409	
Allowance for loan losses	$ 3,979		$ 3,828	
Allowance for loan losses coverage of non-performing loans	33.4	x	9.4	x
Non-performing loans to total loans	.04	%	.13	%
Non-performing assets to total assets	.03	%	.09	%

<u>Deposits</u>

Total deposits as of September 30, 2007 were $367.6 million increasing from $358.1 million as of December 31, 2006. The increase of $9.5 million was used to fund loan growth. The increase in non-interest bearing demand deposits of $7.0 million and money market accounts of $4.7 million is due in part to new commercial accounts and seasonality of certain corporate and municipal accounts.

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

(dollars in thousands)	**September 30, 2007**	**December 31, 2006**