NORWOOD FINANCIAL CORP
Form 10-Q
May 11, 2009

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2009

OR

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

For the transition period from _________________ to ________________

Commission file number 0-28366

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

Pennsylvania	23-2828306
(State or other jurisdiction of	(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 has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

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

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

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

Class	Outstanding as of May 8, 2009
Common stock, par value $0.10 per share	2,739,446

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NORWOOD FINANCIAL CORP.

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2009

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
ASSETS		
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
TOTAL ASSETS	$ 511,424	$ 504,296
LIABILITIES		
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
TOTAL LIABILITIES	451,274	445,606
STOCKHOLDERS' EQUITY		
Common stock, $.10 par value per share, authorized 10,000,000; shares issued 2,840,872	284	284
Surplus	9,993	9,972

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.

NORWOOD FINANCIAL CORP. Consolidated Statements of Income (unaudited)

(dollars in thousands, except per share data)

	Three Months Ended	
	2009	2008
INTEREST INCOME		
Loans receivable, including fees	$ 5,287	$ 5,641
Securities	1,397	1,489
Other	6	19
Total interest income	6,690	7,149
INTEREST EXPENSE		
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
OTHER INCOME		
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
OTHER EXPENSES		
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.

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 Shares	Common Stock Amount	Surplus	Retained Earnings	Treasury Stock Shares	Treasury Stock Amount	Accumulated Other Comprehensive Income	Total
Balance December 31, 2007	2,840,872	$ 284	$ 10,159	$ 47,030	87,256	($2,708)	$1,054	$ 55,819
Comprehensive Income:								
Net Income				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								

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
CASH FLOWS FROM OPERATING ACTIVITIES		
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
Dncrease in accrued interest payable and other liabilities	(6)	(389)
Net cash provided by operating activities	1,997	1,484
CASH FLOWS FROM INVESTING ACTIVITIES		
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)
CASH FLOWS FROM FINANCING ACTIVITIES		
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)

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.

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.

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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	(788)	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. <u>Off-Balance Sheet Financial Instruments and Guarantees</u>

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

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

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

(in thousands)	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			
Description	Total	(Level 1) Quoted Prices in Active Markets For Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
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:

	Fair Value Measurement Reporting Date using			
(In Thousands)		(Level 1) Quoted Prices in Active Markets For Identical	(Level 2) Significant Other Observable	(Level 3) Significant Unobservable
Description	Total	Assets	Inputs	Inputs
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.

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. <u>Branch Closure</u>

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 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:

	March 31, 2009			December 31, 2008		
(dollars in thousands)	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	