NORWOOD FINANCIAL CORP
Form 10-Q
August 11, 2008

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008

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, 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. (Check one):

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

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

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

Class	Outstanding as of August 8, 2008
Common stock, par value $0.10 per share	2,736,836

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NORWOOD FINANCIAL CORP.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2008

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NORWOOD FINANCIAL CORP.

Consolidated Balance Sheets (unaudited)

(dollars in thousands, except per share data)

	June 30, 2008	December 31, 2007
ASSETS		
Cash and due from banks	$ 9,664	$ 9,014
Interest bearing deposits with banks	51	50
Cash and cash equivalents	9,715	9,064
Securities available for sale	130,811	123,987
Securities held to maturity, fair value 2008 $721, 2007: $721	706	705
Loans receivable (net of unearned income)	332,754	331,296
Less: Allowance for loan losses	4,237	4,081
Net loans receivable	328,517	327,215
Investment in FHLB Stock, at cost	2,657	2,072
Bank premises and equipment, net	5,702	5,742
Bank owned life insurance	7,916	7,767
Foreclosed real estate owned	1,200	—
Accrued interest receivable	2,221	2,343
Other assets	2,464	1,715
TOTAL ASSETS	$ 491,909	$ 480,610
LIABILITIES		
Deposits:		
Non-interest bearing demand	$ 59,496	$ 60,061
Interest bearing	305,775	309,939
Total deposits	365,271	370,000
Short-term borrowings	42,060	26,686
Other borrowings	23,000	23,000
Accrued interest payable	2,686	3,198
Other liabilities	2,961	1,907
TOTAL LIABILITIES	435,978	424,791
STOCKHOLDERS' EQUITY		
Common stock, $.10 par value, authorized 10,000,000 shares, issued: 2,840,872	284	284
Surplus	10,043	10,159

Retained earnings	48,642	47,030
Treasury stock at cost: 2008: 104,641 shares, 2007: 87,256 shares	(3,250)	(2,708)
Accumulated other comprehensive income	212	1,054
TOTAL STOCKHOLDERS' EQUITY	55,931	55,819
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 491,909	$ 480,610

See accompanying notes to the unaudited consolidated financial statements

NORWOOD FINANCIAL CORP.

Consolidated Statements of Income (unaudited)

(dollars in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
INTEREST INCOME				
Loans receivable, including fees	$ 5,410	$ 5,878	$ 11,051	$ 11,718
Securities	1,537	1,278	3,026	2,496
Other	6	90	25	111
Total interest income	6,953	7,246	14,102	14,325
INTEREST EXPENSE				
Deposits	1,963	2,474	4,334	4,960
Short-term borrowings	178	205	365	461
Other borrowings	238	281	505	527
Total interest expense	2,379	2,960	5,204	5,948
NET INTEREST INCOME	4,574	4,286	8,898	8,377
PROVISION FOR LOAN LOSSES	110	55	185	105
NET INTEREST INCOME AFTER PROVSION FOR LOAN LOSSES	4,464	4,231	8,713	8,272
OTHER INCOME				
Service charges and fees	670	635	1,308	1,241
Income from fiduciary activities	110	93	202	218
Net realized gains on sales of securities	9	15	9	15
Gain on sale of loans	8	1	396	8
Other	165	113	309	269
Total other income	962	857	2,224	1,751
OTHER EXPENSES				
Salaries and employee benefits	1,498	1,438	3,044	2,935
Occupancy, furniture & equipment, net	414	416	844	831
Data processing related	180	168	368	342
Taxes, other than income	131	121	257	239
Professional fees	88	94	178	183
Other	661	610	1,242	1,178
Total other expenses	2,972	2,847	5,933	5,708
INCOME BEFORE INCOME TAXES	2,454	2,241	5,004	4,315
INCOME TAX EXPENSE	733	671	1,504	1,282
NET INCOME	$ 1,721	$ 1,570	$ 3,500	$ 3,033
BASIC EARNINGS PER SHARE	$ 0.63	$ 0.56	$ 1.28	$ 1.09
DILUTED EARNINGS PER SHARE	$ 0.62	$ 0.55	$ 1.26	$ 1.07

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	Accumulated Other Comprehensive (Loss) Income	Total
Balance December 31, 2006	2,840,872	$ 284	$ 10,149	$ 43,125	$ (1,283)	$ (44)	$ 52,231
Comprehensive Income:							
Net Income				3,033			3,033
Change in unrealized gains on securities available for sale, net of reclassification adjustment and tax effects						(275)	(285)
Total comprehensive income							2,758
Cash dividends declared, $.46 per share				(1,281)			(1,281)
Acquisition of 31,676 shares of treasury stock					(1,011)		(1,011)
Stock options exercised (14,483 shares)			(243)		431		188
Tax benefit of stock options exercised			98				98
Compensation expense related to stock options			151				151
Balance June 30, 2007	2,840,872	$ 284	$ 10,155	$ 44,877	$ (1,863)	$ (319)	$ 53,134

(dollars in thousands, except per share data)	Number of shares issued	Common Stock	Surplus	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive (Loss) Income	Total
Balance December 31, 2007	2,840,872	$ 284	$ 10,159	$ 47,030	$ (2,708)	$ 1,054	$ 55,819
Comprehensive Income:							
Net Income				3,500			3,500
Change in unrealized gains on securities available for sale, net of reclassification adjustment and tax effects						(842)	(842)
Total comprehensive income							2,658
Cash dividends declared, $.50 per share				(1,368)			(1,368)
Acquisition of 34,388 shares of treasury stock					(1,072)		(1,072)
Stock options exercised (16,593 shares)			(276)		530		254
Tax benefit of stock options exercised			83				83
Compensation expense related to stock options			77				77
Cumulative effect of net periodic postretirement benefit				(520)			(520)
Balance June 30, 2008	2,840,872	$ 284	$ 10,043	$ 48,642	$ (3,250)	$ 212	$ 55,931

See accompanying notes to the consolidated financial statements

NORWOOD FINANCIAL CORP.

Consolidated Statements of Cash Flows (unaudited)

(dollars in thousands)

	Six Months Ended June 30, 2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income	$ 3,500	$ 3,033
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	185	105
Depreciation	283	287
Amortization of intangible assets	26	26
Deferred income taxes	(59)	(149)
Net amortization of securities premiums and discounts	26	92
Net realized gain on sales of securities	(9)	(15)
Earnings on life insurance policy	(149)	(142)
Net gain on sale of mortgage loans	(396)	(8)
Mortgage loans originated for sale	(866)	(421)
Proceeds from sale of mortgage loans originated for sale	881	429
Compensation expense related to stock options	77	151
Increase in accrued interest receivable and other assets	(130)	(494)
Increase (decrease) in accrued interest payable and other liabilities	26	(3,145)
Net cash provided by (used in) operating activities	3,395	(251)
CASH FLOWS FROM INVESTING ACTIVITIES		
Securities available for sale:		
Proceeds from sales	59	74
Proceeds from maturities and principal reductions on mortgage-backed securities	26,234	27,236
Purchases	(34,416)	(31,196)
Increase in investment in FHLB stock	(585)	(246)
Net increase in loans	(16,214)	(6,156)
Proceeds from sale of mortgage loans	13,885	—
Purchase of bank premises and equipment	(243)	(120)
Net cash used in investing activities	(11,280)	(10,408)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net (decrease) increase in deposits	(4,729)	15,641
Net increase (decrease) in short-term borrowings	15,374	(3,589)
Repayments of other borrowings	(5,000)	—
Proceeds from other borrowings	5,000	10,000
Tax benefit of stock options exercised	83	98
Stock options exercised	254	188
Acquisition of treasury stock	(1,072)	(1,011)
Cash dividends paid	(1,374)	(1,283)
Net cash provided by financing activities	8,536	20,044
Increase in cash and cash equivalents	651	9,385

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	9,064	9,517
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 9,715	$ 18,902

See accompanying notes to the unaudited consolidated financial statements

Notes to Unaudited Consolidated Financial Statements

1. Basis of Presentation

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

The accompanying unaudited consolidated financial statements have been prepared in conformity with generally accepted accounting principles for interim financial statements and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted principles for complete financial statements. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ from those estimates. The financial statements reflect, in the opinion of management all normal, recurring adjustments necessary to present fairly the financial position of the Company. The operating results for the three and six month periods ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008 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, 2007.

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 June 30,**		**Six Months Ended June 30,**	
	2008	**2007**	**2008**	**2007**
Basic EPS weighted average shares outstanding	2,736	2,786	2,744	2,789
Dilutive effect of stock options	35	55	35	55
Diluted EPS weighted average shares outstanding	2,771	2,841	2,779	2,844

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 44,000 and 22,500 as of June 30, 2008 and 2007, respectively.

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3. Stock-Based Compensation

The Company's stockholders approved the Norwood Financial Corp 2006 Stock Option Plan at the annual meeting on April 25, 2006 and the Company awarded 47,700 options in 2006, and 22,000 options in 2007, all of which have a twelve month vesting period. As of June 30, 2008, there was approximately $77,000 of total unrecognized compensation cost related to nonvested options under the plan, which will be fully amortized by December 31, 2008.

No stock options were granted for the six months ended June 30, 2008. 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, 2008	180,422	$ 24.04	5.8 Yrs.	$ 895
Exercised	(16,953)	14.96		
Outstanding at June 30, 2008	163,469	$ 24.98	5.6	$ 657
Exerciseable at June 30, 2008	141,469	$ 23.43	5.8	$ 788

Intrinsic value represents the amount by which the market price of the stock on the measurement date exceeded the exercise price of the option. The intrinsic value of options exercised during the six months ended June 30, 2008 was $265,000, cash received from such exercises was $254,000 and the tax benefit recognized was $83,000.

4. Cash Flow Information

For the purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing deposits with banks and federal funds sold, all of which mature within 90 days.

Cash payments for interest for the six months ended June 30, 2008 and 2007 were $5,716,000 and $6,040,000 respectively. Cash payments for income taxes in 2008 were $1,583,000 compared to $1,333,000 in 2007. Non-cash investing activities for 2008 and 2007 included foreclosed mortgage loans and repossession of other assets of $1,223,000 and $35,000, respectively.

5. Comprehensive Income

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

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	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Unrealized holding losses on available for sale securities	$ (2,279)	$ (702)	$ (1,272)	$ (408)
Reclassification adjustment for gains realized in net income	(9)	(15)	(9)	(15)
Net unrealized losses	(2,288)	(717)	(1,281)	(423)
Income tax benefit	(780)	(246)	(439)	(148)
Other comprehensive loss	$ (1,508)	$ (471)	$ (842)	$ (275)

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)

	June 30, 2008	June 30, 2007
Commitments to grant loans	$ 12,507	$ 12,085
Unfunded commitments under lines of credit	36,067	31,940
Standby letters of credit	2,677	7,302
	$ 51,251	$ 51,327

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 risks involved in issuing letters of credit are essentially the same as those that are involved in extending loan facilities to customers. The Bank, generally, holds collateral and/or personal guarantees supporting these commitments. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payment required under the corresponding guarantees. The current amount of the liability as of June 30, 2008 for guarantees under standby letters of credit issued is not material.

7. Fair Value Measurements

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements* ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements. The standard is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years. The Company adopted SFAS 157 effective for its fiscal year beginning January 1, 2008. In December 2007, the FASB issued FASB Staff Position (FSP) No. SFAS 157-2, "Effective Date of FAS 157" for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. The adoption of SFAS 157 and FSP No. FAS 157-2 had no impact on the amounts reported in the consolidated financial statements.

The primary effect of SFAS 157 on the Company was to expand the required disclosures pertaining to the methods used to determine fair values.

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 are unobservable (i.e. supported with little or no market activity).

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

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

	Fair Value Measurement Reporting Date using			
Description	**June 30, 2008**	**(Level 1) Quoted Prices in Active Markets For Identical Assets**	**(Level 2) Significant Other Observable Inputs**	**(Level 3) Significant Unobservable Inputs**
Securities available for sale	$ 130,811	$ 1,146	$ 129,665	$ —
Impaired loans	1,785	—	—	1,785
Other Real Estate Owned	1,200	—	—	1,200
Total	$ 133,796	$ 1,146	$ 129,665	$ 2,985

The following valuation techniques were used to measure fair value of assets in the table above on a recurring basis as of June 30, 2008:

Available for Sale Securities:

The Company holds equity securities which are traded with quoted prices, on an active market. Such securities are carried at a market price quote and considered Level 1 Fair Values.

The Company also holds debt offerings of U.S. Government Agencies, state and political subdivisions, high-grade corporate obligations and mortgage-backed securities issued by U.S. Government agencies. The Company utilizes a third party source to provide fair value of its fixed income securities. The methodology consists of pricing models based on asset class and include available trade, bid, other market information, broker quotes, proprietary models, various databases and trading desk quotes. This valuation is based on observable inputs and is considered Level 2.

Imparied Loasn:

Impaired loans are evaluated and valued at the time the loan is first considered impaired. The realizable value is measured based on the value of the collateral securing the loan and is considered a Level 3 measurement. The value of real estate related collateral is established by a formal appraisal performed for the Company. The loan is carried at the lower of cost or market, net of any valuation allowance. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted as needed.

Other Real Estate Owned:

The realizable value is measured based on the value of the real estate less cost to sell and is considered a Level 3 measurement. The value of the real estate is established by formal appraisal performed by the Company.

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The following is a reconciliation of the beginning and ending balances of recurring value measurements of impaired loans and other real estate owned using significant unobservable (Level 3) inputs:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	Impaired Loans	**Other Real Estate Owned**	**Impaired Loans**	**Other Real Estate Owned**
Balance at the beginning of the period	$ 3,230	$ —	$ 3,208	$ —
Transfer from impaired loans	—	1,200	—	1,200
Loan advances			22	—
Loan payments	(53)	—	(53)	—
Specific allowance	(192)	—	(192)	—
Transfer to Other Real Estate Owned	(1,200)	—	(1,200)	—
Balance at the end of the period	$ 1,785	$ 1,200	$ 1,785	$ 1,200

8. <u>New and Recently Adopted Accounting Pronouncements</u>

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 policyholder 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 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 has chosen approach (b) and recorded a cumulative effect adjustment as of January 1, 2008 to the balance of retained earnings of $520,000, with $90,000 of Net Periodic Postretirement Benefit expense expected for the year ended December 31, 2008.

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 adoption of SFAS No. 159 did not have a material impact on our consolidated financial statements.

FASB Statement No. 141 (R) “Business Combinations” was issued in December of 2007. This Statement establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The Statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The guidance will become effective as of the beginning of a company’s fiscal year beginning after December 15, 2008. This new pronouncement will impact the Company’s accounting for business combinations beginning January 1, 2009.

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FASB Statement No. 160 “Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51” was issued in December of 2007. This Statement establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The guidance will become effective as of the beginning of a company’s fiscal year beginning after December 15, 2008. The Company believes that this new pronouncement will have an immaterial impact on the Company’s consolidated financial statements in future periods.

Staff Accounting Bulletin No. 109 (SAB 109), “Written Loan Commitments Recorded at Fair Value Through Earnings” expresses the views of the staff regarding written loan commitments that are accounted for at fair value through earnings under generally accepted accounting principles. To make the staff’s views consistent with current authoritative accounting guidance, the SAB revises and rescinds portions of SAB No. 105, “Application of Accounting Principles to Loan Commitments.” Specifically, the SAB revises the SEC staff’s views on incorporating expected net future cash flows related to loan servicing activities in the fair value measurement of a written loan commitment. The SAB retains the staff’s views on incorporating expected net future cash flows related to internally-developed intangible assets in the fair value measurement of a written loan commitment. The staff expects registrants to apply the views in Question 1 of SAB 109 on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. SAB 109 did not have a material impact on the Company’s consolidated financial statements.

In March 2008, the FASB issued Statement No. 161, “Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133” (Statement 161). Statement 161 requires entities that utilize derivative instruments to provide qualitative disclosures about their objectives and strategies for using such instruments, as well as any details of credit-risk-related contingent features contained within derivatives. Statement 161 also requires entities to disclose additional information about the amounts and location of derivatives located within the financial statements, how the provisions of SFAS 133 have been applied, and the impact that hedges have on an entity’s financial position, financial performance, and cash flows. Statement 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles.” This Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements. This Statement is effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles.” The Company believes that this new pronouncement will have an immaterial impact on the Company’s consolidated financial statements in future periods.

In April 2008, the FASB issued FASB Staff Position (“FSP”) FAS 142-3, “Determination of the Useful Life of Intangible Assets.” This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, “Goodwill and Other Intangible Assets” (“SFAS 142”). The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R, and other GAAP. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Company is evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In May 2008, the FASB issued FASB Staff Position (FSP) APB 14-1, “Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)” which clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. The FSP requires issuers to account separately for the liability and equity components of certain convertible debt instruments in a manner that reflects the issuer’s nonconvertible debt borrowing rate when interest cost is recognized. The FSP requires bifurcation of a component of the debt, classification of that component in equity and the accretion of the resulting discount on the debt to be recognized as part of interest expense. The FSP requires retrospective application to the terms of instruments as they existed for all periods presented. The FSP is effective for fiscal years beginning after December 15, 2008, and interim periods within those years. Early adoption is not permitted. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In June 2008, the FASB issued FASB Staff Position (FSP) EITF 03-6-1, “Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities.” This FSP clarifies that all outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends participate in undistributed earnings with common shareholders. Awards of this nature are considered participating securities and the two-class method of computing basic and diluted earnings per share must be applied. This FSP is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In June 2008, the FASB ratified EITF Issue No. 07-5, “Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity’s Own Stock” (EITF 07-5). EITF 07-5 provides that an entity should use a two step approach to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock, including evaluating the instrument’s contingent exercise and settlement provisions. It also clarifies the impact of foreign currency denominated strike prices and market-based employee stock option valuation instruments on the evaluation. EITF 07-5 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

In June 2008, the FASB ratified EITF Issue No. 08-3, “Accounting for Lessees for Maintenance Deposits Under Lease Arrangements” (EITF 08-3). EITF 08-3 provides guidance for accounting for nonrefundable maintenance deposits. It also provides revenue recognition accounting guidance for the lessor. EITF 08-3 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the potential impact the new pronouncement will have on its 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, 2007 (incorporated by reference in Item 8 of the Form 10-K) lists significant accounting policies used in the development and presentation of its consolidated 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 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 June 30, 2008 and December 31, 2007 represent temporary impairment of the securities, related to changes in interest rates.

Changes in Financial Condition

General

Total assets as of June 30, 2008 were $491.9 million compared to $480.6 million as of December 31, 2007, an increase of $11.3 million. The increase reflects a $6.8 million increase in securities available for sale and a $1.5 million increase in loans receivable, funded by a $15.4 million increase in short-term borrowings.

Securities

The fair value of securities available for sale as of June 30, 2008 was $130.8 million compared to $124.0 million as of December 31, 2007. The Company purchased $34.4 million of securities using the proceeds from $26.2 million of securities called, maturities and principal reductions and from short-term borrowings.

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

	June 30, 2008		December 31, 2007	
	Amount	**% of Portfolio**	**Amount**	**% of Portfolio**
US Government agencies	$ 39,200	29.8 %	$ 41,508	33.4 %
States and political subdivisions	22,698	17.3	22,622	18.1
Corporate securities	5,934	4.5	4,994	4.0
Mortgage-backed securities	62,539	47.5	54,082	43.3
Equity securities	1,146	0.9	1,486	1.2
Total	$ 131,517	100.0 %	$ 124,692	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 3.6 years. Interest rates in the 2-5 year section of the treasury yield curve decreased during the six months ended June 30, 2008 favorably impacting the fair value of individual securities. This has been somewhat offset by a widening of credit spreads in the market. Management believes that the unrealized losses represent temporary impairment of the securities 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 and spreads. The Company monitors the credit ratings of its securities which may impact the valuation of the securities. Credit ratings were within Company policy guidelines at June 30, 2008 and December 31, 2007.

Loans Receivable

Loans receivable totaled $332.8 million compared to $331.3 million as of December 31, 2007. Residential real estate loans decreased $5.7 million due to the sale of $14.4 million of 30 year fixed rate 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 $12.8 million during the period, reflecting new activity and the completion of $3.6 million of construction projects. The activity was principally centered in the Monroe County, Pennsylvania market 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)	**June 30, 2008**			**December 31, 2007**		
Real Estate-Residential	$ 124,185	37.4	%	$ 129,888	39.2	%
Commercial	146,347	43.9		133,593	40.3	
Construction	15,296	4.6		20,404	6.2	
Commercial, financial and agricultural	30,090	9.0		29,159	8.8	
Consumer loans to individuals	17,083	5.1		18,526	5.6	
Total loans	333,001	100.0	%	331,570	100.0	%
Deferred fees (net)	(247)			(274)		
	332,754			331,296		