NORWOOD FINANCIAL CORP
Form 10-Q
November 14, 2006

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, 2006

OR

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

For the transition period from ______________________ to ______________________

Commission file number 0-28366

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

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

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

N/A
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 [ ]

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

Large accelerated filer [ ] Accelerated filer [ ] 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 [ ] 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, 2006
Common stock, par value $0.10 per share	2,795,335

NORWOOD FINANCIAL CORP.
FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2006
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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

NORWOOD FINANCIAL CORP.
Consolidated Balance Sheets
(dollars in thousands, except per share data)

	September 30, 2006	Decem 2
	(Unaudited)	

ASSETS		
Cash and due from banks	$ 9,448	$ 9
Interest bearing deposits with banks	141	
Federal funds sold	1,525	
Cash and cash equivalents	11,114	9
Securities available for sale	112,402	115
Securities held to maturity, fair value 2006: $976, 2005: $1,480	954	1
Loans receivable (net of unearned income)	313,678	290
Less: Allowance for loan losses	3,828	3
Net loans receivable	309,850	287
Investment in FHLB Stock, at cost	1,634	1
Bank premises and equipment, net	5,489	5
Accrued interest receivable	2,086	1
Other assets	9,641	10
TOTAL ASSETS	$453,170	$433
LIABILITIES		
Deposits:		
Non-interest bearing demand	$ 63,331	$ 50
Interest bearing	301,275	289
Total deposits	364,606	340
Short-term borrowings	15,086	18
Other borrowings	18,000	23
Accrued interest payable	2,277	1
Other liabilities	2,142	1,5
TOTAL LIABILITIES	402,111	385
STOCKHOLDERS' EQUITY		
Common stock, $.10 par value, authorized 10,000,000 shares, issued 2006: 2,840,872, 2005: 2,705,715	284	
Surplus	10,123	5
Retained earnings	42,187	43
Treasury stock at cost: 2006: 42,900 shares, 2005: 21,189	(1,246)	
Unearned ESOP shares	-	
Accumulated other comprehensive loss	(289)	
TOTAL STOCKHOLDERS' EQUITY	51,059	48
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$453,170	$433

See accompanying notes to the consolidated financial statements

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NORWOOD FINANCIAL CORP.
Consolidated Statements of Income (unaudited)
(dollars in thousands, except per share data)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
INTEREST INCOME				
Loans receivable, including fees	$ 5,506	$ 4,527	$15,651	$12,735
Securities	1,105	993	3,221	3,054
Other	36	58	121	75
Total interest income	6,647	5,578	18,993	15,864
INTEREST EXPENSE				
Deposits	2,032	1,262	5,360	3,351
Short-term borrowings	235	83	585	294
Other borrowings	278	299	991	919
Total interest expense	2,545	1,644	6,936	4,564
NET INTEREST INCOME	4,102	3,934	12,057	11,300
PROVISION FOR LOAN LOSSES	45	90	170	280
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	4,057	3,844	11,887	11,020
OTHER INCOME				
Service charges and fees	616	648	1,850	1,830
Income from fiduciary activities	89	78	261	254
Net realized gains on sales of securities	45	3	66	83
Gain on sale of loans and servicing rights	3	8	110	63
Other	141	171	434	463
Total other income	894	908	2,721	2,693
OTHER EXPENSES				
Salaries and employee benefits	1,482	1,360	4,344	4,081
Occupancy, furniture & equipment, net	329	356	1,078	1,105
Data processing related	185	161	511	474
Taxes, other than income	110	19	334	226
Professional fees	62	102	279	350
Other	562	629	1,791	1,719
Total other expenses	2,730	2,627	8,337	7,955
INCOME BEFORE INCOME TAXES	2,221	2,125	6,271	5,758
INCOME TAX EXPENSE	699	643	1,940	1,703
NET INCOME	$ 1,522	$ 1,482	$ 4,331	$ 4,055
BASIC EARNINGS PER SHARE	$ 0.54	$ 0.53*	$ 1.55	$ 1.45*
DILUTED EARNINGS PER SHARE	$ 0.53	$ 0.52*	$ 1.52	$ 1.42*

See accompanying notes to the consolidated financial statements

*References to share amounts and per-share amounts reflect the 5% stock dividend distributed to shareholders on May 26, 2006.

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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
Balance December 31, 2004	2,705,715	$270	$5,336	$40,222	($149)
Comprehensive Income:					
Net Income				4,055	
Change in unrealized gains (losses) on securities available for sale, net of reclassification adjustment and tax effects					
Total comprehensive income					
Cash dividends declared, $.51 per share				(1,437)	
Stock options exercised			(78)		229
Tax benefit of stock options exercised			18		
Release of treasury stock for ESOP					22
Acquisition of treasury stock					(570)
Release of earned ESOP shares			269		
Balance, September 30, 2005	2,705,715	$270	$5,545	$42,840	($468)

	Number of shares issued	Common Stock	Surplus	Retained Earnings	Treasury Stock
Balance December 31, 2005	2,705,715	$270	$5,648	$43,722	($633)
Comprehensive Income:					
Net Income				4,331	
Change in unrealized gains (losses) on securities available for sale, net of reclassification adjustment and tax effects					
Total comprehensive income					

Cash dividends declared, $.62 per share				(1,727)	
5% Stock dividend at $30.59 per share	135,157	14	4,121	(4,139)	
Acquisition of treasury stock					(671)
Stock option			(26)		58
Tax benefit of stock options exercised			1		
Compensation expense related to stock options			85		
Release of earned ESOP shares			294		
Balance, September 30, 2006	2,840,872	$284	$10,123	$42,187	($1,246)

See accompanying notes to the consolidated financial statements

NORWOOD FINANCIAL CORP.
Consolidated Statements of Cash Flows (unaudited)
(dollars in thousands)

	Nine Months Ende
	2006
CASH FLOWS FROM OPERATING ACTIVITIES	
Net Income	$ 4,331
Adjustments to reconcile net income to net cash provided by operating activities:	
Provision for loan losses	170
Depreciation	372
Amortization of intangible assets	39
Deferred income taxes	145
Net amortization of securities premiums and discounts	243
Net realized gain on sales of securities	(66)
Earnings on life insurance policy	(197)
Net gain on sale of mortgage loans	(110)
Gain on sale of bank premises and equipment and foreclosed real estate	(5)
Mortgage loans originated for sale	(572)
Proceeds from sale of mortgage loans and servicing rights	682
Tax benefit of stock options exercised	1
Release of ESOP shares	421
Compensation expense related to stock options	85
(Increase) decrease in accrued interest receivable and other assets	613
Increase in accrued interest payable and other liabilities	676
Net cash provided by operating activities	6,828
CASH FLOWS FROM INVESTING ACTIVITIES	
Securities available for sale:	
Proceeds from sales	96
Proceeds from maturities and principal reductions on mortgage-backed securities	20,616
Purchases	(16,750)
Securities held to maturity- proceeds	505
(Increase) decrease in investment in FHLB stock	(14)

Net increase in loans	(22,910)
Purchase of bank premises and equipment	(468)
Proceeds from sale of bank premises and equipment and foreclosed real estate	29
Net cash used in investing activities	(18,896)
CASH FLOWS FROM FINANCING ACTIVITIES	
Net increase in deposits	24,003
Net decrease in short-term borrowings	(3,294)
Repayments of long-term debt	(5,000)
Proceeds from other borrowings	-
Stock options exercised	32
Acquisition of treasury stock	(671)
Cash dividends paid	(1,704)
Net cash provided by financing activities	13,366
Increase (decrease) in cash and cash equivalents	1,298
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	9,816
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 11,114

See accompanying notes to the consolidated financial statements

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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.

2. Estimates

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information. 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 of the Company. The operating results for the three and nine month periods ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006 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, 2005.

3. Earnings Per Share

On April 11, 2006, the Company declared a 5% stock dividend on common stock outstanding payable May 26, 2006 to shareholders of record on May 12, 2006. The stock dividend resulted in the issuance of 135,157 additional common shares. All per share data has been adjusted for the effect of the stock dividend.

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 computations of basic and diluted earnings per share:

(in thousands)

	Three Months Ended		Nine Months En	
	September 30,		September 30	
	2006	2005	2006	2
Basic EPS weighted average shares outstanding	2,794	2,801*	2,794	2,
Dilutive effect of stock options	59	56*	58	
Diluted EPS weighted average shares outstanding	2,853	2,857	2,852	2,

* References to share amounts and per-share amounts reflect the 5% stock dividend distributed to shareholders on May 26, 2006.

4. 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 the fair value of share-based payment transactions to be recognized as compensation costs in the financial statements over the period than 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. The Company did not issue any stock options in 2005 (1) As outstandng options as of December 31, 2005 was fully vested. The Company's shareholders approved the Norwood Financial Corp 2006 Stock Option Plan at the annual meeting on April 25, 2006. As a result, the Company awarded 25,200 options, all of which have a twelve month vesting period. Included in the results for the three and nine months ended September 30, 2006 were $51,000 and $85,000 respectively in compensation costs relating to the adoption of Statement No. 123(R). Net income for the three and nine months ended September 30, 2006 was reduced by approximately $34,000 and $56,000 respectively. As of September 30, 2006, there was approximately $119,000 of total unrecognized compensation cost related to nonvested options under the plan.

The following table illustrates the effect on net income and earnings per share, for the three and nine months ended September 30, 2005, if the Company had applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation to stock-based compensation:

	Three Months Ended September 30, 2005	N S
(in thousands, except for per share data)		
Net income as reported	$1,482	
Total stock-based employee compensation cost, net of tax, which would have been included in the determination of net income if the fair value based method had been applied to all awards	(49)	
Pro forma net income	$1,433	
Earnings per share (basic)		
As Reported	$ .53*	
Pro forma	.51*	
Diluted earnings per share (assuming dilution)		
As Reported	.52*	
Pro forma	.50*	

* References to share amounts and per-share amounts reflect the 5% stock dividend distributed to shareholders on May 26, 2006.

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Term (in years)

Outstanding at the beginning of the year	140,296	$18.45	
Granted................................	25,200	30.38	
Exercised..............................	(1,988)	17.05	
Forfeited..............................	-	-	
Outstanding as of September 30, 2006	163,508	20.72	5.6
Exercisable as of September 30, 2006	138,308	18.96	4.9

The fair value of options granted for the period ended September 30, were estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions:

	Nine Months Ended September 30
	2006
Dividend yield......................................	2.71%
Expected life.......................................	7 years
Expected volatility................................	25.4%
Risk-free interest rate............................	4.99%
Weighted average fair value of options granted.....	$8.12

There were no new options granted for the nine months ended September 30, 2005.

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.

Cash payments for interest for the nine months ended September 30, 2006 and 2005 were $6,340,000 and $4,395,000 respectively. Cash payments for income taxes in 2006 were $1,873,000 compared to $1,746,000 in 2005. Non-cash investing activities for 2006 and 2005 included foreclosed mortgage loans and repossession of other assets of $111,000 and $76,000, 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 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	Nine Months
	Ended September 30,	Ended September 30,

	2006	2005	2006	2005
Unrealized holding gains/(losses) on available for sale securities	$ 1,285	$ (664)	$ 799	$(1,248)
Reclassification adjustment for gains realized in net income	(45)	(3)	(66)	(83)
Net unrealized gains/(losses)	1,240	(667)	733	(1,331)
Income tax (benefit)	423	(229)	250	(457)
Other comprehensive income (loss)	$ 817	$ (438)	$ 483	$ (874)

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 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)

	Sept. 30 2006	Dec. 31 2005
Commitments to grant loans	$15,993	$16,078
Unfunded commitments under lines of credit	34,507	29,969
Standby letters of credit	7,290	6,791
	$57,790	$52,838

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, 2006 and December 31,2005 for guarantees under standby letters of credit issued is not material.

8. New Accounting Pronouncements

FAS 157

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 No. 157 applies to other 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.

FAS 158

On September 29, 2006, the Financial Accounting Standards Board "FASB" issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans ("SFAS 158"), which amends SFAS 87 and SFAS 106 to require recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. Under SFAS 158, gains and losses, prior service costs and credits, and any remaining transition amounts under SFAS 87 and SFAS 106 that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects, until they are amortized as a component of net periodic cost. The measurement date - the date at which the benefit obligation and plan assets are measured - is required to be the company's fiscal year end. SFAS 158 is effective for publicly-held companies for fiscal years ending after December 15, 2006, except for the measurement date provisions, which are effective for fiscal years ending after December 15, 2008. The Company is currently analyzing the effects of SFAS 158 but does not expect its implementation will have a significant impact on the Company's financial condition or results of operations.

SAB 108

On September 13, 2006, the Securities and Exchange Commission "SEC" issued Staff Accounting Bulleting No. 108 ("SAB 108"). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a potential current year misstatement. Prior to SAB 108, Companies might evaluate the materiality of financial-statement misstatements using either the income statement or balance sheet approach, with the income statement approach focusing on new misstatements added in the current year, and the balance sheet approach focusing on the cumulative amount of misstatement present in a company's balance sheet. Misstatements that would be material under one approach could be viewed as immaterial under another approach and not be corrected. SAB 108 now requires that companies view financial statement misstatements as material if they are material according to either the income statement or balance sheet approach. The Company has analyzed SAB 108 and determined that upon adoption it will have no impact on the reported results of operations or financial condition.

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 (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. For periods ending prior to January 1, 2006, the Company accounted for stock option plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations. No stock-based employee compensation was reflected in net income, as all options granted had an exercise price equal to the market value of the underlying common stock on the grant date. The Company adopted SFAS No. 123(R), "Share-Based Payment" as of January 1, 2006. However, no stock options were awarded in 2005 or for the three months ended March 31, 2006. The Norwood Financial Corp. 2006 Stock Option Plan was approved on April 25, 2006. The Company granted 25,200 options in the second quarter of 2006. See Note 4 for a discussion of this pronouncement's impact on the Company's consolidated financial statements.

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 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.

Changes in Financial Condition

General

Total assets as of September 30, 2006 were $453.2 million compared to $433.6 million as of December 31, 2005, an increase of $19.6 million, or 4.5%.

Securities

The fair value of securities available for sale as of September 30, 2006 was $112.4 million compared to $115.8 million as of December 31, 2005. The Company purchased $16.8 million of securities to offset $20.6 million of maturities and principal reductions on mortgage-backed securities. The purchases were principally in short-term U.S. Government sponsored agencies and pass-through mortgage-backed securities. The additional proceeds not reinvested were used to fund loan growth.

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 1.8 years. Interest rates in the 2-3 year section of the treasury yield curve have increased over 100 basis points over the life of the securities impacting the fair value of individual securities. Management believes that the unrealized losses represent temporary impairment of the securities, as a 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 before allowance totaled $313.7 million compared to $290.9 million as of December 31, 2005. Commercial real estate loans increased $6.0 million with growth primarily in the third quarter, which offset the pay off of a short-term $6.7 million loan originated in the first quarter of 2005. Commercial term loans and lines of credit also increased $6.2 million. The $12.8 million growth in residential real estate loans 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, 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, 2006		December 31
	$	%	$
Real Estate-Residential	113,514	36.1	100,705
Commercial	139,532	44.5	133,495
Construction	5,762	1.8	5,944
Commercial, financial and agricultural	32,910	10.5	26,755
Consumer loans to individuals	22,340	7.1	24,353
Total loans	314,058	100.0	291,252
Deferred fees (net)	(380)		(362)
	313,678		290,890
Allowance for loan losses	(3,828)		(3,669)
Net loans receivable	309,850		287,221

Allowance for Loan Losses and Non-performing Assets

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

	Three Months Ended September 30		Nine Months Ended September 30	
(dollars in thousands)	2006	2005	2006	2005
Balance, beginning	$3,794	$3,600	$3,669	$3,44
Provision for loan losses	45	90	170	28
Charge-offs	(34)	(66)	(84)	(14
Recoveries	23	19	73	5
Net charge-offs	(11)	(47)	(11)	(8
Balance, ending	$3,828	$3,643	$3,828	$3,64
Allowance to total loans	1.22%	1.29%	1.22%	1.2
Net charge-offs to average loans (annualized)	.01%	.07%	.-%	.0

The allowance for loan losses totaled $3,828,000 as of September 30, 2006 and represented 1.22% of total loans compared to $3,669,000 and 1.26% as of December 31, 2005. Net charge-offs for the nine months ended September 30, 2006 totaled $11,000 declining from net charge-offs of $85,000 for the similar period in 2005. The decrease was principally due to the lower level of repossessed automobiles, as the Company has lowered its exposure to indirect automobile lending. As a result of the lower net charge-offs, the provision for loan losses was less for the nine months ended September 30, 2006, $170,000, compared to $280,000 for the similar period in 2005.

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, 2006 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, 2006, non-performing loans totaled $395,000, which is .13% of total loans compared to $353,000, or .12% of total loans at December 31, 2005. The following table sets forth information regarding non-performing loans and foreclosed real estate at the dates indicated:

(dollars in thousands)	September 30, 2006	December 31
Loans accounted for on a non accrual basis:		
Commercial and all other	$ -	$
Real Estate	332	33
Consumer	10	1
Total	342	34
Accruing loans which are contractually past due 90 days or more	53	1
Total non-performing loans	395	35
Foreclosed real estate	-	
Total non-performing assets	$395	$35
Allowance for loan losses coverage of non-performing loans	9.7x	10.
Non-performing loans to total loans	.13%	.1
Non-performing assets to total assets	.09%	.0

Deposits

Total deposits as of September 30, 2006 were $364.6 million increasing from $340.6 million as of December 31, 2005. Non-interest bearing demand deposits increased $12.4 million or 24.4%. The increase in non-interest bearing demand deposits is due in part to new commercial accounts and the seasonality of certain corporate and municipal accounts. Savings have decreased $5.9 million as customers have moved funds to short-term time deposits which have higher yields. Time deposits less than $100,000 increased $17.0 million, principally due to promotional efforts in short-term certificates of deposit.

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

(dollars in thousands)	September 30, 2006	December 31, 2005
Non-interest bearing demand	$63,331	$50,891
Interest bearing demand	37,830	40,738
Money Market	56,703	52,194
Savings	47,329	53,311
Time deposits		