

NORWOOD FINANCIAL CORP  
Form 10-Q  
November 09, 2016  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q  
(Mark One)

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

For the quarterly period ended September 30, 2016

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 0-28364

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)

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  No

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  No

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  Accelerated filer

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Non-accelerated filer  Smaller reporting company   
(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):   
 Yes  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 October 31, 2016 |
|--|------------------------------------|
| Common stock, par value \$0.10 per share | 4,125,576                          |

NORWOOD FINANCIAL CORP.  
FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 2016

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## PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

## NORWOOD FINANCIAL CORP.

Consolidated Balance Sheets (unaudited)

(dollars in thousands, except share and per share data)

|   | September 30,<br>2016 | December<br>31,<br>2015 |
|---|-----------------------|-------------------------|
| <b>ASSETS</b>   |                       |                         |
| Cash and due from banks   | \$ 19,404             | \$ 9,744                |
| Interest bearing deposits with banks  | 13,729                | 266                     |
| Cash and cash equivalents   | 33,133                | 10,010                  |
| Securities available for sale, at fair value  | 310,126               | 138,851                 |
| Loans receivable  | 706,199               | 559,925                 |
| Less: Allowance for loan losses   | 6,164                 | 7,298                   |
| Net loans receivable  | 700,035               | 552,627                 |
| Regulatory stock, at cost   | 2,351                 | 3,412                   |
| Bank premises and equipment, net  | 13,617                | 6,472                   |
| Bank owned life insurance   | 35,889                | 18,820                  |
| Accrued interest receivable   | 3,541                 | 2,363                   |
| Foreclosed real estate owned  | 5,386                 | 2,847                   |
| Goodwill  | 11,679                | 9,715                   |
| Other intangibles   | 652                   | 285                     |
| Deferred tax asset  | 5,560                 | 3,669                   |
| Other assets  | 3,088                 | 1,434                   |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,125,057</b>   | <b>\$ 750,505</b>       |
| <b>LIABILITIES</b>  |                       |                         |
| Deposits:   |                       |                         |
| Non-interest bearing demand   | \$ 200,481            | \$ 107,814              |
| Interest-bearing  | 721,763               | 443,095                 |
| Total deposits  | 922,244               | 550,909                 |
| Short-term borrowings   | 33,156                | 53,235                  |
| Other borrowings  | 34,294                | 41,126                  |
| Junior subordinated debentures  | 8,248                 | -                       |
| Accrued interest payable  | 1,040                 | 957                     |
| Other liabilities   | 10,375                | 3,280                   |
| <b>TOTAL LIABILITIES</b>  | <b>1,009,357</b>      | <b>649,507</b>          |
| <b>STOCKHOLDERS' EQUITY</b>   |                       |                         |
| Common stock, \$.10 par value per share,<br>authorized 10,000,000 shares; issued 2016: 4,156,273 shares, 2015: 3,724,668 shares | 416                   | 373                     |
| Surplus   | 47,576                | 35,351                  |
| Retained earnings   | 66,210                | 65,412                  |
| Treasury stock at cost: 2016: 32,797 shares,  |                       |                         |

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|  |              |            |
|--|--------------|------------|
| 2015: 23,311 shares                        | (908)        | (626)      |
| Accumulated other comprehensive income     | 2,406        | 488        |
| TOTAL STOCKHOLDERS' EQUITY                 | 115,700      | 100,998    |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 1,125,057 | \$ 750,505 |

See accompanying notes to the unaudited consolidated financial statements.

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

|  | Three Months<br>Ended<br>September 30,<br>2016 |              | Nine Months<br>Ended<br>September 30,<br>2015 |              |
|--|--|--------------|---|--------------|
| <b>INTEREST INCOME</b>                                 |  |              |   |              |
| Loans receivable, including fees                       | \$ 7,267                                       | \$ 5,958     | \$ 19,752                                     | \$ 17,943    |
| Securities   | 1,239  | 911          | 3,008   | 2,884        |
| Other  | 22   | 3            | 28  | 15           |
| Total interest income                                  | 8,528  | 6,872        | 22,788  | 20,842       |
| <b>INTEREST EXPENSE</b>                                |  |              |   |              |
| Deposits   | 677  | 611          | 1,838   | 1,833        |
| Short-term borrowings                                  | 65   | 19           | 142   | 47           |
| Other borrowings                                       | 216  | 189          | 669   | 553          |
| Total interest expense                                 | 958  | 819          | 2,649   | 2,433        |
| NET INTEREST INCOME                                    | 7,570  | 6,053        | 20,139  | 18,409       |
| PROVISION FOR LOAN LOSSES                              | 450  | 720          | 1,600   | 1,760        |
| NET INTEREST INCOME AFTER<br>PROVISION FOR LOAN LOSSES | 7,120  | 5,333        | 18,539  | 16,649       |
| <b>OTHER INCOME</b>                                    |  |              |   |              |
| Service charges and fees                               | 829  | 592          | 2,000   | 1,776        |
| Income from fiduciary activities                       | 126  | 126          | 342   | 341          |
| Net realized gains on sales of securities              | -  | 63           | 269   | 508          |
| Gains on sale of loans and servicing rights, net       | -  | 16           | 54  | 56           |
| Earnings and proceeds on bank owned life insurance     | 283  | 167          | 616   | 497          |
| Other  | 161  | 107          | 408   | 305          |
| Total other income                                     | 1,399  | 1,071        | 3,689   | 3,483        |
| <b>OTHER EXPENSES</b>                                  |  |              |   |              |
| Salaries and employee benefits                         | 3,070  | 2,175        | 7,620   | 6,383        |
| Occupancy, furniture & equipment, net                  | 755  | 473          | 1,736   | 1,571        |
| Data processing  | 423  | 247          | 949   | 682          |
| Taxes, other than income                               | 205  | 175          | 535   | 525          |
| Professional fees                                      | 185  | 140          | 516   | 447          |
| Federal Deposit Insurance Corporation insurance        | 170  | 119          | 402   | 278          |
| Foreclosed real estate owned                           | 119  | 47           | 582   | 436          |
| Amortization of intangibles                            | 34   | 24           | 81  | 80           |
| Merger related   | 1,659  | -            | 1,664   | -            |
| Other  | 1,059  | 670          | 2,471   | 2,023        |
| Total other expenses                                   | 7,679  | 4,070        | 16,556  | 12,425       |
| <b>INCOME BEFORE INCOME TAXES</b>                      | <b>840</b>                                     | <b>2,334</b> | <b>5,672</b>                                  | <b>7,707</b> |

|                            |         |          |          |          |
|----------------------------|---------|----------|----------|----------|
| INCOME TAX EXPENSE         | 228     | 557      | 1,307    | 1,926    |
| NET INCOME                 | \$ 612  | \$ 1,777 | \$ 4,365 | \$ 5,781 |
| <br>                       |         |          |          |          |
| BASIC EARNINGS PER SHARE   | \$ 0.15 | \$ 0.48  | \$ 1.16  | \$ 1.57  |
| <br>                       |         |          |          |          |
| DILUTED EARNINGS PER SHARE | \$ 0.15 | \$ 0.48  | \$ 1.15  | \$ 1.57  |

See accompanying notes to the unaudited consolidated financial statements.

NORWOOD FINANCIAL CORP.  
 Consolidated Statements of Comprehensive Income (unaudited)  
 (dollars in thousands)

|  | Three Months<br>Ended<br>September 30, |          |
|--|--|----------|
|  | 2016                                   | 2015     |
| Net income   | \$ 612                                 | \$ 1,777 |
| Other comprehensive income (loss):                 |  |          |
| Investment securities available for sale:          |  |          |
| Unrealized holding gain (loss)                     | (653)                                  | 1,938    |
| Tax effect   | 221                                    | (654)    |
| Reclassification of gains recognized in net income | -                                      | (63)     |
| Tax effect   | -                                      | 22       |
| Other comprehensive income (loss)                  | (432)                                  | 1,243    |
| Comprehensive Income                               | \$ 180                                 | \$ 3,020 |

|  | Nine Months<br>Ended<br>September 30, |          |
|--|---------------------------------------|----------|
|  | 2016                                  | 2015     |
| Net income   | \$ 4,365                              | \$ 5,781 |
| Other comprehensive income:                        |                                       |          |
| Investment securities available for sale:          |                                       |          |
| Unrealized holding gain                            | 3,176                                 | 890      |
| Tax effect   | (1,080)                               | (296)    |
| Reclassification of gains recognized in net income | (269)                                 | (508)    |
| Tax effect   | 91                                    | 173      |
| Other comprehensive income                         | 1,918                                 | 259      |
| Comprehensive Income                               | \$ 6,283                              | \$ 6,040 |

See accompanying notes to the unaudited consolidated financial statements.



## NORWOOD FINANCIAL CORP.

Consolidated Statements of Changes in Stockholders' Equity (unaudited)

Nine Months Ended September 30, 2016

(dollars in thousands, except share and per share data)

|  | Common Stock |        |           | Retained  | Treasury Stock |          | Accumulated<br>Other<br>Comprehensive |            |
|--|--------------|--------|-----------|-----------|----------------|----------|---------------------------------------|------------|
|  | Shares       | Amount | Surplus   | Earnings  | Shares         | Amount   | Income                                | Total      |
| Balance, December 31, 2015                       | 3,724,668    | \$ 373 | \$ 35,351 | \$ 65,412 | 23,311         | \$ (626) | \$ 488                                | \$ 100,998 |
| Net Income                                       |              |        |           | 4,365     |                |          |                                       | 4,365      |
| Other comprehensive income                       |              |        |           |           |                |          | 1,918                                 | 1,918      |
| Cash dividends declared (\$ .93 per share)       |              |        |           | (3,567)   |                |          |                                       | (3,567)    |
| Compensation expense related to restricted stock |              |        | 67        |           |                |          |                                       | 67         |
| Acquisition of treasury stock                    |              |        |           |           | 15,538         | (447)    |                                       | (447)      |
| Stock options exercised                          |              |        | (5)       |           | (6,052)        | 165      |                                       | 160        |
| Tax benefit of stock options                     |              |        | 3         |           |                |          |                                       | 3          |
| Compensation expense related to stock options    |              |        | 53        |           |                |          |                                       | 53         |
| Delaware Bancshares acquisition                  | 431,605      | 43     | 12,107    |           |                |          |                                       | 12,150     |
| Balance, September 30, 2016                      | 4,156,273    | \$ 416 | \$ 47,576 | \$ 66,210 | 32,797         | \$ (908) | \$ 2,406                              | \$ 115,700 |

See accompanying notes to the unaudited consolidated financial statements.

NORWOOD FINANCIAL CORP.  
Consolidated Statements of Cash Flows (Unaudited)

(dollars in thousands)

|   | Nine Months Ended September 30,<br>2016 | 2015     |
|---|---|----------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |   |          |
| Net Income  | \$ 4,365                                | \$ 5,781 |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |          |
| Provision for loan losses   | 1,600                                   | 1,760    |
| Depreciation  | 484                                     | 414      |
| Amortization of intangible assets   | 81                                      | 80       |
| Deferred income taxes   | 155                                     | 184      |
| Net amortization of securities premiums and discounts                             | 1,039                                   | 711      |
| Net realized gain on sales of securities  | (269)                                   | (508)    |
| Earnings and proceeds on bank owned life insurance                                | (616)                                   | (497)    |
| Loss on sales of fixed assets and foreclosed real estate owned                    | 2                                       | 271      |
| Gain on sale of mortgage loans  | (54)                                    | (56)     |
| Mortgage loans originated for sale  | (1,685)                                 | (2,605)  |
| Proceeds from sale of mortgage loans originated for sale                          | 1,739                                   | 2,661    |
| Compensation expense related to stock options                                     | 53                                      | 49       |
| Compensation expense related to restricted stock                                  | 67                                      | 49       |
| Decrease (increase) in accrued interest receivable and other assets               | 1,894                                   | (609)    |
| (Decrease) increase in accrued interest payable and other liabilities             | (920)                                   | 531      |
| Net cash provided by operating activities   | 7,935                                   | 8,216    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                       |   |          |
| Securities available for sale:  |   |          |

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|   |           |           |
|---|-----------|-----------|
| Proceeds from sales   | 101,804   | 28,850    |
| Proceeds from maturities and principal reductions on mortgage-backed securities | 18,083    | 19,408    |
| Purchases   | (80,538)  | (44,987)  |
| Purchase of regulatory stock  | (2,675)   | (1,830)   |
| Redemption of regulatory stock  | 4,015     | 1,056     |
| Net increase in loans   | (35,325)  | (44,592)  |
| Proceeds from bank-owned life insurance   | 205       | -         |
| Purchase of bank-owned life insurance   | (2,000)   | -         |
| Purchase of premises and equipment  | (337)     | (184)     |
| Proceeds from sales of fixed assets and foreclosed real estate owned            | 387       | 2,378     |
| Acquisition, net of cash and cash equivalents acquired                          | 11,112    | -         |
| Net cash provided by (used in) investing activities                             | 14,731    | (39,901)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                     |           |           |
| Net increase in deposits  | 44,072    | 11,409    |
| Net (decrease) increase in short-term borrowings                                | (21,456)  | 15,851    |
| Repayments of other borrowings  | (18,439)  | (9,038)   |
| Proceeds from other borrowings  | -         | 16,000    |
| Stock options exercised   | 160       | 310       |
| Tax benefit of stock options exercised  | 3         | 14        |
| Purchase of treasury stock  | (447)     | (135)     |
| Cash dividends paid   | (3,436)   | (3,386)   |
| Net cash provided by financing activities                                       | 457       | 31,025    |
| Increase (decrease) in cash and cash equivalents                                | 23,123    | (660)     |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                           |           |           |
|   | 10,010    | 12,376    |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>                                 |           |           |
|   | \$ 33,133 | \$ 11,716 |

See accompanying notes to the unaudited consolidated financial statements.



NORWOOD FINANCIAL CORP.  
Consolidated Statements of Cash Flows (Unaudited) (continued)

(dollars in thousands)

|   | Nine Months<br>Ended September<br>30, |          |
|---|---------------------------------------|----------|
|   | 2016                                  | 2015     |
| Supplemental Disclosures of Cash Flow Information                             |                                       |          |
| Cash payments for:  |                                       |          |
| Interest on deposits and borrowings   | \$ 2,566                              | \$ 2,403 |
| Income taxes paid, net of refunds   | \$ 1,135                              | \$ 1,881 |
| Supplemental Schedule of Noncash Investing Activities                         |                                       |          |
| Transfers of loans to foreclosed real estate and repossession of other assets | \$ 2,953                              | \$ 290   |
| Cash dividends declared   | \$ 1,278                              | \$ 1,142 |
| Merger with Delaware Bancshares, Inc.   |                                       |          |
| Noncash assets acquired:  |                                       |          |
| Securities available-for-sale   | \$ 208,488                            |          |
| Regulatory stock  | 279                                   |          |
| Loans   | 116,674                               |          |
| Premises and equipment, net   | 7,292                                 |          |
| Accrued interest receivable   | 1,626                                 |          |
| Bank-owned life insurance   | 14,762                                |          |
| Core deposit intangible   | 449                                   |          |
| Deferred tax assets   | 3,034                                 |          |
| Other assets  | 2,934                                 |          |
| Goodwill  | 1,964                                 |          |
|   | \$ 357,502                            |          |
| Liabilities assumed:  |                                       |          |
| Time deposits   | \$ 71,342                             |          |
| Deposits other than time deposits   | 255,921                               |          |
| Borrowings  | 21,232                                |          |
| Accrued interest payable  | 95                                    |          |
| Other liabilities   | 7,873                                 |          |
|   | 356,463                               |          |
| Net Noncash Assets Acquired   | 1,039                                 |          |
| Cash Acquired   | \$ 14,977                             |          |

See accompanying notes to the unaudited consolidated financial statements.

Notes to the Unaudited Consolidated Financial Statements1. 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., Norwood Settlement Services, LLC, and WTRO Properties, Inc. 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 and nine-month periods ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016 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, 2015.

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 reflect 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<br>Months<br>Ended<br>September<br>30,<br>2016 |       | Nine Months<br>Ended<br>September<br>30,<br>2015 |       |
|---|--|-------|--|-------|
| Weighted average shares outstanding             | 3,978  | 3,683 | 3,790  | 3,681 |
| Less: Unvested restricted shares                | (14)   | (9)   | (14)   | (9)   |
| Basic EPS weighted average shares outstanding   | 3,964  | 3,674 | 3,776  | 3,672 |
| Basic EPS weighted average shares outstanding   | 3,964  | 3,683 | 3,776  | 3,681 |
| Add: Dilutive effect of stock options           | 9  | 9     | 9  | 10    |
| Diluted EPS weighted average shares outstanding | 3,973  | 3,692 | 3,785  | 3,691 |

Stock options with a strike price of \$29.08 which had no intrinsic value, because their effect would be anti-dilutive and therefore would not be included in the diluted EPS calculation, were 11,000 as of September

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30, 2016 based upon the closing price of Norwood common stock of \$29.07 per share on September 30, 2016. At September 30, 2015, there were 12,000 anti-dilutive shares based on Norwood's closing price of \$29.00 per share.

### 3. Stock-Based Compensation

No awards were granted during the nine-month period ending September 30, 2016. As of September 30, 2016, there was \$18,000 of total unrecognized compensation cost related to non-vested options granted in 2015 under the 2014 Equity Incentive Plan, which will be fully amortized by December 31, 2016. Compensation costs related to stock options amounted to \$53,000 and \$49,000 during the nine-month periods ended September 30, 2016 and 2015, respectively.

A summary of stock options from all plans, adjusted for stock dividends declared, is shown below.

|                                   | Options  | Weighted<br>Average<br>Exercise<br>Price<br>Per Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Yrs. | Aggregate<br>Intrinsic<br>Value<br>(\$000) |
|-----------------------------------|----------|---|---|------|--|
| Outstanding at January 1, 2016    | 194,521  | \$ 26.91  | 5.2   | Yrs. | \$ 363                                     |
| Granted                           | -        | -   | -   |      | -  |
| Exercised                         | (6,052)  | 26.37   | 4.1   |      | -  |
| Forfeited                         | (16,019) | 27.71   | 0.5   |      | -  |
| Outstanding at September 30, 2016 | 172,450  | \$ 26.85  | 4.9   | Yrs. | \$ 383                                     |
| Exercisable at September 30, 2016 | 157,950  | \$ 26.70  | 4.5   | Yrs. | \$ 375                                     |

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 stock price was \$29.07 as of September 30, 2016 and \$28.75 as of December 31, 2015.

A summary of the Company's restricted stock activity and related information for the nine-month period ended September 30, 2016 is as follows:

|                             | Number of<br>Restricted Stock | Weighted-Average<br>Grant Date<br>Fair Value |
|-----------------------------|-------------------------------|--|
| Outstanding, January 1,     | 13,810                        | \$ 28.82                                     |
| Granted                     | -                             | -  |
| Vested                      | -                             | -  |
| Forfeited                   | -                             | -  |
| Non-vested at September 30, | 13,810                        | \$ 28.82                                     |



The expected future compensation expense relating to the 13,810 shares of non-vested restricted stock outstanding as of September 30, 2016 is \$331,000. This cost will be recognized over the remaining vesting period of 4.25 years. Compensation costs related to restricted stock amounted to \$67,000 and \$41,000 during the nine-month periods ended September 30, 2016 and 2015, respectively.

4. Accumulated Other Comprehensive Income

The following table presents the changes in accumulated other comprehensive income (in thousands) by component net of tax for the three months and nine months ended September 30, 2016 and 2015:

|   | Unrealized<br>gains<br>(losses) on<br>available<br>for sale<br>securities<br>(a) |
|---|--|
| Balance as of June 30, 2016                                     | \$ 2,838   |
| Other comprehensive loss before reclassification                | (432)  |
| Amount reclassified from accumulated other comprehensive income | -  |
| Total other comprehensive loss                                  | (432)  |
| Balance as of September 30, 2016                                | \$ 2,406   |

|   | Unrealized<br>gains<br>(losses) on<br>available<br>for sale<br>securities<br>(a) |
|---|--|
| Balance as of June 30, 2015                                     | \$ (522)   |
| Other comprehensive income before reclassification              | 1,284  |
| Amount reclassified from accumulated other comprehensive income | (41)   |
| Total other comprehensive income                                | 1,243  |
| Balance as of September 30, 2015                                | \$ 721   |

|   | Unrealized<br>gains<br>(losses) on<br>available<br>for sale<br>securities<br>(a) |
|---|--|
| Balance as of December 31, 2015                                 | \$ 488   |
| Other comprehensive income before reclassification              | 2,096  |
| Amount reclassified from accumulated other comprehensive income | (178)  |
| Total other comprehensive income                                | 1,918  |
| Balance as of September 30, 2016                                | \$ 2,406   |

|   | Unrealized<br>gains<br>(losses) on<br>available<br>for sale<br>securities<br>(a) |
|---|--|
| Balance as of December 31, 2014                                 | \$ 462   |
| Other comprehensive income before reclassification              | 594  |
| Amount reclassified from accumulated other comprehensive income | (335)  |
| Total other comprehensive income                                | 259  |
| Balance as of September 30, 2015                                | \$ 721   |

(a) All amounts are net of tax. Amounts in parentheses indicate debits.

The following table presents significant amounts reclassified out of each component of accumulated other comprehensive income (in thousands) for the three months and nine months ended September 30, 2016 and 2015:

| Details about other comprehensive income          | Amount Reclassified<br>From Accumulated<br>Other<br>Comprehensive<br>Income (a) |        | Affected Line Item in<br>Consolidated<br>Statements<br>of Income |
|---|---|--------|--|
|   | Three months ended<br>September 30,<br>2016      2015                           |        |  |
| Unrealized gains on available for sale securities | \$ -  | \$ 63  | Net realized gains on sales<br>of securities                     |
|   | -   | (22)   | Income tax expense   |
|   | \$ -  | \$ 41  |  |
|   | Nine months ended<br>September 30,<br>2016      2015                            |        |  |
| Unrealized gains on available for sale securities | \$ 269  | \$ 508 | Net realized gains on sales<br>of securities                     |
|   | (91)  | (173)  | Income tax expense   |
|   | \$ 178  | \$ 335 |  |

(a) Amounts in parentheses indicate debits to net income

#### 5. 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)

September 30,

|  | 2016      | 2015      |
|--|-----------|-----------|
| Commitments to grant loans                 | \$ 21,764 | \$ 21,279 |
| Unfunded commitments under lines of credit | 62,599    | 51,489    |
| Standby letters of credit                  | 5,642     | 5,504     |
|  | \$ 90,005 | \$ 78,272 |

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 payments required under the corresponding guarantees. The current amount of the liability as of September 30, 2016 for guarantees under standby letters of credit issued is not material.

## 6. Securities

The amortized cost, gross unrealized gains and losses, and fair value of securities were as follows:

|                                      | September 30, 2016 |             |                         |            |
|--------------------------------------|--------------------|-------------|-------------------------|------------|
|                                      | Amortized Cost     | Gross Gains | Gross Unrealized Losses | Fair Value |
|                                      | (In Thousands)     |             |                         |            |
| Available for Sale:                  |                    |             |                         |            |
| U.S. Treasury securities             | \$ 2,006           | \$ -        | \$ (2)                  | \$ 2,004   |
| U.S. Government agencies             | 2,001              | -           | -                       | 2,001      |
| States and political subdivisions    | 127,694            | 3,050       | (172)                   | 130,572    |
| Corporate obligations                | 10,301             | 101         | (17)                    | 10,385     |
| Mortgage-backed securities-          |                    |             |                         |            |
| government sponsored entities        | 164,158            | 845         | (223)                   | 164,780    |
| Total debt securities                | 306,160            | 3,996       | (414)                   | 309,742    |
| Equity securities-financial services | 320                | 64          | -                       | 384        |
|                                      | \$ 306,480         | \$ 4,060    | \$ (414)                | \$ 310,126 |

|  | December 31, 2015 |                        |                         |            |
|--|-------------------|------------------------|-------------------------|------------|
|  | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| (In Thousands)   |                   |                        |                         |            |
| Available for Sale:                                      |                   |                        |                         |            |
| U.S. Government agencies                                 | \$ 9,275          | \$ 2                   | \$ (108)                | \$ 9,169   |
| States and political subdivisions                        | 59,120            | 1,747                  | (112)                   | 60,755     |
| Corporate obligations                                    | 4,933             | 45                     | (4)                     | 4,974      |
| Mortgage-backed securities-government sponsored entities | 64,491            | 23                     | (945)                   | 63,569     |
| Total debt securities                                    | 137,819           | 1,817                  | (1,169)                 | 138,467    |
| Equity securities-financial services                     | 292               | 92                     | -                       | 384        |
|  | \$ 138,111        | \$ 1,909               | \$ (1,169)              | \$ 138,851 |

The following tables show the Company's investments' gross unrealized losses and fair value aggregated by length of time that individual securities have been in a continuous unrealized loss position (in thousands):

|  | September 30, 2016  |                   |                   |                   |            |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities                                 | \$ 2,004            | \$ (2)            | \$ -              | \$ -              | \$ 2,004   | \$ (2)            |
| States and political subdivisions                        | 33,918              | (170)             | 210               | (2)               | 34,128     | (172)             |
| Corporate obligations                                    | 3,312               | (17)              | -                 | -                 | 3,312      | (17)              |
| Mortgage-backed securities-government sponsored entities | 49,341              | (156)             | 9,885             | (67)              | 59,226     | (223)             |
|  | \$ 88,575           | \$ (345)          | \$ 10,095         | \$ (69)           | \$ 98,670  | \$ (414)          |

|                                   | December 31, 2015   |                   |                   |                   |            |                   |
|-----------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                                   | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|                                   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government agencies          | \$ 6,058            | \$ (71)           | \$ 2,109          | \$ (37)           | \$ 8,167   | \$ (108)          |
| States and political subdivisions | 9,086               | (99)              | 1,417             | (13)              | 10,503     | (112)             |

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|  |           |          |           |          |           |            |
|--|-----------|----------|-----------|----------|-----------|------------|
| Corporate obligations                                    | 2,221     | (4)      | -         | -        | 2,221     | (4)        |
| Mortgage-backed securities-government sponsored entities | 40,300    | (432)    | 16,595    | (513)    | 56,895    | (945)      |
|  | \$ 57,665 | \$ (606) | \$ 20,121 | \$ (563) | \$ 77,786 | \$ (1,169) |



At September 30, 2016, the Company has 76 debt securities in an unrealized loss position in the less than twelve months category and 11 debt securities in the twelve months or more category. In Management's opinion the unrealized losses reflect changes in interest rates subsequent to the acquisition of specific securities. No other-than-temporary-impairment charges were recorded in 2016. Management believes that all unrealized losses represent temporary impairment of the securities as the Company does not have the intent to sell the securities and it is more likely than not that it will not have to sell the securities before recovery of its cost basis.

The amortized cost and fair value of debt securities as of September 30, 2016 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties.

|  | Available for Sale |            |
|--|--------------------|------------|
|  | Amortized Cost     | Fair Value |
|  | (In Thousands)     |            |
| Due in one year or less                                  | \$ 983             | \$ 991     |
| Due after one year through five years                    | 20,978             | 21,097     |
| Due after five years through ten years                   | 53,744             | 54,044     |
| Due after ten years                                      | 66,297             | 68,830     |
| Mortgage-backed securities-government sponsored agencies | 164,158            | 164,780    |
|  | \$ 306,160         | \$ 309,742 |

Gross realized gains and gross realized losses on sales of securities available for sale were as follows (in thousands):

|                                   | Three Months        |          | Nine Months         |           |
|-----------------------------------|---------------------|----------|---------------------|-----------|
|                                   | Ended September 30, |          | Ended September 30, |           |
|                                   | 2016                | 2015     | 2016                | 2015      |
| Gross realized gains              | \$ -                | \$ 63    | \$ 269              | \$ 508    |
| Gross realized losses             | -                   | -        | -                   | -         |
| Net realized gain                 | \$ -                | \$ 63    | \$ 269              | \$ 508    |
| Proceeds from sales of securities | \$ 70,028           | \$ 5,466 | \$ 101,804          | \$ 28,850 |

7. Loans Receivable and Allowance for Loan Losses

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

|  | Types of loans<br>(dollars in thousands) |        |                      |        |
|--|--|--------|----------------------|--------|
|  | September 30,<br>2016                    |        | December 31,<br>2015 |        |
| Real Estate Loans:                     |  |        |                      |        |
| Residential                            | \$ 237,897                               | 33.7 % | \$ 161,820           | 28.9 % |
| Commercial                             | 315,270                                  | 44.6   | 279,123              | 49.8   |
| Construction                           | 20,056                                   | 2.8    | 18,987               | 3.4    |
| Commercial, financial and agricultural | 85,145                                   | 12.1   | 71,090               | 12.7   |
| Consumer loans to individuals          | 48,225                                   | 6.8    | 29,231               | 5.2    |
| Total loans                            | 706,593                                  | 100.0% | 560,251              | 100.0% |
| Deferred fees, net                     | (394)                                    |        | (326)                |        |
| Total loans receivable                 | 706,199                                  |        | 559,925              |        |
| Allowance for loan losses              | (6,164)                                  |        | (7,298)              |        |
| Net loans receivable                   | \$ 700,035                               |        | \$ 552,627           |        |

The following table presents the components of the purchase accounting adjustments related to the purchased impaired loans acquired:

(In Thousands)

|   |          |
|---|----------|
| Contractually required principal and interest | \$ 2,621 |
| Non-accretable discount                       | (1,014)  |
| Expected cash flows                           | 1,607    |
| Accretable discount                           | (239)    |
| Estimated fair value                          | \$ 1,368 |

Changes in the amortizable yield for purchased credit-impaired loans were as follows for the nine month periods ended September 30:

|                                | 2016 | 2015 |
|--------------------------------|------|------|
| Balance at beginning of period | \$ - | \$ 8 |
| Additions                      | 239  | -    |

|                            |        |      |
|----------------------------|--------|------|
| Accretion                  | (12)   | (1)  |
| Reclassification and other | -      | -    |
| Balance at end of period   | \$ 227 | \$ 7 |

The following table presents information regarding loans acquired and accounted for in accordance with ASC 310-30 (in thousands):

|                        | September<br>30, 2016 | December<br>31, 2015 |
|------------------------|-----------------------|----------------------|
| Outstanding Balance \$ | 1,855                 | \$ 498               |
| Carrying Amount \$     | 1,368                 | \$ 498               |

As a result of the acquisition of Delaware, the Company added \$1,397,000 of loans that were accounted for in accordance with ASC 310-30. Based on a review of the loans acquired by senior lending management, which included an analysis of credit deterioration of the loans since origination, the Company recorded a specific credit fair value adjustment of \$499,000. For loans that were acquired with specific evidence of deterioration in credit quality, loan losses will be accounted for through a reduction of the specific reserve and will not impact the allowance for loan losses until actual losses exceed the allotted reserves. For loans acquired without a deterioration of credit quality, losses incurred will result in adjustments to the allowance for loan losses through the allowance for loan loss adequacy calculation. As of September 30, 2016, the outstanding balance of ASC 310-30 loans acquired from Delaware was \$1,410,000 and the carrying value was \$911,000, while one loan with an outstanding balance and carrying value of \$445,000 remained from a prior acquisition.

The Company maintains a loan review system, which allows for a periodic review of our loan portfolio and the early identification of potential impaired loans. Such system takes into consideration, among other things, delinquency status, size of loans, type and market value of collateral and financial condition of the borrowers. Specific loan loss allowances are established for identified losses based on a review of such information. A loan evaluated for impairment is considered to be impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. All loans identified as impaired are evaluated independently. We do not aggregate such loans for evaluation purposes. Impairment is measured on a loan-by-loan basis for commercial and construction loans by the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral-dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential mortgage loans for impairment disclosures, unless such loans are part of a larger relationship that is impaired, or are classified as a troubled debt restructuring.

Foreclosed assets acquired in settlement of loans are carried at fair value less estimated costs to sell and are included in foreclosed real estate owned on the Consolidated Balance Sheets. As of September 30, 2016 and December 31, 2015, foreclosed real estate owned totaled \$5,386,000 and \$2,847,000, respectively. As of September 30, 2016, included within foreclosed real estate owned is \$306,000 of consumer residential mortgages that were foreclosed on or received via a deed in lieu transaction prior to the period end. As of September 30, 2016, the Company has initiated formal foreclosure proceedings on \$222,000 of consumer residential mortgages.

The following table shows the amount of loans in each category that were individually and collectively evaluated for impairment at the dates indicated:

| September 30, 2016                              | Real Estate Loans             |            |              | Commercial Consumer |           | Total      |
|---|-------------------------------|------------|--------------|---------------------|-----------|------------|
|   | Residential<br>(In thousands) | Commercial | Construction | Loans               | Loans     |            |
| Individually evaluated for impairment           | \$ 24                         | \$ 2,791   | \$ -         | \$ -                | \$ -      | \$ 2,815   |
| Loans acquired with deteriorated credit quality | 797                           | 571        | -            | -                   | -         | 1,368      |
| Collectively evaluated for impairment           | 237,076                       | 311,908    | 20,056       | 85,145              | 48,225    | 702,410    |
| Total Loans                                     | \$ 237,897                    | \$ 315,270 | \$ 20,056    | \$ 85,145           | \$ 48,225 | \$ 706,593 |

| December 31, 2015                               | Real Estate Loans             |            |              | Commercial Consumer |           | Total      |
|---|-------------------------------|------------|--------------|---------------------|-----------|------------|
|   | Residential<br>(In thousands) | Commercial | Construction | Loans               | Loans     |            |
| Individually evaluated for impairment           | \$ 28                         | \$ 8,660   | \$ -         | \$ 43               | \$ -      | \$ 8,731   |
| Loans acquired with deteriorated credit quality | 140                           | 358        | -            | -                   | -         | 498        |
| Collectively evaluated for impairment           | 161,652                       | 270,105    | 18,987       | 71,047              | 29,231    | 551,022    |
| Total Loans                                     | \$ 161,820                    | \$ 279,123 | \$ 18,987    | \$ 71,090           | \$ 29,231 | \$ 560,251 |

The following table includes the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable. Also presented are the average recorded investments in the impaired loans and the related amount of interest recognized during the time within the period that the impaired loans were impaired.

|                                     | Recorded<br>Investment | Unpaid<br>Principal<br>Balance<br>(in<br>thousands) | Associated<br>Allowance |
|-------------------------------------|------------------------|---|-------------------------|
| September 30, 2016                  |                        |   |                         |
| With no related allowance recorded: |                        |   |                         |
| Real Estate Loans                   |                        |   |                         |
| Residential                         | \$ 1,003               | \$ 1,189  | \$ -                    |
| Commercial                          | 3,349                  | 4,267   | -                       |
| Subtotal                            | 4,352                  | 5,456   | -                       |
| With an allowance recorded:         |                        |   |                         |
| Real Estate Loans                   |                        |   |                         |
| Commercial                          | 74                     | 1,020   | 15                      |
| Subtotal                            | 74                     | 1,020   | 15                      |
| Total:                              |                        |   |                         |
| Real Estate Loans                   |                        |   |                         |
| Residential                         | 1,003                  | 1,189   | -                       |
| Commercial                          | 3,423                  | 5,287   | 15                      |
| Total Impaired Loans                | \$ 4,426               | \$ 6,476  | \$ 15                   |

|                                       | Recorded<br>Investment | Unpaid<br>Principal<br>Balance<br>(in<br>thousands) | Associated<br>Allowance |
|---------------------------------------|------------------------|---|-------------------------|
| December 31, 2015                     |                        |   |                         |
| With no related allowance recorded:   |                        |   |                         |
| Real Estate Loans                     |                        |   |                         |
| Residential                           | \$ 168                 | \$ 173  | \$ -                    |
| Commercial                            | 2,644                  | 4,610   | -                       |
| Commercial, financial and agriculture | 43                     | 43  | -                       |
| Subtotal                              | 2,855                  | 4,826   | -                       |
| With an allowance recorded:           |                        |   |                         |
| Real Estate Loans                     |                        |   |                         |
| Commercial                            | 6,373                  | 6,446   | 1,613                   |
| Subtotal                              | 6,373                  | 6,446   | 1,613                   |
| Total:                                |                        |   |                         |
| Real Estate Loans                     |                        |   |                         |
| Residential                           | 168                    | 173   | -                       |

|                                       |          |           |          |
|---------------------------------------|----------|-----------|----------|
| Commercial                            | 9,017    | 11,056    | 1,613    |
| Commercial, financial and agriculture | 43       | 43        | -        |
| Total Impaired Loans                  | \$ 9,228 | \$ 11,272 | \$ 1,613 |

The following information for impaired loans is presented (in thousands) for the nine months ended September 30, 2016 and 2015:

|                    | Average<br>Recorded<br>Investment |           | Interest<br>Income<br>Recognized |        |
|--------------------|-----------------------------------|-----------|----------------------------------|--------|
|                    | 2016                              | 2015      | 2016                             | 2015   |
| Real Estate Loans: |                                   |           |                                  |        |
| Residential        | \$ 372                            | \$ 236    | \$ 3                             | \$ 3   |
| Commercial         | 3,249                             | 10,477    | 90                               | 510    |
| Total              | \$ 3,621                          | \$ 10,713 | \$ 93                            | \$ 513 |

The following information for impaired loans is presented (in thousands) for the three months ended September 30, 2016 and 2015:

|                    | Average<br>Recorded<br>Investment |           | Interest<br>Income<br>Recognized |       |
|--------------------|-----------------------------------|-----------|----------------------------------|-------|
|                    | 2016                              | 2015      | 2016                             | 2015  |
| Real Estate Loans: |                                   |           |                                  |       |
| Residential        | \$ 579                            | \$ 249    | \$ 1                             | \$ 1  |
| Commercial         | 3,253                             | 10,294    | 33                               | 45    |
| Total              | \$ 3,832                          | \$ 10,543 | \$ 34                            | \$ 46 |

Troubled debt restructured loans are those loans whose terms have been renegotiated to provide a reduction or deferral of principal or interest as a result of financial difficulties experienced by the borrower, who could not obtain comparable terms from alternate financing sources. As of September 30, 2016, troubled debt restructured loans totaled \$1.6 million and resulted in specific reserves of \$15,000. As of December 31, 2015, troubled debt restructured loans totaled \$6.8 million and resulted in specific reserves of \$1,613,000. For the period ended September 30, 2016, there were no new loans identified as troubled debt restructurings. During 2016, the Company has recognized write-downs of \$2,519,000 on loans that were previously identified as troubled debt restructurings.

For the period ended September 30, 2015, there were no new loans identified as troubled debt restructurings. During the 2015 period, the Company recognized write-downs in the amount of \$439,000 on three loans previously identified as troubled debt restructures with a carrying value of \$2.5 million as of September 30, 2015.

Management uses an eight point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first four categories are considered not criticized, and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The Special Mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk,



but not to the point of justifying a Substandard classification. Loans in the Substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are considered Substandard. Any portion of a loan that has been charged off is placed in the Loss category.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Bank has a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the Pass categories unless a

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specific action, such as non performance, repossession, or death occurs to raise awareness of a possible credit event. The Company's Loan Review Department is responsible for the timely and accurate risk rating of the loans on an ongoing basis. Every credit which must be approved by Loan Committee or the Board of Directors is assigned a risk rating at time of consideration. Loan Review also annually reviews relationships of \$1,000,000 and over to assign or re-affirm risk ratings. Loans in the Substandard categories that are collectively evaluated for impairment are given separate consideration in the determination of the allowance.

As the following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard, Doubtful and Loss within the internal risk rating system as of September 30, 2016 and December 31, 2015 (in thousands):

|                              | Pass       | Special<br>Mention | Substandard | Doubtful<br>or Loss | Total      |
|------------------------------|------------|--------------------|-------------|---------------------|------------|
| September 30, 2016           |            |                    |             |                     |            |
| Commercial real estate loans | \$ 306,177 | \$ 4,442           | \$ 4,651    | \$ -                | \$ 315,270 |
| Commercial loans             | 85,087     | 35                 | 23          | -                   | 85,145     |
| Total                        | \$ 391,264 | \$ 4,477           | \$ 4,674    | \$ -                | \$ 400,415 |

|                              | Pass       | Special<br>Mention | Substandard | Doubtful<br>or Loss | Total      |
|------------------------------|------------|--------------------|-------------|---------------------|------------|
| December 31, 2015            |            |                    |             |                     |            |
| Commercial real estate loans | \$ 267,892 | \$ 1,837           | \$ 9,394    | \$ -                | \$ 279,123 |
| Commercial loans             | 71,047     | -                  | 43          | -                   | 71,090     |
| Total                        | \$ 338,939 | \$ 1,837           | \$ 9,437    | \$ -                | \$ 350,213 |

For residential real estate loans, construction loans and consumer loans, the Company evaluates credit quality based on the performance of the individual credits. The following table presents the recorded investment in the loan classes based on payment activity as of September 30, 2016 and December 31, 2015 (in thousands):

|                               | Performing | Nonperforming | Total      |
|-------------------------------|------------|---------------|------------|
| September 30, 2016            |            |               |            |
| Residential real estate loans | \$ 236,711 | \$ 1,186      | \$ 237,897 |
| Construction                  | 20,028     | 28            | 20,056     |
| Consumer loans                | 48,225     | -             | 48,225     |
| Total                         | \$ 304,964 | \$ 1,214      | \$ 306,178 |

Performing Nonperforming Total

December 31, 2015

|                               |            |        |            |
|-------------------------------|------------|--------|------------|
| Residential real estate loans | \$ 161,380 | \$ 440 | \$ 161,820 |
| Construction                  | 18,987     | -      | 18,987     |
| Consumer loans                | 29,231     | -      | 29,231     |
| Total                         | \$ 209,598 | \$ 440 | \$ 210,038 |

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Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans as of September 30, 2016 and December 31, 2015 (in thousands):

|                    | Current    | 31-60<br>Days<br>Past<br>Due | 61-90<br>Days<br>Past<br>Due | Greater<br>than 90<br>Days<br>Past Due<br>and still<br>accruing | Non-Accrual | Total Past<br>Due and<br>Non-Accrual | Total<br>Loans |
|--------------------|------------|------------------------------|------------------------------|---|-------------|--------------------------------------|----------------|
| September 30, 2016 |            |                              |                              |   |             |                                      |                |
| Real Estate loans  |            |                              |                              |   |             |                                      |                |
| Residential        | \$ 234,857 | \$ 1,548                     | \$ 306                       | \$ -  | \$ 1,186    | \$ 3,040                             | \$ 237,897     |
| Commercial         | 313,916    | 198                          | 131                          | 49  | 976         | 1,354                                | 315,270        |
| Construction       | 20,028     | -                            | -                            | -   | 28          | 28                                   | 20,056         |
| Commercial loans   | 85,083     | 62                           | -                            | -   | -           | 62                                   | 85,145         |
| Consumer loans     | 48,118     | 96                           | 11                           | -   | -           | 107                                  | 48,225         |
| Total              | \$ 702,002 | \$ 1,904                     | \$ 448                       | \$ 49   | \$ 2,190    | \$ 4,591                             | \$ 706,593     |

|                   | Current    | 31-60<br>Days<br>Past<br>Due | 61-90<br>Days<br>Past<br>Due | Greater<br>than 90<br>Days<br>Past Due<br>and still<br>accruing | Non-Accrual | Total Past<br>Due and<br>Non-Accrual | Total<br>Loans |
|-------------------|------------|------------------------------|------------------------------|---|-------------|--------------------------------------|----------------|
| December 31, 2015 |            |                              |                              |   |             |                                      |                |
| Real Estate loans |            |                              |                              |   |             |                                      |                |
| Residential       | \$ 160,683 | \$ 646                       | \$ 51                        | \$ -  | \$ 440      | \$ 1,137                             | \$ 161,820     |
| Commercial        | 272,125    | 310                          | 39                           | -   | 6,649       | 6,998                                | 279,123        |
| Construction      | 18,959     | 28                           | -                            | -   | -           | 28                                   | 18,987         |
| Commercial loans  | 71,043     | 4                            | -                            | -   | 43          | 47                                   | 71,090         |
| Consumer loans    | 29,179     | 41                           | 11                           | -   | -           | 52                                   | 29,231         |
| Total             | \$ 551,989 | \$ 1,029                     | \$ 101                       | \$ -  | \$ 7,132    | \$ 8,262                             | \$ 560,251     |

Management reviews the loan portfolio on a quarterly basis using a defined, consistently applied process in order to make appropriate and timely adjustments to the allowance for loan losses. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the allowance. The following table presents the allowance for loan losses by the classes of the loan portfolio:

| (In thousands)  | Residential<br>Real<br>Estate | Commercial<br>Real Estate | Construction | Commercial | Consumer | Total    |
|---|-------------------------------|---------------------------|--------------|------------|----------|----------|
| Beginning balance, December 31, 2015                    | \$ 1,069                      | \$ 5,506                  | \$ 90        | \$ 397     | \$ 236   | \$ 7,298 |
| Charge Offs   | (32)                          | (2,670)                   | -            | (15)       | (71)     | (2,788)  |
| Recoveries  | 4                             | 11                        | -            | -          | 39       | 54       |
| Provision for loan losses                               | 15                            | 1,516                     | (12)         | (46)       | 127      | 1,600    |
| Ending balance, September 30, 2016                      | \$ 1,056                      | \$ 4,363                  | \$ 78        | \$ 336     | \$ 331   | \$ 6,164 |
| Ending balance individually evaluated<br>for impairment | \$ -                          | \$ 15                     | \$ -         | \$ -       | \$ -     | \$ 15    |
| Ending balance collectively evaluated<br>for impairment | \$ 1,056                      | \$ 4,348                  | \$ 78        | \$ 336     | \$ 331   | \$ 6,149 |

| (In thousands)                     | Residential<br>Real<br>Estate | Commercial<br>Real Estate | Construction | Commercial | Consumer | Total    |
|------------------------------------|-------------------------------|---------------------------|--------------|------------|----------|----------|
| Beginning balance, June 30, 2016   | \$ 976                        | \$ 4,191                  | \$ 59        | \$ 293     | \$ 279   | \$ 5,798 |
| Charge Offs                        | (15)                          | (28)                      | -            | (15)       | (41)     | (99)     |
| Recoveries                         | 2                             | 9                         | -            | -          | 4        | 15       |
| Provision for loan losses          | 93                            | 191                       | 19           | 58         | 89       | 450      |
| Ending balance, September 30, 2016 | \$ 1,056                      | \$ 4,363                  | \$ 78        | \$ 336     | \$ 331   | \$ 6,164 |

| (In thousands)                                       | Residential<br>Real<br>Estate | Commercial<br>Real Estate | Construction | Commercial | Consumer | Total    |
|--|-------------------------------|---------------------------|--------------|------------|----------|----------|
| Beginning balance, December 31, 2014                 | \$ 1,323                      | \$ 3,890                  | \$ 222       | \$ 256     | \$ 184   | \$ 5,875 |
| Charge Offs  | (159)                         | (1,692)                   | -            | -          | (59)     | (1,910)  |
| Recoveries   | 4                             | -                         | -            | -          | 18       | 22       |
| Provision for loan losses                            | (181)                         | 1,980                     | (137)        | 28         | 70       | 1,760    |
| Ending balance, September 30, 2015                   | \$ 987                        | \$ 4,178                  | \$ 85        | \$ 284     | \$ 213   | \$ 5,747 |
| Ending balance individually evaluated for impairment | \$ -                          | \$ 389                    | \$ -         | \$ -       | \$ -     | \$ 389   |
| Ending balance collectively evaluated for impairment | \$ 987                        | \$ 3,789                  | \$ 85        | \$ 284     | \$ 213   | \$ 5,358 |

| (In thousands)                     | Residential<br>Real<br>Estate | Commercial<br>Real Estate | Construction | Commercial | Consumer | Total    |
|------------------------------------|-------------------------------|---------------------------|--------------|------------|----------|----------|
| Beginning balance, June 30, 2015   | \$ 1,085                      | \$ 4,152                  | \$ 97        | \$ 405     | \$ 208   | \$ 5,947 |
| Charge Offs                        | (46)                          | (865)                     | -            | -          | (16)     | (927)    |
| Recoveries                         | -                             | -                         | -            | -          | 7        | 7        |
| Provision for loan losses          | (52)                          | 891                       | (12)         | (121)      | 14       | 720      |
| Ending balance, September 30, 2015 | \$ 987                        | \$ 4,178                  | \$ 85        | \$ 284     | \$ 213   | \$ 5,747 |

The Company's primary business activity as of December 31, 2015 was with customers located in northeastern Pennsylvania. As of September 30, 2016, the Company has added the New York counties of Delaware and Sullivan to its market as a result of the acquisition of Delaware Bancshares, Inc. Accordingly, the Company has extended credit primarily to commercial entities and individuals in this area whose ability to honor their contracts is influenced by the region's economy.

As of September 30, 2016, the Company considered its concentration of credit risk to be acceptable. The highest concentrations are in commercial rentals with \$64.8 million of loans outstanding, or 9.2% of total loans outstanding, and the hospitality/lodging industry with loans outstanding of \$51.6 million, or 7.3% of loans outstanding. During

2016, the Company recognized a write down of \$3,000 in the named concentrations.

Gross realized gains and gross realized losses on sales of residential mortgage loans were \$54,000 and \$0, respectively, in the first nine months of 2016 compared to \$56,000 and \$0, respectively, in the same period in 2015. The proceeds from the sales of residential mortgage loans totaled \$1.7 million and \$2.7 million for the nine months ended September 30, 2016 and 2015, respectively.

There were no sales of residential mortgage loans during the three months ended September 30, 2016. Gross realized gains and gross realized losses on sales of residential mortgage loans were \$16,000 and \$0, respectively, in the same period in 2015. The proceeds from the sales of residential mortgage loans totaled \$818,000 for the three months ended September 30, 2015.

#### 8. Fair Value Measurements

Fair value estimates are based on quoted market prices, if available, quoted market prices of similar assets or liabilities, or the present value of expected future cash flows and other valuation techniques. These valuations are significantly affected by discount rates, cash flow assumptions and risk assumptions used. Therefore, fair value estimates may not be substantiated by comparison to independent markets and are not intended to reflect the proceeds that may be realizable in an immediate settlement of the instruments.

Fair value is determined at one point in time and is not representative of future value. These amounts do not reflect the total value of a going concern organization. Management does not have the intention to dispose of a significant portion of its assets and liabilities and therefore, the unrealized gains or losses should not be interpreted as a forecast of future earnings and cash flows.

The following is a discussion of assets and liabilities measured at fair value on a recurring basis and valuation techniques applied:

##### Securities:

The fair value of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) 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 3). 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):

The Company measures 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 lowest level of input that is significant to the fair value measurements.

##### Foreclosed real estate owned (carried at fair value):

Real estate properties acquired through, or in lieu of loan foreclosure are to be sold and are carried at fair value less estimated 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.





For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2016 and December 31, 2015 are as follows:

| Description  | Fair Value Measurement Using Reporting Date |         |            |         |
|--|---|---------|------------|---------|
|  | Total                                       | Level 1 | Level 2    | Level 3 |
|  | (In thousands)                              |         |            |         |
| September 30, 2016                                       |   |         |            |         |
| Available for Sale:                                      |   |         |            |         |
| U.S. Treasury securities                                 | \$ 2,004                                    | \$ -    | \$ 2,004   | \$ -    |
| U.S. Government agencies                                 | 2,001                                       | -       | 2,001      | -       |
| States and political subdivisions                        | 130,572                                     | -       | 130,572    | -       |
| Corporate obligations                                    | 10,385                                      | -       | 10,385     | -       |
| Mortgage-backed securities-government sponsored agencies | 164,780                                     | -       | 164,780    | -       |
| Equity securities-financial services                     | 384   | 384     | -          | -       |
| Total  | \$ 310,126                                  | \$ 384  | \$ 309,742 | \$ -    |

| Description  | Fair Value Measurement Using Reporting Date |         |            |         |
|--|---|---------|------------|---------|
|  | Total                                       | Level 1 | Level 2    | Level 3 |
|  | (In thousands)                              |         |            |         |
| December 31, 2015  |   |         |            |         |
| Available for Sale:                                      |   |         |            |         |
| U.S. Government agencies                                 | \$ 9,169                                    | \$ -    | \$ 9,169   | \$ -    |
| States and political subdivisions                        | 60,755                                      | -       | 60,755     | -       |
| Corporate obligations                                    | 4,974                                       | -       | 4,974      | -       |
| Mortgage-backed securities-government sponsored agencies | 63,569                                      | -       | 63,569     | -       |
| Equity securities-financial services                     | 384   | 384     | -          | -       |
| Total  | \$ 138,851                                  | \$ 384  | \$ 138,467 | \$ -    |

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2016 and December 31, 2015 are as follows:

Fair Value  
Measurement  
Reporting Date  
using Reporting  
Date

(In thousands)

| Description                  | Total    | Level |      | Level 3  |
|------------------------------|----------|-------|------|----------|
|                              |          | 1     | 2    |          |
| September 30, 2016           |          |       |      |          |
| Impaired Loans               | \$ 4,411 | \$ -  | \$ - | \$ 4,411 |
| Foreclosed Real Estate Owned | 5,386    | -     | -    | 5,386    |
| December 31, 2015            |          |       |      |          |
| Impaired Loans               | \$ 7,615 | \$ -  | \$ - | \$ 7,615 |
| Foreclosed Real Estate Owned | 2,847    | -     | -    | 2,847    |

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The following tables present additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Company has utilized Level 3 inputs to determine fair value:

| Quantitative Information about Level 3 Fair Value Measurements |                     |                                    |                          |                          |
|--|---------------------|------------------------------------|--------------------------|--------------------------|
| (dollars in thousands)   | Fair Value Estimate | Valuation Techniques               | Unobservable Input       | Range (Weighted Average) |
| September 30, 2016   |                     |                                    |                          |                          |
| Impaired loans   | \$ 2,847            | Appraisal of collateral(1)         | Appraisal adjustments(2) | 0 - 10% (9.50%)          |
| Impaired loans   | \$ 1,564            | Present value of future cash flows | Loan discount rate       | 4 - 6.75% (5.46%)        |
| Foreclosed real estate owned                                   | \$ 5,386            | Appraisal of collateral(1)         | Liquidation Expenses(2)  | 0 - 10% (9.90%)          |

| Quantitative Information about Level 3 Fair Value Measurements |                     |                                    |                          |                          |
|--|---------------------|------------------------------------|--------------------------|--------------------------|
| (dollars in thousands)   | Fair Value Estimate | Valuation Techniques               | Unobservable Input       | Range (Weighted Average) |
| December 31, 2015  |                     |                                    |                          |                          |
| Impaired loans   | \$ 2,574            | Appraisal of collateral(1)         | Appraisal adjustments(2) | 10% (10%)                |
| Impaired loans   | \$ 5,041            | Present value of future cash flows | Loan discount rate       | 4-7% (5.61%)             |
| Foreclosed real estate owned                                   | \$ 2,847            | Appraisal of collateral(1)         | Liquidation Expenses(2)  | 10% (10%)                |

- (1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable, less any associated allowance.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at September 30, 2016 and December 31, 2015.

Cash and cash equivalents (carried at cost):

The carrying amounts reported in the consolidated balance sheet for cash and short-term instruments approximate those assets' fair values.



Securities:

The fair value of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) 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 3). 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.

Loans receivable (carried at cost):

The fair values of loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

Impaired loans (generally carried at fair value):

The Company measures 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 lowest level of input that is significant to the fair value measurements.

As of September 30, 2016, the fair value investment in impaired loans totaled \$4,411,000 which included one loan for \$74,000 for which a valuation allowance of \$15,000 had been provided based on the estimated value of the collateral, and twenty-four loans for \$4,352,000 which did not require a valuation allowance since either the estimated realizable value of the collateral or the discounted cash flows exceeded the recorded investment in the loan. As of September 30, 2016, the Company has recognized charge-offs against the allowance for loan losses on these impaired loans in the amount of \$1,806,000 over the life of the loans.

As of December 31, 2015, the fair value investment in impaired loans totaled \$7,615,000 which included three loans for \$6,373,000 for which a valuation allowance of \$1,613,000 had been provided based on the estimated value of the collateral or the present value of estimated cash flows, and seventeen loans for \$2,855,000 which did not require a valuation allowance since the estimated realizable value of the collateral exceeded the recorded investment in the loan. As of December 31, 2015, the Company had recognized charge-offs against the allowance for loan losses on these impaired loans in the amount of \$2,044,000 over the life of the loans.

Mortgage servicing rights (generally carried at cost)

The Company utilizes a third party provider to estimate the fair value of certain loan servicing rights. Fair value for the purpose of this measurement is defined as the amount at which the asset could be exchanged in a current transaction between willing parties, other than in a forced liquidation.

Foreclosed real estate owned (carried at fair value):

Real estate properties acquired through, or in lieu of loan foreclosure are to be sold and are carried at fair value less estimated 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.

Regulatory stock (carried at cost):

The Company, as a member of the Federal Home Loan Bank (FHLB) system is required to maintain an investment in capital stock of its district FHLB according to a predetermined formula. This regulatory stock has no quoted market value and is carried at cost.

Bank owned life insurance (carried at cost):

The fair value is equal to the cash surrender value of the Bank owned life insurance.

Accrued interest receivable and payable (carried at cost):

The carrying amount of accrued interest receivable and accrued interest payable approximates its fair value.

Deposit liabilities (carried at cost except certificates of deposit which are at fair value):

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Short-term borrowings (carried at cost):

The carrying amounts of short-term borrowings approximate their fair values.

Other borrowings (carried at cost):

Fair values of FHLB advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

Off-balance sheet financial instruments (disclosed at cost):

Fair values for the Company's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

The estimated fair values of the Bank's financial instruments were as follows at September 30, 2016 and December 31, 2015. (In thousands)

|                           | Fair Value Measurements at September 30, 2016 |            |           |         |         |
|---------------------------|---|------------|-----------|---------|---------|
|                           | Carrying Amount                               | Fair Value | Level 1   | Level 2 | Level 3 |
| Financial assets:         |   |            |           |         |         |
| Cash and cash equivalents | \$ 33,133                                     | \$ 33,133  | \$ 33,133 | \$ -    | \$ -    |
| Securities                | 310,126                                       | 310,126    | 384       | 309,742 | -       |
| Loans receivable, net     | 700,035                                       | 715,469    | -         | -       | 715,469 |
| Mortgage servicing rights | 244   | 260        | -         | -       | 260     |
| Regulatory stock          | 2,351   | 2,351      | 2,351     | -       | -       |
| Bank owned life insurance | 35,889  | 35,889     | 35,889    | -       | -       |

|                             |       |       |       |   |   |
|-----------------------------|-------|-------|-------|---|---|
| Accrued interest receivable | 3,541 | 3,541 | 3,541 | - | - |
|-----------------------------|-------|-------|-------|---|---|



## Financial liabilities:

|                          |         |         |         |   |         |
|--------------------------|---------|---------|---------|---|---------|
| Deposits                 | 922,244 | 922,394 | 275,564 | - | 646,830 |
| Short-term borrowings    | 33,156  | 33,156  | 33,156  | - | -       |
| Other borrowings         | 42,542  | 42,712  | -       | - | 42,712  |
| Accrued interest payable | 1,040   | 1,040   | 1,040   | - | -       |

## Off-balance sheet financial instruments:

|  |   |   |   |   |   |
|--|---|---|---|---|---|
| Commitments to extend credit and outstanding letters of credit | - | - | - | - | - |
|--|---|---|---|---|---|

## Fair Value Measurements at December 31, 2015

|  | Carrying Amount | Fair Value | Level 1   | Level 2 | Level 3 |
|--|-----------------|------------|-----------|---------|---------|
| Financial assets:  |                 |            |           |         |         |
| Cash and cash equivalents                                      | \$ 10,010       | \$ 10,010  | \$ 10,010 | \$ -    | \$ -    |
| Securities   | 138,851         | 138,851    | 384       | 138,467 | -       |
| Loans receivable, net  | 552,627         | 559,416    | -         | -       | 559,416 |
| Mortgage servicing rights                                      | 261             | 291        | -         | -       | 291     |
| Regulatory stock   | 3,412           | 3,412      | 3,412     | -       | -       |
| Bank owned life insurance                                      | 18,820          | 18,820     | 18,820    | -       | -       |
| Accrued interest receivable                                    | 2,363           | 2,363      | 2,363     | -       | -       |
| Financial liabilities:   |                 |            |           |         |         |
| Deposits   | 550,909         | 551,175    | 354,162   | -       | 197,013 |
| Short-term borrowings  | 53,235          | 53,235     | 53,235    | -       | -       |
| Other borrowings   | 41,126          | 41,260     | -         | -       | 41,260  |
| Accrued interest payable                                       | 957             | 957        | 957       | -       | -       |
| Off-balance sheet financial instruments:                       |                 |            |           |         |         |
| Commitments to extend credit and outstanding letters of credit | -               | -          | -         | -       | -       |

9. New and Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (a new revenue recognition standard). The Update's core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this Update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. This Update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that

reporting period. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In August 2015, the FASB issued ASU 2015-14, Revenue from Contract with Customers (Topic 606). The amendments in this Update defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. The Company is evaluating the effect of adopting this new accounting Update.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (g) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (h) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. All entities that are not public business entities may adopt the amendments in this Update earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently



evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718). The amendments in this Update affect all entities that issue share-based payment awards to their employees. The standards in this Update provide simplification for several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as with equity or liabilities, and classification on the statement of cash flows. Some of the areas for simplification apply only to nonpublic entities. In addition to those simplifications, the amendments eliminate the guidance in Topic 718 that was indefinitely deferred shortly after the issuance of FASB Statement No. 123 (revised 2004), Share-Based Payment. This should not result in a change in practice because the guidance that is being superseded was never effective. For public business entities, the amendments in this Update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted for any entity in any interim or annual period. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"), which changes the impairment model for most financial assets. This Update is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The underlying premise of the Update is that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The income statement will be effected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019, and early adoption is permitted for annual and interim periods beginning after December 15, 2018. With certain exceptions, transition to the new requirements will be through a cumulative effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"), which addresses eight specific cash flow issues with the objective of reducing diversity in practice. Among these include recognizing cash payments for debt prepayment or debt extinguishment as cash outflows for financing activities; cash proceeds received from the settlement of insurance claims should be classified on the basis of the related insurance coverage; and cash proceeds received from the settlement of bank-owned life insurance policies should be classified as cash inflows from investing activities while the cash payments for premiums on bank-owned policies may be classified as cash outflows for investing activities, operating activities, or a combination of investing and operating activities. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The amendments in this Update should be applied using a retrospective transition method to each period presented. If it is impracticable to apply the amendments retrospectively for some of the issues, the amendments for those issues would be applied prospectively as of the earliest date



practicable. The Company is currently evaluating the impact the adoption of the standard will have on the Company's statement of cash flows.

#### 10. Acquisition of Delaware Bancshares, Inc.

On July 31, 2016, Norwood Financial Corp. (the "Company") completed its acquisition of Delaware Bancshares, Inc. ("Delaware") pursuant to the terms of the Agreement and Plan of Merger, dated March 10, 2016, by and among the Company, Wayne Bank, Delaware and The National Bank of Delaware County (the "Merger Agreement"). As of June 30, 2016, Delaware had on a consolidated basis total assets of \$378.3 million, total deposits of \$327.5 million and total shareholders' equity of \$24.1 million.

Pursuant to the terms of the Merger Agreement, Delaware was merged with and into the Company, with the Company as the surviving corporation of the merger (the "Merger"). At the effective time of the Merger, each outstanding share of the common stock of Delaware was converted into, at the election of the holder but subject to the limitations and allocation and proration provisions set forth in the Merger Agreement, either \$16.68 in cash or 0.6221 of a share of the common stock, par value \$0.10 per share (the "Common Stock") of the Company. In the aggregate, the merger consideration paid to Delaware shareholders consisted of approximately \$3,859,000 in cash and 431,605 shares of Norwood common stock. Immediately following the Merger, The National Bank of Delaware County ("NBDC") was merged with and into Wayne Bank, a wholly-owned subsidiary of the Company, with Wayne Bank as the surviving entity.

In connection with the Merger, the Company assumed the obligations of Delaware under the Indenture, dated as of October 31, 2007, by and between Delaware, as issuer, and Wells Fargo Bank, National Association, as trustee (the "Indenture") and Delaware's Junior Subordinated Debt Securities, due January 1, 2038 (the "Debt Securities") issued thereunder. The Debt Securities were issued by Delaware in connection with a private placement completed on October 31, 2007 of \$8.0 million of trust preferred securities issued through the Delaware Bancshares Capital Trust I (the "Trust"). The trust preferred securities require quarterly distributions and bear interest at a variable rate equal to LIBOR plus 2.4% per annum. The trust preferred securities mature on January 1, 2038 and are redeemable, in whole or in part, without penalty, on or after January 1, 2013 and on any January 1, April 1, July 1 or October 1 thereafter. The Company redeemed the securities on October 3, 2016.

The proceeds from the initial sale of the trust preferred securities on October 31, 2007 were used by the Trust to purchase the Debt Securities. The Debt Securities bear interest at a variable rate which resets quarterly at LIBOR plus 2.4%, and are redeemable, in whole or in part, without penalty, at the option of the Company, beginning on January 1, 2013 and on any January 1, April 1, July 1 or October 1 thereafter. The interest payments on the Debt Securities made by the Company will be used to pay the quarterly distributions payable by the Trust to the holders of the trust preferred securities. The Company redeemed the securities on October 3, 2016.

The acquired assets and assumed liabilities were measured at estimated fair values. Management made significant estimates and exercised significant judgment in accounting for the acquisition. Management measured loan fair values based on loan file reviews, appraised collateral values, expected cash flows, and historical loss factors of NBDC. The Company also recorded an identifiable intangible asset representing the core deposit base of NBDC based on management's evaluation of the cost of such deposits relative to alternative funding sources. Management used significant estimates including the average lives of depository accounts, future interest rate levels, and the cost of servicing various depository products. Management used market quotations to determine the fair value of investment securities.





The business combination resulted in the acquisition of loans with and without evidence of credit quality deterioration. NBDC loans were deemed impaired at the acquisition date if the Company did not expect to receive all contractually required cash flows due to concerns about credit quality. Such loans were fair valued and the difference between contractually required payments at the acquisition date and cash flows expected to be collected was recorded as a non-accretable difference. At the acquisition date, the Company recorded \$1,410,000 of purchased credit-impaired loans subject to a non-accretable difference of \$260,000. The method of measuring carrying value of purchased loans differs from loans originated by the Company (originated loans), and as such, the Company identifies purchased loans and purchased loans with a credit quality discount and originated loans at amortized cost.

NBDC's loans without evidence of credit deterioration were fair valued by discounting both expected principal and interest cash flows using an observable discount rate for similar instruments that a market participant would consider in determining fair value. Additionally, consideration was given to management's best estimates of default rates and payment speeds. At acquisition, NBDC's loan portfolio without evidence of deterioration totaled \$111,307,000 and was recorded at a fair value of \$109,693,000.

The following table summarizes the purchase of Delaware Bancshares, Inc. as of July 31, 2016:

(In Thousands, Except Per Share Data)

Purchase Price Consideration in Common Stock

|  |          |
|--|----------|
| Delaware Bancshares, Inc. common shares settled for stock  | 694,114  |
| Exchange Ratio   | 0.6221   |
| Norwood Financial Corp. shares issued  | 431,605  |
| Value assigned to Norwood Financial Corp. common share   | \$28.15  |
| Purchase price assigned to Delaware Bancshares, Inc. common shares exchanged for Norwood Financial Corp. | \$12,150 |

Purchase Price Consideration – Cash for Common Stock

|  |          |
|--|----------|
| Delaware Bancshares, Inc. shares exchanged for cash                                    | 231,385  |
| Purchase price paid to each Delaware Bancshares, Inc. common shares exchanged for cash | \$16.68  |
| Purchase price assigned to Delaware Bancshares, Inc. common shares exchanged for cash  | \$3,860  |
| Purchase price consideration-Cash in Lieu of Fractional Shares                         | 6        |
| Total Purchase Price   | \$16,016 |

Net Assets Acquired:

|   |         |
|---|---------|
| Delaware Bancshares, Inc. shareholders' equity        | 19,357  |
| Delaware Bancshares, Inc. goodwill and intangibles    | (7,640) |
| Total tangible equity                                 | 11,717  |
| Adjustments to reflect assets acquired at fair value: |         |
| Investments   | 219     |
| Loans   |         |
| Interest rate   | 1,486   |

|   |         |         |
|---|---------|---------|
| General credit  | (1,614) |         |
| Specific credit- non-amortizing                                   | (260)   |         |
| Specific credit – amortizing                                      | (239)   |         |
| Core deposit intangible   | 449     |         |
| Deferred loan fees  | (296)   |         |
| Premises and equipment  | 3,053   |         |
| Allowance for loan and lease losses                               | 1,651   |         |
| Deferred tax assets   | (1,417) |         |
| Other   | (445)   |         |
| <u>Adjustments to reflect liabilities acquired at fair value:</u> |         |         |
| Time deposits   | (252)   | 14,052  |
| Goodwill resulting from merger                                    |         | \$1,964 |

The following condensed statement reflects the values assigned to Delaware Bancshares, Inc. net assets as of acquisition date:

(In Thousands)

|   |           |          |
|---|-----------|----------|
| Total purchase price  |           | \$16,016 |
| Net assets acquired:  |           |          |
| Cash  | \$14,977  |          |
| Securities available for sale                               | 208,488   |          |
| Loans   | 116,674   |          |
| Premises and equipment, net                                 | 7,292     |          |
| Regulatory stock  | 279       |          |
| Accrued interest receivable                                 | 1,626     |          |
| Bank-owned life insurance                                   | 14,762    |          |
| Core deposit intangible                                     | 449       |          |
| Deferred tax assets   | 3,034     |          |
| Other assets  | 2,934     |          |
| Time deposits   | (71,342)  |          |
| Deposits other than time deposits                           | (255,921) |          |
| Borrowings  | (21,232)  |          |
| Accrued interest payable                                    | (95)      |          |
| Other liabilities   | (7,873)   |          |
|   |           | 14,052   |
| Goodwill resulting from Delaware Bancshares, Inc.<br>Merger |           | \$1,964  |

The Company recorded goodwill and other intangibles associated with the purchase of Delaware Bancshares, Inc. totaling \$1,964,000. Goodwill is not amortized, but is periodically evaluated for impairment. The Company did not recognize any impairment during the nine months ended September 30, 2016. The carrying amount of the goodwill at September 30, 2016 related to the Delaware acquisition was \$1,964,000.

Identifiable intangibles are amortized to their estimated residual values over the expected useful lives. Such lives are also periodically reassessed to determine if any amortization period adjustments are required. During the nine months ended September 30, 2016, no such adjustments were recorded. The identifiable

intangible assets consist of a core deposit intangible which is being amortized on an accelerated basis over the useful life of such assets. The gross carrying amount of the core deposit intangible at September 30, 2016 was \$449,000 with \$14,000 accumulated amortization as of that date.

As of September 30, 2016, the current year and estimated future amortization expense for the core deposit intangible is:

(In thousands)

|                  |       |
|------------------|-------|
| 2016             | \$13  |
| 2017             | 30    |
| 2018             | 30    |
| 2019             | 30    |
| 2020             | 30    |
| After five years | 316   |
|                  | \$449 |

Results of operations for Delaware Bancshares, Inc. prior to the acquisition date are not included in the Consolidated Statement of Income for the three and nine month period ended September 30, 2016. Due to the significant amount of fair value adjustments, historical results of Delaware Bancshares, Inc. are not relevant to the Company's results of operations. Therefore, no pro forma information is presented.

The following table presents financial information regarding the former Delaware Bancshares, Inc. operations included in our Consolidated Statement of Income from the date of acquisition through September 30, 2016 under the column "Actual from acquisition date through September 30, 2016". In addition, the following table presents unaudited pro forma information as if the acquisition of Delaware Bancshares, Inc. had occurred on January 1, 2016 under the "Pro Forma" columns. The table below has been prepared for comparative purposes only and is not necessarily indicative of the actual results that would have been attained had the acquisition occurred as of the beginning of the periods presented, nor is it indicative of future results. Furthermore, the unaudited pro-forma information does not reflect management's estimate of any revenue-enhancing opportunities nor anticipated cost savings as a result of the integration and consolidation of the acquisition. Merger and acquisition integration costs and amortization of fair value adjustments are included in the numbers below.

|  | Actual<br>From<br>Acquisition<br>Date<br>Through<br><u>September</u><br><u>30, 2016</u> | <u>Pro Forma</u><br><u>Nine Months</u><br><u>Ended</u><br><u>September 30</u> |             |
|--|---|---|-------------|
|  |   | <u>2016</u>   | <u>2015</u> |
| <u>(In Thousands, Except Per Share Data)</u> |   |   |             |
| Net interest income                          | \$1,560   | \$25,377  | \$26,340    |
| Non-interest income                          | 357   | 4,715   | 5,179       |
| Net income                                   | 300   | 1,243   | 6,050       |
| Pro forma earnings per share:                |   |   |             |
| Basic  | \$0.08  | \$0.33  | \$1.60      |
| Diluted                                      | \$0.08  | \$0.33  | \$1.60      |



## 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 are as follows:

- our ability to realize the anticipated benefits from our acquisition of Delaware Bancshares, Inc.
- possible future impairment of intangible assets
- our ability to effectively manage future growth
- loan losses in excess of our allowance
- risks inherent in commercial lending
- real estate collateral which is subject to declines in value
- potential other-than-temporary impairments
- higher deposit insurance premiums
- soundness of other financial institutions
- increased compliance burden under new financial reform legislation
- current market volatility
- potential liquidity risk
- availability of capital
- regional economic factors
- loss of senior officers
- comparatively low legal lending limits
- risks of new capital requirements
- limited market for the Company's stock
- restrictions on ability to pay dividends
- common stock may lose value
- competitive environment
- issuing additional shares may dilute ownership
- extensive and complex governmental regulation and associated cost
- interest rate risks
- cybersecurity

Norwood Financial Corp. 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, 2015 (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, the valuation of deferred tax assets, the fair value of financial instruments, the determination of goodwill impairment and the determination of other-than-temporary impairment on securities. Please refer to the discussion of the allowance for loan losses calculation under "Loans" in the "Changes in Financial Condition" section.

The Company uses the modified prospective transition method to account for stock options. Under this method companies are required to record compensation expense, based on the fair value of options over the vesting period. Restricted shares vest over a five year period. The product of the number of shares granted and the grant date market price of the Company's common stock determines the fair value of restricted stock.

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.

Management determines the appropriate classification of debt securities at the time of purchase and re-evaluates such designation as of each Consolidated Balance Sheet date.

Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, the Company considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent of the Company to not sell the securities and it is more likely than not that it will not have to sell the securities before recovery of their cost basis. The Company believes that the unrealized loss on all other securities at September 30, 2016 and December 31, 2015 represent temporary impairment of the securities, related to changes in interest rates.

The Company, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in capital stock of its district FHLB according to a predetermined formula. This restricted stock has no quoted market value and is carried at cost.

Management evaluates the restricted stock for impairment. 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 declines 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 the length of time this situation has persisted, (2) commitments by the 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 considered that the FHLB's regulatory capital ratios have increased from prior years, liquidity appears adequate, and the new shares of FHLB stock continue to change hands at the \$100 par value. Management believes no impairment charge is necessary related to FHLB stock as of September 30, 2016.

In connection with acquisitions, the Company recorded goodwill in the amount of \$11.7 million, representing the excess of amounts paid over the fair value of net assets of the institutions acquired in purchase transactions, at its fair value at the date of acquisition. Goodwill is tested and deemed impaired when the





carrying value of goodwill exceeds its implied fair value. The value of the goodwill can change in the future. We expect the value of the goodwill to decrease if there is a significant decrease in the franchise value of the Company or the Bank. If an impairment loss is determined in the future, we will reflect the loss as an expense for the period in which the impairment is determined, leading to a reduction of our net income for that period by the amount of the impairment loss.

### Changes in Financial Condition

#### General

Total assets as of September 30, 2016 were \$1.125 billion compared to \$750.5 million as of December 31, 2015, an increase of \$374.6 million due primarily to the acquisition of Delaware Bancshares, Inc.

#### Securities

The fair value of securities available for sale as of September 30, 2016 was \$310.1 million compared to \$138.8 million as of December 31, 2015. The increase in the securities portfolio includes \$213.0 million of securities acquired from NBDC. The Company purchased \$80.5 million of securities principally using the proceeds from \$119.9 million of sales, calls, maturities and principal reductions of securities.

The carrying value of the Company's securities portfolio (Available-for Sale) consisted of the following:

| (dollars in thousands)               | September 30, 2016 |                | December 31, 2015 |                |   |
|--------------------------------------|--------------------|----------------|-------------------|----------------|---|
|                                      | Amount             | % of portfolio | Amount            | % of portfolio |   |
| U.S. Treasury securities             | \$ 2,004           | 0.7            | % \$ -            | -              | % |
| U.S. Government agencies             | 2,001              | 0.7            | 9,169             | 6.6            |   |
| States and political subdivisions    | 130,572            | 42.1           | 60,755            | 43.8           |   |
| Corporate obligations                | 10,385             | 3.3            | 4,974             | 3.5            |   |
| Mortgage-backed securities-          |                    |                |                   |                |   |
| government sponsored entities        | 164,780            | 53.1           | 63,569            | 45.8           |   |
| Equity securities-financial services | 384                | 0.1            | 384               | 0.3            |   |
| Total                                | \$ 310,126         | 100.0          | % \$ 138,851      | 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. Management believes that the unrealized losses on all holdings represent temporary impairment of the securities, as the Company has the intent and ability to hold these investments until maturity or market price recovery.

#### Loans

Loans receivable totaled \$706.2 million at September 30, 2016 compared to \$559.9 million as of December 31, 2015. The \$146.3 million increase recorded in the nine-month period ending September 30, 2016 includes \$112.1 million that was acquired from Delaware and \$34.2 million that was generated internally.

The allowance for loan losses totaled \$6,164,000 as of September 30, 2016 and represented 0.87% of total loans outstanding, compared to \$7,298,000, or 1.30% of total loans, at December 31, 2015, and \$5,747,000, or 1.06 % of

total loans, as of September 30, 2015. The Company had net charge-offs for the nine months ended September 30, 2016 of \$2,733,000 compared to \$1,888,000 in the corresponding period in 2015. Included in the 2016 total is \$2,419,000 related to one relationship that was foreclosed on during the second

quarter of 2016. The Company's loan review process assesses the adequacy of the allowance for loan losses on a quarterly basis. The process includes an analysis of the risks inherent in the loan portfolio. It includes an analysis of impaired loans and a historical review of credit losses by loan type. Other factors considered include concentration of credit in specific industries, economic and industry conditions, trends in delinquencies and loan classifications, large dollar exposures and loan growth. Management considers the allowance adequate at September 30, 2016 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, 2016, non-performing loans totaled \$2.2 million, or 0.32% of total loans compared to \$7.1 million, or 1.27% of total loans at December 31, 2015. At September 30, 2016, non-performing assets totaled \$7.6 million, or 0.68%, of total assets compared to \$10.0 million, or 1.33%, of total assets at December 31, 2015. The decrease in non-performing assets principally reflects payments and write-downs on loans carried in nonaccrual assets. The decrease in non-performing loans includes payments and write-downs on loans carried in nonaccrual status, as well as the transfer of one loan relationship to foreclosed real estate which had a carrying value of \$5,015,000 at December 31, 2015.

The following table sets forth information regarding non-performing loans and foreclosed real estate at the dates indicated:

| (dollars in thousands)   | September<br>30, 2016 | December<br>31, 2015 |
|--|-----------------------|----------------------|
| Loans accounted for on a non-accrual basis:                        |                       |                      |
| Real Estate  |                       |                      |
| Residential  | \$ 1,186              | \$ 440               |
| Commercial   | 976                   | 6,649                |
| Construction   | 28                    | -                    |
| Commercial, financial and agricultural                             | -                     | 43                   |
| Consumer loans to individuals                                      | -                     | -                    |
| Total non-accrual loans *  | 2,190                 | 7,132                |
| Accruing loans which are contractually<br>past due 90 days or more |                       |                      |
|  | 49                    | -                    |
| Total non-performing loans   | 2,239                 | 7,132                |
| Foreclosed real estate   | 5,386                 | 2,847                |
| Total non-performing assets  | \$ 7,625              | \$ 9,979             |
| Allowance for loans losses   | \$ 6,164              | \$ 7,298             |
| Coverage of non-performing loans                                   | 275.30 %              | 102.33 %             |
| Non-performing loans to total loans                                | 0.32 %                | 1.27 %               |
| Non-performing loans to total assets                               | 0.20 %                | 0.95 %               |
| Non-performing assets to total assets                              | 0.68 %                | 1.33 %               |

\*Includes non-accrual TDRs of \$554,000 as of September 30, 2016 and \$5.8 million on December 31, 2015. The Company also had \$1.0 million of accruing TDRs on September 30, 2016 and December 31, 2015.



Deposits

During the period, total deposits increased \$371.3 million due primarily to the \$327.3 million of deposits acquired from NBDC. Internally generated deposits increased \$44.0 million, net.

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

| (dollars in thousands)        | September<br>30, 2016 | December<br>31, 2015 |
|-------------------------------|-----------------------|----------------------|
| Non-interest bearing demand   | \$ 200,481            | \$ 107,814           |
| Interest bearing demand       | 96,189                | 52,040               |
| Money market deposit accounts | 158,156               | 119,028              |
| Savings                       | 192,005               | 75,280               |
| Time deposits <\$100,000      | 160,519               | 121,211              |
| Time deposits >\$100,000      | 114,894               | 75,536               |
| <br>Total                     | <br>\$ 922,244        | <br>\$ 550,909       |

Borrowings

Short-term borrowings as of September 30, 2016 totaled \$33.2 million compared to \$53.2 million as of December 31, 2015. Short-term borrowings, which consist of securities sold under agreements to repurchase and overnight borrowings from the FHLB, decreased \$20.0 million due to a reduction in overnight borrowings.

Other borrowings consisted of the following:

(dollars in thousands)

|   | September<br>30, 2016 | December<br>31, 2015 |
|---|-----------------------|----------------------|
| Notes with the FHLB:  |                       |                      |
| Convertible note due January 2017 at 4.71%                  | \$ 10,000             | \$ 10,000            |
| Amortizing fixed rate borrowing due December 2017 at 1.275% | 5,024                 | 8,000                |
| Amortizing fixed rate borrowing due January 2018 at 0.91%   | 814                   | 1,267                |
| Amortizing fixed rate borrowing due December 2018 at 1.425% | 1,835                 | 2,434                |
| Amortizing fixed rate borrowing due June 2020 at 1.490%     | 7,569                 | 9,033                |
| Amortizing fixed rate borrowing due December 2020 at 1.706% | 4,277                 | 5,000                |
| Amortizing fixed rate borrowing due March 2022 at 1.748%    | 4,775                 | 5,392                |
|   | \$ 34,294             | \$ 41,126            |

The convertible note contains an option which allows the FHLB, at quarterly intervals to change the note to an adjustable-rate advance at three month LIBOR plus 17 basis points. If the note is converted, the option allows the Bank to put the funds back to the FHLB without penalty.



Stockholders' Equity and Capital Ratios

As of September 30, 2016, stockholders' equity totaled \$115.7 million, compared to \$101.0 million as of December 31, 2015. The net change in stockholders' equity included \$4.4 million of net income that was partially offset by \$3.6 million of dividends declared, and a \$447,000 decrease due to an increase in Treasury Stock, and a \$283,000 increase, net, due to the exercise and vesting of stock options and restricted stock. In addition, total equity increased \$1.9 million due to an increase in the fair value of securities in the available for sale portfolio, net of tax, and \$12.1 million as a result of the acquisition of Delaware Bancshares, Inc. This increase in fair value is the result of a change in interest rates and spreads, which may impact the value of the securities. Because of interest rate volatility, the Company's accumulated other comprehensive income could materially fluctuate for each interim and year-end period.

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

|   | September 30, 2016 | December 31, 2015 |
|---|--------------------|-------------------|
| Tier 1 Capital<br>(To average assets)                     | 10.64%             | 12.40%            |
| Tier 1 Capital<br>(To risk-weighted assets)               | 14.22%             | 15.86%            |
| Common Equity Tier 1 Capital<br>(To risk-weighted assets) | 14.22%             | 15.86%            |
| Total Capital<br>(To risk-weighted assets)                | 15.04%             | 17.09%            |

Effective January 1, 2015, the Company and the Bank became subject to new regulatory capital rules, which, among other things, impose a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), set the minimum leverage ratio for all banking organizations at a uniform 4% of total assets, increase the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assign a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The new rules also require unrealized gains and losses on certain "available-for-sale" securities holdings to be included for purposes of calculating regulatory capital requirements unless a one-time opt out is exercised which the Company and the Bank have done. The final rule limits a banking organization's dividends, stock repurchases and other capital distributions, and certain discretionary bonus payments to executive officers, if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets above regulatory minimum risk-based requirements. The capital conservation buffer requirement will be phased in beginning January 1, 2016 and ending January 1, 2019, when the full capital conservation buffer requirement will be effective. The Company and the Bank are in compliance with their respective new capital requirements, including the capital conservation buffer, as of September 30, 2016.

Liquidity

As of September 30, 2016, the Company had cash and cash equivalents of \$33.1 million in the form of cash, due from banks and short-term deposits with other institutions. In addition, the Company had total securities available for sale of \$310.1 million which could be used for liquidity needs. This totals \$343.2 million of liquidity and represents



30.5% of total assets compared to \$148.9 million and 19.8% of total assets as of December 31, 2015. The Company also monitors other liquidity measures, all of which were within the

Company's policy guidelines as of September 30, 2016 and December 31, 2015. Based upon these measures, the Company believes its liquidity is adequate.

#### Capital Resources

The Company has a line of credit commitment from Atlantic Community Bankers Bank for \$7,000,000 which expires June 30, 2017. There were no borrowings under this line as of September 30, 2016 and December 31, 2015.

The Company has a line of credit commitment available which has no stated expiration date from PNC Bank for \$16,000,000. There were no borrowings under this line as of September 30, 2016 and December 31, 2015.

The Company has a line of credit commitment available which has no stated expiration date from Zions Bank for \$17,000,000. There were no borrowings under this line as of September 30, 2016 and December 31, 2015.

The Bank's maximum borrowing capacity with the Federal Home Loan Bank was approximately \$256,500,000 as of September 30, 2016, of which \$34,294,000 and \$60,798,000 was outstanding at September 30, 2016 and December 31, 2015, respectively. Advances from the Federal Home Loan Bank are secured by qualifying assets of the Bank.

#### Non-GAAP Financial Measures

This report contains or references fully taxable-equivalent (fte) interest income and net interest income, which are non-GAAP financial measures. Interest income (fte) and net interest income (fte) are derived from GAAP interest income and net interest income using an assumed tax rate of 34%. We believe the presentation of interest income (fte) and net interest income (fte) ensures comparability of interest income and net interest income arising from both taxable and tax-exempt sources and is consistent with industry practice. Net interest income (fte) is reconciled to GAAP net interest income on pages 43 and 47. Although the Company believes that these non-GAAP financial measures enhance investors' understanding of our business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP measures.

## Results of Operations

## NORWOOD FINANCIAL CORP.

## Consolidated Average Balance Sheets with Resultant Interest and Rates

| (Tax-Equivalent Basis,<br>dollars in thousands) | Three Months Ended September 30, |          |                 |                    |          |                 |
|---|----------------------------------|----------|-----------------|--------------------|----------|-----------------|
|   | 2016                             |          |                 | 2015               |          |                 |
|   | Average<br>Balance               | Interest | Average<br>Rate | Average<br>Balance | Interest | Average<br>Rate |
|   | (2)                              | (1)      | (3)             | (2)                | (1)      | (3)             |
| <b>Assets</b>                                   |                                  |          |                 |                    |          |                 |
| Interest-earning assets:                        |                                  |          |                 |                    |          |                 |
| Interest bearing deposits with banks            | \$ 15,756                        | \$ 22    | 0.53%           | \$ 4,508           | \$ 3     | 0.27%           |
| Securities available for sale:                  |                                  |          |                 |                    |          |                 |
| Taxable   | 141,751                          | 625      | 1.77            | 93,051             | 454      | 1.95            |
| Tax-exempt (1)                                  | 100,538                          | 930      | 3.70            | 60,100             | 692      | 4.61            |
| Total securities available for sale (1)         | 242,289                          | 1,555    | 2.57            | 153,151            | 1,146    | 2.99            |
| Loans receivable (1) (4) (5)                    | 661,781                          | 7,437    | 4.50            | 539,487            | 6,083    | 4.51            |
| Total interest-earning assets                   | 919,826                          | 9,014    | 3.92            | 697,146            | 7,232    | 4.15            |
| Non-interest earning assets:                    |                                  |          |                 |                    |          |                 |
| Cash and due from banks                         | 13,340                           |          |                 | 9,016              |          |                 |
| Allowance for loan losses                       | (5,980)                          |          |                 | (5,815)            |          |                 |
| Other assets                                    | 73,091                           |          |                 | 43,808             |          |                 |
| Total non-interest earning assets               | 80,451                           |          |                 | 47,009             |          |                 |
| Total Assets                                    | \$ 1,000,277                     |          |                 | \$ 744,155         |          |                 |
| <b>Liabilities and Stockholders' Equity</b>     |                                  |          |                 |                    |          |                 |
| Interest-bearing liabilities:                   |                                  |          |                 |                    |          |                 |
| Interest bearing demand and money market        | \$ 231,303                       | \$ 91    | 0.16            | \$ 182,645         | \$ 79    | 0.17            |
| Savings   | 155,896                          | 23       | 0.06            | 75,321             | 10       | 0.05            |
| Time  | 245,406                          | 563      | 0.92            | 203,658            | 522      | 1.03            |
| Total interest-bearing deposits                 | 632,605                          | 677      | 0.43            | 461,624            | 611      | 0.53            |
| Short-term borrowings                           | 34,192                           | 65       | 0.76            | 33,175             | 19       | 0.23            |
| Other borrowings                                | 35,386                           | 216      | 2.44            | 30,541             | 189      | 2.48            |
| Total interest-bearing liabilities              | 702,183                          | 958      | 0.55            | 525,340            | 819      | 0.62            |
| Non-interest bearing liabilities:               |                                  |          |                 |                    |          |                 |
| Demand deposits                                 | 171,329                          |          |                 | 113,094            |          |                 |
| Other liabilities                               | 12,542                           |          |                 | 4,376              |          |                 |
| Total non-interest bearing liabilities          | 183,871                          |          |                 | 117,470            |          |                 |
| Stockholders' equity                            | 114,223                          |          |                 | 101,345            |          |                 |
| Total Liabilities and Stockholders' Equity      | \$ 1,000,277                     |          |                 | \$ 744,155         |          |                 |
| Net interest income (tax equivalent basis)      |                                  | 8,056    | 3.37%           |                    | 6,413    | 3.53%           |
| Tax-equivalent basis adjustment                 |                                  | (486)    |                 |                    | (360)    |                 |
| Net interest income                             |                                  | \$ 7,570 |                 |                    | \$ 6,053 |                 |
| Net interest margin (tax equivalent basis)      |                                  |          | 3.50%           |                    |          | 3.68%           |

(1) Interest and yields are presented on a tax-equivalent basis using a marginal tax rate of 34%.

- (2) Average balances have been calculated based on daily balances.
- (3) Annualized
- (4) Loan balances include non-accrual loans and are net of unearned income.
- (5) Loan yields include the effect of amortization of deferred fees, net of costs.

Rate/Volume Analysis. The following table shows the fully taxable equivalent effect of changes in volumes and rates on interest income and interest expense.

|  | Increase/(Decrease)    |          |          |
|--|------------------------|----------|----------|
|  | Three months ended     |          |          |
|  | September 30, 2016     |          |          |
|  | Compared to            |          |          |
|  | Three months ended     |          |          |
|  | September 30, 2015     |          |          |
|  | Variance due to        |          |          |
|  | Volume                 | Rate     | Net      |
|  | (dollars in thousands) |          |          |
| Interest earning assets:                   |                        |          |          |
| Interest bearing deposits with banks       | \$ 10                  | \$ 9     | \$ 19    |
| Securities available for sale:             |                        |          |          |
| Taxable                                    | 230                    | (59)     | 171      |
| Tax-exempt securities                      | 432                    | (194)    | 238      |
| Total securities                           | 662                    | (253)    | 409      |
| Loans receivable                           | 1,371                  | (17)     | 1,354    |
| Total interest earning assets              | 2,043                  | (261)    | 1,782    |
| Interest bearing liabilities:              |                        |          |          |
| Interest-bearing demand and money market   | 18                     | (6)      | 12       |
| Savings                                    | 10                     | 3        | 13       |
| Time                                       | 104                    | (63)     | 41       |
| Total interest bearing deposits            | 132                    | (66)     | 66       |
| Short-term borrowings                      | 2                      | 44       | 46       |
| Other borrowings                           | 31                     | (4)      | 27       |
| Total interest bearing liabilities         | 165                    | (26)     | 139      |
| Net interest income (tax-equivalent basis) | \$ 1,878               | \$ (235) | \$ 1,643 |

Changes in net interest income that could not be specifically identified as either a rate or volume change were allocated proportionately to changes in volume and changes in rate.

Comparison of Operating Results for The Three Months Ended September 30, 2016 to September 30, 2015General

For the three months ended September 30, 2016, net income totaled \$612,000 compared to \$1,777,000 earned in the similar period in 2015. The decrease in net income for the three months ended September 30, 2016 was due primarily to \$1,659,000 of merger related expenses and approximately \$795,000 of expenses related to the operations of the twelve new community offices acquired. Earnings per share for the current period were \$.15 per share for basic and fully diluted compared to \$.48 per share for basic and fully diluted shares for the three months ended September 30, 2015. The resulting annualized return on average assets and annualized return on average equity for the three months ended September 30, 2016 were 0.24% and 2.13%, respectively, compared to 0.95% and 6.95%, respectively, for the similar period in 2015.

The following table sets forth changes in net income:

| (dollars in thousands)                           | Three<br>months<br>ended<br>September<br>30, 2016 to<br>September<br>30, 2015 |
|--|---|
| Net income three months ended September 30, 2015 | \$ 1,777  |
| Change due to:                                   |   |
| Net interest income                              | 1,517   |
| Provision for loan losses                        | 270   |
| Net gain on sales of loans and securities        | (79)  |
| Other income                                     | 407   |
| Salaries and employee benefits                   | (895)   |
| Occupancy, furniture and equipment               | (282)   |
| Foreclosed real estate owned                     | (72)  |
| Merger related                                   | (1,659)   |
| All other expenses                               | (701)   |
| Income tax expense                               | 329   |
| Net income three months ended September 30, 2016 | \$ 612  |

Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the three months ended September 30, 2016 totaled \$8,056,000 which was \$1,643,000 higher than the comparable period in 2015. The increase in net interest income includes a \$1,354,000 increase in interest income (fte) on loans and a \$410,000 increase in interest income (fte) on other interest-earning assets resulting primarily from the acquisition. The fte net interest spread and net interest margin were 3.37% and 3.50%, respectively, for the three months ended September 30, 2016 compared to 3.53% and 3.68%, respectively, for the similar period in 2015.

Interest income (fte) totaled \$9,014,000 with a yield on average earning assets of 3.92% compared to \$7,232,000 and 4.15% for the 2015 period. Average loans increased \$122.3 million over the comparable period of last year primarily due to the acquisition, while average securities increased \$89.1 million. Average earning assets totaled \$919.8 million for the three months ended September 30, 2016, an increase of \$222.7 million over the average for the similar period in 2015.

Interest expense for the three months ended September 30, 2016 totaled \$958,000 at an average cost of 0.55% compared to \$819,000 and 0.62% for the similar period in 2015. The decline in average cost reflects the increase in lower costing core deposits acquired. The cost of time deposits, which is the most significant component of funding, decreased to 0.92% from 1.03% for the similar period in the prior year.

#### Provision for Loan Losses

The Company's provision for loan losses for the three months ended September 30, 2016 was \$450,000 compared to \$720,000 for the three months ended September 30, 2015. The Company makes provisions for loan losses in an amount necessary to maintain the allowance for loan losses at an acceptable level. Net charge-offs were \$84,000 for the quarter ended September 30, 2016 compared to \$920,000 for the similar period in 2015.

#### Other Income

Other income totaled \$1,399,000 for the three months ended September 30, 2016 compared to \$1,071,000 for the similar period in 2015. Net gains from the sale of loans and securities decreased \$79,000 compared to the same period of 2015. All other items of other income increased \$407,000, net, compared to the same period of last year due primarily to the acquisition.

#### Other Expense

Other expense for the three months ended September 30, 2016 totaled \$7,679,000 which was \$3,609,000 higher than the same period of 2015. Merger related expenses totaled \$1,659,000 during the current year period while costs related to the operations of the offices acquired totaled \$795,000. All other operating expenses increased \$1,155,000, net.

#### Income Tax Expense

Income tax expense totaled \$228,000 for an effective tax rate of 27.1% for the period ending September 30, 2016 compared to \$557,000 for an effective tax rate of 23.9% for the similar period in 2015. The increase in the effective tax rate reflects expenses related to the acquisition which are non-deductible for tax purposes.



## Results of Operations

## NORWOOD FINANCIAL CORP.

## Consolidated Average Balance Sheets with Resultant Interest and Rates

| (Tax-Equivalent Basis,<br>dollars in thousands) | Nine Months Ended September 30, |                 |                        |                           |                 |                        |
|---|---------------------------------|-----------------|------------------------|---------------------------|-----------------|------------------------|
|   | 2016                            |                 |                        | 2015                      |                 |                        |
|   | Average<br>Balance<br>(2)       | Interest<br>(1) | Average<br>Rate<br>(3) | Average<br>Balance<br>(2) | Interest<br>(1) | Average<br>Rate<br>(3) |
| <b>Assets</b>                                   |                                 |                 |                        |                           |                 |                        |
| Interest-earning assets:                        |                                 |                 |                        |                           |                 |                        |
| Interest bearing deposits with banks            | \$ 7,117                        | \$ 28           | 0.52%                  | \$ 7,960                  | \$ 15           | 0.25%                  |
| Securities available for sale:                  |                                 |                 |                        |                           |                 |                        |
| Taxable   | 101,851                         | 1,503           | 1.97                   | 97,310                    | 1,509           | 2.07                   |
| Tax-exempt (1)                                  | 72,763                          | 2,279           | 4.18                   | 59,068                    | 2,084           | 4.70                   |
| Total securities available for sale (1)         | 174,614                         | 3,782           | 2.89                   | 156,378                   | 3,593           | 3.06                   |
| Loans receivable (1) (4) (5)                    | 598,808                         | 20,187          | 4.49                   | 523,269                   | 18,230          | 4.65                   |
| Total interest-earning assets                   | 780,539                         | 23,997          | 4.10                   | 687,607                   | 21,838          | 4.23                   |
| Non-interest earning assets:                    |                                 |                 |                        |                           |                 |                        |
| Cash and due from banks                         | 10,034                          |                 |                        | 8,492                     |                 |                        |
| Allowance for loan losses                       | (6,845)                         |                 |                        | (6,001)                   |                 |                        |
| Other assets                                    | 56,345                          |                 |                        | 45,052                    |                 |                        |
| Total non-interest earning assets               | 59,534                          |                 |                        | 47,543                    |                 |                        |
| Total Assets                                    | \$ 840,073                      |                 |                        | \$ 735,150                |                 |                        |
| <b>Liabilities and Stockholders' Equity</b>     |                                 |                 |                        |                           |                 |                        |
| Interest-bearing liabilities:                   |                                 |                 |                        |                           |                 |                        |
| Interest-bearing demand and money market        | \$ 195,501                      | \$ 243          | 0.17                   | \$ 178,248                | \$ 226          | 0.17                   |
| Savings   | 104,281                         | 42              | 0.05                   | 74,756                    | 28              | 0.05                   |
| Time  | 213,518                         | 1,553           | 0.97                   | 214,076                   | 1,579           | 0.98                   |
| Total interest-bearing deposits                 | 513,300                         | 1,838           | 0.48                   | 467,080                   | 1,833           | 0.52                   |
| Short-term borrowings                           | 42,931                          | 142             | 0.44                   | 29,065                    | 47              | 0.22                   |
| Other borrowings                                | 37,656                          | 669             | 2.37                   | 28,056                    | 553             | 2.63                   |
| Total interest bearing liabilities              | 593,887                         | 2,649           | 0.59                   | 524,201                   | 2,433           | 0.62                   |
| Non-interest bearing liabilities:               |                                 |                 |                        |                           |                 |                        |
| Demand deposits                                 | 132,263                         |                 |                        | 105,677                   |                 |                        |
| Other liabilities                               | 6,955                           |                 |                        | 4,250                     |                 |                        |
| Total non-interest bearing liabilities          | 139,218                         |                 |                        | 109,927                   |                 |                        |
| Stockholders' equity                            | 106,968                         |                 |                        | 101,022                   |                 |                        |
| Total Liabilities and Stockholders' Equity      | \$ 840,073                      |                 |                        | \$ 735,150                |                 |                        |
| Net interest income (tax equivalent basis)      |                                 | 21,348          | 3.50%                  |                           | 19,405          | 3.62%                  |
| Tax-equivalent basis adjustment                 |                                 | (1,209)         |                        |                           | (996)           |                        |
| Net interest income                             |                                 | \$ 20,139       |                        |                           | \$ 18,409       |                        |
| Net interest margin (tax equivalent basis)      |                                 |                 | 3.65%                  |                           |                 | 3.76%                  |

(1) Interest and yields are presented on a tax-equivalent basis using a marginal tax rate of 34%.

(2) Average balances have been calculated based on daily balances.

(3) Annualized

- (4) Loan balances include non-accrual loans and are net of unearned income.
- (5) Loan yields include the effect of amortization of deferred fees, net of costs.

Rate/Volume Analysis. The following table shows the fully taxable equivalent effect of changes in volumes and rates on interest income and interest expense.

|  | Increase/(Decrease)    |          |          |
|--|------------------------|----------|----------|
|  | Nine months ended      |          |          |
|  | September 30, 2016     |          |          |
|  | Compared to            |          |          |
|  | Nine months ended      |          |          |
|  | September 30, 2015     |          |          |
|  | Variance due to        |          |          |
|  | Volume                 | Rate     | Net      |
|  | (dollars in thousands) |          |          |
| Interest earning assets:                   |                        |          |          |
| Interest bearing deposits with banks       | \$ (3)                 | \$ 16    | \$ 13    |
| Securities available for sale:             |                        |          |          |
| Taxable                                    | 45                     | (51)     | (6)      |
| Tax-exempt securities                      | 345                    | (150)    | 195      |
| Total securities                           | 390                    | (201)    | 189      |
| Loans receivable                           | 2,273                  | (316)    | 1,957    |
| Total interest earning assets              | 2,660                  | (501)    | 2,159    |
| Interest bearing liabilities:              |                        |          |          |
| Interest-bearing demand and money market   | 17                     | -        | 17       |
| Savings                                    | 14                     | -        | 14       |
| Time                                       | (5)                    | (21)     | (26)     |
| Total interest bearing deposits            | 26                     | (21)     | 5        |
| Short-term borrowings                      | 38                     | 57       | 95       |
| Other borrowings                           | 183                    | (67)     | 116      |
| Total interest bearing liabilities         | 247                    | (31)     | 216      |
| Net interest income (tax-equivalent basis) | \$ 2,413               | \$ (470) | \$ 1,943 |

Changes in net interest income that could not be specifically identified as either a rate or volume change were allocated proportionately to changes in volume and changes in rate.

Comparison of Operating Results for The Nine Months Ended September 30, 2016 to September 30, 2015General

For the nine months ended September 30, 2016, net income totaled \$4,365,000 compared to \$5,781,000 earned in the similar period in 2015. The decrease in net income for the nine months ended September 30, 2016 was due primarily to \$1,664,000 of expenses related to the acquisition of Delaware Bancshares, Inc., as well as approximately \$795,000 of costs to operate the twelve offices acquired. Earnings per share for the current period were \$1.16 per share for basic and \$1.15 per share fully diluted compared to \$1.57 per share for basic and fully diluted shares for the nine months ended September 30, 2015. The resulting annualized return on average assets and annualized return on average equity for the nine months ended September 30, 2016 was 0.69% and 5.45%, respectively, compared to 1.05% and 7.65%, respectively, for the similar period in 2015.

The following table sets forth changes in net income:

| (dollars in thousands)                          | Nine<br>months<br>ended<br>September<br>30, 2016 to<br>September<br>30, 2015 |
|---|--|
| Net income nine months ended September 30, 2015 | \$ 5,781   |
| Change due to:                                  |  |
| Net interest income                             | 1,730  |
| Provision for loan losses                       | 160  |
| Gain on sales of loans and securities           | (241)  |
| Other income                                    | 447  |
| Salaries and employee benefits                  | (1,237)  |
| Occupancy, furniture and equipment              | (165)  |
| Foreclosed real estate owned                    | (146)  |
| Merger related                                  | (1,664)  |
| All other expenses                              | (919)  |
| Income tax expense                              | 619  |
| Net income nine months ended September 30, 2016 | \$ 4,365   |

Net Interest Income

Net interest income on a fully taxable equivalent basis (fte) for the nine months ended September 30, 2016 totaled \$21,348,000 which was \$1,943,000 higher than the comparable period in 2015. The increase in net interest income largely reflects the benefits from assets acquired. The fte net interest spread and net interest margin were 3.50% and 3.65%, respectively, for the nine months ended September 30, 2016 compared to 3.62% and 3.76%, respectively, for the similar period in 2015.

Interest income (fte) totaled \$23,997,000 with a yield on average earning assets of 4.10% compared to \$21,838,000 and 4.23% for the 2015 period. Average loans increased \$75.5 million over the comparable period of last year due to the acquisition while average securities also increased \$18.2 million. Average earning assets totaled \$780.5 million for the nine months ended September 30, 2016, an increase of \$92.9 million over the average for the similar period in 2015.

Interest expense for the nine months ended September 30, 2016 totaled \$2,649,000 at an average cost of 0.59% compared to \$2,433,000 and 0.62% for the similar period in 2015. The cost of time deposits, which is the most significant component of funding, decreased to 0.97% from 0.98% for the similar period in the prior year. As time deposits matured, they repriced at the current market rates.

### Provision for Loan Losses

The Company's provision for loan losses for the nine months ended September 30, 2016 was \$1,600,000 compared to \$1,760,000 for the nine months ended September 30, 2015. The Company makes provisions for loan losses in an amount necessary to maintain the allowance for loan losses at an acceptable level. Net charge-offs were \$2,734,000 for the nine months ended September 30, 2016 compared to \$1,888,000 for the similar period in 2015.

### Other Income

Other income totaled \$3,689,000 for the nine months ended September 30, 2016 compared to \$3,483,000 for the similar period in 2015. Net gains from the sale of loans and securities decreased \$241,000 compared to the same period of 2015. All other items of other income increased \$447,000, net, compared to the same period of last year.

### Other Expense

Other expense for the nine months ended September 30, 2016 totaled \$16,556,000 which was \$4,131,000 higher than the same period of 2015. Merger costs totaled \$1,664,000 in the current period while costs to operate the offices acquired totaled \$795,000. All other operating expenses increased \$1,672,000, net.

### Income Tax Expense

Income tax expense totaled \$1,307,000 for an effective tax rate of 23.0% for the period ending September 30, 2016 compared to \$1,926,000 for an effective tax rate of 25.0% for the similar period in 2015. The reduction in the effective tax rate reflects an increase in the level of tax-exempt income.

## Item 3. Quantitative and Qualitative Disclosures about Market Risk

### Market Risk

Interest rate sensitivity and the repricing characteristics of assets and liabilities are managed by the Asset and Liability Management Committee (ALCO). The principal objective of ALCO is to maximize net interest income within acceptable levels of risk, which are established by policy. Interest rate risk is monitored and managed by using financial modeling techniques to measure the impact of changes in interest rates.

Net interest income, which is the primary source of the Company's earnings, is impacted by changes in interest rates and the relationship of different interest rates. To manage the impact of the rate changes, the balance sheet must be structured so that repricing opportunities exist for both assets and liabilities at approximately the same time intervals. The Company uses net interest simulation to assist in interest rate risk management. The process includes simulating various interest rate environments and their impact on net interest income. As of September 30, 2016, the level of net interest income at risk in a  $\pm 200$  basis point change in interest rates was within the Company's policy limits. The Company's policy allows for a decline of no more than 8% of net interest income for a  $\pm 200$  basis point shift in interest rates.

Imbalance in repricing opportunities at a given point in time reflects interest-sensitivity gaps measured as the difference between rate-sensitive assets (RSA) and rate-sensitive liabilities (RSL). These are static gap measurements that do not take into account any future activity, and as such are principally used as early indications of potential interest rate exposures over specific intervals.



As of September 30, 2016, the Company had a positive 90-day interest sensitivity gap of \$51.7 million or 4.6% of total assets, compared to the \$38.8 million or 5.2% of total assets as of December 31, 2015. Rate sensitive assets repricing within 90 days increased \$52.2 million due primarily to a \$32.5 million increase in loans repricing. The majority of this increase reflects new loans acquired. Rate sensitive liabilities increased \$39.3 million since year end due to a \$50.7 million increase in deposits. A positive gap means that rate-sensitive assets are greater than rate-sensitive liabilities at the time interval. This would indicate that in a rising rate environment, the yield on interest-earning assets could increase faster than the cost of interest-bearing liabilities in the 90-day time frame. The repricing intervals are managed by ALCO strategies, including adjusting the average life of the investment portfolio, pricing of deposit liabilities to attract longer term time deposits, loan pricing to encourage variable rate products and evaluation of loan sales of long-term fixed rate mortgages.

Certain interest-bearing deposits with no stated maturity dates are included in the interest-sensitivity table below. The balances allocated to the respective time periods represent an estimate of the total outstanding balance that has the potential to migrate through withdrawal or transfer to time deposits, thereby impacting the interest-sensitivity position of the Company. The estimates were derived from industry-wide statistical information and do not represent historical results.

September 30, 2016  
Rate Sensitivity Table  
(dollars in thousands)

|  | 3 Months   | 3-12<br>Months | 1 to 3<br>Years | Over 3<br>Years | Total        |
|--|------------|----------------|-----------------|-----------------|--------------|
| Federal funds sold and interest bearing deposits | \$ 13,629  | \$ -           | \$ 100          | \$ -            | \$ 13,729    |
| Securities                                       | 10,310     | 26,262         | 59,582          | 213,972         | 310,126      |
| Loans Receivable                                 | 161,944    | 161,183        | 193,287         | 189,785         | 706,199      |
| Total RSA  | \$ 185,883 | \$ 187,445     | \$ 252,969      | \$ 403,757      | \$ 1,030,054 |
| Non-maturity interest-bearing deposits           | \$ 70,248  | \$ 74,399      | \$ 198,304      | \$ 103,399      | \$ 446,350   |
| Time Deposits                                    | 46,095     | 109,264        | 89,342          | 30,712          | 275,413      |
| Other  | 17,824     | 28,016         | 24,793          | 5,065           | 75,698       |
| Total RSL  | \$ 134,167 | \$ 211,679     | \$ 312,439      | \$ 139,176      | \$ 797,461   |
| Interest Sensitivity Gap                         | \$ 51,716  | \$ (24,234)    | \$ (59,470)     | \$ 264,581      | \$ 232,593   |
| Cumulative Gap                                   | 51,716     | 27,482         | (31,988)        | 232,593         |              |
| RSA/RSL-cumulative                               | 138.5%     | 107.9%         | 95.1%           | 129.2%          |              |
| December 31, 2015                                |            |                |                 |                 |              |
| Interest Sensitivity Gap                         | \$ 38,817  | \$ 11,614      | \$ (57,114)     | \$ 168,269      | \$ 161,586   |
| Cumulative Gap                                   | 38,817     | 50,431         | (6,683)         | 161,586         |              |
| RSA/RSL-cumulative                               | 140.9%     | 122.8%         | 98.5%           | 130.1%          |              |





Item 4. Controls and Procedures

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

There were no changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

Reference is made to Part II, Item 1 in the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016.

Item 1A. Risk Factors

There have been no material changes in the risk factors affecting the Company that were identified in Item 1A of Part 1 of the Company's Form 10-K for the year ended December 31, 2015.

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

None

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

No. Description

- 3(i) Articles of Incorporation of Norwood Financial Corp.<sup>(1)</sup>
- 3(ii) Bylaws of Norwood Financial Corp.<sup>(2)</sup>
- 4.0 Specimen Stock Certificate of Norwood Financial Corp.<sup>(1)</sup>
- 4.1 Amended and Restated Declaration of Trust, dated as of October 31, 2007\*
- 4.2 Indenture, dated October 31, 2007, between Wells Fargo Bank National Association, as trustee, and Delaware Bancshares, Inc.\*
- 4.3 First Supplemental Indenture, dated as of July 31, 2016, by and between Wells Fargo Bank, National Association, as Trustee, Delaware Bancshares, Inc. and Norwood Financial Corp.\*
- 10.1 Employment Agreement with Lewis J. Critelli<sup>(3)</sup>
- 10.2 Change in Control Severance Agreement with William S. Lance<sup>(3)</sup>
- 10.3 Norwood Financial Corp. Stock Option Plan<sup>(4)</sup>
- 10.4 Change in Control Severance Agreement with Robert J. Mancuso<sup>(5)</sup>
- 10.5 Salary Continuation Agreement between the Bank and William W. Davis, Jr.<sup>(6)</sup>
- 10.6 Salary Continuation Agreement between the Bank and Lewis J. Critelli<sup>(6)</sup>
- 10.7 1999 Directors Stock Compensation Plan<sup>(4)</sup>
- 10.8 Salary Continuation Agreement between the Bank and John H. Sanders<sup>(7)</sup>
- 10.9 2006 Stock Option Plan<sup>(8)</sup>
- 10.10 First and Second Amendments to Salary Continuation Agreement with William W. Davis, Jr.<sup>(9)</sup>
- 10.11 First and Second Amendments to Salary Continuation Agreement with Lewis J. Critelli<sup>(9)</sup>
- 10.12 First and Second Amendments to Salary Continuation Agreement with John H. Sanders<sup>(9)</sup>
- 10.13 Change In Control Severance Agreement with James F. Burke<sup>(10)</sup>
- 10.14 2014 Equity Incentive Plan<sup>(11)</sup>
- 10.15 Addendum to Change in Control Severance Agreement with William S. Lance<sup>(12)</sup>
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of CEO
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of CFO
- 32 Certification pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of Sarbanes Oxley Act of 2002
- 101 Interactive Data Files

\* Not filed in accordance with the provisions of Item 601(b)(4)(iii)(A) of Regulation S-K. The Registrant undertakes to provide a copy of this document to the Commission upon request.

(1) Incorporated herein by reference into this document from the Exhibits to Form 10, Registration Statement initially filed with the Commission on April 29, 1996, Registration No. 0-28364

(2) Incorporated by reference into this document from the identically numbered exhibit to the Registrant's Form 10-Q filed with the Commission on August 8, 2014.

(3) Incorporated by reference into this document from the identically numbered exhibits to the Registrant's Form 10-K filed with the Commission on March 15, 2010.

(4) Incorporated herein by reference to the identically numbered exhibits of the Registrant's Form 10-K filed with the Commission on March 23, 2000.

(5)

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Incorporated by reference into this document from the identically numbered exhibit to the Registrant's Form 10-K filed with the Commission on March 14, 2013, File No. 0-28364.

(6) Incorporated by reference into this document from the Exhibits to Form S-8 filed with the Commission on August 14, 1998, File No. 333-61487.

- (7) Incorporated herein by reference to the identically numbered exhibit to the Registrant's Form 10-K filed with the Commission on March 22, 2004.
- (8) Incorporated by reference to this document from Exhibit 4.1 to Registrant's Registration Statement on Form S-8 (File No. 333-134831) filed with the Commission on June 8, 2006.
- (9) Incorporated herein by reference from the Exhibits to the Registrant's Current Report on Form 8-K filed on April 4, 2006.
- (10) Incorporated by reference from the identically numbered exhibit to the Registrant's Form 10-Q filed with the Commission on November 7, 2013.
- (11) Incorporated by reference to Exhibit 10.1 to the Registrant's Registration Statement on Form S-8 (File No. 333-195643) filed with the Commission on May 2, 2014.
- (12) Incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed on February 18, 2015.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NORWOOD FINANCIAL CORP.

Date: November 9, 2016 By: /s/ Lewis J. Critelli  
Lewis J. Critelli  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: November 9, 2016 By: /s/ William S. Lance  
William S. Lance  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial Officer)