

NORTHWAY FINANCIAL INC  
Form 10-Q  
August 08, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 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 June 30, 2007

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 000-23129

**NORTHWAY FINANCIAL, INC.**

(Exact name of registrant as specified in its charter)

New Hampshire 04-3368579  
(State or other jurisdiction of incorporation or (I.R.S. Employer Identification No.)  
organization)

9 Main Street 03570  
Berlin, New Hampshire (Zip Code)  
(Address of principal executive offices)

(603) 752-1171  
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last year)

Indicate by check mark 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 twelve (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 ninety (90) days. YES  NO

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
YES  NO

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date. At July 31, 2007, there were 1,494,174 shares of common stock outstanding, par value \$1.00 per share.

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**Table of Contents**

**INDEX**  
**NORTHWAY FINANCIAL, INC.**

| PART I. FINANCIAL INFORMATION  | PAGE |
|--|------|
| Item 1. Financial Statements   |      |
| <u>Condensed Consolidated Balance Sheets at June 30, 2007</u><br><u>(Unaudited)</u>                            | -    |
| <u>and December 31, 2006</u>   | 3    |
| <u>Condensed Consolidated Statements of Income for the Three</u><br><u>Months</u>                              | -    |
| <u>and Six Months Ended June 30, 2007 and 2006 (Unaudited)</u>   | 4    |
| <u>Condensed Consolidated Statements of Cash Flows for the Six</u><br><u>Months</u>                            | -    |
| <u>Ended June 30, 2007 and 2006 (Unaudited)</u>  | 5    |
| <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>  | 6    |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and</u><br><u>Results of Operations</u> | 10   |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>                                      | 13   |
| Item 4. <u>Controls and Procedures</u>   | 13   |
| <b>PART II. <u>OTHER INFORMATION</u></b>   |      |
| Item 1. Legal Proceedings  | 14   |
| Item 1A. Risk Factors  | 14   |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds  | 14   |
| Item 3. Defaults Upon Senior Securities  | 14   |
| Item 4. Submission of Matters to a Vote of Security Holders  | 14   |
| Item 5. Other Information  | 14   |
| Item 6. <u>Exhibits</u>  | 14   |
| <u>Signatures</u>  | 16   |

**Table of Contents**

## PART 1. FINANCIAL INFORMATION

## Item 1. Financial Statements.

NORTHWAY FINANCIAL, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

| (Dollars in thousands)   | June 30,<br>2007<br>(Unaudited) | Dec. 31,<br>2006 |
|--|---------------------------------|------------------|
| Assets:  |                                 |                  |
| Cash and due from banks and interest-bearing deposits  | \$ 19,492                       | \$ 16,053        |
| Federal funds sold   | 5,305                           | 8,755            |
| Securities available-for-sale, at fair value   | 147,950                         | 127,789          |
| Federal Home Loan Bank stock   | 3,762                           | 3,782            |
| Loans held-for-sale  | 168                             | 263              |
| Loans, net before allowance for loan losses  | 481,229                         | 462,230          |
| Less: allowance for loan losses  | 5,814                           | 5,581            |
| Loans, net   | 475,415                         | 456,649          |
| Premises and equipment, net  | 13,158                          | 13,749           |
| Core deposit intangibles, net  | 1,938                           | 2,178            |
| Goodwill   | 10,577                          | 10,577           |
| Other assets   | 12,189                          | 11,082           |
| Total assets   | \$ 689,954                      | \$ 650,877       |
| Liabilities and stockholders' equity:  |                                 |                  |
| Liabilities  |                                 |                  |
| Interest bearing deposits  | \$ 424,990                      | \$ 412,623       |
| Noninterest bearing deposits   | 72,906                          | 72,054           |
| Short-term borrowings  | 47,403                          | 36,497           |
| Long-term debt   | 89,023                          | 73,620           |
| Other liabilities  | 3,850                           | 3,934            |
| Total liabilities  | 638,172                         | 598,728          |
| Stockholders' equity   |                                 |                  |
| Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued  | -                               | -                |
| Common stock, \$1.00 par value; 9,000,000 shares authorized; 1,731,969 issued at June 30, 2007 and December 31, 2006 and 1,494,174 outstanding at June 30, 2007 and 1,491,174 outstanding at December 31, 2006 | 1,732                           | 1,732            |
| Surplus  | 2,041                           | 2,064            |
| Retained earnings  | 57,197                          | 56,140           |
| Treasury stock, at cost (237,795 shares at June 30, 2007 and 240,795 shares at December 31, 2006)  | (6,441)                         | (6,531)          |
| Accumulated other comprehensive loss, net of tax   | (2,747)                         | (1,256)          |
| Total stockholders' equity   | 51,782                          | 52,149           |
| Total liabilities and stockholders' equity   | \$ 689,954                      | \$ 650,877       |

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents**

NORTHWAY FINANCIAL, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

| (Dollars in thousands, except per share data)                           | Three Months Ended June 30, |                 | Six Months Ended June 30, |                 |
|---|-----------------------------|-----------------|---------------------------|-----------------|
|   | 2007                        | 2006            | 2007                      | 2006            |
| <b>Interest and dividend income:</b>                                    |                             |                 |                           |                 |
| Loans   | \$ 8,148                    | \$ 7,611        | \$ 15,945                 | \$ 14,861       |
| <b>Interest on debt securities:</b>                                     |                             |                 |                           |                 |
| Taxable   | 1,261                       | 951             | 2,476                     | 1,840           |
| Tax-exempt  | 410                         | 285             | 745                       | 558             |
| Dividends   | 77                          | 82              | 164                       | 169             |
| Federal funds sold  | 100                         | 8               | 169                       | 52              |
| Interest bearing deposits   | 12                          | 2               | 16                        | 4               |
| <b>Total interest and dividend income</b>                               | <b>10,008</b>               | <b>8,939</b>    | <b>19,515</b>             | <b>17,484</b>   |
| <b>Interest expense:</b>  |                             |                 |                           |                 |
| Deposits  | 2,939                       | 1,956           | 5,792                     | 3,554           |
| Borrowed funds  | 1,597                       | 1,337           | 3,067                     | 2,640           |
| <b>Total interest expense</b>   | <b>4,536</b>                | <b>3,293</b>    | <b>8,859</b>              | <b>6,194</b>    |
| <b>Net interest and dividend income</b>                                 | <b>5,472</b>                | <b>5,646</b>    | <b>10,656</b>             | <b>11,290</b>   |
| Provision for loan losses   | 210                         | 120             | 330                       | 225             |
| <b>Net interest and dividend income after provision for loan losses</b> | <b>5,262</b>                | <b>5,526</b>    | <b>10,326</b>             | <b>11,065</b>   |
| <b>Noninterest income:</b>  |                             |                 |                           |                 |
| Service charges and fees on deposit accounts                            | 771                         | 729             | 1,485                     | 1,344           |
| Securities gains, net   | 206                         | 39              | 347                       | 249             |
| Gain on sales of loans, net   | 45                          | 54              | 78                        | 72              |
| Other   | 516                         | 500             | 1,073                     | 1,227           |
| <b>Total noninterest income</b>   | <b>1,538</b>                | <b>1,322</b>    | <b>2,983</b>              | <b>2,892</b>    |
| <b>Noninterest expense:</b>   |                             |                 |                           |                 |
| Salaries and employee benefits  | 2,942                       | 3,092           | 5,919                     | 6,007           |
| Office occupancy and equipment  | 960                         | 1,070           | 2,040                     | 2,031           |
| Amortization of core deposit intangibles                                | 118                         | 280             | 239                       | 518             |
| Other   | 1,856                       | 1,479           | 3,200                     | 3,064           |
| <b>Total noninterest expense</b>  | <b>5,876</b>                | <b>5,921</b>    | <b>11,398</b>             | <b>11,620</b>   |
| <b>Income before income tax expense</b>                                 | <b>924</b>                  | <b>927</b>      | <b>1,911</b>              | <b>2,337</b>    |
| Income tax expense  | 108                         | 171             | 249                       | 501             |
| <b>Net income</b>   | <b>\$ 816</b>               | <b>\$ 756</b>   | <b>\$ 1,662</b>           | <b>\$ 1,836</b> |
| <b>Comprehensive net (loss) income</b>                                  | <b>\$ (779)</b>             | <b>\$ (273)</b> | <b>\$ 171</b>             | <b>\$ 596</b>   |

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Per share data:

|  |    |           |    |           |    |           |    |           |
|--|----|-----------|----|-----------|----|-----------|----|-----------|
| Basic earnings per common share                      | \$ | 0.54      | \$ | 0.51      | \$ | 1.11      | \$ | 1.23      |
| Earnings per common share<br>assuming dilution       | \$ | 0.54      | \$ | 0.50      | \$ | 1.11      | \$ | 1.22      |
| Cash dividends declared                              | \$ | 0.20      | \$ | 0.20      | \$ | 0.40      | \$ | 0.38      |
| Weighted average number of<br>common shares, basic   |    | 1,494,174 |    | 1,491,174 |    | 1,492,798 |    | 1,491,174 |
| Weighted average number of<br>common shares, diluted |    | 1,501,967 |    | 1,501,499 |    | 1,500,448 |    | 1,501,243 |

The accompanying notes are an integral part of these condensed consolidated financial statements

**Table of Contents**

NORTHWAY FINANCIAL, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

| (Dollars in thousands)  | For the Six Months Ended June 30, |          |
|---|-----------------------------------|----------|
|   | 2007                              | 2006     |
| Cash flows from operating activities:   |                                   |          |
| Net income  | \$ 1,662                          | \$ 1,836 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |          |
| Provision for loan losses   | 330                               | 225      |
| Depreciation and amortization   | 1,035                             | 1,172    |
| Securities gains, net   | (347)                             | (249)    |
| Gain on sale of other real estate owned   | -                                 | (69)     |
| Loss on sale, disposal and write-down of premises and equipment                   | 2                                 | 34       |
| Accretion of discounts and amortization of premiums on securities, net            | (20)                              | 24       |
| Change in unearned income/unamortized premium, net                                | (73)                              | (78)     |
| Accretion of discount on loans acquired   | (86)                              | (61)     |
| Decrease in loans held-for-sale   | 95                                | 453      |
| Net change in other assets and other liabilities                                  | (150)                             | 639      |
| Net cash provided by operating activities   | 2,448                             | 3,926    |
| Cash flows from investing activities:   |                                   |          |
| Proceeds from sales of securities available-for-sale                              | 7,540                             | 9,467    |
| Proceeds from maturities of securities available-for-sale                         | 8,231                             | 9,811    |
| Purchases of securities available-for-sale  | (38,042)                          | (27,099) |
| Purchases of Federal Home Loan Bank stock   | (103)                             | -        |
| Redemption of Federal Home Loan Bank stock  | 123                               | 1,227    |
| Capital contribution in investment in limited partnership                         | (70)                              | -        |
| Loan originations and principal collections, net                                  | (19,103)                          | 412      |
| Recoveries of previously charged-off loans  | 105                               | 108      |
| Loans acquired in branch transaction  | -                                 | (8,192)  |
| Proceeds from sales of and payments received on other real estate owned           | -                                 | 265      |
| Proceeds from sales of and payments received on other personal property           | 68                                | 198      |
| Premises and equipment acquired in branch transactions                            | -                                 | (507)    |
| Additions to premises and equipment, net of disposals                             | (206)                             | (1,473)  |
| Net cash used in investing activities   | (41,457)                          | (15,783) |
| Cash flows from financing activities:   |                                   |          |
| Net increase (decrease) in deposits   | 13,219                            | (20,206) |
| Deposits assumed in branch transaction, net of assumption premiums                | -                                 | 27,779   |
| Net increase in securities sold under agreements to repurchase                    | 10,906                            | 16,006   |
| Advances from FHLB  | 20,000                            | 10,000   |
| Repayment of FHLB advances  | (18,000)                          | (34,000) |
| Issuance of junior subordinated debentures  | 20,620                            | -        |
| Redemption of junior subordinated debentures                                      | (7,217)                           | -        |
| Exercise of stock options   | 67                                | 55       |



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|   |           |           |
|---|-----------|-----------|
| Cash dividends paid                                   | (597)     | (566)     |
| Net cash provided by (used in) financing activities   | 38,998    | (932)     |
| Net decrease in cash and cash equivalents             | (11)      | (12,789)  |
| Cash and cash equivalents at beginning of period      | 24,808    | 29,362    |
| Cash and cash equivalents at end of period            | \$ 24,797 | \$ 16,573 |
| Supplemental disclosure of cash flows:                |           |           |
| Interest paid   | \$ 8,862  | \$ 6,130  |
| Taxes paid  | \$ -      | \$ 220    |
| Loans transferred to other personal property          | \$ 61     | \$ 122    |
| Amount due to broker for pending securities purchases | \$ -      | \$ 6,032  |

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents**

NORTHWAY FINANCIAL, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2007  
(Unaudited)

1. Basis of Presentation

The unaudited condensed consolidated financial statements of Northway Financial, Inc. and its wholly-owned subsidiary, Northway Bank, (collectively, “the Company”) included herein have been prepared by the Company in accordance with the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted in accordance with such rules and regulations. The Company, however, believes that the disclosures are adequate to make the information presented not misleading. The amounts shown reflect, in the opinion of management, all adjustments necessary for a fair presentation of the financial statements for the periods reported.

The results of operations for the three month and six month periods ended June 30, 2007 and 2006 are not necessarily indicative of the results of operations to be expected for the full year or any other interim periods. The interim financial statements are meant to be read in conjunction with the Company’s audited financial statements presented in its Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

In preparing financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the dates of the balance sheet and revenues and expenses for the reported periods. Actual results could differ from these estimates. The Company believes that the most critical accounting policies, which are those that are most important to the portrayal of the Company’s financial condition and result of operations and require management’s most difficult, subjective and complex judgments, relate to the determination of the allowance for loan losses, the impairment analysis of goodwill and core deposit intangibles, determination of the expense and liability related to the Company’s pension plan, and determination of mortgage servicing rights.

The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP.

2. Impact of New Accounting Standards.

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, "Accounting for Certain Hybrid Instruments" (SFAS 155), which permits, but does not require, fair value accounting for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133. The statement also subjects beneficial interests issued by securitization vehicles to the requirements of SFAS 133. The statement is effective as of January 1, 2007. The adoption of SFAS 155 did not have a material impact on the Company’s financial condition, results of operations or cash flow.

**Table of Contents**

NORTHWAY FINANCIAL, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-CONTINUED  
June 30, 2007  
(Unaudited)

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets- an amendment of FASB Statement No. 140" (SFAS 156). SFAS 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in specific situations. Additionally, the servicing asset or servicing liability shall be initially measured at fair value; however, an entity may elect the "amortization method" or "fair value method" for subsequent balance sheet reporting periods. SFAS 156 is effective as of an entity's first fiscal year beginning after September 15, 2006. Early adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year. The Company's adoption of this statement did not have a material impact on its financial condition, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles (GAAP) and enhances disclosures about fair value measurements. SFAS 157 retains the exchange price notion and clarifies that the exchange price is the price that would be received for an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. SFAS 157 is effective for the Company's consolidated financial statements for the year beginning on January 1, 2008, with earlier adoption permitted. The Company does not expect the adoption of this statement to have a material impact on its financial condition, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 158, "Employer's Accounting for Defined Benefit Pension and other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)" (SFAS 158). SFAS 158 requires 1) the recognition of an asset or liability for the over-funded or under-funded status of a defined benefit plan, 2) the recognition of actuarial gains and losses and prior service costs and credits in other comprehensive income, 3) measurement of plan assets and benefit obligations as of the employer's balance sheet date, rather than at interim measurement dates as currently allowed, and 4) disclosure of additional information concerning actuarial gains and losses and prior service costs and credits recognized in other comprehensive income. This statement is effective for financial statements with fiscal years ending after December 15, 2006. The adoption of this Statement did not have a material impact on the Company's financial position, result of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115" (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The new standard is effective at the beginning of the Company's fiscal year beginning January 1, 2008, and early application may be elected in certain circumstances. The Company does not expect the adoption of this statement to have a material impact on its financial condition, results of operations or cash flows.

**Table of Contents**

NORTHWAY FINANCIAL, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-CONTINUED  
June 30, 2007  
(Unaudited)

## 3. Pension Benefits.

The following summarizes the net periodic benefit cost for the three months and six months ended June 30:

| (\$000 Omitted)                    | Three Months Ended June |       | Six Months     |       |
|------------------------------------|-------------------------|-------|----------------|-------|
|                                    | 30,                     |       | Ended June 30, |       |
|                                    | 2007                    | 2006  | 2007           | 2006  |
| Service cost                       | \$131                   | \$142 | \$262          | \$284 |
| Interest cost                      | 103                     | 94    | 206            | 188   |
| Expected return on plan assets     | (130)                   | (113) | (260)          | (227) |
| Amortization of prior service cost | (21)                    | (21)  | (42)           | (42)  |
| Recognized net actuarial loss      | 25                      | 36    | 50             | 72    |
| Net periodic benefit cost          | \$108                   | \$138 | \$216          | \$275 |

The Company previously disclosed in its consolidated financial statements for the year ended December 31, 2006 that it expected to make a pension plan contribution of \$435,000 in 2007. During the first quarter of 2007, the Company made a \$400,000 contribution to the pension plan and plans to contribute an additional \$35,000 prior to year-end.

## 4. Going Private Transaction.

As reported in the Company's definitive proxy statement filed on July 13, 2007 with the Securities and Exchange Commission ("SEC"), on April 9, 2007, the Company's Board of Directors approved a 1-for-400 reverse stock split. The purpose of the reverse stock split is to reduce the number of the Company's stockholders below 300 so that the Company may deregister its shares with the SEC and cease being a reporting company. The proposed transaction requires an amendment to the Company's Articles of Incorporation that must be approved by holders of a majority of the outstanding common shares of the Company. Only the Company's stockholders of record as of the close of business on July 6, 2007, will be entitled to notice of, and to vote at, the Annual Meeting of Stockholders, to be held on Tuesday, August 28, 2007 to consider the transaction and certain other matters.

As a result of the proposed reverse stock split, each stockholder owning fewer than 400 shares of common stock of the Company immediately before the reverse stock split will receive \$37.50 in cash, without interest, for each share of the Company's common stock owned by such stockholder immediately prior to the reverse stock split. As disclosed in the Company's definitive proxy statement it is estimated that, as a result of the proposed reverse stock split, the number of outstanding shares of the Company's common stock will decrease approximately 8.7%, from 1,494,174 shares to approximately 1,363,797 shares and its stockholders of record will be reduced from approximately 1,091 stockholders to approximately 268 stockholders. After the repurchase of fractional shares, the Company will effect an 800-for-1 forward stock split of the remaining the Company's common stock. Each holder of 400 or more shares of common

stock immediately before the reverse stock split will participate in the forward stock split, which will result in such stockholder holding twice the number of shares of common stock he held prior to the reverse stock split.

**Table of Contents**

NORTHWAY FINANCIAL, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS-CONTINUED  
June 30, 2007  
(Unaudited)

The Company estimates that the total funds required to fund the payment of the proposed split transaction consideration to the non-continuing stockholders and to pay fees and expenses relating to the split transaction will be approximately \$5,112,000. These numbers and amounts are expected to increase between the date hereof and the effective date of the split transaction based upon changes in share ownership and other factors. The Company has sufficient working capital to pay the estimated cost of the proposed split transaction and reasonably anticipated increases in such estimated cost.

The description of the proposed transaction included in this Form 10-Q is not a solicitation of a proxy or an offer to acquire any common shares of the Company. Proxy solicitations will be made only by means of a definitive proxy statement to be delivered to all stockholders. The Company filed a definitive proxy statement and an amended Schedule 13E-3 with the SEC outlining the proposed transaction on July 12, 2007. All stockholders are advised to read the definitive proxy statement and Schedule 13E-3/A carefully. Stockholders may obtain a free copy of the proxy statement and Schedule 13E-3/A at the SEC's website <http://www.sec.gov>. The Company will also mail a copy of the definitive proxy statement prior to the annual meeting to stockholders entitled to vote at the special meeting.

## **Table of Contents**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis and the related condensed consolidated financial statements relate to the Company.

#### **Forward-Looking Statements**

Certain statements in this Form 10-Q are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements can be identified by the use of the words "expect," "believe," "estimate," "will" and other expressions which predict or indicate future trends and which do not relate to historical matters. Forward-looking statements may include, but are not limited to, expectations for impact of new products or changes in our branch network on noninterest income and expense, projections of revenue, income or loss, and plans related to products or services of the Company and its subsidiary. Such forward-looking statements are subject to known and unknown risks, uncertainties and contingencies, many of which are beyond the control of the Company. The Company's actual results could differ materially from those projected in the forward-looking statements as the result of, among other factors, changes in interest rates, a prolonged continuation of the current interest rate environment, changes in the securities or financial markets, a deterioration in general economic conditions on a national basis or in the local markets in which the Company operates, including changes in local business conditions resulting in rising unemployment and other circumstances which adversely affect borrowers' ability to service and repay our loans, changes in loan defaults and charge-off rates, reduction in deposit levels necessitating increased borrowing to fund loans and investments, the passing of adverse government regulation, and changes in assumptions used in making such forward-looking statements as well as those factors set forth in the Company's Annual Report on Form 10-K for the year ending December 31, 2006, and in the Company's other filings with the Securities & Exchange Commission. These forward-looking statements were based on information, plans and estimates at the date of this Form 10-Q, and the Company does not promise to update any forward-looking statements to reflect changes in underlying assumptions or factors, new information, future events or other changes.

#### **Branch Consolidation**

As part of management's ongoing effort to control costs while continuing to offer excellent customer service, effective October 12, 2007, we will consolidate the loans and deposits of our two branches located in Downtown Belmont and Downtown Tilton into our Tilton Branch located at Exit 20 of Interstate 93. Both of these branches were acquired in April 2006 from Washington Mutual, and are located close to the Tilton Exit 20 Branch as well as other existing Northway branches. The decision to consolidate them with this branch was made only after careful analysis indicated that our customers at the two Downtown Branches could continue to be well-served by our full-service branch at Exit 20, where we recently began offering Sunday hours to strengthen our commitment to customer service in this important market.

#### **Financial Condition**

The Company's total assets at June 30, 2007 were \$689,954,000 compared to \$650,877,000 at December 31, 2006, an increase of \$39,077,000. Securities available-for-sale increased \$20,161,000 to \$147,950,000 at June 30, 2007 from \$127,789,000 at December 31, 2006, due principally to the purchase of US agency securities, mortgage-backed securities and municipal bonds. In addition, gross loans increased \$18,999,000 to \$481,229,000 at June 30, 2007 from \$462,230,000 at December 31, 2006. Increases in residential mortgage loans, commercial real estate loans, commercial loans and municipal loans were partially offset by the continued runoff in indirect installments loans.

Deposits increased \$13,219,000 to \$497,896,000 at June 30, 2007 from \$484,677,000 at December 31, 2006 due primarily to increases in money market accounts and time deposits. Short-term borrowings, which consist of securities sold under agreements to repurchase, increased \$10,906,000 to \$47,403,000 at June 30, 2007 compared to \$36,497,000 at December 31, 2006. Long-term Federal Home Loan Bank advances increased \$2,000,000 to \$55,000,000 at June 30, 2007 from \$53,000,000 at December 31, 2006 due to new advances of \$20,000,000 partially offset by the maturity of \$18,000,000 in other advances. Junior subordinated debentures increased \$13,403,000 to \$34,023,000 at June 30, 2007 compared to \$20,620,000 at December 31, 2006. Proceeds from this increase were subsequently used to refinance the \$13,403,000 junior subordinated debenture callable on July 7, 2007. Total stockholders' equity decreased \$367,000 to \$51,782,000 at June 30, 2007 from \$52,149,000 at December 31, 2006 resulting from an increase in other comprehensive loss of \$1,491,000 due to the comprehensive loss associated with securities available-for-sale described below. Equity was further reduced as the result of a \$7,000 adjustment to retained earnings to reclassify a prior years' income tax expense and dividends paid of \$597,000. These reductions were partially offset by net income of \$1,662,000 and a \$67,000 increase due to the exercise of stock options.

The Company maintains an allowance for loan losses to absorb loan charge-offs in the existing portfolio. The allowance is increased when a loan loss provision is recorded as an expense. When a loan, or portion thereof, is considered uncollectible, it is charged against this allowance. Recoveries of amounts previously charged-off are added to the allowance when collected. The allowance for loan losses is established based on estimates of losses related to customer loan balances. In establishing the appropriate provisions for customer loan balances, the Company makes assumptions with respect to their future collectibility. The Company's assumptions are based on an individual assessment of the customer's credit quality as well as subjective factors and trends, including the credit rating of the loans. Generally, these individual credit assessments occur prior to the inception of the credit exposure and at regular reviews during the life of the exposure and take into account (a) the customer's ability to meet and sustain their financial commitments; (b) the customer's current and projected financial condition; (c) the positive or negative effects of the current and projected industry outlook; and (d) the economy in general. Once the Company considers all of these factors, a determination is made as to the probability of default. The Company then takes into account the severity of the likely loss, based on its experience in collecting outstanding loan balances, and makes what it believes to be an appropriate provision.



**Table of Contents**

At June 30, 2007 the allowance for loan losses was \$5,814,000, or 1.21% of total loans, compared to \$5,581,000, or 1.21% of total loans at December 31, 2006. The composition of the allowance for loan losses for the three month and six month periods ended June 30, 2007 and 2006 is as follows:

| (Dollars in thousands)         | Three Months ended June 30, |          | Six Months Ended June 30, |          |
|--------------------------------|-----------------------------|----------|---------------------------|----------|
|                                | 2007                        | 2006     | 2007                      | 2006     |
| Balance at beginning of period | \$ 5,701                    | \$ 5,211 | \$ 5,581                  | \$ 5,150 |
| Charge-offs                    | (155)                       | (84)     | (202)                     | (190)    |
| Recoveries                     | 58                          | 46       | 105                       | 108      |
| Net (charge-offs) recoveries   | (97)                        | (38)     | (97)                      | (82)     |
| Provision for loan losses      | 210                         | 120      | 330                       | 225      |
| Balance at end of period       | \$ 5,814                    | \$ 5,293 | \$ 5,814                  | \$ 5,293 |

Nonperforming loans totaled \$4,864,000 as of June 30, 2007, compared to \$3,698,000 at December 31, 2006 due primarily to an increase in nonperforming commercial real estate loans. The ratio of nonperforming loans to loans net of unearned income was 1.01% as of June 30, 2007, compared to 0.80% at December 31, 2006. Nonperforming assets, which include nonperforming loans, other real estate owned and other chattels owned, totaled \$4,874,000 as of June 30, 2007, compared to \$3,714,000 at December 31, 2006. The ratio of nonperforming assets to total assets was 0.71% as of June 30, 2007, compared to 0.57% at December 31, 2006.

**Results of Operations**

The Company reported net income of \$816,000, or \$0.54 per common share-basic, for the three months ended June 30, 2007, compared to \$756,000, or \$0.51 per common share-basic, for the three months ended June 30, 2006, an increase of \$60,000, or 7.9%. Net income for the six months ended June 30, 2007 was \$1,662,000, or \$1.11 per common share-basic, compared to \$1,836,000, or \$1.23 per common share-basic, for the six months ended June 30, 2006, a decrease of \$174,000, or 9.5%.

Net interest and dividend income for the second quarter of 2007 decreased \$174,000 to \$5,472,000 compared to \$5,646,000 for the second quarter of 2006. Net interest and dividend income for the six months ended June 30, 2007 decreased \$634,000, or 5.6%, to \$10,656,000 compared to \$11,290,000 for the same period last year. The year-to-date decrease was primarily due to an increase in the cost of interest-bearing liabilities of 83 basis points resulting from an increase in the cost of money market, time deposit, securities sold under agreements to repurchase and capital securities. This was partially offset by an increase in the yield on earning assets of 37 basis points due to the increase in the prime rate as well as the continued redeployment of the amortization from the indirect automobile line of business into higher yielding residential mortgage loans and commercial loans. The decrease in the net interest margin was also partially mitigated by the increase in average earning assets of \$33,956,000 from \$586,980,000 at June 30, 2006 to \$620,936,000 at June 30, 2007.

The provision for loan losses was \$210,000 for the second quarter of 2007, compared to \$120,000 for the second quarter 2006, an increase of \$90,000. For the six months ended June 30, 2007, the provision for loan losses was \$330,000, an increase of \$105,000 from the \$225,000 reported for the same period last year. The provision for loan losses is based upon a review of the adequacy of the allowance for loan losses, which is conducted on a quarterly basis. This review is based upon many factors including the risk characteristics of the portfolio, trends in loan delinquencies, and an assessment of existing economic conditions. In addition, various regulatory agencies, as part of their examination process, review the bank's allowance for loan losses and such review may result in changes to the allowance based on judgments different from those of management.

Noninterest income increased \$216,000 to \$1,538,000 in the second quarter of 2007 compared to \$1,322,000 in the second quarter of 2006. Service charges and fees on deposit accounts increased \$42,000 to \$771,000 for the second quarter of 2007 compared to \$729,000 for the second quarter of 2006 due primarily to an increase in the NSF per item fees in May 2006 as well as the acquisition of deposits in April 2006. Net securities gains increased \$167,000 to \$206,000 in the second quarter of 2007 compared to \$39,000 for the second quarter of 2006 due primarily to the sale of equity securities during the second quarter of 2007. Gains on sales of loans decreased \$9,000 to \$45,000. In the second quarter, other noninterest income increased \$16,000 to \$516,000 compared to \$500,000 for the same period a year ago due primarily to an increase in the cash surrender value of life insurance partially offset by a decrease in gain on sale of other real estate owned.

Noninterest income for the six months ended June 30, 2007 increased \$91,000 to \$2,983,000 compared to \$2,892,000 for the same period last year. Year-to-date, service charges and fees on deposit accounts were \$1,485,000, an increase of \$141,000, compared to the prior year. Net securities gains increased \$98,000 to \$347,000 for the six months ended June 30, 2007 compared to \$249,000 for the same period last year. Gains on sales of loans increased \$6,000 to \$78,000 for the six months ended June 30, 2007 compared to \$72,000 for the same period a year ago due to the lower level of secondary market sales in 2007. For the first six months of 2007, other noninterest income decreased \$154,000 to \$1,073,000 compared to \$1,227,000 for the same period a year ago. The decrease in other noninterest income was due primarily to a decrease in gains on sale of other real estate owned, gains recorded on the redemption of two FHLB symmetrical advances, and the recovery of prior year expenses associated with a non-accrual loan that paid in full during the first quarter of 2006. This was partially offset by an increase in the cash surrender value of life insurance as well as an increase in debit card fee income.

Noninterest expense decreased \$45,000 to \$5,876,000 for the quarter ended June 30, 2007, compared to the \$5,921,000 recorded during the same period last year. Salaries and employee benefits decreased \$150,000 to \$2,942,000 for the second quarter of 2007 compared to \$3,092,000 for the same period last year due primarily to a decrease in pension expense and profit sharing expense. Office occupancy and equipment expense decreased \$110,000 to \$960,000 for the second quarter 2007 compared to \$1,070,000 for the same period last year. This decrease is due primarily to a decrease in equipment maintenance, equipment expense and loss on equipment disposal. Amortization of core deposit intangibles decreased \$162,000 to \$118,000 for the second quarter of 2007 compared to \$280,000 for the second quarter of 2006 due to the cessation of amortization of the core deposit intangible associated with the three branch locations purchased in October 2002. Other noninterest expense increased \$377,000 to \$1,856,000 for the second quarter of 2007 compared to \$1,479,000 for the same period last year. Increases were recorded in legal fees, consultants expense, marketing expense, and the amortization of deferred debenture costs associated with the refinance of the Company's junior subordinated debentures.

### **Table of Contents**

For the six months ended June 30, 2007 noninterest expense totaled \$11,398,000, a decrease of \$222,000 over the \$11,620,000 reported for the same period last year. For the six months ended June 30, 2006, the Company incurred one-time expenses associated with the acquisition of two Washington Mutual Bank branches of \$118,000. For the six months ended June 30, 2007, salaries and employee benefits decreased \$88,000 to \$5,919,000, compared to \$6,007,000 for the same period a year ago due to the decrease in pension expense and profit sharing expense. Office occupancy and equipment expense increased \$9,000 to \$2,040,000 for the six months ended June 30, 2007, compared to the same period last year. Amortization of core deposit intangibles decreased \$279,000 to \$239,000 for the six months ended June 30, 2007, compared to \$518,000 for the same period last year for the same reason stated above. Other noninterest expense increased \$136,000 to \$3,200,000 for the six months ended June 30, 2007 compared to \$3,064,000 for the same period a year ago. Increases were recorded in legal fees, consultants expense, marketing expense, and the amortization of deferred debenture costs associated with the refinance of the Company's junior subordinated debentures which was partially offset by a decrease in telephone expense.

### **Income Tax Expense**

The Company recognized income tax expense of \$249,000 and \$501,000 for the six months ended June 30, 2007 and 2006, respectively. The effective tax rates were 13.0% and 21.4% for those respective periods. The effective tax rate for both years is positively impacted by the Company's significant increase in municipal bond investments as well as certain charitable contributions made which provide tax credits to the Company due to a 75% state tax exemption.

### **Comprehensive Net Income/(Loss)**

Comprehensive net income/(loss) includes net income plus or minus other items required to be reported directly in the equity section of the balance sheet without having been recognized in the determination of net income. These other components include the unrealized holding gains and losses on available-for-sale securities and any unrealized gains and losses on the Company's pension valuation as well as the recognition of prior service costs and credits relating to the pension.

The Company reported a comprehensive net loss of \$779,000 for the quarter ended June 30, 2007, compared to a comprehensive net loss of \$273,000 for the quarter ended June 30, 2006. For the six months ended June 30, 2007, comprehensive net income was \$171,000, compared to \$596,000 for the six months ended June 30, 2006.

For the quarter ended June 30, 2007, the unrealized loss on available-for-sale securities increased \$1,598,000, net of tax. For the quarter ended June 30, 2007, the unrealized loss on pension valuation decreased \$15,000 and the prior service credit decreased \$12,000. When the \$1,595,000 net debit is deducted from the quarterly net income of \$816,000 the result is a comprehensive net loss of \$779,000. For the quarter ended June 30, 2006, the unrealized loss on available-for-sale securities increased \$1,029,000, net of tax. When deducted from the quarterly net income of \$756,000, the result is a comprehensive net loss of \$273,000.

For the six months ended June 30, 2007, the Company increased its unrealized loss on available-for-sale securities by \$1,496,000, net of tax. In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", the negative adjustment to comprehensive income is not expected to impact net income as the Company has the ability and intent to hold available-for-sale securities until cost recovery occurs. Also, for the six months ended June 30, 2007, the unrealized loss on pension valuation decreased \$30,000 and the prior service credit decreased \$25,000. When the \$1,491,000 net debit is deducted from net income year-to-date of \$1,662,000 the result is a net comprehensive income of \$171,000. For the six months ended June 30, 2006, the Company increased its unrealized loss on available-for-sale securities by \$1,240,000, net of tax. When deducted from net income year-to-date of \$1,836,000 the result is a net comprehensive income of \$596,000.

At June 30, 2007 market prices for investment securities were negatively impacted by: i) high relative yields, the highest seen in years; ii) the rapid movement in prices and yields as yields moved over 50 basis points; iii) the steepening yield curve which impacted the long-end of the curve; iv) spread widening; and v) volatility which caused the ten-year yield to move 20 basis points.

### Liquidity

Liquidity risk management refers to the Company's ability to raise funds in order to meet existing and anticipated financial obligations. These obligations to make payments include withdrawal of deposits on demand or at their contractual maturity, the repayment of borrowings as they mature, funding new and existing loan commitments as well as new business opportunities. Liquidity may be provided through amortization, maturity or sale of assets such as loans and securities available-for-sale, liability sources such as increased deposits, utilization of the FHLB credit facility, purchased or other borrowed funds, and access to the capital markets. Liquidity targets are subject to change based on economic and market conditions and are controlled and monitored by the Company's Asset/Liability Committee.

At the subsidiary bank level, liquidity is managed by measuring forecasted cash flows. Liquidity levels are defined as the amount of cash flow available to meet loan origination requirements and potential deposit outflows. Liquidity is managed using a combination of net marketable assets, lines of credit, FHLB borrowings, purchase and sale of loan assets, and brokered/wholesale CD relationships.

Additionally, Northway Financial, Inc. requires cash for various operating needs, including dividends to shareholders, the stock repurchase program, capital contributions to the subsidiary bank, interest payments on capital securities and the payment of general corporate expenses. The primary sources of liquidity for Northway Financial, Inc. are dividends from its subsidiary bank and reimbursement for services performed on behalf of the bank.

Further, the Company is party to off-balance sheet financial instruments in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to originate loans, unadvanced home equity loans, unadvanced lines of credit, standby letters of credit and unadvanced portions of Bounce Protection™, an overdraft privilege program. The amounts of those instruments reflect the extent of the Company's involvement in particular classes of financial instruments, and, if advanced, will impact the Company's liquidity. As of June 30, 2007, off-balance sheet financial commitments totaled approximately \$104,500,000.

## Table of Contents

As explained in more detail on Note 4 of the “Notes to Condensed Consolidated Financial Statements,” on April 9, 2007, the Company's Board of Directors approved a 1-for-400 reverse stock split. The purpose of the proposed reverse stock split is to reduce the number of the Company's stockholders below 300 so that the Company may deregister its shares with the SEC and cease being a reporting company. The proposed transaction requires an amendment to the Company's Articles of Incorporation that must be approved by holders of a majority of the outstanding common shares of the Company. Only the Company's stockholders of record as of the close of business on July 6, 2007, will be entitled to notice of, and to vote at, the annual meeting of stockholders, to be held on Tuesday, August 28, 2007 to consider the transaction.

The Company estimates that the total funds required to fund the payment of the proposed split transaction consideration to the non-continuing stockholders and to pay fees and expenses relating to the split transaction will be approximately \$5,112,000. This amount may change between the date hereof and the effective date of the split transaction. The Company has sufficient working capital to pay the estimated cost of the split transaction and reasonably anticipated increases in such estimated cost.

The Company filed a definitive proxy statement and an amended Schedule 13E-3 with the SEC outlining the proposed transaction on July 13, 2007. The description of the proposed transaction included in this Form 10-Q is not a solicitation of a proxy or an offer to acquire any common shares of the Company. Proxy solicitations will be made only by means of a definitive proxy statement to be delivered to all stockholders. All stockholders are advised to read the definitive proxy statement and Schedule 13E-3/A carefully. Stockholders may obtain a free copy of the proxy statement and Schedule 13E-3/A at the SEC's website <http://www.sec.gov>. The Company will also mail a copy of the definitive proxy statement prior to the annual meeting to stockholders entitled to vote at the special meeting.

Management believes that the Company's current level of liquidity and funds available from outside sources is sufficient to meet the Company's needs.

## Capital

The Company's Tier 1 and Total Risk Based Capital ratios were 13.85% and 15.72%, respectively, at June 30, 2007. The Company's Tier 1 leverage ratio at June 30, 2007 was 9.09%. As of June 30, 2007, the capital ratios of the Company and the subsidiary bank exceeded the minimum capital ratio requirements for the “well-capitalized” category under the Federal Deposit Insurance Corporation Improvement Act of 1991.

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

Since December 31, 2006, there have been no material changes in the Company's quantitative and qualitative disclosures concerning market risk. A more detailed description of the quantitative and qualitative disclosures about market risk was provided by the Company on pages 27 and 28 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

### Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

As required by Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), the Company's management conducted an evaluation with the participation of the Company's Chief Executive Officer and Chief Financial Officer, regarding the effectiveness of the Company's disclosure controls and procedures, as of the end of the last fiscal quarter. In designing and evaluating the Company's disclosure controls and procedures, the Company and its management recognize that any controls and procedures, no matter how well designed and operated, can

provide only a reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating and implementing possible controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that they believe the Company's disclosure controls and procedures are reasonably effective to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. We intend to continue to review and document our disclosure controls and procedures, including our internal controls and procedures for financial reporting, and we may from time to time make changes to the disclosure controls and procedures to enhance their effectiveness and to ensure that our systems evolve with our business.

(b) Changes in internal controls.

There were no changes in the Company's internal controls over financial reporting identified in connection with the Company's evaluation of its disclosure controls and procedures 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.

13

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**Table of Contents**

**PART II. OTHER INFORMATION**

Item 1. Legal Proceedings - None

Item 1A. Risk Factors.

There have been no material changes in the Company's risk factors as previously disclosed on pages 9-11 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds - None

Item 3. Defaults Upon Senior Securities - None

Item 4. Submission of Matters to a Vote of Security Holders - None

Item 5. Other Information - None

Item 6. Exhibits

**Exhibit Number Description of Exhibit**

- |      |  |
|------|--|
| 3.1  | Amended and Restated Articles of Incorporation of Northway Financial, Inc. (incorporated by reference to Exhibit 3.1 to Registration Statement No. 333-33033).                               |
| 3.2  | By-laws of Northway Financial, Inc. (incorporated by reference to Exhibit 3.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005).                             |
| 4    | Form of Certificate representing the Company Common Stock (reference is also made to Exhibits 3.1 and 3.2) (incorporated by reference to Exhibit 4 to Registration Statement No. 333-33033). |
| 10.1 | Employment Agreement for William J. Woodward (incorporated by reference to Exhibit 10.1 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005).                   |
| 10.3 | Amendment to the Employment Agreement for William J. Woodward. (incorporated by reference to Exhibit 10.3 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005). |
| 10.5 | Northway Financial, Inc. 1999 Stock Option and Grant Plan (incorporated by reference to Exhibit 4.1 to Registration Statement No. 333-83571 dated July 23, 1999).                            |
| 10.7 | Form of Key Employee Agreement (incorporated by reference to Exhibit 10.8 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005).                                 |
| 10.8 | Supplemental Executive Retirement Plan (incorporated by reference to Exhibit 10.8 to the Company's Annual Report on Form 10-K for the year ended December 31, 2003).                         |
| 11   | Statement re computation of per Share Earnings.  |

14

**Table of Contents**

**Exhibit Number** **Description of Exhibit**

|      |  |
|------|--|
| 31.1 | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.                                     |
| 31.2 | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.                                     |
| 32.1 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |



**Table of Contents**

**SIGNATURES**

Pursuant to 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.

NORTHWAY FINANCIAL, INC

August 7, 2007

BY:/S/William J. Woodward  
William J. Woodward  
President & CEO  
(Principal Executive Officer)

August 7, 2007

BY:/S/Richard P. Orsillo  
Richard P. Orsillo  
Senior Vice President & CFO  
(Principal Financial and Accounting Officer)

**Table of Contents**

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