

PENNS WOODS BANCORP INC
Form 10-Q
August 09, 2013
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

x Quarterly Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

for the Quarterly Period Ended June 30, 2013.

o Transition report pursuant to Section 13 or 15 (d) of the Exchange Act

For the Transition Period from to .

No. 0-17077

(Commission File Number)

PENNS WOODS BANCORP, INC.

(Exact name of Registrant as specified in its charter)

PENNSYLVANIA
**(State or other jurisdiction of
incorporation or organization)**

23-2226454
**(I.R.S. Employer
Identification No.)**

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300 Market Street, P.O. Box 967 Williamsport, Pennsylvania
(Address of principal executive offices)

17703-0967
(Zip Code)

(570) 322-1111

Registrant's telephone number, including area code

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 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 definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer
Non-accelerated filer

Accelerated filer
Small 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

On August 2, 2013 there were 4,818,483 shares of the Registrant's common stock outstanding.

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PENNS WOODS BANCORP, INC.
CONSOLIDATED BALANCE SHEET
(UNAUDITED)

| (In Thousands, Except Share Data) | June 30, 2013 | December 31, 2012 |
|---|---------------------|----------------------|
| ASSETS: | | |
| Noninterest-bearing balances | \$ 26,888 | \$ 12,695 |
| Interest-bearing deposits in other financial institutions | 1,417 | 2,447 |
| Federal funds sold | 134 | |
| Total cash and cash equivalents | 28,439 | 15,142 |
| Investment securities available for sale, at fair value | 311,289 | 289,316 |
| Loans held for sale | 5,409 | 3,774 |
| Loans | 786,961 | 512,232 |
| Allowance for loan losses | (9,404) | (7,617) |
| Loans, net | 777,557 | 504,615 |
| Premises and equipment, net | 17,101 | 8,348 |
| Accrued interest receivable | 4,999 | 4,099 |
| Bank-owned life insurance | 25,022 | 16,362 |
| Investment in limited partnerships | 2,552 | 2,883 |
| Goodwill | 17,104 | 3,032 |
| Intangibles | 1,984 | |
| Deferred tax asset | 9,906 | 4,731 |
| Other assets | 5,596 | 4,233 |
| TOTAL ASSETS | \$ 1,206,958 | \$ 856,535 |
| LIABILITIES: | | |
| Interest-bearing deposits | \$ 744,265 | \$ 527,073 |
| Noninterest-bearing deposits | 211,096 | 114,953 |
| Total deposits | 955,361 | 642,026 |
| Short-term borrowings | 39,000 | 33,204 |
| Long-term borrowings, Federal Home Loan Bank (FHLB) | 70,750 | 76,278 |
| Accrued interest payable | 442 | 366 |
| Other liabilities | 15,477 | 10,935 |
| TOTAL LIABILITIES | 1,081,030 | 762,809 |
| SHAREHOLDERS EQUITY: | | |
| Preferred stock, no par value, 3,000,000 shares authorized; no shares issued | | |
| Common stock, par value \$8.33, 15,000,000 shares authorized; 4,998,881 and 4,019,112 shares issued | 41,657 | 33,492 |

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| | | |
|--|--------------|------------|
| Additional paid-in capital | 49,759 | 18,157 |
| Retained earnings | 45,343 | 43,030 |
| Accumulated other comprehensive (loss) income: | | |
| Net unrealized gain on available for sale securities | 286 | 10,164 |
| Defined benefit plan | (4,807) | (4,807) |
| Treasury stock at cost, 180,596 shares | (6,310) | (6,310) |
| TOTAL SHAREHOLDERS EQUITY | 125,928 | 93,726 |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | \$ 1,206,958 | \$ 856,535 |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.
CONSOLIDATED STATEMENT OF INCOME
(UNAUDITED)

| (In Thousands, Except Per Share Data) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|--------------|------------------------------|---------------|
| | 2013 | 2012 | 2013 | 2012 |
| INTEREST AND DIVIDEND INCOME: | | | | |
| Loans, including fees | \$ 7,277 | \$ 6,294 | \$ 14,045 | \$ 12,608 |
| Investment securities: | | | | |
| Taxable | 1,507 | 1,517 | 2,950 | 2,991 |
| Tax-exempt | 1,162 | 1,383 | 2,429 | 2,788 |
| Dividend and other interest income | 72 | 86 | 134 | 178 |
| TOTAL INTEREST AND DIVIDEND INCOME | 10,018 | 9,280 | 19,558 | 18,565 |
| INTEREST EXPENSE: | | | | |
| Deposits | 760 | 934 | 1,551 | 1,895 |
| Short-term borrowings | 22 | 28 | 47 | 62 |
| Long-term borrowings, FHLB | 482 | 620 | 1,001 | 1,240 |
| TOTAL INTEREST EXPENSE | 1,264 | 1,582 | 2,599 | 3,197 |
| NET INTEREST INCOME | 8,754 | 7,698 | 16,959 | 15,368 |
| PROVISION FOR LOAN LOSSES | 575 | 600 | 1,075 | 1,200 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 8,179 | 7,098 | 15,884 | 14,168 |
| NON-INTEREST INCOME: | | | | |
| Service charges | 538 | 458 | 980 | 905 |
| Securities gains, net | 1,274 | 170 | 2,260 | 759 |
| Bank-owned life insurance | 144 | 133 | 282 | 401 |
| Gain on sale of loans | 302 | 343 | 653 | 526 |
| Insurance commissions | 247 | 316 | 511 | 758 |
| Brokerage commissions | 299 | 247 | 547 | 459 |
| Other | 731 | 614 | 1,035 | 1,236 |
| TOTAL NON-INTEREST INCOME | 3,535 | 2,281 | 6,268 | 5,044 |
| NON-INTEREST EXPENSE: | | | | |
| Salaries and employee benefits | 3,442 | 2,850 | 6,510 | 5,867 |
| Occupancy | 397 | 318 | 748 | 646 |
| Furniture and equipment | 412 | 357 | 820 | 703 |
| Pennsylvania shares tax | 208 | 167 | 392 | 336 |
| Amortization of investment in limited partnerships | 166 | 166 | 331 | 331 |
| Federal Deposit Insurance Corporation deposit insurance | 119 | 115 | 248 | 238 |
| Marketing | 120 | 140 | 215 | 273 |
| Intangible amortization | 31 | | 31 | |
| Other | 2,070 | 1,230 | 3,521 | 2,413 |
| TOTAL NON-INTEREST EXPENSE | 6,965 | 5,343 | 12,816 | 10,807 |

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| | | | | | | |
|--|-----------|-----------|-----------|-----------|-------|-------|
| INCOME BEFORE INCOME TAX PROVISION | | | | | | |
| | 4,749 | | 4,036 | | 9,336 | 8,405 |
| INCOME TAX PROVISION | 1,090 | | 638 | | 1,993 | 1,318 |
| NET INCOME | \$ 3,659 | \$ 3,398 | \$ 7,343 | \$ 7,087 | | |
| EARNINGS PER SHARE - BASIC | \$ 0.88 | \$ 0.89 | \$ 1.84 | \$ 1.85 | | |
| EARNINGS PER SHARE - DILUTED | \$ 0.88 | \$ 0.89 | \$ 1.84 | \$ 1.85 | | |
| WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC | 4,151,035 | 3,837,579 | 3,995,716 | 3,837,391 | | |
| WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED | 4,151,035 | 3,837,579 | 3,995,716 | 3,837,391 | | |
| DIVIDENDS DECLARED PER SHARE | \$ 0.47 | \$ 0.47 | \$ 1.19 | \$ 0.94 | | |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(UNAUDITED)

| (In Thousands) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|----------|---------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| Net Income | \$ 3,659 | \$ 3,398 | \$ 7,343 | \$ 7,087 |
| Other comprehensive (loss) income: | | | | |
| Change in unrealized (loss) gain on available for sale securities | (11,196) | 2,028 | (12,707) | 7,038 |
| Tax effect | 3,807 | (690) | 4,321 | (2,393) |
| Net realized gain included in net income | (1,274) | (170) | (2,260) | (759) |
| Tax effect | 433 | 58 | 768 | 258 |
| Total other comprehensive (loss) income | (8,230) | 1,226 | (9,878) | 4,144 |
| Comprehensive (loss) income | \$ (4,571) | \$ 4,624 | \$ (2,535) | \$ 11,231 |

See accompanying notes to the unaudited consolidated financial statements.

PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

| (In Thousands, Except Per Share Data) | COMMON STOCK | | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) | TREASURY STOCK | TOTAL SHAREHOLDERS EQUITY |
|---|--------------|-----------|----------------------------|-------------------|---|----------------|---------------------------|
| | SHARES | AMOUNT | | | | | |
| Balance, December 31, 2011 | 4,017,677 | \$ 33,480 | \$ 18,115 | \$ 36,394 | \$ (1,219) | \$ (6,310) | \$ 80,460 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 7,087 | | | 7,087 |
| Other comprehensive income | | | | | 4,144 | | 4,144 |
| Dividends declared, (\$0.94 per share) | | | | (3,607) | | | (3,607) |
| Common shares issued for employee stock purchase plan | 709 | 6 | 21 | | | | 27 |
| Balance, June 30, 2012 | 4,018,386 | \$ 33,486 | \$ 18,136 | \$ 39,874 | \$ 2,925 | \$ (6,310) | \$ 88,111 |

| (In Thousands, Except Per Share Data) | COMMON STOCK | | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) | TREASURY STOCK | TOTAL SHAREHOLDERS EQUITY |
|---------------------------------------|--------------|-----------|----------------------------|-------------------|---|----------------|---------------------------|
| | SHARES | AMOUNT | | | | | |
| Balance, December 31, 2012 | 4,019,112 | \$ 33,492 | \$ 18,157 | \$ 43,030 | \$ 5,357 | \$ (6,310) | \$ 93,726 |
| Comprehensive loss: | | | | | | | |
| Net income | | | | 7,343 | | | 7,343 |

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| | | | | | | | |
|---|-----------|-----------|-----------|-----------|------------|------------|---------|
| Other comprehensive loss | | | | | (9,878) | | (9,878) |
| Dividends declared, (\$1.19 per share) | | | | (5,030) | | | (5,030) |
| Common shares issued for employee stock purchase plan | 792 | 7 | 24 | | | | 31 |
| Common shares issued for acquisition of Luzerne National Bank Corporation | 978,977 | 8,158 | 31,578 | | | | 39,736 |
| Balance, June 30, 2013 | 4,998,881 | \$ 41,657 | \$ 49,759 | \$ 45,343 | \$ (4,521) | \$ (6,310) | 125,928 |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
(UNAUDITED)

| (In Thousands) | Six Months Ended June 30, | |
|---|------------------------------|-----------|
| | 2013 | 2012 |
| OPERATING ACTIVITIES: | | |
| Net Income | \$ 7,343 | \$ 7,087 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 415 | 380 |
| Amortization of intangible assets | 31 | |
| Provision for loan losses | 1,075 | 1,200 |
| Accretion and amortization of investment security discounts and premiums | (117) | (605) |
| Securities gains, net | (2,260) | (759) |
| Originations of loans held for sale | (27,697) | (15,872) |
| Proceeds of loans held for sale | 26,715 | 16,689 |
| Gain on sale of loans | (653) | (526) |
| Earnings on bank-owned life insurance | (282) | (401) |
| (Increase) decrease in deferred tax asset | (162) | 216 |
| Other, net | 889 | (1,937) |
| Net cash provided by operating activities | 5,297 | 5,472 |
| INVESTING ACTIVITIES: | | |
| Investment securities available for sale: | | |
| Proceeds from sales | 42,910 | 18,014 |
| Proceeds from calls and maturities | 8,780 | 13,725 |
| Purchases | (63,942) | (49,670) |
| Investment securities held to maturity: | | |
| Proceeds from calls and maturities | | 55 |
| Net increase in loans | (23,666) | (30,287) |
| Acquisition of bank premises and equipment | (1,200) | (902) |
| Proceeds from the sale of foreclosed assets | | 698 |
| Purchase of bank-owned life insurance | (977) | (29) |
| Proceeds from bank-owned life insurance death benefit | | 383 |
| Proceeds from redemption of regulatory stock | 548 | 549 |
| Purchases of regulatory stock | (822) | |
| Acquisition, net of cash acquired | 17,487 | |
| Net cash used for investing activities | (20,882) | (47,464) |
| FINANCING ACTIVITIES: | | |
| Net increase in interest-bearing deposits | 22,754 | 53,095 |
| Net increase in noninterest-bearing deposits | 13,625 | 6,408 |
| Repayment of long-term borrowings, FHLB | (5,528) | |
| Net increase (decrease) in short-term borrowings | 3,030 | (11,743) |
| Dividends paid | (5,030) | (3,607) |
| Issuance of common stock | 31 | 27 |
| Net cash provided by financing activities | 28,882 | 44,180 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 13,297 | 2,188 |
| CASH AND CASH EQUIVALENTS, BEGINNING | 15,142 | 13,885 |
| CASH AND CASH EQUIVALENTS, ENDING | \$ 28,439 | \$ 16,073 |

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents**CONSOLIDATED STATEMENT OF CASH FLOWS (CONTINUED)**

| (In Thousands) | Six Months Ended June 30, | |
|---|------------------------------|----------|
| | 2013 | 2012 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Interest paid | \$ 2,523 | \$ 3,243 |
| Income taxes paid | 1,795 | 1,950 |
| Transfer of loans to foreclosed real estate | 26 | |
| Acquisition of Luzerne National Bank Corporation | | |
| Noncash assets acquired: | | |
| Federal funds sold | \$ 67 | |
| Securities available for sale | 21,783 | |
| Loans | 250,377 | |
| Premises and equipment, net | 8,014 | |
| Accrued interest receivable | 726 | |
| Bank-owned life insurance | 7,419 | |
| Intangibles | 2,015 | |
| Other assets | 2,636 | |
| Goodwill | 14,072 | |
| | 307,109 | |
| Liabilities assumed: | | |
| Deferred tax liability | 76 | |
| Interest-bearing deposits | 194,438 | |
| Noninterest-bearing deposits | 82,518 | |
| Short-term borrowings | 2,766 | |
| Accrued interest payable | 103 | |
| Other liabilities | 4,892 | |
| | 284,793 | |
| Net noncash assets acquired | 22,316 | |
| Cash acquired | \$ 20,296 | |

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents**PENNS WOODS BANCORP, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 1. Basis of Presentation**

The consolidated financial statements include the accounts of Penns Woods Bancorp, Inc. (the Company) and its wholly-owned subsidiaries: Woods Investment Company, Inc., Woods Real Estate Development Company, Inc., Luzerne Bank (Luzerne) and Jersey Shore State Bank (referred to together as the Bank) and Jersey Shore State Bank's wholly-owned subsidiary, The M Group, Inc. D/B/A The Comprehensive Financial Group (The M Group). All significant inter-company balances and transactions have been eliminated in the consolidation.

The interim financial statements are unaudited but, in the opinion of management, reflect all adjustments necessary for the fair presentation of results for such periods. The results of operations for any interim period are not necessarily indicative of results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

The accounting policies followed in the presentation of interim financial results are the same as those followed on an annual basis. These policies are presented on pages 35 through 39 of the Annual Report on Form 10-K for the year ended December 31, 2012.

In reference to the attached financial statements, all adjustments are of a normal recurring nature pursuant to Rule 10-01(b) (8) of Regulation S-X.

Note 2. Accumulated Other Comprehensive Income

The changes in accumulated other comprehensive income by component as of June 30, 2013 were as follows:

| (In Thousands) | Three Months Ended June 30, 2013 | | | Three Months Ended June 30, 2012 | | |
|--|--|-------------------------|----------|--|-------------------------|----------|
| | Net Unrealized Gain on Available for Sale Securities | Defined Benefit Plan | Total | Net Unrealized Gain on Available for Sale Securities | Defined Benefit Plan | Total |
| Balance, March 31 | \$ 8,516 | \$ (4,807) | \$ 3,709 | \$ 5,832 | \$ (4,133) | \$ 1,699 |
| Other comprehensive (loss) income before reclassifications | (7,389) | | (7,389) | 1,338 | | 1,338 |

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| | | | | |
|---|---------|------------|------------|----------|
| Amounts reclassified from accumulated other comprehensive (loss) income | (841) | (841) | (112) | (112) |
| Net current-period other comprehensive (loss) income | (8,230) | (8,230) | 1,226 | 1,226 |
| Balance, June 30 | \$ 286 | \$ (4,807) | \$ (4,521) | \$ 7,058 |
| | | | \$ (4,133) | \$ 2,925 |

| (In Thousands) | Six Months Ended June 30, 2013 | | | Six Months Ended June 30, 2012 | | |
|---|--|----------------------|------------|--|----------------------|------------|
| | Net Unrealized Gain on Available for Sale Securities | Defined Benefit Plan | Total | Net Unrealized Gain on Available for Sale Securities | Defined Benefit Plan | Total |
| Balance, December 31 | \$ 10,164 | \$ (4,807) | \$ 5,357 | \$ 2,914 | \$ (4,133) | \$ (1,219) |
| Other comprehensive (loss) income before reclassifications | (8,386) | | (8,386) | 4,645 | | 4,645 |
| Amounts reclassified from accumulated other comprehensive (loss) income | (1,492) | | (1,492) | (501) | | (501) |
| Net current-period other comprehensive (loss) income | (9,878) | | (9,878) | 4,144 | | 4,144 |
| Balance, June 30 | \$ 286 | \$ (4,807) | \$ (4,521) | \$ 7,058 | \$ (4,133) | \$ 2,925 |

The reclassifications out of accumulated other comprehensive income as of June 30, 2013 were as follows:

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(In Thousands)

| Details about Accumulated Other Comprehensive Income Components | Amount Reclassified from Accumulated Other Comprehensive Income | | Affected Line Item in the Consolidated Statement of Income |
|---|---|----------------------------------|--|
| | Three Months Ended June 30, 2013 | Three Months Ended June 30, 2012 | |
| Net unrealized gain on available for sale securities | \$ 1,274 | \$ 170 | Securities gains, net |
| | 433 | 58 | Income tax provision |
| Total reclassifications for the period | \$ 841 | \$ 112 | Net of tax |

(In Thousands)

| Details about Accumulated Other Comprehensive Income Components | Amount Reclassified from Accumulated Other Comprehensive Income | | Affected Line Item in the Consolidated Statement of Income |
|---|---|--------------------------------|--|
| | Six Months Ended June 30, 2013 | Six Months Ended June 30, 2012 | |
| Net unrealized gain on available for sale securities | \$ 2,260 | \$ 759 | Securities gains, net |
| | 768 | 258 | Income tax provision |
| Total reclassifications for the period | \$ 1,492 | \$ 501 | Net of tax |

Note 3. Recent Accounting Pronouncements

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*. The amendments in this update affect all entities that have financial instruments and derivative instruments that are either (1) offset in accordance with either Section 210-20-45 or Section 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement. The requirements amend the disclosure requirements on offsetting in Section 210-20-50. This information will enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements on an entity's financial position, including the effect or potential effect of rights of setoff associated with certain financial instruments and derivative instruments in the scope of this update. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. This ASU did not have a significant impact on the Company's financial statements.

In January 2013, the FASB issued ASU 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. The amendments clarify that the scope of Update 2011-11 applies to derivatives accounted for in accordance with Topic 815, *Derivatives and Hedging*, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. An entity is required to apply the amendments for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the required disclosures retrospectively for all comparative periods presented. The effective date is the same as the effective date of Update 2011-11. This ASU is not expected to have a significant impact on the Company's financial statements.

In February 2013, the FASB issued ASU 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. The amendments in this update require an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under U.S. generally accepted accounting principles (GAAP) to be reclassified in its entirety to net income. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under U.S. GAAP that provide additional detail about those amounts. For public entities, the amendments are effective

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prospectively for reporting periods beginning after December 15, 2012. The Company has provided the necessary disclosures in Note 2 - Accumulated Other Comprehensive Income.

Note 4. Per Share Data

There are no convertible securities which would affect the denominator in calculating basic and dilutive earnings per share. Net income as presented on the consolidated statement of income will be used as the numerator. The following table sets forth the composition of the weighted average common shares (denominator) used in the basic and dilutive earnings per share computation.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|-----------|---------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| Weighted average common shares issued | 4,331,631 | 4,018,175 | 4,176,312 | 4,017,987 |
| Average treasury stock shares | (180,596) | (180,596) | (180,596) | (180,596) |
| Weighted average common shares and common stock equivalents used to calculate basic and diluted earnings per share | 4,151,035 | 3,837,579 | 3,995,716 | 3,837,391 |

Note 5. Investment Securities

The amortized cost and fair values of investment securities at June 30, 2013 and December 31, 2012 are as follows:

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| (In Thousands) | June 30, 2013 | | | |
|---|----------------|------------------------|-------------------------|------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available for sale (AFS) | | | | |
| U.S. Government and agency securities | \$ 31,937 | \$ 870 | \$ (293) | \$ 32,514 |
| State and political securities | 164,477 | 4,611 | (4,687) | 164,401 |
| Other debt securities | 103,860 | 933 | (2,479) | 102,314 |
| Total debt securities | 300,274 | 6,414 | (7,459) | 299,229 |
| Financial institution equity securities | 9,810 | 1,515 | (4) | 11,321 |
| Other equity securities | 772 | | (33) | 739 |
| Total equity securities | 10,582 | 1,515 | (37) | 12,060 |
| Total investment securities AFS | \$ 310,856 | \$ 7,929 | \$ (7,496) | \$ 311,289 |

| (In Thousands) | December 31, 2012 | | | |
|---|-------------------|------------------------|-------------------------|------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available for sale (AFS) | | | | |
| U.S. Government and agency securities | \$ 24,475 | \$ 1,384 | \$ (19) | \$ 25,840 |
| State and political securities | 168,843 | 12,805 | (1,424) | 180,224 |
| Other debt securities | 70,108 | 1,750 | (259) | 71,599 |
| Total debt securities | 263,426 | 15,939 | (1,702) | 277,663 |
| Financial institution equity securities | 8,422 | 1,140 | (14) | 9,548 |
| Other equity securities | 2,068 | 74 | (37) | 2,105 |
| Total equity securities | 10,490 | 1,214 | (51) | 11,653 |
| Total investment securities AFS | \$ 273,916 | \$ 17,153 | \$ (1,753) | \$ 289,316 |

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at June 30, 2013 and December 31, 2012.

| (In Thousands) | June 30, 2013 | | | | | |
|---|-------------------------|-------------------------|--------------------------|-------------------------|------------|-------------------------|
| | Less than Twelve Months | | Twelve Months or Greater | | Total | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. Government and agency securities | \$ 15,150 | \$ (293) | \$ | \$ | \$ 15,150 | \$ (293) |
| State and political securities | 41,588 | (3,019) | 4,327 | (1,668) | 45,915 | (4,687) |
| Other debt securities | 60,578 | (2,457) | 728 | (22) | 61,306 | (2,479) |
| Total debt securities | 117,316 | (5,769) | 5,055 | (1,690) | 122,371 | (7,459) |
| Financial institution equity securities | | | 63 | (4) | 63 | (4) |
| Other equity securities | 739 | (33) | | | 739 | (33) |
| Total equity securities | 739 | (33) | 63 | (4) | 802 | (37) |
| Total | \$ 118,055 | \$ (5,802) | \$ 5,118 | \$ (1,694) | \$ 123,173 | \$ (7,496) |

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| (In Thousands) | Less than Twelve Months | | December 31, 2012 Twelve Months or Greater | | Total | |
|---|-------------------------|-------------------------|---|-------------------------|------------|-------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. Government and agency securities | \$ 910 | \$ (19) | \$ | \$ | \$ 910 | \$ (19) |
| State and political securities | 8,882 | (316) | 5,647 | (1,108) | 14,529 | (1,424) |
| Other debt securities | 11,250 | (189) | 3,727 | (70) | 14,977 | (259) |
| Total debt securities | 21,042 | (524) | 9,374 | (1,178) | 30,416 | (1,702) |
| Financial institution equity securities | 66 | (1) | 205 | (13) | 271 | (14) |
| Other equity securities | 701 | (28) | 63 | (9) | 764 | (37) |
| Total equity securities | 767 | (29) | 268 | (22) | 1,035 | (51) |
| Total | \$ 21,809 | \$ (553) | \$ 9,642 | \$ (1,200) | \$ 31,451 | \$ (1,753) |

At June 30, 2013 there were a total of 182 and 13 individual securities that were in a continuous unrealized loss position for less than twelve months and twelve months or greater, respectively.

The Company reviews its position quarterly and has determined that, at June 30, 2013, the declines outlined in the above table represent temporary declines and the Company does not intend to sell and does not believe it will be required to sell these securities before recovery of their cost basis, which may be at maturity. The Company has concluded that the unrealized losses disclosed above are not other than temporary but are the result of interest rate changes, sector credit ratings changes, or company-specific ratings changes that are not expected to result in the non-collection of principal and interest during the period.

The amortized cost and fair value of debt securities at June 30, 2013, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In Thousands) | Amortized Cost | Fair Value |
|-----------------------------------|----------------|------------|
| Due in one year or less | \$ 6,180 | \$ 6,197 |
| Due after one year to five years | 41,234 | 41,746 |
| Due after five years to ten years | 87,544 | 85,721 |
| Due after ten years | 165,316 | 165,565 |
| Total | \$ 300,274 | \$ 299,229 |

Total gross proceeds from sales of securities available for sale were \$42,910,000 and \$18,014,000, for the six months ended June 30, 2013 and 2012, respectively. The following table represents gross realized gains and losses on those transactions:

| (In Thousands) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|------|---------------------------|--------|
| | 2013 | 2012 | 2013 | 2012 |
| Gross realized gains: | | | | |
| U.S. Government and agency securities | \$ | \$ | \$ | \$ 138 |
| State and political securities | 1,062 | 45 | 1,641 | 51 |
| Other debt securities | 178 | 22 | 299 | 77 |
| Financial institution equity securities | | 106 | 130 | 461 |

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| | | | | | | |
|---|----|-------|----|-----|----|-------|
| Other equity securities | | 34 | | 250 | | 126 |
| Total gross realized gains | \$ | 1,274 | \$ | 173 | \$ | 2,320 |
| | | | | | \$ | 853 |
| Gross realized losses: | | | | | | |
| U.S. Government and agency securities | \$ | | \$ | | \$ | |
| State and political securities | | | 2 | 60 | | 2 |
| Other debt securities | | | | | | |
| Financial institution equity securities | | | 1 | | | 67 |
| Other equity securities | | | | | | 25 |
| Total gross realized losses | \$ | | \$ | 3 | \$ | 60 |
| | | | | | \$ | 94 |

There were no impairment charges included in gross realized losses for the three and six months ended June 30, 2013 and 2012, respectively.

Table of Contents**Note 6. Federal Home Loan Bank Stock**

Jersey Shore State Bank and Luzerne are both members of the Federal Home Loan Bank (FHLB) of Pittsburgh and as such, are required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. The stock is bought from and sold to the FHLB based upon its \$100 par value. The stock does not have a readily determinable fair value and as such is classified as restricted stock, carried at cost and evaluated for impairment as necessary. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance (c) the impact of legislative and regulatory changes on the customer base of the FHLB and (d) the liquidity position of the FHLB.

Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein. More consideration was given to the long-term prospects for the FHLB as opposed to the recent stress caused by the extreme economic conditions the world is facing. Management also considered that the FHLB maintains regulatory capital ratios in excess of all regulatory capital requirements, liquidity appears adequate, new shares of FHLB stock continue to change hands at the \$100 par value, and the resumption of dividends.

Note 7. Credit Quality and Related Allowance for Loan Losses

Management segments the Bank's loan portfolio to a level that enables risk and performance monitoring according to similar risk characteristics. Loans are segmented based on the underlying collateral characteristics. Categories include commercial and agricultural, real estate, and installment loans to individuals. Real estate loans are further segmented into three categories: residential, commercial and construction.

The following table presents the related aging categories of loans, by segment, as of June 30, 2013 and December 31, 2012:

| (In Thousands) | Current | Past Due 30 To 89 Days | June 30, 2013 Past Due 90 Days Or More & Still Accruing | Non- Accrual | Total |
|--------------------------------------|------------|------------------------------|--|-----------------|------------|
| Commercial and agricultural | \$ 118,303 | \$ 78 | \$ | \$ 572 | \$ 118,953 |
| Real estate mortgage: | | | | | |
| Residential | 338,083 | 1,779 | 8 | 1,106 | 340,976 |
| Commercial | 292,728 | 137 | | 3,664 | 296,529 |
| Construction | 15,193 | 1 | | 1,165 | 16,359 |
| Installment loans to individuals | 14,753 | 352 | | | 15,105 |
| | 779,060 | \$ 2,347 | \$ 8 | \$ 6,507 | 787,922 |
| Net deferred loan fees and discounts | (961) | | | | (961) |
| Allowance for loan losses | (9,404) | | | | (9,404) |
| Loans, net | \$ 768,695 | | | | \$ 777,557 |

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| (In Thousands) | Current | December 31, 2012 | | Non-Accrual | Total |
|--------------------------------------|------------|------------------------|---|-------------|------------|
| | | Past Due 30 To 89 Days | Past Due 90 Days Or More & Still Accruing | | |
| Commercial and agricultural | \$ 48,322 | \$ 133 | \$ | \$ | \$ 48,455 |
| Real estate mortgage: | | | | | |
| Residential | 245,674 | 4,888 | 351 | 1,229 | 252,142 |
| Commercial | 177,539 | 443 | | 4,049 | 182,031 |
| Construction | 13,813 | 177 | | 6,077 | 20,067 |
| Installment loans to individuals | 10,550 | 109 | | | 10,659 |
| | 495,898 | \$ 5,750 | \$ 351 | \$ 11,355 | 513,354 |
| Net deferred loan fees and discounts | (1,122) | | | | (1,122) |
| Allowance for loan losses | (7,617) | | | | (7,617) |
| Loans, net | \$ 487,159 | | | | \$ 504,615 |

Purchased loans acquired are recorded at fair value on their purchase date without a carryover of the related allowance for loan losses.

Upon acquisition, the Company evaluated whether each acquired loan (regardless of size) was within the scope of ASC 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased credit-impaired loans are loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. There were no material increases or decreases in the expected cash flows of these loans between June 1, 2013 (the acquisition date) and June 30, 2013. The fair value of purchased credit-impaired loans, on the acquisition date, was determined, primarily based on the fair value of loan collateral. The carrying value of purchased loans acquired with deteriorated credit quality was \$882,000 at June 30, 2013.

On the acquisition date, the preliminary estimate of the unpaid principal balance for all loans evidencing credit impairment acquired in the Luzerne acquisition was \$1,211,000 and the estimated fair value of the loans was \$878,000. Total contractually required payments on these loans, including interest, at the acquisition date was \$1,783,000. However, the Company's preliminary estimate of expected cash flows was \$941,000. At such date, the Company established a credit risk related non-accretable discount (a discount representing amounts which are not expected to be collected from the customer nor liquidation of collateral) of \$842,000 relating to these impaired loans, reflected in the recorded net fair value. Such amount is reflected as a non-accretable fair value adjustment to loans. The Company further estimated the timing and amount of expected cash flows in excess of the estimated fair value and established an accretable discount of \$63,000 on the acquisition date relating to these impaired loans.

The carrying value of the loans acquired and accounted for in accordance with ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, was determined by projecting discounted contractual cash flows. The table below presents the components of the purchase accounting adjustments related to the purchased impaired loans acquired in the Luzerne acquisition as of June 1, 2013:

| (In Thousands) | |
|--------------------------|----------|
| Unpaid principal balance | \$ 1,211 |
| Interest | 572 |
| Contractual cash flows | 1,783 |
| Non-accretable discount | (842) |
| Expected cash flows | 941 |
| Accretable discount | (63) |

| | | |
|----------------------|----|-----|
| Estimated fair value | \$ | 878 |
|----------------------|----|-----|

Changes in the amortizable yield for purchased credit-impaired loans were as follows for the month ended June 30, 2013:

(In Thousands)

| | | |
|--------------------------------|----|-----|
| Balance at beginning of period | \$ | 63 |
| Accretion | | (4) |
| Balance at end of period | \$ | 59 |

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

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| (In Thousands) | June 1, 2013 Acquired Loans with Specific Evidence of Deterioration in Credit Quality (ASC 310-30) | June 30, 2013 Acquired Loans with Specific Evidence of Deterioration in Credit Quality (ASC 310-30) |
|---------------------|--|---|
| Outstanding balance | \$ 1,211 | \$ 1,211 |
| Carrying amount | 878 | 882 |

The following table presents the interest income if interest had been recorded based on the original loan agreement terms and rate of interest for non-accrual loans and interest income recognized on a cash basis for non-accrual loans for the three and six months ended June 30, 2013 and 2012:

| (In Thousands) | Three Months Ended June 30, | | | |
|-----------------------------|--|---|--|---|
| | 2013 | | | 2012 |
| | Interest Income That Would Have Been Recorded Based on Original Term and Rate | Interest Income Recorded on a Cash Basis | Interest Income That Would Have Been Recorded Based on Original Term and Rate | Interest Income Recorded on a Cash Basis |
| Commercial and agricultural | \$ 4 | \$ | \$ | \$ |
| Real estate mortgage: | | | | |
| Residential | 22 | 3 | 4 | 7 |
| Commercial | 31 | 34 | 22 | 5 |
| Construction | 40 | 14 | 105 | 25 |
| | \$ 97 | \$ 51 | \$ 131 | \$ 37 |

| (In Thousands) | Six Months Ended June 30, | | | |
|-----------------------------|--|---|--|---|
| | 2013 | | | 2012 |
| | Interest Income That Would Have Been Recorded Based on Original Term and Rate | Interest Income Recorded on a Cash Basis | Interest Income That Would Have Been Recorded Based on Original Term and Rate | Interest Income Recorded on a Cash Basis |
| Commercial and agricultural | \$ 4 | \$ | \$ | \$ |
| Real estate mortgage: | | | | |
| Residential | 54 | 12 | 12 | 13 |
| Commercial | 116 | 84 | 43 | 8 |
| Construction | 81 | 25 | 221 | 56 |
| | \$ 255 | \$ 121 | \$ 276 | \$ 77 |

Impaired Loans

Impaired loans are loans for which it is probable the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Bank evaluates such loans for impairment individually and does not aggregate loans by major risk classifications. The definition of impaired loans is not the same as the definition of non-accrual loans, although the two categories overlap. The Bank may choose to place a loan on non-accrual status due to payment delinquency or uncertain collectability, while not classifying the loan as impaired. A loan evaluated for impairment is considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status and collateral value. The amount of impairment for these types of loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value, or as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loan. When foreclosure is probable, impairment is measured based on the fair value of the collateral.

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan is greater than \$100,000 and if the loan is either on non-accrual status or has a risk rating of substandard. Management may also elect to measure an individual loan for impairment if less than \$100,000 on a case by case basis.

Mortgage loans on one-to-four family properties and all consumer loans are large groups of smaller-balance homogeneous loans and are measured for impairment collectively. Loans that experience insignificant payment delays, which are defined as 90 days or less,

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generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis taking into consideration all circumstances surrounding the loan and the borrower including the length of the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed. Interest income for impaired loans is recorded consistent with the Bank's policy on nonaccrual loans.

The following table presents the recorded investment, unpaid principal balance, and related allowance of impaired loans by segment as of June 30, 2013 and December 31, 2012:

| (In Thousands) | Recorded Investment | June 30, 2013 Unpaid Principal Balance | Related Allowance |
|-------------------------------------|------------------------|--|----------------------|
| With no related allowance recorded: | | | |
| Commercial and agricultural | \$ 303 | \$ 439 | \$ |
| Real estate mortgage: | | | |
| Residential | 986 | 1,151 | |
| Commercial | 1,436 | 1,436 | |
| Construction | 539 | 539 | |
| | 3,264 | 3,565 | |
| With an allowance recorded: | | | |
| Commercial and agricultural | 556 | 556 | 319 |
| Real estate mortgage: | | | |
| Residential | 892 | 1,021 | 302 |
| Commercial | 7,155 | 7,174 | 2,139 |
| Construction | 638 | 2,993 | 267 |
| | 9,241 | 11,744 | 3,027 |
| Total: | | | |
| Commercial and agricultural | 859 | 995 | 319 |
| Real estate mortgage: | | | |
| Residential | 1,878 | 2,172 | 302 |
| Commercial | 8,591 | 8,610 | 2,139 |
| Construction | 1,177 | 3,532 | 267 |
| | \$ 12,505 | \$ 15,309 | \$ 3,027 |

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| (In Thousands) | Recorded Investment | December 31, 2012 Unpaid Principal Balance | Related Allowance |
|-------------------------------------|------------------------|--|----------------------|
| With no related allowance recorded: | | | |
| Commercial and agricultural | \$ | \$ | \$ |
| Real estate mortgage: | | | |
| Residential | 410 | 487 | |
| Commercial | 324 | 324 | |
| Construction | 2,894 | 4,599 | |
| | 3,628 | 5,410 | |
| With an allowance recorded: | | | |
| Commercial and agricultural | 485 | 485 | 46 |
| Real estate mortgage: | | | |
| Residential | 1,146 | 1,255 | 237 |
| Commercial | 8,515 | 8,611 | 2,018 |
| Construction | 3,196 | 4,696 | 234 |
| | 13,342 | 15,047 | 2,535 |
| Total: | | | |
| Commercial and agricultural | 485 | 485 | 46 |
| Real estate mortgage: | | | |
| Residential | 1,556 | 1,742 | 237 |
| Commercial | 8,839 | 8,935 | 2,018 |
| Construction | 6,090 | 9,295 | 234 |
| | \$ 16,970 | \$ 20,457 | \$ 2,535 |

The following table presents the average recorded investment in impaired loans and related interest income recognized for the three and six months ended for June 30, 2013 and 2012:

| (In Thousands) | Three Months Ended June 30, | | | | | |
|-----------------------------|--|---|---|--|---|---|
| | Average Investment in Impaired Loans | 2013 Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans | Average Investment in Impaired Loans | 2012 Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans |
| Commercial and agricultural | \$ 718 | \$ 7 | \$ | \$ | \$ | \$ |
| Real estate mortgage: | | | | | | |
| Residential | 1,679 | 9 | 6 | 1,277 | 12 | 6 |
| Commercial | 8,491 | 46 | 38 | 6,488 | 93 | 5 |
| Construction | 2,532 | 14 | 14 | 8,419 | 26 | 26 |
| | \$ 13,420 | \$ 62 | \$ 58 | \$ 16,184 | \$ 105 | \$ 37 |

| (In Thousands) | Six Months Ended June 30, | | | | | |
|-----------------------------|--|---|---|--|---|---|
| | Average Investment in Impaired Loans | 2013 Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans | Average Investment in Impaired Loans | 2012 Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans |
| Commercial and agricultural | \$ 615 | \$ 13 | \$ | \$ | \$ | \$ |
| Real estate mortgage: | | | | | | |

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| | | | | | | |
|--------------|-----------|--------|--------|-----------|--------|-------|
| Residential | 1,618 | 17 | 11 | 1,386 | 25 | 29 |
| Commercial | 8,598 | 93 | 84 | 6,502 | 161 | 8 |
| Construction | 3,718 | 553 | 553 | 8,861 | | 56 |
| | \$ 14,549 | \$ 676 | \$ 648 | \$ 16,749 | \$ 186 | \$ 93 |

There is approximately \$126,000 committed to be advanced in connection with impaired loans.

Modifications

The loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring (TDR), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These

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concessions typically result from loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

Loan modifications that are considered TDRs completed during the three and six months ended June 30, 2013 and 2012 were as follows:

| (In Thousands, Except Number of Contracts) | Number of Contracts | 2013 | | 2012 | | |
|--|---------------------|--|---|--|---|-------|
| | | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | |
| Three Months Ended June 30, | | | | | | |
| Real estate mortgage: | | | | | | |
| Residential | 2 | \$ 61 | \$ 61 | 1 | \$ 49 | \$ 49 |
| Commercial | | | | | | |
| Construction | 2 | \$ 61 | \$ 61 | 1 | \$ 49 | \$ 49 |

| (In Thousands, Except Number of Contracts) | Number of Contracts | 2013 | | 2012 | | |
|--|---------------------|--|---|--|---|--------|
| | | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | |
| Six Months Ended June 30, | | | | | | |
| Real estate mortgage: | | | | | | |
| Residential | 2 | \$ 61 | \$ 61 | 2 | \$ 154 | \$ 154 |
| Commercial | 2 | 264 | 264 | 1 | 37 | 37 |
| Construction | | | | 2 | 26 | 26 |
| | 4 | \$ 325 | \$ 325 | 5 | \$ 217 | \$ 217 |

There were two loan modifications considered troubled debt restructurings made during the twelve months previous to June 30, 2013 that defaulted during the six months ended June 30, 2013. The loans that defaulted are commercial real estate loans that are currently in litigation with a recorded investment of \$259,000 at June 30, 2013.

Troubled debt restructurings amounted to \$10,961,000 and \$16,217,000 as of June 30, 2013 and December 31, 2012.

Internal Risk Ratings

Management uses a ten point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first six 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

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corrected. All loans greater than 90 days past due are considered Substandard. Loans in the doubtful category exhibit the same weaknesses found in the substandard loans, however, the weaknesses are more pronounced. Such loans are static and collection in full is improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Loans classified loss are considered uncollectible and charge-off is imminent.

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 category unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. An external annual loan review of all commercial relationships \$800,000 or greater is performed, as well as a sample of smaller transactions. Confirmation of the appropriate risk category is included in the review. Detailed reviews, including plans for resolution, are performed on loans classified as Substandard, Doubtful, or Loss on a quarterly basis.

The following table presents the credit quality categories identified above as of June 30, 2013 and December 31, 2012:

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| (In Thousands) | June 30, 2013 | | | | | | Totals |
|-----------------|--------------------------------|-------------|-----------------------|-----------|--------------|-------------------------------------|--------|
| | Commercial and Agricultural | Residential | Real Estate Mortgages | | Construction | Installment Loans to Individuals | |
| Pass | \$ 111,182 | \$ 339,476 | \$ 278,576 | \$ 12,790 | \$ 15,105 | \$ 757,129 | |
| Special Mention | 7,390 | | 5,349 | | | 12,739 | |
| Substandard | 381 | 1,500 | 12,604 | 3,569 | | 18,054 | |
| | \$ 118,953 | \$ 340,976 | \$ 296,529 | \$ 16,359 | \$ 15,105 | \$ 787,922 | |

| (In Thousands) | December 31, 2012 | | | | | | Totals |
|-----------------|--------------------------------|-------------|-----------------------|-----------|--------------|-------------------------------------|--------|
| | Commercial and Agricultural | Residential | Real Estate Mortgages | | Construction | Installment Loans to Individuals | |
| Pass | \$ 46,805 | \$ 250,161 | \$ 167,463 | \$ 13,944 | \$ 10,659 | \$ 489,032 | |
| Special Mention | 1,480 | | 1,630 | | | 3,110 | |
| Substandard | 170 | 1,981 | 12,938 | 6,123 | | 21,212 | |
| | \$ 48,455 | \$ 252,142 | \$ 182,031 | \$ 20,067 | \$ 10,659 | \$ 513,354 | |

Allowance for Loan Losses

An allowance for loan losses (ALL) is maintained to absorb losses from the loan portfolio. The ALL is based on management's continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated future loss experience, and the amount of non-performing loans.

The Bank's methodology for determining the ALL is based on the requirements of ASC Section 310-10-35 for loans individually evaluated for impairment (previously discussed) and ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as the Interagency Policy Statements on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Bank's ALL.

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. Allowances are segmented based on collateral characteristics previously disclosed, and consistent with credit quality monitoring. Loans that are collectively evaluated for impairment are grouped into two classes for evaluation. A general allowance is determined for Pass rated credits, while a separate pool allowance is provided for Criticized rated credits that are not individually evaluated for impairment.

For the general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors. A historical charge-off factor is calculated utilizing a twelve quarter moving average. Management has identified a number of additional qualitative factors which it uses to supplement the historical charge-off factor because these factors are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors that are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources are: national and local economic trends and conditions; levels of and trends in delinquency rates and non-accrual loans; trends in volumes and terms of loans; effects of changes in lending policies; experience, ability, and depth of lending staff; value of underlying collateral; and concentrations of credit from a loan type, industry and/or geographic standpoint.

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Loans in the criticized pools, which possess certain qualities or characteristics that may lead to collection and loss issues, are closely monitored by management and subject to additional qualitative factors. Management also monitors industry loss factors by loan segment for applicable adjustments to actual loss experience.

Management reviews the loan portfolio on a quarterly basis in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL.

There has been no allowance for loan losses recorded for acquired loans with or without specific evidence of deterioration in credit quality as of June 1, 2013 as well as those acquired without specific evidence of deterioration in credit quality as of June 30, 2013.

Activity in the allowance is presented for the three and six months ended June 30, 2013 and 2012:

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| (In Thousands) | Three Months Ended June 30, 2013 | | | | | | | Totals |
|-------------------|----------------------------------|-------------|-----------------------|--------|--------------|----------------------------------|-------------|--------|
| | Commercial and Agricultural | Residential | Real Estate Mortgages | | Construction | Installment Loans to Individuals | Unallocated | |
| Beginning Balance | \$ 568 | \$ 2,772 | \$ 3,759 | \$ 814 | \$ 144 | \$ 773 | \$ 8,830 | |
| Charge-offs | | | (6) | | (25) | | (31) | |
| Recoveries | 11 | 4 | 5 | | 10 | | 30 | |
| Provision | (39) | 269 | 230 | 29 | 12 | 74 | 575 | |
| Ending Balance | \$ 540 | \$ 3,045 | \$ 3,988 | \$ 843 | \$ 141 | \$ 847 | \$ 9,404 | |

| (In Thousands) | Three Months Ended June 30, 2012 | | | | | | | Totals |
|-------------------|----------------------------------|-------------|-----------------------|----------|--------------|----------------------------------|-------------|--------|
| | Commercial and Agricultural | Residential | Real Estate Mortgages | | Construction | Installment Loans to Individuals | Unallocated | |
| Beginning Balance | \$ 396 | \$ 882 | \$ 3,276 | \$ 2,719 | \$ 175 | \$ 297 | \$ 7,745 | |
| Charge-offs | | (11) | (18) | (877) | (19) | | (925) | |
| Recoveries | 5 | 1 | 1 | 1 | 10 | | 18 | |
| Provision | (46) | 88 | (95) | 296 | 3 | 354 | 600 | |
| Ending Balance | \$ 355 | \$ 960 | \$ 3,164 | \$ 2,139 | \$ 169 | \$ 651 | \$ 7,438 | |

| (In Thousands) | Six Months Ended June 30, 2013 | | | | | | | Totals |
|-------------------|--------------------------------|-------------|-----------------------|--------|--------------|----------------------------------|-------------|--------|
| | Commercial and Agricultural | Residential | Real Estate Mortgages | | Construction | Installment Loans to Individuals | Unallocated | |
| Beginning Balance | \$ 361 | \$ 1,954 | \$ 3,831 | \$ 950 | \$ 144 | \$ 377 | \$ 7,617 | |
| Charge-offs | | (134) | (6) | | (50) | | (190) | |
| Recoveries | 13 | 5 | 6 | 850 | 28 | | 902 | |
| Provision | 166 | 1,220 | 157 | (957) | 19 | 470 | 1,075 | |
| Ending Balance | \$ 540 | \$ 3,045 | \$ 3,988 | \$ 843 | \$ 141 | \$ 847 | \$ 9,404 | |

| (In Thousands) | Six Months Ended June 30, 2012 | | | | | | | Totals |
|-------------------|--------------------------------|-------------|-----------------------|----------|--------------|----------------------------------|-------------|--------|
| | Commercial and Agricultural | Residential | Real Estate Mortgages | | Construction | Installment Loans to Individuals | Unallocated | |
| Beginning Balance | \$ 418 | \$ 939 | \$ 2,651 | \$ 2,775 | \$ 190 | \$ 181 | \$ 7,154 | |
| Charge-offs | | (11) | (18) | (877) | (51) | | (957) | |
| Recoveries | 6 | 3 | 2 | 4 | 26 | | 41 | |
| Provision | (69) | 29 | 529 | 237 | 4 | 470 | 1,200 | |
| Ending Balance | \$ 355 | \$ 960 | \$ 3,164 | \$ 2,139 | \$ 169 | \$ 651 | \$ 7,438 | |

The Company grants commercial, industrial, residential, and installment loans to customers throughout north-east and central Pennsylvania. Although the Company has a diversified loan portfolio at June 30, 2013, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within this region.

The Company has a concentration of loans at June 30, 2013 and 2012 as follows:

| | | |
|------|----------|------|
| | June 30, | |
| 2013 | | 2012 |

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| | | |
|---|--------|--------|
| Owners of residential rental properties | 14.71% | 13.52% |
| Owners of commercial rental properties | 14.15% | 15.25% |

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment based on impairment method as of June 30, 2013 and December 31, 2012:

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| (In Thousands) | June 30, 2013 | | | | | | Totals |
|---|-----------------------------|-------------|-----------------------|-----------|--------------|----------------------------------|------------|
| | Commercial and Agricultural | Residential | Real Estate Mortgages | | Construction | Installment Loans to Individuals | |
| Allowance for Loan Losses: | | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | | |
| Individually evaluated for impairment | \$ 319 | \$ 302 | \$ 2,139 | \$ 267 | \$ | \$ | \$ 3,027 |
| Collectively evaluated for impairment | 221 | 2,743 | 1,849 | 576 | 141 | 847 | 6,377 |
| Total ending allowance balance | \$ 540 | \$ 3,045 | \$ 3,988 | \$ 843 | \$ 141 | \$ 847 | \$ 9,404 |
| Loans: | | | | | | | |
| Individually evaluated for impairment | \$ 556 | \$ 1,558 | \$ 8,332 | \$ 1,177 | \$ | \$ | \$ 11,623 |
| Loans acquired with deteriorated credit quality | 303 | 320 | 259 | | | | 882 |
| Collectively evaluated for impairment | 118,094 | 339,098 | 287,938 | 15,182 | 15,105 | | 775,417 |
| Total ending loans balance | \$ 118,953 | \$ 340,976 | \$ 296,529 | \$ 16,359 | \$ 15,105 | \$ | \$ 787,922 |

| (In Thousands) | December 31, 2012 | | | | | | Totals |
|---|-----------------------------|-------------|-----------------------|-----------|--------------|----------------------------------|------------|
| | Commercial and Agricultural | Residential | Real Estate Mortgages | | Construction | Installment Loans to Individuals | |
| Allowance for Loan Losses: | | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | | |
| Individually evaluated for impairment | \$ 46 | \$ 237 | \$ 2,018 | \$ 234 | \$ | \$ | \$ 2,535 |
| Collectively evaluated for impairment | 315 | 1,717 | 1,813 | 716 | 144 | 377 | 5,082 |
| Total ending allowance balance | \$ 361 | \$ 1,954 | \$ 3,831 | \$ 950 | \$ 144 | \$ 377 | \$ 7,617 |
| Loans: | | | | | | | |
| Individually evaluated for impairment | \$ 485 | \$ 1,556 | \$ 8,839 | \$ 6,090 | \$ | \$ | \$ 16,970 |
| Collectively evaluated for impairment | 47,970 | 250,586 | 173,192 | 13,977 | 10,659 | | 496,384 |
| Total ending loans balance | \$ 48,455 | \$ 252,142 | \$ 182,031 | \$ 20,067 | \$ 10,659 | \$ | \$ 513,354 |

Note 8. Net Periodic Benefit Cost-Defined Benefit Plans

For a detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 12 of the Company's Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2012.

The following sets forth the components of the net periodic benefit cost of the domestic non-contributory defined benefit plan for the three months ended June 30, 2013 and 2012, respectively:

Three Months Ended

Six Months Ended

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| (In Thousands) | June 30, | | June 30, | |
|---------------------------------------|----------|--------|----------|--------|
| | 2013 | 2012 | 2013 | 2012 |
| Service cost | \$ 159 | \$ 156 | \$ 318 | \$ 313 |
| Interest cost | 193 | 186 | 386 | 372 |
| Expected return on plan assets | (246) | (195) | (492) | (391) |
| Amortization of transition obligation | | | | (1) |
| Amortization of prior service cost | 6 | 6 | 13 | 13 |
| Amortization of net loss | 120 | 109 | 239 | 218 |
| Net periodic cost | \$ 232 | \$ 262 | \$ 464 | \$ 524 |

Employer Contributions

The Company previously disclosed in its consolidated financial statements, included in the Annual Report on Form 10-K for the year ended December 31, 2012, that it expected to contribute a minimum of \$400,000 to its defined benefit plan in 2013. As of June 30, 2013, there were contributions of \$430,000 made to the plan with additional contributions of at least \$175,000 anticipated during the remainder of 2013.

Note 9. Employee Stock Purchase Plan

The Company maintains an Employee Stock Purchase Plan (Plan). The Plan is intended to encourage employee participation in the ownership and economic progress of the Company. The Plan allows for up to 1,000,000 shares to be purchased by employees. The purchase price of the shares is 95% of market value with an employee eligible to purchase up to the lesser of 15% of base compensation or \$12,000 in market value annually. During the six months ended June 30, 2013 and 2012, there were 792 and 709 shares issued under the plan, respectively.

Table of Contents**Note 10. Off Balance Sheet Risk**

The Company 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 are primarily comprised of commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit, interest rate, or liquidity risk in excess of the amount recognized in the consolidated balance sheet. The contract amounts of these instruments express the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company may require collateral or other security to support financial instruments with off-balance sheet credit risk.

Financial instruments whose contract amounts represent credit risk are as follows at June 30, 2013 and December 31, 2012:

| (In Thousands) | June 30, 2013 | December 31, 2012 |
|------------------------------|---------------|-------------------|
| Commitments to extend credit | \$ 169,959 | \$ 90,503 |
| Standby letters of credit | 4,935 | 3,768 |

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, on an extension of credit is based on management's credit assessment of the counterparty.

Standby letters of credit represent conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These instruments are issued primarily to support bid or performance related contracts. The coverage period for these instruments is typically a one year period with an annual renewal option subject to prior approval by management. Fees earned from the issuance of these letters are recognized upon expiration of the coverage period. For secured letters of credit, the collateral is typically Bank deposit instruments or customer business assets.

Note 11. Fair Value Measurements

The following disclosures show the hierarchal disclosure framework associated with the level of pricing observations utilized in measuring assets and liabilities at fair value.

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- Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.
- Level II: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.
- Level III: Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

This hierarchy requires the use of observable market data when available.

The following table presents the assets reported on the balance sheet at their fair value on a recurring basis as of June 30, 2013 and December 31, 2012, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

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| (In Thousands) | June 30, 2013 | | | | Total |
|--|---------------|----------|-----------|---------|------------|
| | Level I | Level II | Level III | | |
| Assets measured on a recurring basis: | | | | | |
| Investment securities, available for sale: | | | | | |
| U.S. Government and agency securities | \$ | \$ | 32,514 | \$ | \$ 32,514 |
| State and political securities | | | 164,401 | | 164,401 |
| Other debt securities | | | 102,314 | | 102,314 |
| Financial institution equity securities | | 11,321 | | | 11,321 |
| Other equity securities | | 739 | | | 739 |
| Total assets measured on a recurring basis | \$ | 12,060 | \$ | 299,229 | \$ 311,289 |

| (In Thousands) | December 31, 2012 | | | | Total |
|--|-------------------|----------|-----------|---------|------------|
| | Level I | Level II | Level III | | |
| Assets measured on a recurring basis: | | | | | |
| Investment securities, available for sale: | | | | | |
| U.S. Government and agency securities | \$ | \$ | 25,840 | \$ | \$ 25,840 |
| State and political securities | | | 180,224 | | 180,224 |
| Other debt securities | | | 71,599 | | 71,599 |
| Financial institution equity securities | | 9,548 | | | 9,548 |
| Other equity securities | | 2,105 | | | 2,105 |
| Total assets measured on a recurring basis | \$ | 11,653 | \$ | 277,663 | \$ 289,316 |

The following table presents the assets reported on the consolidated balance sheet at their fair value on a non-recurring basis as of June 30, 2013 and December 31, 2012, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| (In Thousands) | June 30, 2013 | | | | Total |
|--|---------------|----------|-----------|----|--------|
| | Level I | Level II | Level III | | |
| Assets measured on a non-recurring basis: | | | | | |
| Impaired loans | \$ | \$ | | \$ | 9,478 |
| Other real estate owned | | | | | 1,560 |
| Total assets measured on a non-recurring basis | \$ | \$ | | \$ | 11,038 |

| (In Thousands) | December 31, 2012 | | | | Total |
|--|-------------------|----------|-----------|----|--------|
| | Level I | Level II | Level III | | |
| Assets measured on a non-recurring basis: | | | | | |
| Impaired loans | \$ | \$ | | \$ | 14,435 |
| Other real estate owned | | | | | 1,449 |
| Total assets measured on a non-recurring basis | \$ | \$ | | \$ | 15,884 |

The following table provides a listing of significant unobservable inputs used in the fair value measurement process for items valued utilizing level III techniques as of June 30, 2013 and December 31, 2012:

| (In Thousands) | Fair Value | June 30, 2013 | | | Weighted Average |
|----------------|------------|--|---------------------|-------|------------------|
| | | Quantitative Information About Level III Fair Value Measurements | Unobservable Inputs | Range | |
| | | Valuation Technique(s) | | | |

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| | | | | | | |
|-------------------------|----|-------|-----------------------------|---------------------------------------|------------|------|
| Impaired loans | \$ | 9,478 | Discounted cash flow | Temporary reduction in payment amount | 0 to -100% | -27% |
| | | | | Probability of default | 0% | |
| | | | | Appraisal adjustments | | |
| | | | Appraisal of collateral | (1) | 0 to -44% | -15% |
| Other real estate owned | \$ | 1,560 | Appraisal of collateral (1) | | | |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

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| December 31, 2012 | | | | | |
|-------------------------|------------|--|---------------------------------------|-----------|------------------|
| (In Thousands) | Fair Value | Quantitative Information About Level III Fair Value Measurements | | | |
| | | Valuation Technique(s) | Unobservable Inputs | Range | Weighted Average |
| Impaired loans | \$ 14,435 | Discounted cash flow | Temporary reduction in payment amount | 0 to -55% | -27% |
| | | | Probability of default | 0% | |
| | | Appraisal of collateral | Appraisal adjustments (1) | 0 to -20% | -11% |
| Other real estate owned | \$ 1,449 | Appraisal of collateral (1) | | | |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

The significant unobservable inputs used in the fair value measurement of the Company's impaired loans using the discounted cash flow valuation technique include temporary changes in payment amounts and the probability of default. Significant increases (decreases) in payment amounts would result in significantly higher (lower) fair value measurements. The probability of default is 0% for impaired loans using the discounted cash flow valuation technique because all defaulted impaired loans are valued using the appraisal of collateral valuation technique.

The significant unobservable input used in the fair value measurement of the Company's impaired loans using the appraisal of collateral valuation technique include appraisal adjustments, which are adjustments to appraisals by management for qualitative factors such as economic conditions and estimated liquidation expenses. The significant unobservable input used in the fair value measurement of the Company's other real estate owned are the same inputs used to value impaired loans using the appraisal of collateral valuation technique.

Note 12. Fair Value of Financial Instruments

The Company is required to disclose fair values for its financial instruments. Fair values are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Also, it is the Company's general practice and intention to hold most of its financial instruments to maturity and not to engage in trading or sales activities. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These fair values are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions can significantly affect the fair values.

Fair values have been determined by the Company using historical data and an estimation methodology suitable for each category of financial instruments. The Company's fair values, methods, and assumptions are set forth below for the Company's other financial instruments.

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As certain assets and liabilities, such as deferred tax assets, premises and equipment, and many other operational elements of the Company, are not considered financial instruments but have value, this fair value of financial instruments would not represent the full market value of the Company.

The fair values of the Company's financial instruments are as follows at June 30, 2013 and December 31, 2012:

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| (In Thousands) | Fair Value Measurements at June 30, 2013 | | | | |
|-------------------------------|--|------------|--|--|---|
| | Carrying Value | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level I) | Significant Other Observable Inputs (Level II) | Significant Unobservable Inputs (Level III) |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 28,439 | \$ 28,439 | \$ 28,439 | \$ | \$ |
| Investment securities: | | | | | |
| Available for sale | 311,289 | 311,289 | 12,060 | 299,229 | |
| Loans held for sale | 5,409 | 5,409 | 5,409 | | |
| Loans, net | 777,557 | 774,344 | | | 774,344 |
| Bank-owned life insurance | 25,022 | 25,022 | 25,022 | | |
| Accrued interest receivable | 4,999 | 4,999 | 4,999 | | |
| Financial liabilities: | | | | | |
| Interest-bearing deposits | \$ 744,265 | \$ 723,925 | \$ 484,783 | \$ | \$ 239,142 |
| Noninterest-bearing deposits | 211,096 | 211,096 | 211,096 | | |
| Short-term borrowings | 39,000 | 39,000 | 39,000 | | |
| Long-term borrowings, FHLB | 70,750 | 73,067 | | | 73,067 |
| Accrued interest payable | 442 | 442 | 442 | | |

| (In Thousands) | Fair Value Measurements at December 31, 2012 | | | | |
|-------------------------------|--|------------|--|--|---|
| | Carrying Value | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level I) | Significant Other Observable Inputs (Level II) | Significant Unobservable Inputs (Level III) |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 15,142 | \$ 15,142 | \$ 15,142 | \$ | \$ |
| Investment securities: | | | | | |
| Available for sale | 289,316 | 289,316 | 11,653 | 277,663 | |
| Loans held for sale | 3,774 | 3,774 | 3,774 | | |
| Loans, net | 504,615 | 506,406 | | | 506,406 |
| Bank-owned life insurance | 16,362 | 16,362 | 16,362 | | |
| Accrued interest receivable | 4,099 | 4,099 | 4,099 | | |
| Financial liabilities: | | | | | |
| Interest-bearing deposits | \$ 527,073 | \$ 530,485 | \$ 359,979 | \$ | \$ 170,506 |
| Noninterest-bearing deposits | 114,953 | 114,953 | 114,953 | | |
| Short-term borrowings | 33,204 | 33,204 | 33,204 | | |
| Long-term borrowings, FHLB | 76,278 | 80,772 | | | 80,772 |
| Accrued interest payable | 366 | 366 | 366 | | |

Cash and Cash Equivalents, Loans Held for Sale, Accrued Interest Receivable, Short-term Borrowings, and Accrued Interest Payable:

The fair value is equal to the carrying value.

Investment Securities:

The fair value of investment securities available for sale and held to maturity is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities. Regulatory stocks fair value is equal to the carrying value.

Loans:

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial and agricultural, commercial real estate, residential real estate, construction real estate, and installment loans to individuals. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions.

Fair value for significant nonperforming loans is based on recent external appraisals. If appraisals are not available, estimated cash

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flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discounted rates are judgmentally determined using available market information and specific borrower information.

Bank-Owned Life Insurance:

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

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW, and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows.

The fair value estimates above do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

Long Term Borrowings:

The fair value of long term borrowings is based on the discounted value of contractual cash flows.

Commitments to Extend Credit, Standby Letters of Credit, and Financial Guarantees Written:

There is no material difference between the notional amount and the estimated fair value of off-balance sheet items. The contractual amounts of unfunded commitments and letters of credit are presented in Note 10 (Off Balance Sheet Risk).

Note 13. Reclassification of Comparative Amounts

Certain comparative amounts for the prior period have been reclassified to conform to current period presentations. Such reclassifications had no effect on net income or shareholders' equity.

Note 14. Acquisition of Luzerne National Bank Corporation

On June 1, 2013, the Company closed on a merger transaction pursuant to which Penns Woods Bancorp, Inc. acquired Luzerne National Bank Corporation in a stock and cash transaction. The acquisition extended the Company's footprint into Luzerne and Lackawanna Counties, Pennsylvania.

Luzerne National Bank Corporation was the holding company for Luzerne Bank, a Pennsylvania bank that conducted its business from a main office in Luzerne, Pennsylvania with eight branch offices in Luzerne County and one loan production office in Lackawanna County, all in northeastern Pennsylvania.

Under the terms of the merger agreement, the Company acquired all of the outstanding shares of Luzerne National Bank Corporation for a total purchase price of approximately \$42,612,000. As a result of the acquisition, the Company issued 978,977 common shares, or 20.31% of the total shares outstanding as of June 30, 2013, to former shareholders of Luzerne National Bank Corporation. Luzerne Bank is operating as an independent bank under the Penns Woods Bancorp, Inc. umbrella.

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 Luzerne Bank. Real estate acquired through foreclosure was primarily valued based on appraised collateral values. The Company also recorded an identifiable intangible asset representing the core deposit base of Luzerne Bank based on management's evaluation of the cost of such deposits relative to alternative funding sources. The Company also recorded an identifiable intangible asset representing the trade name of Luzerne Bank based on management's evaluation of the value of the name in the market. 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. Luzerne Bank's 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 \$1,211,000 of purchased credit-impaired loans subject to a non-accretable difference of \$842,000. 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.

Luzerne'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, Luzerne's loan portfolio without evidence of deterioration totaled \$249,789,000 and was recorded at a fair value of \$249,500,000.

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The following table summarizes the purchase of Luzerne National Bank Corporation as of June 1, 2013:

(In Thousands, Except Per Share Data)

| Purchase Price Consideration in Common Stock | | | |
|--|----|---------|---------------|
| Luzerne National Bank Corporation common shares settled for stock | | 630,216 | |
| Exchange Ratio | | 1.5534 | |
| Penns Woods Bancorp, Inc. shares issued | | 978,977 | |
| Value assigned to Penns Woods Bancorp, Inc. common share | \$ | 40.59 | |
| Purchase price assigned to Luzerne National Bank Corporation common shares exchanged for Penns Woods Bancorp, Inc. | | | \$ 39,736 |
| Purchase Price Consideration - Cash for Common Stock | | | |
| Luzerne National Bank Corporation shares exchanged for cash | | 46,480 | |
| Purchase price paid to each Luzerne National Bank Corporation common share exchanged for cash | \$ | 61.86 | |
| Purchase price assigned to Luzerne National Bank Corporation common shares exchanged for cash | | | 2,876 |
| Total Purchase Price | | | 42,612 |
| Net Assets Acquired: | | | |
| Luzerne National Bank Corporation shareholders' equity | \$ | 27,371 | |
| Adjustments to reflect assets acquired at fair value: | | | |
| Investments | | 33 | |
| Loans | | | |
| Interest rate | | 2,680 | |
| General credit | | (3,206) | |
| Specific credit - non-amortizing | | (58) | |
| Specific credit - amortizing | | (40) | |
| Core deposit intangible | | 1,882 | |
| Trade name intangible | | 133 | |
| Owned premises | | 1,138 | |
| Leased premises contracts | | 122 | |
| Deferred tax assets | | (603) | |
| Adjustments to reflect liabilities acquired at fair value: | | | |
| Time deposits | | (912) | |
| | | | 28,540 |
| Goodwill resulting from merger | \$ | | 14,072 |

The following condensed statement reflects the values assigned to Luzerne National Bank Corporation's net assets as of the acquisition date:

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| | | | |
|--|----|-----------|--------|
| Total purchase price | | \$ | 42,612 |
| Net assets acquired: | | | |
| Cash | \$ | 20,296 | |
| Federal funds sold | | 67 | |
| Securities available for sale | | 21,783 | |
| Loans | | 250,377 | |
| Premises and equipment, net | | 8,014 | |
| Accrued interest receivable | | 726 | |
| Bank-owned life insurance | | 7,419 | |
| Intangibles | | 2,015 | |
| Deferred tax liability | | (76) | |
| Other assets | | 2,636 | |
| Time deposits | | (79,223) | |
| Deposits other than time deposits | | (197,733) | |
| Borrowings | | (2,766) | |
| Accrued interest payable | | (103) | |
| Other liabilities | | (4,892) | |
| | | | 28,540 |
| Goodwill resulting from Luzerne National Bank Corporation Merger | | \$ | 14,072 |

The Company recorded goodwill and other intangibles associated with the purchase of Luzerne National Bank Corporation totaling \$16,086,000. Goodwill is not amortized, but is periodically evaluated for impairment. The Company did not recognize any impairment during the six months ended June 30, 2013. The carrying amount of the goodwill at June 30, 2013 related to the Luzerne acquisition was \$14,072,000.

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 six months ended June 30, 2013, no such adjustments were recorded. The identifiable intangible assets consist of a core deposit intangible and trade name intangible which are being amortized on an accelerated basis over the useful life of such assets. The gross carrying amount of the core deposit intangible and trade name intangible at June 30, 2013 was \$1,882,000 and \$132,000, respectively, with \$29,000 and \$2,000 accumulated amortization as of that date.

As of June 30, 2013, the current year and estimated future amortization expense for the core deposit and trade name intangible was:

(In Thousands)

| | | |
|------|----|-------|
| 2013 | \$ | 214 |
| 2014 | | 345 |
| 2015 | | 308 |
| 2016 | | 272 |
| 2017 | | 235 |
| 2018 | | 198 |
| 2019 | | 162 |
| 2020 | | 125 |
| 2021 | | 89 |
| 2022 | | 52 |
| 2023 | | 15 |
| | \$ | 2,015 |

Results of operations for Luzerne National Bank Corporation prior to the acquisition date are not included in the Consolidated Statement of Income for the three and six month periods ended June 30, 2013. Due to the significant amount of fair value adjustments, historical results of Luzerne National Bank Corporation 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 Luzerne National Bank Corporation operations included in our Consolidated Statement of Income from the date of acquisition through June 30, 2013 under the column Actual from acquisition date through June 30, 2013. In addition, the following table presents unaudited pro forma information as if the acquisition of

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Luzerne National Bank Corporation had occurred on January 1, 2012 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 proforma 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.

| (In Thousands, Except Per Share Data) | Actual from Acquisition Date Through June 30, 2013 | Pro Formas | |
|---------------------------------------|---|-----------------------------------|-----------|
| | | Six Months Ended June 30, 2013 | 2012 |
| Net interest income | \$ 1,049 | \$ 21,546 | \$ 20,771 |
| Non-interest income | 137 | 7,090 | 5,995 |
| Net income | 299 | 6,212 | 8,292 |
| Pro forma earnings per share: | | | |
| Basic | \$ | 1.29 | \$ 1.72 |
| Diluted | | 1.29 | 1.72 |

CAUTIONARY STATEMENT FOR PURPOSES OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Report contains certain forward-looking statements including statements concerning plans, objectives, future events or performance and assumptions and other statements which are other than statements of historical fact. The Company cautions readers that the following important factors, among others, may have affected and could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward-looking statement made by or on behalf of the Company herein: (i) the effect of changes in laws and regulations, including federal and state banking laws and regulations, with which the Company must comply, and the associated costs of compliance with such laws and regulations either currently or in the future as applicable; (ii) the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies as well as by the Financial Accounting Standards Board, or of changes in the Company's organization, compensation and benefit plans; (iii) the effect on the Company's competitive position within its market area of the increasing consolidation within the banking and financial services industries, including the increased competition from larger regional and out-of-state banking organizations as well as non-bank providers of various financial services; (iv) the effect of changes in interest rates; (v) the effect of changes in the business cycle and downturns in the local, regional or national economies; and (vi) our ability to successfully integrate the business of Luzerne.

You should not put undue reliance on any forward-looking statements. These statements speak only as of the date of this Quarterly Report on Form 10-Q, even if subsequently made available by the Company on its website or otherwise. The Company undertakes no obligation to update or revise these statements to reflect events or circumstances occurring after the date of this Quarterly Report on Form 10-Q.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

EARNINGS SUMMARY

Comparison of the Three and Six Months Ended June 30, 2013 and 2012

Summary Results

Net income for the three months ended June 30, 2013 was \$3,659,000 compared to \$3,398,000 for the same period of 2012 as after-tax securities gains increased \$729,000 (from a gain of \$112,000 to a gain of \$841,000). The results for the three months ended June 30, 2013 were negatively impacted by \$535,000 in expenses related to the acquisition of Luzerne. Basic and diluted earnings per share for the three months ended June 30, 2013 and 2012 were \$0.88 and \$0.89, respectively. Return on average assets and return on average equity were 1.48% and 13.54% for the three months ended June 30, 2013 compared to 1.67% and 15.48% for the corresponding period of 2012. Net income from core operations (operating earnings) decreased to \$2,818,000 for the three months ended June 30, 2013 compared to \$3,286,000 for the same period of 2012. Operating earnings per share for the three months ended June 30, 2013 were \$0.68 basic and dilutive compared to \$0.86 basic and dilutive for the three months ended June 30, 2012.

The six months ended June 30, 2013 generated net income of \$7,343,000 compared to \$7,087,000 for the same period of 2012. Comparable results were impacted by an increase in after-tax securities gains of \$991,000 (from a gain of \$501,000 to a gain of \$1,492,000). In addition, a gain of \$109,000 on death benefit related to bank owned life insurance was recorded during the six months ended June 30, 2012. The results for the six months ended June 30, 2013 were negatively impacted by \$623,000 in expenses related to the acquisition of Luzerne. Earnings per share, basic and dilutive, for the six months ended June 30, 2013 were \$1.84 compared to \$1.85 for the comparable period of 2012. Return on average assets and return on average equity were 1.59% and 14.45% for the six months ended June 30, 2013 compared to 1.78% and 16.42% for the corresponding period of 2012. Operating earnings decreased to \$5,851,000 for the six months ended June 30, 2013 compared to \$6,477,000 for the comparable period of 2012. Operating earnings per share for the six months ended June 30, 2013 were \$1.46 basic and dilutive compared to \$1.69 basic and dilutive for the six months ended June 30, 2012.

Management uses the non-GAAP measure of net income from core operations, or operating earnings, in its analysis of the Company's performance. This measure, as used by the Company, adjusts net income by excluding significant gains or losses that are unusual in nature. Because certain of these items and their impact on the Company's performance are difficult to predict, management believes the presentation of financial measures excluding the impact of such items provides useful supplemental information in evaluating the operating results of the Company's core businesses. For purposes of this Quarterly Report on Form 10-Q, net income from core operations, or operating earnings, means net income adjusted to exclude after-tax net securities gains or losses and bank-owned life insurance gains on death benefit. These disclosures should not be viewed as a substitute for net income determined in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies.

Reconciliation of GAAP and Non-GAAP Financial Measures

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| (Dollars in Thousands, Except Per Share Data) | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|----------|------------------------------|----------|
| | 2013 | 2012 | 2013 | 2012 |
| GAAP net income | \$ 3,659 | \$ 3,398 | \$ 7,343 | \$ 7,087 |
| Less: net securities and bank-owned life insurance gains, net of tax | 841 | 112 | 1,492 | 610 |
| Non-GAAP operating earnings | \$ 2,818 | \$ 3,286 | \$ 5,851 | \$ 6,477 |

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-------|------------------------------|-------|
| | 2013 | 2012 | 2013 | 2012 |
| Return on average assets (ROA) | 1.48% | 1.67% | 1.59% | 1.78% |
| Less: net securities and bank-owned life insurance gains, net of tax | 0.34% | 0.06% | 0.33% | 0.15% |
| Non-GAAP operating ROA | 1.14% | 1.61% | 1.26% | 1.63% |

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|--------|------------------------------|--------|
| | 2013 | 2012 | 2013 | 2012 |
| Return on average equity (ROE) | 13.54% | 15.48% | 14.45% | 16.42% |
| Less: net securities and bank-owned life insurance gains, net of tax | 3.11% | 0.51% | 2.93% | 1.42% |
| Non-GAAP operating ROE | 10.43% | 14.97% | 11.52% | 15.00% |

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| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|--|--------------------------------|------|------|------|------------------------------|------|------|------|
| | 2013 | | 2012 | | 2013 | | 2012 | |
| Basic earnings per share (EPS) | \$ | 0.88 | \$ | 0.89 | \$ | 1.84 | \$ | 1.85 |
| Less: net securities and bank-owned life insurance gains, net of tax | | 0.20 | | 0.03 | | 0.38 | | 0.16 |
| Non-GAAP basic operating EPS | \$ | 0.68 | \$ | 0.86 | \$ | 1.46 | \$ | 1.69 |

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|--|--------------------------------|------|------|------|------------------------------|------|------|------|
| | 2013 | | 2012 | | 2013 | | 2012 | |
| Dilutive EPS | \$ | 0.88 | \$ | 0.89 | \$ | 1.84 | \$ | 1.85 |
| Less: net securities and bank-owned life insurance gains, net of tax | | 0.20 | | 0.03 | | 0.38 | | 0.16 |
| Non-GAAP dilutive operating EPS | \$ | 0.68 | \$ | 0.86 | \$ | 1.46 | \$ | 1.69 |

Interest and Dividend Income

Interest and dividend income for the three months ended June 30, 2013 increased to \$10,018,000 compared to \$9,280,000 for the same period of 2012. The increase was due to loan portfolio income increasing as the impact of portfolio growth offset a reduction in yield of 84 basis points (bp) due to the competitive landscape and the continued low rate environment that is impacting new loan rates as well as the variable rate segment of the loan portfolio. The loan portfolio income increase was partially offset by a decrease in investment portfolio interest due to a decline in the average taxable equivalent yield of 57 bp.

During the six months ended June 30, 2013, interest and dividend income was \$19,558,000, an increase of \$993,000 over the same period in 2012. Interest income on the loan portfolio increased as the growth in the portfolio was countered by a 67 bp decline in average yield. The investment portfolio interest income decreased as the increase in portfolio size was more than offset by the decline in yield.

Interest and dividend income composition for the three and six months ended June 30, 2013 and 2012 was as follows:

| (In Thousands) | June 30, 2013 | | For The Three Months Ended June 30, 2012 | | Change | |
|------------------------------------|---------------|---------|---|---------|--------|---------|
| | Amount | % Total | Amount | % Total | Amount | % |
| Loans including fees | \$ 7,277 | 72.64% | \$ 6,294 | 67.82% | \$ 983 | 15.62% |
| Investment securities: | | | | | | |
| Taxable | 1,507 | 15.04 | 1,517 | 16.35 | (10) | (0.66) |
| Tax-exempt | 1,162 | 11.60 | 1,383 | 14.90 | (221) | (15.98) |
| Dividend and other interest income | 72 | 0.72 | 86 | 0.93 | (14) | (16.28) |
| Total interest and dividend income | \$ 10,018 | 100.00% | \$ 9,280 | 100.00% | \$ 738 | 7.95% |

| June 30, 2013 | For The Six Months Ended June 30, 2012 | Change |
|---------------|---|--------|
|---------------|---|--------|

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| (In Thousands) | Amount | % Total | Amount | % Total | Amount | % |
|------------------------------------|-----------|---------|-----------|---------|----------|---------|
| Loans including fees | \$ 14,045 | 71.81% | \$ 12,608 | 67.91% | \$ 1,437 | 11.40% |
| Investment securities: | | | | | | |
| Taxable | 2,950 | 15.08 | 2,991 | 16.11 | (41) | (1.37) |
| Tax-exempt | 2,429 | 12.42 | 2,788 | 15.02 | (359) | (12.88) |
| Dividend and other interest income | 134 | 0.69 | 178 | 0.96 | (44) | (24.72) |
| Total interest and dividend income | \$ 19,558 | 100.00% | \$ 18,565 | 100.00% | \$ 993 | 5.35% |

Interest Expense

Interest expense for the three months ended June 30, 2013 decreased \$318,000 to \$1,264,000 compared to \$1,582,000 for the same period of 2012. The substantial decrease associated with deposits is primarily the result of a reduction of 40 and 23 bps in the rate paid on time deposits and money markets, respectively, and a continued shift from higher cost time deposits to core deposits, with emphasis on money market and NOW accounts. Factors that led to the rate decreases include, but are not limited to, Federal Open Market Committee (FOMC) actions to maintain low interest rates and campaigns conducted by the Company to focus on core deposit (non-time deposit) growth as the building block to solid customer relationships. In addition, during the past two years the time deposit portfolio has been shortened in order to increase repricing frequency. The time deposit portfolio is now slowly being lengthened to build protection when interest rates begin to increase. In addition, the Marcellus Shale natural gas exploration in north

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central Pennsylvania is creating opportunities to gather new and build upon existing deposit relationships. Borrowing interest expense decreased as FHLB long-term borrowings have matured and have been replaced at rates less than 1% with maturities ranging from four to five years.

Interest expense for the six months ended June 30, 2013 decreased 18.71% from the same period of 2012. The reasons noted for the decline in interest expense for the three month period comparison also apply to the six month period.

Interest expense composition for the three and six months ended June 30, 2013 and 2012 was as follows:

| (In Thousands) | June 30, 2013 | | For the Three Months Ended June 30, 2012 | | Change | |
|-------------------------------|---------------|---------|---|---------|----------|----------|
| | Amount | % Total | Amount | % Total | Amount | % |
| Deposits | \$ 760 | 60.13% | \$ 934 | 59.04% | \$ (174) | (18.63)% |
| Short-term borrowings | 22 | 1.74 | 28 | 1.77 | (6) | (21.43) |
| Long-term borrowings, FHLB | 482 | 38.13 | 620 | 39.19 | (138) | (22.26) |
| Total interest expense | \$ 1,264 | 100.00% | \$ 1,582 | 100.00% | \$ (318) | (20.10)% |

| (In Thousands) | June 30, 2013 | | For the Six Months Ended June 30, 2012 | | Change | |
|-------------------------------|---------------|---------|---|---------|----------|----------|
| | Amount | % Total | Amount | % Total | Amount | % |
| Deposits | \$ 1,551 | 59.68% | \$ 1,895 | 59.27% | \$ (344) | (18.15)% |
| Short-term borrowings | 47 | 1.81 | 62 | 1.94 | (15) | (24.19) |
| Long-term borrowings, FHLB | 1,001 | 38.51 | 1,240 | 38.79 | (239) | (19.27) |
| Total interest expense | \$ 2,599 | 100.00% | \$ 3,197 | 100.00% | \$ (598) | (18.71)% |

Net Interest Margin

The net interest margin (NIM) for the three months ended June 30, 2013 was 4.09% compared to 4.47% for the corresponding period of 2012. The NIM declined as a 34 bp decline in the rate paid on interest bearing liabilities was countered by a 66 bp decline in the yield on interest earning assets. The decrease in earning asset yield is due to the impact of the current low rate environment on the loan and investment portfolios. In addition, the duration of the investment portfolio has been shortened by utilizing variable rate and intermediate term corporate bonds to offset the relatively longer duration of the municipal bonds within the portfolio. This shortening of the investment portfolio limits current earnings due to the low rates on the short end of the interest rate curve, but it also limits interest rate risk and will provide cash flow over the next few years as we anticipate a period of increasing rates. The decrease in the cost of interest bearing liabilities from 1.05% to 0.71% was driven by a reduction in the rate paid on time deposits of 40 bp. The reduction in the rate paid on time deposits was the result of shortening the time deposit portfolio, which has resulted in an increasing repricing frequency during this period of low rates. In addition, a focus on increasing core deposits has resulted in significant growth in lower cost core deposits. The duration of the time deposit portfolio has slowly started to be lengthened due to the apparent bottoming or near bottoming of deposit rates. The average rate on long-term borrowings declined due to the maturity of FHLB borrowings during 2012 and 2013 coupled with the addition of \$30,000,000 in borrowings with terms ranging from four to five years at rates less than 1% during the second half of 2012.

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The NIM for the six months ended June 30, 2013 was 4.26% compared to 4.59% for the same period of 2012. The impact of the items mentioned in the three month discussion also applies to the six month period. A 35 bp decline in the rate paid on time deposits served as the foundation for a 21 bp decline in the rate paid on deposits, while the FOMC and general market actions affected the yield on earning assets and cost of borrowings.

The following is a schedule of average balances and associated yields for the three and six months ended June 30, 2013 and 2012:

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| (In Thousands) | AVERAGE BALANCES AND INTEREST RATES | | | AVERAGE BALANCES AND INTEREST RATES | | |
|---|-------------------------------------|----------|--------------|-------------------------------------|----------|--------------|
| | Three Months Ended June 30, 2013 | | | Three Months Ended June 30, 2012 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| Assets: | | | | | | |
| Tax-exempt loans | \$ 21,480 | \$ 249 | 4.65% | \$ 21,621 | \$ 298 | 5.54% |
| All other loans | 596,206 | 7,113 | 4.79% | 435,918 | 6,097 | 5.63% |
| Total loans | 617,686 | 7,362 | 4.78% | 457,539 | 6,395 | 5.62% |
| Fed funds sold | 98 | | 0.00% | | | 0.00% |
| Taxable securities | 178,827 | 1,573 | 3.52% | 163,294 | 1,601 | 3.92% |
| Tax-exempt securities | 119,655 | 1,761 | 5.89% | 130,313 | 2,095 | 6.43% |
| Total securities | 298,482 | 3,334 | 4.47% | 293,607 | 3,696 | 5.04% |
| Interest-bearing deposits | 8,339 | 6 | 0.29% | 13,285 | 2 | 0.06% |
| Total interest-earning assets | 924,605 | 10,702 | 4.64% | 764,431 | 10,093 | 5.30% |
| Other assets | 65,956 | | | 50,251 | | |
| Total assets | \$ 990,561 | | | \$ 814,682 | | |
| Liabilities and shareholders equity: | | | | | | |
| Savings | \$ 107,027 | 27 | 0.10% | \$ 79,465 | 16 | 0.08% |
| Super Now deposits | 149,635 | 171 | 0.46% | 120,066 | 153 | 0.51% |
| Money market deposits | 172,228 | 129 | 0.30% | 152,858 | 202 | 0.53% |
| Time deposits | 191,046 | 433 | 0.91% | 172,431 | 563 | 1.31% |
| Total interest-bearing deposits | 619,936 | 760 | 0.49% | 524,820 | 934 | 0.72% |
| Short-term borrowings | 21,777 | 22 | 0.40% | 17,222 | 28 | 0.65% |
| Long-term borrowings, FHLB | 71,237 | 482 | 2.68% | 61,278 | 620 | 4.00% |
| Total borrowings | 93,014 | 504 | 2.14% | 78,500 | 648 | 3.27% |
| Total interest-bearing liabilities | 712,950 | 1,264 | 0.71% | 603,320 | 1,582 | 1.05% |
| Demand deposits | 153,840 | | | 112,683 | | |
| Other liabilities | 15,652 | | | 10,889 | | |
| Shareholders equity | 108,120 | | | 87,790 | | |
| Total liabilities and shareholders equity | \$ 990,562 | | | \$ 814,682 | | |
| Interest rate spread | | | 3.93% | | | 4.25% |
| Net interest income/margin | | \$ 9,438 | 4.09% | | \$ 8,511 | 4.47% |

- Information on this table has been calculated using average daily balance sheets to obtain average balances.
- Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.

3. Income and rates on a fully taxable equivalent basis include an adjustment for the difference between annual income from tax-exempt obligations and the taxable equivalent of such income at the standard 34% tax rate.

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| (In Thousands) | AVERAGE BALANCES AND INTEREST RATES | | | | | |
|---|-------------------------------------|-----------|--------------|-----------------------------------|-----------|--------------|
| | Six Months Ended June 30, 2013 | | | Six Months Ended June 30, 2012 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| Assets: | | | | | | |
| Tax-exempt loans | \$ 21,860 | \$ 498 | 4.59% | \$ 21,574 | \$ 607 | 5.66% |
| All other loans | 546,033 | 13,716 | 5.07% | 429,040 | 12,207 | 5.72% |
| Total loans | 567,893 | 14,214 | 5.05% | 450,614 | 12,814 | 5.72% |
| Fed funds sold | 49 | | 0.00% | | | 0.00% |
| Taxable securities | 170,226 | 3,076 | 3.61% | 155,247 | 3,167 | 4.08% |
| Tax-exempt securities | 123,543 | 3,680 | 5.96% | 130,452 | 4,224 | 6.48% |
| Total securities | 293,769 | 6,756 | 4.60% | 285,699 | 7,391 | 5.17% |
| Interest-bearing deposits | 6,024 | 8 | 0.27% | 7,660 | 2 | 0.05% |
| Total interest-earning assets | 867,735 | 20,978 | 4.86% | 743,973 | 20,207 | 5.45% |
| Other assets | 57,369 | | | 50,517 | | |
| Total assets | \$ 925,104 | | | \$ 794,490 | | |
| Liabilities and shareholders equity: | | | | | | |
| Savings | \$ 95,848 | 52 | 0.11% | \$ 76,546 | 27 | 0.07% |
| Super Now deposits | 143,509 | 344 | 0.48% | 114,218 | 295 | 0.52% |
| Money market deposits | 158,374 | 264 | 0.34% | 140,122 | 407 | 0.58% |
| Time deposits | 181,443 | 891 | 0.99% | 174,754 | 1,166 | 1.34% |
| Total interest-bearing deposits | 579,174 | 1,551 | 0.54% | 505,640 | 1,895 | 0.75% |
| Short-term borrowings | 21,574 | 47 | 0.44% | 19,640 | 62 | 0.63% |
| Long-term borrowings, FHLB | 73,550 | 1,001 | 2.71% | 61,278 | 1,240 | 4.00% |
| Total borrowings | 95,124 | 1,048 | 2.19% | 80,918 | 1,302 | 3.18% |
| Total interest-bearing liabilities | 674,298 | 2,599 | 0.77% | 586,558 | 3,197 | 1.09% |
| Demand deposits | 135,035 | | | 110,382 | | |
| Other liabilities | 14,164 | | | 11,216 | | |
| Shareholders equity | 101,607 | | | 86,334 | | |
| Total liabilities and shareholders equity | \$ 925,104 | | | \$ 794,490 | | |
| Interest rate spread | | | 4.09% | | | 4.36% |
| Net interest income/margin | | \$ 18,379 | 4.26% | | \$ 17,010 | 4.59% |

- Information on this table has been calculated using average daily balance sheets to obtain average balances.
- Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.

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3. Income and rates on a fully taxable equivalent basis include an adjustment for the difference between annual income from tax-exempt obligations and the taxable equivalent of such income at the standard 34% tax rate.

The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the three and six months ended June 30, 2013 and 2012.

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| (In Thousands) | For the Three Months Ended June 30, | | | For the Six Months Ended June 30, | | |
|--|--|----------|----|--------------------------------------|-----------|----|
| | 2013 | 2012 | | 2013 | 2012 | |
| Total interest income | \$ 10,018 | \$ 9,280 | \$ | \$ 19,558 | \$ 18,565 | \$ |
| Total interest expense | 1,264 | 1,582 | | 2,599 | 3,197 | |
| Net interest income | 8,754 | 7,698 | | 16,959 | 15,368 | |
| Tax equivalent adjustment | 684 | 813 | | 1,420 | 1,642 | |
| Net interest income (fully taxable equivalent) | \$ 9,438 | \$ 8,511 | \$ | \$ 18,379 | \$ 17,010 | \$ |

The following table sets forth the respective impact that both volume and rate changes have had on net interest income on a fully taxable equivalent basis for the three and six months ended June 30, 2013 and 2012:

| (In Thousands) | Three Months Ended June 30, 2013 vs. 2012 | | | Six Months Ended June 30, 2013 vs. 2012 | | |
|------------------------------------|--|----------|---------|--|------------|----------|
| | Volume | Rate | Net | Volume | Rate | Net |
| Interest income: | | | | | | |
| Tax-exempt loans | \$ (2) | \$ (47) | \$ (49) | \$ 8 | \$ (117) | \$ (109) |
| All other loans | 2,032 | (1,016) | 1,016 | 3,017 | (1,508) | 1,509 |
| Fed funds sold | | | | | | |
| Taxable investment securities | 145 | (173) | (28) | 287 | (378) | (91) |
| Tax-exempt investment securities | (164) | (170) | (334) | (218) | (326) | (544) |
| Interest bearing deposits | (1) | 5 | 4 | | 6 | 6 |
| Total interest-earning assets | 2,010 | (1,401) | 609 | 3,094 | (2,323) | 771 |
| Interest expense: | | | | | | |
| Savings deposits | 7 | 4 | 11 | 8 | 17 | 25 |
| Super Now deposits | 35 | (17) | 18 | 70 | (21) | 49 |
| Money market deposits | 74 | (147) | (73) | 148 | (291) | (143) |
| Time deposits | 57 | (187) | (130) | 44 | (319) | (275) |
| Short-term borrowings | 6 | (12) | (6) | 3 | (18) | (15) |
| Long-term borrowings, FHLB | 89 | (227) | (138) | 301 | (540) | (239) |
| Total interest-bearing liabilities | 268 | (586) | (318) | 574 | (1,172) | (598) |
| Change in net interest income | \$ 1,742 | \$ (815) | \$ 927 | \$ 2,520 | \$ (1,151) | \$ 1,369 |

Provision for Loan Losses

The provision for loan losses is based upon management's quarterly review of the loan portfolio. The purpose of the review is to assess loan quality, identify impaired loans, analyze delinquencies, ascertain loan growth, evaluate potential charge-offs and recoveries, and assess general economic conditions in the markets served. An external independent loan review is also performed annually for the Bank. Management remains committed to an aggressive program of problem loan identification and resolution.

The allowance for loan losses is determined by applying loss factors to outstanding loans by type, excluding loans for which a specific allowance has been determined. Loss factors are based on management's consideration of the nature of the portfolio segments, changes in mix and volume of the loan portfolio, and historical loan loss experience. In addition, management considers industry standards and trends with

respect to non-performing loans and its knowledge and experience with specific lending segments.

Although management believes it uses the best information available to make such determinations and that the allowance for loan losses is adequate at June 30, 2013, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy, increased unemployment, and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets, charge-offs, loan loss provisions, and reductions in income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Bank's loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

When determining the appropriate allowance level, management has attributed the allowance for loan losses to various portfolio segments; however, the allowance is available for the entire portfolio as needed.

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The allowance for loan losses increased from \$7,617,000 at December 31, 2012 to \$9,404,000 at June 30, 2013. The increase in the allowance for loan losses was augmented by net loan recoveries of \$712,000 for the six month period ended June 30, 2013. The primary driver of the loan recoveries for the period was one large recovery of a construction real-estate loan that supplemented the provision for loan losses during the six months ended June 30, 2013. At June 30, 2013 and December 31, 2012, the allowance for loan losses to total loans was 1.19% and 1.49%, respectively. The ratio was impacted by the growth in the loan portfolio due to the acquisition of Luzerne and the related purchase accounting adjustments.

The provision for loan losses totaled \$575,000 and \$600,000 for the three months ended June 30, 2013 and 2012 and \$1,075,000 and \$1,200,000 for the six months ended June 30, 2013 and 2012. The amount of the provision for loan losses was the result of several factors, including but not limited to, a ratio of nonperforming loans to total loans of 0.83% at June 30, 2013 and a ratio of the allowance for loan losses to nonperforming loans of 144.34% at June 30, 2013. The large increase in the provision for residential real estate loans was due to the growth of the home equity portfolio while the large decrease in the provision for construction real estate loans was due to a large recovery.

Nonperforming loans decreased to \$6,515,000 at June 30, 2013 from \$8,725,000 at June 30, 2012 due to several partial charge-offs and the payoff of a large construction loan that was on nonaccrual. Internal loan review and analysis and the continued uncertainty surrounding the economy, coupled with the ratios noted previously, dictated that the provision for loan losses was at a level of \$1,075,000 for the six months ended June 30, 2013. The change in level of provision for loan losses did not equate to the change in nonperforming loans due to the economic situation and substantial growth in the loan portfolio.

The following is a table showing total nonperforming loans as of:

| (In Thousands) | Total Nonperforming Loans | | |
|--------------------|---------------------------|------------|----------|
| | 90 Days Past Due | Nonaccrual | Total |
| June 30, 2013 | \$ 8 | \$ 6,507 | \$ 6,515 |
| March 31, 2013 | 37 | 9,022 | 9,059 |
| December 31, 2012 | 351 | 11,355 | 11,706 |
| September 30, 2012 | 654 | 11,387 | 12,041 |
| June 30, 2012 | | 8,725 | 8,725 |

Non-interest Income

Total non-interest income for the three months ended June 30, 2013 compared to the same period in 2012 increased \$1,254,000 to \$3,535,000. Excluding net securities gains, non-interest income for the three months ended June 30, 2013 increased \$150,000 compared to the 2012 period. Gain on sale of loans decreased due to the timing of the transactions which has delayed the recognition of income until the third quarter of 2013. Insurance commissions declined as a shift in product mix towards managed money is occurring and the length of time of the sales cycle related to investment products typically takes to complete. Other income increased as debit and credit card related income continues to build as debit cards continue to gain in popularity, while an increasing number of merchants utilize our merchant card services.

Total non-interest income for the six months ended June 30, 2013 compared to the same period in 2012 increased \$1,224,000. Excluding net securities gains, non-interest income decreased \$277,000 compared to the 2012 period. Gain on sale of loans increased as the level of real estate transactions processed has increased over the past year. The increase in number of transactions processed is a direct result of our strategy

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to increase the number of mortgage originators within our market area, while also hiring additional mortgage originators to expand our market area. Insurance commissions decreased due to several large bonuses that were received during the first quarter of 2012. Other income decreased due to a partial write down of other real estate owned.

Non-interest income composition for the three and six months ended June 30, 2013 and 2012 was as follows:

| (In Thousands) | June 30, 2013 | | For the Three Months Ended June 30, 2012 | | Change | |
|---------------------------|---------------|---------|---|---------|----------|---------|
| | Amount | % Total | Amount | % Total | Amount | % |
| Deposit service charges | \$ 538 | 15.22% | \$ 458 | 20.08% | \$ 80 | 17.47% |
| Securities gains, net | 1,274 | 36.04 | 170 | 7.45 | 1,104 | 649.41 |
| Bank owned life insurance | 144 | 4.07 | 133 | 5.83 | 11 | 8.27 |
| Gain on sale of loans | 302 | 8.54 | 343 | 15.04 | (41) | (11.95) |
| Insurance commissions | 247 | 6.99 | 316 | 13.85 | (69) | (21.84) |
| Brokerage commissions | 299 | 8.46 | 247 | 10.83 | 52 | 21.05 |
| Other | 731 | 20.68 | 614 | 26.92 | 117 | 19.06 |
| Total non-interest income | \$ 3,535 | 100.00% | \$ 2,281 | 100.00% | \$ 1,254 | 54.98% |

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| (In Thousands) | June 30, 2013 | | For the Six Months Ended June 30, 2012 | | Change | |
|---------------------------|---------------|---------|---|---------|----------|---------|
| | Amount | % Total | Amount | % Total | Amount | % |
| Service charges | \$ 980 | 15.63% | \$ 905 | 17.94% | \$ 75 | 8.29% |
| Securities gains, net | 2,260 | 36.06 | 759 | 15.05 | 1,501 | 197.76 |
| Bank owned life insurance | 282 | 4.50 | 401 | 7.95 | (119) | (29.68) |
| Gain on sale of loans | 653 | 10.42 | 526 | 10.43 | 127 | 24.14 |
| Insurance commissions | 511 | 8.15 | 758 | 15.03 | (247) | (32.59) |
| Brokerage commissions | 547 | 8.73 | 459 | 9.10 | 88 | 19.17 |
| Other | 1,035 | 16.51 | 1,236 | 24.50 | (201) | (16.26) |
| Total non-interest income | \$ 6,268 | 100.00% | \$ 5,044 | 100.00% | \$ 1,224 | 24.27% |

Non-interest Expense

Total non-interest expense increased \$1,622,000 for the three months ended June 30, 2013 compared to the same period of 2012. The increase in salaries and employee benefits was attributable to increases in salaries and pension expense. Other expenses increased primarily due to increased fees related to providing debit card services and expenses of \$535,000 related to the acquisition of Luzerne.

Total non-interest expense increased \$2,009,000 for the six months ended June 30, 2013 compared to the same period of 2012. The increase in non-interest expense for the six month period is primarily the result of the same items noted in the three month discussion.

Non-interest expense composition for the three and six months ended June 30, 2013 and 2012 was as follows:

| (In Thousands) | June 30, 2013 | | For the Three Months Ended June 30, 2012 | | Change | |
|---|---------------|---------|---|---------|----------|---------|
| | Amount | % Total | Amount | % Total | Amount | % |
| Salaries and employee benefits | \$ 3,442 | 49.42% | \$ 2,850 | 53.34% | \$ 592 | 20.77% |
| Occupancy | 397 | 5.70 | 318 | 5.95 | 79 | 24.84 |
| Furniture and equipment | 412 | 5.92 | 357 | 6.68 | 55 | 15.41 |
| Pennsylvania shares tax | 208 | 2.99 | 167 | 3.13 | 41 | 24.55 |
| Amortization of investment in limited partnerships | 166 | 2.38 | 166 | 3.11 | | |
| Federal Deposit Insurance Corporation deposit insurance | 119 | 1.71 | 115 | 2.15 | 4 | 3.48 |
| Marketing | 120 | 1.72 | 140 | 2.62 | (20) | (14.29) |
| Intangible amortization | 31 | 0.45 | | | 31 | |
| Other | 2,070 | 29.71 | 1,230 | 23.02 | 840 | 68.29 |
| Total non-interest expense | \$ 6,965 | 100.00% | \$ 5,343 | 100.00% | \$ 1,622 | 30.36% |

| (In Thousands) | June 30, 2013 | | For the Six Months Ended June 30, 2012 | | Change | |
|----------------|---------------|---------|---|---------|--------|--------|
| | Amount | % Total | Amount | % Total | Amount | % |
| | \$ 6,510 | 50.80% | \$ 5,867 | 54.29% | \$ 643 | 10.96% |

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| | | | | | | | |
|--|-----------|---------|-----------|---------|----------|---------|--|
| Salaries and employee benefits | | | | | | | |
| Occupancy | 748 | 5.84 | 646 | 5.98 | 102 | 15.79 | |
| Furniture and equipment | 820 | 6.40 | 703 | 6.51 | 117 | 16.64 | |
| Pennsylvania shares tax | 392 | 3.06 | 336 | 3.11 | 56 | 16.67 | |
| Amortization of investment in limited partnerships | | | | | | | |
| | 331 | 2.58 | 331 | 3.06 | | | |
| Federal Deposit Insurance | | | | | | | |
| Corporation deposit insurance | 248 | 1.94 | 238 | 2.20 | 10 | 4.20 | |
| Marketing | 215 | 1.68 | 273 | 2.53 | (58) | (21.25) | |
| Intangible amortization | 31 | 0.24 | | | 31 | | |
| Other | 3,521 | 27.46 | 2,413 | 22.32 | 1,108 | 45.92 | |
| Total non-interest expense | \$ 12,816 | 100.00% | \$ 10,807 | 100.00% | \$ 2,009 | 18.59% | |

Provision for Income Taxes

Income taxes increased \$452,000 and \$675,000 for the three and six months ended June 30, 2013 compared to the same periods of 2012. The primary cause of the increase in tax expense for the three and six months ended June 30, 2013 compared to 2012 is primarily the impact of increased security gains. Excluding the impact of the net securities gains, the effective tax rate for the three and six months ended June 30, 2013 was 18.91% and 17.31% compared to 15.00% and 13.86% for the same periods of 2012. The Company currently is in a deferred tax asset position due to the low income housing tax credits earned both currently and previously. Management has reviewed the deferred tax asset and has determined that the asset will be utilized within the appropriate carry forward period and therefore does not require a valuation allowance.

Table of Contents**ASSET/LIABILITY MANAGEMENT****Cash and Cash Equivalents**

Cash and cash equivalents increased \$13,163,000 from \$15,142,000 at December 31, 2012 to \$28,305,000 at June 30, 2013 primarily as a result of the following activities during the six months ended June 30, 2013:

Loans Held for Sale

Activity regarding loans held for sale resulted in loan originations exceeding sale proceeds, less \$653,000 in realized gains, by \$1,635,000 for the six months ended June 30, 2013.

Loans

Gross loans increased \$274,729,000 since December 31, 2012 as Luzerne provided approximately \$254,000,000 of the increase concentrated in the commercial real estate and commercial and agricultural segments of the portfolio. The increase in residential real estate was due primarily to an emphasis on home equity products.

The allocation of the loan portfolio, by category, as of June 30, 2013 and December 31, 2012 is presented below:

| (In Thousands) | June 30, 2013 | | December 31, 2012 | | Change | |
|--------------------------------------|---------------|---------|-------------------|---------|------------|---------|
| | Amount | % Total | Amount | % Total | Amount | % |
| Commercial and agricultural | \$ 118,953 | 15.12% | \$ 48,455 | 9.46% | \$ 70,498 | 145.49% |
| Real estate mortgage: | | | | | | |
| Residential | 340,976 | 43.32 | 252,142 | 49.22 | 88,834 | 35.23 |
| Commercial | 296,529 | 37.68 | 182,031 | 35.54 | 114,498 | 62.90 |
| Construction | 16,359 | 2.08 | 20,067 | 3.92 | (3,708) | (18.48) |
| Installment loans to individuals | 15,105 | 1.92 | 10,659 | 2.08 | 4,446 | 41.71 |
| Net deferred loan fees and discounts | (961) | (0.12) | (1,122) | (0.22) | 161 | 14.35 |
| Gross loans | \$ 786,961 | 100.00% | \$ 512,232 | 100.00% | \$ 274,729 | 53.63% |

The following table shows the amount of accrual and nonaccrual TDRs at June 30, 2013 and December 31, 2012:

| (In Thousands) | June 30, 2013 | | | December 31, 2012 | | |
|----------------------------------|---------------|------------|-----------|-------------------|------------|-----------|
| | Accrual | Nonaccrual | Total | Accrual | Nonaccrual | Total |
| Commercial and agricultural | \$ 459 | \$ | \$ 459 | \$ 485 | \$ | \$ 485 |
| Real estate mortgage: | | | | | | |
| Residential | 614 | 435 | 1,049 | 710 | 321 | 1,031 |
| Commercial | 4,825 | 3,442 | 8,267 | 5,172 | 3,424 | 8,596 |
| Construction | 12 | 1,165 | 1,177 | 13 | 6,077 | 6,090 |
| Installment loans to individuals | 9 | | 9 | 15 | | 15 |
| | \$ 5,919 | \$ 5,042 | \$ 10,961 | \$ 6,395 | \$ 9,822 | \$ 16,217 |

Investments

The fair value of the investment securities portfolio at June 30, 2013 increased \$21,973,000 since December 31, 2012 due to the acquisition of Luzerne. The unrealized losses within the debt securities portfolio are the result of market activity, not credit issues/ratings, as approximately 95% of the debt securities portfolio on an amortized cost basis is currently rated A or higher by either S&P or Moody's.

The Company considers various factors, which include examples from applicable accounting guidance, when analyzing the available for sale portfolio for possible other than temporary impairment. The Company primarily considers the following factors in its analysis: length of time and severity of the market value being less than carrying value; reduction of dividend paid (equities); continued payment of dividend/interest, credit rating, and financial condition of an issuer; intent and ability to hold until anticipated recovery (which may be maturity); and general outlook for the economy, specific industry, and entity in question.

The bond portion of the portfolio review is conducted with emphases on several factors. Continued payment of principal and interest is given primary importance with credit rating and financial condition of the issuer following as the next most important. Credit ratings were reviewed with the ratings of the bonds being satisfactory. Bonds that were not currently rated were discussed with a third party and/or underwent an internal financial review. The Company also monitors whether each of the investments incurred a decline in market value from carrying value of at least 20% for twelve consecutive months or a similar decline of at least 50% for three consecutive months. Each bond is reviewed to determine whether it is a general obligation bond, which is backed by the credit and taxing power of the issuing jurisdiction, or revenue bond, which is only payable from specified revenues. Based on the review undertaken by the Company, the Company determined that the decline in value of the various bond holdings were temporary and were the result of the general market downturns and interest rate/yield curve changes, not credit issues. The fact that almost all of such

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bonds are general obligation bonds further solidified the Company's determination that the decline in the value of these bond holdings is temporary.

The fair value of the equity portfolio continues to fluctuate as the economic turbulence continues to impact financial sector stock pricing. The amortized cost of the equity securities portfolio has increased \$92,000 to \$10,582,000 at June 30, 2013 from \$10,490,000 at December 31, 2012 while the fair value increased \$407,000 over the same time period.

The equity portion of the portfolio is reviewed for possible other than temporary impairment in a similar manner to the bond portfolio with greater emphasis placed on the length of time the market value has been less than the carrying value and financial sector outlook. The Company also reviews dividend payment activities and, in the case of financial institutions, whether or not such issuer was participating in the TARP Capital Purchase Program. The starting point for the equity analysis is the length and severity of a market price decline. The Company monitors two primary measures: 20% decline in market value from carrying value for twelve consecutive months and 50% decline for three consecutive months.

The distribution of credit ratings by amortized cost and fair values for the debt security portfolio at June 30, 2013 follows:

| (In Thousands) | A- to AAA | | B- to BBB+ | | C to CCC+ | | Not Rated | | Total | |
|---------------------------------------|----------------|------------|----------------|------------|----------------|------------|----------------|------------|----------------|------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Available for sale (AFS) | | | | | | | | | | |
| U.S. Government and agency securities | \$ 27,874 | \$ 28,605 | \$ | \$ | \$ | \$ | \$ 4,063 | \$ 3,909 | \$ 31,937 | \$ 32,514 |
| State and political securities | 157,668 | 157,823 | 901 | 919 | | | 5,908 | 5,659 | 164,477 | 164,401 |
| Other debt securities | 98,983 | 97,610 | 4,877 | 4,704 | | | | | 103,860 | 102,314 |
| Total debt securities AFS | \$ 284,525 | \$ 284,038 | \$ 5,778 | \$ 5,623 | \$ | \$ | \$ 9,971 | \$ 9,568 | \$ 300,274 | \$ 299,229 |

Financing Activities**Deposits**

Total deposits increased \$313,335,000 from December 31, 2012 to June 30, 2013 with the acquisition of Luzerne providing approximately \$280,000,000 of the increase. The growth was led by an increase in non-interest bearing deposits accounts from December 31, 2012 to June 30, 2013 of 83.64% as Luzerne provided approximately \$85,000,000 of the \$96,143,000 increase. The increase in core deposits (deposits less time deposits) has provided relationship driven funding for the loan and investment portfolios. The increase in deposits is the result of our focus on building relationships, not by offering market leading rates. Over the past year and through the first six months of 2013, time deposits, excluding the impact of the Luzerne acquisition, have decreased as we have taken a position of using these accounts as complementary accounts

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to core deposits. To facilitate this strategy we are actively working single product time deposit relationships to create a solid relationship through the addition of other products to the customer's portfolio.

Deposit balances and their changes for the periods being discussed follow:

| (In Thousands) | June 30, 2013 | | December 31, 2012 | | Change | |
|-----------------------|---------------|---------|-------------------|---------|------------|--------|
| | Amount | % Total | Amount | % Total | Amount | % |
| Demand deposits | \$ 211,096 | 22.10% | \$ 114,953 | 17.90% | \$ 96,143 | 83.64% |
| NOW accounts | 161,972 | 16.95 | 130,454 | 20.32 | 31,518 | 24.16 |
| Money market deposits | 203,076 | 21.26 | 144,722 | 22.54 | 58,354 | 40.32 |
| Savings deposits | 140,667 | 14.72 | 82,546 | 12.86 | 58,121 | 70.41 |
| Time deposits | 238,550 | 24.97 | 169,351 | 26.38 | 69,199 | 40.86 |
| | \$ 955,361 | 100.00% | \$ 642,026 | 100.00% | \$ 313,335 | 48.80% |

Borrowed Funds

Total borrowed funds increased 0.24% or \$268,000 to \$109,750,000 at June 30, 2013 compared to \$109,482,000 at December 31, 2012. Long-term borrowings decreased due to a FHLB borrowings that matured during 2013 at an average rate of 3.94%.

| (In Thousands) | June 30, 2013 | | December 31, 2012 | | Change | |
|---|---------------|---------|-------------------|---------|----------|--------|
| | Amount | % Total | Amount | % Total | Amount | % |
| Short-term borrowings: | | | | | | |
| FHLB repurchase agreements | \$ 21,350 | 19.46% | \$ 16,236 | 14.83% | \$ 5,114 | 31.50% |
| Securities sold under agreement to repurchase | 17,650 | 16.08 | 16,968 | 15.50 | 682 | 4.02 |
| Total short-term borrowings | 39,000 | 35.54 | 33,204 | 30.33 | 5,796 | 17.46 |
| Long-term borrowings, FHLB | 70,750 | 64.46 | 76,278 | 69.67 | (5,528) | (7.25) |
| Total borrowed funds | \$ 109,750 | 100.00% | \$ 109,482 | 100.00% | \$ 268 | 0.24% |

Table of Contents**Capital**

The adequacy of the Company's capital is reviewed on an ongoing basis with reference to the size, composition, and quality of the Company's resources and regulatory guidelines. Management seeks to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings.

Bank holding companies are required to comply with the Federal Reserve Board's risk-based capital guidelines. The risk-based capital rules are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies and to minimize disincentives for holding liquid assets. Specifically, each is required to maintain certain minimum dollar amounts and ratios of total risk-based, tier I risk-based, and tier I leverage capital. In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvements Act (FDICIA) established five capital categories ranging from well capitalized to critically undercapitalized. To be classified as well capitalized, total risk-based, tier I risk-based, and tier I leverage capital ratios must be at least 10%, 6%, and 5%, respectively.

Capital ratios as of June 30, 2013 and December 31, 2012 were as follows:

| (In Thousands) | June 30, 2013 | | December 31, 2012 | |
|--|---------------|--------|-------------------|--------|
| | Amount | Ratio | Amount | Ratio |
| <u>Total Capital (to Risk-weighted Assets)</u> | | | | |
| Actual | \$ 114,518 | 13.01% | \$ 85,377 | 14.97% |
| For Capital Adequacy Purposes | 70,425 | 8.00 | 45,641 | 8.00 |
| To Be Well Capitalized | 88,031 | 10.00 | 57,051 | 10.00 |
| <u>Tier I Capital (to Risk-weighted Assets)</u> | | | | |
| Actual | \$ 104,417 | 11.86% | \$ 77,717 | 13.62% |
| For Capital Adequacy Purposes | 35,213 | 4.00 | 22,820 | 4.00 |
| To Be Well Capitalized | 52,819 | 6.00 | 34,231 | 6.00 |
| <u>Tier I Capital (to Average Assets)</u> | | | | |
| Actual | \$ 104,417 | 10.96% | \$ 77,717 | 9.47% |
| For Capital Adequacy Purposes | 38,109 | 4.00 | 32,818 | 4.00 |
| To Be Well Capitalized | 47,636 | 5.00 | 41,022 | 5.00 |

In June 2012, the federal bank regulatory agencies issued a series of proposed revisions to the agencies' capital adequacy guidelines and prompt corrective action rules, which were designed to enhance such requirements and implement the revised standards of the Basel Committee on Banking Supervision, commonly referred to as Basel III. In July 2013, the federal bank regulatory agencies adopted final rules, which differ in certain respects from the June 2012 proposals.

The July 2013 final rules generally implement higher minimum capital requirements, add a new common equity tier 1 capital requirement, and establish criteria that instruments must meet to be considered common equity tier 1 capital, additional tier 1 capital or tier 2 capital. The new minimum capital to risk-adjusted assets requirements are a common equity tier 1 capital ratio of 4.5% (6.5% to be considered well capitalized) and a tier 1 capital ratio of 6.0%, increased from 4.0% (and increased from 6.0% to 8.0% to be considered well capitalized); the total capital ratio

remains at 8.0% under the new rules (10.0% to be considered well capitalized). Under the new rules, in order to avoid limitations on capital distributions (including dividend payments and certain discretionary bonus payments to executive officers), a banking organization must hold a capital conservation buffer comprised of common equity tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5% of total risk-weighted assets. The new minimum capital requirements are effective on January 1, 2015. The capital contribution buffer requirements phase in over a three-year period beginning January 1, 2016.

The July 2013 final rules include three significant changes from the June 2012 proposals: (i) the final rules do not change the current risk weighting for residential mortgage exposures; (ii) the final rules permit institutions, other than certain large institutions, to elect to continue to treat certain components of accumulated other comprehensive income as permitted under the current general risk-based capital rules, and not reflect unrealized gains and losses on available-for-sale securities in common equity tier 1 calculations; and (iii) the final rules permit institutions with less than \$15.0 billion in assets to grandfather certain non-qualifying capital instruments (including trust preferred securities) issued prior to May 19, 2009 into tier 1 capital.

The Company and the Bank will continue to analyze these new rules and their effects on the business, operations and capital levels of the Company and the Bank.

Liquidity; Interest Rate Sensitivity and Market Risk

The asset/liability committee addresses the liquidity needs of the Company to ensure that sufficient funds are available to meet credit demands and deposit withdrawals as well as to the placement of available funds in the investment portfolio. In assessing liquidity requirements, equal consideration is given to the current position as well as the future outlook.

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The following liquidity measures are monitored for compliance and were within the limits cited at June 30, 2013:

1. Net Loans to Total Assets, 85% maximum
2. Net Loans to Total Deposits, 100% maximum
3. Cumulative 90 day Maturity GAP %, +/- 20% maximum
4. Cumulative 1 Year Maturity GAP %, +/- 25% maximum

Fundamental objectives of the Company's asset/liability management process are to maintain adequate liquidity while minimizing interest rate risk. The maintenance of adequate liquidity provides the Company with the ability to meet its financial obligations to depositors, loan customers, and shareholders. Additionally, it provides funds for normal operating expenditures and business opportunities as they arise. The objective of interest rate sensitivity management is to increase net interest income by managing interest sensitive assets and liabilities in such a way that they can be repriced in response to changes in market interest rates.

The Bank, like other financial institutions, must have sufficient funds available to meet its liquidity needs for deposit withdrawals, loan commitments and originations, and expenses. In order to control cash flow, the Bank estimates future cash flows from deposits, loan payments, and investment security payments. The primary sources of funds are deposits, principal and interest payments on loans and investment securities, FHLB borrowings, and brokered deposits. Management believes the Bank has adequate resources to meet its normal funding requirements.

Management monitors the Company's liquidity on both a long and short-term basis, thereby providing management necessary information to react to current balance sheet trends. Cash flow needs are assessed and sources of funds are determined. Funding strategies consider both customer needs and economical cost. Both short and long-term funding needs are addressed by maturities and sales of available for sale investment securities, loan repayments and maturities, and liquidating money market investments such as federal funds sold. The use of these resources, in conjunction with access to credit provides core funding to satisfy depositor, borrower, and creditor needs.

Management monitors and determines the desirable level of liquidity. Consideration is given to loan demand, investment opportunities, deposit pricing and growth potential, as well as the current cost of borrowing funds. The Company has a total current maximum borrowing capacity at the FHLB of \$399,378,000. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of \$32,166,000. Management believes it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. FHLB borrowings totaled \$92,100,000 as of June 30, 2013.

Interest rate sensitivity, which is closely related to liquidity management, is a function of the repricing characteristics of the Company's portfolio of assets and liabilities. Asset/liability management strives to match maturities and rates between loan and investment security assets with the deposit liabilities and borrowings that fund them. Successful asset/liability management results in a balance sheet structure which can cope effectively with market rate fluctuations. The matching process is affected by segmenting both assets and liabilities into future time periods (usually 12 months, or less) based upon when repricing can be effected. Repriceable assets are subtracted from repriceable liabilities, for a specific time period to determine the gap, or difference. Once known, the gap is managed based on predictions about future market interest

rates. Intentional mismatching, or gapping, can enhance net interest income if market rates move as predicted. However, if market rates behave in a manner contrary to predictions, net interest income will suffer. Gaps, therefore, contain an element of risk and must be prudently managed. In addition to gap management, the Company has an asset/liability management policy which incorporates a market value at risk calculation which is used to determine the effects of interest rate movements on shareholders' equity and a simulation analysis to monitor the effects of interest rate changes on the Company's balance sheet.

The Company currently maintains a GAP position of being liability sensitive. The Company has strategically taken this position as it has decreased the duration of the time deposit portfolio, while continuing to maintain a primarily fixed rate earning asset portfolio with a duration greater than the liabilities utilized to fund earning assets. Lengthening of the liability portfolio coupled with the addition of limited short-term assets is being undertaken. These actions are expected to reduce, but not eliminate, the liability sensitive structure of the balance sheet.

A market value at risk calculation is utilized to monitor the effects of interest rate changes on the Company's balance sheet and more specifically shareholders' equity. The Company does not manage the balance sheet structure in order to maintain compliance with this calculation. The calculation serves as a guideline with greater emphases placed on interest rate sensitivity. Changes to calculation results from period to period are reviewed as changes in results could be a signal of future events. As of the most recent analysis, the results of the market value at risk calculation were within established guidelines due to the strategic direction being taken.

Interest Rate Sensitivity

In this analysis the Company examines the result of a 100, 200, 300, and 400 basis point change in market interest rates and the effect on net interest income. It is assumed that the change is instantaneous and that all rates move in a parallel manner. Assumptions are also made concerning prepayment speeds on mortgage loans and mortgage securities.

The following is a rate shock forecast for the twelve month period ending June 30, 2014 assuming a static balance sheet as of June 30, 2013.

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| (In Thousands) | Parallel Rate Shock in Basis Points | | | | | | | |
|----------------------------|-------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|--|
| | -200 | -100 | Static | +100 | +200 | +300 | +400 | |
| Net interest income | \$ 38,165 | \$ 39,801 | \$ 40,990 | \$ 41,334 | \$ 41,853 | \$ 42,367 | \$ 42,560 | |
| Change from static | (2,825) | (1,189) | | 344 | 863 | 1,377 | 1,570 | |
| Percent change from static | -6.89% | -2.90% | | 0.84% | 2.11% | 3.36% | 3.83% | |

The model utilized to create the report presented above makes various estimates at each level of interest rate change regarding cash flow from principal repayment on loans and mortgage-backed securities and/or call activity on investment securities. Actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change. In addition, the limits stated above do not necessarily represent the level of change under which management would undertake specific measures to realign its portfolio in order to reduce the projected level of change. Generally, management believes the Company is well positioned to respond expeditiously when the market interest rate outlook changes.

Inflation

The asset and liability structure of a financial institution is primarily monetary in nature. Therefore, interest rates rather than inflation have a more significant impact on the Company's performance. Interest rates are not always affected in the same direction or magnitude as prices of other goods and services, but are reflective of fiscal policy initiatives or economic factors which are not measured by a price index.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk for the Company is comprised primarily of interest rate risk exposure and liquidity risk. Interest rate risk and liquidity risk management is performed at the Bank level as well as the Company level. The Company's interest rate sensitivity is monitored by management through selected interest rate risk measures produced by an independent third party. There have been no substantial changes in the Company's gap analyses or simulation analyses compared to the information provided in the Annual Report on Form 10-K for the period ended December 31, 2012. Additional information and details are provided in the Liquidity and Interest Rate Sensitivity section of Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Generally, management believes the Company is well positioned to respond in a timely manner when the market interest rate outlook changes.

Item 4. Controls and Procedures*Evaluation of Disclosure Controls and Procedures*

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An analysis was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2013.

Changes in Internal Control over Financial Reporting

The Company completed its acquisition of Luzerne National Bank Corporation on June 1, 2013. As a result of the Luzerne National Bank Corporation acquisition, the Company has begun the process of evaluating the internal control processes of Luzerne National Bank Corporation, and integrating those processes into the Company's existing control environment. Other than the Luzerne National Bank Corporation acquisition, there were no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2013, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents**Part II. OTHER INFORMATION****Item 1. Legal Proceedings**

None.

Item 1A. Risk Factors

There are no material changes to the risk factors set forth in Part I, Item 1A, Risk Factors, of the Company's Annual Report on Form 10-K for the year ended December 31, 2012. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company's business.

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

| Period | Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Units) Purchased | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|-------------------------------------|---|---|---|---|
| Month #1 (April 1 - April 30, 2013) | | \$ | | 76,776 |
| Month #2 (May 1 - May 31, 2013) | | | | 76,776 |
| Month #3 (June 1 - June 30, 2013) | | | | 76,776 |

On April 23, 2013, the Board of Directors extended the previously approved authorization to repurchase up to 197,000 shares, or approximately 5%, of the outstanding shares of the Company for an additional year to April 30, 2014. To date, there have been 120,224 shares repurchased under this plan.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

- 3(i) Articles of Incorporation of the Registrant as presently in effect (incorporated by reference to Exhibit 3(i) of the Registrant's Annual Report on Form 10-Q for the period ended March 31, 2012 filed May 9, 2012).
- 3(ii) Bylaws of the Registrant as presently in effect (incorporated by reference to Exhibit 3(ii) of the Registrant's Current Report on Form 8-K filed June 17, 2005).
- 31(i) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer.
- 31(ii) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer.
- 32(i) Section 1350 Certification of Chief Executive Officer.
- 32(ii) Section 1350 Certification of Chief Financial Officer.
- 101 Interactive data file containing the following financial statements formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheet at June 30, 2013 and December 31, 2012; (ii) the Consolidated Statement of Income for the three and six months ended June 30, 2013 and 2012; (iii) the Consolidated Statement of Shareholders' Equity for the six months ended June 30, 2013 and 2012; (iv) Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2013 and 2012; (v) the Consolidated Statement of Cash Flows for the six months ended June 30, 2013 and 2012; and (vi) the Notes to Consolidated Financial Statements. As provided in Rule 406T of Regulation S-T, this interactive data file shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, and shall not be deemed filed or part of any registration statement or prospectus for purposes of Section 11 or 12 under the Securities Act of 1933, or otherwise subject to liability under those sections.

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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.

PENNS WOODS BANCORP, INC.
(Registrant)

Date: August 9, 2013

/s/ Richard A. Grafmyre
Richard A. Grafmyre, President and Chief Executive Officer
(Principal Executive Officer)

Date: August 9, 2013

/s/ Brian L. Knepp
Brian L. Knepp, Senior Vice President and Chief Financial Officer
(Principal Financial Officer and Principal Accounting
Officer)

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EXHIBIT INDEX

| | |
|----------------|---|
| Exhibit 31(i) | Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer |
| Exhibit 31(ii) | Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer |
| Exhibit 32(i) | Section 1350 Certification of Chief Executive Officer |
| Exhibit 32(ii) | Section 1350 Certification of Chief Financial Officer |
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