

PENNS WOODS BANCORP INC  
Form 10-Q  
August 11, 2014  
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

ý Quarterly Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934  
for the Quarterly Period Ended June 30, 2014.

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.)

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 ý NO o

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 ý NO o

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

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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 1, 2014 there were 4,820,951 shares of the Registrant's common stock outstanding.

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## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## PENNS WOODS BANCORP, INC.

## CONSOLIDATED BALANCE SHEET

## (UNAUDITED)

(In Thousands, Except Share Data)	June 30, 2014	December 31, 2013
<b>ASSETS:</b>		
Noninterest-bearing balances	\$22,905	\$23,723
Interest-bearing deposits in other financial institutions	1,962	770
Federal funds sold	—	113
Total cash and cash equivalents	24,867	24,606
Investment securities available for sale, at fair value	263,026	288,612
Loans held for sale	1,827	1,626
Loans	856,332	818,344
Allowance for loan losses	(8,811	) (10,144
Loans, net	847,521	808,200
Premises and equipment, net	21,007	20,184
Accrued interest receivable	4,235	4,696
Bank-owned life insurance	25,601	25,410
Investment in limited partnerships	1,891	2,221
Goodwill	17,104	17,104
Intangibles	1,621	1,801
Deferred tax asset	6,807	9,889
Other assets	7,340	7,646
<b>TOTAL ASSETS</b>	<b>\$1,222,847</b>	<b>\$1,211,995</b>
<b>LIABILITIES:</b>		
Interest-bearing deposits	\$753,068	\$755,625
Noninterest-bearing deposits	228,758	217,377
Total deposits	981,826	973,002
Short-term borrowings	21,926	26,716
Long-term borrowings	71,202	71,202
Accrued interest payable	399	405
Other liabilities	11,692	12,855
<b>TOTAL LIABILITIES</b>	<b>1,087,045</b>	<b>1,084,180</b>
<b>SHAREHOLDERS' EQUITY:</b>		
Preferred stock, no par value, 3,000,000 shares authorized; no shares issued	—	—
Common stock, par value \$8.33, 15,000,000 shares authorized; 5,001,222 and 4,999,929 shares issued	41,676	41,665
Additional paid-in capital	49,846	49,800
Retained earnings	49,955	47,554
Accumulated other comprehensive income (loss):		
Net unrealized gain (loss) on available for sale securities	3,360	(2,169
Defined benefit plan	(2,725	) (2,725
Treasury stock at cost, 180,596 shares	(6,310	) (6,310

TOTAL SHAREHOLDERS' EQUITY	135,802	127,815
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$1,222,847	\$1,211,995

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		Six Months Ended	
	June 30, 2014	2013	June 30, 2014	2013
<b>INTEREST AND DIVIDEND INCOME:</b>				
Loans, including fees	\$8,912	\$7,277	\$17,725	\$14,045
Investment securities:				
Taxable	1,406	1,507	2,864	2,950
Tax-exempt	892	1,162	1,823	2,429
Dividend and other interest income	147	72	274	134
<b>TOTAL INTEREST AND DIVIDEND INCOME</b>	<b>11,357</b>	<b>10,018</b>	<b>22,686</b>	<b>19,558</b>
<b>INTEREST EXPENSE:</b>				
Deposits	741	760	1,499	1,551
Short-term borrowings	12	22	27	47
Long-term borrowings	473	482	942	1,001
<b>TOTAL INTEREST EXPENSE</b>	<b>1,226</b>	<b>1,264</b>	<b>2,468</b>	<b>2,599</b>
<b>NET INTEREST INCOME</b>	<b>10,131</b>	<b>8,754</b>	<b>20,218</b>	<b>16,959</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>300</b>	<b>575</b>	<b>785</b>	<b>1,075</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>9,831</b>	<b>8,179</b>	<b>19,433</b>	<b>15,884</b>
<b>NON-INTEREST INCOME:</b>				
Service charges	607	538	1,202	980
Securities gains, net	487	1,274	880	2,260
Bank-owned life insurance	181	144	551	282
Gain on sale of loans	421	302	711	653
Insurance commissions	283	247	703	511
Brokerage commissions	251	299	522	547
Other	699	731	1,571	1,035
<b>TOTAL NON-INTEREST INCOME</b>	<b>2,929</b>	<b>3,535</b>	<b>6,140</b>	<b>6,268</b>
<b>NON-INTEREST EXPENSE:</b>				
Salaries and employee benefits	4,167	3,442	8,670	6,510
Occupancy	552	397	1,182	748
Furniture and equipment	648	412	1,319	820
Pennsylvania shares tax	262	208	506	392
Amortization of investment in limited partnerships	166	166	331	331
Federal Deposit Insurance Corporation deposit insurance	201	119	379	248
Marketing	126	120	236	215
Intangible amortization	88	31	180	31
Other	2,212	2,070	4,262	3,521
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>8,422</b>	<b>6,965</b>	<b>17,065</b>	<b>12,816</b>
<b>INCOME BEFORE INCOME TAX PROVISION</b>	<b>4,338</b>	<b>4,749</b>	<b>8,508</b>	<b>9,336</b>
<b>INCOME TAX PROVISION</b>	<b>875</b>	<b>1,090</b>	<b>1,576</b>	<b>1,993</b>
<b>NET INCOME</b>	<b>\$3,463</b>	<b>\$3,659</b>	<b>\$6,932</b>	<b>\$7,343</b>
<b>EARNINGS PER SHARE - BASIC</b>	<b>\$0.72</b>	<b>\$0.88</b>	<b>\$1.44</b>	<b>\$1.84</b>
<b>EARNINGS PER SHARE - DILUTED</b>	<b>\$0.72</b>	<b>\$0.88</b>	<b>\$1.44</b>	<b>\$1.84</b>
<b>WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC</b>	<b>4,820,193</b>	<b>4,151,035</b>	<b>4,819,886</b>	<b>3,995,716</b>

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WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED	4,820,193	4,151,035	4,819,886	3,995,716
DIVIDENDS DECLARED PER SHARE	\$0.47	\$0.47	\$0.94	\$1.19

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,	
	2014	2013	2014	2013
Net Income	\$3,463	\$3,659	\$6,932	\$7,343
Other comprehensive income (loss):				
Change in unrealized gain (loss) on available for sale securities	3,930	(11,196	) 9,258	(12,707
Tax effect	(1,336	) 3,807	(3,148	) 4,321
Net realized gain included in net income	(487	) (1,274	) (880	) (2,260
Tax effect	166	433	299	768
Total other comprehensive income (loss)	2,272	(8,230	) 5,529	(9,878
Comprehensive income (loss)	\$5,735	\$(4,571	) \$12,461	\$(2,535

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
 CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
 (UNAUDITED)

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

(In Thousands, Except Per Share Data)	COMMON STOCK			RETAINED EARNINGS	ACCUMULATED		TOTAL SHAREHOLDERS' EQUITY
	SHARES	AMOUNT	ADDITIONAL PAID-IN CAPITAL		OTHER COMPREHENSIVE INCOME (LOSS)	TREASURY STOCK	
Balance, December 31, 2013	4,999,929	\$41,665	\$49,800	\$47,554	\$(4,894)	\$(6,310)	\$127,815
Net income				6,932			6,932
Other comprehensive income					5,529		5,529
Dividends declared, (\$0.94 per share)				(4,531)			(4,531)
Common shares issued for employee stock purchase plan	1,293	11	46				57
Balance, June 30, 2014	5,001,222	\$41,676	\$49,846	\$49,955	\$635	\$(6,310)	\$135,802

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,	
	2014	2013
<b>OPERATING ACTIVITIES:</b>		
Net Income	\$6,932	\$7,343
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	725	415
Amortization of intangible assets	180	31
Provision for loan losses	785	1,075
Accretion and amortization of investment security discounts and premiums	329	(117)
Securities gains, net	(880)	(2,260)
Originations of loans held for sale	(21,292)	(27,697)
Proceeds of loans held for sale	21,802	26,715
Gain on sale of loans	(711)	(653)
Earnings on bank-owned life insurance	(551)	(282)
Decrease (increase) in deferred tax asset	233	(162)
Other, net	(373)	889
Net cash provided by operating activities	7,179	5,297
<b>INVESTING ACTIVITIES:</b>		
Investment securities available for sale:		
Proceeds from sales	70,431	42,910
Proceeds from calls, maturities, and repayments of principal	3,582	8,780
Purchases	(39,578)	(63,942)
Net increase in loans	(40,239)	(23,666)
Acquisition of bank premises and equipment	(1,571)	(1,200)
Proceeds from the sale of foreclosed assets	475	—
Purchase of bank-owned life insurance	(25)	(977)
Proceeds from bank-owned life insurance death benefit	367	—
Proceeds from redemption of regulatory stock	1,072	548
Purchases of regulatory stock	(992)	(822)
Acquisition, net of cash acquired	—	17,487
Net cash used for investing activities	(6,478)	(20,882)
<b>FINANCING ACTIVITIES:</b>		
Net (decrease) increase in interest-bearing deposits	(2,557)	22,754
Net increase in noninterest-bearing deposits	11,381	13,625
Repayment of long-term borrowings	—	(5,528)
Net (decrease) increase in short-term borrowings	(4,790)	3,030
Dividends paid	(4,531)	(5,030)
Issuance of common stock	57	31
Net cash (used for) provided by financing activities	(440)	28,882
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>261</b>	<b>13,297</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING</b>	<b>24,606</b>	<b>15,142</b>
<b>CASH AND CASH EQUIVALENTS, ENDING</b>	<b>\$24,867</b>	<b>\$28,439</b>



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(In Thousands)	Six Months Ended June 30,	
	2014	2013
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Interest paid	\$2,474	\$2,523
Income taxes paid	1,665	1,795
Transfer of loans to foreclosed real estate	134	26
Acquisition of Luzerne National Bank Corporation		
Non-cash 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 non-cash assets acquired	—	22,316
Cash acquired	\$—	\$20,296

See accompanying notes to the unaudited consolidated financial statements.

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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 and Jersey Shore State Bank (Jersey Shore State Bank and Luzerne Bank are 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, 2013.

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 38 through 43 of the Annual Report on Form 10-K for the year ended December 31, 2013.

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, 2014 and 2013 were as follows:

(In Thousands)	Three Months Ended June 30, 2014			Three Months Ended June 30, 2013		
	Net Unrealized Gain (Loss) on Available for Sale Securities	Defined Benefit Plan	Total	Net Unrealized Gain on Available for Sale Securities	Defined Benefit Plan	Total
Balance, March 31,	\$1,088	\$(2,725 )	\$(1,637 )	\$8,516	\$(4,807 )	\$3,709
Other comprehensive income (loss) before reclassifications	2,593	—	2,593	(7,389 )	—	(7,389 )
Amounts reclassified from accumulated other comprehensive income (loss)	(321 )	—	(321 )	(841 )	—	(841 )
Net current-period other comprehensive income (loss)	2,272	—	2,272	(8,230 )	—	(8,230 )
Balance, June 30	\$3,360	\$(2,725 )	\$635	\$286	\$(4,807 )	\$(4,521 )
(In Thousands)	Six Months Ended June 30, 2014			Six Months Ended June 30, 2013		
	Net Unrealized Gain	Defined Benefit	Total	Net Unrealized Gain on Available	Defined Benefit	Total

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	(Loss) on Available for Sale Securities	Plan	(Loss) on Available for Sale Securities	Plan	(Loss) on Available for Sale Securities	Plan
Balance, December 31	\$ (2,169 )	\$ (2,725 )	\$ (4,894 )	\$ 10,164	\$ (4,807 )	\$ 5,357
Other comprehensive (loss) income before reclassifications	6,110	—	6,110	(8,386 )	—	(8,386 )
Amounts reclassified from accumulated other comprehensive (loss) income	(581 )	—	(581 )	(1,492 )	—	(1,492 )
Net current-period other comprehensive (loss) income	5,529	—	5,529	(9,878 )	—	(9,878 )
Balance, June 30	\$ 3,360	\$ (2,725 )	\$ 635	\$ 286	\$ (4,807 )	\$ (4,521 )

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The reclassifications out of accumulated other comprehensive income as of June 30, 2014 and 2013 were as follows:

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from Three Months Ended June 30, 2014	Accumulated Other Comprehensive Income Three Months Ended June 30, 2013	Affected Income Item in the Consolidated Statement of Income
Net unrealized gain on available for sale securities	\$ 487	\$ 1,274	Securities gains, net
Income tax effect	166	433	Income tax provision
Total reclassifications for the period	\$ 321	\$ 841	Net of tax
Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from Six Months Ended June 30, 2014	Accumulated Other Comprehensive Income Six Months Ended June 30, 2013	Affected Income Item in the Consolidated Statement of Income
Net unrealized gain on available for sale securities	\$ 880	\$ 2,260	Securities gains, net
Income tax effect	299	768	Income tax provision
Total reclassifications for the period	\$ 581	\$ 1,492	Net of tax

### Note 3. Recent Accounting Pronouncements

In July 2013, the FASB issued ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. This Update applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In January 2014, FASB issued ASU 2014-01, Investments - Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. The amendments in this Update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this Update should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting



investments. The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In January 2014, the FASB issued ASU 2014-04, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amendments in this Update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this Update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in this Update using either a

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modified retrospective transition method or a prospective transition method. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In June 2014, the FASB issued ASU 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. The amendments in this update change the accounting for repurchase-to-maturity transactions to secured borrowing accounting. For repurchase financing arrangements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. The amendments also require enhanced disclosures. The accounting changes in this update are effective for the first interim or annual period beginning after December 15, 2014. An entity is required to present changes in accounting for transactions outstanding on the effective date as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Earlier application is prohibited. The disclosure for certain transactions accounted for as a sale is required to be presented for interim and annual periods beginning after December 15, 2014, and the disclosure for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and for interim periods beginning after March 15, 2015. The disclosures are not required to be presented for comparative periods before the effective date. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In June 2014, the FASB issued ASU 2014-12, Compensation-Stock Compensation (Topic 718): Accounting for Share-Based Payments when the Terms of an Award Provide that a Performance Target Could Be Achieved After the Requisite Service Period. The amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The amendments in this Update are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. Entities may apply the amendments in this Update either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If retrospective transition is adopted, the cumulative effect of applying this Update as of the beginning of the earliest annual period presented in the financial statements should be recognized as an adjustment to the opening retained earnings balance at that date. Additionally, if retrospective transition is adopted, an entity may use hindsight in measuring and recognizing the compensation cost. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

## 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,	
	2014	2013	2014	2013
Weighted average common shares issued	5,000,789	4,331,631	5,000,482	4,176,312
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	4,820,193	4,151,035	4,819,886	3,995,716

earnings per share

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## Note 5. Investment Securities

The amortized cost and fair values of investment securities at June 30, 2014 and December 31, 2013 are as follows:

(In Thousands)	June 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale (AFS)				
U.S. Government and agency securities	\$5,975	\$14	\$(127)	) \$5,862
Mortgage-backed securities	11,420	593	(9)	) 12,004
Asset-backed securities	2,580	40	(3)	) 2,617
State and political securities	126,518	4,089	(1,411)	) 129,196
Other debt securities	99,197	1,202	(962)	) 99,437
Total debt securities	245,690	5,938	(2,512)	) 249,116
Financial institution equity securities	8,588	1,637	(3)	) 10,222
Other equity securities	3,657	122	(91)	) 3,688
Total equity securities	12,245	1,759	(94)	) 13,910
Total investment securities AFS	\$257,935	\$7,697	\$(2,606)	) \$263,026
	December 31, 2013			
(In Thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale (AFS)				
U.S. Government and agency securities	\$9,989	\$17	\$(83)	) \$9,923
Mortgage-backed securities	9,966	694	(68)	) 10,592
Asset-backed securities	6,700	43	(179)	) 6,564
State and political securities	145,121	2,120	(5,446)	) 141,795
Other debt securities	108,939	879	(3,045)	) 106,773
Total debt securities	280,715	3,753	(8,821)	) 275,647
Financial institution equity securities	8,842	1,820	—	) 10,662
Other equity securities	2,342	28	(67)	) 2,303
Total equity securities	11,184	1,848	(67)	) 12,965
Total investment securities AFS	\$291,899	\$5,601	\$(8,888)	) \$288,612

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, 2014 and December 31, 2013.

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(In Thousands)	June 30, 2014					
	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	\$—	\$—	\$3,869	\$(127)	\$3,869	\$(127)
Mortgage-backed securities	3,965	(6)	926	(3)	4,891	(9)
Asset-backed securities	—	—	612	(3)	612	(3)
State and political securities	8,989	(99)	11,530	(1,312)	20,519	(1,411)
Other debt securities	11,631	(237)	29,471	(725)	41,102	(962)
Total debt securities	24,585	(342)	46,408	(2,170)	70,993	(2,512)
Financial institution equity securities	132	(3)	—	—	132	(3)
Other equity securities	668	(59)	768	(32)	1,436	(91)
Total equity securities	800	(62)	768	(32)	1,568	(94)
Total	\$25,385	\$(404)	\$47,176	\$(2,202)	\$72,561	\$(2,606)
(In Thousands)	December 31, 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	\$7,740	\$(83)	\$—	\$—	\$7,740	\$(83)
Mortgage-backed securities	2,483	(68)	—	—	2,483	(68)
Asset-backed securities	3,847	(177)	712	(2)	4,559	(179)
State and political securities	42,577	(2,558)	8,233	(2,888)	50,810	(5,446)
Other debt securities	73,254	(3,045)	—	—	73,254	(3,045)
Total debt securities	129,901	(5,931)	8,945	(2,890)	138,846	(8,821)
Financial institution equity securities	—	—	—	—	—	—
Other equity securities	274	(22)	655	(45)	929	(67)
Total equity securities	274	(22)	655	(45)	929	(67)
Total	\$130,175	\$(5,953)	\$9,600	\$(2,935)	\$139,775	\$(8,888)

At June 30, 2014 there were a total of 20 securities in a continuous unrealized loss position for less than twelve months and 48 individual securities that were in a continuous unrealized loss position for twelve months or greater.

The Company reviews its position quarterly and has determined that, at June 30, 2014, 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, 2014, 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.



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(In Thousands)	Amortized Cost	Fair Value
Due in one year or less	\$3,760	\$3,795
Due after one year to five years	38,383	38,921
Due after five years to ten years	107,423	107,642
Due after ten years	96,124	98,758
Total	\$245,690	\$249,116

Total gross proceeds from sales of securities available for sale were \$70,431,000 and \$42,910,000 for the six months ended June 30, 2014 and 2013, 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,	
	2014	2013	2014	2013
Gross realized gains:				
U.S. Government and agency securities	\$49	\$—	\$49	\$—
Mortgage-backed securities	76	—	76	—
State and political securities	387	1,062	732	1,641
Other debt securities	155	178	462	299
Financial institution equity securities	16	—	128	130
Other equity securities	64	34	119	250
Total gross realized gains	\$747	\$1,274	\$1,566	\$2,320
Gross realized losses:				
U.S. Government and agency securities	\$14	\$—	\$45	\$—
State and political securities	83	—	403	60
Other debt securities	97	—	172	—
Other equity securities	66	—	66	—
Total gross realized losses	\$260	\$—	\$686	\$60

There were no impairment charges included in gross realized losses for the three and six months ended June 30, 2014 and 2013, respectively.

## Note 6. Federal Home Loan Bank Stock

Jersey Shore State Bank and Luzerne Bank 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. Management 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 payment 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



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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, 2014 and December 31, 2013:

(In Thousands)	June 30, 2014				
	Current	Past Due 30 To 89 Days	Past Due 90 Days Or More & Still Accruing	Non- Accrual	Total
Commercial and agricultural	\$118,326	\$645	\$ —	\$ 156	\$119,127
Real estate mortgage:					
Residential	413,513	3,261	397	444	417,615
Commercial	269,481	1,839	—	9,984	281,304
Construction	19,345	—	—	998	20,343
Installment loans to individuals	19,123	96	—	—	19,219
	839,788	\$5,841	\$ 397	\$ 11,582	857,608
Net deferred loan fees and discounts	(1,276 )				(1,276 )
Allowance for loan losses	(8,811 )				(8,811 )
Loans, net	\$829,701				\$847,521
(In Thousands)	December 31, 2013				
	Current	Past Due 30 To 89 Days	Past Due 90 Days Or More & Still Accruing	Non- Accrual	Total
Commercial and agricultural	\$104,419	\$502	\$ —	\$ 108	\$105,029
Real estate mortgage:					
Residential	392,300	6,424	531	526	399,781
Commercial	272,745	2,533	—	7,198	282,476
Construction	15,967	—	73	1,242	17,282
Installment loans to individuals	14,170	477	—	—	14,647
	799,601	\$9,936	\$ 604	\$ 9,074	819,215
Net deferred loan fees and discounts	(871 )				(871 )
Allowance for loan losses	(10,144 )				(10,144 )
Loans, net	\$788,586				\$808,200

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

Upon the acquisition of Luzerne Bank on June 1, 2013, 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, 2014. 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 \$866,000 at June 30, 2014.

On the acquisition date, the preliminary estimate of the unpaid principal balance for all loans evidencing credit impairment acquired in the Luzerne Bank 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 either the customer or 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

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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 in the Luzerne Bank transaction with specific evidence of deterioration in 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 Bank acquisition as of June 1, 2013:

Changes in the amortizable yield for purchased credit-impaired loans were as follows for the six months ended June 30, 2014 and 2013:

(In Thousands)	June 30, 2014	June 30, 2013
Balance at beginning of period or at acquisition	\$35	\$63
Accretion	(12)	(4)
Balance at end of period	\$23	\$59

The following table presents additional information regarding loans acquired in the Luzerne Bank transaction with specific evidence of deterioration in credit quality:

(In Thousands)	June 30, 2014	December 31, 2013
Outstanding balance	\$1,222	\$1,224
Carrying amount	866	868

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, 2014. 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 30, 2014.

The following table presents interest income the Bank would have recorded 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, 2014 and 2013:

(In Thousands)	Three Months Ended June 30, 2014		2013	
	Interest Income That Would Have Been Recorded Based on Original Term and Rate	Interest Income Recorded on Cash Basis	Interest Income That Would Have Been Recorded Based on Original Term and Rate	Interest Income Recorded on Cash Basis
Commercial and agricultural	\$15	\$1	\$4	\$—
Real estate mortgage:				
Residential	5	5	22	3
Commercial	147	53	31	34
Construction	24	—	40	14
	\$191	\$59	\$97	\$51
(In Thousands)	Six Months Ended June 30, 2014		2013	
	Interest Income That Would Have Been Recorded Based on Original Term and Rate	Interest Income Recorded on Cash Basis	Interest Income That Would Have Been Recorded Based on Original Term and Rate	Interest Income Recorded on Cash Basis

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Commercial and agricultural	\$17	\$1	\$4	\$—
Real estate mortgage:				
Residential	7	9	54	12
Commercial	275	86	116	84
Construction	35	—	81	25
	\$334	\$96	\$255	\$121

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## 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, 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, 2014 and December 31, 2013:

	June 30, 2014		
(In Thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:			
Commercial and agricultural	\$—	\$—	\$—
Real estate mortgage:			
Residential	454	563	—
Commercial	2,250	2,506	—
Construction	516	516	—
	3,220	3,585	—
With an allowance recorded:			
Commercial and agricultural	512	512	147
Real estate mortgage:			
Residential	630	653	56
Commercial	8,617	9,116	2,042
Construction	506	1,361	108
	10,265	11,642	2,353

Total:			
Commercial and agricultural	512	512	147
Real estate mortgage:			
Residential	1,084	1,216	56
Commercial	10,867	11,622	2,042
Construction	1,022	1,877	108
	\$13,485	\$15,227	\$2,353

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(In Thousands)	December 31, 2013		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:			
Commercial and agricultural	\$—	\$—	\$—
Real estate mortgage:			
Residential	916	1,173	—
Commercial	623	879	—
Construction	528	528	—
	2,067	2,580	—
With an allowance recorded:			
Commercial and agricultural	532	532	224
Real estate mortgage:			
Residential	319	342	65
Commercial	7,598	7,742	2,153
Construction	512	1,367	113
	8,961	9,983	2,555
Total:			
Commercial and agricultural	532	532	224
Real estate mortgage:			
Residential	1,235	1,515	65
Commercial	8,221	8,621	2,153
Construction	1,040	1,895	113
	\$11,028	\$12,563	\$2,555

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, 2014 and 2013:

(In Thousands)	Three Months Ended June 30, 2014			2013		
	Average Investment in Impaired Loans	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	Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans
Commercial and agricultural	\$517	\$ 7	\$ —	\$718	\$ 7	\$ —
Real estate mortgage:						
Residential	1,117	3	3	1,679	9	6
Commercial	10,901	19	2	8,491	46	38
Construction	1,025	—	—	2,532	—	14
	\$13,560	\$ 29	\$ 5	\$13,420	\$ 62	\$ 58

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(In Thousands)	Six Months Ended June 30, 2014			2013		
	Average Investment in Impaired Loans	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	Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans
Commercial and agricultural	\$522	\$ 13	\$ —	\$615	\$ 13	\$ —
Real estate mortgage:						
Residential	1,142	14	7	1,618	17	11
Commercial	10,008	61	14	8,598	93	84
Construction	1,030	2	8	3,718	553	553
	\$12,702	\$ 90	\$ 29	\$14,549	\$ 676	\$ 648

There is approximately \$299,000 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 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.

There were no loan modifications that are considered TDRs completed during the three and six months ended June 30, 2014. Loan modifications that are considered TDRs completed during the three and six months ended June 30, 2013 were as follows:

(In Thousands, Except Number of Contracts)	Three Months Ended June 30, 2013		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate mortgage:			
Residential	2	\$ 61	\$ 61
	2	\$ 61	\$ 61
(In Thousands, Except Number of Contracts)	Six Months Ended June 30, 2013		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate mortgage:			
Residential	2	\$ 61	\$ 61
Commercial	2	264	264



There were two loan modifications considered troubled debt restructurings made during the twelve months previous to June 30, 2014 that defaulted during the six months ended June 30, 2014. The loans that defaulted are commercial real estate loans that are currently in litigation with a recorded investment of \$1,629,000 at June 30, 2014.

Troubled debt restructurings amounted to \$11,281,000 and \$11,472,000 as of June 30, 2014 and December 31, 2013.

#### Internal Risk Ratings

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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 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, 2014 and December 31, 2013:

(In Thousands)	June 30, 2014				Installment Loans	
	Commercial and Real Estate Mortgages		Commercial	Construction	to Individuals	Totals
	Agricultural	Residential				
Pass	\$ 112,634	\$ 415,617	\$ 259,533	\$ 19,645	\$ 19,219	\$ 826,648
Special Mention	5,173	1,569	9,438	202	—	16,382
Substandard	1,320	429	12,333	496	—	14,578
	\$ 119,127	\$ 417,615	\$ 281,304	\$ 20,343	\$ 19,219	\$ 857,608
	December 31, 2013					
(In Thousands)	Commercial and Real Estate Mortgages				Installment Loans	
	Agricultural	Residential	Commercial	Construction	to Individuals	Totals
Pass	\$ 99,256	\$ 398,327	\$ 259,505	\$ 13,608	\$ 14,647	\$ 785,343
Special Mention	4,529	598	10,181	214	—	15,522
Substandard	1,244	856	12,790	3,460	—	18,350
	\$ 105,029	\$ 399,781	\$ 282,476	\$ 17,282	\$ 14,647	\$ 819,215

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## 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.

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 loans acquired in the Luzerne Bank transaction 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, 2014.

Activity in the allowance is presented for the three and six months ended June 30, 2014 and 2013:

(In Thousands)	Three Months Ended June 30, 2014						
	Agricultural	Commercial and Real Estate Mortgages	Residential	Commercial Construction	Installment Loans to Individuals	Unallocated Totals	
Beginning Balance	\$537	\$3,062	\$3,324	\$795	\$161	\$641	\$8,520
Charge-offs	—	(7)	) —	—	(28)	) —	(35)
Recoveries	8	1	—	—	17	—	26
Provision	149	206	70	(77)	) 48	(96)	) 300

Ending Balance	\$694	\$3,262	\$3,394	\$ 718	\$ 198	\$545	\$8,811
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Three Months Ended June 30, 2013							
(In Thousands)	Commercial and Real Estate Mortgages				Installment Loans		
	Agricultural	Residential	Commercial	Construction	to Individuals	Unallocated	Totals
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
Six Months Ended June 30, 2014							
(In Thousands)	Commercial and Real Estate Mortgages				Installment Loans		
	Agricultural	Residential	Commercial	Construction	to Individuals	Unallocated	Totals
Beginning Balance	\$474	\$3,917	\$4,079	\$741	\$139	\$794	\$10,144
Charge-offs	—	(63)	(2,038)	—	(68)	—	(2,169)
Recoveries	11	3	—	—	37	—	51
Provision	209	(595)	) 1,353	(23)	) 90	(249)	) 785
Ending Balance	\$694	\$3,262	\$3,394	\$718	\$198	\$545	\$8,811
Six Months Ended June 30, 2013							
(In Thousands)	Commercial and Real Estate Mortgages				Installment Loans		
	Agricultural	Residential	Commercial	Construction	to Individuals	Unallocated	Totals
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

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, 2014, 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, 2014 and 2013 as follows:

	June 30,		
	2014	2013	
Owners of residential rental properties	15.69	% 14.71	%
Owners of commercial rental properties	14.12	% 14.15	%



quality						
Collectively evaluated for impairment	104,497	398,546	274,255	16,242	14,647	808,187
Total ending loans balance	\$ 105,029	\$ 399,781	\$ 282,476	\$ 17,282	\$ 14,647	\$ 819,215

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, 2013.

The following sets forth the components of the net periodic benefit cost of the domestic non-contributory defined benefit plan for the three and six months ended June 30, 2014 and 2013, respectively:

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(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,		
	2014	2013	2014	2013	
Service cost	\$140	\$159	\$280	\$318	
Interest cost	214	193	429	386	
Expected return on plan assets	(289	) (246	)(577	) (492	)
Amortization of prior service cost	—	6	—	13	
Amortization of net loss	53	120	105	239	
Net periodic cost	\$118	\$232	\$237	\$464	

## 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, 2013, that it expected to contribute a minimum of \$600,000 to its defined benefit plan in 2014. As of June 30, 2014, there were contributions of \$420,000 made to the plan with additional contributions of at least \$180,000 anticipated during the remainder of 2014.

## 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, 2014 and 2013, there were 1,293 and 792 shares issued under the plan, respectively.

## 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, 2014 and December 31, 2013:

(In Thousands)	June 30, 2014	December 31, 2013
Commitments to extend credit	\$252,693	\$185,415
Standby letters of credit	3,955	4,379
	\$256,648	\$189,794



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.

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## 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.

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, 2014 and December 31, 2013, 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, 2014			
	Level I	Level II	Level III	Total
Assets measured on a recurring basis:				
Investment securities, available for sale:				
U.S. Government and agency securities	\$—	\$5,862	\$—	\$5,862
Mortgage-backed securities		12,004	—	12,004
Asset-backed securities		2,617	—	2,617
State and political securities	—	129,196	—	129,196
Other debt securities	—	99,437	—	99,437
Financial institution equity securities	10,222	—	—	10,222
Other equity securities	3,688	—	—	3,688
Total assets measured on a recurring basis	\$13,910	\$249,116	\$—	\$263,026

(In Thousands)	December 31, 2013			
	Level I	Level II	Level III	Total
Assets measured on a recurring basis:				
Investment securities, available for sale:				
U.S. Government and agency securities	\$—	\$9,923	\$—	\$9,923
Mortgage-backed securities	—	10,592	—	10,592
Asset-backed securities	—	6,564	—	6,564
State and political securities	—	141,795	—	141,795
Other debt securities	—	106,773	—	106,773
Financial institution equity securities	10,662	—	—	10,662
Other equity securities	2,303	—	—	2,303
Total assets measured on a recurring basis	\$12,965	\$275,647	\$—	\$288,612

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, 2014 and December 31, 2013, 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, 2014			
	Level I	Level II	Level III	Total
Assets measured on a non-recurring basis:				
Impaired loans	\$—	\$—	\$11,132	\$11,132
Other real estate owned	—	—	1,552	1,552
Total assets measured on a non-recurring basis	\$—	\$—	\$12,684	\$12,684
(In Thousands)	December 31, 2013			
	Level I	Level II	Level III	Total
Assets measured on a non-recurring basis:				
Impaired loans	\$—	\$—	\$8,473	\$8,473
Other real estate owned	—	—	1,898	1,898
Total assets measured on a non-recurring basis	\$—	\$—	\$10,371	\$10,371

The following tables present a listing of significant unobservable inputs used in the fair value measurement process for items valued utilizing level III techniques as of June 30, 2014 and December 31, 2013:

(In Thousands)	June 30, 2014				
	Fair Value	Valuation Technique(s)	Unobservable Inputs	Range	Weighted Average
Impaired loans	\$11,132	Discounted cash flow	Temporary reduction in payment amount	0 to -91%	12%
			Probability of default	—%	—%
Other real estate owned	\$1,552	Appraisal of collateral	Appraisal adjustments (1)	0 to -44%	16%
		Appraisal of collateral (1)			

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

(In Thousands)	December 31, 2013				
	Fair Value	Valuation Technique(s)	Unobservable Inputs	Range	Weighted Average
Impaired loans	\$8,473	Discounted cash flow	Temporary reduction in payment amount	0 to -91%	-18%
			Probability of default	—%	—%
Other real estate owned	\$1,898	Appraisal of collateral	Appraisal adjustments (1)	0 to -44%	-21%
		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.

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## 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.

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, 2014 and December 31, 2013:

(In Thousands)	Carrying Value	Fair Value	Fair Value Measurements at June 30, 2014		
			Level I	Level II	Level III
Financial assets:					
Cash and cash equivalents	\$24,867	\$24,867	\$24,867	\$—	\$—
Investment securities:					
Available for sale	263,026	263,026	13,910	249,116	—
Loans held for sale	1,827	1,827	1,827	—	—
Loans, net	847,521	848,480	—	—	848,480
Bank-owned life insurance	25,601	25,601	25,601	—	—
Accrued interest receivable	4,235	4,235	4,235	—	—
Financial liabilities:					
Interest-bearing deposits	\$753,068	\$733,414	\$510,673	\$—	\$222,741
Noninterest-bearing deposits	228,758	228,758	228,758	—	—
Short-term borrowings	21,926	21,926	21,926	—	—
Long-term borrowings	71,202	73,614	—	—	73,614
Accrued interest payable	399	399	399	—	—

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(In Thousands)	Carrying Value	Fair Value	Fair Value Measurements at December 31, 2013		
			Level I	Level II	Level III
Financial assets:					
Cash and cash equivalents	\$24,606	\$24,606	\$24,606	\$—	\$—
Investment securities:					
Available for sale	288,612	288,612	12,965	275,647	—
Loans held for sale	1,626	1,626	1,626	—	—
Loans, net	808,200	808,895	—	—	808,895
Bank-owned life insurance	25,410	25,410	25,410	—	—
Accrued interest receivable	4,696	4,696	4,696	—	—
Financial liabilities:					
Interest-bearing deposits	\$755,625	\$724,456	\$488,818	\$—	\$235,638
Noninterest-bearing deposits	217,377	217,377	217,377	—	—
Short-term borrowings	26,716	26,716	26,716	—	—
Long-term borrowings	71,202	73,248	—	—	73,248
Accrued interest payable	405	405	405	—	—

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 cashflows 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.



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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. Since June 1, 2013, the loan production office in Lackawanna County has been closed.

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, 2014, 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 Bank'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 Bank's loan portfolio without evidence of deterioration totaled \$249,789,000 and was recorded at a fair value of \$249,500,000.

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

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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 Bank.

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, 2014 and 2013

## Summary Results

Net income for the three months ended June 30, 2014 was \$3,463,000 compared to \$3,659,000 for the same period of 2013 as after-tax securities gains decreased \$520,000 (from a gain of \$841,000 to a gain of \$321,000). Basic and diluted earnings per share for the three months ended June 30, 2014 and 2013 were \$0.72 and \$0.88, respectively. Return on average assets and return on average equity were 1.13% and 10.29% for the three months ended June 30, 2014 compared to 1.48% and 13.54% for the corresponding period of 2013. Net income from core operations ("operating earnings") increased to \$3,142,000 for the three months ended June 30, 2014 compared to \$2,818,000 for the same period of 2013. Operating earnings per share for the three months ended June 30, 2014 were \$0.65 basic and dilutive compared to \$0.68 basic and dilutive for the three months ended June 30, 2013.

The six months ended June 30, 2014 generated net income of \$6,932,000 compared to \$7,343,000 for the same period of 2013. Comparable results were impacted by a decrease in after-tax securities gains of \$911,000 (from a gain of \$1,492,000 to a gain of \$581,000). In addition, a gain of \$174,000 on death benefit related to bank owned life insurance was recorded during the six months ended June 30, 2014. Earnings per share, basic and dilutive, for the six months ended June 30, 2014 were \$1.44 compared to \$1.84 for the comparable period of 2013. Return on average assets and return on average equity were 1.14% and 10.43% for the six months ended June 30, 2014 compared to 1.59% and 14.45% for the corresponding period of 2013. Operating earnings increased to \$6,177,000 for the six months ended June 30, 2014 compared to \$5,851,000 for the same period of 2013. Operating earnings per share for the six months ended June 30, 2014 were \$1.28 basic and dilutive compared to \$1.46 basic and dilutive for the six months ended June 30, 2013.

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

(Dollars in Thousands, Except Per Share Data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
GAAP net income	\$3,463	\$3,659	\$6,932	\$7,343
Less: net securities and bank-owned life insurance gains, net of tax	321	841	755	1,492
Non-GAAP operating earnings	\$3,142	\$2,818	\$6,177	\$5,851

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	Three Months Ended		Six Months Ended June		
	June 30,		30,		
	2014	2013	2014	2013	
Return on average assets (ROA)	1.13	% 1.48	% 1.14	% 1.59	%
Less: net securities and bank-owned life insurance gains, net of tax	0.10	% 0.34	% 0.12	% 0.33	%
Non-GAAP operating ROA	1.03	% 1.14	% 1.02	% 1.26	%

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	Three Months Ended June 30, 2014		2013		Six Months Ended June 30, 2014		2013	
Return on average equity (ROE)	10.29	%	13.54	%	10.43	%	14.45	%
Less: net securities and bank-owned life insurance gains, net of tax	0.96	%	3.11	%	1.14	%	2.93	%
Non-GAAP operating ROE	9.33	%	10.43	%	9.29	%	11.52	%
	Three Months Ended June 30, 2014		2013		Six Months Ended June 30, 2014		2013	
Basic earnings per share (EPS)	\$0.72		\$0.88		\$1.44		\$1.84	
Less: net securities and bank-owned life insurance gains, net of tax	0.07		0.20		0.16		0.38	
Non-GAAP basic operating EPS	\$0.65		\$0.68		\$1.28		\$1.46	
	Three Months Ended June 30, 2014		2013		Six Months Ended June 30, 2014		2013	
Dilutive EPS	\$0.72		\$0.88		\$1.44		\$1.84	
Less: net securities and bank-owned life insurance gains, net of tax	0.07		0.20		0.16		0.38	
Non-GAAP dilutive operating EPS	\$0.65		\$0.68		\$1.28		\$1.46	

## Interest and Dividend Income

Interest and dividend income for the three months ended June 30, 2014 increased to \$11,357,000 compared to \$10,018,000 for the same period of 2013. The increase was due to loan portfolio income increasing as the impact of portfolio growth, due primarily due to the acquisition of Luzerne Bank, offset a reduction in yield of 44 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 20 bp as the duration in the investment portfolio continues to be shortened in order to reduce interest rate and market risk in the future. This is being undertaken primarily through the sale of long-term municipal bonds that have a maturity date of 2025 or later and securities with a call date within the next five years. To offset the revenue impact of the declining asset yields, a focus has been placed on increasing earning assets by adding quality short and intermediate term loans such as home equity loans, even though these new earning assets are at a lower yields than legacy assets.

During the six months ended June 30, 2014, interest and dividend income was \$22,686,000, an increase of \$3,128,000 over the same period in 2013. 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 portfolio size was decreased in order to reduce interest rate and market risk, while the yield on the investment portfolio declined 31 bp.

Interest and dividend income composition for the three and six months ended June 30, 2014 and 2013 was as follows:

	Three Months Ended June 30, 2014		June 30, 2013		Change			
(In Thousands)	Amount	% Total	Amount	% Total	Amount	%		%
Loans including fees	\$8,912	78.48	\$7,277	72.64	\$1,635	22.47		
Investment securities:								
Taxable	1,406	12.38	1,507	15.04	(101)	(6.70)		
Tax-exempt	892	7.85	1,162	11.60	(270)	(23.24)		

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Dividend and other interest income	147	1.29	72	0.72	75	104.17	
Total interest and dividend income	\$11,357	100.00	% \$10,018	100.00	% \$1,339	13.37	%

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(In Thousands)	Six Months Ended June 30, 2014		June 30, 2013		Change			
	Amount	% Total	Amount	% Total	Amount	%		
Loans including fees	\$17,725	78.13	% \$14,045	71.81	% \$3,680		26.20	%
Investment securities:								
Taxable	2,864	12.62	2,950	15.08	(86	)	(2.92	)
Tax-exempt	1,823	8.04	2,429	12.42	(606	)	(24.95	)
Dividend and other interest income	274	1.21	134	0.69	140		104.48	
Total interest and dividend income	\$22,686	100.00	% \$19,558	100.00	% \$3,128		15.99	%

## Interest Expense

Interest expense for the three months ended June 30, 2014 decreased \$38,000 to \$1,226,000 compared to \$1,264,000 for the same period of 2013. The decrease associated with deposits is primarily the result of a reduction of 14 bps and 14 bps in the rate paid on time deposits and NOW accounts, 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, campaigns conducted by the Company to focus on core deposit (non-time deposit) growth as the building block to solid customer relationships, and the acquisition of Luzerne Bank. 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 against anticipated rising interest rates. In addition, the Marcellus Shale natural gas exploration in north central Pennsylvania is creating opportunities to gather new and build upon existing deposit relationships.

Interest expense for the six months ended June 30, 2014 decreased 5.04% from the same period of 2013. 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, 2014 and 2013 was as follows:

(In Thousands)	Three Months Ended June 30, 2014		June 30, 2013		Change			
	Amount	% Total	Amount	% Total	Amount	%		
Deposits	\$741	60.44	% \$760	60.13	% \$(19	)	(2.50	)%
Short-term borrowings	12	0.98	22	1.74	(10	)	(45.45	)
Long-term borrowings	473	38.58	482	38.13	(9	)	(1.87	)
Total interest expense	\$1,226	100.00	% \$1,264	100.00	% \$(38	)	(3.01	)%
(In Thousands)	Six Months Ended June 30, 2014		June 30, 2013		Change			
	Amount	% Total	Amount	% Total	Amount	%		
Deposits	\$1,499	60.74	% \$1,551	59.68	% \$(52	)	(3.35	)%
Short-term borrowings	27	1.09	47	1.81	(20	)	(42.55	)
Long-term borrowings	942	38.17	1,001	38.51	(59	)	(5.89	)
Total interest expense	\$2,468	100.00	% \$2,599	100.00	% \$(131	)	(5.04	)%

## Net Interest Margin

The net interest margin (“NIM”) for the three months ended June 30, 2014 was 3.84% compared to 4.09% for the corresponding period of 2013. The NIM declined as a 14 bp decline in the rate paid on interest bearing liabilities was



countered by a 37 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 0.71% to 0.57% was driven by a reduction in the rate paid on time deposits of 14 bp. The reduction in the rate paid on time deposits was the result of shortening the time deposit

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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 2013.

The NIM for the six months ended June 30, 2014 was 3.88% compared to 4.26% for the same period of 2013. The impact of the items mentioned in the three month discussion also applies to the six months ended. A 22 bp decline in the rate paid on time deposits served as the foundation for a 14 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, 2014 and 2013:

(In Thousands)	AVERAGE BALANCES AND INTEREST RATES							
	Three Months Ended June 30, 2014				Three Months Ended June 30, 2013			
	Average Balance	Interest	Average Rate		Average Balance	Interest	Average Rate	
<b>Assets:</b>								
Tax-exempt loans	\$26,040	\$286	4.41	%	\$21,480	\$249	4.65	%
All other loans	805,971	8,723	4.34	%	596,206	7,113	4.79	%
Total loans	832,011	9,009	4.34	%	617,686	7,362	4.78	%
Fed funds sold	128	—	—	%	98	—	—	%
Taxable securities	175,374	1,540	3.51	%	178,827	1,573	3.52	%
Tax-exempt securities	98,589	1,352	5.66	%	119,655	1,761	5.89	%
Total securities	273,963	2,892	4.27	%	298,482	3,334	4.47	%
Interest-bearing deposits	14,396	13	0.36	%	8,339	6	0.29	%
Total interest-earning assets	1,120,498	11,914	4.27	%	924,605	10,702	4.64	%
Other assets	105,066				65,956			
Total assets	\$1,225,564				\$990,561			
<b>Liabilities and shareholders' equity:</b>								
Savings	\$141,837	20	0.06	%	\$107,027	27	0.10	%
Super Now deposits	189,473	150	0.32	%	149,635	171	0.46	%
Money market deposits	211,788	138	0.26	%	172,228	129	0.30	%
Time deposits	225,548	433	0.77	%	191,046	433	0.91	%
Total interest-bearing deposits	768,646	741	0.39	%	619,936	760	0.60	%
Short-term borrowings	15,422	11	0.29	%	21,777	22	0.40	%
Long-term borrowings	71,202	474	2.63	%	71,237	482	2.68	%
Total borrowings	86,624	485	2.22	%	93,014	504	2.14	%
Total interest-bearing liabilities	855,270	1,226	0.57	%	712,950	1,264	0.71	%

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Demand deposits	220,975			153,840		
Other liabilities	14,651			15,652		
Shareholders' equity	134,668			108,120		
Total liabilities and shareholders' equity	\$1,225,564			\$990,562		
Interest rate spread			3.70			3.93
Net interest income/margin		\$10,688	3.84		\$9,438	4.09

1. Information on this table has been calculated using average daily balance sheets to obtain average balances.
2. Non-accrual 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, 2014				Six Months Ended June 30, 2013			
	Average Balance	Interest	Average Rate		Average Balance	Interest	Average Rate	
Assets:								
Tax-exempt loans	\$26,714	\$592	4.47	%	\$21,860	\$498	4.59	%
All other loans	798,552	17,334	4.38	%	546,033	13,716	5.07	%
Total loans	825,266	17,926	4.38	%	567,893	14,214	5.05	%
Fed funds sold	344	—	—	%	49	—	—	%
Taxable securities	176,046	3,116	3.54	%	170,226	3,076	3.61	%
Tax-exempt securities	97,864	2,762	5.64	%	123,543	3,680	5.96	%
Total securities	273,910	5,878	4.29	%	293,769	6,756	4.60	%
Interest-bearing deposits	10,000	22	0.44	%	6,024	8	0.27	%
Total interest-earning assets	1,109,520	23,826	4.32	%	867,735	20,978	4.86	%
Other assets	105,718				57,369			
Total assets	\$1,215,238				\$925,104			
Liabilities and shareholders' equity:								
Savings	\$140,803	51	0.07	%	\$95,848	52	0.11	%
Super Now deposits	183,174	307	0.34	%	143,509	344	0.48	%
Money market deposits	209,314	272	0.26	%	158,374	264	0.34	%
Time deposits	228,846	869	0.77	%	181,443	891	0.99	%
Total interest-bearing deposits	762,137	1,499	0.40	%	579,174	1,551	0.54	%
Short-term borrowings	17,749	27	0.31	%	21,574	47	0.44	%
Long-term borrowings	71,202	942	2.63	%	73,550	1,001	2.71	%
Total borrowings	88,951	969	2.17	%	95,124	1,048	2.19	%
Total interest-bearing liabilities	851,088	2,468	0.58	%	674,298	2,599	0.77	%
Demand deposits	216,588				135,035			
Other liabilities	14,642				14,164			
Shareholders' equity	132,920				101,607			
Total liabilities and shareholders' equity	\$1,215,238				\$925,104			
Interest rate spread			3.74	%			4.09	%
Net interest income/margin		\$21,358	3.88	%		\$18,379	4.26	%

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, 2014 and 2013.

(In Thousands)	Three Months Ended June 30, 2014	2013	Six Months Ended June 30, 2014	2013
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Total interest income	\$11,357	\$10,018	\$22,686	\$19,558
Total interest expense	1,226	1,264	2,468	2,599
Net interest income	10,131	8,754	20,218	16,959
Tax equivalent adjustment	557	684	1,140	1,420
Net interest income (fully taxable equivalent)	\$10,688	\$9,438	\$21,358	\$18,379

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, 2014 and 2013:

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(In Thousands)	Three Months Ended June 30, 2014 vs. 2013			Six Months Ended June 30, 2014 vs. 2013		
	Increase (Decrease) Due to Volume	Rate	Net	Increase (Decrease) Due to Volume	Rate	Net
Interest income:						
Tax-exempt loans	\$50	\$(13)	) \$37	\$107	\$(13)	) \$94
All other loans	2,315	(705)	) 1,610	5,682	(2,064)	) 3,618
Fed funds sold	—	—	—	—	—	—
Taxable investment securities	(20)	) (13)	) (33)	) 101	(61)	) 40
Tax-exempt investment securities	(328)	) (81)	) (409)	) (731)	) (187)	) (918)
Interest bearing deposits	7	—	7	5	9	14
Total interest-earning assets	2,024	(812)	) 1,212	5,164	(2,316)	) 2,848
Interest expense:						
Savings deposits	7	(14)	) (7)	) 21	(22)	) (1)
Super Now deposits	40	(61)	) (21)	) 79	(116)	) (37)
Money market deposits	76	(67)	) 9	178	(170)	) 8
Time deposits	70	(70)	) —	203	(225)	) (22)
Short-term borrowings	(5)	) (6)	) (11)	) (7)	) (13)	) (20)
Long-term borrowings	—	(8)	) (8)	) (31)	) (28)	) (59)
Total interest-bearing liabilities	188	(226)	) (38)	) 443	(574)	) (131)
Change in net interest income	\$1,836	\$(586)	) \$1,250	\$4,721	\$(1,742)	) \$2,979

## 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, 2014, 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.

The allowance for loan losses decreased from \$10,144,000 at December 31, 2013 to \$8,811,000 at June 30, 2014. The decrease in the allowance for loan losses was driven by net charge-offs during the six months ended June 30, 2014 of \$2,169,000. The majority of the loans charged-off had a specific allowance within the allowance for losses. At June 30, 2014 and December 31, 2013, the allowance for loan losses to total loans was 1.03% and 1.24%, respectively. The ratio was impacted by the growth in the gross loan portfolio of \$37,998,000 since December 31, 2013 and the previously noted charge-offs.

The provision for loan losses totaled \$300,000 and \$575,000 for the three months ended June 30, 2014 and 2013. 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 1.40% at June 30, 2014 and a ratio of the allowance for loan losses to nonperforming loans of 73.55% at June 30, 2014.

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Nonperforming loans increased to \$11,979,000 at June 30, 2014 from \$6,515,000 at June 30, 2013 due primarily to certain commercial real estate backed loans becoming non-performing. Internal loan review and analysis coupled with the ratios noted previously dictated a provision for loan losses of \$785,000 for the six months ended June 30, 2014. The amount of the provision for loan losses for the period ended June 30, 2014 did not equate to the amount of the change in nonperforming loans as of June 30, 2014 because the majority of the non-performing loans are centered on several loans that are either in a secured position and have sureties with a strong underlying financial position or have a specific allocation for any impairment recorded within the allowance for loan losses.

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

(In Thousands)	Total Nonperforming Loans		
	90 Days Past Due	Non-accrual	Total
June 30, 2014	\$397	\$11,582	\$11,979
March 31, 2014	153	10,461	10,614
December 31, 2013	604	9,074	9,678
September 30, 2013	231	5,833	6,064
June 30, 2013	8	6,507	6,515

## Non-interest Income

Total non-interest income for the three months ended June 30, 2014 compared to the same period in 2013 decreased \$606,000 to \$2,929,000. Excluding net securities gains/losses, non-interest income for the three months ended June 30, 2014 increased \$181,000 compared to the 2013 period due in part to the acquisition of Luzerne Bank. The increase in service charges was driven by the acquisition of Luzerne Bank and the increased number of deposit accounts being serviced. Bank owned life insurance income increased primarily due to a gain on death benefits. Gain on sale of loans increased due to an increase in volume that was driven in part by the access to the greater Wilkes-Barre market provided by the acquisition of Luzerne. Insurance commissions increased and brokerage commissions decreased due in part to the acquisition of Luzerne Bank and a shift in product mix.

Total non-interest income for the six months ended June 30, 2014 compared to the same period in 2013 decreased \$128,000. Excluding net securities gains, non-interest income increased \$1,252,000 compared to the 2013 period. The reasons noted for the three month period comparison also apply to the six month period.

Non-interest income composition for the three and six months ended June 30, 2014 and 2013 was as follows:

(In Thousands)	Three Months Ended		June 30, 2013	Change	June 30, 2013	Change	June 30, 2013	Change
	June 30, 2014	June 30, 2013						
Service charges	\$607	20.72	% \$538	15.22	% \$69	12.83	%	
Securities gains, net	487	16.63	1,274	36.04	(787)	(61.77)	)	
Bank-owned life insurance	181	6.18	144	4.07	37	25.69		
Gain on sale of loans	421	14.37	302	8.54	119	39.40		
Insurance commissions	283	9.66	247	6.99	36	14.57		
Brokerage commissions	251	8.57	299	8.46	(48)	(16.05)	)	
Other	699	23.87	731	20.67	(32)	(4.38)	)	
	\$2,929	100.00	% \$3,535	100.00	% \$(606)	(17.14)	)%	



Total non-interest  
income

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(In Thousands)	Six Months Ended		June 30, 2013		Change			
	June 30, 2014		Amount	% Total	Amount	% Total		
Service charges	\$1,202	19.58	% \$980	15.63	% \$222		22.65	%
Securities gains, net	880	14.33	2,260	36.06	(1,380)	)	(61.06)	)
Bank-owned life insurance	551	8.97	282	4.50	269		95.39	
Gain on sale of loans	711	11.58	653	10.42	58		8.88	
Insurance commissions	703	11.45	511	8.15	192		37.57	
Brokerage commissions	522	8.50	547	8.73	(25)	)	(4.57)	)
Other	1,571	25.59	1,035	16.51	536		51.79	
Total non-interest income	\$6,140	100.00	% \$6,268	100.00	% \$(128)	)	(2.04)	)%

## Non-interest Expense

Total non-interest expense increased \$1,457,000 for the three months ended June 30, 2014 compared to the same period of 2013 due primarily to the acquisition of Luzerne Bank. The increase in salaries and employee benefits was attributable to increases in salaries and health insurance coupled with the acquisition of Luzerne Bank. Occupancy and furniture and equipment expenses increased due to the additional branches of Luzerne Bank and significant upgrades to the core operating system, a new teller system, and various enhancements to other ancillary systems. Other expenses increased primarily due to increased fees related to providing debit card services and other expenses related to the acquisition of Luzerne Bank.

Total non-interest expense for the six months ended June 30, 2014 compared to the same period in 2013 increased \$4,249,000. The reasons noted for the three month period comparison also apply to the six month period.

Non-interest expense composition for the three and six months ended June 30, 2014 and 2013 was as follows:

(In Thousands)	Three Months Ended		June 30, 2013		Change			
	June 30, 2014		Amount	% Total	Amount	% Total		
Salaries and employee benefits	\$4,167	49.48	% \$3,442	49.42	% \$725		21.06	%
Occupancy	552	6.55	397	5.70	155		39.04	
Furniture and equipment	648	7.69	412	5.92	236		57.28	
Pennsylvania shares tax	262	3.11	208	2.99	54		25.96	
Amortization of investment in limited partnerships	166	1.97	166	2.38	—		—	
Federal Deposit Insurance Corporation deposit insurance	201	2.39	119	1.71	82		68.91	
Marketing	126	1.50	120	1.72	6		5.00	
Intangible amortization	88	1.04	31	0.45	57		N/A	
Other	2,212	26.27	2,070	29.71	142		6.86	
Total non-interest expense	\$8,422	100.00	% \$6,965	100.00	% \$1,457		20.92	%

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(In Thousands)	Six Months Ended		June 30, 2013		Change			
	June 30, 2014		Amount	% Total	Amount	%		
Salaries and employee benefits	\$8,670	50.81 %	\$6,510	50.80 %	\$2,160		33.18	%
Occupancy	1,182	6.93	748	5.84	434		58.02	
Furniture and equipment	1,319	7.73	820	6.40	499		60.85	
Pennsylvania shares tax	506	2.97	392	3.06	114		29.08	
Amortization of investment in limited partnerships	331	1.94	331	2.58	—		—	
Federal Deposit Insurance Corporation deposit insurance	379	2.22	248	1.94	131		52.82	
Marketing	236	1.38	215	1.68	21		9.77	
Intangible amortization	180	1.05	31	0.24	149		N/A	
Other	4,262	24.97	3,521	27.46	741		21.05	
Total non-interest expense	\$17,065	100.00 %	\$12,816	100.00 %	\$4,249		33.15	%
Provision for Income Taxes								

Income taxes decreased \$215,000 and \$417,000 for the three and six months ended June 30, 2014 compared to the same periods of 2013. The primary cause of the change in tax expense for the three and six months ended June 30, 2014 compared to 2013 is the impact of security gains. Excluding the impact of the net securities gains, the effective tax rate for the three and six ended June 30, 2014 was 18.41% and 16.74% compared to 18.91% and 17.31% for the same period of 2013. 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.

## ASSET/LIABILITY MANAGEMENT

## Cash and Cash Equivalents

Cash and cash equivalents increased \$261,000 from \$24,606,000 at December 31, 2013 to \$24,867,000 at June 30, 2014 primarily as a result of the following activities during the six months ended June 30, 2014:

## Loans Held for Sale

Activity regarding loans held for sale resulted in loan originations leading sales proceeds, less \$711,000 in realized gains, by \$201,000 for the six months ended June 30, 2014.

## Loans

Gross loans increased \$37,988,000 since December 31, 2013 due to an increase in commercial and agricultural loans coupled with an increase in installment loans due to an auto loan campaign. 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, 2014 and December 31, 2013 is presented below:

(In Thousands)	June 30, 2014		December 31, 2013		Change	
	Amount	% Total	Amount	% Total	Amount	%

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Commercial and agricultural	\$ 119,127	13.91	%	\$ 105,029	12.83	%	\$ 14,098	13.42	%
Real estate mortgage:									
Residential	417,615	48.77		399,781	48.86		17,834	4.46	%
Commercial	281,304	32.85		282,476	34.52		(1,172)	(0.41)	%
Construction	20,343	2.38		17,282	2.11		3,061	17.71	%
Installment loans to individuals	19,219	2.24		14,647	1.79		4,572	31.21	%
Net deferred loan fees and discounts	(1,276)	(0.15)	)	(871)	(0.11)	)	(405)	46.50	%
Gross loans	\$ 856,332	100.00	%	\$ 818,344	100.00	%	\$ 37,988	4.64	%

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The following table shows the amount of accrual and non-accrual TDRs at June 30, 2014 and December 31, 2013:

(In Thousands)	June 30, 2014			December 31, 2013		
	Accrual	Non-accrual	Total	Accrual	Non-accrual	Total
Commercial and agricultural	\$415	\$—	\$415	\$437	\$—	\$437
Real estate mortgage:						
Residential	477	231	708	603	118	721
Commercial	4,060	5,070	9,130	4,145	5,123	9,268
Construction	527	496	1,023	11	1,028	1,039
Installment loans to individuals	4	—	4	7	—	7
	\$5,483	\$5,797	\$11,280	\$5,203	\$6,269	\$11,472

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### Investments

The fair value of the investment securities portfolio at June 30, 2014 decreased \$25,586,000 since December 31, 2013 while the amortized cost of the portfolio decreased \$33,964,000. The decrease in value is the result of the investment portfolio being actively managed in order to reduce interest rate and market risk. This is being undertaken primarily through the sale of long-term municipal bonds that have a maturity date of 2025 or later and securities with a call date within the next five years. The proceeds of the bond sales are being deployed into loans and intermediate term corporate bonds and short and intermediate term municipal bonds. The strategy to sell a portion of the long-term bond portfolio does negatively impact current earnings, but this action plays a key role in our long-term asset liability management strategy as the balance sheet is shortened to better prepare for a rising rate environment. The unrealized losses within the debt securities portfolio are the result of market activity, not credit issues/ratings, as approximately 90% 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 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 stock pricing. The amortized cost of the equity securities portfolio has increased \$1,061,000 to \$12,245,000 at June 30, 2014 from \$11,184,000 at December 31, 2013 while the fair value increased \$945,000 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. 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, 2014 follows:

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(In Thousands)	A- to AAA		B- to BBB+		Not Rated		Total	
	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	\$1,980	\$1,993	\$—	\$—	\$3,995	\$3,869	\$5,975	\$5,862
Mortgage-backed securities	11,420	12,004	—	—	—	—	11,420	12,004
Asset-backed securities	2,580	2,617	—	—	—	—	2,580	2,617
State and political securities	120,559	123,190	—	—	5,959	6,006	126,518	129,196
Other debt securities	84,498	84,922	14,699	14,515	—	—	99,197	99,437
Total debt securities AFS	\$221,037	\$224,726	\$14,699	\$14,515	\$9,954	\$9,875	\$245,690	\$249,116

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## Financing Activities

## Deposits

Total deposits increased \$8,824,000 from December 31, 2013 to June 30, 2014. The growth was led by an increase in demand deposit accounts from December 31, 2013 to June 30, 2014 of 5.24%. 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 first six months of 2014, time deposits have decreased as we have taken a position of using these accounts as complementary accounts to core deposits.

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

(In Thousands)	June 30, 2014		December 31, 2013		Change			
	Amount	% Total	Amount	% Total	Amount	%		
Demand deposits	\$228,758	23.30	% \$217,377	22.34	% \$11,381	5.24		%
NOW accounts	176,066	17.93	177,996	18.29	(1,930)	(1.08)	)	
Money market deposits	212,782	21.67	203,786	20.94	8,996	4.41		
Savings deposits	141,362	14.40	138,621	14.25	2,741	1.98		
Time deposits	222,858	22.70	235,222	24.18	(12,364)	(5.26)	)	
	\$981,826	100.00	% \$973,002	100.00	% \$8,824	0.91		%

## Borrowed Funds

Total borrowed funds decreased 4.89% or \$4,790,000 to \$93,128,000 at June 30, 2014 compared to \$97,918,000 at December 31, 2013. Short-term borrowings primarily decreased due to lower cost core deposit growth.

(In Thousands)	June 30, 2014		December 31, 2013		Change			
	Amount	% Total	Amount	% Total	Amount	%		
Short-term borrowings:								
FHLB repurchase agreements	\$3,125	3.36	% \$14,325	14.63	% \$(11,200)	(78.18)	)%	
Securities sold under agreement to repurchase	18,801	20.19	12,391	12.65	6,410	51.73		%
Total short-term borrowings	21,926	23.55	26,716	27.28	(4,790)	(17.93)	)	
Long-term FHLB borrowings	70,750	75.97	70,750	72.25	—	—		
Long-term capital lease	452	48.54	452	0.46	—	—		
Total long-term borrowings	71,202	76.45	71,202	72.72	—	—		%
Total borrowed funds	\$93,128	100.00	% \$97,918	100.00	% \$(4,790)	(4.89)	)%	

## 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, 2014 and December 31, 2013 were as follows:

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(In Thousands)	June 30, 2014		December 31, 2013		
	Amount	Ratio	Amount	Ratio	
Total Capital (to Risk-weighted Assets)					
Actual	\$ 118,493	12.53	% \$ 117,123	13.16	%
For Capital Adequacy Purposes	75,641	8.00	71,200	8.00	
To Be Well Capitalized	94,552	10.00	89,000	10.00	
Tier I Capital (to Risk-weighted Assets)					
Actual	\$ 108,898	11.52	% \$ 106,178	11.93	%
For Capital Adequacy Purposes	37,821	4.00	35,600	4.00	
To Be Well Capitalized	56,731	6.00	53,400	6.00	
Tier I Capital (to Average Assets)					
Actual	\$ 108,898	9.10	% \$ 106,178	9.02	%
For Capital Adequacy Purposes	47,843	4.00	47,111	4.00	
To Be Well Capitalized	59,803	5.00	58,889	5.00	

In July 2013, the federal bank regulatory agencies adopted 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. 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 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.

The following liquidity measures are monitored for compliance and were within the limits cited at June 30, 2014:

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.

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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 \$452,953,000. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of \$38,271,000. Management believes it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. FHLB borrowings totaled \$73,875,000 as of June 30, 2014.

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 by segments 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, 2015 assuming a static balance sheet as of June 30, 2014.

(In Thousands)	Parallel Rate Shock in Basis Points							
	-200	-100	Static	+100	+200	+300	+400	
Net interest income	\$36,398	\$38,119	\$39,825	\$41,099	\$42,232	\$43,036	\$43,625	
Change from static	(3,427 )	(1,706 )	—	1,274	2,407	3,211	3,800	
Percent change from static	-8.61	% -4.28	% —	3.20	% 6.04	% 8.06	% 9.54	%

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

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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 analysis or simulation analysis compared to the information provided in the Annual Report on Form 10-K for the period ended December 31, 2013. 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

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, 2014.

Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2014, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## 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, 2013. 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, 2014)	—	\$—	—	482,000
Month #2 (May 1 - May 31, 2014)	—	—	—	482,000
Month #3 (June 1 - June 30, 2014)	—	—	—	482,000

On April 15, 2014, the Board of Directors approved authorization to repurchase up to 482,000 shares, or approximately 10%, of the outstanding shares of the Company for one year to April 15, 2015. To date, there have been no 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, 2014 and December 31, 2013; (ii) the Consolidated Statement of Income for the three and six months ended June 30, 2014 and 2013; (iii) the Consolidated Statement of Shareholders' Equity for the six months ended June 30, 2014 and 2013; (iv) Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2014 and 2013; (v) the Consolidated Statement of Cash Flows for the six months ended June 30, 2014 and 2013; 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 11, 2014

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

Date: August 11, 2014

/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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