

PENNS WOODS BANCORP INC  
Form 10-Q  
May 10, 2006

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

- Quarterly Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended March 31, 2006,**
- 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, Williamsport, Pennsylvania**  
(Address of principal executive offices)

**17701-0967**  
(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 Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES

NO

On April 28, 2006 there were 3,941,787 of the Registrant's common stock outstanding.

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**PENNS WOODS BANCORP, INC.**

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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)   | March 31,<br>2006 | December 31,<br>2005 |
|---|-------------------|----------------------|
| <b>ASSETS:</b>  |                   |                      |
| Noninterest-bearing balances  | \$ 14,858         | \$ 14,065            |
| Interest-bearing deposits in other financial institutions                             | 24                | 25                   |
| Total cash and cash equivalents   | 14,882            | 14,090               |
| Investment securities, available for sale, at fair value                              | 187,425           | 187,018              |
| Investment securities held to maturity (fair value of \$284 and \$238)                | 280               | 265                  |
| Loans held for sale   | 2,925             | 3,545                |
| Loans   | 346,012           | 338,438              |
| Less: Allowance for loan losses   | 3,834             | 3,679                |
| Loans, net  | 342,178           | 334,759              |
| Premises and equipment, net   | 6,531             | 6,409                |
| Accrued interest receivable   | 2,610             | 2,828                |
| Bank-owned life insurance   | 10,806            | 10,718               |
| Investment in limited partnerships  | 4,960             | 3,549                |
| Goodwill  | 3,032             | 3,032                |
| Other assets  | 3,768             | 2,455                |
| <b>TOTAL ASSETS</b>   | <b>\$ 579,397</b> | <b>\$ 568,668</b>    |
| <b>LIABILITIES:</b>   |                   |                      |
| Interest-bearing deposits   | \$ 293,317        | \$ 281,150           |
| Noninterest-bearing deposits  | 74,329            | 71,379               |
| Total deposits  | 367,646           | 352,529              |
| Short-term borrowings   | 49,394            | 54,003               |
| Long-term borrowings, Federal Home Loan Bank (FHLB)                                   | 82,878            | 84,478               |
| Accrued interest payable  | 1,096             | 1,108                |
| Other liabilities   | 4,568             | 2,631                |
| <b>TOTAL LIABILITIES</b>  | <b>505,582</b>    | <b>494,749</b>       |
| <b>SHAREHOLDERS EQUITY:</b>   |                   |                      |
| Common stock, par value \$8.33, 10,000,000 shares authorized; 4,002,159 shares issued | 33,351            | 33,351               |
| Additional paid-in capital  | 17,772            | 17,772               |
| Retained earnings   | 23,727            | 22,938               |
| Accumulated other comprehensive income  | 1,266             | 850                  |
| Less: Treasury stock at cost, 60,372 and 26,372 shares                                | (2,301)           | (992)                |
| <b>TOTAL SHAREHOLDERS EQUITY</b>  | <b>73,815</b>     | <b>73,919</b>        |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>                                      | <b>\$ 579,397</b> | <b>\$ 568,668</b>    |

See accompanying notes to the unaudited consolidated financial statements.

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

| (In Thousands, Except Per Share Data)                      | Three Months Ended<br>March 31, |                  |
|--|---------------------------------|------------------|
|  | 2006                            | 2005             |
| <b>INTEREST AND DIVIDEND INCOME:</b>                       |                                 |                  |
| Loans including fees                                       | \$ 5,809                        | \$ 5,284         |
| <b>Investment Securities:</b>                              |                                 |                  |
| Taxable  | 923                             | 1,264            |
| Tax-exempt   | 989                             | 589              |
| Dividend   | 301                             | 298              |
| <b>TOTAL INTEREST AND DIVIDEND INCOME</b>                  | <b>8,022</b>                    | <b>7,435</b>     |
| <b>INTEREST EXPENSE:</b>                                   |                                 |                  |
| Deposits   | 1,837                           | 1,194            |
| Short-term borrowings                                      | 406                             | 202              |
| Long-term borrowings                                       | 946                             | 853              |
| <b>TOTAL INTEREST EXPENSE</b>                              | <b>3,189</b>                    | <b>2,249</b>     |
| <b>NET INTEREST INCOME</b>                                 | <b>4,833</b>                    | <b>5,186</b>     |
| <b>PROVISION FOR LOAN LOSSES</b>                           | <b>198</b>                      | <b>180</b>       |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b> | <b>4,635</b>                    | <b>5,006</b>     |
| <b>NON-INTEREST INCOME:</b>                                |                                 |                  |
| Deposit service charges                                    | 590                             | 455              |
| Securities gains, net                                      | 559                             | 611              |
| Bank-owned life insurance                                  | 88                              | 94               |
| Gain on sale of loans                                      | 150                             | 190              |
| Insurance commissions                                      | 560                             | 643              |
| Other  | 390                             | 314              |
| <b>TOTAL NON-INTEREST INCOME</b>                           | <b>2,337</b>                    | <b>2,307</b>     |
| <b>NON-INTEREST EXPENSE:</b>                               |                                 |                  |
| Salaries and employee benefits                             | 2,232                           | 1,994            |
| Occupancy, net   | 243                             | 291              |
| Furniture and equipment                                    | 297                             | 221              |
| Pennsylvania shares tax                                    | 145                             | 139              |
| Other  | 1,034                           | 950              |
| <b>TOTAL NON-INTEREST EXPENSE</b>                          | <b>3,951</b>                    | <b>3,595</b>     |
| <b>INCOME BEFORE INCOME TAX PROVISION</b>                  | <b>3,021</b>                    | <b>3,718</b>     |
| <b>INCOME TAX PROVISION</b>                                | <b>566</b>                      | <b>1,003</b>     |
| <b>NET INCOME</b>  | <b>\$ 2,455</b>                 | <b>\$ 2,715</b>  |
| <b>EARNINGS PER SHARE - BASIC</b>                          | <b>\$ 0.62</b>                  | <b>\$ 0.68</b>   |
| <b>EARNINGS PER SHARE - DILUTED</b>                        | <b>\$ 0.62</b>                  | <b>\$ 0.68</b>   |
| <b>WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC</b>         | <b>3,934,915</b>                | <b>3,973,526</b> |
| <b>WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED</b>       | <b>3,935,400</b>                | <b>3,976,106</b> |
| <b>DIVIDENDS PER SHARE</b>                                 | <b>\$ 0.42</b>                  | <b>\$ 0.38</b>   |

See accompanying notes to the unaudited consolidated financial statements.

## PENNS WOODS BANCORP, INC.

## CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

| (In Thousands Except Per Share Data)   | COMMON STOCK |           | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE INCOME |            | TREASURY STOCK | TOTAL SHAREHOLDERS EQUITY |
|--|--------------|-----------|----------------------------|-------------------|--|------------|----------------|---------------------------|
|  | SHARES       | AMOUNT    |                            |                   |  |            |                |                           |
| Balance, December 31, 2005   | 4,002,159    | \$ 33,351 | \$ 17,772                  | \$ 22,938         | \$ 850                                 | \$ (992)   | \$             | 73,919                    |
| Comprehensive Income:  |              |           |                            |                   |  |            |                |                           |
| Net income   |              |           |                            | 2,455             |  |            |                | 2,455                     |
| Net change in unrealized gain on investments available for sale, net of tax expense of \$214 |              |           |                            |                   | 416                                    |            |                | 416                       |
| Total comprehensive income   |              |           |                            |                   |  |            |                | 2,871                     |
| Dividends declared, (\$0.42 per share)   |              |           |                            | (1,666)           |  |            |                | (1,666)                   |
| Purchase of treasury stock (34,000 shares)   |              |           |                            |                   |  |            | (1,309)        | (1,309)                   |
| Balance, March 31, 2006  | 4,002,159    | \$ 33,351 | \$ 17,772                  | \$ 23,727         | \$ 1,266                               | \$ (2,301) | \$             | 73,815                    |

|  | COMMON STOCK |           | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE INCOME |          | TREASURY STOCK | TOTAL SHAREHOLDERS EQUITY |
|--|--------------|-----------|----------------------------|-------------------|--|----------|----------------|---------------------------|
|  | SHARES       | AMOUNT    |                            |                   |  |          |                |                           |
| Balance, December 31, 2004   | 3,998,204    | \$ 33,318 | \$ 17,700                  | \$ 18,262         | \$ 4,331                               | \$ (446) | \$             | 73,165                    |
| Comprehensive Income:  |              |           |                            |                   |  |          |                |                           |
| Net income   |              |           |                            | 2,715             |  |          |                | 2,715                     |
| Net change in unrealized gain on investments available for sale, net of tax benefit of \$1,280 |              |           |                            |                   | (2,484)                                |          |                | (2,484)                   |
| Total comprehensive income   |              |           |                            |                   |  |          |                | 231                       |
| Dividends declared, (\$0.38 per share)   |              |           |                            | (1,496)           |  |          |                | (1,496)                   |
| Stock options exercised  | 411          | 4         | 7                          |                   |  |          |                | 11                        |
| Balance, March 31, 2005  | 3,998,615    | \$ 33,322 | \$ 17,707                  | \$ 19,481         | \$ 1,847                               | \$ (446) | \$             | 71,911                    |

See accompanying notes to the unaudited consolidated financial statements.



## PENNS WOODS BANCORP, INC.

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(UNAUDITED)

| (In Thousands)  | 2006  | Three Months Ended March 31, | 2005     |
|---|-------|------------------------------|----------|
| Net Income  | \$    | 2,455                        | \$ 2,715 |
| Other comprehensive income (loss):  |       |                              |          |
| Net unrealized gains (losses) on available for sale securities            | 1,189 | (3,153)                      |          |
| Less: Reclassification adjustment for gain included in net income         | 559   | 611                          |          |
| Other comprehensive income (loss) before tax                              |       | 630                          | (3,764)  |
| Income tax expense (benefit) related to other comprehensive income (loss) |       | 214                          | (1,280)  |
| Other comprehensive income (loss), net of tax                             |       | 416                          | (2,484)  |
| Comprehensive income  | \$    | 2,871                        | \$ 231   |

See accompanying notes to the unaudited consolidated financial statements.

## PENNS WOODS BANCORP, INC.

## CONSOLIDATED STATEMENT OF CASH FLOWS

(UNAUDITED)

| (In Thousands)  | Three Months Ended |                  |
|---|--------------------|------------------|
|   | 2006               | March 31, 2005   |
| <b>OPERATING ACTIVITIES:</b>  |                    |                  |
| Net Income  | \$ 2,455           | \$ 2,715         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                    |                  |
| Depreciation  | 176                | 143              |
| Provision for loan losses   | 198                | 180              |
| Accretion and amortization of investment security discounts and premiums          | (191)              | (105)            |
| Securities gains, net   | (559)              | (611)            |
| Originations of loans held for sale   | (5,735)            | (4,838)          |
| Proceeds of loans held for sale   | 6,505              | 7,077            |
| Gain on sale of loans   | (150)              | (190)            |
| Increases in bank-owned life insurance  | (88)               | (94)             |
| Other, net  | 150                | 1,010            |
| Net cash provided by operating activities   | 2,761              | 5,287            |
| <b>INVESTING ACTIVITIES:</b>  |                    |                  |
| Investment securities available for sale:   |                    |                  |
| Proceeds from sales   | 16,732             | 64,880           |
| Proceeds from calls and maturities  | 1,744              | 3,517            |
| Purchases   | (17,057)           | (64,930)         |
| Investment securities held to maturity:   |                    |                  |
| Proceeds from calls and maturities  |                    | 249              |
| Net (increase) decrease in loans  | (7,638)            | 1,169            |
| Acquisition of bank premises and equipment  | (298)              | (849)            |
| Proceeds from the sale of foreclosed assets                                       | 61                 | 28               |
| Investment in limited partnership   | (1,446)            |                  |
| Net cash (used for) provided by investing activities                              | (7,902)            | 4,064            |
| <b>FINANCING ACTIVITIES:</b>  |                    |                  |
| Net increase (decrease) in interest-bearing deposits                              | 12,167             | (1,193)          |
| Net increase (decrease) in noninterest-bearing deposits                           | 2,950              | (1,342)          |
| Repayment of long-term borrowings   | (1,600)            | (1,400)          |
| Net (decrease) increase in short-term borrowings                                  | (4,609)            | 787              |
| Dividends paid  | (1,666)            | (1,496)          |
| Stock options exercised   |                    | 11               |
| Purchase of treasury stock  | (1,309)            |                  |
| Net cash provided by (used for) financing activities                              | 5,933              | (4,633)          |
| <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>                                  | <b>792</b>         | <b>4,718</b>     |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING</b>                                       | <b>14,090</b>      | <b>12,626</b>    |
| <b>CASH AND CASH EQUIVALENTS, ENDING</b>  | <b>\$ 14,882</b>   | <b>\$ 17,344</b> |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>                         |                    |                  |
| Interest paid   | \$ 3,201           | \$ 2,237         |
| Income taxes paid   | 500                |                  |
| Transfer of loans to foreclosed assets  | 34                 | 77               |

See accompanying notes to the unaudited consolidated financial statements.



**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., and Jersey Shore State Bank (the Bank) and its 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. All of those adjustments are of a normal, recurring nature. 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 financial statements and notes thereto contained in the Company's annual report for the year ended December 31, 2005.

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 thru 43 of the Annual Report on Form 10-K for the year ended December 31, 2005.

**Note 2. Recent Accounting Pronouncements**

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting (FAS) No. 155, *Accounting for Certain Hybrid Instruments, as an amendment of FASB Statements No. 133 and 140*. FAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In March 2006, the FASB issued FAS No. 156, *Accounting for Servicing of Financial Assets*. This Statement, which is an amendment to FAS No. 140, will simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, FAS No. 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting. FAS No. 156 also clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability, requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable, and permits an entity with a separately recognized servicing asset or servicing



liability to choose either of the amortization or fair value methods for subsequent measurement. The provisions of FAS No. 156 are effective as of the beginning of the first fiscal year that begins after September 15, 2006. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

### Note 3. Per Share Data

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

|  | <b>Three Months Ended March 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2006</b>                         | <b>2005</b> |
| Weighted average common shares outstanding   | 3,975,787                           | 3,985,898   |
| Average treasury stock shares  | (40,872)                            | (12,372)    |
| Weighted average common shares and common stock equivalents used to calculate basic earnings per share   | 3,934,915                           | 3,973,526   |
| Additional common stock equivalents (stock options) used to calculate diluted earnings per share         | 485                                 | 2,580       |
| Weighted average common shares and common stock equivalents used to calculate diluted earnings per share | 3,935,400                           | 3,976,106   |

Options to purchase 8,999 shares and 10,092 shares of common stock at the price of \$40.29 were outstanding during the three months ended March 31, 2006 and 2005, respectively, but were not included in the computation of diluted earnings per share as they were anti-dilutive due to the strike price being greater than the market price as of the end of the quarter.

### Note 4. Net Periodic Benefit Cost-Defined Benefit Plans

For a detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 11 of the Company's Consolidated Financial Statements included in the 2005 Annual Report on Form 10-K.

The following sets forth the components of net periodic benefit cost of the domestic non-contributory defined benefit plan for the three months ended March 31, 2006 and 2005, respectively.

|                                       | Three Months Ended |        |
|---------------------------------------|--------------------|--------|
|                                       | March 31,          |        |
|                                       | 2006               | 2005   |
| Service cost                          | \$ 117             | \$ 127 |
| Interest cost                         | 108                | 112    |
| Expected return on plan assets        | (121)              | (95)   |
| Amortization of transition obligation | (1)                | (1)    |
| Amortization of prior service cost    | 6                  | 6      |
| Amortization of net loss              | 6                  | 16     |
| Net periodic cost                     | \$ 115             | \$ 165 |

### Employer Contributions

The Company previously disclosed in its consolidated financial statements, included in the 2005 Annual Report on Form 10-K, that it expected to contribute \$500,000 to its defined benefit plan in 2006. As of March 31, 2006, there were no contributions made for the 2006 plan year. This is the result of the contributions made during 2005 being above the required minimum in order to benefit from a current tax and future financial perspective. In effect, the 2005 contributions eliminated the need for a minimum funding during 2006. The Company is evaluating the amount, if any, of funds to contribute during 2006.

### Note 5. 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 include 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:

| (In Thousands)               | March 31, |           |
|------------------------------|-----------|-----------|
|                              | 2006      | 2005      |
| Commitments to extend credit | \$ 74,106 | \$ 41,361 |
| Standby letters of credit    | 1,412     | 1,705     |





**Note 6. Reclassification of Comparative Amounts**

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

**Note 7. Stock Split**

During the fourth quarter of 2005 the Company initiated a 6 for 5 stock split. Previously reported share and per share amounts have been adjusted to reflect the split.

**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 wishes to caution readers that the following important factors, among others, may have affected and could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward-looking statement made by or on behalf of the Company herein: (i) the effect of changes in laws and regulations, including federal and state banking laws and regulations, 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; and (v) the effect of changes in the business cycle and downturns in the local, regional or national economies.

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

**EARNINGS SUMMARY**

**Comparison of the Three Months Ended March 31, 2006 and 2005**

**Summary Results**

Net income for the three months ended March 31, 2006 was \$2,455,000 compared to \$2,715,000 for the same period of 2005. Basic and diluted earnings per share for the three months ended March 31, 2006 were \$0.62 as compared to \$0.68 for the three months ended March 31, 2005. Return on average assets and return on average equity were 1.72% and 13.24% for the three months ended March 31, 2006 as compared to 2.01% and 14.56% for the corresponding period of 2005. Net income from core operations for the three months ended March 31, 2006 and 2005, excluding after-tax net securities gains of \$369,000 and \$403,000, respectively, were \$2,086,000 and \$2,312,000. (Management uses the non-GAAP measure of net income from core operations in its analysis of the Company's performance. This measure, as used by the Company, adjusts net income by 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. 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.)

**Interest Income**

Interest income for the three months ended March 31, 2006 increased \$587,000 to \$8,022,000 as compared to \$7,435,000 for the same period of 2005. The increase in total interest income was primarily the result of growth in average loans of \$16,301,000 for the three months ended March 31, 2006 as compared to 2005. The average loan growth and a 35 basis point increase in loan portfolio yields accounted for \$525,000 of the total interest income growth. Over this time frame the average balance of investment securities increased \$12,235,000. The investment portfolio continued to shift from taxable mortgage-backed securities to tax-exempt municipal bonds. The average investment portfolio growth coupled with the shift to tax-exempt municipal bonds resulted in interest income from the investment portfolio increasing \$62,000. On a taxable equivalent basis the interest income from the investment portfolio increased by \$268,000. This shift within the investment securities portfolio was strategically designed to ladder cash flows, enhance management's ability to currently maintain the interest margin, and to allow growth through participation in funding local area community housing projects. The increase in dividends received is the result of an increase in the level of dividends from the Federal Home Loan Bank of Pittsburgh coupled with an emphasis on purchasing stocks consistently having an above average dividend yield.

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Interest income composition for the three months ended March 31, 2006 and 2005 was as follows:

| (In Thousands)         | March 31, 2006 |         | For The Three Months Ended<br>March 31, 2005 |         | Change |        |
|------------------------|----------------|---------|--|---------|--------|--------|
|                        | Amount         | % Total | Amount                                       | % Total | Amount | %      |
| Loans including fees   | \$ 5,809       | 72.4%   | \$ 5,284                                     | 71.1%   | \$ 525 | 9.9%   |
| Investment securities: |                |         |  |         |        |        |
| Taxable                | 923            | 11.5    | 1,264  | 17.0    | (341)  | (27.0) |
| Tax-exempt             | 989            | 12.3    | 589  | 7.9     | 400    | 67.9   |
| Dividend               | 301            | 3.8     | 298  | 4.0     | 3      | 1.0    |
| Total interest income  | \$ 8,022       | 100.0%  | \$ 7,435                                     | 100.0%  | \$ 587 | 7.9%   |

### Interest Expense

Interest expense for the three months ended March 31, 2006 increased \$940,000 to \$3,189,000 as compared to \$2,249,000 for the same period of 2005. The increased expense associated with deposits is primarily the result of rate increases for time deposits, which are comprised of various certificates of deposit ( CD ) accounts from the three months ended March 31, 2005 to the corresponding period of 2006. Factors that led to the rate increases include, but are not limited to, several period prime rate increases, competitive market pricing pressure, and attracting new deposit customers while retaining existing accounts. The increase in CD interest rates has exceeded the increase for other deposit accounts. This has led to a shift of a portion of the money market and savings deposit portfolios into higher yielding CDs.

Short-term borrowing costs increased as a direct result of the prime rate increases over the past year and an increase in the average balance of \$4,754,000 for the three months ended March 31, 2006 as compared to the same period of 2005. Long-term FHLB borrowing expense increased due to \$10,000,000 that was borrowed from the FHLB during the second quarter of 2005 at a fixed rate of 3.97% for 5 years with a final maturity of 10 years.

Interest expense composition for the three months ended March 31, 2006 and 2005 was as follows:

| (In Thousands)         | March 31, 2006 |         | For The Three Months Ended<br>March 31, 2005 |         | Change |       |
|------------------------|----------------|---------|--|---------|--------|-------|
|                        | Amount         | % Total | Amount                                       | % Total | Amount | %     |
| Deposits               | \$ 1,837       | 57.6%   | \$ 1,194                                     | 53.1%   | \$ 643 | 53.9% |
| Short-term borrowings  | 406            | 12.7    | 202  | 9.0     | 204    | 101.0 |
| Long-term borrowings   | 946            | 29.7    | 853  | 37.9    | 93     | 10.9  |
| Total interest expense | \$ 3,189       | 100.0%  | \$ 2,249                                     | 100.0%  | \$ 940 | 41.8% |

### Net Interest Margin

The net interest margin ( NIM ) for the three months ended March 31, 2006 was 4.08% as compared to 4.40% for the corresponding period of 2005. The decrease in the NIM was the result of the yield on earning assets increasing 30 basis points ( bp ) to 6.51% for the three months ended March 31, 2006, as compared to 2005, however, interest bearing liabilities increased 76 bp



over the same period. The increase in the yield on earning assets is attributable to a change in the mix of earning assets as previously discussed in the Interest Income section of this Earnings Summary section. The average tax-exempt investment securities portfolio grew by \$42,871,000, the direct result of a shift in investment strategy which also resulted in a decline in taxable investment securities of \$30,636,000. The average loan growth of \$16,301,000 was predominately comprised of commercial real estate loans. The yield on total loans increased to 6.92% from 6.57% due to the impact of the Federal Open Market Committee rate increases enacted over the past year. The investment portfolio yield increased to 5.77% from 5.56% primarily from the previously noted shift in the portfolio to tax-exempt investments. The average interest rates paid on deposit accounts increased to 2.52% as compared to 1.72% for the 2005 period. This increase was driven by growth in time deposits of \$31,026,000 and an increase in the rate paid on time deposits of 96 bp. A portion of the increase in deposit volume and the average interest yield paid is due to several CD promotions during the past year to attract new customers while retaining existing customers. The promotions were designed to gather deposits that would have maturities of two years or less. In addition, the promotions served as a catalyst to implement management's strategy regarding the CD portfolio allocation among various maturities and therefore, reducing the concentration of time deposit maturities within any single month.

Short-term borrowings realized an increase of 175 bp in interest rates charged for the three months ended March 31, 2006. The prime rate increased to 7.75% at March 31, 2006 from 5.75% at March 31, 2005, as further evidence of the correlation between the Company's primary source of borrowed funds, the FHLB, and the primary lending rate indicator used on a national basis.

Following is a schedule of average balances and associated yields for the three month periods ended March 31, 2006 and 2005:

## AVERAGE BALANCES AND INTEREST RATES

| (In Thousands)                            | Three Months Ended<br>March 31, 2006 |          |              | Three Months Ended<br>March 31, 2005 |          |              |
|---|--------------------------------------|----------|--------------|--------------------------------------|----------|--------------|
|   | Average Balance                      | Interest | Average Rate | Average Balance                      | Interest | Average Rate |
| Tax-exempt loans                          | \$ 8,163                             | \$ 127   | 6.31%        | \$ 1,421                             | \$ 21    | 5.99%        |
| All other loans                           | 334,985                              | 5,725    | 6.93%        | 325,426                              | 5,270    | 6.57%        |
| Total loans                               | 343,148                              | 5,852    | 6.92%        | 326,847                              | 5,291    | 6.57%        |
| Taxable investment securities             | 97,648                               | 1,224    | 5.01%        | 128,284                              | 1,562    | 4.87%        |
| Tax-exempt investment securities          | 91,150                               | 1,498    | 6.58%        | 48,279                               | 892      | 7.39%        |
| Total securities                          | 188,798                              | 2,722    | 5.77%        | 176,563                              | 2,454    | 5.56%        |
| Total interest-earning assets             | 531,946                              | 8,574    | 6.51%        | 503,410                              | 7,745    | 6.21%        |
| Other assets                              | 37,576                               |          |              | 37,715                               |          |              |
| Total assets                              | \$ 569,522                           |          |              | \$ 541,125                           |          |              |
| Savings                                   | \$ 62,715                            | 120      | 0.78%        | \$ 66,930                            | 131      | 0.79%        |
| Super Now deposits                        | 48,163                               | 150      | 1.26%        | 53,505                               | 107      | 0.81%        |
| Money market deposits                     | 25,124                               | 115      | 1.86%        | 32,560                               | 91       | 1.13%        |
| Time deposits                             | 159,994                              | 1,452    | 3.68%        | 128,968                              | 865      | 2.72%        |
| Total deposits                            | 295,996                              | 1,837    | 2.52%        | 281,963                              | 1,194    | 1.72%        |
| Short-term borrowings                     | 41,152                               | 406      | 4.00%        | 36,398                               | 202      | 2.25%        |
| Long-term borrowings                      | 84,336                               | 946      | 4.55%        | 75,754                               | 853      | 4.57%        |
| Total borrowings                          | 125,488                              | 1,352    | 4.37%        | 112,152                              | 1,055    | 3.82%        |
| Total interest bearing liabilities        | 421,484                              | 3,189    | 3.07%        | 394,115                              | 2,249    | 2.31%        |
| Demand deposits                           | 68,447                               |          |              | 68,205                               |          |              |
| Other liabilities                         | 5,416                                |          |              | 4,200                                |          |              |
| Shareholders equity                       | 74,175                               |          |              | 74,605                               |          |              |
| Total liabilities and shareholders equity | \$ 569,522                           |          |              | \$ 541,125                           |          |              |
| Interest rate spread                      |                                      |          | 3.44%        |                                      |          | 3.90%        |
| Net interest income/margin                |                                      | \$ 5,385 | 4.08%        |                                      | \$ 5,496 | 4.40%        |

- Information on this table has been calculated using average daily balance sheets to obtain average balances.
- Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.
- 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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The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the three month periods ended March 31, 2006 and 2005.

| (In Thousands)                                 | For the Three Months Ended |          |
|--|----------------------------|----------|
|  | 2006                       | 2005     |
| Total interest income                          | \$ 8,022                   | \$ 7,435 |
| Total interest expense                         | 3,189                      | 2,249    |
| Net interest income                            | 4,833                      | 5,186    |
| Tax equivalent adjustment                      | 552                        | 310      |
| Net interest income (fully taxable equivalent) | \$ 5,385                   | \$ 5,496 |

The following table sets forth the respective impact that both volume and rate changes have had on net interest income and the net interest margin for the three month periods ended March 31, 2006 and 2005:

| (In Thousands)                     | Three Months Ended March 31, |          |          |
|------------------------------------|------------------------------|----------|----------|
|                                    | 2006 vs 2005                 |          |          |
|                                    | Increase (Decrease)          |          | Net      |
| Volume                             | Due to Rate                  |          |          |
| Interest income:                   |                              |          |          |
| Loans, tax-exempt                  | \$ 105                       | \$ 1     | \$ 106   |
| Loans                              | 145                          | 310      | 455      |
| Taxable investment securities      | (383)                        | 45       | (338)    |
| Tax-exempt investment securities   | 714                          | (108)    | 606      |
| Total interest-earning assets      | 581                          | 248      | 829      |
| Interest expenses:                 |                              |          |          |
| Savings deposits                   | (8)                          | (3)      | (11)     |
| Super Now deposits                 | (12)                         | 55       | 43       |
| Money market deposits              | (25)                         | 49       | 24       |
| Time deposits                      | 50                           | 537      | 587      |
| Short-term borrowings              | 22                           | 182      | 204      |
| Long-term borrowings               | 96                           | (3)      | 93       |
| Total interest-bearing liabilities | 123                          | 817      | 940      |
| Change in net interest income      | \$ 458                       | \$ (569) | \$ (111) |

**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 is calculated 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 March 31, 2006, 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, employment, and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets and charge-offs, increased 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.

While 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 increased from \$3,679,000 at December 31, 2005 to \$3,834,000 at March 31, 2006. At March 31, 2006, the allowance for loan losses was 1.11% of total loans compared to 1.09% of total loans at December 31, 2005. Management's conclusion is that the allowance for loan losses is adequate to provide for possible losses inherent in the loan portfolio as of the balance sheet date.

The provision for loan losses totaled \$198,000 for the three months ended March 31, 2006 as compared to \$180,000 for the same period in 2005. The increase was the result of gross loan growth of \$22,872,000, primarily in commercial real estate loans, from April 1, 2005 to March 31, 2006.

An overall increase of \$164,000, or 27.24%, was experienced in non-performing loans (non-accrual and 90 days past due) from December 31, 2005 to \$766,000 at March 31, 2006.

Based upon this analysis, as well as the others noted above, senior management has concluded that the allowance for loan losses remains at a level adequate to provide for probable losses inherent in its loan portfolio.

**Non-interest Income**

Total non-interest income for the quarter ended March 31, 2006 compared to the same period in 2005 increased \$30,000 to \$2,337,000. Excluding net security gains, the increase from period to period was \$82,000. Deposit service charges increased due to the implementation of Bounce Protection during May 2005. This product provides overdraft protection up to a predetermined amount to non-commercial customers for a per event fee which resulted in an approximate \$141,000 increase in overdraft charges over the 2005 period. Gain on the sale of loans from secondary market originations decreased due to a decline in volumes.

Insurance commissions decreased due to a reduction in the overall commissions earned from the underwriter that The M Group receives on each insurance contract written. The management of The M Group continued to gather new and build upon current relationships during the first quarter of 2006, however, the sales cycle for insurance and investment products can take typically from six months to one year or more to complete. The sales call program continues to expand to other financial institutions, and results in shared revenue with The M Group.

Other income increased due primarily to increased revenue generated from the customer usage of debit cards, title insurance income, and the fees recognized related to the origination of secondary market residential loans.

Non-interest income composition for the three months ended March 31, 2006 and 2005 was as follows:

| (In Thousands)            | March 31, 2006 |         | For The Three Months Ended<br>March 31, 2005 |         | Change |        |
|---------------------------|----------------|---------|--|---------|--------|--------|
|                           | Amount         | % Total | Amount                                       | % Total | Amount | %      |
| Deposit service charges   | \$ 590         | 25.2%   | \$ 455                                       | 19.7%   | \$ 135 | 29.7%  |
| Net security gains        | 559            | 23.9    | 611  | 26.5    | (52)   | (8.5)  |
| Bank owned life insurance | 88             | 3.8     | 94   | 4.1     | (6)    | (6.4)  |
| Gain on sale of loans     | 150            | 6.4     | 190  | 8.2     | (40)   | (21.1) |
| Insurance commissions     | 560            | 24.0    | 643  | 27.9    | (83)   | (12.9) |
| Other income              | 390            | 16.7    | 314  | 13.6    | 76     | 24.2   |
| Total non-interest income | \$ 2,337       | 100.0%  | \$ 2,307                                     | 100.0%  | \$ 30  | 1.3%   |

**Non-interest Expenses**

Total non-interest expenses increased \$356,000 from the three months ended March 31, 2005 as compared to the same period of 2006. The increase in salaries and employee benefits was attributable to several items including: standard cost of living wage adjustments for employees, new additions to our staff, increased health insurance cost, and adjustments for the projected annual bonus period estimates for 2006. Furniture and equipment expenses increased due to the previously mentioned new branch in State College and increased cost of maintenance contracts. The decrease in occupancy expenses was attributable to a reduction in leasehold improvements amortization and facilities maintenance coverage amounts. Other expenses increased primarily due to normal anticipated inflationary adjustments to ongoing business operating costs and the Company's share of operating results incurred through a limited partnership arrangement which was initiated during the fourth quarter of 2005 for the purposes of funding the construction of affordable housing in the Company's primary market area.



Non-interest expense composition for the three months ended March 31, 2006 and 2005 was as follows:

| (In Thousands)                   | March 31, 2006 |         | For The Three Months Ended<br>March 31, 2005 |         | Change |        |
|----------------------------------|----------------|---------|--|---------|--------|--------|
|                                  | Amount         | % Total | Amount                                       | % Total | Amount | %      |
| Salaries and employee benefits   | \$ 2,232       | 56.4%   | \$ 1,994                                     | 55.5%   | \$ 238 | 11.9%  |
| Occupancy expense, net           | 243            | 6.2     | 291  | 8.1     | (48)   | (16.5) |
| Furniture and equipment expenses | 297            | 7.5     | 221  | 6.1     | 76     | 34.4   |
| Pennsylvania shares tax          | 145            | 3.7     | 139  | 3.9     | 6      | 4.3    |
| Other expense                    | 1,034          | 26.2    | 950  | 26.4    | 84     | 8.8    |
| Total non-interest expense       | \$ 3,951       | 100.0%  | \$ 3,595                                     | 100.0%  | \$ 356 | 9.9%   |

### Provision for Income Taxes

Income taxes decreased \$437,000 for the three month period ended March 31, 2006 compared to the same period of 2005. The effective tax rates for the three months ended March 31, 2006 and 2005 were 18.7% and 27.0%, respectively. The decline in the effective tax rate is consistent with management's repositioning of the investment portfolio from taxable investment securities to tax-exempt investment securities and tax credits related to an investment in a low income housing project.

### ASSET/LIABILITY MANAGEMENT

Cash and cash equivalents increased \$792,000 from \$14,090,000 at December 31, 2005, and are the results of the following activities which have occurred during the three months ended March 31, 2006:

#### Operating Activities

The significant components of operating activities are net income and the origination and proceeds of loans held for sale. Cash provided by net income, as adjusted for loans held for sale activity, amounted to \$1,991,000. Activity regarding loans held for sale resulted in sale proceeds, less \$150,000 in realized gains, exceeding loan origination disbursements by \$620,000 for the period.

#### Loans

Gross loans increased \$7,574,000 since December 31, 2005 as commercial real estate mortgages increased 5.0% or \$6,393,000. The growth in commercial real estate mortgages is part of the Company's strategy to originate high quality, well secured commercial loans and was driven by the origination of several large loans. Residential real estate mortgages increased \$1,348,000 with a portion of the increase related to the active marketing of a new home equity line of credit product during the first quarter of 2006.



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The allocation of the loan portfolio, by category, as of March 31, 2006 and December 31, 2005 is presented below:

| (In Thousands)                   | March 31,<br>2006 | December 31<br>2005 | Change<br>Amount | %      |
|----------------------------------|-------------------|---------------------|------------------|--------|
| Commercial and agricultural      | \$ 34,252         | \$ 34,407           | \$ (155)         | (0.5)% |
| Real estate mortgage:            |                   |                     |                  |        |
| Residential                      | 151,348           | 150,000             | 1,348            | 0.9    |
| Commercial                       | 133,524           | 127,131             | 6,393            | 5.0    |
| Construction                     | 10,715            | 10,681              | 34               | 0.3    |
| Installment loans to individuals | 17,226            | 17,281              | (55)             | (0.3)  |
| Less: Net deferred loan fees     | 1,053             | 1,062               | (9)              | (0.8)  |
| Gross loans                      | \$ 346,012        | \$ 338,438          | \$ 7,574         | 2.2%   |

The recorded investment in loans for which impairment has been recognized in accordance with Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, was comprised of only three loans totaling \$302,000. The loans identified as impaired were collateral-dependent, and considered well secured, with no valuation allowance necessary due to the collateral position.

A loan is considered impaired, based on current information and events, if it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is generally based on the present value of expected future cash flows discounted at the historical effective interest rate, except that all collateral-dependent loans are measured for impairment based on the fair value of the collateral.

### Investments

The amortized cost and fair market value of the investment securities portfolio in total has remained steady since December 31, 2005. Over the first three months of 2006, the amortized cost of state and political securities has increased \$1,768,000, while U.S. Government and agency securities decreased \$2,323,000. This shift is the result of a repositioning of the security portfolio that began during 2005. The shift from taxable to tax exempt bonds has been undertaken as a strategy to build call protection, maintain the taxable equivalent yield, reduce the effective federal income tax rate, and to invest in communities across the Commonwealth of Pennsylvania and the country.

The amortized cost of investment securities and their approximate fair values are as follows:

## March 31, 2006

| (In Thousands)                        | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <b>Available for Sale (AFS)</b>       |                   |                              |                               |               |
| U.S. Government and agency securities | \$ 63,173         | \$ 8                         | \$ (2,258)                    | \$ 60,923     |
| State and political securities        | 95,537            | 1,870                        | (797)                         | 96,610        |
| Other debt securities                 | 1,825             | 16                           | (21)                          | 1,820         |
| Total debt securities                 | 160,535           | 1,894                        | (3,076)                       | 159,353       |
| Equity securities                     | 24,972            | 3,310                        | (210)                         | 28,072        |
| Total Investment Securities AFS       | \$ 185,507        | \$ 5,204                     | \$ (3,286)                    | \$ 187,425    |
| <b>Held to Maturity (HTM)</b>         |                   |                              |                               |               |
| U.S. Government and agency securities | \$ 28             | \$ 2                         | \$                            | \$ 30         |
| Other debt securities                 | 252               | 2                            |                               | 254           |
| Total Investment Securities HTM       | \$ 280            | \$ 4                         | \$                            | \$ 284        |

## December 31, 2005

| (In Thousands)                        | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <b>Available for Sale (AFS)</b>       |                   |                              |                               |               |
| U.S. Government and agency securities | \$ 65,496         | \$ 30                        | \$ (1,573)                    | \$ 63,953     |
| State and political securities        | 93,769            | 1,390                        | (1,068)                       | 94,091        |
| Other debt securities                 | 1,750             | 12                           | (43)                          | 1,719         |
| Total debt securities                 | 161,015           | 1,432                        | (2,684)                       | 159,763       |
| Equity securities                     | 24,715            | 2,951                        | (411)                         | 27,255        |
| Total Investment Securities AFS       | \$ 185,730        | \$ 4,383                     | \$ (3,095)                    | \$ 187,018    |
| <b>Held to Maturity (HTM)</b>         |                   |                              |                               |               |
| U.S. Government and agency securities | \$ 28             | \$ 2                         | \$                            | \$ 30         |
| Other debt securities                 | 237               |                              | (29)                          | 208           |
| Total Investment Securities HTM       | \$ 265            | \$ 2                         | \$ (29)                       | \$ 238        |

**Financing Activities****Deposits**

Total deposits increased 4.3% or \$15,117,000 from December 31, 2005 as both interest and noninterest bearing deposit categories increased from December 31, 2005 to March 31, 2006. The mix of deposits has remained constant from December 31, 2005 to March 31, 2006 with demand deposits holding steady at 20.2% of total deposits. During the second half of 2005 the Bank began utilizing brokered deposits (time deposits) to supplement the funding of loan



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originations and investment purchases. These time deposits are generally for a term of either four or thirteen weeks presently with interest rates at or below the cost of alternative funding sources, such as short term borrowing instruments from the FHLB. The amount of brokered deposits is continuously monitored and is used to supplement deposits, not as a primary source of deposits.

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

| (In Thousands)           | March 31, 2006 |         | December 31, 2005 |         | Change    |      |
|--------------------------|----------------|---------|-------------------|---------|-----------|------|
|                          | Amount         | % Total | Amount            | % Total | Amount    | %    |
| Demand deposits          | \$ 74,329      | 20.2%   | \$ 71,379         | 20.2%   | \$ 2,950  | 4.1% |
| NOW Accounts             | 50,957         | 13.9    | 48,678            | 13.8    | 2,279     | 4.7  |
| Insured MMDA             | 24,658         | 6.7     | 24,446            | 6.9     | 212       | 0.9  |
| Savings deposits         | 64,260         | 17.5    | 61,906            | 17.6    | 2,354     | 3.8  |
| Time deposits            | 139,739        | 38.0    | 137,373           | 39.0    | 2,366     | 1.7  |
| Time deposits - brokered | 13,703         | 3.7     | 8,747             | 2.5     | 4,956     | 56.7 |
| Total deposits           | \$ 367,646     | 100.0%  | \$ 352,529        | 100.0%  | \$ 15,117 | 4.3% |

### Borrowed Funds

Total borrowed funds decreased 4.5% to \$132,272,000 at March 31, 2006 as compared to December 31, 2005. Short-term borrowings were replaced with brokered time deposits with more favorable interest rates to the Company at this time. FHLB short-term borrowings were utilized during the first three months of 2006; however, there were no such borrowings outstanding at March 31, 2006. Long-term borrowings declined due to a maturity of \$1,600,000 that carried a fixed rate of 2.67%.

| (In Thousands)                                | March 31,<br>2006 | December 31,<br>2005 |
|---|-------------------|----------------------|
| Short-term borrowings:                        |                   |                      |
| FHLB repurchase agreements                    | \$ 35,045         | \$ 1,740             |
| Short-term borrowings, FHLB                   |                   | 37,000               |
| Securities sold under agreement to repurchase | 14,349            | 15,263               |
| Total short-term borrowings                   | 49,394            | 54,003               |
| Long-term borrowings, FHLB                    | 82,878            | 84,478               |
| Total borrowed funds                          | \$ 132,272        | \$ 138,481           |

### 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



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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 requirements. 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 March 31, 2006 and 2005 were as follows:

| (In Thousands)   | 2006      |       | 2005      |       |
|--|-----------|-------|-----------|-------|
|  | Amount    | Ratio | Amount    | Ratio |
| <b><u>Total Capital (to Risk-weighted Assets)</u></b>  |           |       |           |       |
| Actual   | \$ 73,098 | 20.5% | \$ 72,991 | 22.0% |
| For Capital Adequacy Purposes                          | 28,515    | 8.0   | 26,523    | 8.0   |
| To Be Well Capitalized                                 | 35,643    | 10.0  | 33,154    | 10.0  |
| <b><u>Tier I Capital (to Risk-weighted Assets)</u></b> |           |       |           |       |
| Actual   | \$ 67,869 | 19.0% | \$ 67,809 | 20.5% |
| For Capital Adequacy Purposes                          | 14,257    | 4.0   | 13,261    | 4.0   |
| To Be Well Capitalized                                 | 21,386    | 6.0   | 19,892    | 6.0   |
| <b><u>Tier I Capital (to Average Assets)</u></b>       |           |       |           |       |
| Actual   | \$ 67,869 | 12.0% | \$ 67,809 | 12.8% |
| For Capital Adequacy Purposes                          | 22,591    | 4.0   | 21,231    | 4.0   |
| To Be Well Capitalized                                 | 28,239    | 5.0   | 26,538    | 5.0   |

### Liquidity and Interest Rate Sensitivity

The asset/liability committee addresses the liquidity needs of the Company to see 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 within the limits cited.

1. Net Loans to Total Assets, 100% maximum
2. Net Loans to Total Deposits, 100% maximum
3. Cumulative 90 day Maturity GAP %, +/- 20% maximum
4. Cumulative 1 Year Maturity GAP %, +/- 20%, 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 expenses. In order to control cash flow, the Bank estimates future flows of cash from deposits, loan payments, and investment security payments. The primary sources of funds are deposits, principal and interest payments on loans and investment securities, as well as Federal Home Loan Bank borrowings. Funds generated are used principally to fund loans and purchase investment securities. Management believes the Bank has adequate resources to meet its normal funding requirements.

Management monitors the Company's liquidity on both a long and short-term basis, thereby providing management necessary information to react to current balance sheet trends. Cash flow needs are assessed and sources of funds are determined. Funding strategies consider both customer needs and economical cost. Both short and long-term funding needs are addressed by maturities and sales of available for sale investment securities, loan repayments and maturities, and liquidating money market investments such as federal funds sold. The use of these resources, in conjunction with access to credit provides core ingredients 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 current borrowing capacity at the Federal Home Loan Bank of \$213,869,000. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of \$25,500,000. Management believes that it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. Federal Home Loan Bank borrowings totaled \$117,923,000 as of March 31, 2006.

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

income will suffer. Gaps, therefore, contain an element of risk and must be prudently managed. In addition to gap management, the Company has an asset/liability management policy which incorporates a market value at risk calculation which is used to determine the effects of interest rate movements on shareholders' equity and a simulation analysis to monitor the effects of interest rate changes on the Company's balance sheet.

There have been no substantial changes in the Company's GAP analyses or simulation analyses compared to the information provided in the Company's Form 10-K for the period ended December 31, 2005.

Generally, management believes the Company is well positioned to respond in a timely manner 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.

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.

### **Item 3. Quantitative and Qualitative Disclosure About Market Risk**

Market risk for the Company is comprised primarily from interest rate risk exposure and liquidity risk. Interest rate risk and liquidity risk management is performed at the Bank level as well as the Company level. The Company's interest rate sensitivity is monitored by management through selected interest rate risk measures produced by an independent third party. There have been no substantial changes in the Company's GAP analyses or simulation analyses compared to the information provided in the Company's SEC 10-K for the period ended December 31, 2005. 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**

An analysis was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Principal 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 Principal Financial Officer concluded that the Company's disclosure

controls and procedures were effective as of March 31,

2006. During the quarter ended March 31, 2006, the Company strengthened the review process associated with the preparation of the Statement of Cash Flows. There were no other changes in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2006, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Part II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

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, 2005. 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**

During the three months ended March 31, 2006 there were 34,000 shares of the Company's common stock repurchased as part of a previously announced repurchase program.

| 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(January 1-January 31, 2006)    | 15,000                                      | \$ 38.75  | 15,000  | 20,693  |
| Month#2 (February 1-February 28, 2006) |   |   |   |   |
| Month#3 (March 1,- March 31, 2006)     | 19,000                                      | 38.33   | 19,000  | 1,693   |

**Item 3. Defaults Upon Senior Securities**



None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

On April 25, 2006 the Board of Directors authorized the repurchase of approximately 5% of the outstanding shares of the Registrant. The repurchase plan is for a one year period and allows for the repurchase of 197,000 shares of the 3,941,787 shares outstanding.

**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-K for the year ended December 31, 2005).
- (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) Certification of Chief Executive Officer.
- (31) (ii) Rule 13a-14(a) Certification of Principal Accounting Officer.
- (32) (i) Certification of Chief Executive Officer Section 1350.
- (32) (ii) Certification of Principal Accounting Officer Section 1350.

**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: May 9, 2006

/s/ Ronald A. Walko  
Ronald A. Walko, President and Chief Executive Officer

Date: May 9, 2006

/s/ Brian L. Knepp  
Brian L. Knepp, Vice President of Finance (Principal  
Financial Officer)

**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 Principal Accounting Officer |
| Exhibit 32(i)  | Section 1350 Certification of Chief Executive Officer                       |
| Exhibit 32(ii) | Section 1350 Certification of Principal Accounting Officer                  |