

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

WASHINGTON, D.C. 20549

FORM 10-Q

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

for the Quarterly Period Ended June 30, 2013.

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

For the Transition Period from to .

No. 0-17077

(Commission File Number)

PENNS WOODS BANCORP, INC.

(Exact name of Registrant as specified in its charter)

PENNSYLVANIA
(State or other jurisdiction of
incorporation or organization)

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

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

17703-0967
(Zip Code)

(570) 322-1111

Registrant's telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

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

Large accelerated filer
Non-accelerated filer

Accelerated filer
Small reporting company

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

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

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PENNS WOODS BANCORP, INC.

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

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

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

See accompanying notes to the unaudited consolidated financial statements.

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

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

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

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(UNAUDITED)

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

See accompanying notes to the unaudited consolidated financial statements.

PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

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

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

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

See accompanying notes to the unaudited consolidated financial statements.

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

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

See accompanying notes to the unaudited consolidated financial statements.

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

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

See accompanying notes to the unaudited consolidated financial statements.

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

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

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

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

Note 2. Accumulated Other Comprehensive Income

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

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

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

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

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

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(In Thousands)

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

(In Thousands)

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

Note 3. Recent Accounting Pronouncements

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

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

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

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

Note 4. Per Share Data

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

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

Note 5. Investment Securities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Note 7. Credit Quality and Related Allowance for Loan Losses

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

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

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

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

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

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

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

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

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

Estimated fair value	\$	878
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Changes in the amortizable yield for purchased credit-impaired loans were as follows for the month ended June 30, 2013:

(In Thousands)

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

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

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

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

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

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

Impaired Loans

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

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

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

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

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

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

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

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

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

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

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

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

Modifications

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

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

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

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

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

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

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

Internal Risk Ratings

Management uses a ten point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first six categories are considered not criticized, and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The special mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a substandard classification. Loans in the substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not

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

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Bank has a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the pass category unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. An external annual loan review of all commercial relationships \$800,000 or greater is performed, as well as a sample of smaller transactions. Confirmation of the appropriate risk category is included in the review. Detailed reviews, including plans for resolution, are performed on loans classified as Substandard, Doubtful, or Loss on a quarterly basis.

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

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

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

Allowance for Loan Losses

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

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

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

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

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

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

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

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

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

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

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

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

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

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

	June 30,	
2013		2012

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

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

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

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

Note 8. Net Periodic Benefit Cost-Defined Benefit Plans

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

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

Three Months Ended

Six Months Ended

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

Employer Contributions

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

Note 9. Employee Stock Purchase Plan

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

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

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments are primarily comprised of commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit, interest rate, or liquidity risk in excess of the amount recognized in the consolidated balance sheet. The contract amounts of these instruments express the extent of involvement the Company has in particular classes of financial instruments.

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

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

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

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

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

Note 11. Fair Value Measurements

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Note 12. Fair Value of Financial Instruments

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

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

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

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

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

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

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

The fair value is equal to the carrying value.

Investment Securities:

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

Loans:

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

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

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

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

Bank-Owned Life Insurance:

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

Deposits:

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

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

Long Term Borrowings:

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

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

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

Note 13. Reclassification of Comparative Amounts

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

Note 14. Acquisition of Luzerne National Bank Corporation

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

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

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

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

The business combination resulted in the acquisition of loans with and without evidence of credit quality deterioration. Luzerne Bank's loans were deemed impaired at the acquisition date if the Company did not expect to receive all contractually required cash flows due to concerns about credit quality. Such loans were fair valued and the difference between contractually required payments at the acquisition date and cash flows expected to be collected was recorded as a non-accretable difference. At the acquisition date, the Company recorded \$1,211,000 of purchased credit-impaired loans subject to a non-accretable difference of \$842,000. The method of measuring carrying value of purchased loans differs from loans originated by the Company (originated loans), and as such, the Company identifies purchased loans and purchased loans with a credit quality discount and originated loans at amortized cost.

Luzerne's loans without evidence of credit deterioration were fair valued by discounting both expected principal and interest cash flows using an observable discount rate for similar instruments that a market participant would consider in determining fair value. Additionally, consideration was given to management's best estimates of default rates and payment speeds. At acquisition, Luzerne's loan portfolio without evidence of deterioration totaled \$249,789,000 and was recorded at a fair value of \$249,500,000.

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

(In Thousands, Except Per Share Data)

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

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

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

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

Identifiable intangibles are amortized to their estimated residual values over the expected useful lives. Such lives are also periodically reassessed to determine if any amortization period adjustments are required. During the six months ended June 30, 2013, no such adjustments were recorded. The identifiable intangible assets consist of a core deposit intangible and trade name intangible which are being amortized on an accelerated basis over the useful life of such assets. The gross carrying amount of the core deposit intangible and trade name intangible at June 30, 2013 was \$1,882,000 and \$132,000, respectively, with \$29,000 and \$2,000 accumulated amortization as of that date.

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

(In Thousands)

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

Results of operations for Luzerne National Bank Corporation prior to the acquisition date are not included in the Consolidated Statement of Income for the three and six month periods ended June 30, 2013. Due to the significant amount of fair value adjustments, historical results of Luzerne National Bank Corporation are not relevant to the Company's results of operations. Therefore, no pro forma information is presented.

The following table presents financial information regarding the former Luzerne National Bank Corporation operations included in our Consolidated Statement of Income from the date of acquisition through June 30, 2013 under the column Actual from acquisition date through June 30, 2013. In addition, the following table presents unaudited pro forma information as if the acquisition of

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Luzerne National Bank Corporation had occurred on January 1, 2012 under the Pro Forma columns. The table below has been prepared for comparative purposes only and is not necessarily indicative of the actual results that would have been attained had the acquisition occurred as of the beginning of the periods presented, nor is it indicative of future results. Furthermore, the unaudited proforma information does not reflect management's estimate of any revenue-enhancing opportunities nor anticipated cost savings as a result of the integration and consolidation of the acquisition. Merger and acquisition integration costs and amortization of fair value adjustments are included in the numbers below.

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

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

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

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

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

EARNINGS SUMMARY

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

Summary Results

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

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

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

Reconciliation of GAAP and Non-GAAP Financial Measures

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

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

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

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

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

Interest and Dividend Income

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

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

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

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

June 30, 2013	For The Six Months Ended June 30, 2012	Change
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(In Thousands)	Amount	% Total	Amount	% Total	Amount	%
Loans including fees	\$ 14,045	71.81%	\$ 12,608	67.91%	\$ 1,437	11.40%
Investment securities:						
Taxable	2,950	15.08	2,991	16.11	(41)	(1.37)
Tax-exempt	2,429	12.42	2,788	15.02	(359)	(12.88)
Dividend and other interest income	134	0.69	178	0.96	(44)	(24.72)
Total interest and dividend income	\$ 19,558	100.00%	\$ 18,565	100.00%	\$ 993	5.35%

Interest Expense

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

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

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

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

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

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

Net Interest Margin

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

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

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

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

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

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

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

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

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

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

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

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

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

Provision for Loan Losses

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

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

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

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

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

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

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

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

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

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

Non-interest Income

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

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

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

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

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

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(In Thousands)	June 30, 2013		For the Six Months Ended June 30, 2012		Change	
	Amount	% Total	Amount	% Total	Amount	%
Service charges	\$ 980	15.63%	\$ 905	17.94%	\$ 75	8.29%
Securities gains, net	2,260	36.06	759	15.05	1,501	197.76