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(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

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

**17703-0967**  
(Zip Code)

**(570) 322-1111**

Registrant's telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  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

Accelerated filer

Non-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 November 2, 2012 there were 3,838,289 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)**

<b>(In Thousands, Except Share Data)</b>	<b>September 30, 2012</b>	<b>December 31, 2011</b>
<b>ASSETS:</b>		
Noninterest-bearing balances	\$ 13,243	\$ 13,829
Interest-bearing deposits in other financial institutions	7,901	56
Total cash and cash equivalents	21,144	13,885
Investment securities, available for sale, at fair value	296,255	270,097
Investment securities, held to maturity, (fair value of \$0 and \$55)		54
Loans held for sale	2,285	3,787
Loans	485,051	435,959
Allowance for loan losses	(7,521)	(7,154)
Loans, net	477,530	428,805
Premises and equipment, net	8,247	7,707
Accrued interest receivable	4,255	3,905
Bank-owned life insurance	16,238	16,065
Investment in limited partnerships	3,048	3,544
Goodwill	3,032	3,032
Deferred tax asset	3,878	7,991
Other assets	4,694	5,081
<b>TOTAL ASSETS</b>	<b>\$ 840,606</b>	<b>\$ 763,953</b>
<b>LIABILITIES:</b>		
Interest-bearing deposits	\$ 525,825	\$ 470,310
Noninterest-bearing deposits	115,285	111,354
Total deposits	641,110	581,664
Short-term borrowings	17,932	29,598
Long-term borrowings, Federal Home Loan Bank (FHLB)	76,278	61,278
Accrued interest payable	501	536
Other liabilities	11,006	10,417
<b>TOTAL LIABILITIES</b>	<b>746,827</b>	<b>683,493</b>
<b>SHAREHOLDERS EQUITY:</b>		
Preferred stock, no par value, 3,000,000 shares authorized; no shares issued		
Common stock, par value \$8.33, 15,000,000 shares authorized; 4,018,777 and 4,017,677 shares issued	33,489	33,480
Additional paid-in capital	18,148	18,115
Retained earnings	41,737	36,394

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Accumulated other comprehensive gain (loss):				
Net unrealized gain on available for sale securities		10,848		2,914
Defined benefit plan		(4,133)		(4,133)
Treasury stock at cost, 180,596 shares		(6,310)		(6,310)
<b>TOTAL SHAREHOLDERS EQUITY</b>		<b>93,779</b>		<b>80,460</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>		<b>\$ 840,606</b>		<b>\$ 763,953</b>

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 September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>INTEREST AND DIVIDEND INCOME:</b>				
Loans, including fees	\$ 6,346	\$ 6,327	\$ 18,954	\$ 18,759
Investment securities:				
Taxable	1,486	1,445	4,477	4,231
Tax-exempt	1,339	1,336	4,127	3,875
Dividend and other interest income	96	65	274	174
<b>TOTAL INTEREST AND DIVIDEND INCOME</b>	<b>9,267</b>	<b>9,173</b>	<b>27,832</b>	<b>27,039</b>
<b>INTEREST EXPENSE:</b>				
Deposits	902	1,154	2,797	3,530
Short-term borrowings	38	58	100	157
Long-term borrowings, FHLB	637	751	1,877	2,227
<b>TOTAL INTEREST EXPENSE</b>	<b>1,577</b>	<b>1,963</b>	<b>4,774</b>	<b>5,914</b>
<b>NET INTEREST INCOME</b>	<b>7,690</b>	<b>7,210</b>	<b>23,058</b>	<b>21,125</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>600</b>	<b>600</b>	<b>1,800</b>	<b>1,800</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>7,090</b>	<b>6,610</b>	<b>21,258</b>	<b>19,325</b>
<b>NON-INTEREST INCOME:</b>				
Service charges	489	508	1,394	1,538
Securities gains, net	447	8	1,206	142
Earnings on bank-owned life insurance	138	148	539	461
Gain on sale of loans	527	359	1,053	850
Insurance commissions	295	241	1,053	630
Brokerage commissions	239	241	698	797
Other	636	485	1,872	1,390
<b>TOTAL NON-INTEREST INCOME</b>	<b>2,771</b>	<b>1,990</b>	<b>7,815</b>	<b>5,808</b>
<b>NON-INTEREST EXPENSE:</b>				
Salaries and employee benefits	2,939	2,621	8,806	7,728
Occupancy, net	317	313	963	962
Furniture and equipment	355	354	1,058	1,011
Pennsylvania shares tax	169	172	505	516
Amortization of investment in limited partnerships	165	165	496	496
Federal Deposit Insurance Corporation deposit insurance	111	43	349	416
Other	1,402	1,300	4,088	3,683
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>5,458</b>	<b>4,968</b>	<b>16,265</b>	<b>14,812</b>
<b>INCOME BEFORE INCOME TAX PROVISION</b>	<b>4,403</b>	<b>3,632</b>	<b>12,808</b>	<b>10,321</b>

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INCOME TAX PROVISION		736		482		2,054		1,354
<b>NET INCOME</b>	\$	3,667	\$	3,150	\$	10,754	\$	8,967
<b>EARNINGS PER SHARE - BASIC</b>	\$	0.96	\$	0.82	\$	2.80	\$	2.34
<b>EARNINGS PER SHARE - DILUTED</b>	\$	0.96	\$	0.82	\$	2.80	\$	2.34
<b>WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC</b>		3,837,925		3,836,244		3,837,570		3,835,778
<b>WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED</b>		3,837,925		3,836,244		3,837,570		3,835,778
<b>DIVIDENDS PER SHARE</b>	\$	0.47	\$	0.46	\$	1.41	\$	1.38

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 September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net Income	\$ 3,667	\$ 3,150	\$ 10,754	\$ 8,967
Other comprehensive income:				
Change in unrealized gain on available for sale securities	6,190	4,950	13,228	12,605
Tax effect	(2,105)	(1,683)	(4,498)	(4,285)
Net realized gain included in net income	(447)	(8)	(1,206)	(142)
Tax effect	152	3	410	48
Total other comprehensive income	3,790	3,262	7,934	8,226
Comprehensive income	\$ 7,457	\$ 6,412	\$ 18,688	\$ 17,193

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	CAPITAL	EARNINGS	INCOME (LOSS)	STOCK	EQUITY
Balance, December 31, 2010	4,015,753	\$ 33,464	\$ 18,064	\$ 31,091	\$ (9,689)	\$ (6,310)	\$ 66,620
Comprehensive income:							
Net income				8,967			8,967
Other comprehensive income					8,226		8,226
Dividends declared, (\$1.38 per share)				(5,293)			(5,293)
Common shares issued for employee stock purchase plan	1,498	13	39				52
Balance, September 30, 2011	4,017,251	\$ 33,477	\$ 18,103	\$ 34,765	\$ (1,463)	\$ (6,310)	\$ 78,572

(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	CAPITAL	EARNINGS	INCOME (LOSS)	STOCK	EQUITY
Balance, December 31, 2011	4,017,677	\$ 33,480	\$ 18,115	\$ 36,394	\$ (1,219)	\$ (6,310)	\$ 80,460
Comprehensive income:							



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Net income				10,754				10,754
Other comprehensive income						7,934		7,934
Dividends declared, (\$1.41 per share)				(5,411)				(5,411)
Common shares issued for employee stock purchase plan	1,100	9	33					42
Balance, September 30, 2012	4,018,777	\$ 33,489	\$ 18,148	\$ 41,737	\$ 6,715	\$ (6,310)	\$	93,779

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)	Nine Months Ended September 30,	
	2012	2011
<b>OPERATING ACTIVITIES:</b>		
Net Income	\$ 10,754	\$ 8,967
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	569	526
Provision for loan losses	1,800	1,800
Accretion and amortization of investment security discounts and premiums	(816)	(1,320)
Securities gains, net	(1,206)	(142)
Originations of loans held for sale	(32,116)	(28,756)
Proceeds of loans held for sale	34,671	32,641
Gain on sale of loans	(1,053)	(850)
Earnings on bank-owned life insurance	(539)	(461)
Decrease in prepaid federal deposit insurance	315	337
Other, net	(1,189)	(412)
Net cash provided by operating activities	11,190	12,330
<b>INVESTING ACTIVITIES:</b>		
Investment securities available for sale:		
Proceeds from sales	35,847	11,992
Proceeds from calls and maturities	17,259	9,601
Purchases	(64,965)	(58,272)
Investment securities held to maturity:		
Proceeds from sales		5
Proceeds from calls and maturities	55	25
Net increase in loans	(50,513)	(17,275)
Acquisition of bank premises and equipment	(1,109)	(394)
Proceeds from the sale of foreclosed assets	700	388
Purchase of bank-owned life insurance	(33)	(39)
Proceeds from bank-owned life insurance death benefit	383	
Proceeds from redemption of regulatory stock	1,034	985
Net cash used for investing activities	(61,342)	(52,984)
<b>FINANCING ACTIVITIES:</b>		
Net increase in interest-bearing deposits	55,515	42,356
Net increase in noninterest-bearing deposits	3,931	15,436
Proceeds of long-term borrowings, FHLB	15,000	
Net decrease in short-term borrowings	(11,666)	(9,715)
Dividends paid	(5,411)	(5,293)
Issuance of common stock	42	52
Net cash provided by financing activities	57,411	42,836
NET INCREASE IN CASH AND CASH EQUIVALENTS	7,259	2,182
CASH AND CASH EQUIVALENTS, BEGINNING	13,885	9,493
CASH AND CASH EQUIVALENTS, ENDING	\$ 21,144	\$ 11,675
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Interest paid	\$ 4,809	\$ 6,048
Income taxes paid	2,350	1,790
Transfer of loans to foreclosed real estate		2,008

See accompanying notes to the unaudited consolidated financial statements.

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**PENNS WOODS BANCORP, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1. Basis of Presentation**

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

The interim financial statements are unaudited but, in the opinion of management, reflect all adjustments necessary for the fair presentation of results for such periods. 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, 2011.

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 37 through 43 of the Annual Report on Form 10-K for the year ended December 31, 2011.

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. 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 is not expected to have a significant impact on the Company's financial statements.

**Note 3. 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.

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Weighted average common shares issued	4,018,521	4,016,840	4,018,166	4,016,374
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	3,837,925	3,836,244	3,837,570	3,835,778

**Note 4. Investment Securities**

The amortized cost and fair values of investment securities at September 30, 2012 and December 31, 2011 are as follows:

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(In Thousands)	September 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale (AFS)				
U.S. Government and agency securities	\$ 26,136	\$ 1,693	\$ (21)	\$ 27,808
State and political securities	174,782	13,753	(1,328)	187,207
Other debt securities	68,792	1,468	(310)	69,950
Total debt securities	269,710	16,914	(1,659)	284,965
Financial institution equity securities	7,768	1,234	(26)	8,976
Other equity securities	2,340	63	(89)	2,314
Total equity securities	10,108	1,297	(115)	11,290
Total investment securities				
AFS	\$ 279,818	\$ 18,211	\$ (1,774)	\$ 296,255

(In Thousands)	December 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale (AFS)				
U.S. Government and agency securities	\$ 26,755	\$ 1,916	\$	\$ 28,671
State and political securities	174,790	8,398	(4,887)	178,301
Other debt securities	51,447	133	(2,066)	49,514
Total debt securities	252,992	10,447	(6,953)	256,486
Financial institution equity securities	9,939	1,095	(232)	10,802
Other equity securities	2,751	133	(75)	2,809
Total equity securities	12,690	1,228	(307)	13,611
Total investment securities				
AFS	\$ 265,682	\$ 11,675	\$ (7,260)	\$ 270,097
Held to maturity (HTM)				
Other debt securities	\$ 54	\$ 1	\$	\$ 55
Total investment securities				
HTM	\$ 54	\$ 1	\$	\$ 55

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 September 30, 2012 and December 31, 2011.

(In Thousands)	September 30, 2012				Total Fair Value	Total Gross Unrealized Losses
	Less than Twelve Months Fair Value	Gross Unrealized Losses	Twelve Months or Greater Fair Value	Gross Unrealized Losses		
U.S. Government and agency securities	\$ 968	\$ (21)	\$ 7,396	\$ (1,191)	\$ 968	\$ (21)
	5,013	(137)			12,409	(1,328)

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State and political securities										
Other debt securities	7,751	(101)	8,027	(209)	15,778	(310)				
Total debt securities	13,732	(259)	15,423	(1,400)	29,155	(1,659)				
Financial institution equity securities	65	(2)	195	(24)	260	(26)				
Other equity securities	821	(83)	66	(6)	887	(89)				
Total equity securities	886	(85)	261	(30)	1,147	(115)				
Total	\$ 14,618	\$ (344)	\$ 15,684	\$ (1,430)	\$ 30,302	\$ (1,774)				

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(In Thousands)	Less than Twelve Months		December 31, 2011 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	\$	\$	\$	\$	\$	\$
State and political securities	1,142	(6)	28,260	(4,881)	29,402	(4,887)
Other debt securities	35,858	(2,048)	82	(18)	35,940	(2,066)
Total debt securities	37,000	(2,054)	28,342	(4,899)	65,342	(6,953)
Financial institution equity securities	1,140	(116)	273	(116)	1,413	(232)
Other equity securities	263	(65)	130	(10)	393	(75)
Total equity securities	1,403	(181)	403	(126)	1,806	(307)
Total	\$ 38,403	\$ (2,235)	\$ 28,745	\$ (5,025)	\$ 67,148	\$ (7,260)

At September 30, 2012 there were a total of 19 and 31 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 September 30, 2012, 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 September 30, 2012, 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	\$	5,129	\$	5,157
Due after one year to five years		42,516		43,308
Due after five years to ten years		37,652		38,729
Due after ten years		184,413		197,771
Total	\$	269,710	\$	284,965

Total gross proceeds from sales of securities available for sale were \$35,848,000 and \$11,992,000, for the nine months ended September 30, 2012 and 2011, respectively. The following table represents gross realized gains and losses on those transactions:

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Gross realized gains:				
U.S. Government and agency securities	\$	\$	\$	\$
State and political securities	52	109	103	114
Other debt securities	142		219	8



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Financial institution equity securities	144		605	
Other equity securities	397		523	131
Total gross realized gains	\$ 735	\$ 109	\$ 1,588	\$ 257
Gross realized losses:				
U.S. Government and agency securities	\$	\$	\$	\$
State and political securities	144	100	146	100
Other debt securities	53	1	53	15
Financial institution equity securities			67	
Other equity securities	91		116	
Total gross realized losses	\$ 288	\$ 101	\$ 382	\$ 115

There were no impairment charges included in gross realized losses for the three or nine months ended September 30, 2012 and 2011, respectively.

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The Bank is a member of the Federal Home Loan Bank ( FHLB ) of Pittsburgh and as such, is 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.

The FHLB had incurred losses in 2009 and for parts of 2010 due primarily to other-than-temporary impairment credit losses on its private-label mortgage-backed securities portfolio. These securities were the most effected by the extreme economic conditions in place during the previous several years. As a result, the FHLB had suspended the payment of dividends and limited the amount of excess capital stock repurchases. The FHLB has reported net income for the year ended December 31, 2011 and has declared a 0.10 percent annualized dividend to its shareholders during each of the first three quarters of 2012. While the FHLB has not committed to regular dividend payments or future limited repurchases of excess capital stock, it will continue to monitor the overall financial performance of the FHLB in order to determine the status of limited repurchases of excess capital stock or dividends in the future. 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 6. 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 September 30, 2012 and December 31, 2011:

(In Thousands)	Current	September 30, 2012			Total
		Past Due 30 To 89 Days	Past Due 90 Days Or More & Still Accruing	Non- Accrual	
Commercial and agricultural	\$ 51,280	\$ 65	\$	\$	\$ 51,345
Real estate mortgage:					
Residential	222,637	1,164	654	647	225,102
Commercial	165,888	39		4,272	170,199
Construction	22,249	2		6,468	28,719

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Installment loans to individuals	10,873		82				10,955
	472,927	\$	1,352	\$	654	\$	11,387
Less: Net deferred loan fees and discounts	1,269						1,269
Allowance for loan losses	7,521						7,521
Loans, net	\$	464,137				\$	477,530

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(In Thousands)	Current	December 31, 2011			Non-Accrual	Total
		Past Due 30 To 89 Days	Past Due 90 Days Or More & Still Accruing			
Commercial and agricultural	\$ 53,124	\$ 5	\$	\$	\$	\$ 53,129
Real estate mortgage:						
Residential	176,875	1,438	378	692		179,383
Commercial	162,977	135		1,176		164,288
Construction	19,605	95		9,757		29,457
Installment loans to individuals	11,180	111	6			11,297
	423,761	\$ 1,784	\$ 384	\$ 11,625		437,554
Less: Net deferred loan fees and discounts	1,595					1,595
Allowance for loan losses	7,154					7,154
Loans, net	\$ 415,012					\$ 428,805

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 as of September 30, 2012 and September 30, 2011:

(In Thousands)	Three Months Ended September 30,			
	2012		2011	
	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
Real estate mortgages - residential	\$ 13	\$ 4	\$ 7	\$ 1
Real estate mortgages - commercial	92	43	36	3
Real estate mortgages - construction	77	11	290	4
	\$ 182	\$ 58	\$ 333	\$ 8

(In Thousands)	Nine Months Ended September 30,			
	2012		2011	
	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
Real estate mortgages - residential	\$ 25	\$ 17	\$ 31	\$ 20
Real estate mortgages - commercial	135	51	65	5
Real estate mortgages - construction	298	67	562	4
	\$ 458	\$ 135	\$ 658	\$ 29

**Impaired Loans**

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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. 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.

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Mortgage loans on one-to-four family properties and all consumer loans are large groups of smaller-balance homogeneous loans and are measured for impairment collectively. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis taking into consideration all circumstances surrounding the loan and the borrower including the length of the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed. Interest income for impaired loans is recorded consistent with the Bank's policy on nonaccrual loans.

The following table presents the recorded investment, unpaid principal balance, and related allowance of impaired loans by segment as of September 30, 2012 and December 31, 2011:

(In Thousands)	Recorded Investment	September 30, 2012 Unpaid Principal Balance	Related Allowance
With no related allowance recorded:			
Real estate mortgages - residential	\$ 84	\$ 84	\$
Real estate mortgages - commercial	330	330	
Real estate mortgages - construction	553	553	
	967	967	
With an allowance recorded:			
Real estate mortgages - residential	1,287	1,371	290
Real estate mortgages - commercial	6,329	6,348	1,615
Real estate mortgages - construction	5,928	8,746	806
	13,544	16,465	2,711
Total:			
Real estate mortgages - residential	1,371	1,455	290
Real estate mortgages - commercial	6,659	6,678	1,615
Real estate mortgages - construction	6,481	9,299	806
	\$ 14,511	\$ 17,432	\$ 2,711

(In Thousands)	Recorded Investment	December 31, 2011 Unpaid Principal Balance	Related Allowance
With no related allowance recorded:			
Real estate mortgages - residential	\$ 742	\$ 751	\$
Real estate mortgages - commercial	382	382	
Real estate mortgages - construction	815	1,113	
	1,939	2,246	
With an allowance recorded:			
Real estate mortgages - residential	861	888	101
Real estate mortgages - commercial	6,150	6,150	1,481
Real estate mortgages - construction	8,929	10,429	2,155
	15,940	17,467	3,737
Total:			
Real estate mortgages - residential	1,603	1,639	101
Real estate mortgages - commercial	6,532	6,532	1,481
Real estate mortgages - construction	9,744	11,542	2,155
	\$ 17,879	\$ 19,713	\$ 3,737

The following table presents the average recorded investment in impaired loans and related interest income recognized for the three and nine months ended for September 30, 2012 and 2011:



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(In Thousands)	Three Months Ended September 30,					
	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	Average Investment in Impaired Loans	2011 Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans
Commercial and agricultural	\$	\$	\$	\$	41	\$ 1
Real estate mortgages - residential	1,253	10	4	1,448	16	6
Real estate mortgages - commercial	6,576	63	6	5,537	35	3
Real estate mortgages - construction	6,822	1	11	10,540	23	4
	\$ 14,651	\$ 74	\$ 21	\$ 17,566	\$ 75	\$ 13

(In Thousands)	Nine Months Ended September 30,					
	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	Average Investment in Impaired Loans	2011 Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans
Commercial and agricultural	\$	\$	\$	\$	125	\$ 5
Real estate mortgages - residential	1,382	35	33	1,477	42	22
Real estate mortgages - commercial	6,541	224	14	4,657	105	5
Real estate mortgages - construction	8,266	1	67	9,551	77	4
	\$ 16,189	\$ 260	\$ 114	\$ 15,810	\$ 229	\$ 31

There is approximately \$287,000 committed to be advanced in connection with impaired loans.

**Modifications**

The loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring (TDR), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

Loan modifications that are considered TDRs completed during the three and nine months ended September 30, 2012 and 2011 were as follows:

(In Thousands, Except Number of Contracts)	Number of Contracts	Three Months Ended September 30,		
		2012 Pre-Modification Outstanding	Post-Modification Outstanding	Number of Contracts



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		Recorded Investment	Recorded Investment		Recorded Investment	Recorded Investment
Troubled debt restructurings						
Commercial and agricultural		\$	\$		\$	\$
Real estate mortgages - residential	1	100	100	2	161	161
Real estate mortgages - commercial				7	3,902	3,902
Real estate mortgages - construction				4	11,888	11,888
Installment loans to individuals						
Total	1	\$ 100	\$ 100	13	\$ 15,951	\$ 15,951

Nine Months Ended September 30,

(In Thousands, Except Number of Contracts)	Number of Contracts	2012		Number of Contracts	2011	
		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings						
Commercial and agricultural		\$	\$		\$	\$
Real estate mortgages - residential	3	254	254	2	161	161
Real estate mortgages - commercial	1	37	37	7	3,902	3,902
Real estate mortgages - construction	2	26	26	5	12,473	12,473
Installment loans to individuals						
Total	6	\$ 317	\$ 317	14	\$ 16,536	\$ 16,536

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There has been one loan modification considered a troubled debt restructuring made during the twelve months previous to September 30, 2012 that has defaulted during the nine month period ending September 30, 2012. The loan that defaulted is an installment loan to an individual with a recorded investment of \$3,000 at September 30, 2012.

Troubled debt restructurings amounted to \$13,870,000 and \$17,478,000 as of September 30, 2012 and December 31, 2011.

**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 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 September 30, 2012 and December 31, 2011:

(In Thousands)	September 30, 2012						Totals
	Commercial and Agricultural	Residential	Real Estate Mortgages		Installment Loans to Individuals		
			Commercial	Construction			
Pass	\$ 50,452	\$ 223,393	\$ 154,895	\$ 22,204	\$ 10,955	\$ 461,899	
Special Mention	698		5,237			5,935	
Substandard	195	1,709	10,067	6,515		18,486	
Doubtful							
Total	\$ 51,345	\$ 225,102	\$ 170,199	\$ 28,719	\$ 10,955	\$ 486,320	

(In Thousands)	December 31, 2011						Totals
	Commercial and Agricultural	Residential	Real Estate Mortgages		Installment Loans to Individuals		
			Commercial	Construction			
Pass	\$ 51,663	\$ 177,916	\$ 152,994	\$ 19,652	\$ 11,291	\$ 413,516	
Special Mention	1,198	89	5,804			7,091	

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Substandard	268	1,378	5,490	9,805	6	16,947
Doubtful						
Total	\$ 53,129	\$ 179,383	\$ 164,288	\$ 29,457	\$ 11,297	\$ 437,554

**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.

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

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

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

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

Activity in the allowance is presented for the nine months ended September 30, 2012 and 2011:

(In Thousands)	September 30, 2012						Totals
	Commercial and Agricultural	Residential	Real Estate Mortgages		Installment Loans to Individuals		
			Commercial	Construction			
Beginning Balance	\$ 430	\$ 964	\$ 2,719	\$ 2,846	\$ 195	\$ 7,154	
Charge-offs		(60)	(19)	(1,360)	(73)	(1,512)	
Recoveries	6	7	4	24	38	79	
Provision	(61)	532	961	342	26	1,800	
Ending Balance	\$ 375	\$ 1,443	\$ 3,665	\$ 1,852	\$ 186	\$ 7,521	

(In Thousands)	September 30, 2011						Totals
	Commercial and Agricultural	Residential	Real Estate Mortgages		Installment Loans to Individuals		
			Commercial	Construction			
Beginning Balance	\$ 466	\$ 980	\$ 1,508	\$ 2,893	\$ 188	\$ 6,035	
Charge-offs		(34)		(1,500)	(63)	(1,597)	
Recoveries	9	37	23	7	41	117	
Provision	(26)	(41)	321	1,542	4	1,800	
Ending Balance	\$ 449	\$ 942	\$ 1,852	\$ 2,942	\$ 170	\$ 6,355	

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The Company grants commercial, industrial, residential, and installment loans to customers throughout north-central Pennsylvania. Although the Company has a diversified loan portfolio at September 30, 2012, 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 September 30, 2012 and 2011 as follows:

	September 30,	
	2012	2011
Owners of residential rental properties	18.32%	14.38%
Owners of commercial rental properties	14.57%	17.01%

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 September 30, 2012 and December 31, 2011:

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(In Thousands)	September 30, 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	\$	\$	290	\$	1,615	\$	806	\$	2,711			
Collectively evaluated for impairment		375	1,153		2,050		1,046		186	4,810		
Total ending allowance balance	\$	375	\$	1,443	\$	3,665	\$	1,852	\$	186	\$	7,521
Loans:												
Individually evaluated for impairment	\$	\$	1,371	\$	6,659	\$	6,481	\$		\$	14,511	
Collectively evaluated for impairment		51,345	223,731		163,540		22,238		10,955		471,809	
Total ending loans balance	\$	51,345	\$	225,102	\$	170,199	\$	28,719	\$	10,955	\$	486,320

(In Thousands)	December 31, 2011						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	\$	\$	101	\$	1,481	\$	2,155	\$		\$	3,737	
Collectively evaluated for impairment		430	863		1,238		691		195		3,417	
Total ending allowance balance	\$	430	\$	964	\$	2,719	\$	2,846	\$	195	\$	7,154
Loans:												
Individually evaluated for impairment	\$	\$	1,603	\$	6,532	\$	9,744	\$		\$	17,879	
Collectively evaluated for impairment		53,129	177,780		157,756		19,713		11,297		419,675	
Total ending loans balance	\$	53,129	\$	179,383	\$	164,288	\$	29,457	\$	11,297	\$	437,554

**Note 7. 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, 2011.

The following sets forth the components of the net periodic benefit cost of the domestic non-contributory defined benefit plan for the three and nine months ended September 30, 2012 and 2011, respectively:

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(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Service cost	\$ 156	\$ 106	\$ 469	\$ 318
Interest cost	187	178	559	534
Expected return on plan assets	(195)	(186)	(586)	(556)
Amortization of transition obligation	(1)	(1)	(2)	(3)
Amortization of prior service cost	6	6	19	19
Amortization of net loss	109	41	327	123
Net periodic cost	\$ 262	\$ 144	\$ 786	\$ 435

**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, 2011, that it expected to contribute a minimum of \$750,000 to its defined benefit plan in 2012. As of September 30, 2012, there were contributions of \$1,450,000 made to the plan with additional contributions of at least \$225,000 anticipated during the fourth quarter of 2012. The increased level of contributions is the result of management's plan to reduce the unfunded portion of the Company's defined benefit pension plan.

**Note 8. Employee Stock Purchase Plan**

The Company maintains the Penns Woods Bancorp, Inc. 2006 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

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up to the lesser of 15% of base compensation or \$12,000 in market value annually. During the nine months ended September 30, 2012 and 2011, there were 1,100 and 1,498 shares issued under the plan, respectively.

**Note 9. 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 September 30, 2012 and December 31, 2011:

(In Thousands)	September 30, 2012	December 31, 2011
Commitments to extend credit	\$ 91,858	\$ 80,320
Standby letters of credit	1,368	1,180

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 10. Fair Value Measurements**



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

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

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

The following table presents the assets reported on the balance sheet at their fair value on a recurring basis as of September 30, 2012 and December 31, 2011, 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)	September 30, 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	\$	\$ 27,808	\$	\$ 27,808
State and political securities		187,207		187,207
Other debt securities		69,950		69,950
Financial institution equity securities	8,976			8,976
Other equity securities	2,314			2,314
Total assets measured on a recurring basis	\$ 11,290	\$ 284,965	\$	\$ 296,255

(In Thousands)	December 31, 2011			Total
	Level I	Level II	Level III	
Assets measured on a recurring basis:				
Investment securities, available for sale:				
U.S. Government and agency securities	\$	\$ 28,671	\$	\$ 28,671
State and political securities		178,301		178,301
Other debt securities		49,514		49,514
Financial institution equity securities	10,802			10,802
Other equity securities	2,809			2,809
Total assets measured on a recurring basis	\$ 13,611	\$ 256,486	\$	\$ 270,097

The following table presents the assets reported on the consolidated balance sheet at their fair value on a non-recurring basis as of September 30, 2012 and December 31, 2011, 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)	September 30, 2012			Total
	Level I	Level II	Level III	
Assets measured on a non-recurring basis:				
Impaired loans	\$	\$	\$ 11,800	\$ 11,800
Other real estate owned			1,502	1,502
Total assets measured on a non-recurring basis	\$	\$	\$ 13,302	\$ 13,302

(In Thousands)	December 31, 2011			Total
	Level I	Level II	Level III	
Assets measured on a non-recurring basis:				
Impaired loans	\$	\$	\$ 14,142	\$ 14,142
Other real estate owned			2,144	2,144
Total assets measured on a non-recurring basis	\$	\$	\$ 16,286	\$ 16,286

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 September 30, 2012.

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(In Thousands)	Fair Value	Quantitative Information About Level III Fair Value Measurements			Weighted Average
		Valuation Technique(s)	Unobservable Inputs	Range	
Impaired loans	11,800	Discounted cash flow	Temporary change in payment amount	0 to -55%	-31%
			Probability of default	0%	
		Appraisal of collateral	Appraisal adjustments (1)	0 to -20%	-15%
Other real estate owned	1,502	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%

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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 11. Fair Value of Financial Instruments**

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

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

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

The fair values of the Company's financial instruments are as follows at September 30, 2012 and December 31, 2011:

(In Thousands)	Fair Value Measurements at September 30, 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)
<b>Financial assets:</b>					
Cash and cash equivalents	\$ 21,144	\$ 21,144	\$ 21,144	\$	\$
<b>Investment securities:</b>					
Available for sale	296,255	296,255	11,290	284,965	
<b>Held to maturity</b>					
Loans held for sale	2,285	2,285	2,285		
Loans, net	477,530	483,242			483,242

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Bank-owned life insurance	16,238	16,238	16,238
Accrued interest receivable	4,255	4,255	4,255
<b>Financial liabilities:</b>			
Interest-bearing deposits	\$ 525,825	\$ 531,483	\$ 531,483
Noninterest-bearing deposits	115,285	115,285	115,285
Short-term borrowings	17,932	17,932	17,932
Long-term borrowings, FHLB	76,278	81,340	81,340
Accrued interest payable	501	501	501

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(In Thousands)	December 31, 2011	
	Carrying Value	Fair Value
<b>Financial assets:</b>		
Cash and cash equivalents	\$ 13,885	\$ 13,885
<b>Investment securities:</b>		
Available for sale	270,097	270,097
Held to maturity	54	55
Loans held for sale	3,787	3,787
Loans, net	428,805	424,586
Bank-owned life insurance	16,065	16,065
Accrued interest receivable	3,905	3,905
<b>Financial liabilities:</b>		
Interest-bearing deposits	\$ 470,310	\$ 471,212
Noninterest-bearing deposits	111,354	111,354
Short-term borrowings	29,598	29,598
Long-term borrowings, FHLB	61,278	65,848
Accrued interest payable	536	536

**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 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 9 (Off Balance Sheet Risk).

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**Note 12. 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 13. Subsequent Event - Merger Agreement**

On October 18, 2012, the Company entered into a definitive merger agreement with Luzerne National Bank Corporation (Luzerne) under which the Company will acquire Luzerne in a stock and cash transaction. Under the terms of the merger agreement, the Company will acquire all of the outstanding shares of Luzerne for a total purchase price of approximately \$44.5 million as of the date of the agreement. Luzerne shareholders will have the opportunity to elect to receive for each outstanding share of Luzerne common stock either 1.5534 shares of the Company's common stock, \$61.86 in cash or a combination of cash or stock. All shareholder elections will be subject to allocation and proration procedures set forth in the merger agreement that are designed to ensure that no more than 10% of the outstanding Luzerne shares are exchanged for cash. The transaction is expected to be a tax-free exchange to the extent that shareholders of Luzerne receive stock in exchange for their shares. The transaction is expected to close in the second quarter of 2013 subject to customary closing conditions, including receipt of regulatory approvals and approvals by shareholders of both the Company and Luzerne.

**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 complete the pending merger transaction with Luzerne National Bank Corporation and 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 Nine Months Ended September 30, 2012 and 2011**

**Summary Results**

Net income for the three months ended September 30, 2012 was \$3,667,000 compared to \$3,150,000 for the same period of 2011 as after-tax securities gains increased \$290,000 (from a gain of \$5,000 to a gain of \$295,000). Basic and diluted earnings per share for the three months ended September 30, 2012 were \$0.96 compared to \$0.82 for the three months ended September 30, 2011. Return on average assets and return on average equity were 1.77% and 15.94% for the three months ended September 30, 2012 compared to 1.67% and 16.49% for the corresponding period of 2011. Net income from core operations ( operating earnings ) increased to \$3,372,000 for the three months ended September 30, 2012 compared to \$3,145,000 for the same period of 2011. Operating earnings per share for the three months ended September 30, 2012 were \$0.88 basic and dilutive compared to \$0.82 basic and dilutive for the three months ended September 30, 2011.

The nine months ended September 30, 2012 generated net income of \$10,754,000 compared to \$8,967,000 for the same period of 2011. Comparable results were impacted by an increase in after-tax securities gains of \$702,000 (from a gain of \$94,000 to a gain of \$796,000). Earnings per share, basic and dilutive, for the nine months ended September 30, 2012 were \$2.80 compared to \$2.34 for the comparable period of 2011. Return on average assets and return on average equity were 1.78% and 16.25% for the nine months ended September 30, 2012 compared to 1.65% and 16.46% for the corresponding period of 2011. Operating earnings increased 11.0% to \$9,849,000 for the nine months ended September 30, 2012 compared to \$8,873,000 for the comparable period of 2011, resulting in basic and dilutive operating earnings per share increasing 11.3% to \$2.57 from \$2.31 for the nine month periods ended September 30, 2012 and 2011, respectively.

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**

**Three Months Ended  
September 30,**

**Nine Months Ended  
September 30,**

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(Dollars in Thousands, Except Per Share Data)	2012		2011	
GAAP net income	\$	3,667	\$	3,150
Less: net securities and bank-owned life insurance gains, net of tax		295		5
Non-GAAP operating earnings	\$	3,372	\$	3,145
			\$	10,754
			\$	8,967

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Return on average assets (ROA)	1.77%	1.67%	1.78%	1.65%
Less: net securities and bank-owned life insurance gains, net of tax	0.14%	0.00%	0.15%	0.02%
Non-GAAP operating ROA	1.63%	1.67%	1.63%	1.63%

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Return on average equity (ROE)	15.94%	16.49%	16.25%	16.46%
Less: net securities and bank-owned life insurance gains, net of tax	1.28%	0.03%	1.37%	0.18%
Non-GAAP operating ROE	14.66%	16.46%	14.88%	16.28%

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	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2011		2012		2011	
Basic earnings per share (EPS)	\$	0.96	\$	0.82	\$	2.80	\$	2.34
Less: net securities and bank-owned life insurance gains, net of tax		0.08		0.00		0.23		0.03
Non-GAAP basic operating EPS	\$	0.88	\$	0.82	\$	2.57	\$	2.31

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2011		2012		2011	
Dilutive EPS	\$	0.96	\$	0.82	\$	2.80	\$	2.34
Less: net securities and bank-owned life insurance gains, net of tax		0.08		0.00		0.23		0.03
Non-GAAP dilutive operating EPS	\$	0.88	\$	0.82	\$	2.57	\$	2.31

**Interest and Dividend Income**

Interest and dividend income for the three months ended September 30, 2012 increased to \$9,267,000 compared to \$9,173,000 for the same period of 2011. The increase was due in part to loan portfolio income increasing as the impact of portfolio growth offset a reduction in yield of 57 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. Investment portfolio interest increased due to growth in the average investment portfolio of \$47,729,000 primarily from the addition of short-term corporate bonds to the portfolio, which offset a decline in the average taxable equivalent yield of 61 bp.

During the nine months ended September 30, 2012, interest and dividend income was \$27,832,000, an increase of \$793,000 over the same period in 2011. Interest income on the loan portfolio increased as the impact of growth in the portfolio was limited by a 42 bp decline in average yield. The investment portfolio interest income increased as the increase in portfolio size more than offset the 72 bp decline in yield.

Interest and dividend income composition for the three and nine months ended September 30, 2012 and 2011 was as follows:

(In Thousands)	September 30, 2012		For The Three Months Ended September 30, 2011		Change	
	Amount	% Total	Amount	% Total	Amount	%
Loans including fees	\$ 6,346	68.47%	\$ 6,327	68.97%	\$ 19	0.30%
Investment securities:						
Taxable	1,486	16.04	1,445	15.75	41	2.84
Tax-exempt	1,339	14.45	1,336	14.57	3	0.22
Dividend and other interest income	96	1.04	65	0.71	31	47.69
Total interest and dividend income	\$ 9,267	100.00%	\$ 9,173	100.00%	\$ 94	1.02%

**For The Nine Months Ended**

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(In Thousands)	September 30, 2012		September 30, 2011		Change	
	Amount	% Total	Amount	% Total	Amount	%
Loans including fees	\$ 18,954	68.10%	\$ 18,759	69.38%	\$ 195	1.04%
Investment securities:						
Taxable	4,477	16.09	4,231	15.65	246	5.81
Tax-exempt	4,127	14.83	3,875	14.33	252	6.50
Dividend and other interest income	274	0.98	174	0.64	100	57.47
Total interest and dividend income	\$ 27,832	100.00%	\$ 27,039	100.00%	\$ 793	2.93%

**Interest Expense**

Interest expense for the three months ended September 30, 2012 decreased \$386,000 to \$1,577,000 compared to \$1,963,000 for the same period of 2011. The substantial decrease associated with deposits is primarily the result of a reduction of 32 bp in the rate paid on time deposits and a 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

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to increase with a focus on maturities of 36 months and greater. In addition, the Marcellus Shale natural gas exploration in north central Pennsylvania is creating opportunities to gather new and build upon existing deposit relationships. Borrowing interest expense decreased as the significant growth in deposits has allowed for a reduction in the average balance of borrowings.

Interest expense for the nine months ended September 30, 2012 decreased 19.28% from the same period of 2011. The reasons noted for the decline in interest expense for the three month period comparison also apply to the nine month period.

Interest expense composition for the three and nine months ended September 30, 2012 and 2011 was as follows:

(In Thousands)	September 30, 2012		For The Three Months Ended September 30, 2011		Change	
	Amount	% Total	Amount	% Total	Amount	%
Deposits	\$ 902	57.20%	\$ 1,154	58.79%	\$ (252)	(21.84)%
Short-term borrowings	38	2.41	58	2.95	(20)	(34.48)
Long-term borrowings, FHLB	637	40.39	751	38.26	(114)	(15.18)
Total interest expense	\$ 1,577	100.00%	\$ 1,963	100.00%	\$ (386)	(19.66)%

(In Thousands)	September 30, 2012		For The Nine Months Ended September 30, 2011		Change	
	Amount	% Total	Amount	% Total	Amount	%
Deposits	\$ 2,797	58.59%	\$ 3,530	59.69%	\$ (733)	(20.76)%
Short-term borrowings	100	2.09	157	2.65	(57)	(36.31)
Long-term borrowings, FHLB	1,877	39.32	2,227	37.66	(350)	(15.72)
Total interest expense	\$ 4,774	100.00%	\$ 5,914	100.00%	\$ (1,140)	(19.28)%

**Net Interest Margin**

The net interest margin ( NIM ) for the three months ended September 30, 2012 was 4.34% compared to 4.55% for the corresponding period of 2011. The NIM declined as a 36 bp decline in the rate paid on interest bearing liabilities was countered by a 52 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 shorter term corporate and agency 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 1.38% to 1.02% was driven by a reduction in the rate paid on time deposits of 32 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.

The NIM for the nine months ended September 30, 2012 was 4.51% compared to 4.67% for the same period of 2011. The impact of the items mentioned in the three month discussion also applies to the nine month period. A 35 bp decline in the rate paid on time deposits served as the

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foundation for a 31 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 nine months ended September 30, 2012 and 2011:

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(In Thousands)	AVERAGE BALANCES AND INTEREST RATES			AVERAGE BALANCES AND INTEREST RATES		
	Three Months Ended September 30, 2012			Three Months Ended September 30, 2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
<b>Assets:</b>						
Tax-exempt loans	\$ 22,916	\$ 302	5.24%	\$ 20,211	\$ 311	6.10%
All other loans	452,370	6,147	5.41%	407,346	6,122	5.96%
Total loans	475,286	6,449	5.40%	427,557	6,433	5.97%
Taxable securities	162,822	1,580	3.88%	139,510	1,509	4.33%
Tax-exempt securities	132,996	2,029	6.10%	117,917	2,024	6.87%
Total securities	295,818	3,609	4.88%	257,427	3,533	5.49%
Interest-bearing deposits	8,966	2	0.09%	15,734	1	0.03%
Total interest-earning assets	780,070	10,060	5.14%	700,718	9,967	5.66%
Other assets	48,096			53,323		
Total assets	\$ 828,166			\$ 754,041		
<b>Liabilities and shareholders equity:</b>						
Savings	\$ 81,413	16	0.08%	\$ 72,704	28	0.15%
Super Now deposits	120,135	158	0.52%	98,094	141	0.57%
Money market deposits	151,307	173	0.45%	128,012	280	0.87%
Time deposits	171,245	555	1.29%	173,825	705	1.61%
Total interest-bearing deposits	524,100	902	0.68%	472,635	1,154	0.97%
Short-term borrowings	18,607	38	0.81%	17,357	58	1.33%
Long-term borrowings, FHLB	65,517	637	3.80%	71,778	751	4.09%
Total borrowings	84,124	675	3.14%	89,135	809	3.56%
Total interest-bearing liabilities	608,224	1,577	1.02%	561,770	1,963	1.38%
Demand deposits	116,582			104,017		
Other liabilities	11,355			11,821		
Shareholders equity	92,005			76,433		
Total liabilities and shareholders equity	\$ 828,166			\$ 754,041		
Interest rate spread			4.12%			4.28%
Net interest income/margin		\$ 8,483	4.34%		\$ 8,004	4.55%

- Information on this table has been calculated using average daily balance sheets to obtain average balances.
- Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.
- Income and rates on a fully taxable equivalent basis include an adjustment for the difference between annual income from tax-exempt obligations and the taxable equivalent of such income at the standard 34% tax rate.





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(In Thousands)	AVERAGE BALANCES AND INTEREST RATES			AVERAGE BALANCES AND INTEREST RATES		
	Nine Months Ended September 30, 2012			Nine Months Ended September 30, 2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
<b>Assets:</b>						
Tax-exempt loans	\$ 21,977	\$ 909	5.52%	\$ 20,302	\$ 924	6.09%
All other loans	436,921	18,354	5.61%	402,384	18,149	6.03%
Total loans	458,898	19,263	5.61%	422,686	19,073	6.03%
Taxable securities	157,791	4,747	4.01%	126,887	4,402	4.63%
Tax-exempt securities	131,306	6,253	6.35%	109,552	5,871	7.15%
Total securities	289,097	11,000	5.07%	236,439	10,273	5.79%
Interest-bearing deposits	8,098	4	0.07%	11,916	3	0.03%
Total interest-earning assets	756,093	30,267	5.34%	671,041	29,349	5.84%
Other assets	49,702			53,405		
Total assets	\$ 805,795			\$ 724,446		
<b>Liabilities and shareholders equity:</b>						
Savings	\$ 78,180	44	0.08%	\$ 69,994	98	0.19%
Super Now deposits	116,205	452	0.52%	83,357	331	0.53%
Money market deposits	143,878	580	0.54%	120,177	835	0.93%
Time deposits	173,578	1,721	1.32%	181,158	2,266	1.67%
Total interest-bearing deposits	511,841	2,797	0.73%	454,686	3,530	1.04%
Short-term borrowings	19,293	100	0.69%	17,055	157	1.23%
Long-term borrowings, FHLB	62,701	1,877	3.93%	71,778	2,227	4.09%
Total borrowings	81,994	1,977	3.17%	88,833	2,384	3.54%
Total interest-bearing liabilities	593,835	4,774	1.07%	543,519	5,914	1.45%
Demand deposits	112,464			98,000		
Other liabilities	11,258			10,272		
Shareholders equity	88,238			72,655		
Total liabilities and shareholders equity	\$ 805,795			\$ 724,446		
Interest rate spread			4.27%			4.39%
Net interest income/margin		\$ 25,493	4.51%		\$ 23,435	4.67%

- Information on this table has been calculated using average daily balance sheets to obtain average balances.
- Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.
- Income and rates on a fully taxable equivalent basis include an adjustment for the difference between annual income from tax-exempt obligations and the taxable equivalent of such income at the standard 34% tax rate.

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The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the three and nine months ended September 30, 2012 and 2011.

(In Thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Total interest income	\$ 9,267	\$ 9,173	\$ 27,832	\$ 27,039
Total interest expense	1,577	1,963	4,774	5,914
Net interest income	7,690	7,210	23,058	21,125
Tax equivalent adjustment	793	794	2,435	2,310
Net interest income (fully taxable equivalent)	\$ 8,483	\$ 8,004	\$ 25,493	\$ 23,435

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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 nine month periods ended September 30, 2012 and 2011:

(In Thousands)	Three Months Ended September 30, 2012 vs. 2011			Nine Months Ended September 30, 2012 vs. 2011		
	Volume	Increase (Decrease) Due to Rate	Net	Volume	Increase (Decrease) Due to Rate	Net
<b>Interest income:</b>						
Loans, tax-exempt	\$ 38	\$ (47)	\$ (9)	\$ 47	\$ (62)	\$ (15)
Loans	628	(603)	25	1,039	(834)	205
Taxable investment securities	236	(165)	71	724	(379)	345
Tax-exempt investment securities	243	(238)	5	798	(416)	382
Interest bearing deposits	(1)	2	1	(1)	2	1
Total interest-earning assets	1,144	(1,051)	93	2,607	(1,689)	918
<b>Interest expense:</b>						
Savings deposits	3	(15)	(12)	4	(58)	(54)
Super Now deposits	30	(13)	17	124	(3)	121
Money market deposits	94	(201)	(107)	168	(423)	(255)
Time deposits	(10)	(140)	(150)	(90)	(455)	(545)
Short-term borrowings	4	(24)	(20)	5	(62)	(57)
Long-term borrowings, FHLB	(63)	(51)	(114)	(177)	(173)	(350)
Total interest-bearing liabilities	58	(444)	(386)	34	(1,174)	(1,140)
Change in net interest income	\$ 1,086	\$ (607)	\$ 479	\$ 2,573	\$ (515)	\$ 2,058

**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 September 30, 2012, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy, increased unemployment, and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets, charge-offs, loan loss provisions, and reductions in income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Bank's loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

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

The allowance for loan losses increased from \$7,154,000 at December 31, 2011 to \$7,521,000 at September 30, 2012. The increase in the allowance for loan losses was limited by net charge-offs of \$1,433,000 for the nine month period ended September 30, 2012. The primary driver of the charge-offs for the period was two partial charge-offs of construction real-estate loans that partially offset the provision for loan losses during the nine months ended September 30, 2012. At September 30, 2012 and December 31, 2011, the allowance for loan losses to total loans was 1.55% and 1.64%, respectively.

The provision for loan losses totaled \$600,000 and \$1,800,000 for the three and nine months ended September 30, 2012 and September 30, 2011. 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 2.48% at September 30, 2012 and a ratio of the allowance for loan losses to nonperforming loans of 62.46% at September 30, 2012. Nonperforming loans decreased to \$12,041,000 at September 30, 2012 from \$14,344,000 at September 30, 2011 due to charge-offs and the receipt of collateral in lieu of payment with the collateral now carried as other real estate owned. 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 \$1,800,000 for the nine month period ended September 30,

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2012. The level of provision for loan losses did not equate to the change in nonperforming loans due to the economic situation and the collateral status of the nonperforming loans and overall loan portfolio in general, which limits the loan specific allocation of the allowance for loan losses.

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

(In Thousands)	Total Nonperforming Loans		
	90 Days Past Due	Nonaccrual	Total
September 30, 2012	\$ 654	\$ 11,387	\$ 12,041
June 30, 2012		8,725	8,725
March 31, 2012	1	11,307	11,308
December 31, 2011	384	11,625	12,009
September 30, 2011	2,459	11,885	14,344

**Non-interest Income**

Total non-interest income for the three months ended September 30, 2012 compared to the same period in 2011 increased \$781,000 to \$2,771,000. Excluding net securities gains, non-interest income for the three months ended September 30, 2012 would have increased \$342,000 compared to the 2011 period. Deposit service charges decreased as overdraft fees have declined as an overdrawn dollar threshold must now be reached before the customer is charged a fee. 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 to increase the number of mortgage originators within our market area, while also hiring additional mortgage originators to expand our market area. 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.

Insurance commissions for the three months ended September 30, 2012 increased due to continued efforts to add sales representatives. Management of The M Group continues to pursue new and build upon current relationships. The sales call program continues to expand outside of central Pennsylvania, which results in additional revenue for The M Group if an additional sales outlet is added. However, the addition of a sales outlet for The M Group can take up to a year or more to be completed.

Total non-interest income for the nine months ended September 30, 2012 compared to the same period in 2011 increased \$2,007,000. Excluding net securities gains, non-interest income would have increased \$943,000 compared to the 2011 period. The increase in non-interest income for the nine month period is the result of the same items noted in the three month discussion.

Non-interest income composition for the three and nine months ended September 30, 2012 and 2011 was as follows:

(In Thousands)	September 30, 2012		For the Three Months Ended September 30, 2011		Change	
	Amount	% Total	Amount	% Total	Amount	%

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Deposit service charges	\$	489	17.65%	\$	508	25.53%	\$	(19)	(3.74)%
Securities gains, net		447	16.13		8	0.40		439	5,487.50
Bank owned life insurance		138	4.98		148	7.44		(10)	(6.76)
Gain on sale of loans		527	19.02		359	18.04		168	46.80
Insurance commissions		295	10.65		241	12.11		54	22.41
Brokerage commissions		239	8.63		241	12.11		(2)	(0.83)
Other		636	22.94		485	24.37		151	31.13
Total non-interest income	\$	2,771	100.00%	\$	1,990	100.00%	\$	781	39.25%

(In Thousands)	September 30, 2012		For the Nine Months Ended September 30, 2011		Change				
	Amount	% Total	Amount	% Total	Amount	%			
Deposit service charges	\$	1,394	17.84%	\$	1,538	26.48%	\$	(144)	(9.36)%
Securities gains, net		1,206	15.43		142	2.44		1,064	749.30
Bank owned life insurance		539	6.90		461	7.94		78	16.92
Gain on sale of loans		1,053	13.47		850	14.64		203	23.88
Insurance commissions		1,053	13.47		630	10.85		423	67.14
Brokerage commissions		698	8.93		797	13.72		(99)	(12.42)
Other		1,872	23.96		1,390	23.93		482	34.68
Total non-interest income	\$	7,815	100.00%	\$	5,808	100.00%	\$	2,007	34.56%

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Total non-interest expense increased \$490,000 for the three months ended September 30, 2012 compared to the same period of 2011. The increase in salaries and employee benefits was attributable to increases in health insurance, salaries, and bonus accrual. Other expenses increased primarily due to expenses, such as advertising, associated with the opening of a branch during 2012 and increased fees related to providing debit card services.

Total non-interest expense increased \$1,453,000 for the nine months ended September 30, 2012 compared to the same period of 2011. The increase in non-interest expense for the nine month period is primarily the result of the same items noted in the three month discussion.

Non-interest expense composition for the three and nine months ended September 30, 2012 and 2011 was as follows:

(In Thousands)	September 30, 2012		For the Three Months Ended September 30, 2011		Change	
	Amount	% Total	Amount	% Total	Amount	%
Salaries and employee benefits	\$ 2,939	53.85%	\$ 2,621	52.76%	\$ 318	12.13%
Occupancy, net	317	5.81	313	6.30	4	1.28
Furniture and equipment	355	6.50	354	7.13	1	0.28
Pennsylvania shares tax	169	3.10	172	3.46	(3)	(1.74)
Amortization of investment in limited partnerships	165	3.02	165	3.32		
FDIC deposit insurance	111	2.03	43	0.87	68	158.14
Other	1,402	25.69	1,300	26.16	102	7.85
Total non-interest expense	\$ 5,458	100.00%	\$ 4,968	100.00%	\$ 490	9.86%

(In Thousands)	September 30, 2012		For the Nine Months Ended September 30, 2011		Change	
	Amount	% Total	Amount	% Total	Amount	%
Salaries and employee benefits	\$ 8,806	54.14%	\$ 7,728	52.17%	\$ 1,078	13.95%
Occupancy, net	963	5.92	962	6.49	1	0.10
Furniture and equipment	1,058	6.50	1,011	6.83	47	4.65
Pennsylvania shares tax	505	3.10	516	3.48	(11)	(2.13)
Amortization of investment in limited partnerships	496	3.05	496	3.35		
FDIC deposit insurance	349	2.15	416	2.81	(67)	(16.11)
Other	4,088	25.14	3,683	24.87	405	11.00
Total non-interest expense	\$ 16,265	100.00%	\$ 14,812	100.00%	\$ 1,453	9.81%

**Provision for Income Taxes**



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Income taxes increased \$254,000 and \$700,000 for the three and nine months ended September 30, 2012 compared to the same periods of 2011. The primary cause of the increase in tax expense for the three and nine month periods ended September 30, 2012 compared to 2011 is the impact of increased net income. Excluding the impact of the net securities gains, the effective tax rate for the three and nine months ended September 30, 2012 was 14.76% and 14.17% compared to 13.22% and 12.83% for the same period of 2011. The Company currently is in a deferred tax asset position due to the low income housing tax credits earned both currently and previously. Management has reviewed the deferred tax asset and has determined that the asset will be utilized within the appropriate carry forward period and therefore does not require a valuation allowance.

### ASSET/LIABILITY MANAGEMENT

#### Cash and Cash Equivalents

Cash and cash equivalents increased \$7,259,000 from \$13,885,000 at December 31, 2011 to \$21,144,000 at September 30, 2012 primarily as a result of the following activities during the nine months ended September 30, 2012:

#### Loans Held for Sale

Activity regarding loans held for sale resulted in loan originations trailing sale proceeds, less \$1,053,000 in realized gains, by \$1,502,000 for the nine months ended September 30, 2012.

#### Loans

Gross loans increased \$49,092,000 since December 31, 2011 due primarily to an increase of residential real estate loans with an emphasis on home equity products.

The allocation of the loan portfolio, by category, as of September 30, 2012 and December 31, 2011 is presented below:

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(In Thousands)	September 30, 2012		December 31, 2011		Change	
	Amount	% Total	Amount	% Total	Amount	%
Commercial and agricultural	\$ 51,345	10.58%	\$ 53,129	12.19%	\$ (1,784)	(3.36)%
Real estate mortgage:						
Residential	225,102	46.41	179,383	41.15	45,719	25.49
Commercial	170,199	35.09	164,288	37.68	5,911	3.60
Construction	28,719	5.92	29,457	6.76	(738)	(2.51)
Installment loans to individuals	10,955	2.26	11,297	2.59	(342)	(3.03)
Less: Net deferred loan fees and discounts	1,269	(0.26)	1,595	(0.37)	(326)	(20.44)
Gross loans	\$ 485,051	100.00%	\$ 435,959	100.00%	\$ 49,092	11.26%

**Investments**

The fair value of the investment securities portfolio at September 30, 2012 increased \$26,103,000 since December 31, 2011. The change is primarily due to purchases of short-term other debt securities coupled with a net unrealized gain of \$16,437,000 at September 30, 2012 compared to an unrealized gain of \$4,415,000 at December 31, 2011. The unrealized losses within the debt securities portfolio are the result of market activity, not credit issues/ratings, as approximately 94% of the debt securities portfolio on an amortized cost basis is currently rated A or higher by either S&P or Moody's.

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

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

The fair value of the equity portfolio continues to fluctuate as the economic turbulence continues to impact financial sector stock pricing. The amortized cost of the equity securities portfolio has decreased \$2,582,000 to \$10,108,000 at September 30, 2012 from \$12,690,000 at December 31, 2011. The decrease was due in part to the realization of gains in the portfolio.

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

The distribution of credit ratings by amortized cost and fair values for the debt security portfolio at September 30, 2012 follows:

(In Thousands)	A- to AAA		B- to BBB+		C to CCC+		Not Rated		Total	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Available for sale (AFS)										
U.S. Government and agency securities	\$ 26,136	\$ 27,808	\$	\$	\$	\$	\$	\$	\$ 26,136	\$ 27,808
State and political securities	161,299	174,169	5,991	5,592			7,492	7,446	174,782	187,207
Other debt securities	67,106	68,261	689	701			997	988	68,792	69,950
Total debt securities AFS	\$ 254,541	\$ 270,238	\$ 6,680	\$ 6,293	\$	\$	\$ 8,489	\$ 8,434	\$ 269,710	\$ 284,965

### Financing Activities

#### Deposits

Total deposits increased \$59,446,000 from December 31, 2011 to September 30, 2012. The growth was led by an increase in NOW and money market accounts from December 31, 2011 to September 30, 2012 of 23.34% and 19.88%, respectively. The increase in core deposits (deposits less time deposits) has provided relationship driven funding for the loan and investment portfolios. The

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increase in deposits is the result of our focus on building relationships with NOW and money market accounts as the key building blocks. Over the past year and through the first nine months of 2012, time deposits have decreased as we have taken a position of using these accounts as complementary accounts to core deposits. To facilitate this strategy we are actively working single product time deposit relationships to create a solid relationship through the addition of other products to the customer's portfolio. In addition, approximately \$25,000,000 of the total deposit growth has been generated from the opening of the Danville branch in January 2012.

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

(In Thousands)	September 30, 2012		December 31, 2011		Change	
	Amount	% Total	Amount	% Total	Amount	%
Demand deposits	\$ 115,285	17.98%	\$ 111,354	19.14%	\$ 3,931	3.53%
NOW accounts	125,572	19.59	101,808	17.50	23,764	23.34
Money market deposits	149,054	23.25	124,335	21.38		