

PENNS WOODS BANCORP INC  
Form 10-Q  
November 09, 2010  
Table of Contents

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

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

**for the Quarterly Period Ended September 30, 2010.**

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

**for the Transition Period from            to            .**

**No. 0-17077**

**(Commission File Number)**

**PENNS WOODS BANCORP, INC.**

**(Exact name of Registrant as specified in its charter)**

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

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

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

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 5, 2010 there were 3,834,769 shares of the Registrant's common stock outstanding.

Table of Contents

**PENNS WOODS BANCORP, INC.**

**INDEX TO QUARTERLY REPORT ON FORM 10-Q**

	<b>Page Number</b>
<b><u>Part I</u></b>	
<b><u>Financial Information</u></b>	
<b><u>Item 1.</u></b>	
<b><u>Financial Statements</u></b>	
<u>Consolidated Balance Sheet (unaudited) as of September 30, 2010 and December 31, 2009</u>	3
<u>Consolidated Statement of Income (unaudited) for the Three and Nine Months ended September 30, 2010 and 2009</u>	4
<u>Consolidated Statement of Changes in Shareholders' Equity (unaudited) for the Nine Months ended September 30, 2010 and 2009</u>	5
<u>Consolidated Statement of Comprehensive Income (unaudited) for the Three and Nine Months ended September 30, 2010 and 2009</u>	5
<u>Consolidated Statement of Cash Flows (unaudited) for the Nine Months ended September 30, 2010 and 2009</u>	6
<u>Notes to Consolidated Financial Statements (unaudited)</u>	7
<b><u>Item 2.</u></b>	
<b><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	23
<b><u>Item 3.</u></b>	
<b><u>Quantitative and Qualitative Disclosures About Market Risk</u></b>	40
<b><u>Item 4.</u></b>	
<b><u>Controls and Procedures</u></b>	40
<b><u>Part II</u></b>	
<b><u>Other Information</u></b>	
<b><u>Item 1.</u></b>	
<b><u>Legal Proceedings</u></b>	41
<b><u>Item 1A.</u></b>	
<b><u>Risk Factors</u></b>	41
<b><u>Item 2.</u></b>	
<b><u>Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	41
<b><u>Item 3.</u></b>	
<b><u>Defaults Upon Senior Securities</u></b>	41
<b><u>Item 4.</u></b>	
<b><u>(Removed and Reserved)</u></b>	41
<b><u>Item 5.</u></b>	
<b><u>Other Information</u></b>	41
<b><u>Item 6.</u></b>	
<b><u>Exhibits</u></b>	42
<b><u>Signatures</u></b>	43
<b><u>Exhibit Index and Exhibits</u></b>	44

Table of Contents**Part I. FINANCIAL INFORMATION****Item 1. Financial Statements**

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

<b>(In Thousands, Except Share Data)</b>	<b>September 30, 2010</b>	<b>December 31, 2009</b>
<b>ASSETS:</b>		
Noninterest-bearing balances	\$ 15,741	\$ 13,760
Interest-bearing deposits in other financial institutions	7,316	28
Total cash and cash equivalents	23,057	13,788
Investment securities, available for sale, at fair value	232,058	208,768
Investment securities, held to maturity (fair value of \$83 and \$108)	82	107
Loans held for sale	5,360	4,063
Loans	412,873	405,529
Less: Allowance for loan losses	5,479	4,657
Loans, net	407,394	400,872
Premises and equipment, net	7,814	7,988
Accrued interest receivable	3,657	3,523
Bank-owned life insurance	15,345	14,942
Investment in limited partnerships	4,415	4,898
Goodwill	3,032	3,032
Deferred tax asset	7,041	9,491
Other assets	4,241	4,732
<b>TOTAL ASSETS</b>	<b>\$ 713,496</b>	<b>\$ 676,204</b>
<b>LIABILITIES:</b>		
Interest-bearing deposits	\$ 442,042	\$ 417,388
Noninterest-bearing deposits	92,128	79,899
Total deposits	534,170	497,287
Short-term borrowings	14,629	18,354
Long-term borrowings, Federal Home Loan Bank (FHLB)	81,778	86,778
Accrued interest payable	832	1,073
Other liabilities	6,764	5,796
<b>TOTAL LIABILITIES</b>	<b>638,173</b>	<b>609,288</b>
<b>SHAREHOLDERS EQUITY</b>		
Common stock, par value \$8.33, 10,000,000 shares authorized; 4,014,871 and 4,013,142 shares issued	33,457	33,443

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

Additional paid-in capital	18,045	18,008
Retained earnings	29,994	27,218
Accumulated other comprehensive gain (loss):		
Net unrealized gain (loss) on available for sale securities	2,057	(3,569)
Defined benefit plan	(1,920)	(1,920)
Less: Treasury stock at cost, 180,596 and 179,028 shares	(6,310)	(6,264)
<b>TOTAL SHAREHOLDERS EQUITY</b>	<b>75,323</b>	<b>66,916</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 713,496</b>	<b>\$ 676,204</b>

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

**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,	
	2010	2009	2010	2009
<b>INTEREST AND DIVIDEND INCOME:</b>				
Loans including fees	\$ 6,434	\$ 6,457	\$ 19,162	\$ 19,025
Investment securities:				
Taxable	1,428	1,368	4,182	4,105
Tax-exempt	1,266	1,253	3,794	3,748
Dividend and other interest income	54	35	157	165
<b>TOTAL INTEREST AND DIVIDEND INCOME</b>	<b>9,182</b>	<b>9,113</b>	<b>27,295</b>	<b>27,043</b>
<b>INTEREST EXPENSE:</b>				
Deposits	1,458	2,148	4,719	6,357
Short-term borrowings	77	82	197	318
Long-term borrowings, FHLB	889	938	2,733	2,781
<b>TOTAL INTEREST EXPENSE</b>	<b>2,424</b>	<b>3,168</b>	<b>7,649</b>	<b>9,456</b>
<b>NET INTEREST INCOME</b>	<b>6,758</b>	<b>5,945</b>	<b>19,646</b>	<b>17,587</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>700</b>	<b>270</b>	<b>1,400</b>	<b>582</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>6,058</b>	<b>5,675</b>	<b>18,246</b>	<b>17,005</b>
<b>NON-INTEREST INCOME:</b>				
Service charges	562	553	1,609	1,619
Securities gains (losses), net	109	(507)	162	(4,962)
Earnings on bank-owned life insurance	143	144	442	418
Gain on sale of loans	202	305	714	526
Insurance commissions	230	287	767	988
Other	624	599	1,880	1,624
<b>TOTAL NON-INTEREST INCOME</b>	<b>1,870</b>	<b>1,381</b>	<b>5,574</b>	<b>213</b>
<b>NON-INTEREST EXPENSE:</b>				
Salaries and employee benefits	2,427	2,588	7,779	7,665
Occupancy, net	303	299	947	956
Furniture and equipment	296	293	922	906
Pennsylvania shares tax	170	171	508	514
Amortization of investment in limited partnerships	200	142	483	425
Other	1,308	1,604	4,041	4,161
<b>TOTAL NON-INTEREST EXPENSE</b>	<b>4,704</b>	<b>5,097</b>	<b>14,680</b>	<b>14,627</b>
<b>INCOME BEFORE INCOME TAX PROVISION (BENEFIT)</b>	<b>3,224</b>	<b>1,959</b>	<b>9,140</b>	<b>2,591</b>
<b>INCOME TAX PROVISION (BENEFIT)</b>	<b>376</b>	<b>37</b>	<b>1,072</b>	<b>(1,002)</b>
<b>NET INCOME</b>	<b>\$ 2,848</b>	<b>\$ 1,922</b>	<b>\$ 8,068</b>	<b>\$ 3,593</b>

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

<b>NET INCOME PER SHARE - BASIC</b>	\$	0.74	\$	0.50	\$	2.10	\$	0.94
<b>NET INCOME PER SHARE - DILUTED</b>	\$	0.74	\$	0.50	\$	2.10	\$	0.94
<b>WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC</b>		3,833,850		3,833,131		3,834,101		3,832,471
<b>WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED</b>		3,833,990		3,833,305		3,834,241		3,832,555
<b>DIVIDENDS PER SHARE</b>	\$	0.46	\$	0.46	\$	1.38	\$	1.38

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

## PENNS WOODS BANCORP, INC.

## CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

(In Thousands, Except Per Share Data)	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)		TREASURY STOCK	TOTAL SHAREHOLDERS EQUITY
	SHARES	AMOUNT						
Balance, December 31, 2008	4,010,528	\$ 33,421	\$ 17,959	\$ 28,177	\$ (12,266)	\$ (6,264)		61,027
Comprehensive income:								
Net income				3,593				3,593
Other comprehensive income					11,156			11,156
Dividends declared, (\$1.38 per share)				(5,289)				(5,289)
Common shares issued for employee stock purchase plan	1,991	16	36					52
Balance, September 30, 2009	4,012,519	\$ 33,437	\$ 17,995	\$ 26,481	\$ (1,110)	\$ (6,264)		70,539

(In Thousands, Except Per Share Data)	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)		TREASURY STOCK	TOTAL SHAREHOLDERS EQUITY
	SHARES	AMOUNT						
Balance, December 31, 2009	4,013,142	\$ 33,443	\$ 18,008	\$ 27,218	\$ (5,489)	\$ (6,264)		66,916
Comprehensive income:								
Net income				8,068				8,068
Other comprehensive income					5,626			5,626
Dividends declared, (\$1.38 per share)				(5,292)				(5,292)
Common shares issued for employee stock purchase plan	1,729	14	37					51
Purchase of treasury stock (1,568 shares)						(46)		(46)
Balance, September 30, 2010	4,014,871	\$ 33,457	\$ 18,045	\$ 29,994	\$ 137	\$ (6,310)		75,323

## PENNS WOODS BANCORP, INC.

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(UNAUDITED)

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net Income	\$ 2,848	\$ 1,922	\$ 8,068	\$ 3,593
Other Comprehensive income:				
Change in unrealized gain on available for sale securities	5,591	13,119	8,686	11,941
Less: Reclassification adjustment for net gains (losses) included in net income	109	(507)	162	(4,962)
	5,482	13,626	8,524	16,903



Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

Other comprehensive income before tax expense				
Income tax expense related to other comprehensive income	1,864	4,633	2,898	5,747
Other comprehensive income, net of tax	3,618	8,993	5,626	11,156
Comprehensive income	\$ 6,466	\$ 10,915	\$ 13,694	\$ 14,749

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

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

(In Thousands)	Nine Months Ended September 30,	
	2010	2009
<b>OPERATING ACTIVITIES:</b>		
Net Income	\$ 8,068	\$ 3,593
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	558	541
Provision for loan losses	1,400	582
Accretion and amortization of investment security discounts and premiums	(1,557)	(1,052)
Securities (gains) losses, net	(162)	4,962
Originations of loans held for sale	(31,557)	(24,448)
Proceeds of loans held for sale	30,974	23,193
Gain on sale of loans	(714)	(526)
Earnings on bank-owned life insurance	(442)	(418)
Other, net	1,156	(1,169)
Net cash provided by operating activities	7,724	5,258
<b>INVESTING ACTIVITIES</b>		
Investment securities available for sale:		
Proceeds from sales	3,446	5,377
Proceeds from calls and maturities	12,424	7,596
Purchases	(28,918)	(10,963)
Investment securities held to maturity:		
Proceeds from calls and maturities	26	25
Net increase in loans	(8,148)	(20,728)
Acquisition of bank premises and equipment	(384)	(467)
Proceeds from the sale of foreclosed assets	193	
Purchase of bank-owned life insurance	(47)	(59)
Proceeds from bank-owned life insurance death benefit	82	
Investment in limited partnership		(738)
Purchases of regulatory stock		(170)
Net cash used for investing activities	(21,326)	(20,127)
<b>FINANCING ACTIVITIES</b>		
Net increase in interest-bearing deposits	24,654	69,160
Net increase (decrease) in noninterest-bearing deposits	12,229	(466)
Repayment of long-term borrowings, FHLB	(5,000)	
Net decrease in short-term borrowings	(3,725)	(52,506)
Dividends paid	(5,292)	(5,289)
Issuance of common stock	51	52
Purchase of treasury stock	(46)	
Net cash provided by financing activities	22,871	10,951
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	9,269	(3,918)
CASH AND CASH EQUIVALENTS, BEGINNING	13,788	16,581
CASH AND CASH EQUIVALENTS, ENDING	\$ 23,057	\$ 12,663
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>		
Interest paid	\$ 7,890	\$ 9,582

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

Income taxes paid	1,950	1,175
Transfer of loans to foreclosed real estate	226	921

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

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

**NOTES TO**

**CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1. Basis of Presentation**

The consolidated financial statements include the accounts of Penns Woods Bancorp, Inc. (the Company) and its wholly-owned subsidiaries: Woods Investment Company, Inc., Woods Real Estate Development Company, Inc., 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, 2009.

The accounting policies followed in the presentation of interim financial results are the same as those followed on an annual basis. These policies are presented on pages 38 through 44 of the Annual Report on Form 10-K for the year ended December 31, 2009.

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 2009, the FASB issued ASU 2009-16, *Accounting for Transfer of Financial Assets*. ASU 2009-16 provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. ASU 2009-16 is effective for annual periods beginning after November 15, 2009 and for interim periods within those fiscal years. The adoption of this guidance did not have a material impact on the Company's financial statements.

In January 2010, the FASB issued ASU 2010-01, *Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash* a consensus of the FASB Emerging Issues Task Force. ASU 2010-01 clarifies that the stock portion of a distribution to shareholders

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in EPS prospectively and is not a stock dividend. ASU 2010-01 is effective for interim and annual periods ending on or after December 15, 2009 and should be

Table of Contents

applied on a retrospective basis. The adoption of this guidance did not have a material impact on the Company's financial statements.

In January 2010, the FASB issued ASU 2010-05, *Compensation - Stock Compensation (Topic 718): Escrowed Share Arrangements and the Presumption of Compensation*. ASU 2010-05 updates existing guidance to address the SEC staff's views on overcoming the presumption that for certain shareholders escrowed share arrangements represent compensation. ASU 2010-05 is effective January 15, 2010. The adoption of this guidance did not have a material impact on the Company's financial statements.

In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The Company has presented the necessary disclosures in Note 7 (Net Periodic Benefit Cost-Defined Benefit Plans) herein.

In February 2010, the FASB issued ASU 2010-08, *Technical Corrections to Various Topics*. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. The adoption of this guidance did not have a material impact on the Company's financial position or results.

In March 2010, the FASB issued ASU 2010-11, *Derivatives and Hedging*. ASU 2010-11 provides clarification and related additional examples to improve financial reporting by resolving potential ambiguity about the breadth of the embedded credit derivative scope exception in ASC 815-15-15-8. ASU 2010-11 is effective at the beginning of the first fiscal quarter beginning after June 15, 2010. The adoption of this guidance did not have a material impact on the Company's financial statements.

In April 2010, the FASB issued ASU 2010-18, *Receivables (Topic 310): Effect of a Loan Modification When the Loan is a Part of a Pool That is Accounted for as a Single Asset - a consensus of the FASB Emerging Issues Task Force*. ASU 2010-18 clarifies the treatment for a modified loan that was acquired as part of a pool of assets. Refinancing or restructuring the loan does not make it eligible for removal from the pool, the FASB said. The amendment will be effective for loans that are part of an asset pool and are modified during financial reporting periods that end July 15, 2010 or later. The amendment did not have a material impact on the Company's financial statements.

In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. ASU 2010-20 is intended to provide additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses. The

Table of Contents

disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. The amendments in ASU 2010-20 encourage, but do not require, comparative disclosures for earlier reporting periods that ended before initial adoption. However, an entity should provide comparative disclosures for those reporting periods ending after initial adoption. The Company is currently evaluating the impact the adoption of this guidance will have on the Company's financial position or results of operations.

In August, 2010, the FASB issued ASU 2010-21, *Accounting for Technical Amendments to Various SEC Rules and Schedules*. This ASU amends various SEC paragraphs pursuant to the issuance of Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules, and Codification of Financial Reporting Policies and is not expected to have a significant impact on the Company's financial statements.

In August, 2010, the FASB issued ASU 2010-22, *Technical Corrections to SEC Paragraphs* An announcement made by the staff of the U.S. Securities and Exchange Commission. This ASU amends various SEC paragraphs based on external comments received and the issuance of SAB 112, which amends or rescinds portions of certain SAB topics and 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>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Weighted average common shares issued	4,014,446	4,012,159	4,013,891	4,011,499
Average treasury stock shares	(180,596)	(179,028)	(179,790)	(179,028)
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	3,833,850	3,833,131	3,834,101	3,832,471
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	140	174	140	84
Weighted average common shares and common stock equivalents used to calculate diluted earnings per share	3,833,990	3,833,305	3,834,241	3,832,555

Table of Contents

Options to purchase 990 shares of common stock at a strike price of \$24.72 were outstanding during the three and nine months ended September 30, 2010 and were included in the computation of diluted earnings per share. The average market price of the Company's stock was \$31.49 and \$31.47 for the three and nine months ended September 30, 2010. Options to purchase 990 shares of common stock at a strike price of \$31.82 and 990 shares of common stock at a strike price of \$24.72 were outstanding during the three and nine months ended September 30, 2009. The options were included in the computation of diluted earnings per share during the periods that the strike price was less than the average market price of \$32.62 and \$28.41 for the three and nine months ended September 30, 2009.

**Note 4. Investment Securities**

The amortized cost and fair values of investment securities at September 30, 2010 and December 31, 2009 are as follows:



Table of Contents

(In Thousands)	September 30, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available for sale (AFS)</b>				
U.S. Government and agency securities	\$ 27,494	\$ 1,884	\$	\$ 29,378
State and political securities	169,900	4,022	(4,434)	169,488
Other debt securities	19,174	654	(12)	19,816
<b>Total debt securities</b>	<b>216,568</b>	<b>6,560</b>	<b>(4,446)</b>	<b>218,682</b>
Equity securities	12,373	1,245	(242)	13,376
<b>Total investment securities AFS</b>	<b>\$ 228,941</b>	<b>\$ 7,805</b>	<b>\$ (4,688)</b>	<b>\$ 232,058</b>
<b>Held to maturity (HTM)</b>				
U.S. Government and agency securities	\$ 5	\$	\$	\$ 5
Other debt securities	77	1		78
<b>Total investment securities HTM</b>	<b>\$ 82</b>	<b>\$ 1</b>	<b>\$</b>	<b>\$ 83</b>
<b>December 31, 2009</b>				
(In Thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available for sale (AFS)</b>				
U.S. Government and agency securities	\$ 37,038	\$ 2,098	\$	\$ 39,136
State and political securities	153,914	733	(9,770)	144,877
Other debt securities	12,271	834	(129)	12,976
<b>Total debt securities</b>	<b>203,223</b>	<b>3,665</b>	<b>(9,899)</b>	<b>196,989</b>
Equity securities	10,952	981	(154)	11,779
<b>Total investment securities AFS</b>	<b>\$ 214,175</b>	<b>\$ 4,646</b>	<b>\$ (10,053)</b>	<b>\$ 208,768</b>
<b>Held to maturity (HTM)</b>				
U.S. Government and agency securities	\$ 6	\$	\$	\$ 6
Other debt securities	101	1		102
<b>Total investment securities HTM</b>	<b>\$ 107</b>	<b>\$ 1</b>	<b>\$</b>	<b>\$ 108</b>

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, 2010 and December 31, 2009.

Table of Contents

(In Thousands)	Less than Twelve Months		September 30, 2010 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	6,202	35	37,594	4,399	43,796	4,434
Other debt securities	2,071	3	441	9	2,512	12
Total debt securities	8,273	38	38,035	4,408	46,308	4,446
Equity securities	1,320	213	251	29	1,571	242
Total	\$ 9,593	\$ 251	\$ 38,286	\$ 4,437	\$ 47,879	\$ 4,688

(In Thousands)	Less than Twelve Months		December 31, 2009 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	60,005	2,336	36,267	7,434	96,272	9,770
Other debt securities			1,191	129	1,191	129
Total debt securities	60,005	2,336	37,458	7,563	97,463	9,899
Equity securities	159	27	918	127	1,077	154
Total	\$ 60,164	\$ 2,363	\$ 38,376	\$ 7,690	\$ 98,540	\$ 10,053

At September 30, 2010 there were a total of 23 and 88 individual securities that were in a continuous unrealized loss position for less than twelve months and greater than twelve months, respectively.

The Company reviews its position quarterly and has determined that, at September 30, 2010, 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. There were 111 positions that were temporarily impaired at September 30, 2010. 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, 2010, 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.

Table of Contents

(In Thousands)	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 2,003	\$ 2,027	\$ 25	\$ 25
Due after one year to five years	18,942	19,574	52	53
Due after five years to ten years	3,634	3,493		
Due after ten years	191,989	193,588	5	5
Total	\$ 216,568	\$ 218,682	\$ 82	\$ 83

Total gross proceeds from sales of securities available for sale were \$3,446,000 and \$5,377,000, for the nine months ended September 30, 2010 and 2009, respectively. The following table represents gross realized gains and losses on those transactions:

(In Thousands)	Nine Months Ended September 30,	
	2010	2009
Gross realized gains:		
U.S. Government and agency securities	\$	\$
State and political securities		
Other debt securities	117	180
Equity securities	56	21
Total gross realized gains	\$ 173	\$ 201
Gross realized losses:		
U.S. Government and agency securities	\$	\$
State and political securities		
Other debt securities	11	165
Equity securities		4,998
Total gross realized losses	\$ 11	\$ 5,163

Gross realized losses for the equity securities portfolio include impairment charges of \$0 and \$4,614,000 for the nine months ended September 30, 2010 and 2009, respectively.

**Note 5. Federal Home Loan Bank Stock**

The Bank is a member of the Federal Home Loan Bank of Pittsburgh (the "FHLB"), which is one of 12 regional Federal Home Loan Banks. Each Federal Home Loan Bank serves as a reserve or central bank for its members within its assigned region. It is funded primarily from funds deposited by member institutions and proceeds from the sale of consolidated obligations of the Federal Home Loan Bank System. It makes loans to members (i.e., advances) in accordance with policies and procedures established by the board of directors of the Federal Home Loan Bank. As a member, the Bank is required to purchase and maintain stock in the FHLB in an amount equal to the greater of 1% of its aggregate unpaid residential mortgage loans, home purchase contracts or similar obligations at the beginning of each year or 5% of its outstanding advances from the FHLB. At September 30, 2010, the Bank held \$7,271,300 in stock of the FHLB, which was in compliance with this requirement.

The Company evaluated its holding of FHLB stock for impairment and deemed the stock to not be impaired due to the expected recoverability of the par value, which equals the value reflected



Table of Contents

within the Company's financial statements. The decision was based on several items ranging from the estimated true economic losses embedded within the FHLB's mortgage portfolio to the FHLB's liquidity position and credit rating. The Company utilizes the impairment framework outlined in GAAP to evaluate FHLB stock for impairment.

The following factors were evaluated to determine the ultimate recoverability of the par value of the Company's FHLB stock holding; (i) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted; (ii) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB; (iii) the impact of legislative and regulatory changes on the institutions and, accordingly, on the customer base of the FHLB; (iv) the liquidity position of the FHLB; and (v) whether a decline is temporary or whether it affects the ultimate recoverability of the FHLB stock based on (a) the materiality of the carrying amount to the member institution and (b) whether an assessment of the institution's operational needs for the foreseeable future allow management to dispose of the stock.

Based on its analysis of these factors, the Company determined that its holding of FHLB stock was not impaired on September 30, 2010.

**Note 6. Loans**

The allocation of the loan portfolio, by delinquency status, as of September 30, 2010 and December 31, 2009 is presented below:

Table of Contents

(In Thousands)	September 30, 2010					Total
	Current	Past Due 30 To 89 Days	Past Due 90 Days Or More & Still Accruing	Non- Accrual		
Commercial and agricultural	\$ 51,382	\$ 158	\$	\$ 4	\$	\$ 51,544
Real estate mortgage:						
Residential	171,631	1,153	344	520		173,648
Commercial	150,911	2,117	970	1,950		155,948
Construction	19,781			3,117		22,898
Installment loans to individuals	9,654	187	3	10		9,854
	403,359	\$ 3,615	\$ 1,317	\$ 5,601		413,892
Less: Net deferred loan fees	1,019					1,019
Allowance for loan losses	5,479					5,479
Loans, net	\$ 396,861					\$ 407,394

(In Thousands)	December 31, 2009					Total
	Current	Past Due 30 To 90 Days	Past Due 90 Days Or More & Still Accruing	Non- Accrual		
Commercial and agricultural	\$ 45,930	\$ 457	\$ 182	\$ 78	\$	\$ 46,647
Real estate mortgage:						
Residential	165,313	7,333	951	749		174,346
Commercial	147,455	2,860	1,429	465		152,209
Construction	18,247	2,992		556		21,795
Installment loans to individuals	11,192	311	3	43		11,549
	388,137	\$ 13,953	\$ 2,565	\$ 1,891		406,546
Less: Net deferred loan fees	1,017					1,017
Allowance for loan losses	4,657					4,657
Loans, net	\$ 382,463					\$ 400,872

The recorded investment in loans for which impairment has been recognized amounted to \$8,259,000 at September 30, 2010, compared to \$8,312,000 at December 31, 2009. The valuation allowance related to impaired loans amounted to \$1,053,000 at September 30, 2010 and \$802,000 at December 31, 2009. The increase in the valuation allowance is primarily from a few commercial relationships.

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

**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, 2009.



Table of Contents

The following sets forth the components of the net periodic benefit cost of the domestic non-contributory defined benefit plan for the nine months ended September 30, 2010 and 2009, respectively:

(In Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Service cost	\$ 132	\$ 136	\$ 395	\$ 408
Interest cost	170	170	512	510
Expected return on plan assets	(160)	(127)	(481)	(381)
Amortization of transition obligation	(1)	(1)	(3)	(2)
Amortization of prior service cost	6	6	19	19
Amortization of net loss	36	85	109	254
Net periodic cost	\$ 183	\$ 269	\$ 551	\$ 808

The following table sets forth by level, within the fair value hierarchy detailed in Note 10 (Fair Value Measurements), the Plan's assets at fair value as of September 30, 2010:

(In Thousands)	September 30, 2010			
	Level I	Level II	Level III	Total
Assets:				
Cash and cash equivalents	\$ 260	\$	\$	\$ 260
Mutual funds - taxable fixed income	3,118			3,118
Mutual funds - domestic equity	3,815			3,815
Mutual funds - international equity	1,333			1,333
Total assets at fair value	\$ 8,526	\$	\$	\$ 8,526

**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, 2009, that it expected to contribute a minimum of \$400,000 to its defined benefit plan in 2010. As of September 30, 2010, there were contributions of \$344,000 made to the 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 up to the lesser of 15% of base compensation or \$12,000 in market value annually. During the nine months ended September 30, 2010 and 2009, there were 1,729 and 1,991 shares issued under the plan, respectively.





Table of Contents**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, 2010 and December 31, 2009:

(In Thousands)	September 30, 2010	December 31, 2009
Commitments to extend credit	\$ 83,424	\$ 80,061
Standby letters of credit	1,281	1,334

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**

The following disclosures show the hierarchical 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

Table of Contents

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, 2010 and December 31, 2009, 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, 2010			Total
	Level I	Level II	Level III	
Assets measured on a recurring basis:				
Investment securities, available for sale:				
U.S. Government and agency securities	\$	\$ 29,378	\$	\$ 29,378
State and political securities		169,488		169,488
Other debt securities		19,816		19,816
Equity securities		13,376		13,376
Total assets measured on a recurring basis	\$	13,376	\$ 218,682	\$ 232,058

(In Thousands)	December 31, 2009			Total
	Level I	Level II	Level III	
Assets measured on a recurring basis:				
Investment securities, available for sale:				
U.S. Government and agency securities	\$	\$ 39,136	\$	\$ 39,136
State and political securities		144,877		144,877
Other debt securities		12,976		12,976
Equity securities		11,779		11,779
Total assets measured on a recurring basis	\$	11,779	\$ 196,989	\$ 208,768

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, 2010 and December 31, 2009, 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.

Table of Contents

(In Thousands)	September 30, 2010			Total
	Level I	Level II	Level III	
Assets measured on a non-recurring basis:				
Impaired Loans	\$	\$ 7,206	\$	\$ 7,206
Other real estate owned		679		679
Total assets measured on a non-recurring basis	\$	\$ 7,885	\$	\$ 7,885

(In Thousands)	December 31, 2009			Total
	Level I	Level II	Level III	
Assets measured on a non-recurring basis:				
Impaired Loans	\$	\$ 7,510	\$	\$ 7,510
Other real estate owned		672		672
Total assets measured on a non-recurring basis	\$	\$ 8,182	\$	\$ 8,182

**Note 11. Estimated Fair Value of Financial Instruments**

The Company is required to disclose estimated fair values for its financial instruments. Fair value estimates 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 estimates 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 estimates.

Estimated 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 value estimates, 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 estimated fair value of financial instruments would not represent the full market value of the Company.

The estimated fair values of the Company's financial instruments are as follows at September 30, 2010 and December 31, 2009:

Table of Contents

(In Thousands)	September 30, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Financial assets:</b>				
Cash and cash equivalents	\$ 23,057	\$ 23,057	\$ 13,788	\$ 13,788
<b>Investment securities:</b>				
Available for sale	232,058	232,058	208,768	208,768
Held to maturity	82	83	107	108
Loans held for sale	5,360	5,360	4,063	4,063
Loans, net	407,394	408,167	400,872	403,279
Bank-owned life insurance	15,345	15,345	14,942	14,942
Accrued interest receivable	3,657	3,657	3,523	3,523
<b>Financial liabilities:</b>				
Interest-bearing deposits	\$ 442,042	\$ 444,587	\$ 417,388	\$ 408,056
Noninterest-bearing deposits	92,128	92,128	79,899	79,899
Short-term borrowings	14,629	14,629	18,354	18,354
Long-term borrowings, FHLB	81,778	88,289	86,778	89,082
Accrued interest payable	832	832	1,073	1,073

**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, 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.

Table of Contents

**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.

**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.

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



## Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

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; and (v) the effect of changes in the business cycle and downturns in the local, regional or national economies.

Table of Contents

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.

Table of Contents

**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, 2010 and 2009**

**Summary Results**

Net income for the three months ended September 30, 2010 was \$2,848,000 compared to \$1,922,000 for the same period of 2009 as after-tax securities losses decreased \$407,000 (from a loss of \$335,000 to a gain of \$72,000). Basic and diluted earnings per share for the three months ended September 30, 2010 were \$0.74 compared to \$0.50 for the three months ended September 30, 2009. Return on average assets and return on average equity were 1.60% and 15.51% for the three months ended September 30, 2010 compared to 1.15% and 12.08% for the corresponding period of 2009. Net income from core operations ( operating earnings ) increased to \$2,776,000 for the three months ended September 30, 2010 compared to \$2,257,000 for the same period of 2009. Operating earnings per share for the three months ended September 30, 2010 were \$0.72 basic and dilutive compared to \$0.59 basic and dilutive for the three months ended September 30, 2009.

The nine months ended September 30, 2010 generated net income of \$8,068,000 compared to \$3,593,000 for the same period of 2009. Comparable results were impacted by a decrease in after-tax securities losses of \$3,382,000 (from a loss of \$3,275,000 to a gain of \$107,000). Earnings per share, basic and diluted, for the nine months ended September 30, 2010 were \$2.10 compared to \$0.94 for the comparable period of 2009. Return on average assets and return on average equity were 1.54% and 15.21% for the nine months ended September 30, 2010 compared to 0.73% and 7.80% for the corresponding period of 2009. Operating earnings increased 15.9% to \$7,961,000 for the nine months ended September 30, 2010 compared to \$6,868,000 for the comparable period of 2009, resulting in basic and dilutive operating earnings per share increasing 16.2% to \$2.08 from \$1.79 for the nine months ended September 30, 2010 and 2009, 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. 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.

Table of Contents**Reconciliation of GAAP and non-GAAP Income**

(Dollars in Thousands, Except Per Share Data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
GAAP net income	\$ 2,848	\$ 1,922	\$ 8,068	\$ 3,593
Less: securities gains (losses), net of tax	72	(335)	107	(3,275)
Non-GAAP operating earnings	\$ 2,776	\$ 2,257	\$ 7,961	\$ 6,868

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Return on average assets (ROA)	1.60%	1.15%	1.54%	0.73%
Less: securities gains (losses), net of tax	0.04%	-0.20%	0.02%	-0.66%
Non-GAAP operating ROA	1.56%	1.35%	1.52%	1.39%

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Return on average equity (ROE)	15.51%	12.08%	15.21%	7.80%
Less: securities gains (losses), net of tax	0.39%	-2.11%	0.21%	-7.11%
Non-GAAP operating ROE	15.12%	14.19%	15.00%	14.91%

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Basic earnings per share (EPS)	\$ 0.74	\$ 0.50	\$ 2.10	\$ 0.94
Less: securities gains (losses), net of tax	0.02	(0.09)	0.02	(0.85)
Non-GAAP basic operating EPS	\$ 0.72	\$ 0.59	\$ 2.08	\$ 1.79

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Dilutive EPS	\$ 0.74	\$ 0.50	\$ 2.10	\$ 0.94
Less: securities gains (losses), net of tax	0.02	(0.09)	0.02	(0.85)
Non-GAAP dilutive operating EPS	\$ 0.72	\$ 0.59	\$ 2.08	\$ 1.79

**Interest and Dividend Income**

Interest and dividend income for the three months ended September 30, 2010 increased \$69,000 to \$9,182,000 compared to \$9,113,000 for the same period of 2009. The increase in interest income was led by an increase in investment portfolio interest resulting from growth in the average investment portfolio of \$19,374,000. The growth offset a decline in the average taxable equivalent yield of 36 basis points ( bp ). The decrease in loan portfolio income was the result of portfolio growth that was more than offset by a yield that decreased by 27 bp. The decline in yield earned on both loans and investments is the result of the low interest rate environment that has existed over the past year.

During the nine months ended September 30, 2010, interest and dividend income increased \$252,000 over the same period in 2009. Interest income on the loan portfolio increased as the



Table of Contents

growth in the portfolio countered a 27 bp decline in average yield. The investment portfolio interest income increased as portfolio growth offset a decline in yield and a reduction in dividends received. The reduced level of dividend income is the result of a decreased level of equity investment and general decline in dividends paid by the holdings in our portfolio.

Interest and dividend income composition for the three and nine months ended September 30, 2010 and 2009 was as follows:

(In Thousands)	September 30, 2010		For The Three Months Ended September 30, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Loans including fees	\$ 6,434	70.1%	\$ 6,457	70.9%	\$ (23)	(0.4)%
Investment securities:						
Taxable	1,428	15.5	1,368	15.0	60	4.4
Tax-exempt	1,266	13.8	1,253	13.7	13	1.0
Dividend and other interest income	54	0.6	35	0.4	19	54.3
Total interest and dividend income	\$ 9,182	100.0%	\$ 9,113	100.0%	\$ 69	0.8%

(In Thousands)	September 30, 2010		For The Nine Months Ended September 30, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Loans including fees	\$ 19,162	70.2%	\$ 19,025	70.4%	\$ 137	0.7%
Investment securities:						
Taxable	4,182	15.3	4,105	15.2	77	1.9
Tax-exempt	3,794	13.9	3,748	13.9	46	1.2
Dividend and other interest income	157	0.6	165	0.5	(8)	(4.8)
Total interest and dividend income	\$ 27,295	100.0%	\$ 27,043	100.0%	\$ 252	0.9%

**Interest Expense**

Interest expense for the three months ended September 30, 2010 decreased \$744,000 to \$2,424,000 compared to \$3,168,000 for the same period of 2009. The substantial decrease associated with deposits is primarily the result of a reduction of 86 bp in rate paid on time deposits and a shift from higher cost time deposits to core deposits. Factors that led to the rate decreases include, but are not limited to, Federal Open Market Committee ( FOMC ) interest rate actions and campaigns conducted by the Company during the past two years to attract short-term CDs resulting in an increased repricing frequency. In addition, the Marcellus Shale natural gas exploration in north central Pennsylvania is creating opportunities to create new and build upon existing deposit relationships. Short-term borrowings interest expense decreased as the impact of a declining average rate paid compensated for a slight increase in the average balance. Long-term borrowing interest expense decreased modestly due to the maturity of \$5,000,000 that carried an interest rate of 6.65%.

Interest expense for the nine months ended September 30, 2010 decreased 19.1% from the same period of 2009. The reasons noted for the decline in interest expense for the three month period comparison also apply to the nine month period.

Table of Contents

Interest expense composition for the three and nine months ended September 30, 2010 and 2009 was as follows:

(In Thousands)	September 30, 2010		For The Three Months Ended September 30, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Deposits	\$ 1,458	60.1%	\$ 2,148	67.8%	\$ (690)	(32.1)%
Short-term borrowings	77	3.2	82	2.6	(5)	(6.1)
Long-term borrowings, FHLB	889	36.7	938	29.6	(49)	(5.2)
Total interest expense	\$ 2,424	100.0%	\$ 3,168	100.0%	\$ (744)	(23.5)%

(In Thousands)	September 30, 2010		For The Nine Months Ended September 30, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Deposits	\$ 4,719	61.7%	\$ 6,357	67.2%	\$ (1,638)	(25.8)%
Short-term borrowings	197	2.6	318	3.4	(121)	(38.1)
Long-term borrowings, FHLB	2,733	35.7	2,781	29.4	(48)	(1.7)
Total interest expense	\$ 7,649	100.0%	\$ 9,456	100.0%	\$ (1,807)	(19.1)%

**Net Interest Margin**

The net interest margin ( NIM ) for the three months ended September 30, 2010 was 4.56% compared to 4.35% for the corresponding period of 2009. The increase in the NIM was driven by a 65 bp decline in the rate paid on interest bearing liabilities that more than compensated for a 37 bp decline in the yield on interest earning assets. The decrease in earning asset yield is due to the impact on the loan and investment portfolios of the current low rate environment. The decrease in the cost of interest bearing liabilities to 1.76% from 2.41% was driven by a reduction in the rate paid on time deposits of 86 bp. The reduction in the rate paid on time deposits was the result of a shortening of the time deposit portfolio that has resulted in an increasing repricing frequency during this period of low rates. The duration of the time deposit portfolio has been lengthening due to the apparent bottoming or near bottoming of deposit rates. The average rate on long-term borrowings declined due to the maturity of \$5,000,000 in FHLB borrowings that carried a rate of 6.65%.

The NIM for the nine months ended September 30, 2010 was 4.54% compared to 4.39% for the same period of 2009. The impact of the items mentioned in the three month discussion also applies to the nine month period. An 80 bp decline in the rate paid on time deposits served as the foundation for a 71 bp decline in rate paid on deposits, while the FOMC and general market actions affected the yield on earning assets and cost of short-term borrowings.

The following is a schedule of average balances and associated yields for the three and nine months ended September 30, 2010 and 2009:

Table of Contents

(In Thousands)	AVERAGE BALANCES AND INTEREST RATES					
	Three Months Ended September 30, 2010			Three Months Ended September 30, 2009		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
<b>Assets:</b>						
Tax-exempt loans	\$ 18,595	\$ 309	6.59%	\$ 17,207	\$ 279	6.43%
All other loans	397,672	6,230	6.22%	382,670	6,273	6.50%
Total loans	416,267	6,539	6.23%	399,877	6,552	6.50%
Taxable securities	118,344	1,480	5.00%	104,905	1,402	5.35%
Tax-exempt securities	110,654	1,918	6.93%	104,719	1,898	7.25%
Total securities	228,998	3,398	5.94%	209,624	3,300	6.30%
Interest-bearing deposits	11,958	2	0.07%	4,218	1	0.09%
Total interest-earning assets	657,223	9,939	6.02%	613,719	9,853	6.39%
Other assets	52,793			54,284		
Total assets	\$ 710,016			\$ 668,003		
<b>Liabilities and shareholders equity:</b>						
Savings	\$ 66,464	46	0.27%	\$ 62,265	85	0.54%
Super Now deposits	66,188	95	0.57%	60,476	127	0.83%
Money market deposits	106,111	299	1.12%	71,204	345	1.92%
Time deposits	204,801	1,018	1.97%	222,816	1,591	2.83%
Total interest-bearing deposits	443,564	1,458	1.30%	416,761	2,148	2.04%
Short-term borrowings	16,356	77	1.87%	15,457	82	2.13%
Long-term borrowings, FHLB	83,952	889	4.14%	86,778	938	4.23%
Total borrowings	100,308	966	3.77%	102,235	1,020	3.91%
Total interest-bearing liabilities	543,872	2,424	1.76%	518,996	3,168	2.41%
Demand deposits	84,263			75,114		
Other liabilities	8,447			10,256		
Shareholders equity	73,434			63,637		
Total liabilities and shareholders equity	\$ 710,016			\$ 668,003		
Interest rate spread			4.26%			3.97%
Net interest income/margin		\$ 7,515	4.56%		\$ 6,685	4.35%

- 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.





Table of Contents

(In Thousands)	AVERAGE BALANCES AND INTEREST RATES					
	Nine Months Ended September 30, 2010			Nine Months Ended September 30, 2009		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
<b>Assets:</b>						
Tax-exempt loans	\$ 18,148	\$ 914	6.73%	\$ 16,682	\$ 817	6.55%
All other loans	397,303	18,559	6.25%	378,043	18,486	6.54%
Total loans	415,451	19,473	6.27%	394,725	19,303	6.54%
Taxable securities	112,552	4,334	5.13%	102,937	4,269	5.53%
Tax-exempt securities	108,573	5,748	7.06%	103,418	5,679	7.32%
Total securities	221,125	10,082	6.08%	206,355	9,948	6.43%
Interest bearing deposits	9,504	5	0.07%	1,886	1	0.07%
Total interest-earning assets	646,080	29,560	6.11%	602,966	29,252	6.48%
Other assets	54,221			55,080		
Total assets	\$ 700,301			\$ 658,046		
<b>Liabilities and shareholders equity:</b>						
Savings	\$ 64,759	144	0.30%	\$ 61,106	244	0.53%
Super Now deposits	64,733	296	0.61%	57,028	387	0.91%
Money market deposits	98,289	878	1.19%	59,061	924	2.09%
Time deposits	211,397	3,401	2.15%	217,679	4,802	2.95%
Total interest-bearing deposits	439,178	4,719	1.44%	394,874	6,357	2.15%
Short-term borrowings	14,474	197	1.82%	31,491	318	1.39%
Long-term borrowings, FHLB	85,826	2,733	4.20%	86,778	2,781	4.23%
Total borrowings	100,300	2,930	3.86%	118,269	3,099	3.47%
Total interest-bearing liabilities	539,478	7,649	1.89%	513,143	9,456	2.46%
Demand deposits	81,833			73,469		
Other liabilities	8,243			10,018		
Shareholders equity	70,747			61,416		
Total liabilities and shareholders equity	\$ 700,301			\$ 658,046		
Interest rate spread			4.22%			4.02%
Net interest income/margin		\$ 21,911	4.54%		\$ 19,796	4.39%

Table of Contents

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, 2010 and 2009.

(In Thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
Total interest income	\$ 9,182	\$ 9,113	\$ 27,295	\$ 27,043
Total interest expense	2,424	3,168	7,649	9,456
Net interest income	6,758	5,945	19,646	17,587
Tax equivalent adjustment	757	740	2,265	2,209
Net interest income (fully taxable equivalent)	\$ 7,515	\$ 6,685	\$ 21,911	\$ 19,796

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, 2010 and 2009:

(In Thousands)	Three Months Ended September 30, 2010 vs 2009 Increase (Decrease)			Nine Months Ended September 30, 2010 vs 2009 Increase (Decrease)		
	Volume	Due to Rate	Net	Volume	Due to Rate	Net
<b>Interest income:</b>						
Loans, tax-exempt	\$ 23	\$ 7	\$ 30	\$ 76	\$ 21	\$ 97
Loans	1,000	(1,043)	(43)	917	(844)	73
Taxable investment securities	532	(454)	78	221	(156)	65
Tax-exempt investment securities	385	(365)	20	277	(208)	69
Interest bearing deposits	1		1	4		4
Total interest-earning assets	1,941	(1,855)	86	1,495	(1,187)	308
<b>Interest expense:</b>						
Savings deposits	36	(75)	(39)	14	(114)	(100)
Super Now deposits	66	(98)	(32)	47	(138)	(91)
Money market deposits	593	(639)	(46)	454	(500)	(46)
Time deposits	(120)	(453)	(573)	(134)	(1,267)	(1,401)
Short-term borrowings	24	(29)	(5)	(148)	27	(121)
Long-term borrowings, FHLB	(30)	(19)	(49)	(29)	(19)	(48)
Total interest-bearing liabilities	569	(1,313)	(744)	204	(2,011)	(1,807)
Change in net interest income	\$ 1,372	\$ (542)	\$ 830	\$ 1,291	\$ 824	\$ 2,115

**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



Table of Contents

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, 2010, 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.

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

The allowance for loan losses increased from \$4,657,000 at December 31, 2009 to \$5,479,000 at September 30, 2010. At September 30, 2010 and December 31, 2009, the allowance for loan losses to total loans was 1.33% and 1.15%, respectively.

The provision for loan losses totaled \$700,000 and \$1,400,000 for the three and nine months ended September 30, 2010, compared to \$270,000 and \$582,000 for the same periods in 2009. The amount of the increase in the provision was the result of several factors, including but not limited to, an increase in gross loans of \$12,048,000 since September 30, 2009, a ratio of annualized net charge-offs to average loans of 0.19% for the nine months ended September 30, 2010, a ratio of nonperforming loans to total loans of 1.68% at September 30, 2010, and a ratio of the allowance for loan losses to nonperforming loans of 79.20% at September 30, 2010. Nonperforming loans increased to \$6,918,000 at September 30, 2010 from \$4,456,000 at December 31, 2009 due to an increase in commercial loan delinquencies. Internal loan review and analysis and the continued uncertainty surrounding the economy, coupled with the ratios noted previously, dictated an increase in the provision for loan losses. The increase did not equate to the change in charge-offs and 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.

Following is a table showing the changes in the allowance for loan losses for the nine months ended September 30, 2010 and 2009:

Table of Contents

(In Thousands)	For the Nine Months Ended	
	September 30, 2010	September 30, 2009
Balance at beginning of period	\$ 4,657	\$ 4,356
Charge-offs:		
Real estate	321	272
Commercial and industrial	261	129
Installment loans to individuals	107	142
Total charge-offs	689	543
Recoveries:		
Real estate	20	11
Commercial and industrial	16	2
Installment loans to individuals	75	70
Total recoveries	111	83
Net charge-offs	578	460
Additions charged to operations	1,400	582
Balance at end of period	\$ 5,479	\$ 4,478
Ratio of net annualized charge-offs during the period to average loans outstanding during the period	0.19%	0.16%

Following is a table showing the changes in total nonperforming loans as of:

(In Thousands)	Total Nonperforming Loans		
	Nonaccrual	90 Days Past Due	Total
September 30, 2010	\$ 5,601	\$ 1,317	\$ 6,918
June 30, 2010	6,299	347	6,646
March 31, 2010	3,703	160	3,863
December 31, 2009	1,891	2,565	4,456
September 30, 2009	1,448	4,396	5,844

Loans not included above which are troubled debt restructurings, totaled \$934,000, \$426,000, and \$353,000 at September 30, 2010, December 31, 2009, and September 30, 2009, respectively.

**Non-interest Income**

Total non-interest income for the three months ended September 30, 2010 compared to the same period in 2009 increased \$489,000 to \$1,870,000 due to a \$616,000 decrease in net securities losses to a gain of \$109,000. Excluding net securities gains and losses, non-interest income for the third quarter of 2010 would have decreased \$127,000 compared to the 2009 period. The decrease is primarily the result of a reduced level of gain on sale of loans related to a slowdown in the real estate market coupled with federal tax incentives offered to homebuyers that were in place during the first half of 2010 that are believed to have pulled loan generations into the first half of 2010. Other income increased as debit and credit card related income continues to become more prominent

Insurance commissions for the three months ended September 30, 2010 decreased due to continued soft market and shift in product mix. Management of The M Group continues to



Table of Contents

pursue new and build upon current relationships. The sales call program continues to expand to other financial institutions, 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, 2010 compared to the same period in 2009 increased \$5,361,000. Excluding net securities gains, non-interest income would have increased \$237,000 compared to the 2009 period. Gain on sale of loans was positively impacted by the federal tax incentives being offered to home buyers. The incentives increased volume during the first six months of 2010; however, the volume has slowed during the third quarter. Insurance commissions and other income have been impacted for the nine months as noted in the three month discussion.

Non-interest income composition for the three and nine months ended September 30, 2010 and 2009 was as follows:

(In Thousands)	September 30, 2010		For the Three Months Ended September 30, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Deposit service charges	\$ 562	30.1%	\$ 553	40.0%	\$ 9	1.6%
Securities gains (losses), net	109	5.8	(507)	(36.7)	616	121.5
Bank owned life insurance	143	7.6	144	10.4	(1)	(0.7)
Gain on sale of loans	202	10.8	305	22.1	(103)	(33.8)
Insurance commissions	230	12.3	287	20.8	(57)	(19.9)
Other	624	33.4	599	43.4	25	4.2
Total non-interest income	\$ 1,870	100.0%	\$ 1,381	100.0%	\$ 489	35.4%

(In Thousands)	September 30, 2010		For the Nine Months Ended September 30, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Deposit service charges	\$ 1,609	28.9%	\$ 1,619	760.1%	\$ (10)	(0.6)%
Securities gains (losses), net	162	2.9	(4,962)	(2,329.5)	5,124	103.3
Bank owned life insurance	442	7.9	418	196.2	24	5.7
Gain on sale of loans	714	12.8	526	246.9	188	35.7
Insurance commissions	767	13.8	988	463.8	(221)	(22.4)
Other	1,880	33.7	1,624	762.5	256	15.8
Total non-interest income	\$ 5,574	100.0%	\$ 213	100.0%	\$ 5,361	2,516.9%

**Non-interest Expense**

Total non-interest expense decreased \$393,000 for the three months ended September 30, 2010 compared to the same period of 2009. The decrease in salaries and employee benefits was attributable primarily to a reduction in expense associated with the defined benefit pension plan as the plans investment portfolio performance has increased. Other expenses decreased due to various items ranging from advertising to telephone as contracts were renewed at lower levels due to increased vendor competition.



Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

Total non-interest expense increased \$53,000 for the nine months ended September 30, 2010 compared to the same period of 2009. The increase in non-interest expense for the nine month

Table of Contents

period is primarily the result of increased retirement benefit accruals and amortization related to a low income elderly housing limited partnership that began during the three months ended September 30, 2010. Other expenses decreased due to the same items noted in the three month discussion.

Non-interest expense composition for the nine months ended September 30, 2010 and 2009 was as follows:

(In Thousands)	September 30, 2010		For the Three Months Ended September 30, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Salaries and employee benefits	\$ 2,427	51.6%	\$ 2,588	50.8%	\$ (161)	(6.2)%
Occupancy, net	303	6.4	299	5.9	4	1.3
Furniture and equipment	296	6.3	293	5.7	3	1.0
Pennsylvania shares tax	170	3.6	171	3.4	(1)	(0.6)
Amortization of investment in limited partnerships	200	4.3	142	2.8	58	40.9
Other	1,308	27.8	1,604	31.4	(296)	(18.5)
Total non-interest expense	\$ 4,704	100.0%	\$ 5,097	100.0%	\$ (393)	(7.7)%

(In Thousands)	September 30, 2010		For the Nine Months Ended September 30, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Salaries and employee benefits	\$ 7,779	53.0%	\$ 7,665	52.4%	\$ 114	1.5%
Occupancy, net	947	6.4	956	6.5	(9)	(0.9)
Furniture and equipment	922	6.3	906	6.2	16	1.8
Pennsylvania shares tax	508	3.5	514	3.5	(6)	(1.2)
Amortization of investment in limited partnerships	483	3.3	425	2.9	58	13.6
Other	4,041	27.5	4,161	28.5	(120)	(2.9)
Total non-interest expense	\$ 14,680	100.0%	\$ 14,627	100.0%	\$ 53	0.4%

**Provision for Income Taxes**

Income taxes increased \$339,000 and \$2,074,000 for the three and nine months ended September 30, 2010 compared to the same period of 2009. The primary cause of the changes in tax expense is the impact of net securities losses in the three and nine month periods of 2009 compared to net securities gains for the same periods of 2010. Excluding the impact of the net securities gains and losses, the effective tax rate for the three and nine months ended September 30, 2010 was 10.88% and 11.33% compared to 8.48% and 9.07% for the same period of 2009. The Company currently is in a deferred tax asset position due to the low income housing tax credits earned both currently and previously. Management has reviewed the deferred tax asset and has determined that the asset will be utilized within the appropriate carry forward period and therefore does not require a valuation allowance.

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

Cash and cash equivalents increased \$9,269,000 from \$13,788,000 at December 31, 2009 to \$23,057,000 at September 30, 2010 primarily as a result of the following activities during the nine months ended September 30, 2010:

**Loans Held for Sale**

Activity regarding loans held for sale resulted in loan originations exceeding sale proceeds, less \$714,000 in realized gains, by \$1,297,000 for the nine months ended September 30, 2010.

**Loans**

Gross loans increased \$7,344,000 since December 31, 2009 due primarily to an increase of non-real estate and commercial real estate loans, which was partially offset by a decrease in residential and installment loans.

The allocation of the loan portfolio, by category, as of September 30, 2010 and December 31, 2009 is presented below:

(In Thousands)	September 30, 2010		December 31, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Commercial, financial and agricultural	\$ 51,544	12.5%	\$ 46,647	11.5%	\$ 4,897	10.5%
Real estate mortgage:						
Residential	173,648	42.0	174,346	43.1	(698)	(0.4)
Commercial	155,948	37.8	152,209	37.5	3,739	2.5
Construction	22,898	5.5	21,795	5.4	1,103	5.1
Installment loans to individuals	9,854	2.4	11,549	2.8	(1,695)	(14.7)
Less: Net deferred loan fees	1,019	(0.2)	1,017	(0.3)	2	0.2
Gross loans	\$ 412,873	100.0%	\$ 405,529	100.0%	\$ 7,344	1.8%

**Investments**

## Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

The fair value of the investment securities portfolio at September 30, 2010 has increased \$23,265,000 since December 31, 2009. The change is primarily due to purchases of state and political securities and short-term corporate securities coupled with the level of net unrealized gains/losses increasing \$8,524,000 to a gain of \$3,118,000 for the entire portfolio. 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 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.

Table of Contents

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. Those 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 deemed to be 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 equity market improvement over the first nine months of 2010 has led to an increase in net unrealized gains of \$176,000 to \$1,003,000 at September 30, 2010. In addition, the amortized cost of the equity securities portfolio has increased \$1,421,000 as the Company has begun to build the portfolio balance, while continuing to diversify geographic risk.

The equity portion of the portfolio, which is invested entirely in financial institutions, 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 for twelve consecutive months and 50% decline for three consecutive months in market value from carrying value.

The distribution of credit ratings by amortized cost and fair values for the debt security portfolio at September 30, 2010 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
<b>Available for sale (AFS)</b>										
U.S. Government and agency securities	\$ 27,494	\$ 29,378	\$	\$	\$	\$	\$	\$	\$ 27,494	\$ 29,378
State and political securities	157,815	157,948	5,850	5,475			6,235	6,065	169,900	169,488
Other debt securities	18,253	18,884	800	812			121	120	19,174	19,816
Total debt securities AFS	\$ 203,562	\$ 206,210	\$ 6,650	\$ 6,287	\$	\$	\$ 6,356	\$ 6,185	\$ 216,568	\$ 218,682
<b>Held to maturity (HTM)</b>										
U.S. Government and agency securities	\$ 5	\$ 5	\$	\$	\$	\$	\$	\$	\$ 5	\$ 5
Other debt securities	77	78							77	78
Total debt securities HTM	\$ 82	\$ 83	\$	\$	\$	\$	\$	\$	\$ 82	\$ 83

Table of Contents**Financing Activities****Deposits**

Total deposits increased 7.4% or \$36,883,000 from December 31, 2009 to September 30, 2010. The growth was led by a substantial increase in money market deposits of 40.9% from December 31, 2009 to September 30, 2010. The increase in core deposits (deposits less time deposits) has provided relationship driven funding for the loan and investment portfolios, while also reducing the utilization of FHLB borrowings. The increase in deposits is the result of a deposit gathering program coupled with customers returning to their hometown bank in the wake of the economic turbulence. Electronic delivery channels, such as remote deposit capture and mobile banking, are being emphasized as efforts to capitalize on the economic development being provided by the Marcellus Shale natural gas exploration.

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

(In Thousands)	September 30, 2010		December 31, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Demand deposits	\$ 92,128	17.3%	\$ 79,899	16.1%	\$ 12,229	15.3%
NOW accounts	66,957	12.5	64,361	12.9	2,596	4.0
Money market deposits	105,147	19.7	74,634	15.0	30,513	40.9
Savings deposits	66,763	12.5	60,827	12.2	5,936	9.8
Time deposits	203,175	38.0	217,566	43.8	(14,391)	(6.6)
Total deposits	\$ 534,170	100.0%	\$ 497,287	100.0%	\$ 36,883	7.4%

**Borrowed Funds**

Total borrowed funds decreased 8.3% or \$8,725,000 to \$96,407,000 at September 30, 2010 compared to \$105,132,000 at December 31, 2009. The decrease in borrowed funds is primarily the result of growth in deposits as part of the previously discussed deposit gathering campaigns that were utilized to provide loan portfolio funding and to reduce the level of total borrowings. FHLB repurchase agreements were utilized as their structure allowed for a reduction in interest expense, while providing the ability to reduce the borrowings at our discretion as deposit levels increased.

(In Thousands)	September 30, 2010		December 31, 2009		Change	
	Amount	% Total	Amount	% Total	Amount	%
Short-term borrowings:						
FHLB repurchase agreements	\$		\$ 5,155	4.9%	\$ (5,155)	(100.0)%
Securities sold under agreement to repurchase	14,629	15.2	13,199	12.6	1,430	10.8
Total short-term borrowings	14,629	15.2	18,354	17.5	(3,725)	(20.3)
Long-term borrowings, FHLB	81,778	84.8	86,778	82.5	(5,000)	(5.8)
Total borrowed funds	\$ 96,407	100.0%	\$ 105,132	100.0%	\$ (8,725)	(8.3)%



Table of Contents**Capital**

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

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

Capital ratios as of September 30, 2010 and December 31, 2009 were as follows:

(In Thousands)	September 30, 2010		December 31, 2009	
	Amount	Ratio	Amount	Ratio
<b><u>Total Capital (to Risk-weighted Assets)</u></b>				
Actual	\$ 70,973	15.5%	\$ 67,738	15.4%
For Capital Adequacy Purposes	36,637	8.0	35,094	8.0
To Be Well Capitalized	45,796	10.0	43,867	10.0
<b><u>Tier I Capital (to Risk-weighted Assets)</u></b>				
Actual	\$ 65,043	14.2%	\$ 62,709	14.3%
For Capital Adequacy Purposes	18,318	4.0	17,547	4.0
To Be Well Capitalized	27,478	6.0	26,320	6.0
<b><u>Tier I Capital (to Average Assets)</u></b>				
Actual	\$ 65,043	9.3%	\$ 62,709	9.3%
For Capital Adequacy Purposes	27,986	4.0	26,914	4.0
To Be Well Capitalized	34,983	5.0	33,642	5.0

**Liquidity; Interest Rate Sensitivity and Market Risk**

The asset/liability committee addresses the liquidity needs of the Company to ensure that sufficient funds are available to meet credit demands and deposit withdrawals as well as to the





Table of Contents

placement of available funds in the investment portfolio. In assessing liquidity requirements, equal consideration is given to the current position as well as the future outlook.

The following liquidity measures are monitored for compliance and were within the limits cited at September 30, 2010:

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

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

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

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

Management monitors and determines the desirable level of liquidity. Consideration is given to loan demand, investment opportunities, deposit pricing and growth potential, as well as the current cost of borrowing funds. The Company has a current borrowing capacity at the FHLB of \$217,313,000. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of \$13,593,000. Management believes it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. FHLB borrowings totaled \$81,778,000 as of September 30, 2010.

Interest rate sensitivity, which is closely related to liquidity management, is a function of the repricing characteristics of the Company's portfolio of assets and liabilities. Asset/liability management strives to match maturities and rates between loan and investment security assets



Table of Contents

with the deposit liabilities and borrowings that fund them. Successful asset/liability management results in a balance sheet structure which can cope effectively with market rate fluctuations. The matching process is affected by segmenting both assets and liabilities into future time periods (usually 12 months, or less) based upon when repricing can be effected. Repriceable assets are subtracted from repriceable liabilities, for a specific time period to determine the gap, or difference. Once known, the gap is managed based on predictions about future market interest rates. Intentional mismatching, or gapping, can enhance net interest income if market rates move as predicted. However, if market rates behave in a manner contrary to predictions, net interest income will suffer. Gaps, therefore, contain an element of risk and must be prudently managed. In addition to gap management, the Company has an asset/liability management policy which incorporates a market value at risk calculation which is used to determine the effects of interest rate movements on shareholders' equity and a simulation analysis to monitor the effects of interest rate changes on the Company's balance sheet.

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

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

**Interest Rate Sensitivity**

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

The following is a rate shock forecast for the twelve month period ended September 30, 2011 assuming a static balance sheet as of September 30, 2010.

(In Thousands)	Parallel Rate Shock in Basis Points				
	-200	-100	Static	+100	+200
Net interest income	\$ 25,411	\$ 26,315	\$ 26,420	\$ 25,948	\$ 25,340
Change from static	(1,009)	(105)		(472)	(1,080)
Percent change from static	-3.82%	-0.40%		-1.79%	-4.09%

Table of Contents

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

**Inflation**

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

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk for the Company is comprised primarily of interest rate risk exposure and liquidity risk. Interest rate risk and liquidity risk management is performed at the Bank level as well as the Company level. The Company's interest rate sensitivity is monitored by management through selected interest rate risk measures produced by an independent third party. There have been no substantial changes in the Company's gap analyses or simulation analyses compared to the information provided in the Annual Report on Form 10-K for the period ended December 31, 2009. Additional information and details are provided in the Liquidity and Interest Rate Sensitivity section of Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

**Item 4. Controls and Procedures**

An analysis was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of September 30, 2010. There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2010, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

None.

**Item 1A. Risk Factors**

There are no material changes to the risk factors set forth in Part I, Item 1A, Risk Factors, of the Company's Annual Report on Form 10-K for the year ended December 31, 2009. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company's business.

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

<b>Period</b>	<b>Total Number of Shares (or Units) Purchased</b>	<b>Average Price Paid per Share (or Units) Purchased</b>	<b>Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs</b>
Month #1 (July 1 - July 31, 2010)				76,776
Month #2 (August 1 - August 31, 2010)				76,776
Month #3 (September 1 - September 30, 2010)				76,776

On April 27, 2010, the Board of Directors extended the previously approved authorization to repurchase up to 197,000 shares, or approximately 5%, of the outstanding shares of the Company for an additional year to April 30, 2011. To date, there have been 120,224 shares repurchased under this plan.

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. (Removed and Reserved)**

**Item 5. Other Information**

None

Table of Contents

**Item 6. Exhibits**

- (3) (i) Articles of Incorporation of the Registrant, as presently in effect (incorporated by reference to Exhibit 3(i) of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2005).
- (3) (ii) Bylaws of the Registrant as presently in effect (incorporated by reference to Exhibit 3(ii) of the Registrant's Current Report on Form 8-K filed June 17, 2005).
- (31) (i) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer.
- (31) (ii) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer.
- (32) (i) Section 1350 Certification of Chief Executive Officer.
- (32) (ii) Section 1350 Certification of Chief Financial Officer.



Table of Contents

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PENNS WOODS BANCORP, INC.  
(Registrant)

Date: November 9, 2010

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

Date: November 9, 2010

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

Table of Contents

**EXHIBIT INDEX**

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