PENNS WOODS BANCORP INC
Form 10-K
March 14, 2008

FORM 10-K

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (NO FEE REQUIRED)

For the transition period from to

Commission file number 0-17077

PENNS WOODS BANCORP, INC.

(exact name of registrant as specified in its charter)

Pennsylvania	**23-2226454**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

300 Market Street, P.O. Box 967
Williamsport, Pennsylvania 17703-0967

(Address of principal executive offices)

Registrant s telephone number, including area code **(570) 322-1111**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
Common stock, par value $8.33 per share	The NASDAQ Stock Market LLC

Securities to be registered pursuant to Section 12(g) of the Act:

None

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
o Yes xNo

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
¨ Yes xNo

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 x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

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

State the aggregate market value of the voting stock held by non-affiliates of the registrant **$133,109,369 at June 30, 2007.**

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at March 4, 2008
Common Stock, $8.33 Par Value	**3,876,114 Shares**

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive proxy statement prepared in connection with its annual meeting of shareholders to be held on April 30, 2008 are incorporated by reference in Part III hereof.

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PART I

ITEM 1 BUSINESS

A. General Development of Business and History

On January 7, 1983, Penns Woods Bancorp, Inc. (the Company) was incorporated under the laws of the Commonwealth of Pennsylvania as a bank holding company. The Jersey Shore State Bank (the Bank) became a wholly owned subsidiary of the Company, and each outstanding share of Bank common stock was converted into one share of Company common stock. This transaction was approved by the shareholders of the Bank on April 11, 1983 and was officially effective on July 12, 1983. The Company s two other wholly-owned subsidiaries are Woods Real Estate Development Company, Inc. and Woods Investment Company, Inc. The Company s business has consisted primarily of managing and supervising the Bank, and its principal source of income has been dividends paid by the Bank and Woods Investment Company, Inc.

The Bank is engaged in commercial and retail banking which includes the acceptance of time, savings, and demand deposits, the funding of commercial, consumer, and mortgage loans, and safe deposit services. Utilizing a thirteen branch office network, ATMs, internet, and telephone banking delivery channels, the Bank delivers its products and services to the communities it resides in.

In October 2000, the Bank acquired The M Group, Inc. D/B/A The Comprehensive Financial Group (The M Group). The M Group, which operates as a subsidiary of the Bank, offers insurance and securities brokerage services. Securities are offered by The M Group through ING Financial Partners, Inc., a registered broker-dealer.

Neither the Company nor the Bank anticipates that compliance with environmental laws and regulations will have any material effect on capital expenditures, earnings, or on its competitive position. The Bank is not dependent on a single customer or a few customers, the loss of whom would have a material effect on the business of the Bank.

The Bank employed 191 persons as of December 31, 2007 in either a full-time or part-time capacity. The Company does not have any employees. The principal officers of the Bank also serve as officers of the Company.

Woods Investment Company, Inc., a Delaware holding company, maintains an investment portfolio that is managed for total return and to fund dividend payments to the Company.

Woods Real Estate Development Company, Inc. serves the Company through its acquisition and ownership of certain properties utilized by the Bank.

A copy of the Code of Ethics and Code of Conduct for the Corporation can be requested from Brian Knepp, Vice President of Finance, at 300 Market Street, Williamsport, PA 17701. A link with access to the Corporation s SEC 10-K filings, annual reports, and quarterly filings can be found at www.jssb.com.

B. Regulation and Supervision

The Company is also subject to the provisions of the Bank Holding Company Act of 1956, as amended (the BHCA) and to supervision and examination by the Board of Governors of the Federal Reserve System (the FRB). The Bank is subject to the supervision and examination by the Federal Deposit Insurance Corporation (the FDIC), as its primary federal regulator and as the insurer of the

Bank s deposits. The Bank is also regulated and examined by the Pennsylvania Department of Banking (the Department).

The insurance activities of The M Group are subject to regulation by the insurance departments of the various states in which The M Group conducts business including principally the Pennsylvania Department of Insurance. The securities brokerage activities of The M Group are subject to regulation by federal and state securities commissions.

The FRB has issued regulations under the BHCA that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the FRB, pursuant to such regulations, may require the Company to stand ready to use its resources to provide adequate capital funds to the Bank during periods of financial stress or adversity. The BHCA requires the Company to secure the prior approval of the FRB before it can acquire all or substantially all of the assets of any bank, or acquire ownership or control of 5% or more of any voting shares of any bank. Such a transaction would also require approval of the Department.

A bank holding company is prohibited under the BHCA from engaging in, or acquiring direct or indirect control of, more than 5% of the voting shares of any company engaged in non-banking activities unless the FRB, by order or regulation, has found such activities to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. Under the BHCA, the FRB has the authority to require a bank holding company to terminate any activity or relinquish control of a non-bank subsidiary (other than a non-bank subsidiary of a bank) upon the FRB s determination that such activity or control constitutes a serious risk to the financial soundness and stability of any bank subsidiary of the bank holding company.

Bank holding companies are required to comply with the FRB 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. Currently, the required minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) is 8%. At least half of the total capital is required to be Tier 1 capital, consisting principally of common shareholders equity, less certain intangible assets. The remainder (Tier 2 capital) may consist of certain preferred stock, a limited amount of subordinated debt, certain hybrid capital instruments and other debt securities, 45% of net unrealized gains on marketable equity securities, and a limited amount of the general loan loss allowance. The risk-based capital guidelines are required to take adequate account of interest rate risk, concentration of credit risk, and risks of nontraditional activities.

In addition to the risk-based capital guidelines, the FRB requires each bank holding company to comply with the leverage ratio, under which the bank holding company must maintain a minimum level of Tier 1 capital to average total consolidated assets of 3% for those bank holding companies which have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. All other bank holding companies are expected to maintain a leverage ratio of at least 4% to 5%. The Bank is subject to similar capital requirements adopted by the FDIC.

C. Regulation of the Bank

From time to time, various types of federal and state legislation have been proposed that could result in additional regulation of, and restrictions of, the business of the Bank. It cannot be predicted whether any such legislation will be adopted or how such legislation would affect the business of the Bank. As a consequence of the extensive regulation of commercial banking activities in the United States, the Bank s business is particularly susceptible to being affected by federal legislation and regulations that may increase the costs of doing business.

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Prompt Corrective Action - The FDIC has specified the levels at which an insured institution will be considered well-capitalized, adequately capitalized, undercapitalized, and critically undercapitalized. In the event an institution s capital deteriorates to the undercapitalized category or below, the Federal Deposit Insurance Act (the FDIA) and FDIC regulations prescribe an increasing amount of regulatory intervention, including: (1) the institution of a capital restoration plan by a bank and a guarantee of the plan by a parent institution; and (2) the placement of a hold on increases in assets, number of branches, or lines of business. If capital has reached the significantly or critically undercapitalized levels, further material restrictions can be imposed, including restrictions on interest payable on accounts, dismissal of management and (in critically undercapitalized situations) appointment of a receiver. For well-capitalized institutions, the FDIA provides authority for regulatory intervention where the institution is deemed to be engaging in unsafe or unsound practices or receives a less than satisfactory examination report rating for asset quality, management, earnings or liquidity.

Deposit Insurance Historically, there were two deposit insurance funds administered by the FDIC - the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF). The Bank s deposits were insured under the BIF; however, the deposits assumed by the Bank in connection with the merger of Lock Haven Savings Bank were treated and assessed as SAIF-insured deposits. The FDIC has implemented a risk-related premium schedule for all insured depository institutions that results in the assessment of premiums based on capital and supervisory measure. Under the risk-related premium schedule, the FDIC assigns, on a semiannual basis, each institution to one of three capital groups (well-capitalized, adequately capitalized or undercapitalized) and further assigns such institution to one of three subgroups within a capital group. The institution s subgroup assignment is based upon the FDIC s judgment of the institution s strength in light of supervisory evaluations, including examination reports, statistical analyses, and other information relevant to gauging the risk posed by the institution. Only institutions with a total capital to risk-adjusted assets ratio of 10.0% or greater, a Tier 1 capital to risk-adjusted assets ratio of 6.0% or greater and a Tier 1 leverage ratio of 5.0% or greater, are assigned to the well-capitalized group. As of December 31, 2007, the Bank s ratios were well above required minimum ratios.

The assessment rates range from zero for those institutions with the least risk, to $0.27 for every $100 of insured deposits for institutions deemed to have the highest risk. The Bank is in the category of institutions that presently pay nothing for deposit insurance. While the Bank presently pays no premiums for deposit insurance, it is subject to assessments to pay the interest on Financing Corporation (FICO) bonds. FICO was created by Congress to issue bonds to finance the resolution of failed thrift institutions. The current annual FICO assessment for the Bank (and all banks) is $.0132 per $100 of BIF deposits.

In February 2006, deposit insurance modernization legislation was enacted. The legislation merged the BIF and SAIF into a single Deposit Insurance Fund, increased deposit insurance coverage for IRAs to $250,000, provided for the future increase of deposit insurance on all accounts by authorizing the FDIC to index the coverage to the rate of inflation, authorized the FDIC to set the reserve ratio of the combined Deposit Insurance Fund at a level between 1.15% and 1.50%, and permited the FDIC to establish assessments to be paid by insured banks to maintain the minimum ratios.

Other Legislation

The Fair and Accurate Credit Transactions Act (FACT) was signed into law on December 4, 2003. This law extends the previously existing Fair Credit Reporting Act. New provisions added by FACT address the growing problem of identity theft. Consumers will be able to initiate a fraud alert when they are victims of identity theft, and credit reporting agencies will have additional duties. Consumers will also be entitled to obtain free credit reports through the credit beaures, and will be granted certain additional privacy rights.

The Sarbanes-Oxley Act of 2002 was enacted to enhance penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures under the federal securities laws. The Sarbanes-Oxley Act generally applies to all companies, including the Company, that file or are required to file periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934, or the Exchange Act. The legislation includes provisions, among other things, governing the services that can be provided by a public company s independent auditors and the procedures for approving such services, requiring the chief executive officer and principal accounting officer to certify certain matters relating to the company s periodic filings under the Exchange Act, requiring expedited filings of reports by insiders of their securities transactions and containing other provisions relating to insider conflicts of interest, increasing disclosure requirements relating to critical financial accounting policies and their application, increasing penalties for securities law violations, and creating a new public accounting oversight board, a regulatory body subject to SEC jurisdiction with broad powers to set auditing, quality control, and ethics standards for accounting firms. In response to the legislation, the national securities exchanges and NASDAQ have adopted new rules relating to certain matters, including the independence of members of a company s audit committee as a condition to listing or continued listing.

In addition, Congress is often considering some financial industry legislation. The Company cannot predict how any new legislation, or new rules adopted by the federal banking agencies, may affect its business in the future.

In addition to federal banking law, the Bank is subject to the Pennsylvania Banking Code. The Banking Code was amended in late 2000 to provide more complete parity in the powers of state-chartered institutions compared to national banks and federal savings banks doing business in Pennsylvania. Pennsylvania banks have the same ability to form financial subsidiaries authorized by the Gramm-Leach-Bliley Act, as do national banks.

Environmental Laws

Environmentally related hazards have become a source of high risk and potential liability for financial institutions relating to their loans. Environmentally contaminated properties owned by an institution s borrowers may result in a drastic reduction in the value of the collateral securing the institution s loans to such borrowers, high environmental clean up costs to the borrower affecting its ability to repay the loans, the subordination of any lien in favor of the institution to a state or federal lien securing clean up costs, and liability to the institution for clean up costs if it forecloses on the contaminated property or becomes involved in the management of the borrower. The Company is not aware of any borrower who is currently subject to any environmental investigation or clean up proceeding which is likely to have a material adverse effect on the financial condition or results of operations of the Company.

Effect of Government Monetary Policies

The earnings of the Company are and will be affected by domestic economic conditions and the monetary and fiscal policies of the United States Government and its agencies. The monetary policies of the FRB have had, and will likely continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order, among other things, to curb inflation or combat a recession. The FRB has a major effect upon the levels of bank loans, investments, and deposits through its open market operations in the United States Government securities and through its regulation of, among other things, the discount rate on borrowing of member banks and the reserve requirements against member bank deposits. It is not possible to predict the nature and impact of future changes in monetary and fiscal policies.

DESCRIPTION OF BANK

History and Business

Jersey Shore State Bank (Bank) was incorporated under the laws of the Commonwealth of Pennsylvania as a state bank in 1934 and became a wholly owned subsidiary of the Company on July 12, 1983.

As of December 31, 2007, the Bank had total assets of $615,285,000; total shareholders equity of $56,971,000 and total deposits of $389,659,000. The Bank s deposits are insured by the Federal Deposit Insurance Corporation for the maximum amount provided under current law.

The Bank engages in business as a commercial bank, doing business at several locations in Lycoming, Clinton, and Centre Counties, Pennsylvania. The Bank offers insurance, securities brokerage services, annuity and mutual fund investment products, and financial planning through its wholly owned subsidiary, The M Group, Inc. D/B/A The Comprehensive Financial Group.

Services offered by the Bank include accepting time, demand and savings deposits including Super NOW accounts, statement savings accounts, money market accounts, fixed rate certificates of deposit, and club accounts. Its services also include making secured and unsecured business and consumer loans that include financing commercial transactions as well as construction and residential mortgage loans and revolving credit loans with overdraft protection.

The Bank s loan portfolio mix can be classified into four principal categories. These are real estate, agricultural, commercial, and consumer. Real estate loans can be further segmented into construction and land development, farmland, one-to-four family residential, multi-family, and commercial or industrial. Qualified borrowers are defined by policy and our underwriting standards. Owner provided equity requirements range from 20% to 30% with a first lien status required. Terms are generally restricted to between 10 and 20 years with the exception of construction and land development, which are limited to one to five years. Real estate appraisals, property construction verifications, and site visitations comply with policy and industry regulatory standards.

Prospective residential mortgage customer s repayment ability is determined from information contained in the application and recent income tax returns. Emphasis is on credit, employment, income, and residency verification. Broad hazard insurance is always required and flood insurance where applicable. In the case of construction mortgages, builders risk insurance is requested.

Agricultural loans for the purchase or improvement of real estate must meet the Bank s real estate underwriting criteria. The only permissible exception is when a Farmers Home Loan Administration guaranty is obtained. Agricultural loans made for the purchase of equipment are usually payable in five years, but never more than seven, depending upon the useful life of the purchased asset. Minimum borrower equity ranges from 20% to 30%. Livestock financing criteria depends upon the nature of the operation. Agricultural loans are also made for crop production purposes. Such loans are structured to repay within the production cycle and not carried over into a subsequent year.

Commercial loans are made for the acquisition and improvement of real estate, purchase of equipment, and for working capital purposes on a seasonal or revolving basis. General purpose working capital loans are also available with repayment expected within one year. Equipment loans are generally amortized over three to seven years, with an owner equity contribution required of at least 20% of the purchase price. Insurance coverage with the Bank as loss payee is required, especially in the case where the equipment is rolling stock. It is also a general policy to collateralize non-real estate loans with the asset purchased and, dependant upon loan terms, junior liens are filed on other available assets. Financial information required on all commercial mortgages includes the most current three years balance sheets and income statements and projections on income to be developed through the project. In the case of corporations and partnerships, the principals are often asked to indebt themselves personally as well.

Seasonal and revolving lines of credit are offered for working capital purposes. Collateral for such a loan includes the pledge of inventory and/or receivables. Drawing availability is usually 50% of inventory and 75% of eligible receivables. Eligible receivables are defined as invoices less than 90 days delinquent. Exclusive reliance is very seldom placed on such collateral; therefore, other lienable assets are also taken into the collateral pool. Where reliance is placed on inventory and accounts receivable, the applicant must provide financial information including agings on a monthly basis. In addition, the guaranty of the principals is usually obtained.

Letter of Credit availability is limited to standbys where the customer is well known to the Bank. Credit criteria is the same as that utilized in making a direct loan. Collateral is obtained in most cases, and whenever the expiration date is beyond one year.

Consumer loan products include second mortgages, automobile financing, small loan requests, overdraft check lines, and PHEAA referral loans. Our policy includes standards used in the industry on debt service ratios and terms are consistent with prudent underwriting standards and the use of proceeds. Verifications are made of employment and residency, along with credit history. Second mortgages are confined to equity borrowing and home improvements. Terms are generally ten years or less and rates are fixed. Loan to collateral value criteria is 80% or less and verifications are made to determine values. Automobile financing is generally restricted to five years and done on a direct basis. The Bank, as a practice, does not floor plan and therefore does not discount dealer paper. Small loan requests are to accommodate personal needs such as the purchase of small appliances or for the payment of taxes. Overdraft check lines are limited to $5,000 or less.

The Bank s investment portfolio is analyzed and priced on a monthly basis. Investments are made in U.S. Treasuries, U.S. Agency issues, bank qualified municipal bonds, corporate bonds, and corporate stocks which consist of Pennsylvania bank stocks. Bonds with BAA or better ratings are used, unless a local issue is purchased that has a lesser or no rating. Factors taken into consideration when investments are purchased include liquidity, the Company s tax position, tax equivalent yield, third party investment ratings, and the policies of the Asset/Liability Committee.

The banking environment in Lycoming, Clinton, and Centre Counties, Pennsylvania is highly competitive. The Bank operates thirteen full service offices in these markets and competes for loans and deposits with numerous commercial banks, savings and loan associations, and other financial institutions. The economic base of the region is developed around small business, health care, educational facilities (college and public schools), light manufacturing industries, and agriculture.

The Bank has a relatively stable deposit base and no material amount of deposits is obtained from a single depositor or group of depositors, excluding public entities that account for approximately 10% of total deposits. Although the Bank has regular opportunities to bid on pools of funds of $100,000 or more in the hands of municipalities, hospitals, and others, it does not rely on these monies to fund loans or intermediate or longer-term investments.

The Bank has not experienced any significant seasonal fluctuations in the amount of its deposits.

Supervision and Regulation

The earnings of the Bank are affected by the policies of regulatory authorities including the FDIC and the FRB. An important function of the FRB is to regulate the money supply and interest rates. Among the instruments used to implement these objectives are open market operations in U.S. Government Securities, changes in reserve requirements against member bank deposits, and limitations on interest rates that member banks may pay on time and savings deposits. These instruments are used in varying combinations to influence overall growth and distribution of bank loans, investments on deposits, and their use may also affect interest rates charged on loans or paid for deposits.

The policies and regulations of the FRB have had and will probably continue to have a significant effect on the Bank s deposits, loans and investment growth, as well as the rate of interest earned and paid, and are expected to affect the Bank s operation in the future. The effect of such policies and regulations upon the future business and earnings of the Bank cannot accurately be predicted.

ITEM 1A RISK FACTORS

The following sets forth several risk factors that are unique to the Company.

Changes in interest rates could reduce our income, cash flows and asset values.

Our income and cash flows and the value of our assets depend to a great extent on the difference between the interest rates we earn on interest-earning assets, such as loans and investment securities, and the interest rates we pay on interest-bearing liabilities such as deposits and borrowings. These rates are highly sensitive to many factors which are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, will influence not only the interest we receive on our loans and investment securities and the amount of interest we pay on deposits and borrowings but will also affect our ability to originate loans and obtain deposits and the value of our investment portfolio. If the rate of interest we pay on our deposits and other borrowings increases more than the rate of interest we earn on our loans and other investments, our net interest income, and therefore our earnings, could be adversely affected. Our earnings also could be adversely affected if the rates on our loans and other investments fall more quickly than those on our deposits and other borrowings.

Economic conditions either nationally or locally in areas in which our operations are concentrated may adversely affect our business.

Deterioration in local, regional, national or global economic conditions could cause us to experience a reduction in deposits and new loans, an increase in the number of borrowers who default on their loans and a reduction in the value of the collateral securing their loans, all of which could adversely affect our performance and financial condition. Unlike larger banks that are more geographically diversified, we provide banking and financial services locally. Therefore, we are particularly vulnerable to adverse local economic conditions.

Our financial condition and results of operations would be adversely affected if our allowance for loan losses is not sufficient to absorb actual losses or if we are required to increase our allowance.

Despite our underwriting criteria, we may experience loan delinquencies and losses. In order to absorb losses associated with nonperforming loans, we maintain an allowance for loan losses based on, among other things, historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality. Determination of the allowance inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. At any time there are likely to be loans in our portfolio that will result in losses but that have not been identified as nonperforming or potential problem credits. We cannot be sure that we will be able to identify deteriorating credits before they become nonperforming assets or that we will be able to limit losses on those loans that are identified. We may be required to increase our allowance for loan losses for any of several reasons. Federal regulators, in reviewing our loan portfolio as part of a regulatory examination, may request that we increase our allowance for loan losses. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in our allowance. In addition, if

charge-offs in future periods exceed our allowance for loan losses, we will need additional increases in our allowance for loan losses. Any increases in our allowance for loan losses will result in a decrease in our net income and, possibly, our capital, and may materially affect our results of operations in the period in which the allowance is increased.

Many of our loans are secured, in whole or in part, with real estate collateral which is subject to declines in value.

In addition to considering the financial strength and cash flow characteristics of a borrower, we often secure our loans with real estate collateral. Real estate values and the real estate market are generally affected by, among other things, changes in local, regional or national economic conditions, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other governmental statutes, regulations and policies, and acts of nature. The real estate collateral provides an alternate source of repayment in the event of default by the borrower. If real estate prices in our markets decline, the value of the real estate collateral securing our loans could be reduced. If we are required to liquidate real estate collateral securing loans during a period of reduced real estate values to satisfy the debt, our earnings and capital could be adversely affected.

Competition may decrease our growth or profits.

We face substantial competition in all phases of our operations from a variety of different competitors, including commercial banks, savings and loan associations, mutual savings banks, credit unions, consumer finance companies, factoring companies, leasing companies, insurance companies, and money market mutual funds. There is very strong competition among financial services providers in our principal service area. Our competitors may have greater resources, higher lending limits, or larger branch systems than we do. Accordingly, they may be able to offer a broader range of products and services as well as better pricing for those products and services than we can.

In addition, some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on federally insured financial institutions. As a result, those nonbank competitors may be able to access funding and provide various services more easily or at less cost than we can, adversely affecting our ability to compete effectively.

We may be adversely affected by government regulation.

The banking industry is heavily regulated. Banking regulations are primarily intended to protect the federal deposit insurance funds and depositors, not shareholders. Changes in the laws, regulations, and regulatory practices affecting the banking industry may increase our costs of doing business or otherwise adversely affect us and create competitive advantages for others. Regulations affecting banks and financial services companies undergo continuous change, and we cannot predict the ultimate effect of these changes, which could have a material adverse effect on our profitability or financial condition.

We rely on our management and other key personnel, and the loss of any of them may adversely affect our operations.

We are and will continue to be dependent upon the services of our executive management team. In addition, we will continue to depend on our ability to retain and recruit key commercial loan officers. The unexpected loss of services of any key management personnel or commercial loan officers could have an adverse effect on our business and financial condition because of their skills, knowledge of our market, years of industry experience, and the difficulty of promptly finding qualified replacement personnel.

Environmental liability associated with lending activities could result in losses.

In the course of our business, we may foreclose on and take title to properties securing our loans. If hazardous substances were discovered on any of these properties, we could be liable to governmental entities or third parties for the costs of remediation of the hazard, as well as for personal injury and property damage. Many environmental laws can impose liability regardless of whether we knew of, or were responsible for, the contamination. In addition, if we arrange for the disposal of hazardous or toxic substances at another site, we may be liable for the costs of cleaning up and removing those substances from the site even if we neither own nor operate the disposal site. Environmental laws may require us to incur substantial expenses and may materially limit use of properties we acquire through foreclosure, reduce their value or limit our ability to sell them in the event of a default on the loans they secure. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability.

Failure to implement new technologies in our operations may adversely affect our growth or profits.

The market for financial services, including banking services and consumer finance services, is increasingly affected by advances in technology, including developments in telecommunications, data processing, computers, automation, Internet-based banking, and telebanking. Our ability to compete successfully in our markets may depend on the extent to which we are able to exploit such technological changes. However, we can provide no assurance that we will be able to properly or timely anticipate or implement such technologies or properly train our staff to use such technologies. Any failure to adapt to new technologies could adversely affect our business, financial condition or operating results.

An investment in our common stock is not an insured deposit.

Our common stock is not a bank deposit and, therefore, is not insured against loss by the Federal Deposit Insurance Corporation, commonly referred to as the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our common stock is subject to the same market forces that affect the price of common stock in any company.

ITEM 1B UNRESOLVED STAFF COMMENTS

None.

ITEM 2 PROPERTIES

The Company owns and leases its properties. Listed herewith are the locations of properties owned or leased as of December 31, 2007, in which the banking offices are located; all properties are in good condition and adequate for the Bank s purposes:

Office	Address	Ownership
Main	115 South Main Street P.O. Box 5098 Jersey Shore, Pennsylvania 17740	Owned
Bridge Street	112 Bridge Street Jersey Shore, Pennsylvania 17740	Owned
DuBoistown	2675 Euclid Avenue Williamsport, Pennsylvania 17702	Owned

Williamsport	300 Market Street P.O. Box 967 Williamsport, Pennsylvania 17703-0967	Owned

Montgomery	9094 Rt. 405 Highway Montgomery, Pennsylvania 17752	Under Lease
Lock Haven	4 West Main Street Lock Haven, Pennsylvania 17745	Owned
Mill Hall	(Inside Wal-Mart), 173 Hogan Boulevard Mill Hall, Pennsylvania 17751	Under Lease
Spring Mills	3635 Penns Valley Road, P.O. Box 66 Spring Mills, Pennsylvania 16875	Owned
Centre Hall	2842 Earlystown Road Centre Hall, Pennsylvania 16828	Land Under Lease
Zion	100 Cobblestone Road Bellefonte, Pennsylvania 16823	Under Lease
State College	(Inside Wal-Mart), 1665 North Atherton Place State College, Pennsylvania 16803	Under Lease
State College	2050 North Atherton Street State College, Pennsylvania 16803	Land Under Lease
Montoursville	820 Broad Street Montoursville, Pennsylvania 17754	Under Lease
The M Group, Inc. D/B/A The Comprehensive Financial Group	705 Washington Boulevard Williamsport, Pennsylvania 17701	Under Lease

ITEM 3 LEGAL PROCEEDINGS

The Company is subject to lawsuits and claims arising out of its business. In the opinion of management, after review and consultation with counsel, any proceedings that may be assessed will not have a material adverse effect on the consolidated financial position of the Company.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2007.

PART II

ITEM 5 MARKET FOR THE REGISTRANT S COMMON STOCK, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

The Common Stock is listed on the NASDAQ Global Select Market under the symbol PWOD . The following table sets forth (1) the quarterly high and low close prices for a share of the Company s

Common Stock during the periods indicated, and (2) quarterly dividends on a share of the Common Stock with respect to each quarter since January 1, 2005. The following quotations represent prices between buyers and sellers and do not include retail markup, markdown or commission. They may not necessarily represent actual transactions.

	HIGH	LOW	Dividends Declared
2005			
First quarter	$ 41.67	$ 38.58	$ 0.38
Second quarter	41.58	37.08	0.38
Third quarter	38.30	36.76	0.39
Fourth quarter	39.76	36.67	0.41
2006			
First quarter	$ 38.75	$ 37.75	$ 0.42
Second quarter	39.50	36.50	0.43
Third quarter	38.48	37.02	0.44
Fourth quarter	38.59	36.20	0.44
2007			
First quarter	$ 37.75	$ 35.00	$ 0.44
Second quarter	35.00	33.86	0.44
Third quarter	35.00	30.80	0.45
Fourth quarter	32.50	30.33	0.46

The Bank has paid cash dividends since 1941. The Company has paid dividends since the effective date of its formation as a bank holding company. It is the present intention of the Registrant s Board of Directors to continue the dividend payment policy; however, further dividends must necessarily depend upon earnings, financial condition, appropriate legal restrictions, and other factors relevant at the time the Board of Directors of the Registrant considers dividend policy. Cash available for dividend distributions to shareholders of the Registrant primarily comes from dividends paid by the Bank to the Company. Therefore, the restrictions on the Bank s dividend payments are directly applicable to the Company. See also the information appearing in Note 18 to Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K for additional information related to dividend restrictions.

Under the Pennsylvania Business Corporation Law of 1988 a corporation may not pay a dividend, if after giving effect thereto, the corporation would be unable to pay its debts as they become due in the usual course of business and after giving effect thereto the total assets of the corporation would be less than the sum of its total liabilities plus the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of the shareholders whose preferential rights are superior to those receiving the dividend.

As of March 4, 2008, the Company had approximately 1,273 shareholders of record.

Following is a schedule of the shares of the Company s common stock purchased by the Company during the fourth quarter of 2007.

Period	**Total Number of Shares (or Units) Purchased**	**Average Price Paid per Share (or Units) Purchased**	**Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs**	**Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs**
Month#1(October 1-October 31, 2007)				
Month#2 (November 1-November 30, 2007)				
Month#3 (December 1,-December 31, 2007)	2,500	$ 32.11	2,500	126,070

Set forth below is a line graph comparing the yearly dollar changes in the cumulative shareholder return on the Company s common stock against the cumulative total return of the S&P 500 Stock Index, NASDAQ Bank Index, and NASDAQ Composite for the period of five fiscal years assuming the investment of $100.00 on December 31, 2002 and assuming the reinvestment of dividends. The shareholder return shown on the graph below is not necessarily indicative of future performance.

	Period Ending					
Index	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**
Penns Woods Bancorp, Inc.	100.00	146.37	157.11	158.36	161.13	146.21
S&P 500	100.00	128.68	142.69	149.70	173.34	182.86
NASDAQ Composite	100.00	150.01	162.89	165.13	180.85	198.60
NASDAQ Bank	100.00	129.93	144.21	137.97	153.15	119.35

ITEM 6 SELECTED FINANCIAL DATA

The following table sets forth certain financial data as of and for each of the years in the five-year period ended December 31, 2007.

(In Thousands, Except Per Share Data)	2007	2006	2005	2004	2003
Consolidated Statement of Income Data:					
Interest income	$ 35,949	$ 33,753	$ 30,903	$ 29,845	$ 28,384
Interest expense	16,447	14,210	10,381	8,768	9,265
Net interest income	19,502	19,543	20,522	21,077	19,119
Provision for loan losses	150	635	720	465	255
Net interest income after provision for loan losses	19,352	18,908	19,802	20,612	18,864
Noninterest income	7,478	9,029	9,431	8,918	9,150
Noninterest expense	17,316	16,329	15,108	14,184	13,137
Income before income taxes	9,514	11,608	14,125	15,346	14,877
Applicable income taxes	637	1,961	3,224	4,263	3,703
Net Income	$ 8,877	$ 9,647	$ 10,901	$ 11,083	$ 11,174
Consolidated Balance Sheet at End of Period:					
Total assets	$ 628,138	$ 592,285	$ 568,668	$ 546,703	$ 527,381
Loans	360,478	360,384	338,438	324,505	275,828
Allowance for loan losses	(4,130)	(4,185)	(3,679)	(3,338)	(3,069)
Deposits	389,022	395,191	352,529	356,836	334,318
Long-term debt other	106,378	82,878	84,478	75,878	70,878
Shareholders' equity	70,559	74,594	73,919	73,165	69,769
Per Share Data:					
Earnings per share - Basic	$ 2.28	$ 2.45	$ 2.75	$ 2.78	$ 2.79
Earnings per share - Diluted	2.28	2.45	2.74	2.78	2.79
Cash dividends declared	1.79	1.73	1.56	1.47	1.24
Book value	18.21	19.12	18.59	18.36	17.50
Number of shares outstanding, at end of period	3,875,632	3,900,742	3,975,787	3,985,832	3,985,872
Average number of shares outstanding-basic	3,886,277	3,934,138	3,971,926	3,990,008	3,996,702
Selected financial ratios:					
Return on average shareholders equity	12.14%	12.93%	14.54%	15.49%	16.60%
Return on average total assets	1.49%	1.67%	1.97%	2.06%	2.24%
Net interest income to average interest earning assets	3.95%	4.06%	4.29%	4.32%	4.36%
Dividend payout ratio	78.33%	70.51%	57.10%	52.72%	44.76%
Average shareholders equity to average total assets	12.23%	12.92%	13.56%	13.30%	13.51%
Loans to deposits, at end of period	92.66%	91.19%	96.00%	90.94%	82.50%

Per share data and number of shares outstanding have been adjusted in each reporting period to give retroactive effect to a 10% stock dividend issued October 30, 2003 and a six for five stock split issued November 18, 2005.

ITEM 7 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

RESULTS OF OPERATIONS

NET INTEREST INCOME

Net interest income is determined by calculating the difference between the yields earned on interest-earning assets and the rates paid on interest-bearing liabilities. To compare the tax-exempt asset yields to taxable yields, amounts are adjusted to taxable equivalents based on the marginal corporate federal tax rate of 34%. The tax equivalent adjustments to net interest income for 2007, 2006, and 2005 were $2,410,000, $2,245,000, and $1,764,000, respectively.

2007 vs 2006

Reported net interest income decreased $41,000 or 0.21% to $19,502,000 for the year ended December 31, 2007 as compared to the year ended December 31, 2006 although the yield on earning assets increased to 6.91% from 6.70%, respectively. On a tax equivalent basis the change in net interest income was an increase of $124,000 which is primarily the result of the yield on investment securities increasing to 6.25% from 5.93% at December 31, 2006. Total interest income increased 6.5% or $2,196,000 primarily due to growth in the average balance of the loan portfolio of $8,688,000 coupled with an increase in the loan yield to 7.27% from 7.10% at December 31, 2006. Interest and dividend income generated from the investment portfolio and interest bearing cash deposits increased $975,000. The increase was the result of the yield on the investment portfolio increasing 32 basis points while the average balance of the investment portfolio increased by $8,749,000.

Interest expense increased $2,237,000 to $16,447,000 for the year ended December 31, 2007 as compared to 2006. The majority of the increase, 91% or $2,043,000, is related to increased levels of average deposits and increased rates being paid on deposit accounts, which had an average rate paid of 3.35% and 2.88% for the years ended December 31, 2007 and 2006, respectively. The increases were driven by market competition and rate increases enacted throughout 2006 by the Federal Open Markets Committee (FOMC) resulting in a higher average prime rate during 2007 than 2006. Interest expense related to time deposits increased $2,121,000 as the average rate paid on time deposits increased to 4.73% from 4.11% for the year ended December 31, 2006. The increase in time deposit rates was the result of competitive pressure, FOMC rate increases, rate specials related to the opening of a new branch and the one year anniversary of a second, and incentive to customers to invest in short-term time deposits. In addition, the average balance in time deposits increased $21,508,000 due to the before mentioned rate specials, transfer of dollars from transaction accounts due to the increasing rate disparity between products, and the use of brokered deposits to limit the reliance on short-term FHLB funding

The rate paid on borrowings increased to 4.57% from 4.50% for the year ended December 31, 2007. The increase in rate resulted in interest expense on borrowings increasing $194,000 with the majority of the increase occurring in the short-term borrowing category. The short-term borrowing rate increased 11 basis points to 4.45% due to the FOMC rate increases since the start of 2006. Interest expense associated with long-term borrowings increased $58,000 due to the average balance of long-term FHLB borrowings increasing $253,000 and a weighted average interest rate on the long-term debt increase of 6 basis points to 4.62% at December 31, 2007.

2006 vs 2005

Reported net interest income decreased $979,000 or 4.8% to $19,543,000 for the year ended December 31, 2006 as compared to the year ended December 31, 2005 as the yield on earning assets increased to 6.70% from 6.29%, respectively. On a tax equivalent basis the change in net interest income was a decrease of $498,000 which is the result of the rate paid on interest bearing liabilities increasing at nearly twice the rate of increases in the yield on earning assets. Total interest income increased 9.2% or $2,850,000 primarily due to growth in the average balance of the loan portfolio of $22,150,000 coupled with an increase in loan yield to 7.10% from 6.73% at December 31, 2005. Interest and dividend income generated from the investment portfolio and interest bearing cash deposits increased $98,000. The increase was the result of the yield on the investment portfolio increasing 39 basis points while the average balance of the investment portfolio declined by $3,474,000.

Interest expense increased $3,829,000 to $14,210,000 for the year ended December 31, 2006 as compared to 2005. The majority of the increase, 82% or $3,134,000, is related to increased rates being paid on deposit accounts, which had an average rate paid of 2.88% and 1.98% for the years ended December 31, 2006 and 2005, respectively. The increases were driven by market competition and rate increases enacted by the Federal Open Markets Committee (FOMC). Interest expense related to time deposits increased $2,827,000 as the average rate paid on time deposits increased to 4.11% from 3.02% for the year ended December 31, 2005. The increase in time deposit rates was the result of competitive pressure, FOMC rate increases, rate specials related to the opening of a new branch and the one year anniversary of a second, and incentive to customers to invest in short-term time deposits. In addition, the average balance in time deposits increased $30,130,000 due to the before mentioned rate specials, transfer of dollars from transaction accounts due to the increasing rate disparity between products, and the use of brokered deposits to limit the reliance on short-term FHLB funding

The rate paid on borrowings increased to 4.50% from 4.08% for the year ended December 31, 2006. The increase in rate resulted in interest expense on borrowings increasing $695,000 with the majority of the increase occurring in the short-term borrowing category. The short-term borrowing rate increased 144 basis points to 4.34% due to the FOMC rate increases since the start of 2005. Interest expense associated with long-term borrowings increased $123,000 due to the average balance of long-term FHLB borrowings increasing $2,417,000 while the weighted average interest rate on the long-term debt remained constant.

AVERAGE BALANCES AND INTEREST RATES

The following tables set forth certain information relating to the Company s average balance sheet and reflect the average yield on assets and average cost of liabilities for the periods indicated and the average yields earned and rates paid. Such yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods presented.

	2007			2006			2005		
(In Thousands)	**Average Balance**	**Interest**	**Average Rate**	**Average Balance**	**Interest**	**Average Rate**	**Average Balance**	**Interest**	**Average Rate**
ASSETS:									
Tax-exempt loans	$ 7,857	$ 485	6.17%	$ 8,173	$ 503	6.15%	$ 5,370	$ 307	5.72%
All other loans	353,528	25,779	7.29%	344,524	24,545	7.12%	325,177	21,924	6.74%
Total loans	361,385	26,264	7.27%	352,697	25,048	7.10%	330,547	22,231	6.73%
Taxable securities	93,480	5,474	5.86%	91,767	4,837	5.27%	115,041	5,529	4.81%
Tax-exempt securitites	99,728	6,602	6.62%	92,692	6,102	6.58%	72,892	4,882	6.70%
Total securities	193,208	12,076	6.25%	184,459	10,939	5.93%	187,933	10,411	5.54%
Interest-bearing deposits	345	19	5.51%	152	11	7.24%	873	25	2.86%
Total interest-earning assets	554,938	38,359	6.91%	537,308	35,998	6.70%	519,353	32,667	6.29%
Other assets	42,602			40,413			33,308		
Total assets	$ 597,540			$ 577,721			$ 552,661		
LIABILITIES:									
Savings	$ 58,710	428	0.73%	$ 61,958	509	0.82%	$ 64,795	500	0.77%
Super Now deposits	46,596	611	1.31%	47,294	655	1.38%	50,756	438	0.86%
Money market deposits	23,920	540	2.26%	23,905	493	2.06%	29,317	412	1.41%
Time deposits	198,029	9,372	4.73%	176,521	7,251	4.11%	146,391	4,424	3.02%
Total deposits	327,255	10,951	3.35%	309,678	8,908	2.88%	291,259	5,774	1.98%
Short-term borrowings	36,816	1,639	4.45%	34,612	1,503	4.34%	32,114	931	2.90%
Long-term borrowings	83,490	3,857	4.62%	83,237	3,799	4.56%	80,820	3,676	4.55%
Total borrowings	120,306	5,496	4.57%	117,849	5,302	4.50%	112,934	4,607	4.08%
Total interest-bearing liabilities	447,561	16,447	3.67%	427,527	14,210	3.32%	404,193	10,381	2.57%
Demand deposits	69,953			69,668			69,457		
Other liabilities	6,924			5,899			4,057		
Shareholders equity	73,102			74,627			74,954		
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 597,540			$ 577,721			$ 552,661		
Interest rate spread			3.24%			3.38%			3.72%
Net interest income/margin		$ 21,912	3.95%		$ 21,788	4.06%		$ 22,286	4.29%

Fees on loans are included with interest on loans. Loan fees are included in interest income as follows: 2007 $453,000, 2006 $478,000, 2005 $491,000

Information on this table has been calculated using average daily balances 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.

Reconcilement of Taxable Equivalent Net Interest Income

	2007	2006	2005
Total interest income	$ 35,949	$ 33,753	$ 30,903
Total interest expense	16,447	14,210	10,381
Net interest income	19,502	19,543	20,522
Tax equivalent adjustment	2,410	2,245	1,764
Net interest income (fully taxable equivalent)	$ 21,912	$ 21,788	$ 22,286

Rate/Volume Analysis

The table below sets forth certain information regarding changes in our interest income and interest expense for the periods indicated. For interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (changes in average volume multiplied by old rate) and (ii) changes in rates (changes in rate multiplied by old average volume). Increases and decreases due to both interest rate and volume, which cannot be separated, have been allocated proportionally to the change due to volume and the change due to interest rate. Income and interest rates are on a taxable equivalent basis.

	Year Ended December 31,					
	2007 vs 2006 Increase (Decrease) Due to			2006 vs 2005 Increase (Decrease) Due to		
(In Thousands)	Volume	Rate	Net	Volume	Rate	Net
Interest income:						
Loans, tax-exempt	$ (20)	$ 2	$ (18)	$ 174	$ 22	$ 196
Loans	650	584	1,234	1,342	1,279	2,621
Taxable investment securities	88	549	637	(1,192)	500	(692)
Tax-exempt investment securities	466	34	500	1,304	(84)	1,220
Interest-bearing deposits	12	(4)	8	(32)	18	(14)
Total interest-earning assets	1,196	1,165	2,361	1,596	1,735	3,331
Interest expenses:						
Savings deposits	(30)	(51)	(81)	(23)	32	9
Super Now deposits	(10)	(34)	(44)	(32)	249	217
Money market deposits		47	47	(86)	167	81
Time deposits	344	1,777	2,121	471	2,356	2,827
Short-term borrowings	100	36	136	65	507	572
Long-term borrowings	12	46	58	110	13	123
Total interest-bearing liabilities	416	1,821	2,237	505	3,324	3,829
Change in net interest income	$ 780	$ (656)	$ 124	$ 1,091	$ (1,589)	$ (498)

PROVISION FOR LOAN LOSSES

2007 vs 2006

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

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

Although management believes that it uses the best information available to make such determinations and that the allowance for loan losses is adequate at December 31, 2007, 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 or employment and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in interest income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Bank s loan loss allowance. The banking regulators 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.

The allowance for loan losses decreased from $4,185,000 at December 31, 2006 to $4,130,000 at December 31, 2007. At December 31, 2007, allowance for loan losses was 1.15% of total loans compared to 1.16% of total loans at December 31, 2006. Management s conclusion is that the allowance for loan losses is adequate to provide for probable losses inherent in its loan portfolio as of the consolidated balance sheet date.

The provision for loan losses totaled $150,000 for the year ended December 31, 2007. The provision for the same period in 2006 was $635,000. Management concluded that the decrease of the provision was appropriate when considering the gross loan growth experienced during 2007 of $94,000 coupled with the low levels of charge-offs and delinquencies during the year. Utilizing both internal and external resources, as noted, senior management has concluded that the allowance for loan losses remains at a level adequate to provide for probable losses inherent in the loan portfolio.

2006 vs 2005

The allowance for loan losses increased 13.8% or $506,000 from fiscal 2005 after net charge-offs of $129,000 contributed to a year-end allowance for loan losses of $4,185,000 or 1.16% of total loans. Based upon this analysis, as well as the others noted above, senior management concluded that the allowance for loan losses was at a level adequate to provide for probable losses inherent in the loan portfolio at December 31, 2006.

Following is a table showing the changes in the allowance for loan losses for the years ended December 31:

(In Thousands)	**2007**	**2006**	**2005**	**2004**	**2003**
Balance at beginning of period	$ 4,185	$ 3,679	$ 3,338	$ 3,069	$ 2,953
Charge-offs:					
Real estate		50	132	121	63
Commercial and industrial	103	28	206	50	37
Installment loans to individuals	201	249	108	112	116
Total charge-offs	304	327	446	283	216
Recoveries:					
Real estate	13	68	45	50	42
Commercial and industrial	1	40	8	4	16
Installment loans to individuals	85	90	14	33	19
Total recoveries	99	198	67	87	77
Net charge-offs	205	129	379	196	139
Additions charged to operations	150	635	720	465	255
Balance at end of period	$ 4,130	$ 4,185	$ 3,679	$ 3,338	$ 3,069
Ratio of net charge-offs during the period to average loans outstanding during the period	0.06%	0.04%	0.11%	0.06%	0.05%

NON-INTEREST INCOME

2007 vs 2006

Total non-interest income decreased $1,551,000 from the year ended December 31, 2007 to 2006. Excluding security (loss) gains and the gain on sale of loans, non-interest income increased $114,000. Service charges decreased $120,000 as overdraft protection fees declined and customers migrated to new checking accounts having reduced or no service charges. Earnings on bank-owned life insurance increased $36,000. Insurance commissions decreased $59,000 due to a reduction in the overall commission, from the underwriter, that The M Group receives on each insurance contract written. Management of The M Group continues to pursue new and build upon current relationships.

However, the sales cycle for insurance and investment products can take typically from six months to one year or more to complete. The sales call program continues to expand to other financial institutions, which results in additional revenue for The M Group. The increase in other income was primarily due to increases in revenues from debit card transactions, merchant card commissions, and commissions generated by The M Group for securities transactions.

	2007		2006		Change	
(In Thousands)	**Amount**	**% Total**	**Amount**	**% Total**	**Amount**	**%**
Deposit service charges	$ 2,246	30.03%	$ 2,366	26.20%	$ (120)	(5.07)%
Securities (losses) gains, net	(54)	(0.72)	1,679	18.60	(1,733)	(103.22)
Bank-owned life insurance	410	5.48	374	4.14	36	9.63
Gain on sale of loans	921	12.32	853	9.45	68	7.97
Insurance commissions	2,222	29.72	2,281	25.26	(59)	(2.59)
Other income	1,733	23.17	1,476	16.35	257	17.41
Total non-interest income	$ 7,478	100.00%	$ 9,029	100.00%	$ (1,551)	(17.18)%

2006 vs 2005

Total non-interest income decreased $402,000 from the year ended December 31, 2005 to 2006. Excluding security gains and the gain on sale of loans, non-interest income increased $120,000. Service charges increased $138,000 due to the full year impact of an overdraft protection program that was started in May 2005. Earnings on bank-owned life insurance decreased $194,000, however, the year ended December 31, 2005 included the receipt of $196,000 due to a death benefit claim. Insurance commissions decreased $46,000 due to a reduction in the overall commission, from the underwriter, that The M Group receives on each insurance contract written. Management of The M Group continues to pursue new and build upon current relationships. However, the sales cycle for insurance and investment products can take typically from six months to one year or more to complete. The sales call program continues to expand to other financial institutions, which results in additional revenue for The M Group. The increase in other income was primarily due to increases in revenues from debit cards and fees associated with the origination of mortgage loans on the behalf of PHFA and other secondary market entities.

	2006		2005		Change	
(In Thousands)	**Amount**	**% Total**	**Amount**	**% Total**	**Amount**	**%**
Deposit service charges	$ 2,366	26.20%	$ 2,228	23.62%	$ 138	6.19%
Securities gains, net	1,679	18.60	2,190	23.22	(511)	(23.33)
Bank-owned life insurance	374	4.14	568	6.02	(194)	(34.15)
Gain on sale of loans	853	9.45	864	9.16	(11)	(1.27)
Insurance commissions	2,281	25.26	2,327	24.68	(46)	(1.98)
Other income	1,476	16.35	1,254	13.30	222	17.70
Total non-interest income	$ 9,029	100.00%	$ 9,431	100.00%	$ (402)	(4.26)%

NON-INTEREST EXPENSES

2007 vs 2006

Total non-interest expenses increased $987,000 from the year ended December 31, 2006 to December 31, 2007. Salaries and employee benefits increased by $245,000 and were attributed to several items including standard cost of living wage adjustments for employees, full year impact of the Montoursville branch, and increased benefit costs. Occupancy expense increased due to the new branch in Montoursville, which opened in the third quarter of 2006, and increased cost of maintenance and property taxes. Amortization increase attributed to low income housing partnership that began operation during the fourth quarter of 2006.

	2007		2006		Change	
(In Thousands)	Amount	% Total	Amount	% Total	Amount	%
Salaries and employee benefits	$ 9,078	52.43%	$ 8,833	54.09%	$ 245	2.77%
Occupancy, net	1,306	7.54	1,137	6.96	169	14.86
Furniture and equipment	1,126	6.50	1,201	7.36	(75)	(6.24)
Pennsylvania shares tax	643	3.71	598	3.66	45	7.53
Amortization of investment in limited partnership	761	4.39	245	1.50	516	210.61
Other expenses	4,402	25.43	4,315	26.43	87	2.02
Total non-interest expense	$ 17,316	100.00%	$ 16,329	100.00%	$ 987	6.04%

2006 vs 2005

Total non-interest expenses increased $1,221,000 from the year ended December 31, 2005 to December 31, 2006. Salaries and employee benefits increased by $519,000 and was the result of increased staffing due in part to two new branches since mid 2005, standard wage increases, and increased health insurance costs. Occupancy expense and furniture and equipment expenses increased primarily due to the before mentioned branch additions and increased maintenance costs related to the software and equipment utilized by the Bank. Other expenses and amortization of investment in limited partnership increased $377,000 as amortization of the low income housing partnership investments increased $155,000 and due to general increases in the cost of business specifically Pennsylvania shares tax, donations, and director fees. The increase in low income housing partnership investment amortization is the result of the Bank s involvement with two partnerships that became eligible for tax credit recognition during 2006.

	2006		2005		Change	
(In Thousands)	Amount	% Total	Amount	% Total	Amount	%
Salaries and employee benefits	$ 8,833	54.09%	$ 8,314	55.03%	$ 519	6.24%
Occupancy, net	1,137	6.96	1,089	7.21	48	4.41
Furniture and equipment	1,201	7.36	973	6.44	228	23.43
Pennsylvania shares tax	598	3.66	549	3.63	49	8.93
Amortization of investment in limited partnership	245	1.50	90	0.60	155	172.22
Other expenses	4,315	26.43	4,093	27.09	222	5.42
Total non-interest expense	$ 16,329	100.00%	$ 15,108	100.00%	$ 1,221	8.08%

INCOME TAXES

2007 vs 2006

The provision for income taxes for the year ended December 31, 2007 resulted in an effective income tax rate of 6.7% compared to 16.9% for 2006. This decrease is the result of a shift in the investment portfolio from taxable mortgage-backed bonds to tax-exempt municipal bonds coupled with the receipt of tax credits related to low income housing partnerships.

2006 vs 2005

The provision for income taxes for the year ended December 31, 2006 resulted in an effective income tax rate of 16.9% compared to 22.8% for 2005. This decrease is the result of a shift in the investment portfolio from taxable mortgage-backed bonds to tax-exempt municipal bonds coupled with the receipt of tax credits related to low income housing partnerships.

FINANCIAL CONDITION

INVESTMENTS

2007

The estimated fair value of the investment portfolio increased $29,429,000 or 15.77% from December 31, 2006 to 2007, while the amortized cost increased $35,762,000 over the same period. The majority of the changes in value occurred within the state and municipal segment of the portfolio. The amortized cost position in state and political securities increased $14,993,000 as the Bank continued to build call protection, maintain taxable equivalent yields, reduce the effective federal income tax rate, and invest in communities across the Commonwealth of Pennsylvania and the country. The amortized cost position of other debt securities increased $13,919,000 as the Bank began a new leverage transaction to enhance net interest income, return on average assets, and return on average equity. The increased level of unrealized losses, which offset the increase in amortized cost, was the result of changes in the yield curve, not credit quality, as the credit quality of the portfolio remains sound.

2006

The investment portfolio decreased $1,800,000 or 0.96% from December 31, 2005 to 2006. The decrease was the result of the cash flow from the portfolio being utilized to assist in the funding of the higher yielding loan portfolio. Within the portfolio, the asset allocation continued to be weighted in tax-exempt municipal bonds. This continued shift to a tax-exempt weighting was part of a strategy to increase yield, provide call protection, and to reduce the Company s overall effective tax rate. At December 31, 2006 the portfolio was comprised of 55.56% tax-exempt bonds as compared to 47.66% at December 31, 2005. The taxable portion of the portfolio was revamped to reduce exposure to falling interest rates, while at the same time increasing the current yield.

The carrying amounts of investment securities at the dates indicated are summarized as follows for the years ended December 31:

	2007		2006		2005	
(In Thousands)	**Balance**	**% Portfolio**	**Balance**	**% Portfolio**	**Balance**	**% Portfolio**
U.S. Treasury securities:						
Available for Sale	$		$		$	
U.S. Government agencies:						
Held to Maturity	14	0.01%	26	0.01%	28	0.01%
Available for Sale	62,904	29.29%	54,152	29.20%	63,953	34.15%
State and political subdivisions (tax-exempt):						
Held to Maturity						
Available for Sale	107,314	49.98%	103,057	55.56%	89,265	47.66%
State and political subdivisions (taxable):						
Held to Maturity						
Available for Sale	10,501	4.89%	2,889	1.56%	4,826	2.58%

Other bonds, notes and debentures:						
Held to Maturity	263	0.12%	257	0.14%	237	0.13%
Available for Sale	15,767	7.34%	2,024	1.09%	1,719	0.92%
Total bonds, notes and debentures	196,763	91.63%	162,405	87.56%	160,028	85.45%
Corporate stock - Available for Sale	17,969	8.37%	23,078	12.44%	27,255	14.55%
Total	$ 214,732	100.00%	$ 185,483	100.00%	$ 187,283	100.00%

The following table shows the maturities and repricing of investment securities, at amortized cost, at December 31, 2007 and the weighted average yields (for tax-exempt obligations on a fully taxable basis assuming a 34% tax rate) of such:

(In Thousands)	Within One Year	After One But Within Five Years	After Five But Within Ten Years	After Ten Years	Amortized Cost Total
U.S. Treasury securities:					
HTM Amount	$	$	$	$	$
Yield					
AFS Amount					
Yield					
U.S. Government agencies:					
HTM Amount				14	14
Yield				9.07%	9.07%
AFS Amount		750		61,632	62,382
Yield		5.02%		5.81%	5.80%
State and political subdivisions(tax-exempt):					
HTM Amount					
Yield					
AFS Amount			392	108,355	108,747
Yield			6.24%	4.31%	4.32%
State and political subdivisions(taxable):					
HTM Amount					
Yield					
AFS Amount				10,904	10,904
Yield				5.41%	5.41%
Other bonds, notes and debentures:					
HTM Amount	50	123	90		263
Yield	5.83%	6.37%	5.77%		6.06%
AFS Amount	75	50	3	15,789	15,917
Yield	4.96%	6.45%	5.54%	6.18%	6.18%
Total Amount	$ 125	$ 923	$ 485	$ 196,694	$ 198,227
Total Yield	5.31%	5.28%	6.15%	4.99%	5.00%
Equity Securities					$ 19,776
Total Investment Portfolio Value					$ 218,003
Total Investment Portfolio Yield					4.54%

All yields represent weighted average yields expressed on a tax equivalent basis. They are calculated on the basis of the cost, adjusted for amortization of premium and accretion of discount, and effective yields weighted for the scheduled maturity of each security. The taxable equivalent adjustment represents the difference between annual income from tax-exempt obligations and the taxable equivalent of such income at the standard 34% tax rate (derived by dividing tax-exempt interest by 66%).

LOAN PORTFOLIO

2007

Gross loans of $360,478,000 at December 31, 2007 represented an increase of $94,000 from December 31, 2006. The continued emphasis on well collateralized real estate loans resulted in real estate secured loans increasing $1,991,000 from December 31, 2006 to 2007. The success in carrying out this long term strategy has played a significant role in limiting net charge-offs for 2007 to 0.06% of average loans. Commercial and agricultural loans declined due to the before mentioned emphasis on real estate secured loans versus equipment, receivables, or inventory secured loans.

2006

Gross loans of $360,384,000 at December 31, 2006 represented an increase of $21,946,000 from December 31, 2005. The continued emphasis on well collateralized real estate loans resulted in real estate secured loans increasing $22,560,000 from December 31, 2005 to 2006. The success in carrying out this long term strategy has played a significant role in limiting net charge-offs for 2006 to 0.04% of average loans. Commercial and agricultural loans declined due to the before mentioned emphasis on real estate secured loans versus equipment, receivables, or inventory secured loans.

The amounts of loans outstanding at the indicted dates are shown in the following table according to type of loan:

(In Thousands)		**2007**		**2006**		**2005**		**2004**		**2003**
Commercial and agricultural	$	35,739	$	36,995	$	37,553	$	31,100	$	24,520
Real estate mortgage:										
Residential		163,268		158,219		150,000		147,461		147,697
Commercial		132,943		135,404		127,131		123,757		82,896
Construction		16,152		16,749		10,681		8,365		7,652
Installment loans to individuals		13,317		14,035		14,135		14,918		14,003
Less: Net deferred loan fees		941		1,018		1,062		1,096		940
Gross loans	$	360,478	$	360,384	$	338,438	$	324,505	$	275,828

The amounts of domestic loans at December 31, 2007 are presented below by category and maturity:

(In Thousands)		**Real Estate**		**Commercial and Other**		**Installment Loans to Individuals**		**Total**
Loans with floating interest rates:								
1 year or less	$	25,014	$	9,105	$	2,258	$	36,377
1 through 5 years		9,215		1,608		151		10,974
5 through 10 years		28,421		4,421		6		32,848
After 10 years		196,938		1,918		391		199,247
Total floating interest rate loans		259,588		17,052		2,806		279,446
Loans with predetermined interest rates:								
1 year or less		5,609		1,091		1,355		8,055
1 through 5 years		15,843		9,992		8,495		34,330
5 through 10 years		19,578		7,693		646		27,917
After 10 years		10,480		189		61		10,730
Total predetermined interest rate loans		51,510		18,965		10,557		81,032
Total	$	311,098	$	36,017	$	13,363	$	360,478

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* The loan maturity information is based upon original loan terms and is not adjusted for rollovers. In the ordinary course of business, loans maturing within one year may be renewed, in whole or in part, as to principal amount at interest rates prevailing at the date of renewal.
* Scheduled repayments are reported in maturity categories in which the payment is due.

The Bank does not make loans that provide for negative amortization nor do any loans contain conversion features. The Bank does not have any foreign loans outstanding at December 31, 2007.

ALLOWANCE FOR LOAN LOSSES

2007

The allowance for loan losses represents the amount which management estimates is adequate to provide for probable losses inherent in its loan portfolio, as of the consolidated balance sheet date. The allowance method is used in providing for loan losses. Accordingly, all loan losses are charged to the allowance and all recoveries are credited to it. The allowance for loan losses is established through a provision for loan losses charged to operations. The provision for loan losses is based upon management s quarterly review of the loan portfolio. The purpose of the review is to assess loan quality, identify impaired loans, analyze delinquencies, ascertain loan growth, evaluate potential charge-offs and recoveries, and assess general economic conditions in the markets served. An external independent loan review is also performed annually for the Bank. Management remains committed to an aggressive program of problem loan identification and resolution.

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

Although management believes that it uses the best information available to make such determinations and that the allowance for loan losses is adequate at December 31, 2007, 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 or employment and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in interest 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.

The allowance for loan losses decreased from $4,185,000 at December 31, 2006 to $4,130,000 at December 31, 2007. At December 31, 2007, allowance for loan losses was 1.15% of total loans compared to 1.16% of total loans at December 31, 2006. This percentage is consistent with the Bank s historical experience and peer banks. Management s conclusion is that the allowance for loan losses is adequate to provide for probable losses inherent in its loan portfolio as of the balance sheet date.

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2006

At December 31, 2006, the allowance for loan losses as a percent of total loans increased to 1.16% from 1.09% at December 31, 2005. Gross loans increased by $21,946,000 from $338,438,000 at December 31, 2005 to $360,384,000 at December 31, 2006.

Based on management s loan-by-loan review, the past performance of the borrowers and current economic conditions, including recent business closures and bankruptcy levels, management does not anticipate any current losses related to nonaccrual, nonperforming, or classified loans above those that have already been considered in its overall judgment of the adequacy of the reserve.

NONPERFORMING LOANS

Non-accrual loans increased to $955,000 at December 31, 2007 primarily due to the addition of a commercial real estate relationship which has filed for bankruptcy. Overall nonperforming loans increased $831,000 to $1,320,000 from fiscal year end 2006.

The following table presents information concerning nonperforming loans. The accrual of interest will be discontinued when the principal or interest of a loan is in default for 90 days or more, or as soon as payment is questionable, unless the loan is well secured and in the process of collection. Consumer loans and residential real estate loans secured by 1 to 4 family dwellings shall ordinarily not be subject to those guidelines. The reversal of previously accrued but uncollected interest applicable to any loan placed in a nonaccrual status and the treatment of subsequent payments of either principal or interest will be handled in accordance with U.S. generally accepted accounting principles. These principles do not require a write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. A nonperforming loan may be restored to an accruing status when:

1. Principal and interest is no longer due and unpaid.
2. It becomes well secured and in the process of collection.
3. Prospects for future contractual payments are no longer in doubt.

	Total Nonperforming Loans		
(In Thousands)	**Nonaccrual**	**90 Days Past Due**	**Total**
2007	$ 955	$ 365	$ 1,320
2006	370	119	489
2005	540	63	603
2004	1,381	345	1,726
2003	827	429	1,256

The level of nonaccruing loans continues to fluctuate annually and is attributed to the various economic factors experienced both regionally and nationally. Overall the portfolio is well secured with a majority of the balance making regular payments or scheduled to be satisfied in the near future. Presently there are no significant amounts of loans where serious doubts exist as to the ability of the borrower to comply with the current loan payment terms which are not included in the nonperforming categories as indicated above.

Management s judgment in determining the amount of the additions to the allowance charged to operating expense considers the following factors:

1. Economic conditions and the impact on the loan portfolio.
2. Analysis of past loan charge-offs experienced by category and comparison to outstanding loans.
3. Problem loans on overall portfolio quality.

4. Reports of examination of the loan portfolio by the Pennsylvania State Banking Department and the Federal Deposit Insurance Corporation.

Allocation In The Allowance For Loan Losses

(In Thousands)		Amount	Percent Of Loan In Each Category To Total Loans
December 31, 2007:			
Balance at end of period applicable to:			
Commercial and agricultural	$	823	9.9%
Real estate mortgage:			
Residential		1,031	45.2%
Commercial		1,634	36.8%
Construction		112	4.5%
Installment loans to individuals		228	3.6%
Unallocated		302	
Total	$	4,130	100.0%
December 31, 2006:			
Balance at end of period applicable to:			
Commercial and agricultural	$	679	7.9%
Real estate mortgage:			
Residential		951	43.8%
Commercial		1,972	37.5%
Construction		108	4.6%
Installment loans to individuals		295	6.2%
Unallocated		180	
Total	$	4,185	100.0%
December 31, 2005:			
Balance at end of period applicable to:			
Commercial and agricultural	$	582	10.1%
Real estate mortgage:			
Residential		1,107	44.2%
Commercial		1,482	37.5%
Construction		79	3.1%
Installment loans to individuals		192	5.1%
Unallocated		237	
Total	$	3,679	100.0%
December 31, 2004:			
Balance at end of period applicable to:			
Commercial and agricultural	$	361	9.1%
Real estate mortgage:			
Residential		1,280	46.1%
Commercial		1,399	37.5%
Construction		75	2.5%
Installment loans to individuals		207	4.8%
Unallocated		16	
Total	$	3,338	100.0%
December 31, 2003:			
Balance at end of period applicable to:			
Commercial and agricultural	$	353	8.5%
Real estate mortgage:			

Residential		1,483	53.4%
Commercial		916	29.9%
Construction		77	2.8%
Installment loans to individuals		240	5.4%
Total	$	3,069	100.0%

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DEPOSITS

2007 vs 2006

Total average deposits were $397,208,000 for 2007, an increase of $17,862,000 or 4.71% from 2006. Noninterest-bearing deposits increased slightly to $69,953,000. Time deposits increased $21,508,000 or 12.19% as deposits shifted from transaction accounts to time deposits due to the continued rate disparity between time deposits and other deposit types. The rate on time deposits increased due to the actions taken by the FOMC during 2006, which increased the overall rate paid on time deposits. In addition, the Bank utilized brokered time deposits to supplement market area deposit funding with the level of brokered deposits decreasing $16,197,000 to $8,831,000 at December 31, 2007.

2006 vs 2005

Total average deposits were $379,346,000 for 2006, an increase of $18,630,000 or 5.16% from 2005. Non-interest bearing deposits increased slightly to $69,668,000. Time deposits increased $30,130,000 or 20.58% as deposits shifted from transaction accounts to time deposits due to the continued rate disparity between time deposits and other deposit types. The rate on time deposits has been increasing due to the actions taken by the FOMC and market competition. In addition, the Bank utilized brokered time deposits to supplement market area deposit funding.

The average amount and the average rate paid on deposits are summarized below:

	2007		2006		2005	
(In Thousands)	**Average Amount**	**Rate**	**Average Amount**	**Rate**	**Average Amount**	**Rate**
Noninterest-bearing	$ 69,953	0.00%	$ 69,668	0.00%	$ 69,457	0.00%
Savings	58,710	0.73%	61,958	0.82%	64,795	0.77%
Super Now	46,596	1.31%	47,294	1.38%	50,756	0.86%
Money Market	23,920	2.26%	23,905	2.06%	29,317	1.41%
Time	198,029	4.73%	176,521	4.11%	146,391	3.02%
Total average deposits	$ 397,208	2.76%	$ 379,346	2.35%	$ 360,716	1.60%

SHAREHOLDERS EQUITY

2007

Shareholders equity decreased $4,035,000 to $70,559,000 at December 31, 2007 as net income outpaced dividends paid, accumulated comprehensive income decreased $5,094,000, and $972,000 in treasury stock was strategically purchased as part of the previously announced stock buyback plan. The decrease in accumulated comprehensive income is the result of a decrease in market value, or net unrealized loss, of the investment portfolio at December 31, 2007 as compared to December 31, 2006, and the net excess of the projected benefit obligation over the market value of the plan assets of the defined benefit pension plan. The current level of shareholders equity equates to a book value per share of $18.21 at December 31, 2007 as compared to $19.12 at December 31, 2006 and an equity to asset ratio of 11.23% at December 31, 2007. During the twelve months ended December 31, 2007 cash dividends of $1.79 per share were paid to shareholders. The dividends represented a 3% increase or $0.06 per share over the dividends paid during the comparable period of 2006.

2006

Shareholders   equity increased $675,000 to $74,594,000 at December 31, 2006 as net income outpaced dividends paid, accumulated comprehensive income increased $710,000, and $2,929,000 in treasury stock was strategically purchased as part of the previously announced stock buyback plan. The increase in accumulated comprehensive income is the result of an increase in market value, or net unrealized gains, of the investment portfolio at December 31, 2006 as compared to December 31, 2005, offset by the net excess of the projected benefit obligation over the market value of the plan assets of the defined benefit pension plan. The current level of shareholders equity equates to a book value per share of $19.12 at December 31, 2006 as compared to $18.59 at December 31, 2005 and an equity to asset ratio of 12.59% at December 31, 2006. During the twelve months ended December 31, 2006 cash dividends of $1.73 per share were paid to shareholders. The dividends represented an 11% increase or $0.17 per share over the dividends paid during the comparable period of 2005.

Bank regulators have risk based capital guidelines. Under these guidelines the Company and Bank are required to maintain minimum ratios of core capital and total qualifying capital as a percentage of risk weighted assets and certain off-balance sheet items. At December 31, 2007, both the Company s and Bank s required ratios were well above the minimum ratios as follows:

	Company	Bank	Minimum Standards
Tier 1 capital ratio	10.8%	8.8%	4.0%
Total capital ratio	18.0%	15.1%	8.0%

For a more comprehensive discussion of these requirements, see Regulations and Supervision in Item 1 of the Annual Report on Form 10-K. Management believes that the Company will continue to exceed regulatory capital requirements.

RETURN ON EQUITY AND ASSETS

The ratio of net income to average total assets and average shareholders equity and other certain equity ratios are presented as follows:

	2007	2006	2005
Percentage of net income to:			
Average total assets	1.49%	1.67%	1.97%
Average shareholders equity	12.14%	12.93%	14.54%
Percentage of dividends declared to net income	78.33%	70.51%	57.10%
Percentage of average shareholders equity to average total assets	12.23%	12.92%	13.56%

LIQUIDITY, INTEREST RATE SENSITIVITY AND MARKET RISK

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 Company, like other financial institutions, must have sufficient funds available to meet its liquidity needs for deposit withdrawals, loan commitments, and expenses. In order to control cash flow, the bank estimates future flows of cash from deposits and loan payments. The primary sources of funds are deposits, principal and interest payments on loans and mortgage-backed securities, as well as Federal Home Loan Bank borrowings. Funds generated are used principally to fund loans and purchase investment securities. Management believes the Company has adequate resources to meet its normal funding requirements.

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

Management monitors and determines the desirable level of liquidity. Consideration is given to loan demand, investment opportunities, deposit pricing and growth potential as well as the current cost of borrowing funds. The Company has a current borrowing capacity at the Federal Home Loan Bank of $220,053,000 with $144,538,000 utilized, leaving $75,515,000 available. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of $29,539,000. The Company s management believes that it has sufficient liquidity to satisfy estimated short-term and long-term funding needs.

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

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 December 31, 2008 assuming a static balance sheet as of December 31, 2007.

	Parallel Rate Shock in Basis Points				
(In Thousands)	**-200**	**-100**	**Static**	**+100**	**+200**
Net interest income	$ 21,322	$ 21,484	$ 21,134	$ 20,578	$ 19,797
Change from static	188	350		(556)	(1,337)
Percent change from static	0.89%	1.66%		(2.63)%	(6.33)%

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 that are not measured by a price index.

CRITICAL ACCOUNTING POLICIES

The Company s accounting policies are integral to understanding the results reported. The accounting policies are described in detail in Note 1 of the consolidated financial statements. Our most complex accounting policies require management s judgment to ascertain the valuation of assets, liabilities, commitments, and contingencies. We have established detailed policies and control procedures that are intended to ensure valuation methods are well controlled and applied consistently from period to period. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. The following is a brief description of our current accounting policies involving significant management valuation judgments.

Other Than Temporary Impairment of Equity Securities

Equity securities are evaluated periodically to determine whether a decline in their value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline, in addition to the reason underlying the decline, to determine whether the loss in value is other than temporary. The term other than temporary is not intended to indicate that the decline is permanent. It indicates that the prospects for a near term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment. Once a decline in value is determined to be other than temporary, the value of the security is reduced and a corresponding charge to earnings is recognized. For a full discussion of the Company s methodology of assessing impairment, refer to Note 3 of Notes and Consolidated Financial Statements of the Annual Report on Form 10-K.

Allowance for Loan Losses

Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. The Company s allowance for loan losses provides for probable losses based upon evaluations of known and inherent risks in the loan portfolio.

Management uses historical information to assess the adequacy of the allowance for loan losses as well as the prevailing business environment; as it is affected by changing economic conditions and various external factors, which may impact the portfolio in ways currently unforeseen. The allowance is increased by provisions for loan losses and by recoveries of loans previously charged-off and reduced by loans charged-off. For a full discussion of the Company s methodology of assessing the adequacy of the reserve for loan losses, refer to Note 1 of Notes and

Consolidated Financial Statements of the Annual Report of Form 10-K.

Goodwill and Other Intangible Assets

As discussed in Note 6 of the Notes to Consolidated Financial Statements of the Annual Report on Form 10-K, the Company must assess goodwill and other intangible assets each year for impairment.

This assessment involves estimating cash flows for future periods. If the future cash flows were less than the recorded goodwill and other intangible assets balances, we would be required to take a charge against earnings to write down the assets to the lower value.

Deferred Tax Assets

We use an estimate of future earnings to support our position that the benefit of our deferred tax assets will be realized. If future income should prove non-existent or less than the amount of the deferred tax assets within the tax years to which they may be applied, the asset may not be realized and our net income will be reduced. Our deferred tax assets are described further in Note 10 of Notes to Consolidated Financial Statements of the Annual Report on Form 10-K.

Pension Benefits

Pension costs and liabilities are dependent on assumptions used in calculating such amounts. These assumptions include discount rates, benefits earned, interest costs, expected return on plan assets, mortality rates, and other factors. In accordance with generally accepted accounting principles, actual results that differ from the assumptions are accumulated and amortized over future periods and, therefore, generally affect recognized expense and the recorded obligation of future periods. While management believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect the Company s pension obligations and future expense. Our pension benefits are described further in Note 11 of Notes to Consolidated Financial Statements of the Annual Report on Form 10-K.

CONTRACTUAL OBLIGATIONS

The Company has various financial obligations, including contractual obligations which may require future cash payments. The following table presents, as of December 31, 2007, significant fixed and determinable contractual obligations to third parties by payment date. Further discussion of the nature of each obligation is included in Notes to the Consolidated Financial Statements of the Annual Report on Form 10-K.

		Payments Due in			
(In Thousands)	**One Year or Less**	**One to Three Years**	**Three to Five Years**	**Over Five Years**	**Total**
Deposits without a stated maturity	$ 203,340	$	$	$	$ 203,340
Time Deposits	157,621	24,372	3,064	625	185,682
Repurchase agreements	17,154				