GERBER SCIENTIFIC INC
Form 10-Q
December 08, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

# FORM 10-Q

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

For the Quarterly Period Ended October 31, 2006

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ___________ to ___________

Commission file number 1-5865

# Gerber Scientific, Inc.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Connecticut | 06-0640743 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 83 Gerber Road West, South Windsor, Connecticut | 06074 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: (860) 644-1551

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 ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.
Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

Common stock $0.01 par value per share.
22,976,912

**Total shares outstanding November 30, 2006**

GERBER SCIENTIFIC, INC.
INDEX
Quarter Ended October 31, 2006


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PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

GERBER SCIENTIFIC, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Quarter Ended October 31, | |
|---|---|---|
| In thousands, except per share data | 2006 | 2005 |
| Revenue: | | |
| Product sales | $128,423 | $ 118,376 |
| Service sales | 16,626 | 15,585 |
| | 145,049 | 133,961 |
| Costs and Expenses: | | |
| Cost of products sold | 91,272 | 84,205 |
| Cost of services sold | 10,145 | 9,306 |
| Selling, general and administrative expenses | 30,990 | 29,308 |
| Research and development | 6,175 | 6,518 |
| Restructuring charges | --- | (195) |
| | 138,582 | 129,142 |
| Operating income | 6,467 | 4,819 |
| Other income (expense), net | 279 | (508) |
| Loss on early extinguishment of debt | --- | (2,483) |
| Interest expense | (971) | (1,525) |
| Income before income taxes | 5,775 | 303 |
| Income tax expense | 2,086 | 427 |
| Net income (loss) | $ 3,689 | $ (124) |
| Earnings (Loss) per share of common stock: | | |
| Basic | $ 0.16 | $ (0.01) |
| Diluted | $ 0.16 | $ (0.01) |
| Weighted average shares outstanding: | | |

| | | |
|---|---|---|
| Basic | 22,854 | 22,368 |
| Diluted | 23,343 | 22,368 |

See accompanying notes to condensed consolidated financial statements.

GERBER SCIENTIFIC, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

**(Unaudited)**

| In thousands, except per share data | Six Months Ended October 31, 2006 | Six Months Ended October 31, 2005 |
|---|---|---|
| Revenue: | | |
| Product sales | $ 249,835 | $ 231,793 |
| Service sales | 32,702 | 30,932 |
| | 282,537 | 262,725 |
| Costs and Expenses: | | |
| Cost of products sold | 177,520 | 164,070 |
| Cost of services sold | 19,680 | 18,949 |
| Selling, general and administrative expenses | 62,353 | 58,883 |
| Research and development | 12,143 | 12,830 |
| Restructuring charges | --- | (231) |
| | 271,696 | 254,501 |
| Operating income | 10,841 | 8,224 |
| Other income (expense), net | 120 | (683) |
| Loss on early extinguishment of debt | --- | (2,483) |
| Interest expense | (1,748) | (2,956) |
| Income before income taxes | 9,213 | 2,102 |
| Income tax expense | 3,500 | 3,309 |
| Net income (loss) | $ 5,713 | $ (1,207) |
| Earnings (Loss) per share of common stock: | | |
| Basic | $ 0.25 | $ (0.05) |
| Diluted | $ 0.25 | $ (0.05) |
| Weighted average shares outstanding: | | |
| Basic | 22,737 | 22,340 |
| Diluted | 23,183 | 22,340 |

See accompanying notes to condensed consolidated financial statements.

GERBER SCIENTIFIC, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

| In thousands | October 31, 2006 | April 30, 2006 |
|---|---|---|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 10,312 | $ 14,145 |
| Accounts receivable, net | 100,150 | 92,422 |
| Inventories | 59,163 | 53,794 |
| Deferred tax assets | 9,711 | 10,651 |
| Prepaid expenses and other current assets | 6,389 | 6,067 |
| | 185,725 | 177,079 |
| Total current assets | | |
| Property, plant and equipment, net | 36,617 | 38,366 |
| Goodwill | 52,218 | 51,554 |
| Deferred tax assets | 28,285 | 27,696 |
| Other assets, net | 15,500 | 15,785 |
| Total Assets | $ 318,345 | $ 310,480 |
| Liabilities and Shareholders' Equity | | |
| Current Liabilities: | | |
| Current portion of long-term debt | $ 831 | $ 284 |
| Accounts payable | 47,852 | 53,886 |
| Accrued compensation and benefits | 18,609 | 21,670 |
| Other accrued liabilities | 24,118 | 21,539 |
| Deferred revenue | 13,638 | 14,039 |
| | 105,048 | 111,418 |
| Total current liabilities | | |
| Long-term debt | 39,954 | 36,836 |
| Accrued pension benefit liabilities | 18,996 | 19,641 |
| Other liabilities | 17,013 | — |
| | | 16,969 |
| | 75,963 | 73,446 |
| Commitments and contingencies | | |

| | | |
|---|---|---|
| Shareholders' Equity: | | |
| Preferred stock | --- | --- |
| Common stock | 236 | 233 |
| Additional paid-in capital | 71,350 | 67,339 |
| Retained earnings | 75,495 | 69,782 |
| Treasury stock, at cost | (13,173) | (13,496) |
| Unamortized value of restricted stock grants | --- | (136) |
| Accumulated other comprehensive income | 3,426 | 1,894 |
| | 137,334 | 125,616 |
| Total Liabilities and Shareholders' Equity | $ 318,345 | $ 310,480 |

See accompanying notes to condensed consolidated financial statements.

GERBER SCIENTIFIC, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

**(Unaudited)**

| | Six Months Ended October 31, | |
|---|---|---|
| In thousands | 2006 | 2005 |
| Cash flows from operating activities: | | |
| Net income (loss) | $ 5,713 | $ (1,207) |
| Adjustments to reconcile net income (loss) to cash (used for) provided by operating activities: | | |
| Depreciation and amortization | 4,209 | 4,307 |
| Restructuring charges | --- | (231) |
| Deferred income taxes | 448 | 726 |
| Loss on early extinguishment of debt | --- | 2,483 |
| Stock-based compensation cost | 611 | 29 |
| Other non-cash items | 617 | 1,159 |
| Changes in operating accounts: | | |
| Accounts receivable | (8,224) | 1,621 |
| Inventories | (4,929) | (39) |
| Prepaid expenses and other assets | 441 | (107) |
| Accounts payable and other liabilities | (4,446) | 1,702 |
| Accrued compensation and benefits | (3,232) | 3,159 |
| Net cash (used for) provided by operating activities | (8,792) | 13,602 |
| Cash flows from investing activities: | | |
| Capital expenditures | (1,533) | (5,241) |
| Proceeds from sale of investments | 365 | --- |
| Purchases of investments | (163) | --- |
| Proceeds from sale of assets | --- | 434 |
| Acquisitions of intangible assets | (338) | (532) |
| Net cash used for investing activities | (1,669) | (5,339) |
| Cash flows from financing activities: | | |
| Debt repayments | (139,179) | (157,656) |
| Debt proceeds | 142,840 | 157,852 |
| Debt issue costs | --- | (1,146) |

| | | |
|---|---|---|
| Excess tax benefits from stock-based compensation | 902 | --- |
| Stock issued under employee plans | 2,677 | 419 |
| Net cash provided by (used for) financing activities | 7,240 | (531) |
| Effect of exchange rate changes on cash | (612) | (1,675) |
| (Decrease) Increase in cash and cash equivalents | (3,833) | 6,057 |
| Cash and cash equivalents at beginning of year | 14,145 | 6,148 |
| Cash and cash equivalents at end of period | $ 10,312 | $ 12,205 |

See accompanying notes to condensed consolidated financial statements.

GERBER SCIENTIFIC, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Gerber Scientific, Inc. and its subsidiaries (collectively, the "Company") have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial statements and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. All significant intercompany transactions have been eliminated in the condensed consolidated financial statements. The condensed consolidated financial statements have been prepared, in all material respects, in accordance with the same accounting principles followed in the preparation of the Company's annual financial statements for the fiscal year ended April 30, 2006, except for the adoption of the Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 123R, "Share-Based Payment" ("SFAS 123R"), on May 1, 2006. Management believes that all adjustments, which include only normal recurring adjustments necessary to fairly present the Company's consolidated financial position, results of operations and cash flows for the periods reported, have been included. The financial information included in this Quarterly Report on Form 10-Q should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company's Annual Report on Form 10-K for the fiscal year ended April 30, 2006, filed with the Securities and Exchange Commission on July 28, 2006. The condensed consolidated balance sheet has been derived from the April 30, 2006 audited consolidated financial statements, but does not include all of the information and disclosures required by accounting principles generally accepted in the United States of America. Certain reclassifications have been made to the prior year amounts disclosed in the condensed consolidated financial statements to conform to the presentation for the fiscal quarter and six months ended October 31, 2006.

The Company has expanded its Revenue Recognition significant accounting policy disclosure in order to provide an improved understanding of its accounting for distribution-related sales. The paragraph below should be read in conjunction with the Company's significant accounting policies disclosed in its Annual Report on Form 10-K for the fiscal year ended April 30, 2006.

Distribution

- The Company's Apparel and Flexible Materials sales are primarily made through its domestic and international in-house direct distribution and service network. Independent agents and third party distributors are used in certain foreign countries. The Ophthalmic Lens Processing sales are primarily made through its in-house sales force and through independent agents in certain foreign countries. The Sign Making and Specialty Graphics segment's sales are made through both third party distributors and the Company's wholly-owned subsidiary, Spandex. The Company's sales of third-party purchased products are recorded on a gross revenue basis in accordance with Emerging Issues Task Force Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent." The Company is the primary obligor in these transactions, bears general inventory and credit risks and sets the pricing terms with its customers.

Note 2. Stock-Based Compensation

The Company has stock-based compensation plans under which incentive and non-qualified stock options and restricted stock may be granted to employees from common stock. Directors may receive share grants from treasury stock. Options issued by the Company under its stock plans have a term of ten years and generally vest ratably over a period of three years. Restricted stock grants are expensed over the vesting period of the award. Under all stock plans, the exercise price of the stock option is set on the grant date and may not be less than the fair market value per share on that date.

On May 1, 2006, the Company adopted the provisions of SFAS 123R, which establishes accounting for equity instruments exchanged for employee services. Under the provisions of SFAS 123R, stock-based compensation cost is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity grant). Prior to May 1, 2006, the Company accounted for stock-based compensation to employees in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and related interpretations. The Company also followed the disclosure requirements of SFAS 123, "Accounting for Stock-Based Compensation," as amended by SFAS 148, "Accounting for Stock-Based Compensation - Transition and Disclosure." The Company elected to adopt the prospective transition method as provided by SFAS 123R and, accordingly, financial statement amounts for the periods prior to May 1, 2006 presented in this Form 10-Q have not been restated to reflect the fair value method of expensing stock-based compensation.

The following table illustrates the effects on net loss and loss per share for the quarter and six months ended October 31, 2005 as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee awards.

| In thousands | Quarter Ended October 31, 2005 | Six Months Ended October 31, 2005 |
|---|---|---|
| Net loss, as reported | $ (124) | $ (1,207) |
| Add: Stock-based compensation expense included in reported net loss, net of related tax effects | 7 | 14 |
| Less: Stock-based employee compensation expense determined under the Black-Scholes option pricing model, net of related tax effects | (89) | (177) |
| **Net loss, pro forma** | $ (206) | $ (1,370) |
| | | |
| Loss per share: | | |
| Basic, as reported | $(0.01) | $(0.05) |
| Basic, pro forma | $(0.01) | $(0.06) |
| Diluted, as reported | $(0.01) | $(0.05) |
| Diluted, pro forma | $(0.01) | $(0.06) |

The Company's condensed consolidated statements of operations included $0.2 million and $0.4 million, net of $0.1 million and $0.2 million of tax benefits, respectively, of stock-based compensation expense for the fiscal quarter and six months ended October 31, 2006. The stock-based compensation expense was recorded substantially within selling, general and administrative expenses.

The Company estimates the fair value of stock options using the Black-Scholes valuation model. Key assumptions used to estimate the fair value of stock options include the exercise price of the award, the expected option term, the expected volatility of the Company's stock over the expected option term and the risk-free interest rate over the expected option term. No dividend yield was assumed for the fiscal quarter or six months ended October 31, 2006 or 2005. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by employees who receive equity awards.

The fair value of each option grant was estimated on the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions.

| | Quarter and Six Months Ended October 31, 2006 | Quarter and Six Months Ended October 31, 2005 |
|---|---|---|
| Expected option term[1] | 6.0 years | 5.7 years |
| Expected volatility[2] | 55% | 70% |
| Risk-free interest rate[3] | 4.8% | 3.9% |

(1) The option term was determined using the simplified method for estimating expected option life. The Company's options qualify as "plain-vanilla" options.

(2) The stock volatility for each grant is measured using the weighted average of historical daily price changes of the Company's common stock over the most recent period equal to the expected option life of the grant.

(3) The risk-free interest rate is based on the U.S. Treasury note yield in effect at the time of grant.

The Company did not recognize compensation expense for employee stock-based awards for the fiscal quarter or six months ended October 31, 2005. The Company recognized compensation expense under APB 25 related to restricted stock.

Stock option activity under all of the Company's stock plans since April 30, 2006 is summarized as follows:

| | Shares (in thousands) | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (in millions) |
|---|---|---|---|---|
| Outstanding as of April 30, 2006 | 2,846 | $11.08 | 5.2 years | |
| Options granted | 5 | $15.00 | | |
| Options exercised | (350) | $ 7.71 | | $2.3 |
| Options canceled | (224) | $15.04 | | |
| Outstanding as of October 31, 2006 | 2,277 | $11.21 | 5.0 years | $11.0 |
| Options exercisable at October 31, 2006 | 1,798 | | | $8.5 |

The following table summarizes information about stock options outstanding as of October 31, 2006:

–

| Range of Exercise Prices | Outstanding Options Shares (in thousands) | Weighted-Average Remaining Contractual Term | Weighted-Average Exercise Price | **Exercisable Options** Shares (in thousands) | Weighted-Average Exercise Price |
|---|---|---|---|---|---|
| $3.35 - $5.03 | 247 | 5.6 years | $ 3.42 | 247 | $ 3.42 |
| $5.04 - $7.54 | 580 | 6.5 years | $ 6.80 | 413 | $ 6.88 |
| $7.55 - $11.31 | 644 | 6.9 years | $ 9.32 | 342 | $ 9.20 |
| $11.32 - $16.96 | 408 | 2.7 years | $14.37 | 398 | $14.39 |
| $16.97 - $25.44 | 377 | 1.6 years | $21.99 | 377 | $21.99 |
| $25.45 - $28.12 | 21 | 1.0 years | $27.33 | 21 | $27.33 |
| | 2,277 | 5.0 years | $11.21 | 1,798 | $11.92 |

The following table summarizes the activity for the Company's nonvested shares of restricted stock during the fiscal six months ended October 31, 2006:

| In thousands except per share amounts | Shares | Weighted-Average Fair Value |
|---|---|---|
| Nonvested as of April 30, 2006 | 23 | $ 8.03 |
| Granted | 2 | $15.43 |
| Vested | (5) | $ 6.92 |
| Forfeited | (1) | $ 9.45 |
| Nonvested as of October 31, 2006 | 19 | $ 8.92 |

As of October 31, 2006, there was $1.8 million of unrecognized compensation cost related to nonvested stock-based compensation arrangements granted under the Company's stock plans. That cost is expected to be recognized over a weighted-average period of 2.6 years.

Note 3. Inventories

Inventories, net of reserves, were as follows:

| In thousands | October 31, 2006 | April 30, 2006 |
|---|---|---|
| Raw materials and purchased parts | $ 46,039 | $ 41,061 |
| Work in process | 1,454 | 1,497 |
| Finished goods | 11,670 | 11,236 |
| **Total inventories** | $ 59,163 | $ 53,794 |

Note 4. Restructuring

The Company's restructuring accrual as of April 30, 2006 was related to a leased facility consolidation in the Sign Making and Specialty Graphics segment that was initiated in the fiscal year ended April 30, 2004. During the six months ended October 31, 2006, payments of $0.1 million reduced the accrual to an ending balance of $1.3 million. The remaining cash payments will continue over the life of the lease, through the fiscal year ending April 30, 2019.

Note 5. Goodwill and Intangible Assets

The table below presents the gross carrying amount and accumulated amortization of the Company's acquired intangible assets other than goodwill included in Other assets, net on the Company's Condensed Consolidated Balance Sheets:

| | October 31, 2006 | | April 30, 2006 | |
|---|---|---|---|---|
| In thousands | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortized intangible assets: | | | | |
| Patents | $ 7,366 | $ 2,860 | $ 7,313 | $ 2,775 |
| Other | 517 | 215 | 525 | 194 |
| **Total amortized intangible assets** | $ 7,883 | $ 3,075 | $ 7,838 | $ 2,969 |

Intangible asset amortization expense was $0.2 million and $0.3 million for the quarter and six months ended October 31, 2006, respectively. Intangible asset amortization expense was $0.1 million and $0.3 million for the quarter and six months ended October 31, 2005, respectively. Intangible asset amortization is estimated to be approximately $0.5 million annually for the fiscal year ending April 30, 2007, and $0.4 million for each of the fiscal years ending April 30, 2008 through 2012.

There were no impairments of goodwill during the six months ended October 31, 2006 or 2005. Balances and changes in the carrying amount of goodwill for the six months ended October 31, 2006 were as follows:

| In thousands | Sign Making and Specialty Graphics | Apparel and Flexible Materials | Ophthalmic Lens Processing | Total |
|---|---|---|---|---|
| Balance as of April 30, 2006 | $ 22,060 | $ 12,498 | $ 16,996 | $51,554 |
| Effects of currency translation | 756 | (92) | --- | 664 |
| **Balance as of October 31, 2006** | $ 22,816 | $ 12,406 | $ 16,996 | $52,218 |

Note 6. Segment Reporting

The Company's operations are classified into three reportable operating segments: Sign Making and Specialty Graphics, Apparel and Flexible Materials and Ophthalmic Lens Processing. The Sign Making and Specialty Graphics reportable operating segment is comprised of the Gerber Scientific Products and Spandex, Ltd. business units.

The following table presents revenue by operating segment.

| | Quarter Ended October 31, | | Six Months Ended October 31, | |
|---|---|---|---|---|
| In thousands | 2006 | 2005 | 2006 | 2005 |
| Sign Making and Specialty Graphics: | | | | |
| Gerber Scientific Products | $ 23,298 | $ 22,985 | $ 46,435 | $ 45,779 |
| Spandex | 52,283 | 48,051 | 102,305 | 95,177 |

| | | | | |
|---|---|---|---|---|
| Sign Making and Specialty Graphics | 75,581 | 71,036 | 148,740 | 140,956 |
| Apparel and Flexible Materials | 49,038 | 44,653 | 95,581 | 86,882 |
| Ophthalmic Lens Processing | 20,430 | 18,272 | 38,216 | 34,887 |
| **Consolidated revenue** | $ 145,049 | $ 133,961 | $ 282,537 | $ 262,725 |

The table below presents operating income (loss) by segment and a reconciliation to consolidated operating income.

| | Quarter Ended October 31, | | Six Months Ended October 31, | |
|---|---|---|---|---|
| In thousands | 2006 | 2005 | 2006 | 2005 |
| Sign Making and Specialty Graphics: | | | | |
| Gerber Scientific Products | $ 1,557 | $ 1,539 | $ 3,263 | $ 3,662 |
| Spandex | 1,717 | 1,120 | 3,249 | 2,077 |
| Sign Making and Specialty Graphics | 3,274 | 2,659 | 6,512 | 5,739 |
| Apparel and Flexible Materials | 7,008 | 5,744 | 12,975 | 10,812 |
| Ophthalmic Lens Processing | 381 | 670 | 641 | (12) |
| Segment operating income | 10,663 | 9,073 | 20,128 | 16,539 |
| Corporate operating expenses | (4,196) | (4,254) | (9,287) | (8,315) |
| **Consolidated operating income** | $ 6,467 | $ 4,819 | $10,841 | $ 8,224 |

Note 7. Comprehensive Income (Loss)

The Company's total comprehensive income (loss) was as follows:

| | Quarter Ended October 31, | | Six Months Ended October 31, | |
|---|---|---|---|---|
| In thousands | 2006 | 2005 | 2006 | 2005 |
| Net income (loss) | $ 3,689 | $ (124) | $ 5,713 | $ (1,207) |
| Other comprehensive income (loss): | | | | |
| Foreign currency translation adjustments | 597 | 215 | 1,427 | (6,135) |
| Unrealized investment income, net of taxes | 148 | --- | 105 | --- |
| **Total comprehensive income (loss)** | $ 4,434 | $ 91 | $ 7,245 | $ (7,342) |

Note 8. Earnings (Loss) Per Share

Basic and diluted earnings (loss) per common share are calculated in accordance with the provisions of FASB Statement of Financial Accounting Standards No. 128, "Earnings per Share." Basic earnings (loss) per common share are equal to net income (loss) divided by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per common share are equal to net income (loss) divided by the weighted average number of common shares outstanding during the period, including the effect of stock options and stock awards, where such effect is dilutive. The following tables set forth the computation of basic and diluted net earnings (loss) per common share:

| | Quarter Ended October 31, 2006 | | | Quarter Ended October 31, 2005 | | |
|---|---|---|---|---|---|---|
| In thousands except per share amounts | Net Income | Average Shares | Per Share Amount | Net Loss | Average Shares | Per Share Amount |

| | | | | | | |
|---|---|---|---|---|---|---|
| Basic earnings (loss) per share | $ 3,689 | 22,854 | $ 0.16 | $ (124) | 22,368 | $ (0.01) |
| Effect of dilutive options and awards | --- | 489 | --- | --- | --- | --- |
| **Diluted earnings (loss) per share** | $ 3,689 | 23,343 | $ 0.16 | $ (124) | 22,368 | $ (0.01) |

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| In thousands except per share amounts | Six Months Ended October 31, 2006 | | | Six Months Ended October 31, 2005 | | |
|---|---|---|---|---|---|---|
| | **Net Income** | Average Shares | Per Share Amount | **Net Loss** | Average Shares | Per Share Amount |
| **Basic earnings (loss) per share** | $ 5,713 | 22,737 | $ 0.25 | $ (1,207) | 22,340 | $ (0.05) |
| **Effect of dilutive options and awards** | --- | 446 | --- | --- | --- | --- |
| **Diluted earnings (loss) per share** | $ 5,713 | 23,183 | $ 0.25 | $ (1,207) | 22,340 | $ (0.05) |

For both the quarter and six months ended October 31, 2005, stock options exercisable for 0.2 million shares of common stock were excluded from the calculation of diluted loss per share because the Company reported a net loss for those periods.

Note 9. Guarantees

The Company extends financial and product performance guarantees to third parties. There have been no material changes to guarantees outstanding during the quarter and six months ended October 31, 2006.

Changes in the carrying amounts of product warranties were as follows:

| In thousands | Six Months Ended October 31, 2006 | 2005 |
|---|---|---|
| Beginning balance | $ 2,445 | $ 1,782 |
| Warranties issued in the current period | 2,453 | 1,487 |
| Reductions for costs incurred | (2,627) | (1,678) |
| Ending balance | $ 2,271 | $ 1,591 |

Note 10. Employee Benefit Plans

Components of net periodic benefit cost were as follows:

| In thousands | Quarter Ended October 31, 2006 | 2005 | Six Months Ended October 31, 2006 | 2005 |
|---|---|---|---|---|
| Service cost | $ 614 | $ 765 | $ 1,228 | $ 1,530 |
| Interest cost | 1,576 | 1,484 | 3,151 | 2,968 |
| Expected return on plan assets | (1,533) | (1,511) | (3,066) | (3,023) |
| Amortization of: | | | | |
| Prior service cost | 73 | 73 | 146 | 146 |
| Actuarial loss | 188 | 456 | 376 | 913 |
| Net periodic benefit cost | $ 918 | $ 1,267 | $ 1,835 | $ 2,534 |

For the quarter and six months ended October 31, 2006, $1.4 million and $2.2 million, respectively, in cash contributions were made to the Gerber Scientific, Inc. and Participating Subsidiaries Pension Plan. The Company expects to contribute $4.1 million to the plan for the fiscal year ending April 30, 2007 in accordance with funding requirements.

Note 11. Income Taxes

The Company's effective tax rate was 36.1 percent and 38.0 percent for the quarter and six months ended October 31, 2006, respectively, and 140.9 percent and 157.4 percent for the quarter and six months ended October 31, 2005, respectively. As compared with the statutory rate of 35.0 percent, the higher consolidated tax rate for the quarter and six months ended October 31, 2006 was primarily attributable to the establishment of certain valuation allowances for anticipated losses for the fiscal year ending April 30, 2007 in certain foreign jurisdictions where the Company was unable to take a tax benefit. The higher consolidated tax rates for the quarter and six months ended October 31, 2005 were primarily attributable to a tax charge of $2.3 million recorded as a result of a change in United Kingdom tax law and the application of interim tax reporting requirements related to losses incurred in foreign jurisdictions where the Company was unable to take a tax benefit. Additionally, the establishment of valuation allowances for anticipated losses for the fiscal year ended April 30, 2006 in those jurisdictions also negatively impacted the consolidated tax rate.

Note 12. Recently Issued Accounting Standards

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS 157"), which is effective for the Company beginning in the fiscal year ending April 30, 2008. SFAS 157 defines fair value, establishes a framework for measuring fair value and expands related disclosure requirements. The Company is evaluating the potential impact of SFAS 157 on its consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106 and 132(R)" ("SFAS 158"). SFAS 158 requires balance sheet recognition of the overfunded or underfunded status of pension plans. Under SFAS 158, actuarial gains and losses, prior service costs or credits, and any remaining transition assets or obligations that have not been recognized under previous accounting standards must be recognized in accumulated other comprehensive income, net of tax effects, until they are amortized as a component of net periodic benefit cost. SFAS 158 is required to be adopted as of April 30, 2007. Based on the Company's unfunded obligation as of April 30, 2006, the adoption of SFAS 158 would decrease total assets by approximately $1.4 million, increase total liabilities by approximately $13.5 million and reduce total shareholders' equity by approximately $14.9 million. The adoption of SFAS 158 will not affect the Company's results of operations. At the time of adoption on April 30, 2007, plan performance and actuarial assumptions used could have a significant impact on the actual amounts recorded.

In July 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return (including a decision whether to file or not file a return in a particular jurisdiction). Under FIN 48, the financial statements will reflect expected future tax consequences of such positions presuming the taxing authorities' full knowledge of the position and all relevant facts, but without considering time values. FIN 48 substantially changes the applicable accounting model and is likely to cause greater volatility in income statements as more items are recognized discretely within income tax expense. The Interpretation also revises disclosure requirements and introduces a prescriptive, annual tabular rollforward of the unrecognized tax benefits. FIN 48 is effective for the Company beginning May 1, 2007. The Company is evaluating the potential impact of adopting FIN 48 on its consolidated financial position and results of operations.

Note 13. Subsequent Event

On November 3, 2006, the Company acquired for cash certain assets and assumed certain liabilities of Rápida, a former distributor of the Company's Gerber Technology business in Spain. The acquisition of certain of the former distributor's business operations is expected to provide the Company with greater flexibility and improved profitability in Spain through a more focused direct sales and service effort to Gerber Technology customers. Under the terms of the asset purchase agreement, the Company paid $1.5 million to Rápida. The Company funded this acquisition through borrowings on its existing credit facility and operating cash flows.

The Company also assumed certain current liabilities. In addition, the agreement provides for additional consideration in the form of commission payments to be paid contingent upon the closing of certain sales contracts in-progress at the time of acquisition. The operating results of this business will be included in the Company's consolidated financial statements from the date of acquisition.

The Company is in the process of determining the fair value of the acquired intangible assets through the use of certain valuation models. Acquired intangible assets include a service portfolio of business, customer list and non-compete agreements. Any remaining unallocated purchase price will be recorded as goodwill of the Apparel and Flexible Materials operating segment.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

| | | |
|---|---|---|
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | $ | 634,504 |
| | $ | 628,138 |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF INCOME

(UNAUDITED)

| (In Thousands, Except Per Share Data) | Three Months Ended June 30, 2008 | Three Months Ended June 30, 2007 | Six Months Ended June 30, 2008 | Six Months Ended June 30, 2007 |
|---|---|---|---|---|
| INTEREST AND DIVIDEND INCOME | | | | |
| Loans including fees | $ 6,246 | $ 6,516 | $ 12,625 | $ 12,939 |
| Investment Securities: | | | | |
| Taxable | 1,276 | 924 | 2,466 | 1,747 |
| Tax-exempt | 1,210 | 1,052 | 2,436 | 2,163 |
| Dividend and other interest income | 204 | 301 | 457 | 623 |
| TOTAL INTEREST AND DIVIDEND INCOME | 8,936 | 8,793 | 17,984 | 17,472 |
| INTEREST EXPENSE | | | | |
| Deposits | 2,551 | 2,868 | 5,092 | 5,380 |
| Short-term borrowings | 257 | 227 | 686 | 732 |
| Long-term borrowings, FHLB | 972 | 904 | 2,169 | 1,826 |
| TOTAL INTEREST EXPENSE | 3,780 | 3,999 | 7,947 | 7,938 |
| NET INTEREST INCOME | 5,156 | 4,794 | 10,037 | 9,534 |
| PROVISION FOR LOAN LOSSES | 60 | 10 | 120 | 50 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 5,096 | 4,784 | 9,917 | 9,484 |
| NON-INTEREST INCOME | | | | |
| Service charges | 540 | 567 | 1,110 | 1,108 |
| Securities (losses) gains, net | (251) | 293 | (213) | 619 |
| Bank-owned life insurance | 91 | 86 | 246 | 201 |
| Gain on sale of loans | 212 | 234 | 364 | 372 |
| Insurance commissions | 486 | 550 | 1,066 | 988 |
| Other | 543 | 456 | 962 | 872 |
| TOTAL NON-INTEREST INCOME | 1,621 | 2,186 | 3,535 | 4,160 |
| NON-INTEREST EXPENSE | | | | |
| Salaries and employee benefits | 2,469 | 2,301 | 4,920 | 4,582 |
| Occupancy, net | 314 | 337 | 652 | 668 |
| Furniture and equipment | 287 | 297 | 572 | 583 |
| Pennsylvania shares tax | 105 | 161 | 210 | 322 |
| Amortization of investment in limited partnerships | 178 | 142 | 356 | 283 |
| Other | 1,158 | 1,102 | 2,246 | 2,030 |
| TOTAL NON-INTEREST EXPENSE | 4,511 | 4,340 | 8,956 | 8,468 |
| INCOME BEFORE INCOME TAX PROVISION | 2,206 | 2,630 | 4,496 | 5,176 |
| INCOME TAX PROVISION | 149 | 295 | 308 | 560 |
| NET INCOME | $ 2,057 | $ 2,335 | $ 4,188 | $ 4,616 |
| EARNINGS PER SHARE - BASIC | $ 0.53 | $ 0.60 | $ 1.08 | $ 1.19 |

| | | | | |
|---|---|---|---|---|
| EARNINGS PER SHARE - DILUTED | $ 0.53 | $ 0.60 | $ 1.08 | $ 1.19 |
| WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC | 3,865,977 | 3,889,139 | 3,870,359 | 3,893,286 |
| WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED | 3,866,115 | 3,889,401 | 3,870,523 | 3,893,586 |
| DIVIDENDS PER SHARE | $ 0.46 | $ 0.44 | $ 0.92 | $ 0.88 |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

| (In Thousands Except Per Share Data) | COMMON STOCK SHARES | COMMON STOCK AMOUNT | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) | TREASURY STOCK | TOTAL SHAREHOLDERS EQUITY |
|---|---|---|---|---|---|---|---|
| Balance, December 31, 2007 | 4,006,934 | $ 33,391 | $ 17,888 | $ 27,707 | $ (3,534) | $ (4,893) | $ 70,559 |
| Comprehensive Income: | | | | | | | |
| Net income | | | | 4,188 | | | 4,188 |
| Unrealized loss on investments available for sale, net of reclassification adjustment, net of income tax benefit of $2,938 | | | | | (5,701) | | (5,701) |
| Total comprehensive loss | | | | | | | (1,513) |
| Dividends declared, ($0.92 per share) | | | | (3,560) | | | (3,560) |
| Purchase of treasury stock (18,516 shares) | | | | | | (585) | (585) |
| Cumulative effect of change in accounting for postretirement benefits | | | | (437) | | | (437) |
| Stock options exercised | 330 | 3 | 8 | | | | 11 |
| Common shares issued for employee stock purchase plan | 1,569 | 13 | 34 | | | | 47 |
| Balance, June 30, 2008 | 4,008,833 | $ 33,407 | $ 17,930 | $ 27,898 | $ (9,235) | $ (5,478) | $ 64,522 |

| (In Thousands Except Per Share Data) | COMMON STOCK SHARES | COMMON STOCK AMOUNT | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) | TREASURY STOCK | TOTAL SHAREHOLDERS EQUITY |
|---|---|---|---|---|---|---|---|
| Balance, December 31, 2006 | 4,003,514 | $ 33,362 | $ 17,810 | $ 25,783 | $ 1,560 | $ (3,921) | $ 74,594 |
| Comprehensive Income: | | | | | | | |
| Net income | | | | 4,616 | | | 4,616 |
| Unrealized loss on investments available for sale, net of reclassification adjustment, net of income tax benefit of $2,882 | | | | | (5,594) | | (5,594) |
| Total comprehensive loss | | | | | | | (978) |
| Dividends declared, ($0.88 per share) | | | | (3,425) | | | (3,425) |
| Purchase of treasury stock (15,030 shares) | | | | | | (529) | (529) |
| Stock options exercised | 330 | 3 | 5 | | | | 8 |
| Common shares issued for employee stock purchase plan | 1,498 | 13 | 37 | | | | 50 |
| Balance, June 30, 2007 | 4,005,342 | $ 33,378 | $ 17,852 | $ 26,974 | $ (4,034) | $ (4,450) | $ 69,720 |

PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(UNAUDITED)

| (In Thousands) | Three Months Ended June 30, 2008 | Three Months Ended June 30, 2007 | Six Months Ended June 30, 2008 | Six Months Ended June 30, 2007 |
|---|---|---|---|---|
| Net Income | $ 2,057 | $ 2,335 | $ 4,188 | $ 4,616 |
| Other comprehensive loss: | | | | |
| Change in net unrealized losses on available for sale securities | (7,061) | (7,194) | (8,852) | (7,857) |
| Less: Reclassification adjustment for net (losses)gains included in net income | (251) | 293 | (213) | 619 |
| Other comprehensive loss before tax | (6,810) | (7,487) | (8,639) | (8,476) |
| Income tax benefit related to other comprehensive loss | (2,315) | (2,546) | (2,938) | (2,882) |
| Other comprehensive loss, net of tax | (4,495) | (4,941) | (5,701) | (5,594) |
| Comprehensive loss | $ (2,438) | $ (2,606) | $ (1,513) | $ (978) |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(UNAUDITED)

| (In Thousands) | Six Months Ended June 30, 2008 | 2007 |
|---|---|---|
| OPERATING ACTIVITIES | | |
| Net Income | $ 4,188 | $ 4,616 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 323 | 366 |
| Provision for loan losses | 120 | 50 |
| Accretion and amortization of investment security discounts and premiums | (636) | (479) |
| Securities losses (gains), net | 213 | (619) |
| Originations of loans held for sale | (16,137) | (19,875) |
| Proceeds of loans held for sale | 17,125 | 18,618 |
| Gain on sale of loans | (364) | (372) |
| Increases in bank-owned life insurance | (246) | (201) |
| Other, net | (1,465) | 207 |
| Net cash provided by operating activities | 3,121 | 2,311 |
| INVESTING ACTIVITIES | | |
| Investment securities available for sale: | | |
| Proceeds from sales | 36,098 | 39,212 |
| Proceeds from calls and maturities | 5,139 | 3,165 |
| Purchases | (45,132) | (46,179) |
| Investment securities held to maturity: | | |
| Proceeds from calls and maturities | 154 | 11 |
| Net (increase) decrease in loans | (5,520) | 4,136 |
| Acquisition of bank premises and equipment | (998) | (593) |
| Proceeds from the sale of foreclosed assets | 70 | 66 |
| Purchase of bank-owned life insurance | (698) | (602) |
| Proceeds from redemption of regulatory stock | 3,560 | 2,550 |
| Purchases of regulatory stock | (1,996) | (2,097) |
| Net cash used for investing activities | (9,323) | (331) |
| FINANCING ACTIVITIES | | |
| Net increase in interest-bearing deposits | 43,662 | 13,872 |
| Net increase (decrease) in noninterest-bearing deposits | 5,237 | (3,160) |
| Proceeds of long-term borrowings, FHLB | | 10,000 |
| Repayment of long-term borrowings, FHLB | (29,600) | (16,500) |
| Net decrease in short-term borrowings | (7,234) | (6,338) |
| Dividends paid | (3,560) | (3,425) |
| Issuance of common stock | 47 | 50 |
| Stock options exercised | 11 | 8 |
| Purchase of treasury stock | (585) | (529) |
| Net cash provided by (used for) financing activities | 7,978 | (6,022) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 1,776 | (4,042) |
| CASH AND CASH EQUIVALENTS, BEGINNING | 15,433 | 15,373 |
| CASH AND CASH EQUIVALENTS, ENDING | $ 17,209 | $ 11,331 |
| | | |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION | | |

| | | | | |
|---|---|---|---|---|
| Interest paid | $ | 8,228 | $ | 7,823 |
| Income taxes paid | | 1,075 | | 1,185 |

See accompanying notes to the unaudited consolidated financial statements.

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

**NOTES TO**

**CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1. Basis of Presentation**

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

The interim financial statements are unaudited but, in the opinion of management, reflect all adjustments necessary for the fair presentation of results for such periods. The results of operations for any interim period are not necessarily indicative of results for the full year. These financial statements should be read in conjunction with financial statements and notes thereto contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

The accounting policies followed in the presentation of interim financial results are the same as those followed on an annual basis. These policies are presented on pages 41 through 47 of the Annual Report on Form 10-K for the year ended December 31, 2007.

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

**Note 2. Recent Accounting Pronouncements**

In December 2007, the FASB issued FAS No. 141 (revised 2007), Business Combinations ( FAS 141(R) ), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. FAS No. 141(R) is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Company s results of operations or financial position.

In September 2006, the FASB issued FAS No. 157, Fair Value Measurements, which provides enhanced guidance for using fair value to measure assets and liabilities. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The Standard does not expand the use of fair value in any new circumstances. FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. In February 2008, the FASB issued Staff Position No. 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other

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Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13, which removed leasing transactions accounted for under FAS No. 13 and related guidance from the scope of FAS No. 157. Also in February 2008, the FASB issued Staff Position No.157-2, Partial Deferral of the Effective Date of Statement 157, which deferred the effective date of FAS No. 157 for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008. On January 1, 2008, the Company adopted FAS No. 157 which did not have a material effect on the Company s results of operations or financial position, see Note 8.

In February 2007, the FASB issued FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115, which provides all entities with an option to report selected financial assets and liabilities at fair value. The objective of the FAS No. 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in earnings caused by measuring related assets and liabilities differently without having to apply the complex provisions of hedge accounting. FAS No. 159 is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided the entity also elects to apply the provisions of FAS No. 157, Fair Value Measurements. On January 31, 2008, the Company adopted FAS No. 159 which did not have a material effect on the Company s results of operations or financial position.

In December 2007, the FASB issued FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51. FAS No. 160 amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Among other requirements, this statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. FAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Company s results of operations or financial position.

In September 2006, the FASB reached consensus on the guidance provided by Emerging Issues Task Force Issue 06-4 ( EITF 06-4 ), Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. The guidance is applicable to endorsement split-dollar life insurance arrangements, whereby the employer owns and controls the insurance policy, that are associated with a postretirement benefit. EITF 06-4 requires that for a split-dollar life insurance arrangement within the scope of the Issue, an employer should recognize a liability for future benefits in accordance with FAS No. 106 (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. On January 1, 2008, the Company adopted

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EITF 06-04 which resulted in an adjustment to retained earnings and an associated liability in the amount of $437,000.

In March 2007, the FASB ratified Emerging Issues Task Force Issue No. 06-10 ( EITF 06-10 ), Accounting for Collateral Assignment Split-Dollar Life Insurance Agreements. EITF 06-10 provides guidance for determining a liability for the postretirement benefit obligation as well as recognition and measurement of the associated asset on the basis of the terms of the collateral assignment agreement. EITF 06-10 is effective for fiscal years beginning after December 15, 2007. On January 1, 2008, the Company adopted EITF 06-10 which did not have a material effect on the Company s results of operations or financial position.

In June 2007, the FASB ratified Emerging Issues Task Force Issue No. 06-11 ( EITF 06-11 ), Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards. EITF 06-11 applies to share-based payment arrangements with dividend protection features that entitle employees to receive (a) dividends on equity-classified nonvested shares, (b) dividend equivalents on equity-classified nonvested share units, or (c) payments equal to the dividends paid on the underlying shares while an equity-classified share option is outstanding, when those dividends or dividend equivalents are charged to retained earnings under FAS No. 123R, Share-Based Payment, and result in an income tax deduction for the employer. A consensus was reached that a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity-classified nonvested equity shares, nonvested equity share units, and outstanding equity share options should be recognized as an increase in additional paid-in capital. EITF 06-11 is effective for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. On January 1, 2008, the Company adopted EITF 06-11 which did not have a material effect on the Company s results of operations or financial position.

In March 2008, the FASB issued FAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, to require enhanced disclosures about derivative instruments and hedging activities. The new standard has revised financial reporting for derivative instruments and hedging activities by requiring more transparency about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under FAS No. 133, Accounting for Derivative Instruments and Hedging Activities; and how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. FAS No. 161 requires disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also requires entities to provide more information about their liquidity by requiring disclosure of derivative features that are credit risk-related. Further, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. FAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encourage. The adoption of this standard is not expected to have a material effect on the Company s results of operations or financial position.

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In May 2008, the FASB issued FAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. FAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). FAS No. 162 will become effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. The Company does not expect the adoption of FAS No. 162 to have a material effect on its results of operations and financial position.

In April 2008, the FASB issued FASB Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets ( FSP 142-3 ). FSP 142-3 amends the factors that should be considered in developing assumptions about renewal or extension used in estimating the useful life of a recognized intangible asset under FAS No. 142, Goodwill and Other Intangible Assets. This standard is intended to improve the consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141R and other GAAP. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The measurement provisions of this standard will apply only to intangible assets of the Company acquired after the effective date.

In June 2008, the FASB issued FASB Staff Position (FSP) No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities, to clarify that instruments granted in share-based payment transactions can be participating securities prior to the requisite service having been rendered. A basic principle of the FSP is that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of EPS pursuant to the two-class method. The provisions of this FSP are effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented (including interim financial statements, summaries of earnings, and selected financial data) are required to be adjusted retrospectively to conform with the provisions of the FSP. The adoption of this FSP is not expected to have a material effect on the Company s results of operations or financial position.

**Note 3. Per Share Data**

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

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| | Three Months Ended June 30, 2008 | 2007 | Six Months Ended June 30, 2008 | 2007 |
|---|---|---|---|---|
| Weighted average common shares outstanding | 4,008,030 | 4,004,798 | 4,007,603 | 4,004,369 |
| Average treasury stock shares | (142,053) | (115,659) | (137,244) | (111,083) |
| Weighted average common shares and common stock equivalents used to calculate basic earnings per share | 3,865,977 | 3,889,139 | 3,870,359 | 3,893,286 |
| Additional common stock equivalents(stock options) used to calculate diluted earnings per share | 138 | 262 | 164 | 300 |
| Weighted average common shares and common stock equivalents used to calculate diluted earnings per share | 3,866,115 | 3,889,401 | 3,870,523 | 3,893,586 |

Options to purchase 8,273 and 9,923 shares of common stock during the three and six months ended June 30, 2008 were outstanding but were not included in the computation of diluted earnings per share as they were anti-dilutive due to the strike prices of $40.29 and $31.82 being greater than the market price of $31.25 at June 30, 2008. Options to purchase 8,276 and 9,002 shares of common stock during the three and six months ended June 30, 2007 were outstanding but were not included in the computation of diluted earnings per share as they were anti-dilutive due to the strike price of $40.29 being greater than the market price of $34.24 at June 30, 2007.

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

For a detailed disclosure on the Company s pension and employee benefits plans, please refer to Note 11 of the Company s Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2007.

The following sets forth the components of the net periodic benefit cost of the domestic non-contributory defined benefit plan for the three and six months ended June 30, 2008 and 2007, respectively:

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| (In Thousands) | Three Months Ended June 30, 2008 | Three Months Ended June 30, 2007 | Six Months Ended June 30, 2008 | Six Months Ended June 30, 2007 |
|---|---|---|---|---|
| Service cost | $ 136 | $ 117 | $ 273 | $ 233 |
| Interest cost | 152 | 121 | 304 | 243 |
| Expected return on plan assets | (163) | (140) | (320) | (281) |
| Amortization of transition obligation | | (1) | (1) | (1) |
| Amortization of prior service cost | 7 | 6 | 13 | 13 |
| Amortization of net loss | 14 | | 28 | |
| Net periodic cost | $ 146 | $ 103 | $ 297 | $ 207 |

**Employer Contributions**

The Company previously disclosed in its consolidated financial statements, included in the Annual Report on Form 10-K for the year ended December 31, 2007, that it expected to contribute $450,000 to its defined benefit plan in 2008. As of June 30, 2008, a contribution in the amount of $500,000 was made for the 2007 plan year with no additional contributions anticipated during 2008.

**Note 5. Off Balance Sheet Risk**

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

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

Outstanding financial instruments with off balance sheet risk are as follows:

| (In Thousands) | | June 30, 2008 | | December 31, 2007 |
|---|---|---|---|---|
| Commitments to extend credit | $ | 74,746 | $ | 74,349 |
| Standby letters of credit | | 928 | | 974 |

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**Note 6. Reclassification of Comparative Amounts**

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

**Note 7. Employee Stock Purchase Plan**

The Company issues shares under the Penns Woods Bancorp, Inc. 2006 Employee Stock Purchase Plan ( Plan ) which is intended to encourage employee participation in the ownership and economic progress of the Company. The Plan allows for up to 1,000,000 shares to be purchased by employees. The purchase price of the shares is 95% of market value with an employee eligible to purchase up to the lesser of 15% of base compensation or $12,000 in market value annually. During the six months ended June 30, 2008 and 2007, there were 1,569 and 1,498 shares issued under the plan, respectively.

**Note 8. Fair Value Measurements**

Effective January 1, 2008, the Company adopted FAS 157, which, among other things, requires enhanced disclosures about assets and liabilities carried at fair value. FAS 157 establishes a hierarchal disclosure framework associated with the level of pricing observability utilized in measuring assets and liabilities at fair value. The three broad levels defined by FAS 157 hierarchy are as follows:

Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level II: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level III: Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management s best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

The following table presents the assets and liabilities reported on the consolidated statements of financial condition at their fair value as of June 30, 2008 by level within the fair value hierarchy. As required by FAS 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| | June 30, 2008 | | | |
|---|---|---|---|---|
| **(In Thousands)** | **Level I** | **Level II** | **Level III** | **Total** |
| Assets: | | | | |
| Investment Securities, available-for-sale | $ | $ 209,284 | $ | $ 209,284 |

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**CAUTIONARY STATEMENT FOR PURPOSES OF THE PRIVATE**

**SECURITIES LITIGATION REFORM ACT OF 1995**

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

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

**EARNINGS SUMMARY**

**Comparison of the Three and Six Months Ended June 30, 2008 and 2007**

**Summary Results**

Net income for the three months ended June 30, 2008 was $2,057,000 compared to $2,335,000 for the same period of 2007 as after-tax securities gains decreased $359,000 (from $193,000 to a loss of $166,000). The decrease in security gains is the result of a write down in value of certain equity holdings that have been deemed other than temporarily impaired. Basic and diluted earnings per share for the three months ended June 30, 2008 were $0.53 compared to $0.60 for the three months ended June 30, 2007. Return on average assets and return on average equity were 1.30% and 11.73% for the three months ended June 30, 2008 compared to 1.58% and 12.57% for the corresponding period of 2007. Net income from core operations ( operating earnings ) increased 3.8% to $2,223,000 for the three months ended June 30, 2008 compared to $2,142,000 for the same period of 2007 Operating earnings per share for the three months ended June 30, 2008 increased to $0.58 basic and $0.57 dilutive compared to $0.55 basic and dilutive for the three months ended June 30, 2007.

The six months ended June 30, 2008 generated net income of $4,188,000 compared to $4,616,000 for the same period of 2007 due to a decline in after-tax securities gains of $550,000 (from $409,000 to a loss of $141,000). Earnings per share, basic and diluted, for the six months ended June 30, 2008 were $1.08 as compared to $1.19 for the comparable period of 2007. Return on average assets and return on average equity were 1.33% and 11.87% for the six months ended June 30, 2007 as compared to 1.57% and 12.35% for the corresponding period of 2007. Operating earnings increased 2.9% to $4,329,000 for the six months ended June 30, 2008 compared to $4,207,000 for the comparable period of 2007 resulting in basic and dilutive operating earnings per share of $1.12 and $1.08 for the six month periods ended June 30, 2008 and 2007, respectively.

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

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**Interest And Dividend Income**

Interest and dividend income for the three months ended June 30, 2008 increased $143,000 to $8,936,000 compared to $8,793,000 for the same period of 2007. The increase in interest income was primarily the result of growth in average taxable investment securities of $21,967,000 offset by an 18 basis point ( bp ) decrease in the related security yields for the three months ended June 30, 2008 over the same period of 2007. The combination of taxable investment security growth and slight yield decrease resulted in a $352,000 increase in taxable interest income. Over the same time frame, the average balance of tax-exempt investment securities increased $8,267,000 with the portfolio yield increasing 40 bp resulting in a $158,000 increase in tax-exempt interest income. On a taxable equivalent basis, the interest income from the investment portfolio increased $510,000 due to the investment portfolio being strategically shifted toward tax-exempt instruments. The decrease in dividends received is the result of a decrease in equity investments coupled with a general decline in the dividends per share received from the equity holdings. Interest and fee income from the loan portfolio decreased $270,000 as the actions of the FOMC served as the foundation for the 48 bp decline in loan portfolio yield.

During the six months ended June 30, 2008, interest and dividend income was $17,984,000, an increase of $512,000 over the same period in 2007. The reasons for the 2.9% growth in interest income for the six month period are identical to those for the three month period ending June 30, 2008 discussed above. The growth in average loans of $4,256,000 coupled with a 28 bp decrease in the loan portfolio yield due to the decreasing prime rate resulted in a decrease of $314,000 in loan interest and fee income. Average investment securities and interest bearing deposit income increased $826,000 due to an increase in average balance of $29,493,000 and a 6 bp increase in yield. The increase in yield was due to an increase in yield on tax-exempt securities as portfolio cash flow was reinvested into higher yielding bonds over the past year. The asset allocation between loans and the investment portfolio composition resulted in taxable equivalent interest income increasing $659,000 for the six months ended June 30, 2008 compared to the same period of 2007.

Interest and dividend income composition for the three and six months ended June 30, 2008 and 2007 was as follows:

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| | For The Three Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | June 30, 2008 | | June 30, 2007 | | Change | |
| **(In Thousands)** | **Amount** | **% Total** | **Amount** | **% Total** | **Amount** | **%** |
| Loans including fees | $ 6,246 | 69.9% | $ 6,516 | 74.1% | $ (270) | (4.1)% |
| Investment securities: | | | | | | |
| Taxable | 1,276 | 14.3 | 924 | 10.5 | 352 | 38.1 |
| Tax-exempt | 1,210 | 13.5 | 1,052 | 12.0 | 158 | 15.0 |
| Dividend and other interest income | 204 | 2.3 | 301 | 3.4 | (97) | (32.2) |
| Total interest and dividend income | $ 8,936 | 100.0% | $ 8,793 | 100.0% | $ 143 | 1.6% |

| | For The Six Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | June 30, 2008 | | June 30, 2007 | | Change | |
| **(In Thousands)** | **Amount** | **% Total** | **Amount** | **% Total** | **Amount** | **%** |
| Loans including fees | $ 12,625 | 70.2% | $ 12,939 | 74.0% | $ (314) | (2.4)% |
| Investment securities: | | | | | | |
| Taxable | 2,466 | 13.7 | 1,747 | 10.0 | 719 | 41.2 |
| Tax-exempt | 2,436 | 13.6 | 2,163 | 12.4 | 273 | 12.6 |
| Dividend and other interest income | 457 | 2.5 | 623 | 3.6 | (166) | (26.6) |
| Total interest and dividend income | $ 17,984 | 100.0% | $ 17,472 | 100.0% | $ 512 | 2.9% |

**Interest Expense**

Interest expense for the three months ended June 30, 2008 decreased $219,000 to $3,780,000 compared to $3,999,000 for the same period of 2007. The decreased expense associated with deposits is primarily the result of a reduction in rate paid of 77 bp on time deposits. Factors that led to the rate decreases include, but are not limited to, Federal Open Market Committee ( FOMC ) actions over the past year, campaigns conducted to attract 8 to 12 month maturity CDs that have resulted in an increased repricing frequency, and decreased average utilization of $9,000,000 in brokered CDs. Short-term borrowings interest expense increased $30,000 as the increase in average balance of $19,080,000 countered a decrease in the rate paid of 164 bp due to the FOMC rate actions over the past year. Long-term borrowings interest expense increased $68,000 as the average balance of such borrowings increased $7,818,000 for the three months ended June 30, 2008 compared to the same period of 2007, while the average rate decreased 22 bp to 4.43% for the 2008 period.

Interest expense for the six months ended June 30, 2008 remained stable at $7,947,000 compared to $7,938,000 for the same period of 2007. Interest on deposits decreased $288,000 due to the reasons noted in the above three month analysis. Borrowing costs increased primarily due to the addition of $30,000,000 in borrowings during the latter portion of 2007 as part of a program to increase net interest income through the purchase of fixed rate investment securities.

Interest expense composition for the three and six months ended June 30, 2008 and 2007 was as follows:

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| | For The Three Months Ended | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | June 30, 2008 | | | June 30, 2007 | | | Change | | | |
| (In Thousands) | | Amount | % Total | | Amount | % Total | | Amount | % | |
| Deposits | $ | 2,551 | 67.5% | $ | 2,868 | 71.7% | $ | (317) | (11.1)% | |
| Short-term borrowings | | 257 | 6.8 | | 227 | 5.7 | | 30 | 13.2 | |
| Long-term borrowings, FHLB | | 972 | 25.7 | | 904 | 22.6 | | 68 | 7.5 | |
| Total interest expense | $ | 3,780 | 100.0% | $ | 3,999 | 100.0% | $ | (219) | (5.5)% | |

| | For The Six Months Ended | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | June 30, 2008 | | | June 30, 2007 | | | Change | | |
| (In Thousands) | | Amount | % Total | | Amount | % Total | | Amount | % |
| Deposits | $ | 5,092 | 64.1% | $ | 5,380 | 67.8% | $ | (288) | (5.4)% |
| Short-term borrowings | | 686 | 8.6 | | 732 | 9.2 | | (46) | (6.3) |
| Long-term borrowings, FHLB | | 2,169 | 27.3 | | 1,826 | 23.0 | | 343 | 18.8 |
| Total interest expense | $ | 7,947 | 100.0% | $ | 7,938 | 100.0% | $ | 9 | 0.1% |

**Net Interest Margin**

The net interest margin ( NIM ) for the three months ended June 30, 2008 was 4.01% compared to 3.95% for the corresponding period of 2007. The increase in the NIM was driven by a 53 bp decline in the rate paid on interest bearing liabilities that more than compensated for a 30 bp decline in the yield on earning assets. The decrease in earning asset yield is due to the impact on the loan portfolio of the FOMC rate decreases over the past year coupled with the investment portfolio growth that occurred during the second half of 2007. Despite this investment growth being accretive to earnings, return on average assets, and return on average equity, it lowered the net interest margin due to the spread between the yield on assets purchased and the associated funding cost being less than historical levels. The growth in the investment portfolio was driven by a strategic initiative in the second half of 2007 to increase tax equivalent net interest income by purchasing fixed rate instruments in anticipation of the decreasing rate environment that is continuing into 2008. The decrease in the cost of interest bearing liabilities to 3.12% from 3.65% was driven primarily by a reduction in the rate paid on time deposits of 77 bp. The reduction was the result of a shortening of the time deposit portfolio initiated in the early stages of 2007 that has resulted in an increasing repricing frequency during this period of decreasing rates.

The NIM for the six months ended June 30, 2008 and 2007 was 3.95%. The impact of the items mentioned in the three month discussion also applies to for the six month period. A 44 bp decline in the rate paid on time deposits served as the foundation for a 27 `bp decline in rate paid on deposits, while the FOMC actions steered the yield on earning assets and cost of borrowings.

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Following is a schedule of average balances and associated yields for the three and six month periods ended June 30, 2008 and 2007:

**AVERAGE BALANCES AND INTEREST RATES**

| | Three Months Ended June 30, 2008 | | | Three Months Ended June 30, 2007 | | |
|---|---|---|---|---|---|---|
| **(In Thousands)** | **Average Balance** | **Interest** | **Average Rate** | **Average Balance** | **Interest** | **Average Rate** |
| Assets: | | | | | | |
| Tax-exempt loans | $ 8,506 | $ 135 | 6.31% | $ 7,819 | $ 120 | 6.16% |
| All other loans | 358,980 | 6,157 | 6.82% | 353,019 | 6,437 | 7.31% |
| Total loans | 367,486 | 6,292 | 6.81% | 360,838 | 6,557 | 7.29% |
| | | | | | | |
| Taxable investment securities | 105,295 | 1,480 | 5.62% | 83,328 | 1,209 | 5.80% |
| Tax-exempt investment securities | 108,670 | 1,833 | 6.75% | 100,403 | 1,594 | 6.35% |
| Total securities | 213,965 | 3,313 | 6.19% | 183,731 | 2,803 | 6.10% |
| | | | | | | |
| Interest bearing deposits | 34 | | 0.00% | 1,230 | 16 | 5.22% |
| | | | | | | |
| Total interest-earning assets | 581,485 | 9,605 | 6.58% | 545,799 | 9,376 | 6.88% |
| | | | | | | |
| Other assets | 50,186 | | | 43,594 | | |
| | | | | | | |
| Total assets | $ 631,671 | | | $ 589,393 | | |
| | | | | | | |
| Liabilities: | | | | | | |
| Savings | $ 61,197 | 115 | 0.75% | $ 59,906 | 110 | 0.74% |
| Super Now deposits | 54,327 | 183 | 1.34% | 47,531 | 153 | 1.29% |
| Money market deposits | 26,803 | 146 | 2.17% | 26,346 | 158 | 2.41% |
| Time deposits | 209,539 | 2,107 | 4.00% | 205,554 | 2,447 | 4.77% |
| Total deposits | 351,866 | 2,551 | 2.88% | 339,337 | 2,868 | 3.39% |
| | | | | | | |
| Short-term borrowings | 41,319 | 257 | 2.45% | 22,239 | 227 | 4.09% |
| Long-term borrowings, FHLB | 85,789 | 972 | 4.43% | 77,971 | 904 | 4.65% |
| Total borrowings | 127,108 | 1,229 | 3.79% | 100,210 | 1,131 | 4.53% |
| | | | | | | |
| Total interest-bearing liabilities | 478,974 | 3,780 | 3.12% | 439,547 | 3,999 | 3.65% |
| | | | | | | |
| Demand deposits | 73,485 | | | 68,677 | | |
| Other liabilities | 9,095 | | | 6,888 | | |
| Shareholders equity | 70,117 | | | 74,281 | | |
| Total liabilities and shareholders equity | $ 631,671 | | | $ 589,393 | | |
| | | | | | | |
| Interest rate spread | | | 3.46% | | | 3.23% |
| Net interest income/margin | | $ 5,825 | 4.01% | | $ 5,377 | 3.95% |

1. Information on this table has been calculated using average daily balance sheets to obtain average balances.

2. Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.

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

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**AVERAGE BALANCES AND INTEREST RATES**

| (In Thousands) | Six Months Ended June 30, 2008 Average Balance | Interest | Average Rate | Six Months Ended June 30, 2007 Average Balance | Interest | Average Rate |
|---|---|---|---|---|---|---|
| Assets: | | | | | | |
| Tax-exempt loans | $ 8,277 | $ 262 | 6.37% | $ 8,022 | $ 247 | 6.21% |
| All other loans | 356,830 | 12,453 | 7.02% | 352,829 | 12,776 | 7.30% |
| Total loans | 365,107 | 12,715 | 7.00% | 360,851 | 13,023 | 7.28% |
| | | | | | | |
| Taxable securities | 103,013 | 2,923 | 5.68% | 82,952 | 2,353 | 5.67% |
| Tax-exempt securities | 111,630 | 3,691 | 6.61% | 101,588 | 3,277 | 6.45% |
| Total securities | 214,643 | 6,614 | 6.16% | 184,540 | 5,630 | 6.10% |
| | | | | | | |
| Interest bearing deposits | 19 | | 0.00% | 629 | 17 | 5.45% |
| | | | | | | |
| Total interest-earning assets | 579,769 | 19,329 | 6.69% | 546,020 | 18,670 | 6.88% |
| | | | | | | |
| Other assets | 49,325 | | | 41,723 | | |
| Total assets | $ 629,094 | | | $ 587,743 | | |
| | | | | | | |
| Liabilities: | | | | | | |
| Savings | $ 59,880 | 224 | 0.75% | $ 59,454 | 215 | 0.73% |
| Super Now deposits | 50,347 | 338 | 1.35% | 46,196 | 302 | 1.32% |
| Money market deposits | 25,064 | 273 | 2.19% | 24,962 | 283 | 2.29% |
| Time deposits | 200,233 | 4,257 | 4.28% | 195,712 | 4,580 | 4.72% |
| Total Deposits | 335,524 | 5,092 | 3.05% | 326,324 | 5,380 | 3.32% |
| | | | | | | |
| Short-term borrowings | 46,216 | 686 | 2.95% | 32,206 | 732 | 4.58% |
| Other borrowings | 95,661 | 2,169 | 4.48% | 79,339 | 1,826 | 4.64% |
| Total borrowings | 141,877 | 2,855 | 3.99% | 111,545 | 2,558 | 4.62% |
| | | | | | | |
| Total interest-bearing liabilities | 477,401 | 7,947 | 3.33% | 437,869 | 7,938 | 3.66% |
| | | | | | | |
| Demand deposits | 71,864 | | | 68,446 | | |
| Other liabilities | 9,280 | | | 6,673 | | |
| Shareholders equity | 70,459 | | | 74,755 | | |
| | $ 629,004 | | | $ 587,743 | | |
| Interest rate spread | | | 3.36% | | | 3.22% |
| Net interest income/margin | | $ 11,382 | 3.95% | | $ 10,732 | 3.95% |

1. Information on this table has been calculated using average daily balance sheets to obtain average balances.

2. Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.

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

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**The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the three and six month periods ended June 30, 2008 and 2007.**

| (In Thousands) | For the Three Months Ended June 30, 2008 | 2007 | For the Six Months Ended June 30, 2008 | 2007 |
|---|---|---|---|---|
| Total interest income | $ 8,936 | $ 8,793 | $ 17,984 | $ 17,472 |
| Total interest expense | 3,780 | 3,999 | 7,947 | 7,938 |
| Net interest income | 5,156 | 4,794 | 10,037 | 9,534 |
| Tax equivalent adjustment | 669 | 583 | 1,345 | 1,198 |
| Net interest income (fully taxable equivalent) | $ 5,825 | $ 5,377 | $ 11,382 | $ 10,732 |

**The following table sets forth the respective impact that both volume and rate changes have had on net interest income on a fully taxable equivalent basis for the three and six month periods ended June 30, 2008 and 2007:**

| | Three Months Ended June 30, 2008 vs 2007 Increase (Decrease) Due to | | | Six Months Ended June 30, 2008 vs 2007 Increase (Decrease) Due to | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Volume | Rate | Net | Volume | Rate | Net |
| Interest income: | | | | | | |
| Loans, tax-exempt | $ 11 | $ 4 | $ 15 | $ 12 | $ 3 | $ 15 |
| Loans | 117 | (397) | (280) | 150 | (473) | (323) |
| Taxable investment securities | 310 | (39) | 271 | 569 | 1 | 570 |
| Tax-exempt investment securities | 166 | 73 | 239 | 335 | 79 | 414 |
| Interest bearing deposits | (16) | | (16) | (17) | | (17) |
| Total interest-earning assets | 588 | (359) | 229 | 1,049 | (390) | 659 |
| | | | | | | |
| Interest expense: | | | | | | |
| Savings deposits | 3 | 2 | 5 | 2 | 7 | 9 |
| Super Now deposits | 25 | 5 | 30 | 30 | 6 | 36 |
| Money market deposits | 3 | (15) | (12) | 1 | (11) | (10) |
| Time deposits | 48 | (388) | (340) | 107 | (430) | (323) |
| Short-term borrowings | 145 | (115) | 30 | 262 | (308) | (46) |
| Long-term borrowings, FHLB | 105 | (37) | 68 | 403 | (60) | 343 |
| Total interest-bearing liabilities | 329 | (548) | (219) | 805 | (796) | 9 |
| Change in net interest income | $ 259 | $ 189 | $ 448 | $ 244 | $ 406 | $ 650 |

**Provision for Loan Losses**

The provision for loan losses is based upon management s quarterly review of the loan portfolio. The purpose of the review is to assess loan quality, identify impaired loans, analyze delinquencies, ascertain loan growth, evaluate potential charge-offs and recoveries, and assess general economic conditions in the markets served. An external independent loan review is also

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performed annually for the Bank.  Management remains committed to an aggressive program of problem loan identification and resolution.

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

Although management believes it uses the best information available to make such determinations and that the allowance for loan losses is adequate at June 30, 2008, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations.  A downturn in the local economy, employment, and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets, charge-offs, loan loss provisions, and reductions in income.  Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Bank s loan loss allowance.  The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

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

The allowance for loan losses increased from $4,130,000 at December 31, 2007 to $4,207,000 at June 30, 2008.  At June 30, 2008 and December 31, 2007, the allowance for loan losses was 1.15%.  Management s conclusion is that the allowance for loan losses is adequate to provide for possible losses inherent in the loan portfolio as of the balance sheet date.

The provision for loan losses totaled $60,000 and $120,000 for the three and six months ended June 30, 2008, as compared to $10,000 and $50,000 for the same periods in 2007.  The size of the increase in the provision was the result of several continuing positive factors, including but not limited to, an increase in gross loans of $5,477,000 since December 31, 2007, a ratio of annualized net charge offs to average loans of 0.01%, a ratio of nonperforming loans to total loans of 0.25%, and a ratio of the allowance for loan losses to nonperforming loans of 462.82% at June 30, 2008.

**Non-interest Income**

Total non-interest income for the three months ended June 30, 2008 compared to the same period in 2007 decreased $565,000 to $1,621,000 due to a $544,000 decrease in net securities gains and losses realized when comparing the three month periods ended June 30, 2008 and 2007.  Excluding net securities gains and losses, non-interest income for the second quarter of 2008 would have decreased $21,000 as compared to the 2007 period.  Deposit service charges decreased $27,000 as customers migrated to no service charge checking accounts that were

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introduced as part of a customer obtainment and retention program. Earnings on bank owned life insurance increased $5,000 as a result of increased holdings as of June 30, 2008 as compared to the 2007 period.

Insurance commissions for the three months ended June 30, 2008 decreased $64,000 compared to the same period in 2007 due to a shift in product mix. Management of The M Group continues to pursue new and build upon current relationships. The sales call program continues to expand to other financial institutions, which results in additional revenue for The M Group. However, the addition of another sales outlet for The M Group can take up to a year or more to be completed.

Total non-interest income for the six months ended June 30, 2008 compared to the same period in 2007 decreased $625,000. Excluding net securities gains, non-interest income would have increased $207,000 as compared to the 2007 period. The increase in non-interest income for the six month period is the result of the same items noted in the three month discussion.

Non-interest income composition for the three and six months ended June 30, 2008 and 2007 was as follows:

| | For The Three Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | June 30, 2008 | | June 30, 2007 | | Change | |
| **(In Thousands)** | **Amount** | **% Total** | **Amount** | **% Total** | **Amount** | **%** |
| Deposit service charges | $ 540 | 33.3% | $ 567 | 25.9% | $ (27) | (4.8)% |
| Securities (losses) gains, net | (251) | (15.5) | 293 | 13.4 | (544) | (185.7) |
| Bank owned life insurance | 91 | 5.6 | 86 | 3.9 | 5 | 5.8 |
| Gain on sale of loans | 212 | 13.1 | 234 | 10.7 | (22) | (9.4) |
| Insurance commissions | 486 | 30.0 | 550 | 25.2 | (64) | (11.6) |
| Other | 543 | 33.5 | 456 | 20.9 | 87 | 19.0 |
| Total non-interest income | $ 1,621 | 100.0% | $ 2,186 | 100.0% | $ (565) | (25.8)% |

| | For The Six Months Ended | | | | | |
|---|---|---|---|---|---|---|
| | June 30, 2008 | | June 30, 2007 | | Change | |
| **(In Thousands)** | **Amount** | **% Total** | **Amount** | **% Total** | **Amount** | **%** |
| Deposit service charges | $ 1,110 | 31.4% | $ 1,108 | 26.6% | $ 2 | 0.2% |
| Securities (losses) gains, net | (213) | (6.0) | 619 | 14.9 | (832) | (134.4) |
| Bank owned life insurance | 246 | 7.0 | 201 | 4.8 | 45 | 22.4 |
| Gain on sale of loans | 364 | 10.3 | 372 | 8.9 | (8) | (2.2) |
| Insurance commissions | 1,066 | 30.1 | 988 | 23.8 | 78 | 7.9 |
| Other | 962 | 27.2 | 872 | 21.0 | 90 | 10.3 |
| Total non-interest income | $ 3,535 | 100.0% | $ 4,160 | 100.0% | $ (625) | (15.0)% |

**Non-interest Expense**

Total non-interest expense increased $171,000 for the three months ended June 30, 2008 compared to the same period of 2007.  The increase in salaries and employee benefits was attributable to several items including standard cost of living wage adjustments for employees,

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increased pension expense, and other benefit costs. Occupancy expense decreased due to decreased cost of utilities, maintenance and property taxes. Pennsylvania shares tax decreased $56,000 due to the use of Pennsylvania Enterprise Zone tax credits from a low income housing partnership committed to during 2007. Other expenses increased primarily due to normal anticipated inflationary adjustments to ongoing business operating costs and the amortization related to the before mentioned low income housing.

Total non-interest expenses increased $488,000 for the six months ended June 30, 2008 compared to the same period of 2007. As noted above in the three month discussion, normal increases in general business expenses and the amortization of a low income housing partnership, impacted the level of non-interest expenses.

Non-interest expense composition for the three and six months ended June 30, 2008 and 2007 was as follows:

| | For The Three Months Ended | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | June 30, 2008 | | | June 30, 2007 | | | Change | | |
| (In Thousands) | | Amount | % Total | | Amount | % Total | | Amount | % |
| Salaries and employee benefits | $ | 2,469 | 54.7% | $ | 2,301 | 53.0% | $ | 168 | 7.3% |
| Occupancy, net | | 314 | 7.0 | | 337 | 7.8 | | (23) | (6.8) |
| Furniture and equipment | | 287 | 6.4 | | 297 | 6.8 | | (10) | (3.4) |
| Pennsylvania shares tax | | 105 | 2.3 | | 161 | 3.7 | | (56) | (34.8) |
| Amortization of investment in limited partnerships | | 178 | 3.9 | | 142 | 3.3 | | 36 | 25.4 |
| Other | | 1,158 | 25.7 | | 1,102 | 25.4 | | 56 | 5.1 |
| Total non-interest expense | $ | 4,511 | 100.0% | $ | 4,340 | 100.0% | $ | 171 | 3.9% |

| | For The Six Months Ended | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | June 30, 2008 | | | June 30, 2007 | | | Change | | |
| (In Thousands) | | Amount | % Total | | Amount | % Total | | Amount | % |
| Salaries and employee benefits | $ | 4,920 | 54.9% | $ | 4,582 | 54.1% | $ | 338 | 7.4% |
| Occupancy, net | | 652 | 7.3 | | 668 | 7.9 | | (16) | (2.4) |
| Furniture and equipment | | 572 | 6.4 | | 583 | 6.9 | | (11) | (1.9) |
| Pennsylvania shares tax | | 210 | 2.3 | | 322 | 3.8 | | (112) | (34.8) |
| Amortization of investment in limited partnerships | | 356 | 4.0 | | 283 | 3.3 | | 73 | 25.8 |
| Other | | 2,246 | 25.1 | | 2,030 | 24.0 | | 216 | 10.6 |
| Total non-interest expense | $ | 8,956 | 100.0% | $ | 8,468 | 100.0% | $ | 488 | 5.8% |

**Provision for Income Taxes**

Income taxes decreased $146,000 and $252,000 for the three and six month periods ended June 30, 2008 compared to the same period of 2007. The effective tax rate for the three and six months ended June 30, 2008 was 6.75% and 6.85% as compared to 11.22% and 10.82% for the same periods of 2007. The decline in the effective tax rate is consistent with management s repositioning of the investment portfolio from taxable investment securities to tax-exempt investment securities, and the elimination of the allowance for loan loss recapture. The current effective tax rate has resulted in a deferred tax asset due to the low income housing tax credits. Management has reviewed the deferred tax asset and has determined that the asset will be

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utilized within the appropriate carry forward period and therefore does not require a valuation allowance.

**ASSET/LIABILITY MANAGEMENT**

**Cash and Cash Equivalents**

Cash and cash equivalents increased $1,776,000 from $15,433,000 at December 31, 2007 to $17,209,000 at June 30, 2008 primarily as a result of the following activities during the six months ended June 30, 2008:

**Loans Held for Sale**

Activity regarding loans held for sale resulted in sale proceeds exceeding loan originations, less $364,000 in realized gains, by $624,000 for the six months ended June 30, 2008.

**Loans**

Gross loans increased $5,477,000 since December 31, 2007 due to the increase of residential mortgages coupled with increased competition for commercial loans and a softening of the market.

The allocation of the loan portfolio, by category, as of June 30, 2008 and December 31, 2007 is presented below:

| **(In Thousands)** | **June 30, 2008** | **December 31, 2007** | **Change Amount** | **%** |
|---|---|---|---|---|
| Commercial, financial and agricultural | $ 36,266 | $ 35,739 | $ 527 | 1.5% |
| Real estate mortgage: | | | | |
| Residential | 171,552 | 163,268 | 8,284 | 5.1 |
| Commercial | 129,498 | 132,943 | (3,445) | (2.6) |
| Construction | 16,650 | 16,152 | 498 | 3.1 |
| Installment loans to individuals | 12,948 | 13,317 | (369) | (2.8) |
| Less: Net deferred loan fees | 959 | 941 | 18 | 1.9 |
| Gross loans | $ 365,955 | $ 360,478 | $ 5,477 | 1.5% |

The recorded investment in loans for which impairment has been recognized in accordance with Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, amounted to $4,473,000 at June 30, 2008, compared to $1,477,000 at December 31, 2007. The valuation allowance related to impaired loans amounted to $49,000 at June 30, 2008 and $102,000 at December 31, 2007. The increase in impaired loans is from a few commercial relationships, while the decrease in valuation allowance is the result of the charge off of a commercial relationship that had a specific collateral weakness.

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

**Investments**

The estimated fair value of the investment securities portfolio in total at June 30, 2008 has decreased $5,289,000 since December 31, 2007, while the amortized cost increased $3,351,000. The majority of the changes in value occurred within the agency securities and state and municipal segments of the portfolio. The amortized cost position in state and political securities increased $19,922,000 as the Bank continued its strategy 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. Over the same time period, the above strategy resulted in the amortized cost position of U.S. Government and agency securities to decrease by $15,713,000. The increased level of unrealized losses within the bond portfolio, 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.

The equity portfolio continues to feel the effects of the economic turbulence that is effecting the financial sector. This sector of the portfolio, as of June 30, 2008, held $4,930,000 in unrealized losses on an amortized cost basis of $18,573,000. The amount of the declines has caused several of our equity holdings to be deemed other than temporarily impaired resulting in a write down in value of these holdings of $366,000 and $574,000 for the three and six months ended June 30, 2008. Certain positions may be liquidated, in whole or part, through the balance of 2008 so that the losses can be carried back for tax purposes and offset against gains that have been recognized over the past several years.

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

| | June 30, 2008 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **(In Thousands)** | | **Amortized Cost** | | **Gross Unrealized Gains** | | **Gross Unrealized Losses** | | **Estimated Fair Value** |
| Available for sale (AFS) | | | | | | | | |
| U.S. Government and agency securities | $ | 46,669 | $ | 95 | $ | (215) | $ | 46,549 |
| State and political securities | | 139,573 | | 263 | | (6,459) | | 133,377 |
| Other debt securities | | 16,379 | | 15 | | (926) | | 15,468 |
| Total debt securities | | 202,621 | | 373 | | (7,600) | | 195,394 |
| Equity securities | | 18,573 | | 247 | | (4,930) | | 13,890 |
| Total investment securities AFS | $ | 221,194 | $ | 620 | $ | (12,530) | $ | 209,284 |
| | | | | | | | | |
| Held to maturity (HTM) | | | | | | | | |
| U.S. Government and agency securities | $ | 11 | $ | | $ | | $ | 11 |
| Other debt securities | | 149 | | 1 | | | | 150 |
| Total investment securities HTM | $ | 160 | $ | 1 | $ | | $ | 161 |

| | December 31, 2007 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **(In Thousands)** | | **Amortized Cost** | | **Gross Unrealized Gains** | | **Gross Unrealized Losses** | | **Estimated Fair Value** |
| Available for sale (AFS) | | | | | | | | |
| U.S. Government and agency securities | $ | 62,382 | $ | 522 | $ | | $ | 62,904 |
| State and political securities | | 119,651 | | 581 | | (2,417) | | 117,815 |
| Other debt securities | | 15,917 | | 290 | | (440) | | 15,767 |
| Total debt securities | | 197,950 | | 1,393 | | (2,857) | | 196,486 |
| Equity securities | | 19,776 | | 496 | | (2,303) | | 17,969 |
| Total investment securities AFS | $ | 217,726 | $ | 1,889 | $ | (5,160) | $ | 214,455 |
| | | | | | | | | |
| Held to maturity (HTM) | | | | | | | | |
| U.S. Government and agency securities | $ | 14 | $ | 1 | $ | | $ | 15 |
| Other debt securities | | 263 | | 1 | | | | 264 |
| Total investment securities HTM | $ | 277 | $ | 2 | $ | | $ | 279 |

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**Financing Activities**

**Deposits**

Total deposits increased 12.6% or $48,899,000 from December 31, 2007 to June 30, 2008. The growth was led by a 37.2% or $7,831,000 increase in money market accounts coupled with growth in time deposits of 17.8% or $31,561,000 from December 31, 2007 to June 30, 2008. In addition, demand deposits have increased 7.0% or $5,237,000 with NOW and savings accounts increasing $8,155,000 in aggregate. The increases in all core deposit categories have allowed for a 44.0% reduction in the balance of brokered time deposits due to the ability to attract market area deposits at more favorable terms through the first six months of 2008.

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

| (In Thousands) | June 30, 2008 Amount | June 30, 2008 % Total | December 31, 2007 Amount | December 31, 2007 % Total | Change Amount | Change % |
|---|---|---|---|---|---|---|
| Demand deposits | $ 79,908 | 18.2% | $ 74,671 | 19.2% | $ 5,237 | 7.0% |
| NOW accounts | 52,948 | 12.1 | 50,883 | 13.1 | 2,065 | 4.1 |
| Money market deposits | 28,860 | 6.6 | 21,029 | 5.4 | 7,831 | 37.2 |
| Savings deposits | 62,847 | 14.4 | 56,757 | 14.6 | 6,090 | 10.7 |
| Time deposits | 208,412 | 47.6 | 176,851 | 45.4 | 31,561 | 17.8 |
| Time deposits - brokered | 4,946 | 1.1 | 8,831 | 2.3 | (3,885) | (44.0) |
| Total deposits | $ 437,921 | 100.0% | $ 389,022 | 100.0% | $ 48,899 | 12.6% |

**Borrowed Funds**

Total borrowed funds decreased 22.8% to $124,859,000 at June 30, 2008 as compared to $161,693,000 at December 31, 2007. The decrease in borrowed funds is primarily the result of the previously discussed deposit gathering campaigns that were utilized to provide funds to reduce the level of higher cost short-term borrowings and to assist in replacing long-term borrowing maturities. Long-term borrowings decreased $29,600,000 since December 31, 2007 due to the maturity of several borrowings that carried rates between 3.14% and 5.56%.

| | June 30, 2008 | | December 31, 2007 | | Change | |
|---|---|---|---|---|---|---|
| **(In Thousands)** | **Amount** | **% Total** | **Amount** | **% Total** | **Amount** | **%** |
| Short-term borrowings: | | | | | | |
| FHLB repurchase agreements | $ 31,819 | 25.5% | $ 38,160 | 23.6% | $ (6,341) | (16.6)% |
| Short-term borrowings, FHLB | | | | | | |
| Securities sold under agreement to repurchase | 16,262 | 13.0 | 17,155 | 10.6 | (893) | (5.2) |
| Total short-term borrowings | 48,081 | 38.5% | 55,315 | 34.2% | (7,234) | (13.1) |
| | | | | | | |
| Long-term borrowings, FHLB | 76,778 | 61.5 | 106,378 | 65.8 | (29,600) | (27.8) |
| Total borrowed funds | $ 124,859 | 100.0% | $ 161,693 | 100.0% | $ (36,834) | (22.8)% |

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**Capital**

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

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

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Capital ratios as of June 30, 2008 and December 31, 2007 were as follows:

| | 2008 | | 2007 | |
|---|---|---|---|---|
| **(In Thousands)** | **Amount** | **Ratio** | **Amount** | **Ratio** |
| Total Capital | | | | |
| (to Risk-weighted Assets) | | | | |
| | | | | |
| Actual | $ 66,597 | 16.5% | $ 70,381 | 18.0% |
| For Capital Adequacy Purposes | 32,342 | 8.0 | 31,280 | 8.0 |
| To Be Well Capitalized | 40,428 | 10.0 | 39,100 | 10.0 |
| | | | | |
| Tier I Capital | | | | |
| (to Risk-weighted Assets) | | | | |
| | | | | |
| Actual | $ 62,390 | 15.4% | $ 66,251 | 16.9% |
| For Capital Adequacy Purposes | 16,171 | 4.0 | 15,640 | 4.0 |
| To Be Well Capitalized | 24,257 | 6.0 | 23,460 | 6.0 |
| | | | | |
| Tier I Capital | | | | |
| (to Average Assets) | | | | |
| | | | | |
| Actual | $ 62,390 | 10.0% | $ 66,251 | 10.8% |
| For Capital Adequacy Purposes | 25,054 | 4.0 | 24,664 | 4.0 |
| To Be Well Capitalized | 31,317 | 5.0 | 30,830 | 5.0 |

**Liquidity and Interest Rate Sensitivity**

**The asset/liability committee addresses the liquidity needs of the Company to ensure that sufficient funds are available to meet credit demands and deposit withdrawals as well as to the placement of available funds in the investment portfolio. In assessing liquidity requirements, equal consideration is given to the current position as well as the future outlook.**

The following liquidity measures are monitored for compliance within the limits cited:

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

Fundamental objectives of the Company s asset/liability management process are to maintain adequate liquidity while minimizing interest rate risk. The maintenance of adequate liquidity

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provides the Company with the ability to meet its financial obligations to depositors, loan customers, and shareholders. Additionally, it provides funds for normal operating expenditures and business opportunities as they arise. The objective of interest rate sensitivity management is to increase net interest income by managing interest sensitive assets and liabilities in such a way that they can be repriced in response to changes in market interest rates.

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

Management monitors the Company s liquidity on both a long and short-term basis, thereby providing management necessary information to react to current balance sheet trends. Cash flow needs are assessed and sources of funds are determined. Funding strategies consider both customer needs and economical cost. Both short and long-term funding needs are addressed by maturities and sales of available for sale investment securities, loan repayments and maturities, and liquidating money market investments such as federal funds sold. The use of these resources, in conjunction with access to credit provides core 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 FHLB of $202,644,000. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of $28,876,000. Management believes it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. FHLB borrowings totaled $108,597,000 as of June 30, 2008.

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.

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There have been no substantial changes in the Company s gap analyses or simulation analyses compared to the information provided in the Company s Form 10-K for the year ended December 31, 2007.

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

**Inflation**

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

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

Market risk for the Company is comprised primarily of interest rate risk exposure and liquidity risk. Interest rate risk and liquidity risk management is performed at the Bank level as well as the Company level. The Company s interest rate sensitivity is monitored by management through selected interest rate risk measures produced by an independent third party. There have been no substantial changes in the Company s gap analyses or simulation analyses compared to the information provided in the Annual Report on Form 10-K for the period ended December 31, 2007. Additional information and details are provided in the Liquidity and Interest Rate Sensitivity section of Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

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

**Item 4. Controls and Procedures**

An analysis was performed under the supervision and with the participation of the Company s management, including the Chief Executive Officer and the Principal Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures. Based on that evaluation, the Company s Chief Executive Officer and Principal Financial Officer concluded that the Company s disclosure controls and procedures were effective as of June 30, 2008. There were no changes in the Company s internal control over financial reporting that occurred during the quarter ended June 30, 2008, that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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**Part II. OTHER INFORMATION**

**Item 1.** **Legal Proceedings**

None.

**Item 1A. Risk Factors**

There are no material changes to the risk factors set forth in Part I, Item 1A, Risk Factors, of the Company s Annual Report on Form 10-K for the year ended December 31, 2007. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company s business.

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

| 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 (April 1 - April 30, 2008) | 4,569 | $ 32.44 | 4,569 | 117,204 |
| Month #2 (May 1 - May 31, 2008) | 5,000 | 32.16 | 5,000 | 112,204 |
| Month #3 (June 1 - June 30, 2008) | 4,650 | 30.55 | 4,650 | 107,554 |

On April 22, 2008, the Board of Directors extended the authorization to repurchase up to 197,000 shares, or approximately 5%, of the outstanding shares of the Company for an additional year to April 30, 2009. The repurchase plan was originally for a one year period expiring on April 25, 2007. To date, there have been 89,446 shares repurchased under this plan.

**Item 3.** **Defaults Upon Senior Securities**

None

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

Penns Woods Bancorp, Inc. s annual meeting of the shareholders was held on April 30, 2008. The results of the items voted on are listed below:

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| Issue Description | | For | Withhold |
|---|---|---|---|
| 1. | Election of Directors for a Three Year Term | | |
| | H. Thomas Davis, Jr. | 3,001,180 | 71,853 |
| | James M. Furey, II | 3,003,586 | 69,447 |
| | D. Michael Hawbaker | 3,003,000 | 70,033 |

| Issue Description | | For | Against | Abstain |
|---|---|---|---|---|
| 2. | Ratification of S.R. Snodgrass, A.C., Certified Public Accountants as independent auditors | 3,026,116 | 24,019 | 22,898 |

**Item 5. Other Information**

None

**Item 6.** **Exhibits**

| | |
|---|---|
| (3) (i) | Articles of Incorporation of the Registrant, as presently in effect (incorporated by reference to Exhibit 3(i) of the Registrant s Annual Report on Form 10-K for the year ended December 31, 2007). |
| (3) (ii) | Bylaws of the Registrant s as presently in effect (incorporated by reference to Exhibit 3(ii) of the Registrant s Current Report on Form 8-K filed June 17, 2005). |
| (31) (i) | Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer. |
| (31) (ii) | Rule 13a-14(a)/Rule 15d-14(a) Certification of Principal Financial Officer. |
| (32) (i) | Section 1350 Certification of Chief Executive Officer. |
| (32) (ii) | Section 1350 Certification of Principal Financial Officer. |

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**SIGNATURES**

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

| | | |
|---|---|---|
| | | PENNS WOODS BANCORP, INC.<br>(Registrant) |
| Date: | August 5, 2008 | /s/ Ronald A. Walko<br>Ronald A. Walko, President and Chief Executive Officer |
| Date: | August 5, 2008 | /s/ Brian L. Knepp<br>Brian L. Knepp, Chief Financial Officer (Principal Financial Officer) |

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**EXHIBIT INDEX**

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