

PENNS WOODS BANCORP INC
Form 10-K
March 15, 2007

FORM 10-K
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from _____ to _____

Commission file number 0-17077

PENNS WOODS BANCORP, INC.

(exact name of registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction
of incorporation or organization)

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

300 Market Street, P.O. Box 967
Williamsport, Pennsylvania 17703-0967
(Address of principal executive offices)

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

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

Title of each class
Common stock, par value \$8.33 per share

Name of each exchange
which registered
The NASDAQ Stock Market LLC

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

None

(Title of Class)

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

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Yes No

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

Yes No

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

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

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. (Check one):

Large accelerated filer Accelerated filer 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

State the aggregate market value of the voting stock held by non-affiliates of the registrant **\$151,295,164 at June 30, 2006.**

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

Class	Outstanding at March 6, 2007
Common Stock, \$8.33 Par Value	3,896,492 Shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement prepared in connection with its annual meeting of shareholders to be held on April 25, 2007 are incorporated by reference in Part III hereof.

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PART I

ITEM 1 BUSINESS

A. General Development of Business and History

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

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

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

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

The Bank employed 187 persons as of December 31, 2006 in either a full-time or part-time capacity. The Company does not have any employees. The principal officers of the Bank also serve as officers of the Company.

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

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

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

B. Regulation and Supervision

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

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

The FRB has issued regulations under the BHCA that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the FRB, pursuant to such regulations, may require the Company to

stand ready to use its resources to provide adequate capital funds to the Bank during periods of financial stress or adversity. The BHCA requires the Company to secure the prior approval of the FRB before it can acquire all or substantially all of the assets of any bank, or acquire ownership or control of 5% or more of any voting shares of any bank. Such a transaction would also require approval of the Department.

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

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

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

C. Regulation of the Bank

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

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

Deposit Insurance Historically, there were two deposit insurance funds administered by the FDIC - the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF). The Bank's deposits were insured under the BIF; however, the deposits assumed by the Bank in connection with the merger of Lock Haven Savings Bank were treated and assessed as SAIF-insured deposits. The FDIC has implemented a risk-related premium schedule for all insured depository institutions that results in the assessment of premiums based on capital and supervisory measure. Under the risk-related premium schedule, the FDIC assigns, on a semiannual basis, each institution to one of three capital groups (well-capitalized, adequately capitalized or undercapitalized) and further assigns such institution to one of three subgroups

within a capital group. The institution's subgroup assignment is based upon the FDIC's judgment of the institution's strength in light of supervisory evaluations, including examination reports, statistical analyses, and other information relevant to gauging the risk posed by the institution. Only institutions with a total capital to risk-adjusted assets ratio of 10.0% or greater, a Tier 1 capital to risk-adjusted assets ratio of 6.0% or greater and a Tier 1 leverage ratio of 5.0% or greater, are assigned to the well-capitalized group. As of December 31, 2006, the Bank's ratios were well above required minimum ratios.

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

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

Other Legislation

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

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

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

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

Environmental Laws

Environmentally related hazards have become a source of high risk and potential liability for financial institutions relating to their loans. Environmentally contaminated properties owned by an institution's borrowers may result in a drastic reduction in the value of the collateral securing the institution's loans to such borrowers, high environmental clean up costs to the borrower affecting its ability to repay the loans, the subordination of any lien in favor of the institution to a state or

federal lien securing clean up costs, and liability to the institution for clean up costs if it forecloses on the contaminated property or becomes involved in the management of the borrower. The Company is not aware of any borrower who is currently subject to any environmental investigation or clean up proceeding which is likely to have a material adverse effect on the financial condition or results of operations of the Company.

Effect of Government Monetary Policies

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

DESCRIPTION OF BANK

History and Business

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

As of December 31, 2006, the Bank had total assets of \$576,896,000; total shareholders' equity of \$57,789,000 and total deposits of \$396,204,000. The Bank's deposits are insured by the Federal Deposit Insurance Corporation for the maximum amount provided under current law.

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

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

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

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

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

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

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

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

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

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

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

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

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

Supervision and Regulation

The earnings of the Bank are affected by the policies of regulatory authorities including the FDIC and the FRB. An important function of the FRB is to regulate the money supply and interest rates. Among the instruments used to implement these objectives are open market operations in U.S. Government Securities, changes in reserve requirements against member bank deposits, and limitations on interest rates that member banks may pay on time and savings deposits.

These instruments are used in varying combinations to influence overall growth and distribution of bank loans, investments on deposits, and their use may also affect interest rates charged on loans or paid for deposits.

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

ITEM 1A RISK FACTORS

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

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

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

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

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

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

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

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

In addition to considering the financial strength and cash flow characteristics of a borrower, we often secure our loans with real estate collateral. Real estate values and the real estate market are generally affected by, among other things, changes in local, regional or national economic conditions, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other governmental statutes, regulations and policies, and acts of nature. The real

estate collateral provides an alternate source of repayment in the event of default by the borrower. If real estate prices in our markets decline, the value of the real estate collateral securing our loans could be reduced. If we are required to liquidate real estate collateral securing loans during a period of reduced real estate values to satisfy the debt, our earnings and capital could be adversely affected.

Competition may decrease our growth or profits.

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

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

We may be adversely affected by government regulation.

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

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

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

Environmental liability associated with lending activities could result in losses.

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

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

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

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

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

ITEM 1B UNRESOLVED STAFF COMMENTS

None.

ITEM 2 PROPERTIES

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

Office	Address	Ownership
Main	115 South Main Street P.O. Box 5098 Jersey Shore, Pennsylvania 17740	Owned
Bridge Street	112 Bridge Street Jersey Shore, Pennsylvania 17740	Owned
DuBoistown	2675 Euclid Avenue Williamsport, Pennsylvania 17702	Owned
Williamsport	300 Market Street P.O. Box 967 Williamsport, Pennsylvania 17703-0967	Owned
Montgomery	9094 Rt. 405 Highway Montgomery, Pennsylvania 17752	Under Lease
Lock Haven	4 West Main Street Lock Haven, Pennsylvania 17745	Owned
Mill Hall	(Inside Wal-Mart), 173 Hogan Boulevard Mill Hall, Pennsylvania 17751	Under Lease
Spring Mills	3635 Penns Valley Road, P.O. Box 66 Spring Mills, Pennsylvania 16875	Owned
Centre Hall	2842 Earlstown Road Centre Hall, Pennsylvania 16828	Land Under Lease
Zion	100 Cobblestone Road Bellefonte, Pennsylvania 16823	Under Lease
State College	(Inside Wal-Mart), 1665 North Atherton Place State College, Pennsylvania 16803	Under Lease
State College	2050 North Atherton Street State College, Pennsylvania 16803	Land Under Lease

Montoursville	820 Broad Street Montoursville, Pennsylvania 17754	Under Lease
The M Group, Inc. D/B/A The Comprehensive Financial Group	705 Washington Boulevard Williamsport, Pennsylvania 17701	Under Lease

ITEM 3 LEGAL PROCEEDINGS

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

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2006.

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

The Common Stock is listed on the NASDAQ Global Market under the symbol PWOD. The following table sets forth (1) the quarterly high and low prices for a share of the Company's Common Stock during the periods indicated, and (2) quarterly dividends on a share of the Common Stock with respect to each quarter since January 1, 2004.

	HIGH	LOW	Dividends Declared
2004			
First quarter	\$ 40.33	\$ 35.92	\$ 0.29
Second quarter	39.09	35.39	0.29
Third quarter	42.29	36.80	0.29
Fourth quarter	41.77	37.72	0.60
2005			
First quarter	\$ 41.67	\$ 38.58	\$ 0.38
Second quarter	41.58	37.08	0.38
Third quarter	38.30	36.76	0.39
Fourth quarter	39.76	36.67	0.41
2006			
First quarter	\$ 38.75	\$ 37.75	\$ 0.42
Second quarter	39.50	36.50	0.43
Third quarter	38.48	37.02	0.44
Fourth quarter	38.59	36.20	0.44

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

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Form 10-K for additional information related to dividend restrictions.

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

As of March 6, 2007, the Company had approximately 1,300 shareholders of record.

Following is a schedule of the shares of the Company's common stock purchased by the Company during the fourth quarter of 2006.

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Units) Purchased	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
Month#1(October 1- October 31, 2006)		\$		
Month#2 (November 1- November 30, 2006)	11,400	38.40	11,400	159,600
Month#3 (December 1- December 31, 2006)	5,000	37.65	5,000	154,600

Set forth below is a line graph comparing the yearly dollar changes in the cumulative shareholder return on the Company's common stock against the cumulative total return of the S&P 500 Stock Index, NASDAQ Bank Index, and NASDAQ Composite for the period of five fiscal years assuming the investment of \$100.00 on December 31, 2001 and assuming the reinvestment of dividends. The shareholder return shown on the graph below is not necessarily indicative of future performance.

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Index	Period Ending					
	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
Penns Woods Bancorp, Inc.	100.00	107.85	157.86	169.44	170.79	173.77
S&P 500	100.00	77.90	100.24	111.14	116.59	135.00
NASDAQ Composite	100.00	68.76	103.67	113.16	115.57	127.58
NASDAQ Bank Index	100.00	106.95	142.29	161.73	158.61	180.53

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ITEM 6 SELECTED FINANCIAL DATA

The following table sets forth certain financial data as of and for each of the years in the five-year period ended December 31, 2006.

(In Thousands, Except Per Share Data)	2006	2005	2004	2003	2002	
Consolidated Statement of Income Data:						
Interest income	\$ 33,753	\$ 30,903	\$ 29,845	\$ 28,384	\$ 28,465	
Interest expense	14,210	10,381	8,768	9,265	10,846	
Net interest income	19,543	20,522	21,077	19,119	17,619	
Provision for loan losses	635	720	465	255	365	
Net interest income after provision for loan losses	18,908	19,802	20,612	18,864	17,254	
Noninterest income	9,029	9,431	8,918	9,150	5,965	
Noninterest expense	16,329	15,108	14,184	13,137	12,086	
Income before income taxes	11,608	14,125	15,346	14,877	11,133	
Applicable income taxes	1,961	3,224	4,263	3,703	2,247	
Net Income	\$ 9,647	\$ 10,901	\$ 11,083	\$ 11,174	\$ 8,886	
Consolidated Balance Sheet at End of Period:						
Total assets	\$ 592,285	\$ 568,668	\$ 546,703	\$ 527,381	\$ 472,206	
Loans	360,384	338,438	324,505	275,828	257,845	
Allowance for loan losses	(4,185)	(3,679)	(3,338)	(3,069)	(2,953)	
Deposits	395,191	352,529	356,836	334,318	339,848	
Long-term debt other	82,878	84,478	75,878	70,878	51,778	
Shareholders equity	74,594	73,919	73,165	69,769	63,142	
Per Share Data:						
Earnings per share - Basic	\$ 2.45	\$ 2.75	\$ 2.78	\$ 2.79	\$ 2.22	
Earnings per share - Diluted	2.45	2.74	2.78	2.79	2.22	
Cash dividends declared	1.73	1.56	1.47	1.24	1.03	
Book value	19.12	18.59	18.36	17.50	15.78	
Number of shares outstanding, at end of period	3,900,742	3,975,787	3,985,832	3,985,872	3,637,595	
Average number of shares outstanding-basic	3,934,138	3,971,926	3,990,008	3,996,702	4,003,575	
Selected financial ratios:						
Return on average shareholders equity	12.93	% 14.54	% 15.49	% 16.60	% 15.00	%
Return on average total assets	1.67	% 1.97	% 2.06	% 2.24	% 2.01	%
Net interest income to average interest earning assets	4.06	% 4.29	% 4.32	% 4.36	% 4.25	%
Dividend payout ratio	70.51	% 57.10	% 52.72	% 44.76	% 46.40	%
Average shareholders equity to average total assets	12.92	% 13.56	% 13.30	% 13.51	% 13.39	%
Loans to deposits, at end of period	91.19	% 96.00	% 90.94	% 82.50	% 75.87	%

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

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

RESULTS OF OPERATIONS

NET INTEREST INCOME

Net interest income is determined by calculating the difference between the yields earned on interest-earning assets and the rates paid on interest-bearing liabilities. To compare the tax-exempt asset yields to taxable yields, amounts are adjusted to taxable equivalents based on the marginal corporate federal tax rate of 34%. The tax equivalent adjustments to net interest income for 2006, 2005, and 2004 were \$2,245,000, \$1,764,000, and \$906,000, respectively.

2006 vs 2005

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

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

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

2005 vs 2004

Reported net interest income decreased \$555,000 or 2.6 % from the year ended December 31, 2004 to 2005. Total interest income increased \$1,058,000 and is attributed to the increase of \$27,940,000 in the average balance of the loan portfolio coupled with an increase of the tax equivalent yield on investment securities of 45 basis points offset partially by a decrease in the average balance of the investment securities of \$17,608,000.

On a tax equivalent basis, net interest income increased to \$22,286,000 from \$21,983,000 for the year ended December 31, 2004. The tax equivalent interest income on the investment portfolio remained stable despite a decrease in the average

balance of the investment portfolio of \$17,608,000. Offsetting the decline in average balance of the portfolio was a shift in the portfolio to tax-exempt bonds from taxable. This repositioning was undertaken to provide portfolio call protection, strategic investment at the community level, and as part of the Company's tax strategy. The net growth in the volume of the loan portfolio was the driving force behind the increase in loan interest income as the yield on loans increased 3 basis points to 6.73% at December 31, 2005.

For the year ended December 31, 2005, reported interest expense increased \$1,613,000 over the same period of 2004. Over half of the increased level of interest expense was due to market driven increases in the rates paid on deposit accounts. The increases are primarily the result of the continued rate increases enacted by the FOMC coupled with aggressive pricing due to competition for deposits. In addition, deposit dollars have shifted from lower rate transaction based accounts to higher rate time deposits during 2005. This shift has resulted in the average balance of time deposits increasing \$16,051,000 in 2005 as compared to 2004. The shift in dollars and the FOMC rate increases resulted in the average rate paid on deposits increasing to 1.98% from 1.65% for the year ended December 31, 2004 with the time deposit portfolio average rate increasing 40 basis points over the time period.

The Company increased long-term borrowing during 2005 through the FHLB to manage future borrowing costs and to enhance liability positioning. These additional borrowings were utilized by management to replace maturing debt and to supplement the funding of the growth in the loan portfolio. The increase in the expense on long-term borrowings is the result of average balances of long-term FHLB borrowings increasing \$5,093,000 while the weighted average interest rate on the long-term debt remained constant. Short-term borrowing interest increased \$392,000 as a result of the before mentioned FOMC rate increases and an increase of the average balances outstanding during the year of \$257,000.

AVERAGE BALANCES AND INTEREST RATES

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

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(In Thousands)	2006 Average Balance	Interest	Average Rate	
ASSETS:				
Tax-exempt loans	\$ 8,173	\$ 503	6.15	%
All other loans	344,524	24,545	7.12	%
Total loans	352,697	25,048	7.10	%
Taxable securities	91,767	4,837	5.27	%
Tax-exempt securities	92,692	6,102	6.58	%
Total securities	184,459	10,939	5.93	%
Interest-bearing deposits	152	11	7.24	%
Total interest-earning assets	537,308	35,998	6.70	%
Other assets	40,413			
Total assets	\$ 577,721			
LIABILITIES:				
Savings	\$ 61,958	509	0.82	%
Super Now deposits	47,294	655	1.38	%
Money market deposits	23,905	493	2.06	%
Time deposits	176,521	7,251	4.11	%
Total deposits	309,678	8,908	2.88	%
Short-term borrowings	34,612	1,503	4.34	%
Long-term borrowings	83,237	3,799	4.56	%
Total borrowings	117,849	5,302	4.50	%
Total interest-bearing liabilities	427,527	14,210	3.32	%
Demand deposits	69,668			
Other liabilities	5,899			
Shareholders' equity	74,627			
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 577,721			
Interest rate spread			3.38	%
Net interest income/margin		\$ 21,788	4.06	%

Fees on loans are included with interest on loans. Loan fees are included in interest income as follows: 2006 \$478,000, 2005 \$491,000, 2004 \$470,000

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

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

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

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(In Thousands)	2005			2004			
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	
ASSETS:							
Tax-exempt loans	\$ 5,370	\$ 307	5.72	% \$ 1,359	\$ 82	6.03	%
All other loans	325,177	21,924	6.74	% 301,248	20,207	6.71	%
Total loans	330,547	22,231	6.73	% 302,607	20,289	6.70	%
Taxable securities	115,041	5,529	4.81	% 170,876	7,872	4.61	%
Tax-exempt securities	72,892	4,882	6.70	% 34,665	2,586	7.46	%
Total securities	187,933	10,411	5.54	% 205,541	10,458	5.09	%
Interest-bearing deposits	873	25	2.86	% 434	4	0.92	%
Total interest-earning assets	519,353	32,667	6.29	% 508,582	30,751	6.05	%
Other assets	33,308			29,064			
Total assets	\$ 552,661			\$ 537,646			
LIABILITIES:							
Savings	\$ 64,795	500	0.77	% \$ 69,796	578	0.83	%
Super Now deposits	50,756	438	0.86	% 54,690	391	0.71	%
Money market deposits	29,317	412	1.41	% 35,164	392	1.11	%
Time deposits	146,391	4,424	3.02	% 130,340	3,414	2.62	%
Total deposits	291,259	5,774	1.98	% 289,990	4,775	1.65	%
Short-term borrowings	32,114	931	2.90	% 31,857	539	1.69	%
Long-term borrowings	80,820	3,676	4.55	% 75,727	3,454	4.56	%
Total borrowings	112,934	4,607	4.08	% 107,584	3,993	3.71	%
Total interest-bearing liabilities	404,193	10,381	2.57	% 397,574	8,768	2.21	%
Demand deposits	69,457			64,434			
Other liabilities	4,057			4,091			
Shareholders' equity	74,954			71,547			
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 552,661			\$ 537,646			
Interest rate spread			3.72	%		3.84	%
Net interest income/margin		\$ 22,286	4.29	%	\$ 21,983	4.32	%

Reconciliation of Taxable Equivalent Net Interest Income

	2006	2005	2004
Total interest income	\$ 33,753	\$ 30,903	\$ 29,845
Total interest expense	14,210	10,381	8,768
Net interest income	19,543	20,522	21,077
Tax equivalent adjustment	2,245	1,764	906
Net interest income (fully taxable equivalent)	\$ 21,788	\$ 22,286	\$ 21,983

Rate/Volume Analysis

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

(In Thousands)	Year Ended December 31, 2006 vs 2005			2005 vs 2004		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Net	Volume	Rate	Net
Interest income:						
Loans, tax-exempt	\$ 174	\$ 22	\$ 196	\$ 229	\$ (4)	\$ 225
Loans	1,342	1,279	2,621	1,614	103	1,717
Taxable investment securities	(1,192)	500	(692)	(2,670)	327	(2,343)
Tax-exempt investment securities	1,304	(84)	1,220	2,585	(289)	2,296
Interest-bearing deposits	(32)	18	(14)	7	14	21
Total interest-earning assets	1,596	1,735	3,331	1,765	151	1,916
Interest expenses:						
Savings deposits	(23)	32	9	(40)	(38)	(78)
Super Now deposits	(32)	249	217	(29)	76	47
Money market deposits	(86)	167	81	(72)	92	20
Time deposits	471	2,356	2,827	161	849	1,010
Short-term borrowings	65	507	572	4	388	392
Long-term borrowings	110	13	123	231	(9)	222
Total interest-bearing liabilities	505	3,324	3,829	255	1,358	1,613
Change in net interest income	\$ 1,091	\$ (1,589)	\$ (498)	\$ 1,510	\$ (1,207)	\$ 303

PROVISION FOR LOAN LOSSES

2006 vs 2005

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

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

Although management believes that it uses the best information available to make such determinations and that the allowance for loan losses is adequate at December 31, 2006, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy or employment and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in interest income. Additionally, as an integral part of the

examination process, bank regulatory agencies periodically review the Bank's loan loss allowance. The banking regulators could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

The allowance for loan losses increased from \$3,679,000 at December 31, 2005 to \$4,185,000 at December 31, 2006. At December 31, 2006, allowance for loan losses was 1.16% of total loans compared to 1.09% of total loans at December 31, 2005. Management's conclusion is that the allowance for loan losses is adequate to provide for probable losses inherent in its loan portfolio as of the consolidated balance sheet date.

The provision for loan losses totaled \$635,000 for the year ended December 31, 2006. The provision for the same period in 2005 was \$720,000. Management concluded that the decrease of the provision was appropriate when considering the gross loan growth experienced during 2006 of \$21,946,000 coupled with the low levels of charge-offs, delinquencies and economic changes during the year. Utilizing both internal and external resources, as noted, senior management has concluded that the allowance for loan losses remains at a level adequate to provide for probable losses inherent in the loan portfolio.

2005 vs 2004

The allowance for loan losses increased 10.2% or \$341,000 from fiscal 2004 after net charge-offs of \$379,000 contributed to a year-end allowance for loan losses of \$3,679,000 or 1.09% of total loans. Based upon this analysis, as well as the others noted above, senior management concluded that the allowance for loan losses was at a level adequate to provide for probable losses inherent in the loan portfolio at December 31, 2005.

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

(In Thousands)	2006	2005	2004	2003	2002	
Balance at beginning of period	\$ 3,679	\$ 3,338	\$ 3,069	\$ 2,953	\$ 2,927	
Charge-offs:						
Real estate	50	132	121	63	262	
Commercial and industrial	28	206	50	37	80	
Installment loans to individuals	249	108	112	116	60	
Total charge-offs	327	446	283	216	402	
Recoveries:						
Real estate	68	45	50	42	25	
Commercial and industrial	40	8	4	16	21	
Installment loans to individuals	90	14	33	19	17	
Total recoveries	198	67	87	77	63	
Net charge-offs	129	379	196	139	339	
Additions charged to operations	635	720	465	255	365	
Balance at end of period	\$ 4,185	\$ 3,679	\$ 3,338	\$ 3,069	\$ 2,953	
Ratio of net charge-offs during the period to average loans outstanding during the period	0.04	% 0.11	% 0.06	% 0.05	% 0.13	%

NON-INTEREST INCOME

2006 vs 2005

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

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

2005 vs 2004

Total non-interest income increased \$513,000 from fiscal 2004 to 2005. Excluding security gains and the gain on sale of loans, non-interest income increased \$604,000. Service charges increased \$245,000 due to the implementation of a new overdraft protection program that was started in May 2005. Earnings on bank-owned life insurance increased \$274,000 due in large part to the receipt of \$196,000 due to a death benefit claim. Commissions earned on the sale of insurance products increased \$45,000 as The M Group continued to expand its market area by adding sales representatives to meet commitments made with other financial institutions to provide these same services to their customers. Gain on sale of loans decreased as the volume of loans sold decreased as compared to 2004. The increase in other income was primarily due to increases in card revenues from both ATM and debit cards offset by decreases in other areas of other income. Transaction volume increases attributed to our customers increased utilization of debit cards resulting in debit card fees increasing \$74,000.

(In Thousands)	2005		2004		Change	
	Amount	% Total	Amount	% Total	Amount	%
Deposit service charges	\$ 2,228	23.62	% \$ 1,983	22.24	% \$ 245	12.36
Securities gains, net	2,190	23.22	2,176	24.40	14	0.64
Bank-owned life insurance	568	6.02	294	3.30	274	93.20
Gain on sale of loans	864	9.16	969	10.87	(105)	(10.84)
Insurance commissions	2,327	24.68	2,282	25.58	45	1.97
Other income	1,254	13.30	1,214	13.61	40	3.29
Total non-interest income	\$ 9,431	100.00	% \$ 8,918	100.00	% \$ 513	5.75

NON-INTEREST EXPENSES

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2006 vs 2005

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

(In Thousands)	2006 Amount	% Total	2005 Amount	% Total	Change Amount	%
Salaries and employee benefits	\$ 8,833	54.09	\$ 8,314	55.03	\$ 519	6.24
Occupancy, net	1,137	6.96	1,089	7.21	48	4.41
Furniture and equipment	1,201	7.36	973	6.44	228	23.43
Pennsylvania shares tax	598	3.66	549	3.63	49	8.93
Other expenses	4,560	27.93	4,183	27.69	377	9.01
Total non-interest expense	\$ 16,329	100.00	\$ 15,108	100.00	\$ 1,221	8.08

2005 vs 2004

Total non-interest expenses increased \$924,000 from the year ended December 31, 2004 to December 31, 2005. Salaries and employee benefits increased by \$510,000 and was the result of increased staffing due in part to a new branch in the State College area, standard wage increases, and increased pension and health insurance costs. Occupancy expense increased due primarily to the new State College office which was operational since May 2005. Furniture and equipment expenses declined due in part to the reduction of several computer, hardware, and equipment maintenance contracts deemed unnecessary. Other expenses increased \$286,000 due to general increases in the cost of business specifically ATM transaction processing, advertising, telephone, stationery, and office supplies.

(In Thousands)	2005 Amount	% Total	2004 Amount	% Total	Change Amount	%
Salaries and employee benefits	\$ 8,314	55.03	\$ 7,804	55.03	\$ 510	6.54
Occupancy, net	1,089	7.21	959	6.76	130	13.56
Furniture and equipment	973	6.44	1,016	7.16	(43)	(4.23)
Pennsylvania shares tax	549	3.63	508	3.58	41	8.07
Other expenses	4,183	27.69	3,897	27.47	286	7.34
Total non-interest expense	\$ 15,108	100.00	\$ 14,184	100.00	\$ 924	6.51

INCOME TAXES

2006 vs 2005

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

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2005 vs 2004

The provision for income taxes for the year ended December 31, 2005 resulted in an effective income tax rate of 22.8% compared to 27.8% for 2004. This decrease is the result of a shift in the investment portfolio from taxable mortgage-backed bonds to tax-exempt municipal bonds.

FINANCIAL CONDITION

INVESTMENTS

2006

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

2005

The investment portfolio increased \$2,562,000 or 1.39% from December 31, 2004 to 2005. During 2005 the investment portfolio components were shifted from taxable bonds to tax-exempt municipal bonds. This shift was part of a strategy to increase yield, provide call protection, and to reduce the Company's overall effective tax rate. This strategy resulted in state and political tax-exempt holdings increasing \$42,197,000 or 89.65% from year end 2004 to 2005, while the investment in government agencies and treasuries has decreased by \$40,076,000 or 38.5%.

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

(In Thousands)	2006 Balance	% Portfolio	2005 Balance	% Portfolio	2004 Balance	% Portfolio
U.S. Treasury securities:						
Available for Sale	\$		\$		\$ 1,024	0.55 %
U.S. Government agencies:						
Held to Maturity	26	0.01 %	28	0.01 %	32	0.02 %
Available for Sale	54,152	29.20 %	63,953	34.15 %	103,001	55.76 %
State and political subdivisions (tax-exempt):						
Held to Maturity					248	0.13 %
Available for Sale	103,057	55.56 %	89,265	47.66 %	47,068	25.48 %
State and political subdivisions (taxable):						
Held to Maturity						
Available for Sale	2,889	1.56 %	4,826	2.58 %		
Other bonds, notes and debentures:						
Held to Maturity	257	0.14 %	237	0.13 %	278	0.15 %
Available for Sale	2,024	1.09 %	1,719	0.92 %	1,342	0.73 %
Total bonds, notes and debentures	162,405	87.56 %	160,028	85.45 %	152,993	82.82 %
Corporate stock - Available for Sale						
	23,078	12.44 %	27,255	14.55 %	31,728	17.18 %
Total	\$ 185,483	100.00 %	\$ 187,283	100.00 %	\$ 184,721	100.00 %

The following table shows the maturities and repricing of investment securities, at amortized cost, at December 31, 2006 and the weighted average yields (for tax-exempt obligations on a fully taxable basis assuming a 34% tax rate) of such:

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(in thousands)	Within One Year	After One But Within Five Years	After Five But Within Ten Years	After Ten Years	Amortized Cost Total
U.S. Treasury securities:					
HTM Amount	\$	\$	\$	\$	\$
Yield					
AFS Amount					
Yield					
U.S. Government agencies:					
HTM Amount				26	26
Yield				8.95	% 8.96 %
AFS Amount			1,500	53,449	54,949
Yield			5.14	% 5.37	% 5.36 %
State and political subdivisions(tax-exempt):					
HTM Amount					
Yield					
AFS Amount			15	101,633	101,648
Yield			6.42	% 6.70	% 6.70 %
State and political subdivisions(taxable):					
HTM Amount					
Yield					
AFS Amount				3,010	3,010
Yield				5.02	% 5.02 %
Other bonds, notes and debentures:					
HTM Amount					
Yield		125	132		257
AFS Amount		6.24	% 5.91	%	6.07 %
Yield		25		1,973	1,998
Yield		5.05	%	6.39	% 6.31 %
Total Amount	\$	\$ 150	\$ 1,647	\$ 160,091	\$ 161,888
Total Yield		6.04	% 5.21	% 6.12	% 6.21 %
Equity Securities					
Total Investment Portfolio Value					\$ 20,353
Total Investment Portfolio Yield					\$ 182,241
					5.51 %

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

LOAN PORTFOLIO

2006

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

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2005

Gross loans for the year ended December 31, 2005 increased 4.29% to \$338,438,000 from \$324,505,000 at December 31, 2004. The increase was concentrated in real estate mortgages which increased \$8,229,000 as a whole from December 31, 2004 to 2005. Commercial and agricultural loans and installment loans increased \$4,304,000 and \$1,366,000 respectively. The growth in real estate secured loans is part of the Company's overall lending strategy to underwrite well collateralized real estate loans. The opening of the Atherton Street, State College branch along with a home equity loan campaign also assisted in increasing real estate loans. Commercial and individuals loan categories increased modestly as the Company broadens its lending base and expands its market coverage.

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

(In Thousands)	2006	2005	2004	2003	2002
Commercial and agricultural	\$ 28,555	\$ 34,407	\$ 30,103	\$ 23,523	\$ 23,708
Real estate mortgage:					
Residential	158,219	150,000	147,461	147,697	140,724
Commercial	135,404	127,131	123,757	82,896	75,892
Construction	16,749	10,681	8,365	7,652	3,356
Installment loans to individuals	22,475	17,281	15,915	15,000	14,934
Less: Net deferred loan fees	1,018	1,062	1,096	940	769
Gross loans	\$ 360,384	\$ 338,438	\$ 324,505	\$ 275,828	\$ 257,845

The amounts of domestic loans at December 31, 2006 are presented below by category and maturity:

(In Thousands)	Real Estate	Commercial and Other	Installment Loans to Individuals	Total
Loans with floating interest rates:				
1 year or less	\$ 25,282	\$ 8,588	\$ 2,368	\$ 36,238
1 through 5 years	10,390	1,692	179	12,261
5 through 10 years	29,124	3,458	283	32,865
After 10 years	188,788	1,916	282	190,986
Total floating interest rate loans	253,584	15,654	3,112	272,350
Loans with predetermined interest rates:				
1 year or less	5,800	660	917	7,377
1 through 5 years	17,800	9,845	10,850	38,495
5 through 10 years	19,156	2,243	7,596	28,995
After 10 years	12,996	153	18	13,167
Total predetermined interest rate loans	55,752	12,901	19,381	88,034
Total	\$ 309,336	\$ 28,555	\$ 22,493	\$ 360,384

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

* Scheduled repayments are reported in maturity categories in which the payment is due.

The Bank does not make loans that provide for negative amortization nor do any loans contain conversion features. The Bank does not have any foreign loans outstanding at December 31, 2006.

ALLOWANCE FOR LOAN LOSSES

2006

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

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

Although management believes that it uses the best information available to make such determinations and that the allowance for loan losses is adequate at December 31, 2006, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy or employment and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in interest income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Bank's loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

The allowance for loan losses increased from \$3,679,000 at December 31, 2005 to \$4,185,000 at December 31, 2006. At December 31, 2006, allowance for loan losses was 1.16% of total loans compared to 1.09% of total loans at December 31, 2005. This percentage is consistent with the Bank's historical experience and peer banks. Management's conclusion is that the allowance for loan losses is adequate to provide for probable losses inherent in its loan portfolio as of the balance sheet date.

2005

At December 31, 2005, the allowance for loan losses as a percent of total loans increased to 1.09% from 1.03% at December 31, 2004. Gross loans increased by \$13,933,000 from \$324,505,000 at December 31, 2004 to \$338,438,000 at December 31, 2005.

Based on management's loan-by-loan review, the past performance of the borrowers and current economic conditions, including recent business closures and bankruptcy levels, management does not anticipate any

current losses related to nonaccrual, nonperforming, or classified loans above that have already been considered in its overall judgment of the adequacy of the reserve.

NONPERFORMING LOANS

Non-accrual loans decreased to \$370,000 at December 31, 2006 primarily due to settlement of a commercial real estate relationship which previously filed for bankruptcy. Overall nonperforming loans decreased \$114,000 to \$489,000 from fiscal year end 2005.

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

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

(In Thousands)	Total Nonperforming Loans		
	Nonaccrual	90 Days Past Due	Total
2006	\$ 370	\$ 119	\$ 489
2005	540	63	603
2004	1,381	345	1,726
2003	827	429	1,256
2002	871	1,225	2,096

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

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

1. Economic conditions and the impact on the loan portfolio.
2. Analysis of past loan charge-offs experienced by category and comparison to outstanding loans.
3. Problem loans on overall portfolio quality.
4. Reports of examination of the loan portfolio by the Pennsylvania State Banking Department and the Federal Deposit Insurance Corporation.

Allocation In The Allowance For Loan Losses

(In Thousands)	Amount	Percent Of Loan In Each Category To Total Loans	
December 31, 2006:			
Balance at end of period applicable to:			
Commercial and agricultural	\$ 679	7.9	%
Real estate mortgage:			
Residential	951	43.8	%
Commercial	1,972	37.5	%
Construction	108	4.6	%
Installment loans to individuals	295	6.2	%
Unallocated	180		
Total	\$ 4,185	100.0	%
December 31, 2005:			
Balance at end of period applicable to:			
Commercial and agricultural	\$ 582	10.1	%
Real estate mortgage:			
Residential	1,107	44.2	%
Commercial	1,482	37.5	%
Construction	79	3.1	%
Installment loans to individuals	192	5.1	%
Unallocated	237		
Total	\$ 3,679	100.0	%
December 31, 2004:			
Balance at end of period applicable to:			
Commercial and agricultural	\$ 361	9.1	%
Real estate mortgage:			
Residential	1,280	46.1	%
Commercial	1,399	37.5	%
Construction	75	2.5	%
Installment loans to individuals	207	4.8	%
Unallocated	16		
Total	\$ 3,338	100.0	%
December 31, 2003:			
Balance at end of period applicable to:			
Commercial and agricultural	\$ 353	8.5	%
Real estate mortgage:			
Residential	1,483	53.4	%
Commercial	916	29.9	%
Construction	77	2.8	%
Installment loans to individuals	240	5.4	%
Total	\$ 3,069	100.0	%
December 31, 2002:			
Balance at end of period applicable to:			
Commercial and agricultural	\$ 471	9.2	%
Real estate mortgage:			
Residential	1,162	54.4	%
Commercial	1,082	29.3	%
Construction	66	1.3	%
Installment loans to individuals	172	5.8	%
Total	\$ 2,953	100.0	%

DEPOSITS**2006 vs 2005**

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

2005 vs 2004

Total average deposits were \$360,716,000 for 2005, an increase of \$6,292,000 or 1.78% from 2004. Non-interest bearing deposits increased \$5,023,000 or 7.80% year over year. Time deposits increased \$16,051,000 or 12.31% as deposits shifted from transaction accounts to time deposits in light of the increasing spread in interest rates between the deposit types. Increases in rates paid were the result of the FOMC rate increases during 2004 and increased competition for deposits.

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

(In Thousands)	2006		2005		2004	
	Average Amount	Rate	Average Amount	Rate	Average Amount	Rate
Noninterest-bearing	\$ 69,668	0.00	% \$ 69,457	0.00	% \$ 64,434	0.00
Savings	61,958	0.82	% 64,795	0.77	% 69,796	0.83
Super Now	47,294	1.38	% 50,756	0.86	% 54,690	0.71
Money Market	23,905	2.06	% 29,317	1.41	% 35,164	1.11
Time	176,521	4.11	% 146,391	3.02	% 130,340	2.62
Total average deposits	\$ 379,346	2.35	% \$ 360,716	1.60	% \$ 354,424	1.35

SHAREHOLDERS EQUITY**2006**

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

2005

Shareholders' equity increased \$754,000 to \$73,919,000 at December 31, 2005 as net retained earnings outpaced a decline in accumulated other comprehensive income of \$3,481,000. The decrease in accumulated other comprehensive income is a reflection of a decline in market value, unrealized gains and losses, for our investment portfolio, net of gains and losses realized in the available for sale portfolio during the year, at December 31, 2005 as compared to December 31, 2004. The level of shareholders' equity equated to a book value per share of \$18.59 as compared to \$18.36 at December 31, 2004. During the year ended December 31, 2005 a dividend of \$1.56 per share was paid to shareholders in addition to a 6 for 5 stock split that occurred in December 2005 prior to the cash dividend payment. The dividend represented a 6.12% increase over the dividend paid during 2004.

Bank regulators have risk based capital guidelines. Under these guidelines the Company and Bank are required to maintain minimum ratios of core capital and total qualifying capital as a percentage of risk weighted assets and certain off-balance sheet items. At December 31, 2006, both the Company's and Bank's required ratios were well above the minimum ratios as follows:

	Company	Bank	2006 Minimum Standards
Tier 1 capital ratio	11.8	% 9.3	% 4.0
Total capital ratio	20.3	% 16.2	% 8.0

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

RETURN ON EQUITY AND ASSETS

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

	2006	2005	2004
Percentage of net income to:			
Average total assets	1.67	% 1.97	% 2.06
Average shareholders' equity	12.93	% 14.54	% 15.49
Percentage of dividends declared to net income	70.51	% 57.10	% 52.72
Percentage of average shareholders' equity to average total assets	12.92	% 13.56	% 13.30

LIQUIDITY, INTEREST RATE SENSITIVITY AND MARKET RISK

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

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

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

Management monitors and determines the desirable level of liquidity. Consideration is given to loan demand, investment opportunities, deposit pricing and growth potential as well as the current cost of borrowing funds. The Company has a current borrowing capacity at the Federal Home Loan Bank of \$225,122,000 with \$101,584,000 utilized, leaving

\$123,538,000 available. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of \$28,048,000. The Company's management believes that it has sufficient liquidity to satisfy estimated short-term and long-term funding needs.

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

INTEREST RATE SENSITIVITY

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

The following is a rate shock forecast for the twelve month period ended December 31, 2007 assuming a static balance sheet as of December 31, 2006.

(In Thousands)	Parallel Rate Shock in Basis Points				
	-200	-100	Static	+100	+200
Net interest income	\$ 19,509	\$ 18,945	\$ 18,102	\$ 16,930	\$ 15,731
Change from static	1,407	843		(1,172)	(2,371)

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

INFLATION

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

CRITICAL ACCOUNTING POLICIES

The Company's accounting policies are integral to understanding the results reported. The accounting policies are described in detail in Note 1 of the consolidated financial statements. Our most complex accounting policies require

management's judgment to ascertain the valuation of assets, liabilities, commitments, and contingencies. We have established detailed policies and control procedures that are intended to ensure valuation methods are well controlled and applied consistently from period to period. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. The following is a brief description of our current accounting policies involving significant management valuation judgments.

Other Than Temporary Impairment of Equity Securities

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

Allowance for Loan Losses

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

Management uses historical information to assess the adequacy of the allowance for loan losses as well as the prevailing business environment; as it is affected by changing economic conditions and various external factors, which may impact the portfolio in ways currently unforeseen. The allowance is increased by provisions for loan losses and by recoveries of loans previously charged-off and reduced by loans charged-off. For a full discussion of the Company's methodology of assessing the adequacy of the reserve for loan losses, refer to Note 1 of Notes and Consolidated Financial Statements of the Form 10-K.

Goodwill and Other Intangible Assets

As discussed in Note 6 of the Notes to Consolidated Financial Statements of the Annual Report on Form 10-K, the Company must assess goodwill and other intangible assets each year for impairment. This assessment involves estimating cash flows for future periods. If the future cash flows were less than the recorded goodwill and other intangible assets balances, we would be required to take a charge against earnings to write down the assets to the lower value.

Deferred Tax Assets

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

CONTRACTUAL OBLIGATIONS

The Company has various financial obligations, including contractual obligations which may require future cash payments. The following table presents, as of December 31, 2006, significant fixed and determinable contractual obligations to third parties by payment date. Further discussion of the nature of each obligation is included in Notes to the Consolidated Financial Statements of the Annual Report on Form 10-K.

(In Thousands)	Payments Due in				Total
	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	
Deposits without a stated maturity	\$ 200,313	\$	\$	\$	\$ 200,313
Time Deposits	157,818	31,035	3,791	805	193,449
Repurchase agreements	15,991				15,991
Short-term borrowings, FHLB	18,706				18,706
Long-term borrowings, FHLB	11,500	34,600	15,500	21,278	82,878
Operating leases	411	531	220	1,282	2,444

The Corporation's operating lease obligations represent short and long-term lease and rental payments for branch facilities. The Bank leases certain facilities under operating leases which expire on various dates through 2024. Renewal options are available on these leases.

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 Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, the Company notes that a variety of factors could cause the Company's actual results and experience to differ materially from the anticipated results or other expectations expressed in the Company's forward-looking statements. The risks and uncertainties that may affect the operations, performance, development and results of the Company's business include the following: general economic conditions and changes in interest rates including their impact on capital expenditures; business conditions in the banking industry; the regulatory environment; rapidly changing technology and evolving banking industry standards; the effect of changes in accounting policies and practices, including increased competition with community, regional and national financial institutions; new service and product offerings by competitors and price pressures; changes in the Company's organization, compensation and benefit plans; and similar items.

[Letterhead of S.R. Snodgrass, A.C.]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Penns Woods Bancorp, Inc.

We have audited the consolidated balance sheets of Penns Woods Bancorp, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Penns Woods Bancorp, Inc. and subsidiaries as of December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 11 to the consolidated financial statements, Penns Woods Bancorp, Inc. changed its method of accounting for its defined benefit pension plan as of December 31, 2006, in accordance with Financial Accounting Standards Board Statement No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans*.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Penns Woods Bancorp, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 9, 2007, expressed an unqualified opinion on management's assessment of the effectiveness of Penns Woods Bancorp, Inc.'s internal control over financial reporting and an unqualified opinion on the effectiveness of Penns Woods Bancorp, Inc.'s internal control over financial reporting.

/s/ S.R. Snodgrass, A.C.
Wexford, Pennsylvania
March 9, 2007

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Market risk for the Company is comprised primarily from 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 internally. Additional information and details are provided in the Interest Sensitivity section of Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Generally, management believes the Company is well positioned to respond expeditiously when the market interest rate outlook changes.

ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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PENNS WOODS BANCORP, INC.

CONSOLIDATED BALANCE SHEET

(In Thousands, Except Share Data)	December 31, 2006	December 31, 2005
ASSETS:		
Noninterest-bearing balances	\$ 15,348	\$ 14,065
Interest-bearing deposits in other financial institutions	25	25
Total cash and cash equivalents	15,373	14,090
Investment securities, available for sale, at fair value	185,200	187,018
Investment securities held to maturity (fair value of \$286 and \$238)	283	265
Loans held for sale	3,716	3,545
Loans	360,384	338,438
Less: Allowance for loan losses	4,185	3,679
Loans, net	356,199	334,759
Premises and equipment, net	6,737	6,409
Accrued interest receivable	2,939	2,828
Bank-owned life insurance	11,346	10,718
Investment in limited partnerships	4,950	3,549
Goodwill	3,032	3,032
Other assets	2,510	2,455
TOTAL ASSETS	\$ 592,285	\$ 568,668
LIABILITIES:		
Interest-bearing deposits	\$ 322,031	\$ 281,150
Noninterest-bearing deposits	73,160	71,379
Total deposits	395,191	352,529
Short-term borrowings	34,697	54,003
Long-term borrowings, Federal Home Loan Bank (FHLB)	82,878	84,478
Accrued interest payable	1,532	1,108
Other liabilities	3,393	2,631
TOTAL LIABILITIES	517,691	494,749
SHAREHOLDERS EQUITY:		
Common stock, par value \$8.33, 10,000,000 shares authorized; 4,003,514 and 4,002,159 shares issued	33,362	33,351
Additional paid-in capital	17,810	17,772
Retained earnings	25,783	22,938
Accumulated other comprehensive income(loss):		
Net unrealized gain on available-for-sale securities	2,139	850
Defined benefit plan	(579))
Less: Treasury stock at cost, 102,772 and 26,372 shares	(3,921)) (992)
TOTAL SHAREHOLDERS EQUITY	74,594	73,919
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 592,285	\$ 568,668

See Accompanying Notes to the Consolidated Financial Statements

PENNS WOODS BANCORP, INC.
CONSOLIDATED STATEMENT OF INCOME

(In Thousands, Except Per Share Data)	Year Ended December 31,		
	2006	2005	2004
INTEREST AND DIVIDEND INCOME:			
Loans including fees	\$ 24,878	\$ 22,126	\$ 20,261
Investment Securities:			
Taxable	3,577	4,351	6,686
Tax-exempt	4,027	3,223	1,708
Dividend and other interest income	1,271	1,203	1,190
TOTAL INTEREST AND DIVIDEND INCOME	33,753	30,903	29,845
INTEREST EXPENSE:			
Deposits	8,908	5,774	4,775
Short-term borrowings	1,503	931	539
Long-term borrowings	3,799	3,676	3,454
TOTAL INTEREST EXPENSE	14,210	10,381	8,768
NET INTEREST INCOME	19,543	20,522	21,077
PROVISION FOR LOAN LOSSES	635	720	465
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	18,908	19,802	20,612
NON-INTEREST INCOME:			
Service charges	2,366	2,228	1,983
Securities gains, net	1,679	2,190	2,176
Bank-owned life insurance	374	568	294
Gain on sale of loans	853	864	969
Insurance commissions	2,281	2,327	2,282
Other income	1,476	1,254	1,214
TOTAL NON-INTEREST INCOME	9,029	9,431	8,918
NON-INTEREST EXPENSES:			
Salaries and employee benefits	8,833	8,314	7,804
Occupancy expense, net	1,137	1,089	959
Furniture and equipment expense	1,201	973	1,016
Pennsylvania shares tax expense	598	549	508
Other expenses	4,560	4,183	3,897
TOTAL NON-INTEREST EXPENSES	16,329	15,108	14,184
INCOME BEFORE INCOME TAX PROVISION	11,608	14,125	15,346
INCOME TAX PROVISION	1,961	3,224	4,263
NET INCOME	\$ 9,647	\$ 10,901	\$ 11,083
NET INCOME PER SHARE - BASIC	\$ 2.45	\$ 2.75	\$ 2.78
NET INCOME PER SHARE - DILUTED	\$ 2.45	\$ 2.74	\$ 2.78

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WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC	3,934,138	3,971,926	3,990,008
WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED	3,934,617	3,974,055	3,994,352

See Accompanying Notes to the Consolidated Financial Statements.

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PENNS WOODS BANCORP, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(In Thousands, Except Per Share Data)	Common Stock Shares	Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders Equity
Balance, December 31, 2003	3,991,872	\$ 33,265	\$ 17,559	\$ 13,022	\$ 6,132	\$ (209)	\$ 69,769
Comprehensive income:							
Net income				11,083			11,083
Unrealized loss on available for sale securities, net of reclassification adjustments and tax benefit of \$926					(1,801)		(1,801)
Total comprehensive income							9,282
Dividends declared (\$1.47 per share)				(5,843)			(5,843)
Stock options exercised	6,332	53	141				194
Purchase of treasury stock (6,372 shares)						(237)	(237)
Balance, December 31, 2004	3,998,204	33,318	17,700	18,262	4,331	(446)	73,165
Stock split fractional shares	(293)	(2)	2				
Comprehensive income:							
Net income				10,901			10,901
Unrealized loss on available for sale securities, net of reclassification adjustments and tax benefit of \$1,793					(3,481)		(3,481)
Total comprehensive income							7,420
Dividends declared (\$1.56 per share)				(6,225)			(6,225)
Stock options exercised	4,248	35	70				105
Purchase of treasury stock (14,000 shares)						(546)	(546)
Balance, December 31, 2005	4,002,159	33,351	17,772	22,938	850	(992)	73,919
Comprehensive income:							
Net income				9,647			9,647
Unrealized gain on available for sale securities, net of reclassification adjustments and tax of \$664					1,289		1,289
Total comprehensive income							10,936
Cumulative effect of change in accounting for pension obligations, net of tax benefit of \$298					(579)		(579)
Dividends declared (\$1.73 per share)				(6,802)			(6,802)
Common shares issued for employee stock purchase plan	1,355	11	38				49
Purchase of treasury stock (76,400 shares)						(2,929)	(2,929)
Balance, December 31, 2006	4,003,514	\$ 33,362	\$ 17,810	\$ 25,783	\$ 1,560	\$ (3,921)	\$ 74,594

	2006	2005	2004
Components of comprehensive income (loss):			
Change in net unrealized gain (loss) on investments available for sale	\$ 2,397	\$ (2,036)	\$ (365)
Net realized gains included in net income, net of taxes of \$571, \$745, and \$740	(1,108)	(1,445)	(1,436)
Total	\$ 1,289	\$ (3,481)	\$ (1,801)

See Accompanying Notes to the Consolidated Financial Statements.

PENNS WOODS BANCORP, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS

(In Thousands)	Year Ended December 31,		
	2006	2005	2004
OPERATING ACTIVITIES			
Net income	\$ 9,647	\$ 10,901	\$ 11,083
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	744	549	585
Provision for loan losses	635	720	465
Accretion and amortization of investment security discounts and premiums	(784)	(453)	(132)
Securities gains, net	(1,679)	(2,190)	(2,176)
Originations of loans held for sale	(37,192)	(30,353)	(34,398)
Proceeds of loans held for sale	37,874	32,296	35,546
Gain on sale of loans	(853)	(864)	(969)
Increases in bank-owned life insurance	(628)	(568)	(294)
Other, net	(29)	254	482
Net cash provided by operating activities	7,735	10,292	10,192
INVESTING ACTIVITIES			
Investment securities available for sale:			
Proceeds from sales	76,249	123,546	162,796
Proceeds from calls and maturities	7,477	12,664	28,732
Purchases	(78,241)	(141,798)	(159,295)
Investment securities held to maturity:			
Proceeds from calls and maturities	25	328	142
Purchases	(25)	(35)	(14)
Net increase in loans	(22,353)	(14,745)	(49,002)
Acquisition of bank premises and equipment	(1,072)	(2,076)	(842)
Proceeds from the sale of foreclosed assets	329	329	237
Proceeds from bank-owned life insurance death benefit		826	
Purchase of bank-owned life insurance			(1,774)
Investment in limited partnership	(1,646)	(3,124)	
Proceeds from redemption of regulatory stock	3,630	4,862	3,322
Purchases of regulatory stock	(2,899)	(4,760)	(2,940)
Net cash used for investing activities	(18,526)	(23,983)	(18,638)
FINANCING ACTIVITIES			
Net increase (decrease) in interest-bearing deposits	40,881	(1,636)	13,343
Net increase (decrease) in noninterest-bearing deposits	1,781	(2,671)	9,175
Net (decrease) increase in short-term borrowings	(19,306)	17,528	(10,790)
Proceeds from long term borrowings, FHLB		10,000	5,000
Repayment of long term borrowings, FHLB	(1,600)	(1,400)	
Dividends paid	(6,802)	(6,225)	(5,843)
Issuance of common stock	49		
Stock options exercised		105	194
Purchase of treasury stock	(2,929)	(546)	(237)
Net cash provided by financing activities	12,074	15,155	10,842
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,283	1,464	2,396
CASH AND CASH EQUIVALENTS, BEGINNING	14,090	12,626	10,230

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CASH AND CASH EQUIVALENTS, ENDING	\$ 15,373	\$ 14,090	\$ 12,626
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SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Interest paid	\$ 13,786	\$ 10,123	\$ 8,754
Income taxes paid	2,645	2,625	4,350
Transfer of loans to foreclosed real estate	278	433	129

See Accompanying Notes to the Consolidated Financial Statements.

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PENNS WOODS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

Nature of Business

The Bank engages in a full-service commercial banking business, making available to the community a wide range of financial services including, but not limited to, installment loans, credit cards, mortgage and home equity loans, lines of credit, construction financing, farm loans, community development loans, loans to non-profit entities and local government, and various types of time and demand deposits including, but not limited to, checking accounts, savings accounts, clubs, money market deposit accounts, certificates of deposit, and IRAs. Deposits are insured by the Federal Deposit Insurance Corporation (FDIC) to the extent provided by law.

The financial services are provided by the Bank to individuals, partnerships, non-profit organizations, and corporations through its thirteen offices located in Clinton, Lycoming, and Centre Counties, Pennsylvania.

Woods Real Estate Development Co., Inc. engages in real estate transactions on behalf of Penns Woods Bancorp, Inc. and the Bank.

Woods Investment Company, Inc., a Delaware holding company, is engaged in investing activities.

The M Group engages in securities brokerage and financial planning services, which include the sale of life insurance products, annuities, and estate planning services.

Operations are managed and financial performance is evaluated on a corporate-wide basis. Accordingly, all financial services operations are considered by management to be aggregated in one reportable operating segment.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, deferred tax assets and liabilities, and the valuation of real estate acquired through, or in lieu of, foreclosure on settlement of debt.

Stock Split

During the fourth quarter of 2005 the Company initiated a 6 for 5 stock split. Previously reported share and per share amounts have been adjusted to reflect the split.

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Cash and Cash Equivalents

Cash equivalents include cash on hand and in banks and interest-earning deposits. Interest-earning deposits mature within one year and are carried at cost. Net cash flows are reported for loan, deposit, and short term borrowing transactions.

Restrictions on Cash and Cash Equivalents

Based on deposit levels, the Company must maintain cash and other reserves with the Federal Reserve Bank of Philadelphia (FRB).

Investment Securities

Investment securities are classified as available for sale or held to maturity.

Securities held to maturity include bonds, notes, and debentures for which the Company has the positive intent and ability to hold to maturity and are reported at amortized cost.

Available for sale securities consist of bonds, notes, debentures, and certain equity securities not classified as trading securities nor as held to maturity securities. Unrealized holding gains and losses, net of tax, on available for sale securities are reported as a net amount in a separate component of shareholders' equity until realized.

Gains and losses on the sale of equity securities are determined using the average cost method, while all other investment securities use the specific cost method.

All investment securities, regardless of classification, are monitored and tested for impairment. An investment security is considered to be impaired when the unrealized loss is considered to be other than temporary. When this occurs, the investment is written down to the current fair market value with the write-down being reflected as a realized loss.

Premiums and discounts on all securities are recognized in interest income using the level yield method over the period to maturity.

Investment securities fair values are based on observed market prices. Certain investment securities do not have observed bid prices and their fair value is based on instruments with similar risk elements. Since regulatory stock is redeemable at par, the Company carries it at cost.

Loans

Loans are stated at the principal amount outstanding, net of deferred fees, unamortized loan fees and costs, and the allowance for loan losses. Interest on loans is recognized as income when earned on the accrual method. The Company's general policy has been to stop accruing interest on loans when it is determined a reasonable doubt exists as to the collectibility of additional interest. Income is subsequently recognized only to the extent that cash payments are received provided the loan is not delinquent in payment and, in management's judgment, the borrower has the ability and intent to make future principal payments.

Loan origination and commitment fees as well as certain direct loan origination costs are being deferred and amortized as an adjustment to the related loan's yield over the contractual lives of the related loans.

Allowance for Loan Losses

The allowance for loan losses represents the amount which management estimates is adequate to provide for probable losses inherent in its loan portfolio, as of the balance sheet date. The allowance method is used in providing for loan losses. Accordingly, all loan losses are charged to the allowance and all recoveries are credited to it. The allowance for loan losses is established through a provision for loan losses charged to operations. The provision for loan losses is based upon management's quarterly review of the loan portfolio. The purpose of the review is to assess loan quality, identify impaired

loans, analyze delinquencies, ascertain loan growth, evaluate potential charge-offs and recoveries, and assess general economic conditions in the markets served. An external independent loan review is also performed annually for the Bank. Management remains committed to an aggressive program of problem loan identification and resolution.

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

Although management believes that it uses the best information available to make such determinations and that the allowance for loan losses is adequate at December 31, 2006, 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, rising unemployment, or negative performance trends in financial information from borrowers could be indicators of subsequent increased levels of nonperforming assets and possible charge-offs, which would normally require increased loan loss provisions. An integral part of the periodic regulatory examination process is the review of the adequacy of the Bank's loan loss allowance. The regulatory agencies could require the Bank based on their evaluation of information available at the time of their examination to provide additional loan loss provisions to further supplement the allowance.

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

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

Loans Held for Sale

In general, fixed rate residential mortgage loans originated by the Bank are held for sale and are carried at cost due to their short holding period which can range from less than two weeks up to thirty days. Sold loans are not serviced by the Bank. Proceeds from the sale of loans in excess of the carrying value are accounted for as a gain. Total gains on the sale of loans are shown as a component of non-interest income within the consolidated statement of income.

Foreclosed Assets Held for Sale

Foreclosed assets held for sale are carried at the lower of cost or fair value minus estimated selling costs. Prior to foreclosure, the value of the underlying loan is written down to the fair value of the real estate to be acquired by a charge to the allowance for loan losses, if necessary. Any subsequent write-downs are charged against operating expenses. Net operating expenses and gains and losses realized from disposition are included in non-interest expense and income, respectively.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed using straight-line and accelerated methods over the estimated useful lives of the related assets, which range from five to ten years for furniture, fixtures, and equipment and fifteen to forty years for buildings and improvements. Costs incurred for routine maintenance and repairs are charged to operations as incurred. Costs of major additions and improvements are capitalized.

Bank-Owned Life Insurance

The Company has purchased life insurance policies on certain officers, and is the sole beneficiary on those policies. Bank-owned life insurance is recorded at its cash surrender value, or the amount that can be realized. Increases in the cash surrender value are recognized as non-interest income.

Goodwill

The Company accounts for goodwill in accordance with Statement of Financial Accounting Standards (FAS) No. 142, *Goodwill and Other Intangible Assets*. This statement, among other things, requires a two-step process for testing the impairment of goodwill on at least an annual basis. This approach could cause more volatility in the Company's reported net income because impairment losses, if any, could occur irregularly and in varying amounts. The Company performs an annual impairment analysis of goodwill for its purchased subsidiary, The M Group. Based on the fair value of this reporting unit, estimated using the expected present value of future cash flows, no impairment of goodwill was recognized in 2006 and 2005.

Investments in Limited Partnerships

The Company is a limited partner in three partnerships at December 31, 2006 that provide low income elderly housing in the Company's geographic market area. The carrying value of the Company's investments in limited partnerships was \$4,950,000 at December 31, 2006 and \$3,549,000 at December 31, 2005. The Company is fully amortizing the investment in the partnership entered into prior to 2005 over the fifteen-year holding period. The partnerships entered into after 2004 are being fully amortized over the ten-year tax credit receipt period utilizing the straight-line method. The partnerships began being amortized once the projects reached the level of occupancy needed to begin the ten year tax credit recognition period. Amortization of limited partnership investments amounted to \$245,000 in 2006 and \$90,000 for 2005 and 2004.

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Company enters into off-balance sheet financial instruments. Those instruments consist of commitments to extend credit and standby letters of credit. When those instruments are funded or become payable, the Company reports the amounts in its financial statements.

Advertising Cost

Advertising costs are generally expensed as incurred.

Income Taxes

Deferred tax assets and liabilities result from temporary differences in financial and income tax methods of accounting, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Earnings Per Share

The Company provides dual presentation of basic and diluted earnings per share. Basic earnings per share is calculated utilizing net income as reported in the numerator and weighted average shares outstanding in the denominator. The computation of diluted earnings per share differs in that the dilutive effects of any stock options are adjusted in the denominator.

Employee Benefits

Pension and employee benefits include contributions, determined actuarially, to a defined benefit retirement plan covering the eligible employees of the Bank. The plan is funded on a current basis to the extent that it is deductible under existing federal tax regulations. Pension and other employee benefits also include contributions to a defined contribution Section 401(k) plan covering eligible employees. Contributions matching those made by eligible employees are funded throughout the year. In addition, an elective contribution is made annually at the discretion of the Board of Directors.

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The M Group Products and Income Recognition

The M Group product line is comprised primarily of annuities, life insurance, and mutual funds. The revenues generated from life insurance sales are commission only, as The M Group does not underwrite the policies. Life insurance sales include permanent and term policies with the majority of the policies written being permanent. Term life insurance policies are written for 10, 15, 20, and 30 year terms with the majority of the policies being written for 20 years. None of these products are offered as an integral part of lending activities.

Commissions from the sale of annuities are recognized at the time notice is received from the third party broker/dealer or an insurance company that the transaction has been accepted and approved, which is also the time when commission income is received.

Life insurance commissions are recognized at varying points based on the payment option chosen by the customer. Commissions from monthly and annual payment plans are recognized at the start of each annual period for the life insurance, while quarterly and semi-annual premium payments are recognized quarterly and semi-annually when the earnings process is complete. For example, semi-annual payments on the first of January and July would result in commission income recognition on the first of January and July, while payments on the first of January, April, July, and October would result in commission income recognition on those dates. The potential for chargebacks only exists for those policies on a monthly payment plan since income is recognized at the beginning of the annual coverage period versus at the time of each monthly payment. No liability is maintained for chargebacks as these are removed from income at the time of the occurrence.

Stock Options

The Company maintains a stock option plan for directors and certain officers and employees. For all options granted prior to January 1, 2006, when the exercise price of the Company's stock options was greater than or equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized in the Company's financial statements.

Accumulated Other Comprehensive Income

The Company is required to present accumulated other comprehensive income in a full set of general-purpose financial statements for all periods presented. Accumulated other comprehensive income is comprised of unrealized holding gains (losses) on the available for sale securities portfolio and the unrecognized components of net periodic benefit costs of the defined benefit pension plan.

Segment Reporting

Statement of Financial Accounting Standards No. 131, *Disclosure about Segments of an Enterprise and Related Information*, requires that public business enterprises report financial and descriptive information about their reportable operating segments. Based on the guidance provided by the Statement, the company has determined that its only reportable segment is Community Banking.

Reclassification of Comparative Amounts

Certain items previously reported have been reclassified to conform to the current year's reporting format. Such reclassifications did not affect net income or shareholders' equity.

Recent Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued FAS No. 155, *Accounting for Certain Hybrid Instruments, as an amendment of FASB Statements No. 133 and 140*. FAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In March 2006, the FASB issued FAS No. 156, *Accounting for Servicing of Financial Assets*. This statement, which is an amendment to FAS No. 140, will simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, FAS No. 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting. FAS No. 156 also clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability; requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; and permits an entity with a separately recognized servicing asset or servicing liability to choose either of the amortization or fair value methods for subsequent measurement. The provisions of FAS No. 156 are effective as of the beginning of the first fiscal year that begins after September 15, 2006. 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. Early adoption is permitted. 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. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. FAS No. 158 requires that a company recognize the overfunded or underfunded status of its defined benefit post-retirement plans (other than multiemployer plans) as an asset or liability in its statement of financial position and that it recognize changes in the funded status in the year in which the changes occur through other comprehensive income. FAS No. 158 also requires the measurement of defined benefit plan assets and obligations as of the fiscal year-end, in addition to footnote disclosures. On December 31, 2006, the Company adopted FAS No. 158, except for the measurement provisions, which are effective for fiscal years ending after December 15, 2008. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. FIN 48 is an interpretation of FAS No. 109, *Accounting for Income Taxes*, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. This Interpretation clarifies that management is expected to evaluate an income tax position taken or expected to be taken for likelihood of realization before recording any amounts for such position in the financial statement. FIN 48 also requires expanded disclosure with respect to income tax positions taken that are not certain to be realized. This Interpretation is effective for fiscal years beginning after December 15, 2006, and will require management to evaluate every open tax position that exists in every jurisdiction on the date of initial adoption. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations.

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. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations or financial condition.

In September 2006, the FASB reached consensus on the guidance provided by Emerging Issues Task Force Issue 06-5 (EITF 06-5), *Accounting for Purchases of Life Insurance - Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance*. EITF 06-5 states that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the

cash surrender value in determining the amount that could be realized under the insurance contract. EITF 06-5 also states that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). EITF 06-5 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations or financial condition.

NOTE 2 - PER SHARE DATA

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

	2006	2005	2004
Weighted average common shares outstanding	4,002,416	3,986,569	3,993,336
Average treasury stock shares	(68,278)	(14,643)	(3,328)
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	3,934,138	3,971,926	3,990,008
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	479	2,129	4,344
Weighted average common shares and common stock equivalents used to calculate diluted earnings per share	3,934,617	3,974,055	3,994,352

Options to purchase 9,002 shares of common stock at a price of \$40.29 were outstanding during 2006 and 2005, and 10,455 shares of common stock at a price of \$40.29 were outstanding during 2004. The options were not included in the computation of diluted earnings per share as they were anti-dilutive due to the strike price at December 31, of each period presented being greater than the market value at that time.

NOTE 3 - INVESTMENT SECURITIES

The amortized cost and estimated fair values of investment securities at December 31, 2006 and 2005 are as follows:

(In Thousands)	2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for sale (AFS)				
U.S. Government and agency securities	\$ 54,949	\$ 24	\$ (821)	\$ 54,152
State and political securities	104,658	1,646	(358)	105,946
Other debt securities	1,998	37	(11)	2,024
Total debt securities	161,605	1,707	(1,190)	162,122
Equity securities	20,353	2,883	(158)	23,078
Total investment securities AFS	\$ 181,958	\$ 4,590	\$ (1,348)	\$ 185,200
Held to maturity (HTM)				
U.S. Government and agency securities	\$ 26	\$ 2	\$	\$ 28
Other debt securities	257	1		258
Total investment securities HTM	\$ 283	\$ 3	\$	\$ 286
2005				
(In Thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for sale (AFS)				
U.S. Government and agency securities	\$ 65,496	\$ 30	\$ (1,573)	\$ 63,953
State and political securities	93,769	1,390	(1,068)	94,091
Other debt securities	1,750	12	(43)	1,719
Total debt securities	161,015	1,432	(2,684)	159,763
Equity securities	24,715	2,951	(411)	27,255
Total investment securities AFS	\$ 185,730	\$ 4,383	\$ (3,095)	\$ 187,018
Held to maturity (HTM)				
U.S. Government and agency securities	\$ 28	\$ 2	\$	\$ 30
Other debt securities	237		(29)	208
Total investment securities HTM	\$ 265	\$ 2	\$ (29)	\$ 238

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at December 31, 2006 and 2005.

(In Thousands)	2006 Less than Twelve Months		Twelve Months or Greater		Total Estimated Fair Value	Gross Unrealized Losses
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses		
U.S. Government and agency securities	\$ 24,552	\$ 97	\$ 25,053	\$ 724	\$ 49,605	\$ 821
State and political securities	31,286	195	11,706	163	42,992	358
Other debt securities	292	7	146	4	438	11
Total debt securities	56,130	299	36,905	891	93,035	1,190
Equity securities	726	33	2,592	125	3,318	158
Total	\$ 56,856	\$ 332	\$ 39,497	\$ 1,016	\$ 96,353	\$ 1,348

(In Thousands)	2005 Less than Twelve Months		Twelve Months or Greater		Total Estimated Fair Value	Gross Unrealized Losses
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses		
U.S. Government and agency securities	\$ 34,028	\$ 925	\$ 26,038	\$ 648	\$ 60,066	\$ 1,573
State and political securities	46,864	1,063	586	5	47,450	1,068
Other debt securities	707	54	232	18	939	72
Total debt securities	81,599	2,042	26,856	671	108,455	2,713
Equity securities	2,721	249	1,340	162	4,061	411
Total	\$ 84,320	\$ 2,291	\$ 28,196	\$ 833	\$ 112,516	\$ 3,124

At December 31, 2006 there were a total of 88 and 32 individual securities that were in a continuous unrealized loss position for less than twelve months and greater than twelve months, respectively.

The policy of the Company is to recognize other than temporary impairment of equity securities where the fair value has been significantly below cost for four consecutive quarters. For fixed maturity investments with unrealized losses due to interest rates where the Company has the positive intent and ability to hold the investment for a period of time sufficient to allow a market recovery, declines in value below cost are not assumed to be other than temporary. The Company reviews its position quarterly and has asserted that at December 31, 2006, the declines outlined in the above table represent temporary declines and the Company does have the intent and ability to hold those securities either to maturity or to allow a market recovery.

The Company has concluded that any impairment of its investment securities portfolio is not other than temporary but is the result of interest rate changes that are not expected to result in the non-collection of principal and interest during the period.

The amortized cost and fair value of debt securities at December 31, 2006, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(In Thousands)	Available for Sale		Held to Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$	\$	\$	\$
Due after one year to five years	25	25	125	125
Due after five years to ten years	1,515	1,477	132	133
Due after ten years	160,065	160,620	26	28
Total	\$ 161,605	\$ 162,122	\$ 283	\$ 286

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Total gross proceeds from sales of securities available for sale were \$76,249,000, \$123,546,000, and \$162,796,000 for 2006, 2005, and 2004, respectively. The following table represents gross realized gains and losses on those transactions:

(In Thousands)	2006	2005	2004
Gross realized gains:			
U.S. Government and agency securities	\$	\$ 128	\$ 459
State and political securities	1,248	819	1,191
Other debt securities			1
Equity securities	1,655	2,209	2,192
Total gross realized gains	\$ 2,903	\$ 3,156	\$ 3,843
Gross realized losses:			
U.S. Government and agency securities	\$ 913	\$ 791	\$ 1,623
State and political securities	302	116	23
Other debt securities		59	
Equity securities	9		21
Total gross realized losses	\$ 1,224	\$ 966	\$ 1,667

Investment securities with a carrying value of approximately \$64,821,000 and \$72,642,000 at December 31, 2006 and 2005, respectively, were pledged to secure certain deposits, repurchase agreements, and for other purposes as required by law.

There is no concentration of investments that exceed ten percent of shareholders' equity for any individual issuer, excluding those guaranteed by the U.S. Government.

NOTE 4 LOANS

Major loan classifications as of December 31, 2006 and 2005 are summarized as follows:

(In Thousands)	2006				Total
	Current	Past Due 30 To 90 Days	Past Due 90 Days Or More & Still Accruing	Non- Accrual	
Commercial and agricultural	\$ 27,682	\$ 764	\$ 109	\$	\$ 28,555
Real estate mortgage:					
Residential	156,976	1,050	8	185	158,219
Commercial	133,813	1,406		185	135,404
Construction	16,695	54			16,749
Installment loans to individuals	22,127	346	2		22,475
	357,293	\$ 3,620	\$ 119	\$ 370	361,402
Less: Net deferred loan fees	1,018				1,018
Allowance for loan losses	4,185				4,185
Loans, net	\$ 352,090				\$ 356,199

(In Thousands)	2005				Total
	Current	Past Due 30 To 90 Days	Past Due 90 Days Or More & Still Accruing	Non- Accrual	
Commercial and agricultural	\$ 34,000	\$ 238	\$	\$ 169	\$ 34,407
Real estate mortgage:					

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Residential	148,190	1,413	34	363	150,000
Commercial	125,587	1,544			127,131
Construction	10,599	79		3	10,681
Installment loans to individuals	16,859	388	29	5	17,281
	335,235	\$ 3,662	\$ 63	\$ 540	339,500
Less: Net deferred loan fees	1,062				1,062
Allowance for loan losses	3,679				3,679
Loans, net	\$ 330,494				\$ 334,759

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Impaired loans totaled \$574,000 at December 31, 2006. The portion of the allowance for loan losses allocated for impaired loans was \$42,000 at December 31, 2006. The average recorded investment in impaired loans during the year ended December 31, 2006 was approximately \$504,000. There were no impaired loans for the years ended December 31, 2005 and 2004.

The Company recognized interest income on impaired loans in the amount of \$72,000 for the year ended December 31, 2006. On a cash basis interest income on impaired loans amounted to \$58,000 for the year ended December 31, 2006.

No additional funds are committed to be advanced in connection with impaired loans.

Loans on which the accrual of interest has been discontinued or reduced, exclusive of impaired loans, amounted to approximately \$370,000 and \$540,000 at December 31, 2006 and 2005, respectively. If interest had been recorded based on the original loan agreement terms and rate of interest for those loans, income would have approximated \$23,000, \$39,000, and \$64,000 for the years ended December 31, 2006, 2005, and 2004, respectively. Interest income on such loans, is recorded as received and amounted to approximately \$15,000, \$18,000, and \$10,000, for the years ended December 31, 2006, 2005, and 2004, respectively.

Changes in the allowance for loan losses for the years ended December 31, are as follows:

	2006	2005	2004
Balance, beginning of year	\$ 3,679	\$ 3,338	\$ 3,069
Provision charged to operations	635	720	465
Loans charged off	(327)	(446)	(283)
Recoveries	198	67	87
Balance, end of year	\$ 4,185	\$ 3,679	\$ 3,338

The Company has a concentration of loans to both owners of commercial and residential rental properties at December 31, 2006 and 2005 of 15.38% and 15.09% and 15.82% and 15.92% of total loans, respectively.

The Company grants commercial, industrial, residential, and installment loans to customers throughout north-central Pennsylvania. Although the Company has a diversified loan portfolio at December 31, 2006 and 2005, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within this region.

NOTE 5 - PREMISES AND EQUIPMENT

Major classifications of premises and equipment are summarized as follows at December 31:

(In Thousands)	2006	2005
Land	\$ 1,370	\$ 1,046
Premises	6,038	6,022
Furniture and equipment	4,844	4,118
Leasehold improvements	811	805
Total	13,063	11,991
Less accumulated depreciation and amortization	6,326	5,582
Net premises and equipment	\$ 6,737	\$ 6,409

Depreciation and amortization charged to operations for the years ended 2006, 2005, and 2004 was \$744,000, \$549,000, and \$585,000, respectively.

NOTE 6 GOODWILL

As of December 31, 2006, 2005, and 2004 goodwill had a gross carrying value of \$3,308,000 and accumulated amortization of \$276,000 resulting in a net carrying amount of \$3,032,000.

The gross carrying amount of goodwill is tested for impairment in the third quarter of each fiscal year. Based on fair value of the reporting unit, estimated using the expected present value of future cash flows, there was no evidence of impairment of the carrying amount at December 31, 2006 and 2005, respectively.

NOTE 7 TIME DEPOSITS

Time deposits of \$100,000 or more totaled approximately \$49,793,000 on December 31, 2006 and \$36,762,000 on December 31, 2005. Interest expense related to such deposits was approximately \$1,873,000, \$1,417,000, and \$818,000, for the years ended December 31, 2006, 2005, and 2004, respectively.

At December 31, 2006, the scheduled maturities on time deposits of \$100,000 or more are as follows:

(In Thousands)	2006
Three months or less	\$ 18,963
Three months to six months	11,230
Six months to twelve months	11,705
Over twelve months	7,895
Total	\$ 49,793

Total time deposit maturities are as follows:

(In Thousands)	2006
2007	\$ 157,818
2008	23,983
2009	7,052
2010	3,245
2011	546
Thereafter	805
Total	\$ 193,449

NOTE 8 - SHORT-TERM BORROWINGS

Short-term borrowings consist of securities sold under agreements to repurchase and FHLB advances which generally represent overnight or less than six month borrowings. In addition to the outstanding balances noted below, the Bank also had additional lines of credit totaling \$28,048,000 available from correspondent banks other than the FHLB. The outstanding balances and related information for short-term borrowings are summarized as follows:

(In Thousands)	2006	2005	2004	
Repurchase Agreements:				
Balance at year end	\$ 15,991	\$ 15,263	\$ 13,845	
Maximum amount outstanding at any month end	19,916	16,754	15,301	
Average balance outstanding during the year	16,028	14,268	13,317	
Weighted-average interest rate:				
At year end	3.96	% 2.74	% 1.82	%
Paid during the year	3.55	% 2.19	% 1.77	%
Open Repo Plus:				
Balance at year end	\$ 18,706	\$ 1,740	\$ 22,630	
Maximum amount outstanding at any month end	43,040	24,990	32,480	
Average balance outstanding during the year	15,301	10,765	18,336	
Weighted-average interest rate:				
At year end	5.40	% 4.25	% 2.24	%
Paid during the year	5.07	% 3.33	% 1.64	%
Short-Term FHLB:				
Balance at year end	\$	\$ 37,000	\$	
Maximum amount outstanding at any month end		37,000	900	
Average balance outstanding during the year	3,283	7,081	204	
Weighted-average interest rate:				
At year end		4.24	%	
Paid during the year	4.82	% 3.66	% 1.42	%

NOTE 9 LONG TERM BORROWINGS

The following represents outstanding long-term borrowings with the FHLB by contractual maturities at December 31, 2006 and 2005:

(In Thousands)	2006	2005
Variable rate of 4.49%, maturing in 2007	\$ 5,000	\$ 5,000
Variable rates between 3.14% and 5.56%, maturing in 2008	29,600	29,600
Variable rate of 5.06%, maturing in 2009	5,000	5,000
Variable rate of 6.65%, maturing in 2010	5,000	5,000
Variable rates between 4.25% and 4.72%, maturing in 2011	10,000	10,000
Variable rate of 3.68%, maturing in 2012	5,000	5,000
Variable rate of 3.74%, maturing in 2013	5,000	5,000
Variable rate of 3.97%, maturing in 2015	10,000	10,000
Fixed rate of 2.58%, maturing in 2006		1,600
Fixed rates between 2.67% and 3.13%, maturing in 2007	6,500	6,500
Fixed rate of 6.92%, maturing in 2011	500	500
Fixed rate of 5.87%, maturing in 2013	528	528
Fixed rate of 6.92%, maturing in 2015	750	750
Total	\$ 82,878	\$ 84,478

The terms of the convertible borrowings allow the FHLB to convert the interest rate to an adjustable rate based on the three month London Interbank Offered Rate (LIBOR) at a predetermined anniversary date of the borrowing s origination, ranging from three months to five years. If the FHLB converts the interest rate on one of the predetermined dates, the Bank has the ability to payoff the debt on the conversion date and quarterly thereafter without incurring the customary pre-payment penalty.

The Bank maintains a credit arrangement, which includes a revolving line of credit with the FHLB. Under this credit arrangement, the Bank has a remaining borrowing capacity of \$123,538,000 at December 31, 2006, which is subject to annual renewal, and typically incurs no service charges. Under terms of a blanket agreement, collateral for the FHLB borrowings must be secured by certain qualifying assets of the Bank which consist principally of first mortgage loans and mortgage-backed securities.

NOTE 10 - INCOME TAXES

The following temporary differences gave rise to the net deferred tax position at December 31, 2006 and 2005:

(In Thousands)	2006	2005
Deferred tax assets:		
Allowance for loan losses	\$ 1,292	\$ 1,022
Deferred compensation	386	368
Pension	517	249
Loan fees and costs	346	356
Investment securities allowance	2	97
Other	134	59
Total	2,677	2,151
Deferred tax liabilities:		
Bond accretion	49	27
Depreciation	85	96
Amortization	376	301
Unrealized gains on available for sale securities	1,102	438
Total	1,612	862
Deferred tax asset, net	\$ 1,065	\$ 1,289

No valuation allowance was established at December 31, 2006 and 2005, in the view of the Company's ability to carry back taxes paid in previous years and certain tax strategies, coupled with the anticipated future taxable income as evidenced by the Company's earning potential.

The provision for income taxes is comprised of the following:

(In Thousands)	2006	2005	2004
Currently payable	\$ 2,103	\$ 3,188	\$ 4,512
Deferred (benefit) expense	(142)	36	(249)
Total provision	\$ 1,961	\$ 3,224	\$ 4,263

A reconciliation between the expected income tax and the effective income tax rate on income before income tax provision follows:

(In Thousands)	2006 Amount	%	2005 Amount	%	2004 Amount	%
Provision at expected rate	\$ 3,947	34.0 %	\$ 4,803	34.0 %	\$ 5,218	34.0 %
Decrease in tax resulting from:						
Tax-exempt income	(1,425)	(12.3)	(1,275)	(9.0)	(651)	(4.2)
Other, net	(561)	(4.8)	(304)	(2.2)	(304)	(2.0)
Effective income tax and rate	\$ 1,961	16.9 %	\$ 3,224	22.8 %	\$ 4,263	27.8 %

NOTE 11 - EMPLOYEE BENEFIT PLANS**Defined Benefit Pension Plan**

The Company has a noncontributory defined benefit pension plan (the Plan) for all employees meeting certain age, length of service requirements, and were hired prior to January 1, 2004, at which time entrance into the Plan was frozen. Benefits are based primarily on years of service and the average annual compensation during the highest five consecutive years within the final ten years of employment.

The Company adopted the recognition provisions of FAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* and initially applied them to the funded status of its defined benefit pension plan as of December 31, 2006. The initial recognition of the funded status of its defined benefit pension plan resulted in a decrease in Shareholders' equity of \$579,000, which was net of a tax benefit of \$298,000.

The following table sets forth the incremental effect of applying FAS No. 158 on individual line items in the Consolidated Balance Sheet at December 31, 2006:

(In Thousands)	Before Application of FAS No. 158	Adjustments	After Application of FAS No. 158
Other assets	\$ 2,212	\$ 298	\$ 2,510
Total assets	591,987	298	592,285
Other liabilities	2,516	877	3,393
Total liabilities	516,814	877	517,691
Accumulated other comprehensive income	2,139	(579)	1,560
Total shareholders' equity	75,173	(579)	74,594
Total liabilities and shareholders' equity	591,987	298	592,285

The following table sets forth the obligation and funded status as of December 31:

(In Thousands)	2006	2005
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 8,780	\$ 7,549
Service cost	467	505
Interest cost	434	446
Actuarial (gain) loss	(785)	280
Benefits paid	(186)	(218)
Other, change in actuarial assumptions	(200)	218
Benefit obligation at end of year	8,510	8,780
Change in plan assets		
Fair value of plan assets at beginning of year	6,011	4,549
Actual return on plan assets	629	272
Employer contribution	550	1,420
Benefits paid	(186)	(218)
Expenses paid	(14)	(12)
Fair value of plan assets at end of year	6,990	6,011
Funded status	\$ (1,520)	\$ (2,769)
Amounts not yet recognized as a component of net periodic pension cost:		
Amounts recognized in accumulated other comprehensive income (loss)		
consists of:		
Net transition asset	\$ (15)	\$
Prior service cost	179	
Net loss	713	
Amounts not recognized in accumulated other comprehensive income (loss)		
consists of:		
Net transition asset		(17)
Prior service cost		204
Net loss		1,849
Total	\$ 877	\$ 2,036

The accumulated benefit obligation for the Plan was \$6,451,000 and \$6,560,000 at December 31, 2006 and 2005, respectively.

Components of Net Periodic Cost and Other Amounts Recognized in other Comprehensive Income as of December 31, 2006, 2005, and 2004, respectively, are as follows:

(In Thousands)	2006	2005	2004
Net periodic pension cost:			
Service cost	\$ 467	\$ 505	\$ 447
Interest cost	434	446	398
Expected return on plan assets	(485)	(402)	(376)
Amortization of transition asset	(3)	(2)	(3)
Amortization of prior service cost	26	25	26
Recognized net actuarial gain			109
Amortization of unrecognized net loss	22	65	
Net periodic benefit cost	\$ 461	\$ 637	\$ 601

The estimated net transition asset and prior service cost for the defined benefit pension plan that will be amortized from accumulated other comprehensive income (loss) into net periodic benefit cost over the next fiscal year are \$3,000 and \$25,000, respectively.

Assumptions

Weighted-average assumptions used to determine benefit obligations at December 31:

	2006	2005	2004
Discount rate	5.75 %	5.50 %	5.75 %
Rate of compensation increase	4.75 %	4.50 %	4.75 %

Weighted-average assumptions used to determine net periodic cost for years ended December 31:

	2006	2005	2004
Discount rate	5.50 %	5.75 %	6.00 %
Expected long-term return on plan assets	8.00 %	8.00 %	8.00 %
Rate of compensation increase	4.50 %	4.75 %	5.00 %

The expected long-term rate of return was estimated using market benchmarks by which the plan assets would outperform the market value in the future, based on historical experience adjusted for changes in asset allocation and expectations for overall lower future returns on similar investments compared to past periods.

Plan Assets

The Plan's weighted-average asset allocations at December 31 by asset category are as follows:

Asset Category	2006	2005
Cash	0.4 %	0.4 %
Fixed income securities	39.2 %	39.4 %
Equity	60.4 %	60.2 %
Total	100.0 %	100.0 %

The investment objective for the Plan is to maximize total return with tolerance for slightly above average risk, meaning the fund is able to tolerate short-term volatility to achieve above-average returns over the long term.

Asset allocation favors equities, with target allocation of approximately 60% equity securities, 37.5% fixed income securities and 2.5% cash. Due to volatility in the market, the target allocation is not always desirable and asset allocations will fluctuate between the acceptable ranges. The equity portfolio's exposure is in mid and large capitalization domestic equities. Exposure to small capitalization and international stocks may be allowed.

It is management's intent to give the investment managers flexibility, within the overall guidelines, with respect to investment decisions and their timing. However, certain investments require specific review and approval by management. Management is also informed of anticipated, significant modifications of any previously approved investment, or anticipated use of derivatives to execute investment strategies.

The following benefit payments that reflect expected future service, as appropriate, are expected to be paid:

Estimated future benefit payments(in thousands):

2007	\$	240
2008		246
2009		287
2010		315
2011		339
2012-2016		2,791
	\$	4,218

The company expects to contribute \$500,000 to its Pension Plan in 2007.

401(k) Savings Plan

The Company also offers a 401(k) savings plan in which eligible participating employees may elect to contribute up to a maximum percentage allowable not to exceed the limits of Code Sections 401(k), 404, and 415. The Company may make matching contributions equal to a discretionary percentage that is determined by the Board of Directors. Participants are at all times fully vested in their contributions and vest over a period of five years in the employer contribution. Contribution expense was approximately \$96,000, \$80,000, and \$83,000 for the years ended December 31, 2006, 2005, and 2004, respectively.

Deferred Compensation Plan

The Company has a deferred compensation plan whereby participating directors elected to forego directors' fees for a period of five years. Under this plan, the Company will make payments for a ten-year period beginning at age 65 in most cases or at death, if earlier, at which time payments would be made to their designated beneficiaries.

To fund benefits under the deferred compensation plan, the Company has acquired bank-owned life insurance policies on the lives of the participating directors for which insurance benefits are payable to the Company. The Company incurred expenses related to the plan of \$69,000, \$69,000, and \$73,000 for the years ended December 31, 2006, 2005, and 2004, respectively. Benefits paid under the plan were approximately \$122,000, \$112,000, and \$127,000 in 2006, 2005, and 2004 respectively.

NOTE 12 EMPLOYEE STOCK PURCHASE PLAN

Effective April 26, 2006 the Company implemented the Penns Woods Bancorp, Inc. 2006 Employee Stock Purchase Plan (Plan). The Plan is intended to encourage employee participation in the ownership and economic progress of the Company. The Plan allows for up to 1,000,000 shares to be purchased by employees. The purchase price of the shares is 95% of market value with an employee eligible to purchase up to the lesser of 15% of base compensation or \$12,000 in market value annually. For the year ended December 31, 2006, there were 1,355 shares issued under the plan.

NOTE 13 - STOCK OPTIONS

Prior to 1998, the Company granted a select group of its officers options to purchase shares of its common stock. These options, which are immediately exercisable, expire within three to ten years after having been granted. Also, in 1998, the Company adopted the 1998 Stock Option Plan for key employees and directors. Incentive stock options and nonqualified stock options may be granted to eligible employees of the Bank and nonqualified options may be granted to directors of the Company. Incentive nonqualified stock options granted under the 1998 Plan may be exercised not later than ten years after

the date of grant. Each option granted under the 1998 Plan shall be exercisable only after the expiration of six months following the date of grant of such options.

A summary of the status of the Company's common stock option plans are presented below:

	2006	Weighted Average Exercise Price	2005	Weighted Average Exercise Price
	Shares		Shares	
Outstanding, beginning of year	11,972	\$ 37.41	19,158	\$ 33.53
Granted				
Exercised			(4,248)	24.76
Forfeited			(2,938)	30.43
Outstanding, end of year	11,972	37.41	11,972	37.41
Options exercisable at year-end	11,972	\$ 37.41	11,972	\$ 37.41

The following table summarizes information about nonqualified and incentive stock options outstanding at December 31, 2006:

Exercise Price	Outstanding			Exercisable	
	Shares	Average Life	Average Exercise Price	Shares	Average Exercise Price
\$ 40.29	9,002	2	\$ 40.29	9,002	\$ 40.29
31.82	1,650	3	31.82	1,650	31.82
24.72	1,320	4	24.72	1,320	24.72

NOTE 14 - RELATED PARTY TRANSACTIONS

Certain directors and executive officers of the Company and the Bank, including their immediate families and companies in which they are principal owners (more than ten percent), are indebted to the Company. Such indebtedness was incurred in the ordinary course of business on the same terms and at those rates prevailing at the time for comparable transactions with others.

A summary of loan activity with executive officers, directors, principal shareholders, and associates of such persons is listed below for the years ended December 31:

(In Thousands)	Beginning Balance	Additions	Payments	Ending Balance
2006	\$ 9,635	\$ 2,001	\$ 1,894	\$ 9,742
2005	10,295	781	1,441	9,635

NOTE 15 - COMMITMENTS AND CONTINGENT LIABILITIES

The following schedule of future minimum rental payments under operating leases with noncancellable terms in excess of one year as of December 31, 2006:

(In Thousands)

2007	\$ 411
2008	288
2009	243
2010	212
2011	128
Thereafter	1,162
Total	\$ 2,444

The Company's operating lease obligations represent short and long-term lease and rental payments for facilities. Total rental expense for all operating leases for the years ended December 31, 2006, 2005, and 2004 were \$380,000, \$361,000, and \$320,000 respectively.

The Company is subject to lawsuits and claims arising out of its business. There are no such legal proceedings or claims currently pending or threatened other than those encountered during the normal course of business.

NOTE 16 - 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 include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit, interest rate, or liquidity risk in excess of the amount recognized in the consolidated balance sheet. The contract amounts of these instruments express the extent of involvement the Company has in particular classes of financial instruments.

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

Financial instruments whose contract amounts represent credit risk are as follows at December 31:

(In Thousands)	2006	2005
Commitments to extend credit	\$ 61,736	\$ 72,583
Standby letters of credit	1,033	2,193

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

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

NOTE 17 - CAPITAL REQUIREMENTS

Federal regulations require the Company and the Bank to maintain minimum amounts of capital. Specifically, each is required to maintain certain minimum dollar amounts and ratios of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average total assets.

In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) established five capital categories ranging from well capitalized to critically undercapitalized. Should any institution fail to meet the requirements to be considered adequately capitalized, it would become subject to a series of increasingly restrictive regulatory actions.

As of December 31, 2006 and 2005, the Federal Deposit Insurance Corporation (FDIC) categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be classified as a well capitalized financial institution, Total risk-based, Tier 1 risk-based, and Tier 1 leverage capital ratios must be at least 10%, 6%, and 5%, respectively.

The Company s and the Bank s actual capital ratios are presented in the following tables, which shows that both met all regulatory capital requirements.

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Consolidated Company

(In Thousands)	2006 Amount	Ratio	2005 Amount	Ratio	
Total Capital					
<u>(to Risk-weighted Assets)</u>					
Actual	\$ 74,342	20.3	% \$ 73,210	21.0	%
For Capital Adequacy Purposes	29,299	8.0	27,937	8.0	
To Be Well Capitalized	36,623	10.0	34,921	10.0	
Tier I Capital					
<u>(to Risk-weighted Assets)</u>					
Actual	\$ 68,931	18.8	% \$ 68,388	19.6	%
For Capital Adequacy Purposes	14,649	4.0	13,968	4.0	
To Be Well Capitalized	21,974	6.0	20,952	6.0	
Tier I Capital					
<u>(to Average Assets)</u>					
Actual	\$ 68,931	11.8	% \$ 68,388	12.2	%
For Capital Adequacy Purposes	23,332	4.0	22,495	4.0	
To Be Well Capitalized	29,165	5.0	28,119	5.0	

Bank

(In Thousands)	2006 Amount	Ratio	2005 Amount	Ratio	
Total Capital					
<u>(to Risk-weighted Assets)</u>					
Actual	\$ 57,260	16.2	% \$ 56,604	17.0	%
For Capital Adequacy Purposes	28,243	8.0	26,716	8.0	
To Be Well Capitalized	35,304	10.0	33,394	10.0	
Tier I Capital					
<u>(to Risk-weighted Assets)</u>					
Actual	\$ 52,860	15.0	% \$ 52,527	15.7	%
For Capital Adequacy Purposes	14,121	4.0	13,358	4.0	
To Be Well Capitalized	21,182	6.0	20,037	6.0	
Tier I Capital					
<u>(to Average Assets)</u>					
Actual	\$ 52,860	9.3	% \$ 52,527	9.6	%
For Capital Adequacy Purposes	22,671	4.0	21,809	4.0	
To Be Well Capitalized	28,339	5.0	27,261	5.0	

NOTE 18 REGULATORY RESTRICTIONS

The Pennsylvania Banking Code restricts the availability of capital funds for payment of dividends by all state-chartered banks to the additional paid in capital of the Bank. Accordingly, at December 31, 2006, the balance in the additional paid in capital account totaling \$11,657,000 is unavailable for dividends.

The Bank is subject to regulatory restrictions, which limit its ability to loan funds to Penns Woods Bancorp, Inc. At December 31, 2006, the regulatory lending limit amounted to approximately \$5,715,000.

Cash and Due from Banks

Included in cash and due from banks are reserves required by the district Federal Reserve Bank of \$990,000 and \$1,410,000 at December 31, 2006 and 2005. The required reserves are computed by applying prescribed ratios to the classes of average deposit balances. These are held in the form of cash on hand and a balance maintained directly with the Federal Reserve Bank.

NOTE 19 - ESTIMATED FAIR VALUE OF FINANCIAL INSTRUMENTS

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

Estimated fair values have been determined by the Company using historical data and an estimation methodology suitable for each category of financial instruments. The estimated fair value of the Company's investment securities is described in Note 1. The Company's fair value estimates, methods, and assumptions are set forth below for the Company's other financial instruments.

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

The estimated fair values of the Company's financial instruments are as follows at December 31:

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(In Thousands)	2006 Carrying Value	Fair Value	2005 Carrying Value	Fair Value
Financial assets:				
Cash and cash equivalents	\$ 15,373	\$ 15,373	\$ 14,090	\$ 14,090
Investment securities:				
Available for sale	185,200	185,200	187,018	187,018
Held to maturity	283	286	265	238
Loans held for sale	3,716	3,716	3,545	3,545
Loans, net	356,199	356,788	334,759	337,093
Bank-owned life insurance	11,346	11,346	10,718	10,718
Accrued interest receivable	2,939	2,939	2,828	2,828
Financial liabilities:				
Interest-bearing deposits	\$ 322,031	\$ 320,906	\$ 281,150	\$ 278,909
Noninterest-bearing deposits	73,160	73,160	71,379	71,379
Short-term borrowings	34,697	34,697	54,003	54,003
Long-term borrowings, FHLB	82,878	82,050	84,478	83,877
Accrued interest payable	1,532	1,532	1,108	1,108

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

Cash and Cash Equivalents, Loans Held for Sale, Regulatory Stock, Accrued Interest Receivable, Short-term Borrowings

The fair value is equal to the carrying value.

Investment Securities:

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

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Loans:

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

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

Fair value for significant nonperforming loans is based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discounted rates are judgmentally determined using available market information and specific borrower information.

Bank-Owned Life Insurance:

The fair value is equal to the Cash Surrender Value of the life insurance policies.

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW, and money market accounts, is equal to the amount payable on demand as of December 31, 2006 and 2005. The fair value of certificates of deposit is based on the discounted value of contractual cash flows.

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

Long Term Borrowings:

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

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

There is no material difference between the notional amount and the estimated fair value of off-balance sheet items at December 31, 2006 and 2005, respectively. The contractual amounts of unfunded commitments and letters of credit are presented in Note 16.

NOTE 20- PARENT COMPANY ONLY FINANCIAL STATEMENTS

Condensed financial information for Penns Woods Bancorp, Inc. follows:

**CONDENSED BALANCE SHEET, DECEMBER 31,
(In Thousands)**

	2006	2005
ASSETS		
Cash	\$ 41	\$ 159
Investment in subsidiaries:		
Bank	57,790	57,170
Nonbank	16,595	16,452
Other assets	234	186
Total Assets	\$ 74,660	\$ 73,967
LIABILITIES AND SHAREHOLDERS' EQUITY		
Other liabilities	\$ 66	\$ 48
Shareholders' equity	74,594	73,919
Total liability and shareholders' equity	\$ 74,660	\$ 73,967

**CONDENSED STATEMENT OF INCOME
FOR THE YEARS ENDED DECEMBER 31,
(In Thousands)**

	2006	2005	2004
Operating income:			
Dividends from subsidiaries	\$ 9,890	\$ 7,311	\$ 6,440
Equity in undistributed net income of subsidiaries	53	3,822	4,833
Operating expenses:	(296)	(232)	(190)
Net income	\$ 9,647	\$ 10,901	\$ 11,083

**CONDENSED STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31,
(In Thousands)**

	2006	2005	2004
OPERATING ACTIVITIES			
Net income	\$ 9,647	\$ 10,901	\$ 11,083
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net income of subsidiaries	(53)	(3,822)	(4,833)
Other, net	(30)	(70)	(9)
Net cash provided by operating activities	9,564	7,009	6,241
INVESTING ACTIVITIES			
Additional investment in subsidiaries		(637)	(271)
FINANCING ACTIVITIES			
Dividends paid	(6,802)	(6,225)	(5,843)
Issuance of common stock	49		
Proceeds from exercise of stock options		105	194
Purchase of treasury stock	(2,929)	(546)	(237)
Net cash used for financing activities	(9,682)	(6,666)	(5,886)
NET INCREASE (DECREASE) IN CASH	(118)	(294)	84
CASH, BEGINNING OF YEAR	159	453	369
CASH, END OF YEAR	\$ 41	\$ 159	\$ 453

Cash and Cash Equivalents, Loans Held for Sale, Regulatory Stock, Accrued Interest Receivable, Short-term Borrowings



NOTE 21 CONSOLIDATED QUARTERLY FINANCIAL DATA (UNAUDITED)

(In Thousands, Except Per Share Data) 2006	For The Three Months Ended			
	March 31,	June 30,	Sept. 30,	Dec. 31,
Interest income	\$ 8,022	\$ 8,347	\$ 8,547	\$ 8,837
Interest expense	3,189	3,421	3,707	3,893
Net interest income	4,833	4,926	4,840	4,944
Provision for loan losses	198	198	89	150
Non-interest income	1,778	1,951	1,826	1,795
Securities gains, net	559	265	561	294
Non-interest expenses	3,951	4,078	4,114	4,186
Income before income tax provision	3,021	2,866	3,024	2,697
Income tax provision	566	432	560	403
Net income	\$ 2,455	\$ 2,434	\$ 2,464	\$ 2,294
Earnings per share - basic	\$ 0.62	\$ 0.62	\$ 0.62	\$ 0.59
Earnings per share - diluted	\$ 0.62	\$ 0.62	\$ 0.62	\$ 0.59

(In Thousands, Except Per Share Data) 2005	For The Three Months Ended			
	March 31,	June 30,	Sept. 30,	Dec. 31,
Interest income	\$ 7,435	\$ 7,654	\$ 7,816	\$ 7,998
Interest expense	2,249	2,457	2,701	2,974
Net interest income	5,186	5,197	5,115	5,024
Provision for loan losses	180	180	180	180
Non-interest income	1,696	1,788	1,991	1,766
Securities gains, net	611	687	556	336
Non-interest expenses	3,595	3,849	3,788	3,876
Income before income tax provision	3,718	3,643	3,694	3,070
Income tax provision	1,003	883	746	592
Net income	\$ 2,715	\$ 2,760	\$ 2,948	\$ 2,478
Earnings per share - basic	\$ 0.68	\$ 0.70	\$ 0.74	\$ 0.63
Earnings per share - diluted	\$ 0.68	\$ 0.70	\$ 0.74	\$ 0.62

ITEM 9 CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

ITEM 9A CONTROLS AND PROCEDURES

The Company, under the supervision and with the participation of the Company's management, including the Company's President and Chief Executive Officer along with the Company's Principal Accounting Officer (the Principal Financial Officer), has evaluated the effectiveness as of December 31, 2006 of the design and operation of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon that evaluation, the Company's President and Chief Executive Officer along with the Company's Principal Accounting Officer concluded that the Company's disclosure controls and procedures were effective as of December 31, 2006.

There have been no material changes in the Company's internal control over financial reporting during the fourth quarter of 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Management's Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a significant deficiency (as defined in Public Company Accounting Oversight Board Auditing Standard No. 2), or a combination of significant deficiencies, that results in there being more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by management or employees in the normal course by management or employees in the normal course of performing their assigned functions.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2006. Management's assessment did not identify any material weaknesses in the Company's internal control over financial reporting.

In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Because there were no material weaknesses discovered, management believes that, as of December 31, 2006, the Company's internal control over financial reporting was effective.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006, has been audited by S.R. Snodgrass, A.C., an independent registered public accounting firm, as stated in its attestation report which is included herein.

Date: March 13, 2007 /s/ Ronald A. Walko
Chief Executive Officer

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

[Letterhead of S.R. Snodgrass, A.C.]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
Penns Woods Bancorp, Inc.

We have audited management's assessment, included in the accompanying Report on Management's Assessment of Internal Control Over Financial Reporting, that Penns Woods Bancorp, Inc. (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Penns Woods Bancorp, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Penns Woods Bancorp, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, Penns Woods Bancorp, Inc., maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Penns Woods Bancorp, Inc. and subsidiaries as of December 31, 2006 and 2005, and

the related consolidated statement of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2006, and our report dated March 9, 2007, expressed an unqualified opinion.

/s/ S.R. Snodgrass, A.C.
Wexford, Pennsylvania
March 9, 2007

ITEM 9B OTHER INFORMATION

None.

PART III

ITEM 10 DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information appearing under the captions "The Board of Directors and Committees," "Election of Directors," "Section 16(a) Beneficial Ownership Reporting Compliance," "Principal Officers of the Corporation," "Certain Transactions," and "Audit Committee Financial Expert" in the Company's Proxy Statement dated March 20, 2007 (the "Proxy Statement") is incorporated herein by reference.

ITEM 11 EXECUTIVE COMPENSATION

Information appearing under the captions "Compensation of Directors," "Compensation Committee Interlocks and Insider Participation," "Compensation Discussion and Analysis," "Compensation Committee and Benefits Committee Report," and "Executive Compensation" in the Proxy Statement is incorporated herein by reference.

ITEM 12 SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information appearing under the caption "Security Ownership of Certain Beneficial Owners and Management" in the Proxy Statement is incorporated herein by reference.

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Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	11,972	\$ 37.41	
Equity compensation plans not approved by security holders			
Total	11,972	\$ 37.41	

ITEM 13 CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

There have been no material transactions between the Company and the Bank, nor any material transactions proposed, with any Director or Executive Officer of the Company and the Bank, or any associate of the foregoing persons. The Company and the Bank have had, and intend to continue to have, banking and financial transactions in the ordinary course of business with Directors and Officers of the Company and the Bank and their associates on comparable terms and with similar interest rates as those prevailing from time to time for other customers of the Company and the Bank.

Total loans outstanding from the Bank at December 31, 2006 to the Company's and the Bank's Officers and Directors as a group and members of their immediate families and companies in which they had an ownership interest of 10% or more was \$9,742,000 or approximately 13.06% of the total equity capital of the Company. Loans to such persons were made in the ordinary course of business, were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons, and did not involve more than the normal risk of collectability or present other unfavorable features. See also the information appearing in Note 14 to the Consolidated Financial Statements included elsewhere in the Annual Report.

In addition, the information appearing under the caption "Election of Directors" in the Proxy Statement is incorporated herein by reference.

ITEM 14 PRINCIPAL ACCOUNTING FEES AND SERVICES

The information appearing in the Proxy Statement under the captions, "Audit Fees," "Audit-Related Fees," "Tax Fees," "All Other Fees," and "Audit Committee Pre-Approval Policies and Procedures" is incorporated herein by reference.

PART IV**ITEM 15 EXHIBITS FINANCIAL STATEMENT SCHEDULES****(a)1. Financial Statements**

The following consolidated financial statements and reports are set forth in Item 8:

- Report of Independent Auditors
- Consolidated Balance Sheet
- Consolidated Statement of Income
- Consolidated Statement of Changes in Shareholders' Equity
- Consolidated Statement of Cash Flows
- Notes to the Consolidated Financial Statements

Cash and Cash Equivalents, Loans Held for Sale, Regulatory Stock, Accrued Interest Receivable, Short-term Borrowings



2. Financial Statement Schedules

Financial statement schedules are omitted because the required information is either not applicable, not required or is shown in the respective financial statements or in the notes thereto.

(b) Exhibits:

- (3) (i) Articles of Incorporation of the Registrant, as presently in effect (incorporated by reference to Exhibit 3(i) of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2005).
- (3) (ii) Bylaws of the Registrant as presently in effect (incorporated by reference to Exhibit 3(ii) of the Registrant's Current Report on Form 8-K filed on June 17, 2005).
- (10) (i) Employment Agreement, dated August, 1991, between Jersey Shore State Bank and Ronald A. Walko (incorporated by reference to Exhibit 10.3 of the Registrant's Registration Statement on form S-4, No. 333-65821).*
- (10) (ii) Employment Agreement, dated May 31, 2005, between Jersey Shore State Bank and Thomas A. Donofrio (incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K filed on June 3, 2005).*
- (10) (iii) Employee Severance Benefit Plan, dated May 30, 1996, for Ronald A. Walko (incorporated by reference to Exhibit 10.4 of the Registrant's Registration Statement on form S-4, No. 333-65821).*
- (10) (iv) Penns Woods Bancorp, Inc. 1998 Stock Option Plan (incorporated by reference to Exhibit 10.1 of the Registrant's Registration Statement on form S-4, No. 333-65821).*
- (10) (v) Form of First Amendment to the Jersey Shore State Bank Amendment and Restatement of the Director Fee Agreement, Dated as of October 1, 2004 (incorporated by reference to Exhibit 10.7 of the Registrant's Current Report on Form 8-K filed on June 29, 2006).
- (10) (vi) Consulting Agreement, dated July 18, 2005 between Hubert A. Valencik and Penns Woods Bancorp, Inc. (incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed on July 18, 2005).
- (21) Subsidiaries of the Registrant.
- (23) Consent of Independent Certified Public Accountants.
- (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 Principle Accounting Officer.
- (32) (i) Section 1350 Certification of Chief Executive Officer.
- (32) (ii) Section 1350 Certification of Principle Accounting Officer.

* Denotes compensatory plan or arrangement.

EXHIBIT INDEX

- (21) Subsidiaries of the Registrant.
- (23) Consent of Independent Certified Public Accountants.
- (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 Principle Accounting Officer.
- (32) (i) Section 1350 Certification of Chief Executive Officer.
- (32) (ii) Section 1350 Certification of Principle Accounting Officer.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

March 13, 2007

PENNS WOODS BANCORP, INC.

By: /s/ Ronald A. Walko
Ronald A. Walko, President & Chief Executive Officer

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

/s/ Ronald A. Walko Ronald A. Walko, President, Chief Executive Officer and Director (Principal Executive Officer)	March 13, 2007
/s/ Brian L. Knepp Brian L. Knepp, Principal Accounting Officer	March 13, 2007
/s/ Lynn S. Bowes Lynn S. Bowes, Director	March 13, 2007
/s/ Michael J. Casale, Jr. Michael J. Casale, Jr., Director	March 13, 2007
/s/ H. Thomas Davis, Jr. H. Thomas Davis, Jr., Director	March 13, 2007
/s/ James M. Furey II James M. Furey II, Director	March 13, 2007
/s/ Leroy H. Keiler III Leroy H. Keiler III, Director	March 13, 2007
/s/ Jay H. McCormick Jay H. McCormick, Director	March 13, 2007

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/s/ R. Edward Nestlerode, Jr.
R. Edward Nestlerode, Jr., Director

March 13,
2007

/s/ James E. Plummer
James E. Plummer, Director

March 13,
2007

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/s/ William H. Rockey, Sr.

William H. Rockey, Sr. Vice President & Director

March 13, 2007

/s/ Hubert A. Valencik

Hubert A. Valencik, Director

March 13, 2007

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