

PENNS WOODS BANCORP INC  
Form 10-Q  
November 09, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

**for the Quarterly Period Ended September 30, 2012**

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

**for the Transition Period from \_\_\_\_\_ to \_\_\_\_\_ .**

**No. 0-17077**

**(Commission File Number)**

**PENNS WOODS BANCORP, INC.**

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

**PENNSYLVANIA**

**23-2226454**

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(State or other jurisdiction of  
incorporation or organization)

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

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

**17703-0967**  
(Zip Code)

**(570) 322-1111**

Registrant's telephone number, including area code

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Small reporting company

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

On November 2, 2012 there were 3,838,289 shares of the Registrant's common stock outstanding.

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

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

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

See accompanying notes to the unaudited consolidated financial statements.

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

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

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

See accompanying notes to the unaudited consolidated financial statements.

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## PENNS WOODS BANCORP, INC.

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(UNAUDITED)

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

See accompanying notes to the unaudited consolidated financial statements.

## PENNS WOODS BANCORP, INC.

## CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(UNAUDITED)

(In Thousands, Except Per Share Data)	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TREASURY STOCK	TOTAL SHAREHOLDERS EQUITY
	SHARES	AMOUNT	CAPITAL	EARNINGS	INCOME (LOSS)	STOCK	EQUITY
Balance, December 31, 2010	4,015,753	\$ 33,464	\$ 18,064	\$ 31,091	\$ (9,689)	\$ (6,310)	\$ 66,620
Comprehensive income:							
Net income				8,967			8,967
Other comprehensive income					8,226		8,226
Dividends declared, (\$1.38 per share)				(5,293)			(5,293)
Common shares issued for employee stock purchase plan	1,498	13	39				52
Balance, September 30, 2011	4,017,251	\$ 33,477	\$ 18,103	\$ 34,765	\$ (1,463)	\$ (6,310)	\$ 78,572

(In Thousands, Except Per Share Data)	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TREASURY STOCK	TOTAL SHAREHOLDERS EQUITY
	SHARES	AMOUNT	CAPITAL	EARNINGS	INCOME (LOSS)	STOCK	EQUITY
Balance, December 31, 2011	4,017,677	\$ 33,480	\$ 18,115	\$ 36,394	\$ (1,219)	\$ (6,310)	\$ 80,460
Comprehensive income:							



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

See accompanying notes to the unaudited consolidated financial statements.

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

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

See accompanying notes to the unaudited consolidated financial statements.

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1. Basis of Presentation**

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

The interim financial statements are unaudited but, in the opinion of management, reflect all adjustments necessary for the fair presentation of results for such periods. The results of operations for any interim period are not necessarily indicative of results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The accounting policies followed in the presentation of interim financial results are the same as those followed on an annual basis. These policies are presented on pages 37 through 43 of the Annual Report on Form 10-K for the year ended December 31, 2011.

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

**Note 2. Recent Accounting Pronouncements**

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*. The amendments in this update affect all entities that have financial instruments and derivative instruments that are either (1) offset in accordance with either Section 210-20-45 or Section 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement. The requirements amend the disclosure requirements on offsetting in Section 210-20-50. This information will enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements on an entity's financial position, including the effect or potential effect of rights of setoff associated with certain financial instruments and derivative instruments in the scope of this update. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. This ASU is not expected to have a significant impact on the Company's financial statements.

**Note 3. Per Share Data**

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Weighted average common shares issued	4,018,521	4,016,840	4,018,166	4,016,374
Average treasury stock shares	(180,596)	(180,596)	(180,596)	(180,596)
Weighted average common shares and common stock equivalents used to calculate basic and diluted earnings per share	3,837,925	3,836,244	3,837,570	3,835,778

**Note 4. Investment Securities**

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

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

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

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at September 30, 2012 and December 31, 2011.

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

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

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

At September 30, 2012 there were a total of 19 and 31 individual securities that were in a continuous unrealized loss position for less than twelve months and twelve months or greater, respectively.

The Company reviews its position quarterly and has determined that, at September 30, 2012, the declines outlined in the above table represent temporary declines and the Company does not intend to sell and does not believe it will be required to sell these securities before recovery of their cost basis, which may be at maturity. The Company has concluded that the unrealized losses disclosed above are not other than temporary but are the result of interest rate changes, sector credit ratings changes, or company-specific ratings changes that are not expected to result in the non-collection of principal and interest during the period.

The amortized cost and fair value of debt securities at September 30, 2012, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(In Thousands)	Amortized Cost		Fair Value	
Due in one year or less	\$	5,129	\$	5,157
Due after one year to five years		42,516		43,308
Due after five years to ten years		37,652		38,729
Due after ten years		184,413		197,771
Total	\$	269,710	\$	284,965

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

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



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

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

Table of Contents**Note 5. Federal Home Loan Bank Stock**

The Bank is a member of the Federal Home Loan Bank ( FHLB ) of Pittsburgh and as such, is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. The stock is bought from and sold to the FHLB based upon its \$100 par value. The stock does not have a readily determinable fair value and as such is classified as restricted stock, carried at cost and evaluated for impairment as necessary. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance (c) the impact of legislative and regulatory changes on the customer base of the FHLB and (d) the liquidity position of the FHLB.

The FHLB had incurred losses in 2009 and for parts of 2010 due primarily to other-than-temporary impairment credit losses on its private-label mortgage-backed securities portfolio. These securities were the most effected by the extreme economic conditions in place during the previous several years. As a result, the FHLB had suspended the payment of dividends and limited the amount of excess capital stock repurchases. The FHLB has reported net income for the year ended December 31, 2011 and has declared a 0.10 percent annualized dividend to its shareholders during each of the first three quarters of 2012. While the FHLB has not committed to regular dividend payments or future limited repurchases of excess capital stock, it will continue to monitor the overall financial performance of the FHLB in order to determine the status of limited repurchases of excess capital stock or dividends in the future. Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein. More consideration was given to the long-term prospects for the FHLB as opposed to the recent stress caused by the extreme economic conditions the world is facing. Management also considered that the FHLB maintains regulatory capital ratios in excess of all regulatory capital requirements, liquidity appears adequate, new shares of FHLB stock continue to change hands at the \$100 par value, and the resumption of dividends.

**Note 6. Credit Quality and Related Allowance for Loan Losses**

Management segments the Bank's loan portfolio to a level that enables risk and performance monitoring according to similar risk characteristics. Loans are segmented based on the underlying collateral characteristics. Categories include commercial and agricultural, real estate, and installment loans to individuals. Real estate loans are further segmented into three categories: residential, commercial and construction.

The following table presents the related aging categories of loans, by segment, as of September 30, 2012 and December 31, 2011:

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

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

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

The following table presents the interest income if interest had been recorded based on the original loan agreement terms and rate of interest for non-accrual loans and interest income recognized on a cash basis for non-accrual loans as of September 30, 2012 and September 30, 2011:

(In Thousands)	Three Months Ended September 30,			
	2012		2011	
	Interest Income That Would Have Been Recorded Based on Original Term and Rate	Interest Income Recorded on a Cash Basis	Interest Income That Would Have Been Recorded Based on Original Term and Rate	Interest Income Recorded on a Cash Basis
Real estate mortgages - residential	\$ 13	\$ 4	\$ 7	\$ 1
Real estate mortgages - commercial	92	43	36	3
Real estate mortgages - construction	77	11	290	4
	\$ 182	\$ 58	\$ 333	\$ 8

(In Thousands)	Nine Months Ended September 30,			
	2012		2011	
	Interest Income That Would Have Been Recorded Based on Original Term and Rate	Interest Income Recorded on a Cash Basis	Interest Income That Would Have Been Recorded Based on Original Term and Rate	Interest Income Recorded on a Cash Basis
Real estate mortgages - residential	\$ 25	\$ 17	\$ 31	\$ 20
Real estate mortgages - commercial	135	51	65	5
Real estate mortgages - construction	298	67	562	4
	\$ 458	\$ 135	\$ 658	\$ 29

**Impaired Loans**

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

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan is greater than \$100,000 and if the loan is either on non-accrual status or has a risk rating of substandard. Management may also elect to measure an individual loan for impairment if less than \$100,000 on a case by case basis.

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

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

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

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

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



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(In Thousands)	Three Months Ended September 30,					
	Average Investment in Impaired Loans	2012 Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans	Average Investment in Impaired Loans	2011 Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans
Commercial and agricultural	\$	\$	\$	\$	41	\$ 1
Real estate mortgages - residential	1,253	10	4	1,448	16	6
Real estate mortgages - commercial	6,576	63	6	5,537	35	3
Real estate mortgages - construction	6,822	1	11	10,540	23	4
	\$ 14,651	\$ 74	\$ 21	\$ 17,566	\$ 75	\$ 13

(In Thousands)	Nine Months Ended September 30,					
	Average Investment in Impaired Loans	2012 Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans	Average Investment in Impaired Loans	2011 Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans
Commercial and agricultural	\$	\$	\$	\$	125	\$ 5
Real estate mortgages - residential	1,382	35	33	1,477	42	22
Real estate mortgages - commercial	6,541	224	14	4,657	105	5
Real estate mortgages - construction	8,266	1	67	9,551	77	4
	\$ 16,189	\$ 260	\$ 114	\$ 15,810	\$ 229	\$ 31

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

**Modifications**

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

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

(In Thousands, Except Number of Contracts)	Number of Contracts	Three Months Ended September 30,			
		2012 Pre-Modification Outstanding	Post-Modification Outstanding	Number of Contracts	2011 Pre-Modification Outstanding



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