2002 Annual Report

BUSINESS OF PENNS WOODS BANCORP, INC.

Penns Woods Bancorp, Inc. is a bank holding company incorporated on January 7, 1983, under the Pennsylvania Business Corporation Law.

Jersey Shore State Bank, the principal subsidiary of Penns Woods Bancorp, Inc., is a full-service commercial bank offering a wide range of commercial and consumer banking services to individual, business, public and institutional customers.

Currently, Jersey Shore State Bank operates eleven banking offices in Jersey Shore, Duboistown, Williamsport, Montgomery, Mill Hall, Lock Haven, Spring Mills, Centre Hall, State College and Zion, as well as a Financial Center in State College.

MISSION STATEMENT

Jersey Shore State Bank is a locally owned, independent, community bank with emphasis on servicing the needs of consumers and small to medium size businesses at a profit, thereby enhancing shareholder value through a professionally-trained and dedicated staff with sound financial resources. We are committed to community leadership and growth.

TABLE OF CONTENTS

Letter to Shareholders 2

Three Year Financial Highlights 3

Report of Independent Auditors 4

Consolidated Balance Sheet 5

Consolidated Statement of Income 6

Consolidated Statement of Changes in Shareholders' Equity 7

Consolidated Statement of Cash Flows 8

Notes to Consolidated Financial Statements 9-24

Management's Discussion and Analysis of Consolidated

Financial Condition and Results of Operation 25-38

To our Shareholders

Dear Shareholders:

PROFITABILITY, HONESTY, QUALITY and ***LOYALTY***. These are the core values of Penns Woods Bancorp, Inc. and the principles that define who we are.

PROFITABILITY. It was another great year for Penns Woods Bancorp, Inc. Record net income of $8,886,000 or $2.93 per basic and dilutive share is a product of our hard work and dedication. This compares to consolidated net income for the same period in 2001 of $7,742,000 or $2.53 per basic and dilutive share representing an increase of 14.78%. Operating earnings alone increased an impressive 23.68% from year end 2001 to 2002.

Strong earnings have produced favorable results in Penns Woods Bancorp, Inc.'s key financial ratios, which have surpassed our results of the prior year. Our return on average assets and return on average equity for the year ended December 31, 2002 were 2.01% and 15.00%, respectively. At December 31, 2001 return on average assets and return on average equity were 1.95% and 14.38%, respectively.

The M Group, Inc., D/B/A The Comprehensive Financial Group, has greatly contributed to our success and has had a positive impact on all stakeholders. Aside from the four registered representatives in our branches, several Jersey Shore State Bank employees are now licensed, and are selling a variety of investment products. The development of this relationship has produced favorable results that have substantially added to our bottom line. The M Group, Inc. has added $549,000 to net income representing a 17% rate of return on our original investment.

Success is also measured by the growth in shareholder value. Total dividends paid for 2002 were $1.36, or $0.14 more than the previous year of $1.22. This represents an 11.48% increase from last year and a current dividend payout of more than 46% of earnings. Book value per share of Penns Woods Bancorp, Inc. stock has increased 14.58% from the previous year to $20.83. In addition, our stock repurchase program extended to August 8, 2003 has bought back more than 101,000 shares to date.

HONESTY. We take pride in not only our results, but also the path we take to achieve them. In 2002, investor confidence in the stock market as a whole was justifiably low due to a few large corporate scandals. The banking industry is already one of the more heavily regulated industries in this country, which has prepared us well to respond to new corporate regulations.

QUALITY. Excellent financial performance and enhanced shareholder value are byproducts of providing quality service to our customers and community.

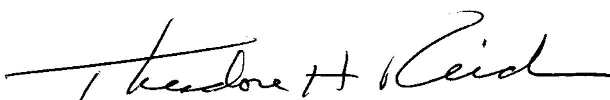
Over the past few years, the Bank has expanded considerably into the Centre County market in an effort to spread our quality service to more consumers and communities. State College's efficient and productive economy supports growth, which makes it attractive for business development. In 2002, we continued our expansion into the region with the opening of our fifth Centre County branch office. The State College Wal-Mart branch opened in May 2002. Our first office in State College, the Jersey Shore State Bank Financial Center, continues to excel in the market. In 2002, 40% of the bank's closed mortgage loans were generated from the Financial Center.

Technology continues to be an important issue in the banking industry and a top priority for our company. In order to provide quality service to our customers, technological advancements are vital. New technology is being used everyday to provide quick and easy access of information to our customers. For example, internet banking now offers the option to view check images in addition to bill payment services and the ability to view and download your statements. Internet banking has proven to be a useful tool to customers. The number of internet banking users has increased every week for more than one hundred consecutive weeks. Recently, we installed a wide area network. This will allow us to implement the most up to date technology throughout our branch system and reduce costs due to more efficient processing. In addition, it offers the ability for our branch personnel to communicate and advise customers with information not previously available.

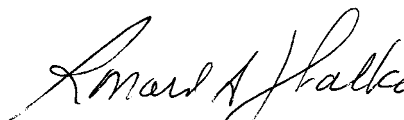
LOYALTY. Last year we wrote about the strong foundation of Penns Woods Bancorp, Inc., built upon our loyal employees, customers and shareholders. Loyalty to a company is a waning quality in many organizations but in 2002 we had 31 employees with over 20 years of experience with the company. To mention employee loyalty and devotion and not include Theodore H. Reich would be an oversight. As a force behind the success of Penns Woods Bancorp, Inc. Mr. Reich stepped away from his duties as Chairman of the Board on December 31, after 32 years of service. He will continue to support the company as an investment portfolio consultant.

We have many things for which to be thankful including our loyal customers, shareholders and staff. It takes everyone working together to insure success. We look forward to meeting the challenges for the future with enthusiasm and confidence in the ability of our company.

Very truly yours,



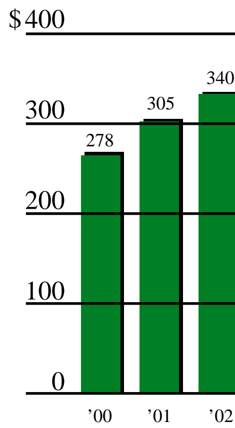
Theodore H. Reich
Chairman Emeritus



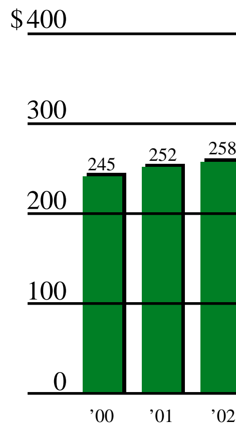
Ronald A. Walko
President and Chief Executive Officer

Three Year Financial Highlights

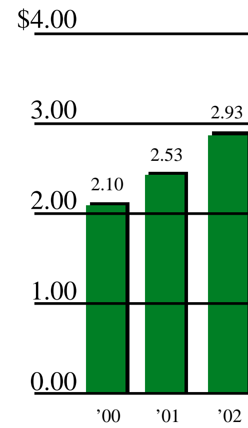
YEAR-END DEPOSITS
In Millions of Dollars



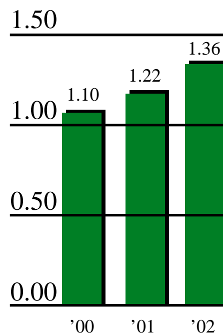
YEAR-END LOANS
In Millions of Dollars



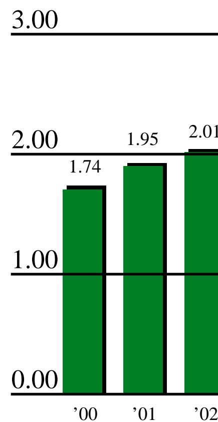
DILUTED EARNINGS PER SHARE



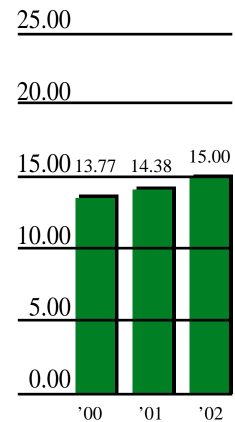
DIVIDENDS PER SHARE



RETURN ON AVERAGE ASSETS
Percent



RETURN ON AVERAGE EQUITY
Percent



REPORT OF INDEPENDENT AUDITORS

SNODGRASS
Certified Public Accountants and Consultants

Board of Directors and Shareholders
Penns Woods Bancorp, Inc.

We have audited the accompanying consolidated balance sheet of Penns Woods Bancorp, Inc. and subsidiaries, as of December 31, 2002 and 2001, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2002. 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 auditing standards generally accepted in the United States of America. 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, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

S.R. Snodgrass, A.C.

Wexford, PA
February 14, 2003

S.R. Snodgrass, A.C.
1000 Stonewood Drive, Suite 200 Wexford, PA 15090~8399 Phone: 724~934~0344 Facsimile: 724~934~0345

Penns Woods Bancorp, Inc.
Consolidated Balance Sheet

	December 31,	
	2002	2001
	(in thousands)	
ASSETS:		
Cash and due from banks	$ 11,731	$ 14,844
Securities available for sale	176,436	131,985
Securities held to maturity (fair value of $1,289 and $1,312)	1,181	1,302
Loans held for sale	2,651	3,993
Loans, net of unearned discount of $769	257,845	251,623
Less: Allowance for loan losses	2,953	2,927
Loans, net	254,892	248,696
Bank premises and equipment, net	4,856	4,478
Accrued interest receivable	2,460	2,685
Bank-owned life insurance	8,537	8,126
Goodwill	3,032	3,032
Other assets	6,430	5,669
TOTAL	$ 472,206	$ 424,810
LIABILITIES:		
Interest-bearing deposits	$ 272,787	$ 249,873
Noninterest-bearing deposits	67,061	55,277
TOTAL DEPOSITS	339,848	305,150
Short-term borrowings	13,563	19,105
Other borrowings	51,778	41,778
Accrued interest payable	1,092	1,190
Other liabilities	2,783	2,335
TOTAL LIABILITIES	409,064	369,558
SHAREHOLDERS' EQUITY:		
Common stock, par value $10; 10,000,000 shares authorized 3,136,832 and 3,131,644 shares issued	31,368	31,316
Additional paid-in capital	18,291	18,230
Retained earnings	11,749	6,987
Accumulated other comprehensive income	5,145	1,729
Treasury stock, at cost (105,503 and 92,054 shares)	(3,411)	(3,010)
TOTAL SHAREHOLDERS' EQUITY	63,142	55,252
TOTAL	$ 472,206	$ 424,810

See Accompanying Notes to the Consolidated Financial Statements.

Penns Woods Bancorp, Inc.

Consolidated Statement of Income

	Year Ended December 31,		
	2002	2001	2000
	(in thousands, except per share data)		
INTEREST AND DIVIDEND INCOME:			
Interest and fees on loans	$ 20,911	$ 21,919	$ 21,570
Interest and dividends on investments:			
Taxable interest	4,314	3,112	3,954
Tax-exempt interest	3,252	3,066	2,205
Other dividend income	627	639	725
TOTAL INTEREST AND DIVIDEND INCOME	29,104	28,736	28,454
INTEREST EXPENSE:			
Interest on deposits	7,857	9,657	9,165
Interest on short-term borrowings	501	903	1,866
Interest on other borrowings	2,488	1,921	1,747
TOTAL INTEREST EXPENSE	10,846	12,481	12,778
NET INTEREST INCOME	18,258	16,255	15,676
PROVISION FOR LOAN LOSSES	365	372	286
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	17,893	15,883	15,390
OTHER INCOME:			
Service charges	1,833	1,565	1,357
Securities gains, net	233	1,033	269
Earnings on bank-owned life insurance	416	174	97
Insurance commissions	1,807	1,416	368
Other operating income	1,164	921	524
TOTAL OTHER INCOME	5,453	5,109	2,615
OTHER EXPENSES:			
Salaries and employee benefits	6,944	5,792	5,136
Occupancy expense, net	831	787	745
Furniture and equipment expense	837	739	758
Pennsylvania shares tax expense	411	370	334
Other operating expenses	3,190	3,584	2,847
TOTAL OTHER EXPENSES	12,213	11,272	9,820
INCOME BEFORE INCOME TAX PROVISION	11,133	9,720	8,185
INCOME TAX PROVISION	2,247	1,978	1,619
NET INCOME	$ 8,886	$ 7,742	$ 6,566
EARNINGS PER SHARE – BASIC	$ 2.93	$ 2.53	$ 2.10
EARNINGS PER SHARE – DILUTED	$ 2.93	$ 2.53	$ 2.10

See Accompanying Notes to the Consolidated Financial Statements.

Penns Woods Bancorp, Inc.
Consolidated Statement of Changes In Shareholders' Equity

	...COMMON STOCK...		ADDITIONAL	RETAINED	ACCUMULATED OTHER COMPREHENSIVE	TREASURY	TOTAL SHAREHOLDERS'
	SHARES	AMOUNT	PAID-IN CAPITAL	EARNINGS	INCOME (LOSS)	STOCK	EQUITY
			(in thousands, except per share data)				
Balance, December 31, 1999	3,128,332	$ 31,283	$ 18,165	$ (166)	$ (2,927)	$ (270)	$ 46,085
Comprehensive Income:							
Net income				6,566			6,566
Unrealized gain on available for sale securities, net of reclassification adjustments and tax $1,091					2,117		2,117
Total comprehensive income							8,683
Dividends declared, ($1.10 per share)				(3,426)			(3,426)
Stock options exercised	2,512	25	49				74
Treasury stock acquired, 28,591 shares						(902)	(902)
Balance, December 31, 2000	3,130,844	31,308	18,214	2,974	(810)	(1,172)	50,514
Comprehensive Income:							
Net income				7,742			7,742
Unrealized gain on available for sale securities, net of reclassification adjustments and tax of $1,308					2,539		2,539
Total comprehensive income							10,281
Dividends declared, ($1.22 per share)				(3,729)			(3,729)
Stock options exercised	800	8	16				24
Treasury stock acquired, 58,503 shares						(1,838)	(1,838)
Balance, December 31, 2001	3,131,644	31,316	18,230	6,987	1,729	(3,010)	55,252
Comprehensive Income:							
Net income				8,886			8,886
Unrealized gain on available for sale securities, net of reclassification adjustments and tax of $1,760					3,416		3,416
Total comprehensive income							12,302
Dividends declared, ($1.36 per share)				(4,124)			(4,124)
Stock options exercised	5,188	52	61				113
Treasury stock acquired, 13,449 shares						(401)	(401)
Balance, December 31, 2002	3,136,832	$ 31,368	$ 18,291	$ 11,749	$ 5,145	$ (3,411)	$ 63,142

Components of comprehensive income:	2002	2001	2000
Change in net unrealized gain on investments available for sale	$ 3,570	$ 3,221	$ 2,295
Realized gains included in net income, net of tax $79, $351 and $91	(154)	(682)	(178)
Total	$ 3,416	$ 2,539	$ 2,117

See Accompanying Notes to the Consolidated Financial Statements

Penns Woods Bancorp, Inc.
Consolidated Statement of Cash Flows

	Year Ended December 31,		
	2002	2001	2000
		(in thousands)	
OPERATING ACTIVITIES:			
Net income	$ 8,886	$ 7,742	$ 6,566
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	526	489	551
Provision for loan losses	365	372	286
Accretion and amortization of investment security discounts and premiums	(906)	(843)	(610)
Securities gains, net	(233)	(1,033)	(269)
Originations of loans held for sale	(16,597)	(24,311)	(14,022)
Proceeds of loans held for sale	17,939	22,006	14,342
Earnings on bank-owned life insurance	(416)	(174)	(97)
Decrease (increase) in all other assets	(1,465)	(577)	588
Increase in all other liabilities	473	59	309
Net cash provided by operating activities	8,572	3,730	7,644
INVESTING ACTIVITIES:			
Investment securities available for sale:			
Proceeds from sales	79,022	22,156	53,301
Proceeds from calls and maturities	13,047	12,765	6,142
Purchases	(130,328)	(48,151)	(57,973)
Investment securities held to maturity:			
Proceeds from calls and maturities	137	1,963	58
Purchases	(41)	(25)	(273)
Net increase in loans	(6,800)	(7,148)	(13,213)
Acquisition of bank premises and equipment	(992)	(323)	(390)
Proceeds from the sale of foreclosed assets	344	592	168
Purchase of bank-owned life insurance	–	(5,589)	(1,298)
Acquisition of a subsidiary	–	–	(3,321)
Gross proceeds from redemption of regulatory stock	1,262	943	–
Gross purchases of regulatory stock	(2,080)	(941)	(179)
Net cash used for investing activities	(46,429)	(23,758)	(16,978)
FINANCING ACTIVITIES:			
Net increase in interest-bearing deposits	22,914	19,208	18,138
Net increase in noninterest-bearing deposits	11,784	7,808	4,423
Net decrease in short-term borrowings	(5,542)	(11,916)	(10,620)
Proceeds from other borrowings	10,000	10,000	5,000
Repayment of other borrowings	–	–	(500)
Dividends paid	(4,124)	(3,729)	(3,426)
Stock options exercised	113	21	65
Purchase of treasury stock	(401)	(1,838)	(902)
Net cash provided by financing activities	34,744	19,554	12,178
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(3,113)	(474)	2,844
CASH AND CASH EQUIVALENTS, BEGINNING	14,844	15,318	12,474
CASH AND CASH EQUIVALENTS, ENDING	$ 11,731	$ 14,844	$ 15,318

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

The Company paid approximately $10,944,000, $12,743,000, and $12,449,000 in interest on deposits and other borrowings during 2002, 2001, and 2000, respectively.

The Company made income tax payments of approximately $3,394,000, $2,136,000, and $2,008,000 during 2002, 2001, and 2000, respectively.

Transfers from loans to foreclosed assets held for sale amounted to approximately $254,000, $493,000, and $294,000 in 2002, 2001, and 2000, respectively.

See Accompanying Notes to the Consolidated Financial Statements

PENNS WOODS BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE A — NATURE OF 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 nonprofit entities and local government loans 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 eleven offices and Financial Center 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. is engaged in investing activities.

The M Group engages in securities brokerage and insurance activities.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 and the valuation of real estate acquired through, or in lieu of, foreclosure on settlement of debt.

Investment Securities

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

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.

Trading account securities are recorded at their fair values. Unrealized gains and losses on trading account securities are included in other income. The Company has no trading account securities as of December 31, 2002 or 2001.

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.

Declines in the fair value of individual securities held to maturity and available for sale below their cost that are other than temporary result in write-downs of the individual securities to their fair value and are included in earnings as realized losses.

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

The fair value of investments and mortgage-backed securities, except certain state and political securities, is estimated based on bid prices published in financial newspapers, quotations received from securities dealers, or, in the case of equity securities, the closing price of the day as listed on the Internet. The fair value of certain state and political securities is not readily available through market sources other than dealer quotations, therefore these fair value estimates are then based on quoted market prices of similar instruments, adjusted for differences between the quoted instruments and the instruments being valued.

Loans

Loans are stated at the principal amount outstanding, net of unearned discount, 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.

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 on management's periodic evaluation of individual loans, economic factors, past loan loss experience, changes in the composition and volume of the portfolio, and other relevant factors. The estimates used in determining the adequacy of the allowance for loan losses, including the amounts and timing of future cash flows expected on impaired loans, are particularly susceptible to changes in the near term.

Impaired loans are commercial and commercial real estate loans for which it is probable the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Company 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 Company 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 impaired 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 the aggregate lower of cost or market. Such loans sold are not serviced by the Bank.

Foreclosed Assets Held for Sale

Foreclosed assets held for sale are carried at the lower of fair value minus estimated costs to sell or cost. 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. Operating expenses of such properties, net of related income, and gains and losses on their disposition are included in other expenses.

Bank Premises and Equipment

Bank 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 seven years for furniture, fixtures and equipment and thirty-one and a half 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.

Goodwill

Goodwill is the excess cost over the fair market value of assets acquired in connection with business acquisitions and was being amortized on the straight-line method over fifteen years, prior to October 1, 2001. On October 1, 2001, the Company adopted FAS No. 142, *Goodwill and Other Intangible Assets*, which changed the accounting for goodwill from an amortization method to an impairment-only approach. This statement eliminates the regularly scheduled amortization of goodwill and replaces this method with 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, upon adoption of this statement, stopped amortizing existing goodwill of $3.0 million. In addition, the Company performed its initial impairment analysis of goodwill and other intangible assets and determined that the estimated fair value exceeded the carrying amount.

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 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.

Stock Options

The Company maintains a stock option plan for the directors, officers and employees. When the exercise price of the Company's stock options is greater than or equal to the market price of the underlying stock on the date of the grant, no compensation expense is recognized in the Company's financial statements. Pro forma net income and earnings per share are presented to reflect the impact of the stock option plan assuming compensation expense had been recognized based on the fair value of the stock options granted under the plan.

The Company applies Accounting Principles Board Opinion No. 25 and related interpretations in accounting for these options. Accordingly, compensation expense is recognized on the grant date, in the amount equivalent to the intrinsic value of the options (stock price less exercise price, at measurement date).

Had compensation costs for these options been determined based on the fair values at the grant dates for awards consistent with the method of FAS No. 123, there would be no effect on the Company's net income and earnings per share for 2002, 2001, and 2000 would have been insignificant. For purposes of the calculations required by FAS No. 123, the fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants issued in 2000, 1999 and 1998, respectively: dividend yield of 1.03 percent, 1.03 percent, and 1.85 percent, respectively; risk-free interest rates of 4.95 percent, 4.95 percent, and 6.75 percent, respectively; expected option lives of three years and expected volatility of 23.81 percent, 23.81 percent, and 18.73 percent, respectively.

Comprehensive Income

The Company is required to present comprehensive income in a full set of general-purpose financial statements for all periods presented. Other comprehensive income is comprised exclusively of unrealized holding gains (losses) on the available for sale securities portfolio. The Company has elected to report the effects of other comprehensive income as part of the Consolidated Statement of Changes in Shareholders' Equity.

Cash Flows

The Company utilizes the net reporting of cash receipts and cash payments for deposit and lending activities.

The Company considers amounts due from banks as cash equivalents.

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 stockholders' equity.

Recent Accounting Pronouncements

In August 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("FAS") No. 143, *Accounting for Asset Retirement Obligations*, which requires that the fair value of a liability be recognized when incurred for the retirement of a long-lived asset and the value of the asset be increased by that amount. The statement also requires that the liability be maintained at its present value in subsequent periods and outlines certain disclosures for such obligations. The adoption of this statement, which is effective January 1, 2003, is not expected to have a material effect on the Company's financial statements.

In October 2001, the FASB issued FAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. FAS No. 144 supercedes FAS No. 121 and applies to all long-lived assets (including discontinued operations) and consequently amends APB Opinion No. 30, *Reporting Results of Operations-Reporting the Effects of Disposal of a Segment of a Business*. FAS No. 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less costs to sell. FAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and, generally, its provisions are to be applied prospectively. The adoption of this statement did not have a material effect on the Company's financial statements.

In April 2002, the FASB issued FAS No. 145, *Recission of FASB Statement No. 4, 44 and 64*, *Amendment of FASB Statement No. 13, and Technical Corrections*. FAS No. 145 rescinds FAS No. 4, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. As a result, the criteria in APB Opinion No. 30 will now be used to classify those gains and losses. This statement also amends FAS No. 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. This statement also makes technical corrections to existing pronouncements, which are not substantive but in some cases may change accounting practice. The provisions of this statement related to the rescission of FAS No. 4 shall be applied in fiscal years beginning after May 15, 2002. Any gain or loss on extinguishments of debt that was classified as an extraordinary item in prior periods presented that does not meet the criteria in APB Opinion No. 30 for classification as an extraordinary item shall be reclassified. Early adoption of the provisions of this statement related to FAS No. 13 shall be effective for transactions occurring after May 15, 2002. All other provisions of this statement shall be effective for financial statements issued on or after May 15, 2002. Early application of this statement is encouraged. The adoption of the effective portions of this statement did not have an impact on the Company's financial position or results of operations. The adoption of the remaining portions of this statement is not expected to have an impact on the Company's financial position or results of operations.

In July 2002, the FASB issued FAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. This statement replaces EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*. The new statement will be effective for exit or disposal activities initiated after December 31, 2002, the adoption of which is not expected to have a material effect on the Company's financial statements.

On October 1, 2002, FASB issued FAS No. 147, *Acquisitions of Certain Financial Institutions*, effective for all business combinations initiated after October 1, 2002. This statement addresses the financial accounting and reporting for the acquisition of all or part of a financial institution, except for a transaction between two or more mutual enterprises. This statement removes acquisitions of financial institutions, other than transactions between two or more mutual enterprises, from the scope of FAS No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, and FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method.* The acquisition of all or part of a financial institution that meets the definition of a business combination shall be accounted for by the purchase method in accordance with FAS No. 141, *Business Combinations*, and FAS No. 142, *Goodwill and Other Intangible Assets*. This statement also provides guidance on the accounting for the impairment or disposal of acquired long-term customer-relationship intangible assets (such as depositor- and borrower-relationship intangible assets and credit cardholder intangible assets), including those acquired in transactions between two or more mutual enterprises. The adoption of this statement did not have a material effect on the Company's financial statements.

On December 31, 2002, the FASB issued FAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, which amends FAS No. 123, *Accounting for Stock-Based Compensation*. FAS No. 148 amends the disclosure requirements of FAS No. 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. Under the provisions of FAS No. 123, companies that adopted the preferable, fair value based method were required to apply that method prospectively for new stock option awards. This contributed to a "ramp-up" effect on stock-based compensation expense in the first few years following adoption, which caused concern for companies and investors because of the lack of consistency in reported results. To address that concern, FAS No. 148 provides two additional methods of transition that reflect an entity's full complement of stock-based compensation expense immediately upon adoption, thereby eliminating the ramp-up effect. FAS No. 148 also improves the clarity and prominence of disclosures about the pro forma effects of using the fair value based method of accounting for stock-based compensation for all companies—regardless of the accounting method used—by requiring that the data be presented more prominently and in a more user-friendly format in the footnotes to the financial statements. In addition, the statement improves the timeliness of those disclosures by requiring that this information be included in interim as well as annual financial statements. The transition guidance and annual disclosure provisions of FAS No. 148 are effective for fiscal years ending after December 15, 2002, with earlier application permitted in certain circumstances. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002.

In November, 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. This interpretation clarifies that a guarantor is required to disclose (a) the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee; (b) the maximum potential amount of future payments under the guarantee; (c) the carrying amount of the liability, if any, for the guarantor's obligations under the guarantee; and (d) the nature and extent of any recourse provisions or available collateral that would enable the guarantor to recover the amounts paid under the guarantee. This interpretation also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, including its ongoing obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur. The objective of the initial measurement of that liability is the fair value of the guarantee at its inception. The initial recognition and initial measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements in this interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002.

NOTE B - 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.

	2002	2001	2000
Weighted average common shares outstanding	3,132,252	3,130,846	3,130,178
Average treasury stock shares	(99,241)	(65,532)	(10,638)
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	3,033,011	3,065,314	3,119,540
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	2,670	2,037	—
Weighted average common shares and common stock equivalents used to calculate diluted earnings per share	3,035,681	3,067,351	3,119,540

Options to purchase 20,350 shares of common stock at prices from $42.00 to $53.18 were outstanding during 2002 and 2001, and 30,350 shares at prices from $32.63 to $53.18 were outstanding during 2000, but were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive.

NOTE C - INVESTMENT SECURITIES

The amortized cost of investment securities and their approximate fair values are as follows (in thousands):

	2002			
	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
Available for Sale:				
U.S. Government and agency securities	$ 87,142	$ 1,856	$ —	$ 88,998
State and political securities	67,319	3,596	(234)	70,681
Other debt securities	1,766	46	(2)	1,810
Total debt securities	156,227	5,498	(236)	161,489
Equity securities	12,414	2,989	(456)	14,947
	$ 168,641	$ 8,487	$ (692)	$ 176,436
Held to Maturity:				
U.S. Government and agency securities	$ 94	$ —	$ —	$ 94
State and political securities	796	109	—	905
Other debt securities	291	—	(1)	290
	$ 1,181	$ 109	$ (1)	$ 1,289

	2001			
	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
Available for Sale:				
U.S. Government and agency securities	$ 25,851	$ 130	$ (161)	$ 25,820
State and political securities	81,559	2,494	(797)	83,256
Other debt securities	817	3	(4)	816
Total debt securities	108,227	2,627	(962)	109,892
Equity securities	21,138	2,911	(1,956)	22,093
	$ 129,365	$ 5,538	$ (2,918)	$ 131,985
Held to Maturity:				
U.S. Government and agency securities	$ 196	$ 7	$ —	$ 203
State and political securities	796	23	(20)	799
Other debt securities	310	—	—	310
	$ 1,302	$ 30	$ (20)	$ 1,312

The amortized cost and fair value of debt securities at December 31, 2002, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	HELD TO MATURITY		AVAILABLE FOR SALE	
	AMORTIZED COST	FAIR VALUE	AMORTIZED COST	FAIR VALUE
Due in one year or less	$ 300	$ 306	$ 2,017	$ 2,087
Due after one year to five years	100	100	10,377	10,654
Due after five years to ten years	141	141	27,149	27,566
Due after ten years	640	742	116,684	121,182
	$ 1,181	$ 1,289	$ 156,227	$ 161,489

Total gross proceeds from sales of securities available for sale were $79,022,000, $22,156,000 and $53,301,000 for 2002, 2001 and 2000, respectively. The following table represents gross realized gains and gross realized losses on those transactions (in thousands):

	2002	2001	2000
Gross realized gains:			
U.S. Government and agency securities	$ 204	$ 133	$ 36
State and political securities	2,234	20	170
Other debt securities	6	—	—
Equity securities	1,803	1,226	1,577
	$ 4,247	$ 1,379	$ 1,783
Gross realized losses:			
U.S. Government and agency securities	$ 125	$ 13	$ 731
State and political securities	67	149	30
Equity securities	3,822	184	753
	$ 4,014	$ 346	$ 1,514

In 2002, the Company recorded an investment security gain of $69,000 resulting from a business combination where the Company received the common stock of the acquirer in a non-monetary exchange. This gain is included in the above table.

A charge of $270,000 was recorded in 2002 to recognize other than temporary declines in the value of marketable equity securities. This loss is included in the above table.

Investment securities with a carrying value of approximately $34,914,000 and $36,539,000 at December 31, 2002 and 2001, respectively, were pledged to secure certain deposits, security 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 D - LOANS

Major loan classifications are summarized as follows (in thousands):

	2002				
	CURRENT	PAST DUE 30 TO 90 DAYS	PAST DUE 90 DAYS OR MORE	NON-ACCRUAL	TOTAL
Commercial and agricultural	$ 22,652	$ 769	$ 7	$ 280	$ 23,708
Real estate mortgage:					
Residential	136,819	2,752	175	526	140,272
Commercial	73,988	504	1,006	65	75,563
Construction	3,335	21	—	—	3,356
Installment loans to individuals	14,593	316	37	—	14,946
	$ 251,387	$ 4,362	$ 1,225	$ 871	$ 257,845
Less: Allowance for loan losses	2,953				2,953
Loans, net	$ 248,434				$ 254,892

	2001				
	CURRENT	PAST DUE 30 TO 90 DAYS	PAST DUE 90 DAYS OR MORE	NON-ACCRUAL	TOTAL
Commercial and agricultural	$ 22,233	$ 334	$ 36	$ 26	$ 22,629
Real estate mortgage:					
Residential	136,361	3,311	296	255	140,223
Commercial	64,051	2,712	—	—	66,763
Construction	4,042	35	—	—	4,077
Installment loans to individuals	17,583	342	6	—	17,931
	$ 244,270	$ 6,734	$ 338	$ 281	$ 251,623
Less: Allowance for loan losses	2,927				2,927
Loans, net	$ 241,343				$ 248,696

Loans on which the accrual of interest has been discontinued or reduced amounted to approximately $871,000 and $281,000 at December 31, 2002 and 2001, respectively. If interest had been recorded at the original rate on those loans, such income would have approximated $24,000, $28,000 and $86,000 for the years ended December 31, 2002, 2001 and 2000, respectively. Interest income on such loans, which is recorded as received, amounted to approximately $17,000, $19,000 and $45,000 for the years ended December 31, 2002, 2001 and 2000, respectively.

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

	2002	2001	2000
Balance, beginning of year	$ 2,927	$ 2,879	$ 2,823
Provision charged to operations	365	372	286
Loans charged off	(402)	(358)	(269)
Recoveries	63	34	39
Balance, end of year	$ 2,953	$ 2,927	$ 2,879

The Company had no concentration of loans to borrowers engaged in similar businesses or activities which exceed five percent of total assets at December 31, 2002 or December 31, 2001.

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, 2002 and 2001, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within this region.

NOTE E - BANK PREMISES AND EQUIPMENT

Major classifications of Bank premises and equipment are summarized as follows at December 31, (in thousands):

	2002	2001
Land	$ 566	$ 566
Bank premises	4,855	4,668
Furniture and equipment	6,001	5,292
Leasehold improvements	842	834
Total	12,264	11,360
Less accumulated depreciation	7,408	6,882
Net	$ 4,856	$ 4,478

Depreciation charges to operations for the years ended 2002, 2001 and 2000 was $526,000, $489,000 and $551,000, respectively.

NOTE F - GOODWILL

A summary of goodwill is as follows:

	2002	2001
Gross carrying amount	$ 3,308	$ 3,308
Less accumulated amortization	(276)	(276)
Net carrying amount	$ 3,032	$ 3,032

Amortization expense amounted to $221,000 for 2001.

The gross carrying amount of goodwill was tested for impairment in the second quarter. The Company performed its initial impairment analysis of goodwill noting that the estimated fair value exceeded the carrying amount.

The following tables sets forth a comparison of net income and basic and diluted earnings per share adjusted for the adoption of FAS No. 142, *Goodwill and Other Intangible Assets:*

	2002	2001	2000
	(Dollars in thousands, except per share amounts)		
Goodwill amortization	$ —	$ 221	$ 55
Net income	$ 8,886	$ 7,742	$ 6,566
Addback: Goodwill amortizaton (net of tax)	—	146	36
Adjusted net income	$ 8,886	$ 7,888	$ 6,602
Basic earnings per share:			
Net income	$ 2.93	$ 2.53	$ 2.10
Goodwill amortization	—	0.04	0.01
Adjusted basic earnings per share	$ 2.93	$ 2.57	$ 2.11
Diluted earnings per share:			
Net income	$ 2.93	$ 2.53	$ 2.10
Goodwill amortization	—	0.04	0.01
Adjusted diluted earnings per share	$ 2.93	$ 2.57	$ 2.11

NOTE G - DEPOSITS

Time deposits of $100,000 or more totaled approximately $29,126,000 on December 31, 2002 and $32,646,000 on December 31, 2001. Interest expense related to such deposits was approximately $1,098,000, $1,913,000 and $1,571,000 for the years ended December 31, 2002, 2001 and 2000, respectively.

Maturities on time deposits of $100,000 or more are as follows:

	2002
Three months or less	$ 6,770
Three months to six months	7,436
Six months to twelve months	6,093
Over twelve months	8,827
Total	$ 29,126

Time deposits at December 31, 2002 mature as follows: 2003 - $85,397,000; 2004 - $20,365,000; 2005 - $15,168,000; 2006 - $10,627,000; 2007 – $1,169,000; thereafter - $1,054,000.

NOTE H - SHORT-TERM BORROWINGS

Short-term borrowings consist of securities sold under agreements to repurchase and FHLB advances which generally represent overnight or less than 30-day borrowings. The outstanding balances and related information for short-term borrowings are summarized as follows (in thousands):

	2002	2001
Open Repo Plus:		
Balance at year end	$ 1,840	$ 8,830
Maximum amount outstanding at any month end	8,510	16,861
Average balance outstanding during the year	1,646	4,425
Weighted-average interest rate:		
At year end	1.31%	1.20%
Paid during the year	1.96%	3.48%
Repurchase Agreements:		
Balance at year end	$ 11,723	$ 10,275
Maximum amount outstanding at any month end	20,870	18,825
Average balance outstanding during the year	14,819	15,697
Weighted-average interest rate:		
At year end	2.68%	3.76%
Paid during the year	3.17%	4.77%

NOTE I - OTHER BORROWINGS

Other borrowings are comprised of advances from the FHLB. A schedule of other borrowings by maturity as of December 31, 2002 and 2001 is summarized as follows (in thousands):

Description	Maturity		Interest Rate	2002	2001
FHLB Borrowing	April 30, 2007	(7)	4.49%	$ 5,000	$ —
Convertible Select Advance	April 7, 2008	(1)	5.54%	10,000	10,000
Convertible Select Advance	June 16, 2008	(2)	5.56%	10,000	10,000
Convertible Select Advance	February 26, 2009	(3)	5.06%	5,000	5,000
Convertible Select Advance	August 10, 2010	(4)	6.65%	5,000	5,000
Convertible Select Advance	October 15, 2011	(5)	4.72%	5,000	5,000
FHLB Borrowing	October 17, 2011		6.92%	500	500
Convertible Select Advance	November 5, 2011	(6)	4.25%	5,000	5,000
FHLB Borrowing	October 10, 2012	(8)	3.68%	5,000	—
FHLB Borrowing	June 24, 2013		5.87%	528	528
FHLB Borrowing	May 25, 2015		6.92%	750	750
Total				$ 51,778	$ 41,778

The Bank maintains a credit arrangement, which includes a revolving line of credit with FHLB. Under this credit arrangement, the Bank has a remaining borrowing capacity of approximately $153,147,000 at December 31, 2002, 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.

(1) The FHLB has the option to convert this interest rate to an adjustable rate based on the three-month LIBOR at the five-year anniversary date of the borrowings origination, which will occur in the third quarter of 2003.

(2) The FHLB has the option to convert this interest rate to an adjustable rate based on the three-month LIBOR at the five-year anniversary date of the borrowings origination, which will occur in the second quarter of 2003.

(3) The FHLB has the option to convert this interest rate to an adjustable rate based on the three-month LIBOR at the five-year anniversary date of the borrowings origination, which will occur in the first quarter of 2004.

(4) The FHLB has the option to convert this interest rate to an adjustable rate based on the three-month LIBOR at the five-year anniversary date of the borrowings origination, which will occur in the third quarter of 2005.

(5) The FHLB has the option to convert this interest rate to an adjustable rate based on the three-month LIBOR at the two-year anniversary date of the borrowings origination, which will occur in the fourth quarter of 2003.

(6) The FHLB has the option to convert this interest rate to an adjustable rate based on the three-month LIBOR at the three-year anniversary date of the borrowings origination, which will occur in the fourth quarter of 2004.

(7) The FHLB has the option to convert this interest rate to an adjustable rate based on the three-month LIBOR at the one-year anniversary date of the borrowings origination, which will occur in the second quarter of 2003.

(8) The FHLB has the option to convert this interest rate to an adjustable rate based on the three-month LIBOR at the two-year anniversary date of the borrowings origination, which will occur in the fourth quarter of 2004.

NOTE J - INCOME TAXES

The following temporary differences gave rise to the net deferred tax asset at December 31, 2002 and 2001 (in thousands):

	2002	2001
Deferred tax asset:		
Allowance for loan losses	$ 693	$ 668
Deferred compensation	337	303
Contingencies	20	55
Pension	371	348
Loan fees and costs	261	215
Investment securities allowance	92	—
Total	1,774	1,589
Deferred tax liability:		
Bond accretion	31	25
Depreciation	192	129
Unrealized gains on available for sale securities	2,650	891
Total	2,873	1,045
Deferred tax asset (liability), net	$ (1,099)	$ 544

No valuation allowance was established at December 31, 2002 and 2001, 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):

	YEAR ENDED DECEMBER 31,		
	2002	2001	2000
Currently payable	$ 2,363	$ 2,117	$ 1,730
Deferred benefit	(116)	(139)	(111)
Total provision	$ 2,247	$ 1,978	$ 1,619

The effective federal income tax rate for the years ended December 31, 2002, 2001 and 2000 was 20.2 percent, 20.3 percent, and 19.8 percent, respectively. A reconciliation between the expected income tax and rate and the effective income tax and rate on income before income tax provision follows (in thousands):

	2002		2001		2000	
	AMOUNT	%	AMOUNT	%	AMOUNT	%
Provision at expected rate	$ 3,785	34.0%	$ 3,305	34.0%	$ 2,783	34.0%
Decrease in tax resulting from:						
Tax-exempt income	(1,367)	(12.3)	(1,103)	(11.4)	(837)	(10.2)
Other, net	(171)	(1.5)	(224)	(2.3)	(327)	(4.0)
Effective income tax and rates	$ 2,247	20.2%	$ 1,978	20.3%	$ 1,619	19.8%

NOTE K - EMPLOYEE BENEFIT PLANS

DEFINED BENEFIT PENSION PLAN

The Company has a noncontributory defined benefit pension plan (the "Plan") for all employees meeting certain age and length of service requirements. 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 following tables show the funded status and components of net periodic benefit cost from this defined benefit plan (in thousands):

	2002	2001
CHANGE IN BENEFIT OBLIGATION:		
Benefit obligation at beginning of year	$ 4,976	$ 3,935
Service cost	381	298
Interest cost	342	271
Amendments	97	—
Actuarial adjustment	753	524
Benefits paid	(76)	(52)
Benefit obligation at end of year	6,473	4,976
CHANGE IN PLAN ASSETS:		
Fair value of plan assets at beginning of year	3,115	3,597
Actual loss on plan assets	(407)	(430)
Employer contribution	499	—
Benefits paid	(76)	(52)
Fair value of plan assets at end of year	3,131	3,115
Funded status	(3,342)	(1,861)
Unrecognized net actuarial gain	1,996	609
Unrecognized transition asset	(24)	(27)
Unrecognized prior service cost	280	209
Accrued benefit payable	$ (1,090)	$ (1,070)
WEIGHTED-AVERAGE ASSUMPTIONS AS OF DECEMBER 31:		
Discount rate	6.00%	6.50%
Expected return on plan assets	8.00%	8.00%
Rate of compensation increase	5.00%	5.00%

	2002	2001	2000
COMPONENTS OF NET PERIODIC BENEFIT COST:			
Service cost	$ 381	$ 298	$ 256
Interest cost	342	271	242
Expected return on plan assets	(246)	(286)	(291)
Amortization of transition asset	(3)	(3)	(3)
Amortization of prior service cost	26	20	20
Recognized net actuarial (gain) loss	19	(15)	(33)
Net periodic benefit cost	$ 519	$ 285	$ 191

The plan assets are invested primarily in bonds, stocks, equity funds, and mortgages under the control of the plan's trustees as of December 31, 2002.

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 to be determined by the Company. 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 $80,000, $65,000 and $67,000 for the years ended December 31, 2002, 2001 and 2000, 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 corporate-owned life insurance policies on the lives of the participating directors for which insurance benefits are payable to the Company. The total expense charged to other expenses was $98,000, $67,000 and $66,000 for the years ended December 31, 2002, 2001 and 2000, respectively. Benefits paid under the plan were approximately $51,000 in 2002 and $51,000 in 2001 and $53,000 in 2000.

NOTE L - 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. In addition, non-employee directors are eligible to receive grants of nonqualified stock options. 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:

	2002		2001	
	SHARES	WEIGHTED-AVERAGE EXERCISE PRICE	SHARES	WEIGHTED-AVERAGE EXERCISE PRICE
Outstanding, beginning of year	41,501	$ 38.60	42,301	$ 37.87
Granted	—	—	—	—
Exercised	5,188	25.98	800	25.98
Forfeited	5,963	25.98	—	—
Outstanding, end of year	30,350	$ 42.56	41,501	$ 38.10
Options exercisable at year-end	30,350	$ 42.56	41,501	$ 38.10

The following table summarizes information about nonqualified and incentive stock options outstanding at December 31, 2002:

	Outstanding			Exercisable	
Exercise Price	Shares	Average Life	Average Exercise Price	Shares	Average Exercise Price
$ 53.18	9,900	6	$ 53.18	9,900	$ 53.18
$ 42.00	10,450	7	$ 42.00	10,450	$ 42.00
$ 32.63	10,000	8	$ 32.63	10,000	$ 32.63

NOTE M - 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 (in thousands):

YEAR	BEGINNING BALANCE	ADDITIONS	PAYMENTS	ENDING BALANCE
2002	$ 5,192	$ 3,234	$ 1,641	$ 6,785

NOTE N - 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, 2002 (in thousands):

YEAR ENDING DECEMBER 31,	
2003	$ 237
2004	218
2005	205
2006	179
2007	149
Thereafter	76
Total	$ 1,064

Total rental expense for all operating leases for the years ended December 31, 2002, 2001 and 2000 approximated $258,000, $270,000 and $213,000, respectively.

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.

NOTE O - 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):

	2002	2001
Commitments to extend credit	$ 29,497	$ 29,490
Standby letters of credit	$ 741	$ 348

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 over the coverage period. For secured letters of credit, the collateral is typically Bank deposit instruments or customer business assets.

NOTE P - 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, 2002 and 2001, the 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.

The Company's actual capital amounts and ratios are presented in the following table (in thousands):

	2002		2001	
	Amount	Ratio	Amount	Ratio
Total Capital (to Risk-weighted Assets)				
Actual	$ 58,953	22.2%	$ 53,281	20.1%
For Capital Adequacy Purposes	21,236	8.0	21,208	8.0
To Be Well Capitalized	26,545	10.0	26,510	10.0
Tier 1 Capital (to Risk-weighted Assets)				
Actual	$ 54,915	20.7%	$ 49,936	18.8%
For Capital Adequacy Purposes	10,618	4.0	10,604	4.0
To Be Well Capitalized	15,927	6.0	15,906	6.0
Tier 1 Capital (to Average Assets)				
Actual	$ 54,915	12.0%	$ 49,936	12.6%
For Capital Adequacy Purposes	18,310	4.0	15,880	4.0
To Be Well Capitalized	22,888	5.0	19,805	5.0

The Bank's actual capital amounts and ratios are presented in the following table (in thousands):

	2002		2001	
	Amount	Ratio	Amount	Ratio
Total Capital (to Risk-weighted Assets)				
Actual	$ 47,232	18.3%	$ 41,409	16.3%
For Capital Adequacy Purposes	20,616	8.0	20,390	8.0
To Be Well Capitalized	25,770	10.0	25,488	10.0
Tier 1 Capital (to Risk-weighted Assets)				
Actual	$ 43,723	17.0%	$ 38,100	15.0%
For Capital Adequacy Purposes	10,308	4.0	10,195	4.0
To Be Well Capitalized	15,462	6.0	15,293	6.0
Tier 1 Capital (to Average Assets)				
Actual	$ 43,723	9.7%	$ 38,100	9.7%
For Capital Adequacy Purposes	17,970	4.0	15,727	4.0
To Be Well Capitalized	22,462	5.0	19,659	5.0

NOTE Q - REGULATORY RESTRICTIONS

The Pennsylvania Banking Code restricts the availability of capital funds for payment of dividend by all state-chartered banks to the additional paid in capital of the Bank. Accordingly, at December 31, 2002, the balance in the additional paid in capital account totaling approximately $11,700,000 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, 2002, the regulatory lending limit amounted to approximately $4,676,000.

Cash and Due from Banks

Included in cash and due from banks are reserves required by the district Federal Reserve Bank of $1,152,000 and $1,523,000 at December 31, 2002 and 2001. 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 R - ACQUISITION

On October 1, 2000, the Bank acquired The M Group in a business acquisition accounted for as a purchase. The M Group is engaged in the insurance business. The results of operations of The M Group are included in the accompanying consolidated financial statements since the date of acquisition. The total cost of the acquisition was $3,321,000, which exceeds the fair value of the net assets of The M Group by $3,308,000 which was allocated to goodwill.

NOTE S - 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 A. 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:

	2002		2001	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
Cash and due from banks	$ 11,731	$ 11,731	$ 14,844	$ 14,844
Investment securities:				
Available for sale	176,436	176,436	131,985	131,985
Held to maturity	1,181	1,289	1,302	1,312
Loans held for sale	2,651	2,651	3,993	3,993
Loans, net	254,892	267,563	248,696	257,062
Bank-owned life insurance	8,537	8,537	8,126	8,126
Regulatory stock	3,963	3,963	2,875	2,875
Accrued interest receivable	2,460	2,460	2,685	2,685
Total	$ 461,851	$ 474,630	$ 414,506	$ 422,882
Financial liabilities:				
Interest-bearing deposits	$ 272,787	$ 276,881	$ 249,873	$ 251,955
Noninterest-bearing deposits	67,061	67,061	55,277	55,277
Short-term borrowings	13,563	13,563	19,105	19,105
Other borrowings	51,778	56,384	41,778	42,369
Accrued interest payable	1,092	1,092	1,190	1,190
Total	$ 406,281	$ 414,981	$ 367,223	$ 369,896

Cash and due from banks, loans held for sale, regulatory stock, accrued interest receivable, short-term borrowings, and accrued interest payable:

The fair value is equal to the carrying value.

Investment securities:

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

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 mortgage, credit card, 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, except residential mortgage and credit card 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. For performing residential mortgage loans, fair value is estimated by discounting contractual cash flows adjusted for prepayment estimates using discounted rates based on secondary market sources adjusted to reflect differences in servicing and credit costs. For credit card loans, cash flows and maturities are estimated based on contractual interest rates and historical experience and are discounted using secondary market rates adjusted for differences in servicing and credit costs.

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 life insurance policies.

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings and NOW accounts, and money market and checking accounts, is equal to the amount payable on demand as of December 31, 2002 and 2001. 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.

Other borrowings:

The fair value of other 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, 2002 and 2001 respectively. The contractual amounts of unfunded commitments and letters of credit are presented in Note O.

NOTE T - PARENT COMPANY ONLY FINANCIAL STATEMENTS

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

CONDENSED BALANCE SHEET, DECEMBER 31,	**2002**	**2001**
ASSETS:	**(in thousands)**	
Cash	$ 481	$ 151
Investment in subsidiaries:		
Bank	51,019	43,371
Nonbank	11,760	11,938
Other assets	20	29
Total assets	$ 63,280	$ 55,489
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Other liabilities	$ 138	$ 237
Shareholders' equity	63,142	55,252
Total liabilities and shareholders' equity	$ 63,280	$ 55,489

CONDENSED STATEMENT OF INCOME FOR THE YEARS ENDED DECEMBER 31,	**2002**	**(IN THOUSANDS) 2001**	**2000**
Operating income:			
Dividends from subsidiaries	$ 4,878	$ 5,984	$ 6,220
Equity in undistributed net income of subsidiaries	4,121	1,899	443
Other income	—	—	2
Operating expenses	(113)	(141)	(99)
Net income	$ 8,886	$ 7,742	$ 6,566

CONDENSED STATEMENT OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31,	**2002**	**(IN THOUSANDS) 2001**	**2000**
OPERATING ACTIVITIES:			
Net income	$ 8,886	$ 7,742	$ 6,566
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net income of subsidiaries	(4,121)	(1,899)	(443)
Other, net	(23)	(26)	21
Net cash provided by operating activities	4,742	5,817	6,144
INVESTING ACTIVITIES:			
Additional investment in subsidiaries	—	(276)	(1,752)
FINANCING ACTIVITIES:			
Dividends paid	(4,124)	(3,729)	(3,426)
Proceeds from exercise of stock options	113	21	65
Purchase of treasury stock	(401)	(1,838)	(902)
Net cash used in financing activities	(4,412)	(5,546)	(4,263)
NET INCREASE (DECREASE) IN CASH	330	(5)	129
CASH, BEGINNING OF YEAR	151	156	27
CASH, END OF YEAR	$ 481	$ 151	$ 156

NOTE U - CONSOLIDATED QUARTERLY FINANCIAL DATA (UNAUDITED) (IN THOUSANDS, EXCEPT PER SHARE DATA)

2002	FOR THE THREE MONTHS ENDED MARCH 31,	JUNE 30,	SEPT. 30,	DEC. 31,
Interest income	$ 7,076	$ 7,199	$ 7,399	$ 7,430
Interest expense	2,719	2,740	2,715	2,672
Net interest income	4,357	4,459	4,684	4,758
Provision for loan losses	105	80	90	90
Other income	1,401	1,317	1,231	1,271
Securities gains (losses), net	(119)	(72)	281	143
Other expenses	2,952	3,056	3,070	3,135
Income before income tax provision	2,582	2,568	3,036	2,947
Income tax provision	485	528	660	574
Net income	$ 2,097	$ 2,040	$ 2,376	$ 2,373
Earnings per share - basic	$ 0.69	$ 0.67	$ 0.78	$ 0.79
Earnings per share - diluted	$ 0.69	$ 0.67	$ 0.78	$ 0.79

2001	FOR THE THREE MONTHS ENDED MARCH 31,	JUNE 30,	SEPT. 30,	DEC. 31,
Interest income	$ 7,103	$ 7,150	$ 7,229	$ 7,254
Interest expense	3,293	3,197	3,055	2,936
Net interest income	3,810	3,953	4,174	4,318
Provision for loan losses	93	93	93	93
Other income	907	906	1,058	1,205
Securities gains, net	135	211	369	318
Other expenses	2,684	2,739	2,796	3,053
Income before income tax provision	2,075	2,238	2,712	2,695
Income tax provision	391	432	586	569
Net income	$ 1,684	$ 1,806	$ 2,126	$ 2,126
Earnings per share - basic	$ 0.55	$ 0.58	$ 0.70	$ 0.70
Earnings per share - diluted	$ 0.55	$ 0.58	$ 0.70	$ 0.70

Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations

RESULTS OF OPERATIONS

ITEM 7

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.

2002 vs 2001

Fully taxable equivalent net interest income increased $2,053,000 or 11.44% to $19,997,000 during the year 2002. The net interest income growth was the result of an increase in interest income of $418,000 and a decrease in interest expense of $1,635,000.

The effective interest differential increased 3 basis points to 4.87% from December 31, 2001 to December 31, 2002. Prime rates and federal funds rates held steady most of the year declining 50 basis points in November. The low rates had a greater impact on the repricing of deposits than they had on loans and investment securities. The Company's assets and liabilities were positioned to benefit from the rate environment. Overall, rates had a positive impact on earnings. Although interest-earning assets suffered a reduction in income due to rates of $2,033,000, interest expense relating to interest-bearing liabilities also declined by $2,326,000. The net effect was an increase in income of $293,000 due to rates.

Total average interest-earning assets increased $39,805,000 during 2002 which contributed $2,451,000 to net interest income.

Interest income on loans decreased during 2002 by $1,055,000. This was the result of a decrease of interest income of $1,669,000 due to rate offset by an increase of interest income of $614,000 due to volume. Total average loans increased from 2001 to 2002 by $7,021,000 which contributed to the volume increase. Although the volume increased, as loans were paid off and new loans originated, low prime rates caused a reduction in interest income. Bank prime rates remained relatively low in 2002 compared to historical standards and were directly responsible for the decline of interest income of $1,669,000. This is evident by the decline of the average rate on total loans from 8.92% in 2001 to 8.26% in 2002.

Investment securites interest income contributed $1,473,000 of additional income in 2002 relative to 2001. Taxable securities income represented the majority of the increase at $1,390,000 while tax-exempt investment securities added $83,000. Together, an increase of investment securities income of $1,837,000 due to volume more than offset a decrease of $364,000 due to rates. Total average securities increased $32,784,000 or 26.53% from 2001 to 2002. This increase explains the substantial increase in income related to volume.

Total average interest-bearing liabilities increased $35,898,000 or 12.26% during 2002. The interest expense related to volume increased $691,000 while rates subtracted interest expenses totaling, $2,326,000.

Due to successful marketing strategies and market penetration in the Centre County region, the bank increased total average deposits by $31,166,000. Average savings deposits increased $35,893,000 while average time deposits decreased $9,010,000. Noninterest-bearing demand deposits increased $4,283,000. Deposit rates held steady through most of 2002. Savings deposits had little change in average rate while other time deposits repriced throughout the year into the current low rates. The average rate on other time deposits declined from 5.28% in 2001 to 3.77% in 2002.

The increase in funding due to deposits added to an increase in average other borrowings of $12,672,000 and offset the reduction of average short-term borrowings of $3,657,000. The bank had less need for overnight borrowings to fund assets with the increase of deposits and other borrowings. The bank acquired two loans totaling $10,000,000 with the Federal Home Loan Bank that are reflected in the increase of other borrowings. The Federal Home Loan Bank borrowings were intended to match investment security purchases that generate long-term interest income with minimal risk.

2001 vs 2000

Taxable equivalent net interest income increased 5.9% or $992,000, to $17,944,000 from year-end 2000 to year-end 2001. The increase in net interest income is due to a $695,000 increase in interest income and a reduction of $297,000 in interest expense. Tax-exempt investment securities contributed the most to interest income adding $1,374,000 in income of which $1,298,000 was due to volume and $76,000 due to rate. Taxable investment securities partially offset the gain in interest income declining $998,000. Again, the decrease was mainly due to the reduction in volume that amounted to $752,000. Rates caused a reduction of $246,000 of income on taxable investment securities. The average balance of state and political subdivisions increased $16,471,000 while the average balances of U.S. Treasury and federal agencies and other securities declined $10,883,000 and $2,006,000, respectively. The shift to tax-exempt securities was to take advantage of their higher after-tax yields. The average rate of state and political subdivisions was 7.88% as opposed to 6.41% on U.S. Treasury and federal agency securities and 3.89% on other securities.

Loan interest income contributed $319,000 to total interest income. The increase was caused by the net effect of a $622,000 increase due to volume and a $303,000 decrease due to rates. The average balance of total loans increased $6,938,000 to $246,907,000 during 2001. Prime rate reductions resulting from Federal Open Markets Committees' monetary policy initiatives during 2001 affected income collected on loans negatively.

Total expense on interest-bearing liabilities declined $297,000 in 2001 due to the net effect of a $963,000 decrease in expense on short-term borrowings, an increase of $438,000 on other time deposits and interest expense increases on savings deposits and other borrowings of $54,000 and $174,000, respectively. Interest expense related to volume increased $831,000 while rates contributed a net decrease of $1,128,000. Total average interest bearing liabilities increased $9,236,000 to $292,923,000 in 2001. Average other time deposits contributed the most to the total, increasing $14,396,000. The interest expense due to the volume on other time deposits increased $770,000. Average balances of savings, and other borrowings added $2,063,000 and $4,468,000 respectively. Savings and other borrowings also added $43,000 and $258,000 in interest expense related to volume. The average balances on short-term borrowings decreased $11,691,000, resulting in an expense reduction due to volume of $240,000. The bank successfully attracted time deposits resulting in the substantial increase in average other time deposits. This caused less need for short-term borrowings, which consists of overnight Federal Home Loan Bank borrowings. Short-term borrowings experienced a decline in its average balance in 2001. Although interest expense on short-term deposits declined, interest expense on other time deposits more than offset the reduction. Overall, interest rates declined considerably in 2001. This resulted in a reduction in interest expense related to rates in every category except savings deposits. Interest rates on savings deposits change only minimally year-to-year. This explains the $11,000 increase in expense related to rates, even with other deposit rates declining considerably. Interest expense related to rates on short-term borrowings decreased the most of the four categories. Short-term borrowings consisting of overnight Federal Home Loan Bank advances, naturally, are affected much more by the federal funds target rate set by the Federal Open Markets Committee. Interest on other time deposits, other borrowings and short term borrowings due to rate decreased $332,000, $84,000 and $723,000, respectively.

The effective interest differential increased 13 basis points during 2001. The increase was due to the net effect of a five basis point interest rate decrease in total average earning assets and an 18 basis point rate decrease in total average interest-bearing liabilities. The shape of the economy in 2001 was such that the Federal Open Markets Committee (FOMC) felt the need to reduce its federal funds target rate 475 basis points. Rates on both deposits and loans have fallen in response to the FOMC's policy objective. Rates have affected liabilities positively. This has allowed earning assets to increase $10,520,000 to $370,481,000 while interest expense decreased, resulting in an interest expense/earning assets ratio of 18 points less than 2000.

AVERAGE BALANCES AND INTEREST RATES
(IN THOUSANDS)

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.

	2002		
	AVERAGE BALANCE	INTEREST	AVERAGE RATE
ASSETS:			
Interest-earning assets:			
Securities:			
U.S. Treasury and federal agency	$ 54,690	$ 2,923	5.34%
State and political subdivisions (4)	77,216	6,034	7.81%
Other	24,452	912	3.73%
Total securities	156,358	9,869	6.31%
LOANS:			
Tax-exempt loans (4)	2,309	185	8.01%
All other loans, net of discount where applicable	251,619	20,789	8.26%
Total loans (1), (3)	253,928	20,974	8.26%
Total interest-earning assets	410,286	$ 30,843	7.52%
Other assets	31,977		
TOTAL ASSETS	$ 442,263		
LIABILITIES AND SHAREHOLDERS' EQUITY:			
Interest-bearing liabilities:			
Deposits:			
Savings	$ 129,244	$ 2,701	2.09%
Other time	136,813	5,156	3.77%
Total interest-bearing deposits	266,057	7,857	2.95%
Short-term borrowings	16,465	501	3.04%
Other borrowings	46,299	2,488	5.37%
Total interest-bearing liabilities	328,821	$ 10,846	3.30%
Demand deposits	50,877		
Other liabilities	3,334		
Shareholders' equity	59,231		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 442,263		
Interest rate margin			4.22%
Effective interest differential		$ 19,997	4.87%

1. Fees on loans are included with interest on loans. Loan fees are included in interest income as follows: 2002, $803,000, 2001, $668,000, 2000, $411,000.
2. Information on this table has been calculated using average daily balance sheets to obtain average balances.
3. Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.
4. 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 (derived by dividing tax-exempt interest by 66%).

AVERAGE BALANCES AND INTEREST RATES
(IN THOUSANDS)

2001			2000		
AVERAGE BALANCE	INTEREST	AVERAGE RATE	AVERAGE BALANCE	INTEREST	AVERAGE RATE
$ 22,877	$ 1,466	6.41%	$ 33,760	$ 2,361	6.99%
75,556	5,951	7.88%	59,085	4,577	7.75%
25,141	979	3.89%	27,147	1,082	3.99%
123,574	8,396	6.79%	119,992	8,020	6.68%
3,935	322	8.18%	5,164	412	7.98%
242,972	21,707	8.93%	234,805	21,298	9.07%
246,907	22,029	8.92%	239,969	21,710	9.05%
370,481	$ 30,425	8.21%	359,961	$ 29,730	8.26%
27,081			18,027		
$ 397,562			$ 377,988		
$ 93,351	$ 1,961	2.10%	$ 91,288	$ 1,907	2.09%
145,823	7,696	5.28%	131,427	7,258	5.52%
239,174	9,657	4.04%	222,715	9,165	4.12%
20,122	903	4.49%	31,813	1,866	5.87%
33,627	1,921	5.71%	29,159	1,747	5.99%
292,923	$ 12,481	4.26%	283,687	$ 12,778	4.50%
46,594			42,765		
4,214			3,837		
53,831			47,699		
$ 397,562			$ 377,988		
		3.95%			3.75%
	$ 17,944	4.84%		$ 16,952	4.71%

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); (ii) changes in rates (changes in rate multiplied by old average volume). Increases and decreases due to both rate and volume, which cannot be separated, have been allocated proportionally to the change due to volume and the change due to rate.

	Year Ended December 31,					
	2002 vs 2001 Increase (Decrease) Due to			2001 vs 2000 Increase (Decrease) Due to		
	Volume	Rate	Net	Volume	Rate	Net
Interest income:						
Taxable investment securities	$ 1,707	$ (317)	$ 1,390	$ (752)	$ (246)	$ (998)
Tax-exempt investment securities	130	(47)	83	1,298	76	1,374
Loans	614	(1,669)	(1,055)	622	(303)	319
Total interest-earning assets	$ 2,451	$ (2,033)	$ 418	$ 1,168	$ (473)	$ 695
Interest expenses:						
Savings deposits	$ 750	$ (10)	$ 740	$ 43	$ 11	$ 54
Other time deposits	(514)	(2,026)	(2,540)	770	(332)	438
Short-term borrowings	(232)	(170)	(402)	(240)	(723)	(963)
Other borrowings	687	(120)	567	258	(84)	174
Total interest-bearing liabilities	$ 691	$ (2,326)	$ (1,635)	$ 831	$ (1,128)	$ (297)
Change in net interest income	$ 1,760	$ 293	$ 2,053	$ 337	$ 655	$ 992

PROVISION FOR LOAN LOSSES

2002 vs 2001

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 was adequate at December 31, 2002, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy, employment and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Bank's loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgement of information available to them at the time of their examination.

The allowance for loan losses increased 0.9% or $26,000 from fiscal 2001 after net charge-offs of $339,000 contributing to a year-end allowance for loan losses of $2,953,000 or 1.1% of total loans. This percentage is consistent with the guidelines of regulators and peer banks. Management's conclusion is that the provision for loan loss is adequate.

2001 vs 2000

The allowance for loan losses increased 1.7% or $48,000 from fiscal 2000 after net charge-offs of $324,000 contributing to a year-end allowance for loan losses of $2,927,000 or 1.2% of total loans.

	YEAR ENDED DECEMBER 31, (IN THOUSANDS)				
	2002	2001	2000	1999	1998
Balance at beginning of period	$ 2,927	$ 2,879	$ 2,823	$ 2,681	$ 2,579
Charge-offs:					
Domestic:					
Real estate	262	154	165	50	—
Commercial and industrial	80	122	38	28	91
Installment loans to individuals	60	82	66	98	180
Total charge-offs	402	358	269	176	271
Recoveries:					
Real estate	25	9	8	4	—
Commercial and industrial	21	8	20	11	29
Installment loans to individuals	17	17	11	17	39
Total recoveries	63	34	39	32	68
Net charge-offs	339	324	230	144	203
Additions charged to operations	365	372	286	286	305
Balance at end of period	$ 2,953	$ 2,927	$ 2,879	$ 2,823	$ 2,681
Ratio of net charge-offs during the period to average loans outstanding during the period	0.13%	0.13%	0.10%	0.06%	0.09%

OTHER INCOME

2002 vs 2001

Total other income for 2002 was $5,453,000, an increase of $344,000 from the prior year. Excluding security gains of $233,000 in 2002 and $1,033,000 in 2001, other income increased $1,144,000. Service charges increased 17.12% or $268,000 to $1,833,000 in 2002. The rate charged for overdraft fees was increased in 2002 which resulted in $229,000 additional service charge income.

Other operating income increased $876,000 from 2001 to 2002. Commission income growth from the sale of financial products sold by the Bank's subsidiary, The M Group, account for $401,000 of the total increase of other operating income. Income on cash surrender value adjustments on bank owned life insurance increased $242,000. The year 2002 was the first full year the life insurance policies were in effect, resulting in a greater adjustment. Life insurance proceeds also added $102,000. The remaining contributors were credit card merchant machine processing fees, debit card fees and ATM surcharge revenue.

2001 vs 2000

Total other income for the year ended December 31, 2001 of $5,109,000 grew from $2,615,000 in 2000, an increase of $2,494,000 or 95.37%. Most of the $2,494,000 increase of other operating income is due to the growth of $1,313,000 commission income recognized from the sale of various financial products, sold by the Bank's subsidiary, The M Group. The substantial increase in commission is due to comparing an entire year's commission in 2001 and a partial year for the newly acquired subsidiary in 2000. The Company realized security gains of $1,033,000 versus $269,000 in 2001, an increase of $764,000. The majority of the gains taken were due to the liquidation of equity securities that had reached, in management's opinion, their peak performance. Service charges increased $208,000, or 15.3%, which is mostly attributable to an increase on deposits and in fees collected on deposit accounts.

OTHER EXPENSES

2002 vs 2001

Total other expenses increased $941,000 or 8.35% from the year ended December 31, 2001 to December 31, 2002. Salaries and employee benefits increased $1,152,000, the most substantial of the other expenses category. Employee salaries and benefits increased more than $500,000 as a result of increased salaries that correspond with the growth in sales of financial products offered by The M Group and the cost of staff at the new State College Wal-Mart Branch. The Bank's pension expense increased $320,000 in 2002. The remaining expenses were due to normal wage increases. The new branch also caused the majority of the $44,000 increase to occupancy expense. The Bank has substantially upgraded its computer networking capabilities which has resulted in most of the $98,000 increase to furniture and equipment expense. Other operating expenses decreased $353,000. The elimination of goodwill amortization as per the adoption of FAS No. 142 represents $221,000 of the decrease in expenses. Bookkeeping expenses increased due to securities transactions and maintenance. The other miscellaneous operating expenses decrease was additionally offset by a $55,000 expense as a result of a check kiting incident.

2001 vs 2000

Other expenses at year-end December 31, 2001 increased $1,452,000 or 14.79%. The majority of the other operating expense increase of $870,000 is due to a full year of expenses of the Bank's subsidiary, The M Group, an entry fee of $53,000 for The NASDAQ National Market, audit and consulting fees in excess of $50,000, additional advertising expenses and other miscellaneous operating expenses. The salaries and employee benefits expense increase of $656,000 or 12.77% is attributable to the normal wage increases and the additional salaries expense of the Bank's subsidiary for a full year. Occupancy expense increased $42,000 or 5.64%. Most of the expense was also produced by a full year of The M Group's occupancy expenses. Furniture and equipment expenses were $19,000 less in 2001 than in 2000.

INCOME TAXES

2002 vs 2001

The provision for income taxes for the year ended December 31, 2002 resulted in an effective income tax rate of 20.2% compared to 20.3% for 2001

2001 vs 2000

The provision for income taxes for the year ended December 31, 2001 resulted in an effective income tax rate of 20.3% compared to 19.8% for 2000.

FINANCIAL CONDITION

INVESTMENTS

2002

The investment portfolio increased $44,330,000 or 33.3% in 2002. Deposits grew faster than loan demand with the excess funding the purchase of additional investment securities. Most of the increase is attributable to an increase of $62,906,000 in U.S. Government agencies category, $975,000 in other bonds, notes and debentures and $170,000 in U.S. Treasury securities category. State and Political subdivisions category decreased $12,575,000 and a $7,146,000 decrease was also found in the equity securities category. The investment portfolio at year-end 2002 comprised of 50.2% U.S. Government agency and Treasury securities, 40.2% state and political subdivisions, 8.4% equity securities, and 1.2% other bonds, notes and debentures. Held to maturity securities had a carrying value of $1,181,000. Available for sale securities occupied 99% of the total portfolio and had an amortized cost of $168,641,000 with an estimated market value of $176,436,000. The unrealized gain of $7,795,000 effected shareholders' equity by $5,145,000 net of deferred taxes.

2001

The investment portfolio increased $17,015,000 or 14.6% in 2001. The bank borrowed $10,000,000 in long-term FHLB advances to purchase state and political bonds and take advantage of interest rate imbalances in the market. Deposits grew greater than loan demand with the excess funding the purchase of additional investment securities. Most of the increase is attributable to an increase of $15,591,000 in the state and political subdivisions category and corporate stock of $2,791,000 and a decrease of $2,136,000 in the U.S. Government agencies category. U.S. Treasury securities also increased $1,080,000, and other bonds, notes and debentures decreased $311,000. The investment portfolio at year end 2001 comprised of 19.5% U.S. Government agency and Treasury securities, 63.1% state and political subdivisions, 16.6% equity securities and .8% other bonds, notes and debentures. Held to maturity securities had a carrying value of $1,302,000. Available for sale securities occupied 99% of the total portfolio and had an amortized cost of $129,365,000 with an estimated market value of $131,985,000. The unrealized gain of $2,620,000 effected shareholders' equity by $1,729,000, net of deferred taxes.

The carrying amounts of investment securities at the dates indicated are summarized as follows (in thousands):

	DECEMBER 31,		
	2002	2001	2000
U.S. Treasury securities:			
Available for sale	$ 4,296	$ 4,126	$ 3,046
U.S. Government agencies:			
Held to maturity	94	196	206
Available for sale	84,702	21,694	23,820
State and political subdivisions:			
Held to maturity	796	796	2,712
Available for sale	70,681	83,256	65,749
Other bonds, notes and debentures:			
Held to maturity	291	310	310
Available for sale	1,810	816	1,127
Total bonds, notes and debentures	162,670	111,194	96,970
Corporate stock - Available for sale	14,947	22,093	19,302
Total	$ 177,617	$ 133,287	$ 116,272

The following table shows the maturities and repricing of investment securities at December 31, 2002 and the weighted average yields (for tax-exempt obligations on a fully taxable basis assuming a 34% tax rate) of such securities (in thousands):

	WITHIN ONE YEAR	AFTER ONE BUT WITHIN FIVE YEARS	AFTER FIVE BUT WITHIN TEN YEARS	AFTER TEN YEARS
U.S. Treasury securities:				
AFS Amount	$ 1,019	$ 3,277	$ —	$ —
Yield	6.36%	4.04%	—	—
U.S. Government agencies:				
HTM Amount	—	—	—	94
Yield	—	—	—	8.84%
AFS Amount	1,067	7,257	27,566	48,812
Yield	4.96%	4.34%	5.08%	5.75%
State and political subdivisions:				
HTM Amount	250	—	—	546
Yield	4.55%	—	—	5.20%
AFS Amount	—	120	—	70,561
Yield	—	9.63%	—	5.18%
Other bonds, notes and debentures:				
HTM Amount	50	100	141	—
Yield	5.75%	7.15%	6.85%	—
AFS Amount	—	—	—	1,810
Yield	—	—	—	6.11%
Total Amount	$ 2,386	$ 10,754	$ 27,707	$ 121,823
Total Yield	5.53%	4.34%	5.10%	5.43%

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

2002

Gross loans for the year ended December 31, 2002, were $257,845,000 or $6,222,000 (2.47%) more than the prior year. Real estate mortgages increased $8,128,000 as a whole with residential and commercial real estate loans increasing $49,000 and $8,800,000, respectively. Construction real estate mortgages decreased $721,000. Commercial and agricultural loans increased $1,079,000, while installment loans to individuals decreased $2,985,000.

2001

At December 31, 2001, gross loans totaled $251,623,000, an increase of $6,825,000 or 2.8% over year-end 2000. While commercial, agricultural, construction real estate mortgages and installment loans to individuals decreased from 2000, loans secured by residential and commercial real estate grew by $14,964,000 or 7.8%. Residential real estate mortgages increased $8,823,000 or (6.7%). Commercial real estate mortgages grew by 10.1% or $6,141,000. Commercial and agricultural loans decreased $3,842,000 or (14.5%). Construction real estate mortgages declined $671,000 or 14.1% and installment loans to individuals decreased 16.8% or $3,626,000.

The amount of loans outstanding at the indicated dates are shown in the following table according to type of loan (in thousands):

	DECEMBER 31,				
	2002	2001	2000	1999	1998
Domestic:					
Commercial and agricultural	$ 23,708	$ 22,629	$ 26,471	$ 31,735	$ 32,920
Real estate mortgage:					
Residential	140,272	140,223	131,400	121,384	109,937
Commercial	75,563	66,763	60,622	51,445	43,562
Construction	3,356	4,077	4,748	3,732	3,874
Installment loans to individuals	14,946	17,931	21,557	23,519	24,505
Gross loans	$ 257,845	$ 251,623	$ 244,798	$ 231,815	$ 214,798

The amount of domestic loans at December 31, 2002 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	$ 6,020	$ 7,424	$ 1,298	$ 14,742
1 through 5 years	6,309	2,294	25	8,628
5 through 10 years	15,692	1,227	17	16,936
After 10 years	74,771	2,193	2	76,966
Sub Total	102,792	13,138	1,342	117,272
Loans with predetermined interest rates:				
1 year or less	4,094	1,309	1,601	7,004
1 through 5 years	21,122	6,678	10,323	38,123
5 through 10 years	30,589	1,788	942	33,319
After 10 years	60,594	795	738	62,127
Sub Total	116,399	10,570	13,604	140,573
Total	$ 219,191	$ 23,708	$ 14,946	$ 257,845

(1) 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.
(2) 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, 2002.

ALLOWANCE FOR LOAN LOSSES

2002

The allowance for loan losses represents the amount that management estimates is adequate to provide for probable losses inherent in the loan portfolio as of the balance sheet date. 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, which is charged to operations. The provision is based on management's quarterly evaluation of the adequacy of the allowance for loan losses, taking into account the overall risk characteristics of the various portfolio segments, past experience with losses, the impact of economic conditions on borrowers, and other relevant factors. Underwriting continues to emphasize the need for security and adequate collateral margins. The total allowance for loan losses is a combination of a specific allowance for identified problem loans, a homogeneous pool allowance, and off balance sheet risk allowance.

At December 31, 2002, the allowance for loan losses as a percent of gross loans declined from December 31, 2001, to 1.1%. Gross loans increased by $6,222,000 from $251,623,000 at December 31, 2001 to $257,845,000 at December 31, 2002.

Nonaccruing loans increased $590,000 to $871,000 from year-end 2001. Overall nonperforming loans increased $1,477,000 to $2,096,000 from fiscal 2001.

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.

2001

At December 31, 2001, the allowance for loan losses as a percent of gross loans remained unchanged from December 31, 2000, at 1.2%. Gross loans increased by $6,825,000 from $244,798,000 at December 31, 2000 to $251,623,000 at December 31, 2001.

Nonaccruing loans decreased $496,000 (63.8%) to $281,000 from year-end 2000. Overall nonperforming loans decreased $185,000 (23.0%) to $619,000 from fiscal 2000.

Based on management's loan-by-loan review, the past performance of the borrowers and current economic conditions, including recent plant 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.

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 accounting principles generally accepted in the United States of America. These principles do not require a write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. A nonperforming loan may be restored to an accruing status when:

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

TOTAL NONPERFORMING LOANS (IN THOUSANDS)

	NONACCRUAL	90 DAYS PAST DUE
2002	$ 871	$ 1,225
2001	$ 281	$ 338
2000	$ 777	$ 27
1999	$ 284	$ 241
1998	$ 646	$ 60

If interest had been recorded at the original rate on those loans, such income would have approximated $24,000, $28,000 and $86,000 for the years ended December 31, 2002, 2001, and 2000, respectively. Interest income on such loans, which is recorded as received, amounted to approximately $17,000, $19,000 and $45,000 for the years ended December 31, 2002, 2001 and 2000, respectively.

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 LOANS IN EACH CATEGORY TO TOTAL LOANS
DECEMBER 31, 2002:		
Balance at end of period applicable to:		
Domestic:		
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%
DECEMBER 31, 2001:		
Balance at end of period applicable to:		
Domestic:		
Commercial and agricultural	$ 414	9.0%
Real estate mortgage:		
Residential	1,379	55.8%
Commercial	763	26.5%
Construction	74	1.6%
Installment loans to individuals	271	7.1%
Unallocated general allowance	26	—
Total	$ 2,927	100.0%

DECEMBER 31, 2000:		
Balance at end of period applicable to:		
Domestic:		
Commercial and agricultural	$ 541	10.8%
Real estate mortgage:		
Residential	1,211	53.7%
Commercial	723	24.8%
Construction	71	1.9%
Installment loans to individuals	306	8.8%
Unallocated general allowance	27	—
Total	$ 2,879	100.0%
DECEMBER 31, 1999:		
Balance at end of period applicable to:		
Domestic:		
Commercial and agricultural	$ 531	13.7%
Real estate mortgage:		
Residential	1,186	52.4%
Commercial	710	22.2%
Construction	70	1.6%
Installment loans to individuals	300	10.1%
Unallocated general allowance	26	—
Total	$ 2,823	100.0%
DECEMBER 31, 1998:		
Balance at end of period applicable to:		
Domestic:		
Commercial and agricultural	$ 505	15.3%
Real estate mortgage:		
Residential	1,126	51.2%
Commercial	673	20.3%
Construction	67	1.8%
Installment loans to individuals	284	11.4%
Unallocated general allowance	26	—
Total	$ 2,681	100.0%

DEPOSITS

2002

Total average deposits were $316,934,000 for 2002, an increase of $31,166,000 or 10.9%. Unlike the previous year, the majority of the increase was in the demand deposit category. Total demand deposits increased $29,903,000. Noninterest-bearing demand deposits increased $4,283,000 and interest-bearing demand deposits increased $25,620,000. Savings deposits increased $10,273,000 while time deposits decreased $9,010,000. The Bank continues to penetrate into the Centre County market with the opening of a new branch office inside the State College Wal-Mart on North Atherton Street. Historically low rate levels have influenced investors away from longer term commitments which has resulted in a decrease in time deposits and a significant increase in more liquid accounts such as demand deposits and savings. The shift from time deposits to demand and savings deposits have also had a positive impact on earnings. More details pertaining to the changes in interest expense are stated in the Net Interest Income discussion.

2001

Total average deposits increased $20,288,000 during 2001. The most significant growth occurred in time deposits. Time deposits increased $14,396,000. Demand and savings deposits increased $4,519,000 and $1,373,000, respectively. Time deposits increased 11.0% from 2000 mostly due to successful marketing strategies and penetration into the Centre County market. In addition to growth, the downward rate environment in 2001 caused the average rate paid on time deposits to decline. Noninterest bearing deposits increased 9.0% to $46,594,000. Interest-bearing demand deposits also increased minimally to $46,154,000 (1.5%).

Time deposits of $100,000 or more totaled approximately $29,126,000 on December 31, 2002 and $32,646,000 on December 31, 2001. Interest expense related to such deposits was approximately $1,098,000, $1,913,000 and $1,571,000 for the years ended December 31, 2002, 2001 and 2000, respectively.

Maturities on time deposits of $100,000 or more are as follows:

	2002
Three months or less	$ 6,770
Three months to six months	7,436
Six months to twelve	6,093
Over twelve months	8,827
Total	$ 29,126

Time deposits at December 31, 2002 mature as follows: 2003 - $85,397,000; 2004 - $20,365,000; 2005 - $15,168,000; 2006 - $10,627,000; 2007 - $1,169,000; thereafter - $1,054,000.

The average amount and the average rate paid on deposits are summarized below (in thousands):

	2002 AVERAGE		2001 AVERAGE		2000 AVERAGE	
	AMOUNT	RATE	AMOUNT	RATE	AMOUNT	RATE
DEPOSITS IN DOMESTIC BANK OFFICES:						
Demand deposits:						
Noninterest-bearing	$ 50,877	0.00%	$ 46,594	0.00%	$ 42,765	0.00%
Interest-bearing	71,774	2.13%	46,154	2.17%	45,464	2.17%
Savings deposits	57,470	2.04%	47,197	2.03%	45,824	2.00%
Time deposits	136,813	3.77%	145,823	5.28%	131,427	5.52%
Total average deposits	$ 316,934		$ 285,768		$ 265,480	

SHAREHOLDERS' EQUITY

2002

Shareholders' equity is evaluated in relation to total assets and the risks associated with those assets. A company is more likely to meet its cash obligations and absorb unforeseen losses when the capital resources are greater. Total shareholders' equity at December 31, 2002 was $63,142,000, increasing $7,890,000 from the balance at December 31, 2001 of $55,252,000. Net income and the exercising of stock options contributed $8,886,000 and $113,000, respectively, to shareholders' equity. The unrealized appreciation on securities also added $3,416,000 to total equity. Reductions to shareholders' equity included $4,124,000 that was paid out in dividends and $401,000 for the purchase of treasury stock.

2001

Total shareholders' equity at December 31, 2001 was $55,252,000, increasing $4,738,000 from the balance at December 31, 2000 of $50,514,000. Net income and the exercising of stock options contributed $7,742,000 and $24,000, respectively, to shareholders' equity. The unrealized appreciation on securities also added $2,539,000 to total equity. Reductions to shareholders' equity included $3,729,000 that was paid out in dividends and $1,838,000 for the purchase of treasury stock.

Bank regulators have risk based capital guidelines. Under these guidelines, banks 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, 2002, the Company's required ratios were well above the minimum ratios as follows:

	Company	2002 Minimum Standards
Tier 1 capital ratio	20.7%	4.0%
Total capital ratio	22.2%	8.0%

For a more comprehensive discussion of these requirements, see "Regulations and Supervision" on the 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 certain ratios are presented as follows:

	2002	2001	2000
Percentage of net income to:			
Average total assets	2.01%	1.95%	1.74%
Average shareholders' equity	15.00%	14.38%	13.77%
Percentage of dividends declared per common share	46.40%	48.17%	52.18%
Percentage of average shareholders' equity to average total assets	13.39%	13.54%	12.62%

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 stockholders. 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 $153,147,000. In addition to this credit arrangement the Company has additional lines of credit with correspondent banks of $10,500,000. The Company's management believes that it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. Federal Home Loan Bank advances totaled $53,618,000 as of December 31, 2002.

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

The following table sets forth the Company's interest rate sensitivity as of December 31, 2002:

	WITHIN ONE YEAR	AFTER ONE BUT WITHIN TWO YEARS	AFTER TWO BUT WITHIN FIVE YEARS	AFTER FIVE YEARS
Earning assets:				
Investment securities (1)	$ 15,080	$ 32,929	$ 52,097	$ 69,839
Loans (2)	81,782	37,257	106,062	35,395
Total earning assets	96,862	70,186	158,159	105,234
Interest-bearing liabilities:				
Deposits (3)	103,031	41,584	86,529	41,645
Borrowings	43,554	15,000	5,000	1,787
Total interest-bearing liabilities	146,585	56,584	91,529	43,432
Net noninterest-bearing funding (4)	9,231	9,231	27,693	46,156
Total net funding sources	$ 155,816	65,815	$ 119,222	$ 89,588
Excess assets (liabilities)	(58,954)	4,371	38,937	15,646
Cumulative excess assets (liabilities)	(58,954)	(54,583)	(15,646)	—

(1) Investment balances reflect estimated prepayments on mortgage-backed securities.

(2) Loan balances include annual repayment assumptions based on projected cash flow from the loan portfolio. The cash flow projections are based on the terms of the credit facilities and estimated prepayments on fixed rate mortgage loans. Loans include loans held for sale.

(3) Adjustments to the interest sensitivity of Savings, NOW and MMDA account balances reflect managerial assumptions based on historical experience, expected behavior in future rate environments and the Company's positioning for these products.

(4) Net noninterest-bearing funds are the sum of noninterest-bearing liabilities and shareholders' equity minus noninterest-earning assets and reflect managerial assumptions as to the appropriate investment maturity categories.

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 analysis for the period indicated:

Changes in Rates	December 31, 2002 Net Interest Income Change (After Tax) (In thousands)	
-200	$	(350)
-100	$	(226)
+100	$	140
+200	$	6

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.

COMPREHENSIVE INCOME

Comprehensive income is a measure of all the changes in equity of a corporation. It excludes transactions with owners in their capacity as owners (i.e. stock options granted or exercised, repurchase of treasury stock transactions and dividends to shareholders).

Other comprehensive income is the difference between net income and comprehensive income. The Company's other comprehensive income is composed of unrealized gains and losses on available for sale securities, net of deferred income tax. Comprehensive income is not a measure of net income. Net income would be affected by other comprehensive income only in the event that the entire securities portfolio was sold on the statement date.

Unrealized gains or losses reflected in the Company's comprehensive income may vary widely at statement dates as a result of changing markets and /or interest rate movements.

Other comprehensive income for the years ended December 31, 2002, 2001 and 2000 were $3,416,000, $2,539,000 and $2,117,000, respectively.

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.

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 2. 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.