PENNS
WOODS
BANCORP, INC.

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.

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To our Shareholders

Dear Shareholders:

Our financial performance during the past year illustrates the strength of Penns Woods Bancorp, Inc., and the changes implemented demonstrate our commitment to the future growth and continued success of our company.

Strong Earnings

Consolidated net earnings for the year ended December 31, 2003 were $11,174,000. This represents a 25.75% increase over the same period in 2002 when net earnings were $8,886,000. Operating earnings, excluding tax adjusted net security gains of $2,415,000, were $8,759,000 for the year ended 2003. This represents a 1.66% increase over operating earnings of $8,616,000 for the same period in 2002 excluding tax adjusted net security gains of $154,000 and a non-recurring income item of $116,000.

Our diversified revenue stream, including net margin, security gains, service charges, and commissions from Jersey Shore State Bank's subsidiary, The M Group, Inc., support the solid growth of consolidated net income. In response to the low interest rate environment, we reduced our cost of funds such that net interest income for 2003 increased $1,529,000 over 2002. Lower interest rates prompted refinancing, increasing secondary mortgage market income by $243,000. The securities portfolio was repositioned according to the current interest rate environment to increase interest income by $896,000 and minimize interest rate risk. Also, the second quarter of 2003 brought opportunities to take gains in the securities market and enhance total consolidated earnings by $3,659,000. Service charges improved $84,000 over last year. Additionally, The M Group, Inc., had another great year. Their net income contributed 4% of the bottom line.

The bank has grown substantially over the year. The total asset increase of $55,175,000 is centered in loans and investment securities. Historically low interest rates offered opportunities to minimize future funding costs and enhance liability positioning. Additional borrowings, both long term and short term, are being utilized to take advantage of current spread opportunities while reducing interest rate risk. The above factors produced favorable results relative to prior years. Return on average assets (ROA) and return on average equity (ROE) for the year ended December 31, 2003 were 2.24% and 16.60%, respectively compared to ROA of 2.01% and ROE of 15.00% for the year 2002.

Loan Growth

Committed to steady growth in the Centre County market we added a mortgage representative and commercial lender to the State College Office. The dedication of our lenders helped increase net loans by $17,867,000 during 2003 without compromising loan quality. Non-performing loans to net loans at year end was .46%, a decrease of 40% from 2002. To facilitate our commitment to loan growth and quality of the portfolio, two individuals in the loan department were promoted. Ann M. Riles was named Senior Vice President and Chief Credit Officer and Steven M. Tasselli was named Senior Vice President and Commercial Loan Manager. With their leadership our lending team will continue to develop and thrive.

Shareholder Value

The Company's strong performance provided cash dividends of $1.49 during the year, a 20% increase over 2002. A 10% stock dividend was also issued to Shareholders in October and 45% of net income was paid in cash dividends in 2003. Earnings per share increased 26% to $3.35 per basic and dilutive share. Book value per share at the end of the year increased 11% to $21.00 over last year. Although we are proud of our past performances, we are focused on the future. Our goal is to provide long term value to our Shareholders by investing in our core business of servicing the needs of consumers and small to medium size businesses and providing professional training to our staff.

Moving Forward

With competition intensifying it is imperative that we strive to build new contacts and strengthen existing customer relationships. In 2003, the commitment was made to educate our employees on the importance of cross selling products the company has to offer. To help drive our obligation of future growth and success, G. David Gundy was promoted to Senior Vice President and Customer Sales and Services Manager. Under this initiative, Company employees will receive additional training on identifying the best financial product to fit our customers' needs.

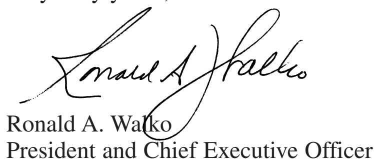
Management will be seeking regulatory approval to add a regional banking center in the State College market. It is anticipated that this will provide a significant presence from which to expand our opportunities in Centre County and the surrounding communities.

Technology plays a pivotal role in our goal to provide unsurpassed service and quality products to help our customers reach their financial objectives. In 2004 we will implement teller machines, combined customer account statements, and a new platform system for loans. The platform system allows for immediate retrieval of information and documents. These new programs will allow us to become more efficient and enhance customer service.

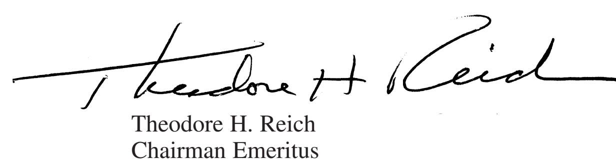
As a company we make every effort to provide our customers the best value at a fair price. It has never been our philosophy to "hide fees" or over charge. As we get ready to celebrate 70 years in business we want to assure you that we will continue to operate with the same ethical standards that our founding officers did 70 years ago.

Thank you for your continued support.

Very truly yours,



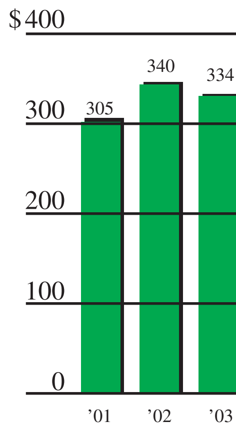
Ronald A. Walko
President and Chief Executive Officer



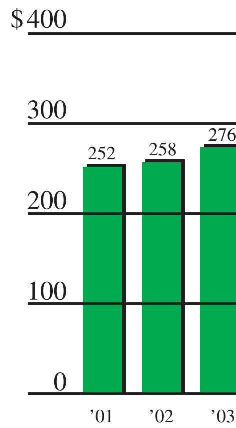
Theodore H. Reich
Chairman Emeritus

Three Year Financial Highlights

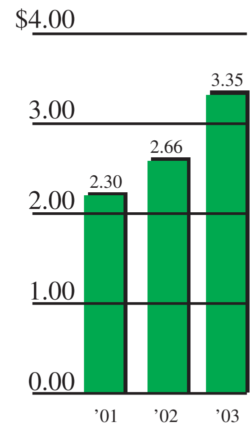
YEAR-END DEPOSITS
In Millions of Dollars



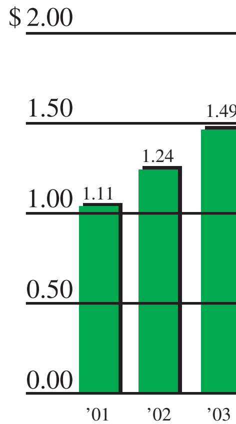
YEAR-END LOANS
In Millions of Dollars



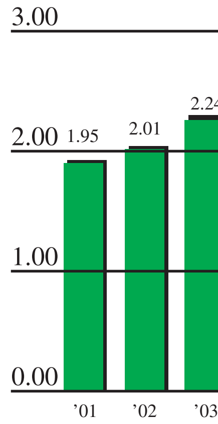
DILUTED EARNINGS PER SHARE



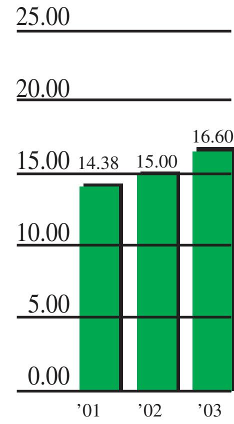
DIVIDENDS PER SHARE



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, 2003 and 2002, 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, 2003. 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, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

S.R. Snodgrass, A.C.

Wexford, PA
February 13, 2004

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,	
	2003	2002
	(in thousands)	
ASSETS:		
Cash and due from banks	$ 10,230	$ 11,731
Securities available for sale	210,611	176,436
Securities held to maturity (fair value of $701 and $1,289)	686	1,181
Loans held for sale	4,803	2,651
Loans, net of unearned discount of $940 and $769	275,828	257,845
Less: Allowance for loan losses	3,069	2,953
Loans, net	272,759	254,892
Premises and equipment, net	4,625	4,856
Accrued interest receivable	2,242	2,460
Bank-owned life insurance	8,908	8,537
Goodwill	3,032	3,032
Other assets	9,485	6,430
TOTAL	$ 527,381	$ 472,206
LIABILITIES:		
Interest-bearing deposits	$ 269,443	$ 272,787
Noninterest-bearing deposits	64,875	67,061
TOTAL DEPOSITS	334,318	339,848
Short-term borrowings	47,265	13,563
Other borrowings	70,878	51,778
Accrued interest payable	836	1,092
Other liabilities	4,315	2,783
TOTAL LIABILITIES	457,612	409,064
SHAREHOLDERS' EQUITY:		
Common stock, par value $10; 10,000,000 shares authorized 3,326,560 and 3,136,832 shares issued	33,265	31,368
Additional paid-in capital	17,559	18,291
Retained earnings	13,022	11,749
Accumulated other comprehensive income	6,132	5,145
Treasury stock, at cost (5,000 and 105,503 shares)	(209)	(3,411)
TOTAL SHAREHOLDERS' EQUITY	69,769	63,142
TOTAL	$ 527,381	$ 472,206

See Accompanying Notes to the Consolidated Financial Statements.

Penns Woods Bancorp, Inc.

Consolidated Statement of Income

	Year Ended December 31,		
	2003	2002	2001
	(in thousands, except per share data)		
INTEREST AND DIVIDEND INCOME:			
Interest and fees on loans	$ 19,963	$ 20,911	$ 21,919
Interest and dividends on investments:			
Taxable interest	6,370	4,314	3,112
Tax-exempt interest	2,608	3,252	3,066
Other dividend income	111	627	639
TOTAL INTEREST AND DIVIDEND INCOME	29,052	29,104	28,736
INTEREST EXPENSE:			
Interest on deposits	5,656	7,857	9,657
Interest on short-term borrowings	428	501	903
Interest on other borrowings	3,181	2,488	1,921
TOTAL INTEREST EXPENSE	9,265	10,846	12,481
NET INTEREST INCOME	19,787	18,258	16,255
PROVISION FOR LOAN LOSSES	255	365	372
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	19,532	17,893	15,883
OTHER INCOME:			
Service charges	1,917	1,833	1,565
Securities gains, net	3,659	233	1,033
Earnings on bank-owned life insurance	404	416	174
Insurance commissions	1,598	1,807	1,416
Other operating income	1,056	1,164	921
TOTAL OTHER INCOME	8,634	5,453	5,109
OTHER EXPENSES:			
Salaries and employee benefits	7,262	6,944	5,792
Occupancy expense, net	877	831	787
Furniture and equipment expense	999	837	739
Advertising expense	388	372	344
Pennsylvania shares tax expense	455	411	370
Other operating expenses	3,308	2,818	3,240
TOTAL OTHER EXPENSES	13,289	12,213	11,272
INCOME BEFORE INCOME TAX PROVISION	14,877	11,133	9,720
INCOME TAX PROVISION	3,703	2,247	1,978
NET INCOME	$ 11,174	$ 8,886	$ 7,742
EARNINGS PER SHARE – BASIC	$ 3.35	$ 2.66	$ 2.30
EARNINGS PER SHARE – DILUTED	$ 3.35	$ 2.66	$ 2.30

See Accompanying Notes to the Consolidated Financial Statements.

Penns Woods Bancorp, Inc.

Consolidated Statement of Changes In Shareholders' Equity

	. . .COMMON STOCK. . .						
	SHARES	AMOUNT	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TREASURY STOCK	TOTAL SHAREHOLDERS' EQUITY
			(in thousands, except per share data)				
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, ($1.11 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, ($1.24 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
Stock split effective in the form of a 10% dividend	187,143	1,871	(793)	(4,900)		3,822	—
Comprehensive Income:							
Net income				11,174			11,174
Unrealized gain on available for sale securities, net of reclassification adjustments and tax $508					987		987
Total comprehensive income							12,161
Dividends declared, ($1.49 per share)				(5,001)			(5,001)
Stock options exercised	2,585	26	61				87
Treasury stock acquired, 14,787 shares						(620)	(620)
Balance, December 31, 2003	3,326,560	$ 33,265	$ 17,559	$ 13,022	$ 6,132	$ (209)	$ 69,769

Components of comprehensive income:	2003	2002	2001
Change in net unrealized gain on investments available for sale	$ 3,402	$ 3,570	$ 3,221
Realized gains included in net income, net of tax $1,244, $79 and $351	(2,415)	(154)	(682)
Total	$ 987	$ 3,416	$ 2,539

See Accompanying Notes to the Consolidated Financial Statements

Penns Woods Bancorp, Inc.
Consolidated Statement of Cash Flows

	Year Ended December 31,		
	2003	2002	2001
		(in thousands)	
OPERATING ACTIVITIES:			
Net income	$ 11,174	$ 8,886	$ 7,742
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	631	526	489
Provision for loan losses	255	365	372
Accretion and amortization of investment security discounts and premiums	(194)	(906)	(843)
Securities gains, net	(3,659)	(233)	(1,033)
Originations of loans held for sale	(15,983)	(16,597)	(24,311)
Proceeds of loans held for sale	13,831	17,939	22,006
Earnings on bank-owned life insurance	(404)	(416)	(174)
Iincrease in all other assets	(490)	(1,465)	(577)
Increase in all other liabilities	1,276	473	59
Net cash provided by operating activities	6,437	8,572	3,730
INVESTING ACTIVITIES:			
Investment securities available for sale:			
Proceeds from sales	82,489	79,022	22,156
Proceeds from calls and maturities	48,046	13,047	12,765
Purchases	(159,363)	(130,328)	(48,151)
Investment securities held to maturity:			
Proceeds from calls and maturities	520	137	1,963
Purchases	(24)	(41)	(25)
Net increase in loans	(18,390)	(6,800)	(7,148)
Acquisition of bank premises and equipment	(400)	(992)	(323)
Proceeds from the sale of foreclosed assets	341	344	592
Purchase of bank-owned life insurance	–	–	(5,589)
Gross proceeds from redemption of regulatory stock	1,507	1,262	943
Gross purchases of regulatory stock	(4,402)	(2,080)	(941)
Net cash used for investing activities	(49,676)	(46,429)	(23,758)
FINANCING ACTIVITIES:			
Net increase (decrease) in interest-bearing deposits	(3,344)	22,914	19,208
Net increase (decrease) in noninterest-bearing deposits	(2,186)	11,784	7,808
Net increase (decrease) in short-term borrowings	33,702	(5,542)	(11,916)
Proceeds from other borrowings	19,100	10,000	10,000
Dividends paid	(5,001)	(4,124)	(3,729)
Stock options exercised	87	113	21
Purchase of treasury stock	(620)	(401)	(1,838)
Net cash provided by financing activities	41,738	34,744	19,554
NET DECREASE IN CASH AND CASH EQUIVALENTS	(1,501)	(3,113)	(474)
CASH AND CASH EQUIVALENTS, BEGINNING	11,731	14,844	15,318
CASH AND CASH EQUIVALENTS, ENDING	$ 10,230	$ 11,731	$ 14,844

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

The Company paid approximately $9,521,000, $10,944,000 and $12,743,000 in interest on deposits and other borrowings during 2003, 2002, and 2001, respectively.

The Company made income tax payments of approximately $3,500,000, $3,394,000 and $2,136,000 during 2003, 2002, and 2001, 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, trading or available for sale.

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, 2003 or 2002.

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.

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

Allowance for Loan Losses

The allowance for loan losses represents the amount which management estimates is adequate to provide for probable losses inherent in its loan portfolio, as of the balance sheet date. The allowance method is used in providing for loan losses. Accordingly, all loan losses are charged to the allowance and all recoveries are credited to it. The allowance for loan losses is established through a provision for loan losses charged to operations. The provision for loan losses is based 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 cost or fair value minus estimated costs to sell. 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 years for buildings and improvements. Costs incurred for routine maintenance and repairs are charged to operations as incurred. Costs of major additions and improvements are capitalized.

Goodwill

On January 1, 2002, the Company adopted Statement of Financial Accounting Standards ("FAS") No. 142, *Goodwill and Other Intangible Assets*. This statement changed the accounting for goodwill from an amortization method to an impairment-only approach. Thus, amortization of goodwill, including goodwill recorded in past business combinations, ceased upon adoption of this statement.

This statement, among other things, 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 at the beginning of its fiscal year immediately stopped amortizing goodwill with a carrying value of $3.0 million. In addition, the Company performs an annual impairment analysis of goodwill. Based on fair value of the reporting unit, estimated using the expected present value of future cash flows, no impairment of goodwill was recognized in 2003 and 2002.

Advertising Costs

Advertising costs are generally expensed as incurred

Income Taxes

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

Earnings Per Share

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

Employee Benefits

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

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 2003, 2002, and 2001.

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 shareholders' equity.

Recent Accounting Pronouncements

In December 2003, the Financial Accounting Standards Board ("FASB") revised FAS No. 132, *Employers' Disclosures about Pension and Other Postretirement Benefit.* This statement retains the disclosures required by FAS No. 132, which standardized the disclosure requirements for pensions and other postretirement benefits to the extent practicable and requires additional information on changes in the benefit obligations and fair value of plan assets. Additional disclosures include information describing the types of plan assets, investment strategy, measurement date(s), plan obligations, cash flows, and components of net periodic benefit cost recognized during interim periods. This statement retains reduced disclosure requirements for nonpublic entities from FAS No. 132, and it includes reduced disclosure for certain of the new requirements. This statement is effective for financial statements with fiscal years ending after December 15, 2003. The interim disclosures required by this statement are effective for interim periods beginning after December 15, 2003.

In August 2001, the FASB issued 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 was effective January 1, 2003, did not have a material effect 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 is effective for exit or disposal activities initiated after December 31, 2002. The adoption of this statement did not have a material effect on the Company's financial position or results of operations.

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 April 2003, the FASB issued FAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This statement amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under FAS No. 133. The amendments set forth in FAS No. 149 improve financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. In particular, this statement clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative as discussed in FAS No. 133. In addition, it clarifies when a derivative contains a financing component that warrants special reporting in the statement of cash flows. FAS No. 149 amends certain other existing pronouncements. Those changes will result in more consistent reporting of contracts that are derivatives in their entirety or that contain embedded derivatives that warrant separate accounting. This statement is effective for contracts entered into or modified after September 30, 2003, except as stated below and for hedging relationships designated after September 30, 2003. The guidance should be applied prospectively. The provisions of this statement that relate to FAS No. 133 Implementation Issues that have been effective for fiscal quarters that began prior to September 15, 2003, should continue to be applied in accordance with their respective effective dates. In addition, certain provisions relating to forward purchases or sales of when-issued securities or other securities that do not yet exist, should be applied to existing contracts as well as new contracts entered into after September 30, 2003. The adoption of this statement did not have a material effect on the Company's financial position or results of operations.

In May 2003, the FASB issued FAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Such instruments may have been previously classified as equity. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after September 15, 2003. The adoption of this statement did not have a material effect on the Company's reported equity.

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. The adoption of this interpretation did not have a material effect on the Company's financial position or results of operations.

In December 2003, the FASB issued a revision to Interpretation No. 46, *Consolidation of Variable Interest Entities*, which established standards for identifying a variable interest entity ("VIE") and for determining under what circumstances a VIE should be consolidated with its primary beneficiary. Application of this Interpretation is required in financial statements of public entities that have interests in special-purpose entities for periods ending after December 15, 2003. Application by public entities, other than small business issuers, for all other types of VIEs is required in financial statements for periods ending after March 15, 2004. Small business issuers must apply this Interpretation to all other types of VIEs at the end of the first reporting period ending after December 15, 2004. The adoption of this Interpretation has not and is not expected to have a material effect on the Company's financial position or results of operations.

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.

	2003	2002	2001
Weighted average common shares outstanding	3,430,302	3,445,477	3,443,930
Average treasury stock shares	(99,717)	(109,165)	(72,085)
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	3,330,585	3,336,312	3,371,845
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	3,213	2,937	2,241
Weighted average common shares and common stock equivalents used to calculate diluted earnings per share	3,333,798	3,339,249	3,374,086

Options to purchase 10,890 shares of common stock at a price of $48.35 were outstanding during 2003 and 22,385 shares of common stock at prices from $38.18 to $48.35 were outstanding during 2002 and 2001, 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):

	2003			
	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
Available for Sale:				
U.S. Government and agency securities	$ 150,218	$ 626	$ (1,015)	$ 149,829
State and political securities	31,364	2,510	(22)	33,852
Other debt securities	1,581	75	(4)	1,652
Total debt securities	183,163	3,211	(1,041)	185,333
Equity securities	18,158	7,146	(26)	25,278
	$ 201,321	$ 10,357	$ (1,067)	$ 210,611
Held to Maturity:				
U.S. Government and agency securities	$ 75	$ —	$ (1)	$ 74
State and political securities	347	16	—	363
Other debt securities	264	—	—	264
	$ 686	$ 16	$ (1)	$ 701

	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

The following table shows the Company's gross unrealized losses and fair value, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at December 31, 2003 (in thousands):

	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government and agency securities	$ 80,605	$ 1,015	$ 62	$ 1	$ 80,667	$ 1,016
State and political securities	198	22	—	—	198	22
Other debt securities	196	4	—	—	196	4
Total debt securites	80,999	1,041	62	1	81,061	1,042
Equity securities	203	3	405	23	608	26
Total	$ 81,202	$ 1,044	$ 467	$ 24	$ 81,669	$ 1,068

The Company's investment securities portfolio contains unrealized losses of direct obligations of the U.S. government, including mortgage-related instruments issued or backed by the full faith and credit of the United States government or are generally viewed as having the implied guarantee of the U.S. government, debt obligations of U.S. states and political subdivisions, corporate entities, and equity securities of common stock in publicly traded companies.

On a monthly basis, the Company evaluates the severity and duration of impairment for its investment securities portfolio unless the Company has the ability to hold the security to maturity without incurring a loss. Generally, impairment is considered other than temporary when an investment security has sustained a decline of ten percent or more for one year.

The Company has concluded that any impairment of its investment securities portfolio as of December 31, 2003 is not other than temporary but is the result of interest rate changes that are not expected to result in the noncollection of principal and interest, during the period.

The amortized cost and fair value of debt securities at December 31, 2003, 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	$ —	$ —	$ 3,032	$ 3,087
Due after one year to five years	125	125	4,779	4,785
Due after five years to ten years	139	139	44,538	44,387
Due after ten years	422	437	130,814	133,074
	$ 686	$ 701	$ 183,163	$ 185,333

Total gross proceeds from sales of securities available for sale were $82,489,000, $79,022,000 and $22,156,000 for 2003, 2002 and 2001, respectively. The following table represents gross realized gains and gross realized losses on those transactions (in thousands):

	2003	2002	2001
Gross realized gains:			
U.S. Government and agency securities	$ 254	$ 204	$ 133
State and political securities	3,345	2,234	20
Other debt securities	27	6	—
Equity securities	1,195	1,803	1,226
	$ 4,821	$ 4,247	$ 1,379
Gross realized losses:			
U.S. Government and agency securities	$ 742	$ 125	$ 13
State and political securities	50	67	149
Other debt securities	2	—	—
Equity securities	368	3,822	184
	$ 1,162	$ 4,014	$ 346

In 2003, the Company recorded an investment security gain of $24,000 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 $292,000 was recorded in 2003 and $2,083,000 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 $34,059,000 and $34,914,000 at December 31, 2003 and 2002, 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):

	2003				
	CURRENT	PAST DUE 30 TO 90 DAYS	PAST DUE 90 DAYS OR MORE & STILL ACCRUING	NON-ACCRUAL	TOTAL
Commercial and agricultural	$ 23,105	$ 215	$ 21	$ 182	$ 23,523
Real estate mortgage:					
Residential	144,102	2,625	383	587	147,697
Commercial	82,156	667	15	58	82,896
Construction	7,637	15	—	—	7,652
Installment loans to individuals	14,738	252	10	—	15,000
	$ 271,738	$ 3,774	$ 429	$ 827	$ 276,768
Less: Net deferred loan fees	940				940
Allowance for loan losses	3,069				3,069
Loans, net	$ 267,729				$ 272,759

	2002				
	CURRENT	PAST DUE 30 TO 90 DAYS	PAST DUE 90 DAYS OR MORE & STILL ACCURING	NON-ACCRUAL	TOTAL
Commercial and agricultural	$ 22,652	$ 769	$ 7	$ 280	$ 23,708
Real estate mortgage:					
Residential	137,271	2,752	175	526	140,724
Commercial	74,317	504	1,006	65	75,892
Construction	3,335	21	—	—	3,356
Installment loans to individuals	14,581	316	37	—	14,934
	$ 252,156	$ 4,362	$ 1,225	$ 871	$ 258,614
Less: Net deferred loan fees	769				769
Allowance for loan losses	2,953				2,953
Loans, net	$ 248,434				$ 254,892

Loans on which the accrual of interest has been discontinued or reduced amounted to approximately $827,000 and $871,000 at December 31, 2003 and 2002, respectively. If interest had been recorded at the original rate on those loans, such income would have approximated $55,000, $24,000, and $28,000 for the years ended December 31, 2003, 2002 and 2001, respectively. Interest income on such loans, which is recorded as received, amounted to approximately $7,000, $17,000, and $19,000 for the years ended December 31, 2003, 2002 and 2001, respectively.

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

	2003	2002	2001
Balance, beginning of year	$ 2,953	$ 2,927	$ 2,879
Provision charged to operations	255	365	372
Loans charged off	(216)	(402)	(358)
Recoveries	77	63	34
Balance, end of year	$ 3,069	$ 2,953	$ 2,927

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, 2003 or December 31, 2002.

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, 2003 and 2002, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within this region.

NOTE E - PREMISES AND EQUIPMENT

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

	2003	2002
Land	$ 566	$ 566
Premises	4,883	4,855
Furniture and equipment	6,348	6,001
Leasehold improvements	867	842
Total	12,664	12,264
Less accumulated depreciation	8,039	7,408
Net	$ 4,625	$ 4,856

Depreciation charges to operations for the years ended 2003, 2002 and 2001 was $631,000, $526,000, and $489,000, respectively.

NOTE F - GOODWILL

As of December 31, 2003 and 2002, goodwill has a gross carrying value amount of $3,308,000 and an accumulated amortization amount of $276,000 resulting in a net carrying amount of $3,032,000. The goodwill amortization for 2001 was $221,000 with a net income of $146,000 or $.04 per share resulting in an adjusted diluted earnings per share of $2.34.

The gross carrying amount of goodwill is tested for impairment in the third quarter. Based on fair value of the reporting unit, estimated using the expected present value of future cash flows, no goodwill impairment loss was recognized in the current year.

NOTE G - DEPOSITS

Time deposits of $100,000 or more totaled approximately $27,386,000 on December 31, 2003 and $29,126,000 on December 31, 2002. Interest expense related to such deposits was approximately $829,000, $1,098,000, and $1,913,000, for the years ended December 31, 2003, 2002 and 2001, respectively.

Maturities on time deposits of $100,000 or more are as follows (in thousands):

		2003
Three months or less	$	5,891
Three months to six months		4,960
Six months to twelve months		5,427
Over twelve months		11,108
Total	$	27,386

Time deposits at December 31, 2003 mature as follows: 2004 - $75,977,000; 2005 - $25,794,000; 2006 - $12,422,000; 2007 - $8,312,000; 2008 – $1,346,000; thereafter - $1,049,000.

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):

		2003		2002
Repurchase Agreements:				
Balance at year end	$	10,225	$	11,723
Maximum amount outstanding at any month end		15,665		20,870
Average balance outstanding during the year		13,214		14,819
Weighted-average interest rate:				
At year end		1.91%		2.68%
Paid during the year		2.07%		3.17%
Open Repo Plus:				
Balance at year end	$	36,140	$	1,840
Maximum amount outstanding at any month end		36,140		8.510
Average balance outstanding during the year		11,537		1,646
Weighted-average interest rate:				
At year end		1.06%		1.31%
Paid during the year		1.16%		1.96%
Short Term FHLB:				
Balance at year end	$	900	$	—
Maximum amount outstanding at any month end		900		—
Average balance outstanding during the year		695		—
Weighted-average interest rate:				
At year end		1.40%		—
Paid during the year		1.42%		—

NOTE I - OTHER BORROWINGS

Other borrowings are comprised of advances from the FHLB. A schedule of other borrowings as of December 31, 2003 and 2002 is summarized as follows (in thousands):

Description	Maturity Range from	Maturity Range to	Weighted Int Rate	Stated Interest Rate from	Stated Interest Rate to	2003	2002
Convertible	4/30/07	3/25/13	4.71%	3.14%	6.65%	$ 64,600	$ 40,000
Bullet Fixed	3/24/05	3/26/07	2.59%	2.02%	3.13%	4,500	—
Fixed	10/17/11	5/26/15	6.61%	5.87%	6.92%	1,778	11,778
						$ 70,878	$ 51,778

Maturities of other borrowings at December 31, 2003 are summarized as follows (in thousands):

Year Ending	Amount	Weighted Yield
2005	$ 1,400	2.02%
2006	1,600	2.58%
2007	6,500	4.18%
2008	29,600	4.77%
2009 and after	31,778	4.79%
	$ 70,878	4.72%

The terms of the convertible borrowings allow the Federal Home Loan Bank ("FHLB") to convert the interest rate to an adjustable rate based on the three-month London Interbank Offered Rate ("LIBOR") at a predttermined anniversary date of the borrowing's origination, ranging from three months to five years. These remaining conversion dates range from February 2004 thorugh August 2005.

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 $166.9 million at December 31, 2003, 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.

NOTE J - INCOME TAXES

The following temporary differences gave rise to the net deferred tax liability at December 31, 2003 and 2002 (in thousands):

	2003	2002
Deferred tax asset:		
Allowance for loan losses	$ 716	$ 693
Deferred compensation	346	337
Contingencies	22	20
Pension	429	371
Loan fees and costs	320	261
Investment securities allowance	119	92
Total	1,952	1,774
Deferred tax liability:		
Bond accretion	28	31
Depreciation	260	192
Amortization	150	—
Unrealized gains on available for sale securities	3,159	2,650
Total	3,597	2,873
Deferred tax liability, net	$ (1,645)	$ (1,099)

No valuation allowance was established at December 31, 2003 and 2002, 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,		
	2003	2002	2001
Currently payable	$ 3,666	$ 2,363	$ 2,117
Deferred expense (benefit)	37	(116)	(139)
Total provision	$ 3,703	$ 2,247	$ 1,978

The effective federal income tax rate for the years ended December 31, 2003, 2002, and 2001 was 24.9 percent, 20.2 percent, and 20.3 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):

	2003		2002		2001	
	AMOUNT	%	AMOUNT	%	AMOUNT	%
Provision at expected rate	$ 5,058	34.0%	3,785	34.0%	$ 3,305	34.0%
Decrease in tax resulting from:						
Tax-exempt income	(964)	(6.4)	(1,367)	(12.3)	(1,103)	(11.4)
Other, net	(391)	(2.7)	(171)	(1.5)	(224)	(2.3)
Effective income tax and rates	$ 3,703	24.9%	$ 2,247	20.2%	$ 1,978	20.3%

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):

	2003	2002
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 6,473	$ 4,976
Service cost	443	381
Interest cost	384	342
Amendments	—	97
Actuarial loss	43	753
Benefits paid	(198)	(76)
Benefit obligation at end of year	7,145	6,473
Change in plan assets:		
Fair value of plan assets at beginning of year	3,131	3,115
Actual loss on plan assets	620	(384)
Employer contribution	506	499
Benefits paid	(198)	(76)
Expenses paid	(17)	(23)
Fair value of plan assets at end of year	4,042	3,131
Funded status	(3,103)	(3,342)
Unrecognized net actuarial loss	1,609	1,996
Unrecognized prior service cost	255	280
Unrecognized transition asset	(22)	(24)
Net Accrued Benefit Cost Recognized	$ (1,261)	$ (1,090)

The accumulated benefit obligation for the defined benefit pension plan was $4,913,000 and $4,409,000 at December 31, 2003 and 2002, respectively. Amounts recognized in the Statement of Income consist of (in thousands):

	2003	2002	2001
Service cost	$ 443	$ 381	$ 298
Interest cost	384	342	271
Expected return on plan assets	(256)	(246)	(286)
Amortization of transition asset	(3)	(3)	(3)
Amortization of prior service cost	26	26	20
Recognized net actuarial (gain) loss	83	19	(15)
Net periodic benefit cost	$ 677	$ 519	$ 285

The following information relates to the Plan's projected benefit obligation, accumulated benefit obligation, and Plan assets at December 31, (in thousands):

	2003	2002
Projected benefit obligation	$ 7,145	$ 6,473
Accumulative benefit obligation	4,913	4,409
Fair value of plan assets	4,042	3,131

Assumptions

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

	2003	2002	2001
Discount rate	6.00%	6.00%	7.00%
Rate of compensation increase	5.00%	5.00%	5.00%

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

	2003	2002	2001
Discount rate	6.00%	6.50%	7.00%
Expected long-term return on plan assets	8.00%	8.00%	8.00%
Rate of compensation increase	5.00%	5.00%	5.00%

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

Plan Assets

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

Asset Category	2003	2002
Cash	0.6%	0.3%
Fixed income securities	38.7%	40.6%
Equity	60.7%	59.1%
Total	100%	100%

The investment objective for the defined benefit penson plan is to maximize total return with tolerance for slightly above average risk, meaning the fund is able to tolerate short-term volatility to achieve above-average returns over the long term. The portfolio's target exposure to equities is 60%, primarily invested in mid and large capitalization domestic equities. Exposure to small capitalization and international stocks may be allowed.

Asset allocation favors equities, with a target allocation of approximately 60% equity securities, 37.5% fixed income securities and 2.5% cash. Due to violatility in the market, the target allocation is not always desirable and asset allocations will fluctuate between the acceptable ranges.

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

The following benefit payments, which reflect expected future cost, are expected to be paid during the year ending December 31, 2003 (in thousands):

2004	$ 169
2005	194
2006	241
2007	274
2008	275
2009-2013	2,130

The company expects to contribute $560,000 to its Pension Plan in 2004.

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 $75,000, $80,000, and $65,000 for the years ended December 31, 2003, 2002, and 2001, 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 $104,000, $98,000, and $67,000 for the years ended December 31, 2003, 2002 and 2001, respectively. Benefits paid under the plan were approximately $132,000 in 2003, $51,000 in 2002 and $51,000 in 2001.

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:

	2003		2002	
	SHARES	WEIGHTED-AVERAGE EXERCISE PRICE	SHARES	WEIGHTED-AVERAGE EXERCISE PRICE
Outstanding, beginning of year	33,385	$ 38.69	45,651	$ 35.09
Granted	—	—	—	—
Exercised	(2,778)	30.93	(5,707)	23.62
Forfeited	—	—	(6,559)	23.62
Outstanding, end of year	30,607	$ 39.39	33,385	$ 38.69
Options exercisable at year-end	30,607	$ 39.39	33,385	$ 38.69

The following table summarizes information about nonqualified and incentive stock options outstanding at December 31, 2003:

	Outstanding			Exercisable	
Exercise Price	Shares	Average Life	Average Exercise Price	Shares	Average Exercise Price
$ 48.35	10.890	5	$ 48.35	10,890	$ 48.35
$ 38.18	11,082	6	$ 38.18	11,082	$ 38.18
$ 29.66	8,635	7	$ 29.66	8,635	$ 29.66

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 for the year ended December 31, 2003 (in thousands):

BEGINNING BALANCE	ADDITIONS	PAYMENTS	RETIRED/ RESIGNED	ENDING BALANCE
$ 6,785	$ 2,374	$ 1,791	$ 141	$ 7,227

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, 2003 (in thousands):

YEAR ENDING DECEMBER 31,		
2004	$	262
2005		248
2006		221
2007		189
2008		89
Thereafter		53
Total	$	1,062

Total rental expense for all operating leases for the years ended December 31, 2003, 2002 and 2001 approximated $269,000, $258,000, and $270,000 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):

	2003	2002
Commitments to extend credit	$ 47,454	$ 29,497
Standby letters of credit	$ 258	$ 741

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

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

NOTE 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, 2003 and 2002, 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):

	2003		2002	
	Amount	**Ratio**	**Amount**	**Ratio**
Total Capital (to Risk-weighted Assets)				
Actual	$ 66,820	23.0%	$ 58,953	22.2%
For Capital Adequacy Purposes	23,225	8.0	21,236	8.0
To Be Well Capitalized	29,031	10.0	26,545	10.0
Tier 1 Capital (to Risk-weighted Assets)				
Actual	$ 60,547	20.9%	$ 54,915	20.7%
For Capital Adequacy Purposes	11,613	4.0	10,618	4.0
To Be Well Capitalized	17,419	6.0	15,927	6.0
Tier 1 Capital (to Average Assets)				
Actual	$ 60,547	11.6%	$ 54,915	12.0%
For Capital Adequacy Purposes	20,922	4.0	18,310	4.0
To Be Well Capitalized	26,153	5.0	22,888	5.0

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

	2003		2002	
	Amount	**Ratio**	**Amount**	**Ratio**
Total Capital (to Risk-weighted Assets)				
Actual	$ 52,161	18.8%	$ 47,232	18.3%
For Capital Adequacy Purposes	22,155	8.0	20,616	8.0
To Be Well Capitalized	27,693	10.0	25,770	10.0
Tier 1 Capital (to Risk-weighted Assets)				
Actual	$ 47,770	17.3%	$ 43,723	17.0%
For Capital Adequacy Purposes	11,077	4.0	10,308	4.0
To Be Well Capitalized	16,616	6.0	15,462	6.0
Tier 1 Capital (to Average Assets)				
Actual	$ 47,770	9.6%	$ 43,723	9.7%
For Capital Adequacy Purposes	19,982	4.0	17,970	4.0
To Be Well Capitalized	24,978	5.0	22,462	5.0

NOTE Q - REGULATORY RESTRICTIONS

The Pennsylvania Banking Code restricts the availability of capital funds for payment of dividends by all state-chartered banks to the additional paid in capital of the Bank. Accordingly, at December 31, 2003, 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, 2003, the regulatory lending limit amounted to approximately $5,081,000.

Cash and Due from Banks

Included in cash and due from banks are reserves required by the district Federal Reserve Bank of $1,151,000 and $1,152,000 at December 31, 2003 and 2002. 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 - 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, riskcharacteristics 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:

	2003		2002	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
Cash and due from banks	$ 10,230	$ 10,230	$ 11,731	$ 11,731
Investment securities:				
Available for sale	210,611	210,611	176,436	176,436
Held to maturity	686	701	1,181	1,289
Loans held for sale	4,803	4,803	2,651	2,651
Loans, net	272,759	287,310	254,892	267,563
Bank-owned life insurance	8,908	8,908	8,537	8,537
Regulatory stock	6,588	6,588	3,963	3,963
Accrued interest receivable	2,242	2,242	2,460	2,460
Financial liabilities:				
Interest-bearing deposits	$ 269,443	$ 271,200	$ 272,787	$ 276,881
Noninterest-bearing deposits	64,875	64,875	67,061	67,061
Short-term borrowings	47,265	47,265	13,563	13,563
Other borrowings	70,878	74,027	51,778	56,384
Accrued interest payable	836	836	1,092	1,092

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 real estate, construction real estate, and other consumer. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

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

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

Bank-owned life insurance:

The fair value is equal to the Cash Surrender Value of 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, 2003 and 2002. 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, 2003 and 2002, respectively. The contractual amounts of unfunded commitments and letters of credit are presented in Note O.

NOTE S - PARENT COMPANY ONLY FINANCIAL STATEMENTS

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

CONDENSED BALANCE SHEET, DECEMBER 31,	2003	2002
	(in thousands)	
ASSETS:		
Cash	$ 369	$ 481
Investment in subsidiaries:		
Bank	54,133	51,019
Nonbank	15,307	11,760
Other assets	91	20
Total assets	$ 69,900	$ 63,280
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Other liabilities	$ 131	$ 138
Shareholders' equity	69,769	63,142
Total liabilities and shareholders' equity	$ 69,900	$ 63,280

CONDENSED STATEMENT OF INCOME FOR THE YEARS ENDED DECEMBER 31,	2003	2002	2001
		(in thousands)	
Operating income:			
Dividends from subsidiaries	$ 6,651	$ 4,878	$ 5,984
Equity in undistributed net income of subsidiaries	4,649	4,121	1,899
Operating expenses	(126)	(113)	(141)
Net income	$ 11,174	$ 8,886	$ 7,742

CONDENSED STATEMENT OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31,	2003	2002	2001
		(in thousands)	
OPERATING ACTIVITIES:			
Net income	$ 11,174	$ 8,886	$ 7,742
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed net income of subsidiaries	(4,649)	(4,121)	(1,899)
Other, net	(64)	(23)	(26)
Net cash provided by operating activities	6,461	4,742	5,817
INVESTING ACTIVITIES:			
Additional investment in subsidiaries	(1,039)	—	(276)
FINANCING ACTIVITIES:			
Dividends paid	(5,001)	(4,124)	(3,729)
Proceeds from exercise of stock options	87	113	21
Purchase of treasury stock	(620)	(401)	(1,838)
Net cash used in financing activities	(5,534)	(4,412)	(5,546)
NET INCREASE (DECREASE) IN CASH	(112)	330	(5)
CASH, BEGINNING OF YEAR	481	151	156
CASH, END OF YEAR	$ 369	$ 481	$ 151

NOTE T - CONSOLIDATED QUARTERLY FINANCIAL DATA (UNAUDITED)

2003	FOR THE THREE MONTHS ENDED MARCH 31,	JUNE 30,	SEPT. 30,	DEC. 31,
	(in thousands, except per share data)			
Interest income	$ 7,092	$ 7,251	$ 7,281	$ 7,428
Interest expense	2,386	2,395	2,327	2,157
Net interest income	4,706	4,856	4,954	5,271
Provision for loan losses	90	45	90	30
Other income	1,182	1,195	1,325	1,273
Securities gains, net	101	1,750	1,247	561
Other expenses	3,139	3,186	3,290	3,674
Income before income tax provision	2,760	4,570	4,146	3,401
Income tax provision	573	1,233	1,135	762
Net income	$ 2,187	$ 3,337	$ 3,011	$ 2,639
Earnings per share - basic	$ 0.72	$ 1.10	$ 1.00	$ 0.53
Earnings per share - diluted	$ 0.72	$ 1.10	$ 0.99	$ 0.54

2002	FOR THE THREE MONTHS ENDED MARCH 31,	JUNE 30,	SEPT. 30,	DEC. 31,
	(in thousands, except per share data)			
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	$ 0.62	$ 0.61	$ 0.71	$ 0.72
Earnings per share - diluted	$ 0.62	$ 0.61	$ 0.71	$ 0.72

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

RESULTS OF OPERATIONS

NET INTEREST INCOME

Net interest income is determined by calculating the difference between the yields earned on interest-earning assets and the rates paid on interest-bearing liabilities. To compare the tax-exempt asset yields to taxable yields, amounts are adjusted to pretax equivalents based on the marginal corporate federal tax rate of 34%. The tax equivalent adjustment to net interest income for 2003, 2002, and 2001 were $1,367,000, $1,739,000, and $1,689,000, respectively.

2003 vs 2002

Reported net interest income increased $1,529,000 or 8.4% from year end 2002 to year end 2003. The decrease in total interest income of $52,000 is the result of an increase of $44,185,000 in the average balance of investment securities held for the current period relative to the same period a year ago offset by a decrease in the return on loans of approximately 62 basis points. Overall, interest income generated from the net increase in volume of interest earning assets was offset by a decline in rates of approximately 94 basis points.

On a tax equivalent basis, net interest income increased 5.8% or $1,157,000, to $21,154,000 in a period when both average interest earning assets and average interest-bearing liabilities increased. The increase of taxable security income of $2,646,000 is due to the significant purchase of U.S. Government securities over the past year, with the average of these securities increasing $70,159,000, while the decrease in the average of tax-exempt State & Political securities decreased tax equivalent interest income $2,082,000. The investment portfolio has been repositioned from longer term assets to shorter term assets to take advantage of the cash flow opportunities for reinvestment in anticipation of rising rates. The net growth in the volume of investment holdings has generated additional interest income that has offset the 111 basis point decline in the overall portfolios weighted average interest rates.

Within the loan portfolio, a 62 basis point decrease of the tax equivalent return on loans was partially offset by an increase of $7,612,000 in the average balance of loans when comparing the year 2003 to the year 2002. Variable rate loans within the portfolio and other new loan originations at lower effective rates aided in the reduction of new income compared to a year ago because of the historically low rates.

For the year ended December 31, 2003, reported interest expense decreased $1,581,000 or 14.6% over the same period of 2002. Lower rates for all deposit accounts contribute the most substantial decrease in interest expense. The weighted average rate on interest paid on deposits declined 92 basis points for the year 2003 since the year end 2002. The overall average balance of savings deposits increased $17,925,000, offset by a decrease in the weighted average rate for a net decrease in the related interest expense of $997,000. Interest expense on time deposits decreased $1,204,000 due to both the 76 basis point decline in the weighted average rate and the decrease in the average balance of $5,453,000.

Favorable long-term borrowing rates offer opportunities to reduce interest expenses over the coming years. Throughout 2003, the Company borrowed an additional $19.1 million in long term advances through the FHLB to minimize future borrowing costs and to enhance liability positioning. These additional borrowings were utilized by management to take advantage of current investment opportunities while minimizing interest rate risk. The $693,000 increase in expense on long-term borrowings is the result of these additional advances with average balances of $20,986,000 partially offset by the 64 basis point decline in the resulting weighted average interest rate for the year ending December 31, 2003 compared to the same period in 2002. Interest paid on short-term borrowings decreased $73,000 as a result of an overall decline in the weighted average interest rate of 131 basis points while the average balances outstanding during the year increased $8,322,000. The increase in short-term borrowings is the result of taking advantage of the opportunity to borrow from Federal Home Loan Bank at historically low rates.

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 in interest income of $1,669,000 due to rate offset by an increase in 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 in 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. Non-interest-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.

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.

	2003		
	AVERAGE BALANCE (2)	INTEREST	AVERAGE RATE
ASSETS:			
Interest-earning assets:			
Securities:			
U.S. Treasury and federal agency	$ 124,849	$ 5,584	4.47%
State and political subdivisions (4)	50,822	3,952	7.78%
Other	24,872	897	3.61%
Total securities	200,543	10,433	5.20%
LOANS:			
Tax-exempt loans (4)	1,008	68	6.75%
All other loans, net of discount where applicable	260,532	19,918	7.65%
Total loans (1), (3)	261,540	19,986	7.64%
Total interest-earning assets	462,083	$ 30,419	6.58%
Other assets	36,297		
TOTAL ASSETS	$ 498,380		
LIABILITIES AND SHAREHOLDERS' EQUITY:			
Interest-bearing liabilities:			
Deposits:			
Savings	$ 147,169	$ 1,704	1.16%
Other time	131,360	3,952	3.01%
Total interest-bearing deposits	278,529	5,656	2.03%
Short-term borrowings	24,787	428	1.73%
Other borrowings	67,285	3,181	4.73%
Total interest-bearing liabilities	370,601	$ 9,265	2.50%
Demand deposits	56,672		
Other liabilities	3,780		
Shareholders' equity	67,327		
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 498,380		
Interest rate margin			4.08%
Effective interest differential		$ 21,154	4.58%

1. Fees on loans are included with interest on loans. Loan fees are included in interest income as follows: 2003 $1,032,000, 2002, $803,000, 2001, $668,000.
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)

2002			2001		
AVERAGE BALANCE(2)	INTEREST	AVERAGE RATE	AVERAGE BALANCE (2)	INTEREST	AVERAGE RATE
$ 54,690	$ 2,923	5.34%	$ 22,877	$ 1,466	6.41%
77,216	6,034	7.81%	75,556	5,951	7.88%
24,452	912	3.73%	25,141	979	3.89%
156,358	9,869	6.31%	123,574	8,396	6.79%
2,309	185	8.01%	3,935	322	8.18%
251,619	20,789	8.26%	242,972	21,707	8.93%
253,928	20,974	8.26%	246,907	22,029	8.92%
410,286	$ 30,843	7.52%	370,481	$ 30,425	8.21%
31,977			27,081		
$ 442,263			$ 397,562		
$ 129,244	$ 2,701	2.09%	$ 93,351	$ 1,961	2.10%
136,813	5,156	3.77%	145,823	7,696	5.28%
266,057	7,857	2.95%	239,174	9,657	4.04%
16,465	501	3.04%	20,122	903	4.49%
46,299	2,488	5.37%	33,627	1,921	5.71%
328,821	$ 10,846	3.30%	292,923	$ 12,481	4.26%
50,877			46,594		
3,334			4,214		
59,231			53,831		
$ 442,263			$ 397,562		
		4.22%			3.95%
	$ 19,997	4.87%		$ 17,944	4.84%

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,					
	2003 vs 2002 Increase (Decrease) Due to			2002 vs 2001 Increase (Decrease) Due to		
	Volume	Rate	Net	Volume	Rate	Net
Interest income:						
Taxable investment securities	$ 3,223	$ (577)	$ 2,646	$ 1,707	$ (317)	$ 1,390
Tax-exempt investment securities	(2,054)	(28)	(2,082)	130	(47)	83
Loans	616	(1,604)	(988)	614	(1,669)	(1,055)
Total interest-earning assets	$ 1,785	$ (2,209)	$ (424)	$ 2,451	$ (2,033)	$ 418
Interest expenses:						
Savings deposits	$ 335	$ (1,332)	$ (997)	$ 750	$ (10)	$ 740
Other time deposits	(216)	(988)	(1,204)	(514)	(2,026)	(2,540)
Short-term borrowings	194	(267)	(73)	(232)	(170)	(402)
Other borrowings	1,021	(328)	693	687	(120)	567
Total interest-bearing liabilities	$ 1,334	$ (2,915)	$ (1,581)	$ 691	$ (2,326)	$ (1,635)
Change in net interest income	$ 451	$ 706	$ 1,157	$ 1,760	$ 293	$ 2,053

PROVISION FOR LOAN LOSSES

2003 vs 2002

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, 2003, 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 judgment of information available to them at the time of their examination.

The allowance for loan losses increased 3.9% or $116,000 from fiscal 2002 after net charge-offs of $139,000, contributing to a year-end allowance for loan losses of $3,069,000 or 1.1% of total loans.

2002 vs 2001

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.

	YEAR ENDED DECEMBER 31, (IN THOUSANDS)				
	2003	2002	2001	2000	1999
Balance at beginning of period	$ 2,953	$ 2,927	$ 2,879	$ 2,823	$ 2,681
Charge-offs:					
Domestic:					
Real estate	63	262	154	165	50
Commercial and industrial	37	80	122	38	28
Installment loans to individuals	116	60	82	66	98
Total charge-offs	216	402	358	269	176
Recoveries:					
Real estate	42	25	9	8	4
Commercial and industrial	16	21	8	20	11
Installment loans to individuals	19	17	17	11	17
Total recoveries	77	63	34	39	32
Net charge-offs	139	339	324	230	144
Additions charged to operations	255	365	372	286	286
Balance at end of period	$ 3,069	$ 2,953	$ 2,927	$ 2,879	$ 2,823
Ratio of net charge-offs during the period to average loans outstanding during the period	0.05%	0.13%	0.13%	0.10%	0.06%

OTHER INCOME

2003 vs 2002

Total other income for 2003 was $8,634,000, an increase of $3,181,000 from the prior year. Excluding security gains of $3,659,000 in 2003 and $233,000 in 2002, other income decreased $245,000. Service charges increased 4.58% or $84,000 to $1,917,000 in 2003.

Decreases in commission income from the sale of financial products sold by the Bank's subsidiary, The M Group, accounted for $209,000 of the total decrease of other operating income. Other operating income decreased $108,000 primarily due to a non-recurring life insurance income item included in 2002, but not in 2003, resulting in a $116,000 decrease.

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.

OTHER EXPENSES

2003 vs 2002

Total other expenses increased $1,076,000 or 8.81% from the year ended December 31, 2002 to December 31, 2003. Salaries and employee benefits increased $318,000. This change was the result of the decline in commission earned by the M Group and the retirement of an executive officer offset by the standard cost of living salary increases and an extra pay paid in 2003 when compared to 2002. Expenses such as rent, maintenance, and utilities for the new State College Wal-Mart Branch caused the majority of the $46,000 increase to occupancy expense. The depreciation of a new Wide Area Network has resulted in most of the $162,000 increase to furniture and equipment expense. Advertising expense increased $16,000 due to a decrease in normal advertising expenses offset by the purchase of new brochures for $22,000. Other operating expenses increased $490,000 consistent with the addition of the aforementioned branch.

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.

INCOME TAXES

2003 vs 2002

The provision for income taxes for the year ended December 31, 2003 resulted in an effective income tax rate of 24.9% compared to 20.2% for 2002. This increase is the result of management's currrent inventment strategy of reinvesting proceeds from tax-exempt portfolio into other U.S. Goverment securities.

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.

FINANCIAL CONDITION

INVESTMENTS

2003

The investment portfolio increased $33,680,000 or 19% in 2003. The growth is largely attributed to management's strategic plan to benefit from the low borrowing rates by taking advantage of over a 200 basis point interest rate spread of investments with similar maturity periods. The bank borrowed $19,100,000 in long-term FHLB advances to purchase securities and take advantage of interest rate imbalances in the market. Short-term borrowing funded the balance of the additional investment securities purchased. Most of the increase is attributable to an increase of $61,980,000 in U.S. Government agencies category, and a $10,331,000 increase in the equity securities category. There was a $185,000 decrease in other bonds, notes and debentures, $1,168,000 decrease in U.S. Treasury securities category, and State and Political subdivisions catergory decreased $37,278,000. The investment portfolio at year end 2003 was comprised of 70.9% U.S. Government agency and Treasury securities, 16.2% state and political subdivisions, 12.0% equity securities, and .9% other bonds, notes and debentures. Held to maturity securities had a carrying value of $686,000. Available for sale securities occupied 99.66% of the total portfolio and had an amoritized cost of $201,321,000 with an estimated market value of $210,611,000. The unrealized gain of $9,290,000 effected shareholders' equity by $6,132,000, net of deferred taxes.

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.

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

	DECEMBER 31,		
	2003	2002	2001
U.S. Treasury securities:			
Available for sale	$ 3,128	$ 4,296	$ 4,126
U.S. Government agencies:			
Held to maturity	75	94	196
Available for sale	146,701	84,702	21,694
State and political subdivisions:			
Held to maturity	347	796	796
Available for sale	33,852	70,681	83,256
Other bonds, notes and debentures:			
Held to maturity	264	291	310
Available for sale	1,652	1,810	816
Total bonds, notes and debentures	186,019	162,670	111,194
Corporate stock - Available for sale	25,278	14,947	22,093
Total	$ 211,297	$ 177,617	$ 133,287

The following table shows the maturities and repricing of investment securities at December 31, 2003 and the weighted average yields 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	$ 2,061	$ 1,067	$ —	$ —
Yield	4.37%	3.43%	—%	—%
U.S. Government agencies:				
HTM Amount	—	—	—	75
Yield	—%	—%	—%	8.80%
AFS Amount	1,026	3,718	44,372	97,585
Yield	4.96%	4.00%	4.43%	5.25%
State and political subdivisions:				
HTM Amount	—	—	—	347
Yield	—%	—%	—%	8.26%
AFS Amount	—	—	15	33,837
Yield	—%	—%	6.58%	7.67%
Other bonds, notes and debentures:				
HTM Amount	—	125	139	—
Yield	—%	7.05%	7.04%	—%
AFS Amount	—	—	—	1,652
Yield	—%	—%	—%	7.36%
Total Amount	$ 3,087	$ 4,910	$ 44,526	$ 133,496
Total Yield	4.57%	3.95%	4.44%	5.90%

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

2003

Gross loans for the year ended December 31, 2003, were $275,828,000 or $17,983,000 (6.97%) more than the prior year. Real estate mortgages increased $18,103,000 as a whole with residential, commercial and construction real estate loans increasing $6,902,000, $6,905,000, and $4,296,000 respectively. Commercial and agricultural loans decreased $185,000, while installment loans to individuals increased $65,000. Given the current market conditions, management has directed its conservative lending approach toward well collateralized real estate loans.

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.

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

	DECEMBER 31,				
	2003	2002	2001	2000	1999
Domestic:					
Commercial and agricultural	$ 23,523	$ 23,708	$ 22,629	$ 26,471	$ 31,735
Real estate mortgage:					
Residential	147,697	140,724	140,614	131,761	121,734
Commercial	82,896	75,892	67,038	60,856	51,641
Construction	7.652	3,356	4,077	4,748	3,732
Installment loans to individuals	15,000	14,934	17,896	21,503	23,470
Less: Net deferred loan fees	940	769	631	541	497
Gross loans	$ 275,828	$ 257,845	$ 251,623	$ 244,798	$ 231,815

The amount of domestic loans at December 31, 2003 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	$ 11,859	$ 8,145	$ 1,526	$ 21,530
1 through 5 years	6,180	2,799	18	8,997
5 through 10 years	26,730	3,088	208	30,026
After 10 years	112,351	672	6	113,029
Sub Total	157,120	14,704	1,758	173,582
Loans with predetermined interest rates:				
1 year or less	3,822	867	1,146	5,835
1 through 5 years	22,060	7,295	10,532	39,887
5 through 10 years	23,488	111	1,561	25,160
After 10 years	30,804	546	14	31,364
Sub Total	80,174	8,819	13,253	102,246
Total	$ 237,294	$ 23,523	$ 15,011	$ 275,828

(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, 2003.

ALLOWANCE FOR LOAN LOSSES

2003

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 and a homogeneous pool allowance.

At December 31, 2003, the allowance for loan losses as a percent of gross loans remained the same as December 31, 2002 at 1.1%. Gross loans increased by $17,983,000 from $257,845,000 at December 31, 2002 to $275,828,000 at December 31, 2003.

Nonaccruing loans decreased $44,000 from year-end 2002. Overall nonperforming loans decreased $840,000 to $1,256,000 from fiscal year end 2002.

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.

2002

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.

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 & STILL ACCRUING
2003	$ 827	$ 429
2002	$ 871	$ 1,225
2001	$ 281	$ 338
2000	$ 777	$ 27
1999	$ 284	$ 241

If interest had been recorded at the original rate on those loans, such income would have approximated $55,000, $24,000, and $28,000 for the years ended December 31, 2003, 2002, and 2001, respectively. Interest income on such loans, which is recorded as received, amounted to approximately $7,000, $17,000 and $19,000 for the years ended December 31, 2003, 2002 and 2001, 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, 2003:		
Balance at end of period applicable to:		
Domestic:		
Commercial and agricultural	$ 353	8.5%
Real estate mortgage:		
Residential	1,483	53.4%
Commercial	916	29.9%
Construction	77	2.8%
Installment loans to individuals	240	5.4%
Total	$ 3,069	100.0%
DECEMBER 31, 2002:		
Balance at end of period applicable to:		
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%

DEPOSITS

2003

Total average deposits were $335,201,000 for 2003, an increase of $18,267,000 or 5.76%. Total demand deposits increased $16,517,000. Noninterest-bearing demand deposits increased $5,795,000 and interest-bearing demand deposits increased $10,722,000. Savings deposits increased $7,203,000 while time deposits decreased $5,453,000. Historically low rate levels have influenced investors away from longer term commitments which has resulted in an increase in more liquid accounts such as demand deposits and savings and a decrease in time deposit accounts. 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.

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.

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

	2003 AVERAGE AMOUNT	2003 RATE	2002 AVERAGE AMOUNT	2002 RATE	2001 AVERAGE AMOUNT	2001 RATE
DEPOSITS IN DOMESTIC BANK OFFICES:						
Demand deposits:						
Noninterest-bearing	$ 56,672	0.00%	$ 50,877	0.00%	$ 46,594	0.00%
Interest-bearing	82,496	1.15%	71,774	2.13%	46,154	2.17%
Savings deposits	64,673	1.17%	57,470	2.04%	47,197	2.03%
Time deposits	131,360	2.25%	136,813	3.77%	145,823	5.28%
Total average deposits	$ 335,201		$ 316,934		$ 285,768	

SHAREHOLDERS' EQUITY

2003

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, 2003 was $69,769,000, increasing $6,627,000 from the balance at December 31, 2002 of $63,142,000. Net income and the exercising of stock options contributed $11,174,000 and $87,000, respectively, to shareholders' equity. The unrealized appreciation on securities also added $987,000 to total equity. Shareholders' equity was reduced by $5,001,000 that was paid out in dividends.

2002

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, 2003, the Company's required ratios were well above the minimum ratios as follows:

	Company	2003 Minimum Standards
Tier 1 capital ratio	20.9%	4.0%
Total capital ratio	23.0%	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:

	2003	2002	2001
Percentage of net income to:			
Average total assets	2.24%	2.01%	1.95%
Average shareholders' equity	16.60%	15.00%	14.38%
Percentage of dividends declared per common share	44.76%	46.40%	48.17%
Percentage of average shareholders' equity to average total assets	13.51%	13.39%	13.54%

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 $166,870,000. 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 $107,918,000 as of December 31, 2003.

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, 2003:

	WITHIN ONE YEAR	AFTER ONE BUT WITHIN TWO YEARS	AFTER TWO BUT WITHIN FIVE YEARS	AFTER FIVE YEARS
Earning assets: (1) (2)				
Investment securities (1)	$ 42,246	$ 81,433	$ 26,870	$ 58,056
Loans (2)	70,067	40,471	123,384	46,709
Total earning assets	112,313	121,904	150,254	104,765
Deposits (3)	94,565	47,829	84,027	43,022
Borrowings	47,225	1,400	37,728	31,790
Total interest-bearing liabilities	141,790	49,229	121,755	74,812
Net noninterest-bearing funding (4)	10,165	10,165	30,495	50,825
Total net funding sources	$ 151,955	$ 59,394	$ 152,250	$ 125,637
Excess assets (liabilities)	(39,642)	62,510	(1,996)	(20,872)
Cumulative excess assets (liabilities)	(39,642)	22,868	20,872	—

(1) Investment balances reflect estimated prepayments on mortgage-backed securities and are inclusive of FHLB stock.

(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, 2003 Net Interest Income Change (After Tax) (In thousands)
-200	$ (1,172)
-100	$ (397)
+100	$ 356
+200	$ 598

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

INFLATION

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

CRITICAL ACCOUNTING POLICIES

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

Other Than Temporary Impairment of Equity Securities

Equity securities are evaluated periodically to determine whether a decline in their value is other than temporary. management utilized criteria such as the magnitude and duration of the decline, in addition to the reason underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent. It indicates that the prospects for a near term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment. Once a decline in value is determined to be other than temporary, the value of the security is reduced and a corresponding charge to earnings is recognized.

Allowance for Loan Losses

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

Management uses historical information to assess the adequacy of the allowance for loan losses as well as the prevailing business environment; as it is affected by changing economic conditions and various external factors, which may impact the portfolio in ways currently unforeseen. The allowance is increased by provisions for loan losses and by recoveries of loans previously charged-off and reduced by loans charged-off. For a full discussion of the Company's methodology of assessing the adequacy of the reserve for loan losses, refer to Note D of "Notes and Consolidated Financial Statements" commencing on page 13 of this Form 10-K.

Goodwill and Other Intangible Assets

As discussed in Note F of the consolidated financial statements, the Company must assess goodwill and other intangible assets each year for impairment. This assessment involves estimating cash flows for future periods. If the future cash flows were less than the recorded goodwill and other intangible assets balances, we would be required to take a charge against earnings to write down and assets to the lower value.

Deferred Tax Assets

We use an estimate of future earnings to support our position that the benefit of our deferred tax assets will be realized. If future income should prove non-existent or less that the amount of the deferred tax assets within the tax years to which they may be applied, the asset may not be realized and our net income will be reduced. Our deferred tax assets are described further in Note J of the consolidated financial statements.

CONTRACTUAL OBLIGATIONS, COMMITMENTS, CONTINGENT LIABILITIES, AND OFF-BALANCE SHEET ARRANGEMENTS

The Corporation has various financial obligations, including contractual obligations and commitments, which may require future cash payments.

Contractual Obligations: The following table presents in thousands, as of December 31, 2003, significant fixed and determinable contractual obligations to third parties by payment date. Further discussion of the nature of each obligation is included in the referenced note to be consolidated financial statements.

	Payments Due in				
	One Year or Less	**One to Three Years**	**Three to Five Years**	**Over Five Years**	**Total**
Deposits without a stated maturity	$ 209,418	$ —	$ —	$ —	$ 209,418
Time deposits	75,977	38,216	9,658	1,049	124,900
Security repurchase agreements	10,225	—	—	—	10,225
Borrowed funds	37,040	—	—	—	37,040
Long-term debt	—	3,000	31,100	36,778	70,878
Operating leases	262	469	278	53	1,062

The Corporation's operating lease obligations represent short and long-term lease and rental payments for facilities, certain software and data processing and other equipment.

Commitments: The following table details the amounts and expected maturities of significant commitments as of December 31, 2003, in thousands. Further discussion of these commitments is included in Note O to the consolidated financial statements.

	One Year or Less	**One to Three Years**	**Three to Five Years**	**Over Five Years**	**Total**
Commitments to extend credit:					
Commercial	$ 10,589	$ —	$ —	$ —	$ 10,589
Commercial real estate	29,139	167	549	4,455	34,310
Home equity	59	—	83	2,413	2,555
Standby letters of credit	258	—	—	—	258

Commitments to extend credit, including loan commitments, standby letters of credit, and commercial letters of credit do not necessarily represent future cash requirements, in that these commitments often expire without being drawn upon.

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.

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