SOCKET MOBILE, INC.
Form 10-Q
November 13, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

[X] **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the quarterly period ended September 30, 2008

OR

[ ] **TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the transition period ____________ to ____________

Commission file number 1-13810

SOCKET MOBILE, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-3155066**
(State of incorporation)	(IRS Employer Identification No.)

39700 Eureka Drive, Newark, CA 94560
(Address of principal executive offices including zip code)

(510) 933-3000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [ ] Smaller reporting company [X]

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

The number of shares of Common Stock ($0.001 par value) outstanding as of October 31, 2008 was 3,229,916 shares. The number of shares outstanding reflects a 1-for-10 reverse stock split effected by the registrant on October 23, 2008. See "Note 10 - Subsequent Events" for additional information.

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Item 1. Financial Statements

SOCKET MOBILE, INC.
CONDENSED BALANCE SHEETS

		September 30, 2008 (Unaudited)		December 31, 2007*
ASSETS				
Current assets:				
Cash and cash equivalents	$	4,139,429	$	4,963,359
Accounts receivable, net		4,215,641		2,614,872
Inventories		4,029,096		2,438,033
Prepaid expenses and other current assets		438,853		282,867
Total current assets		12,823,019		10,299,131
Property and equipment:				
Machinery and office equipment		2,319,488		2,391,991
Computer equipment		1,203,567		1,125,875
		3,523,055		3,517,866
Accumulated depreciation		(2,469,206)		(2,373,409)
Property and equipment, net		1,053,849		1,144,457
Intangible assets, net		378,574		473,934
Goodwill		9,797,946		9,797,946
Other assets		242,334		258,444
Total assets	$	24,295,722	$	21,973,912
LIABILITIES AND STOCKHOLDERS EQUITY				
Current liabilities:				
Accounts payable and accrued expenses	$	4,486,921	$	2,429,168
Accrued payroll and related expenses		937,473		852,185
Bank line of credit		3,035,012		2,622,009
Deferred income on shipments to distributors		2,068,626		1,744,560
Term loan - short term portion		171,522		160,439
Current portion of capital leases and deferred rent		31,593		42,964
Total current liabilities		10,731,147		7,851,325
Term loan - long term portion		138,241		266,543
Long term portion of capital leases and deferred rent		117,831		139,743
Deferred income taxes		206,277		182,322
Total liabilities		11,193,496		8,439,933
Commitments and contingencies				
Stockholders' equity:				
Common stock, $0.001 par value: Authorized shares 10,000,000,				
Issued and outstanding shares 3,230,013 at September 30, 2008 and 3,198,962 at December 31, 2007		3,230		3,199
Additional paid-in capital		54,438,930		53,683,274
Accumulated deficit		(41,339,934)		(40,152,494)
Total stockholders equity		13,102,226		13,533,979

Total liabilities and stockholders equity	$	24,295,722	$	21,973,912

* Derived from audited financial statements.

Note: Authorized shares and issued and outstanding shares reflect a 1-for-10 reverse stock split effected by the Company on October 23, 2008. See "Note 10 - Subsequent Events" for additional information.

See accompanying notes.

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SOCKET MOBILE, INC.
CONDENSED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,				Nine Months Ended September 30,			
		2008** **		2007** **		2008** **		2007** **
Revenues	$	8,018,533	$	5,424,216	$	21,680,966	$	17,272,373
Cost of revenues	** **	4,353,379** **	** **	2,808,200** **	** **	11,360,115** **	** **	8,787,932** **
Gross profit	** **	3,665,154	** **	2,616,016	** **	10,320,851	** **	8,484,441
Operating expenses:								
Research and development		1,101,601		1,122,561		3,433,364		3,711,795
Sales and marketing		1,971,754		1,799,379		5,881,549		5,528,696
General and administrative		610,255		566,336		2,037,702		2,104,677
Amortization of intangible assets	** **	31,786	** **	33,808	** **	95,360	** **	101,423
Total operating expenses		3,715,396		3,522,084		11,447,975		11,446,591
		(50,242)		(906,068)		(1,127,124)		(2,962,150)

Operating loss								
Interest income and other		3,480		30,319		19,628		97,842
Interest expense	** **	(25,018)	** **	(14,645)	** **	(55,989)	** **	(20,707)
Net loss before deferred taxes		(71,780)		(890,394)		(1,163,485)		(2,885,015)
Deferred tax expense	** **	(7,985)	** **	(7,985)	** **	(23,955)	** **	(23,958)
Net loss	** **	(79,765)	** **	(898,379)	** **	(1,187,440)	** **	(2,908,973)
	** **		** **		** **		** **	
Net loss per share:								
Basic	$	(0.02)	$	(0.28)	$	(0.37)	$	(0.91)
Diluted	$	(0.02)	$	(0.28)	$	(0.37)	$	(0.91)
Weighted average shares outstanding:								
Basic		3,230,013		3,194,798		3,214,742		3,191,173
Diluted		3,230,013		3,194,798		3,214,742		3,191,173

Note: Shares used in per share calculations of basic and diluted net loss per share, reflect a 1-for-10 reverse stock split effected by the Company on October 23, 2008. See "Note 10 - Subsequent Events" for additional information.

See accompanying notes.

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SOCKET MOBILE, INC.
CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

		Nine Months Ended September 30, 2008			2007	
Operating activities						
Net loss	$	(1,187,440)		$	(2,908,973)	
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:						
Stock-based compensation		565,574			792,629	
Depreciation and amortization		392,335			436,804	
Amortization of intangible assets		95,360			101,423	
Net foreign currency transaction (gains) losses		37,043			(53,179)	
Change in deferred rent		(3,957)			118,024	
Deferred tax expense		23,955			23,958	
** **						
Changes in operating assets and liabilities:						
Accounts receivable		(1,675,404)			(121,689)	
Inventories		(1,591,063)			194,611	
Prepaid expenses and other current assets		(155,986)			(87,493)	
Other assets		16,110			24,400	
Accounts payable and accrued expenses		2,079,068			(202,269)	
Accrued payroll and related expenses		85,288			(20,961)	
Deferred income on shipments to distributors	** **	324,066	** **		251,990	** **
Net cash used in operating activities	** **	(995,051)	** **	** **	(1,450,725)	** **
Investing activities						
Purchases of equipment and tooling	** **	(301,727)			(804,651)	
Net cash used in investing activities	** **	(301,727)	** **	** **	(804,651)	** **
** **						
Financing activities						
Payments on capital leases and equipment financing notes		(29,326)			(6,805)	
Gross proceeds from borrowings under bank line of credit agreement		8,841,995			6,776,888	
Gross repayments of borrowings under bank line of credit agreement		(8,428,992)			(6,776,420)	
		---			500,000	

Proceeds from bank term loan						
Repayments of bank term loan		(117,219)			(35,913)	
Proceeds from the exercise of stock options and warrants		190,113			83,432	
Net cash provided by financing activities		456,571			541,182	
Effect of exchange rate changes on cash and cash equivalents		16,277			21,025	
Net decrease in cash and cash equivalents		(823,930)			(1,693,169)	
Cash and cash equivalents at beginning of period		4,963,359			6,104,277	
Cash and cash equivalents at end of period	$	4,139,429		$	4,411,108	
Supplemental cash flow information						
Cash paid for interest	$	55,989		$	20,707	

See accompanying notes.

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SOCKET MOBILE, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 - Basis of Presentation

The accompanying unaudited condensed financial statements of Socket Mobile, Inc. (the "Company") (formerly Socket Communications, Inc.) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments, consisting only of normal recurring accruals considered necessary for fair presentation, have been included. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. These condensed financial statements should be read in conjunction with the audited financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

Reverse Stock Split
On October 22, 2008, the Company's Board of Directors approved a 1-for-10 reverse split of its Common Stock effective at 5 PM Eastern Time on October 23, 2008. The Company's Board of Directors implemented the reverse stock split under the authority granted to the Board by the Company's stockholders at their annual meeting on April 23, 2008. As a result of the reverse stock split, each ten shares of Common Stock, par value $0.001 per share, of the Company issued and outstanding were, automatically and without any action on the part of the respective holders thereof, combined and reconstituted as one share of Common Stock, par value $0.001 per share, of the Company. The reverse stock split reduced the number of outstanding shares of Common Stock from approximately 32,300,129 shares to approximately 3,230,013 shares. Consequently, on the Company's balance sheet, the aggregate par value of the issued Common Stock was reduced by reclassifying the par value amount of the eliminated shares of Common Stock to additional paid-in capital. All per share amounts, outstanding share amounts (including all common stock equivalents), and authorized share amounts, have been restated in the Condensed Financial Statements and in the Notes to the Condensed Financial Statements for all periods presented to reflect the reverse stock split. See "Note 10 - Subsequent Events" for additional information.

NOTE 2 - Summary of Significant Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates, and such differences may be material to the financial statements.

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SOCKET MOBILE, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

The Company makes adjustments to the value of inventory based on estimates of potentially excess and obsolete inventory after considering forecasted demand and forecasted average selling prices. However, forecasts are subject to revisions, cancellations, and rescheduling. Actual demand will inevitably differ from anticipated demand, and such differences may have a material effect on the Company's financial statements.

Recent Accounting Pronouncements
In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS 157"), which establishes a framework for measuring fair value and enhances disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, "Effective Date of FASB Statement No. 157," which provides for a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value on a recurring basis. The Company adopted the provisions of SFAS 157 as of January 1, 2008, with respect to its financial assets and liabilities only. The adoption of SFAS 157 did not have a material impact on the Company's financial statements. Under SFAS 157, the definition of fair value focuses on the price that would be

received upon the sale of an asset or the amount paid to transfer a liability. The fair value measurement should reflect all of the assumptions that market participants would use in pricing the asset or liability. SFAS 157 establishes a three-level hierarchy to prioritize the inputs used in valuation techniques for fair value consisting of: 1) observable inputs that reflect quoted prices in active markets; 2) inputs other than quoted prices with observable market data; and 3) unobservable data. SFAS 157 requires disclosures detailing the extent to which the Company measures assets and liabilities at fair value, the methods and assumptions used to measure fair value and the effect of fair value measurements on earnings.

The Company considers all highly liquid investments purchased with a maturity date of 90 days or less at date of purchase to be cash equivalents. At September 30, 2008, all of the Company's cash and cash equivalents consisted of amounts held in demand and money market deposits in banks. The Company regularly enters into forward foreign currency contracts to reduce exposures related to rate changes in certain foreign currencies. The Company's forward foreign currency contracts are recorded at fair value and are included in accrued liabilities at September 30, 2008. At September 30, 2008, these derivative instruments were not designated as hedges, and accordingly, changes in the fair value of the forward foreign currency contracts were recorded in net income. At September 30, 2008, contracts with a notional amount of $649,400 to hedge Euros were recorded as a liability with a fair value of $250 based on quotations from financial institutions.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"), which permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company adopted SFAS 159 as of January 1, 2008. The adoption of SFAS 159 did not have a material impact on the Company's financial statements.

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NOTE 3 - Inventories

Inventories consist principally of raw materials and sub-assemblies, which are stated at the lower of cost (first-in, first-out) or market.

		September 30, 2008			December 31, 2007	
Raw materials and sub-assemblies	$	3,515,331		$	2,012,745	
Finished goods	** **	513,765	** **	** **	425,288	** **
	$	4,029,096		$	2,438,033	

Increases in overall inventory balances at September 30, 2008 are due primarily to higher stocking levels of the Company's mobile handheld computer.

NOTE 4 - Bank Financing Arrangements

On March 24, 2008, the Company agreed with its bank to extend the term of the existing credit facility by an additional year. The facility now expires on March 24, 2010. The credit facility allows the Company to borrow up to $4,000,000 based on the level of qualified domestic and international receivables, up to a maximum of $2,500,000 and $1,500,000, respectively, at the lender's index rate based on prime plus 0.5%. The rates in effect at September 30, 2008 were 5.5% on both the domestic and international lines. At September 30, 2008, outstanding amounts borrowed under the lines were $1,833,001 and $1,202,011, respectively, which were the approximate amounts available on the lines. Of these amounts outstanding at September 30, 2008, $2.0 million was repaid in early October 2008. In fiscal 2007 the Company used the credit facility only at the end of each quarter. At December 31, 2007, outstanding amounts borrowed under the lines were $1,752,459 and $869,550, respectively, which were the approximate amounts available on the lines. These amounts outstanding at December 31, 2007 were repaid in early January 2008. The rates in effect at December 31, 2007 were 7.75% on both the domestic and international lines. Under the terms of the credit agreement, beginning March 31, 2008, the Company must maintain a quarterly minimum tangible net worth of at least $2,500,000, plus beginning thereafter, 50% of quarterly positive net income. The Company was in compliance with the tangible net worth requirement at September 30, 2008.

Under the terms of a term loan agreement, the Company borrowed a principal amount of $500,000 on June 29, 2007. The term loan bears a fixed interest rate of 9.75%, equal to the prime rate plus 1.5% at the time of the advance, and is to be repaid by the Company in 36 equal monthly installments. At September 30, 2008, $309,763 was outstanding on the term loan, of which $171,522 and $138,241 is classified as short term debt and long term debt, respectively. Remaining payments of principal due in future periods are as follows: $40,723, $173,228, and $ 93,315, for the years ending December 31, 2008 (three months remaining), 2009 and 2010, respectively.

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NOTE 5 - Intangible Assets

Intangible assets at September 30, 2008 consist of a patent purchased in 2004 for $600,000 covering the design and functioning of plug-in bar code scanners, bar code imagers, and radio frequency identification products, which is being amortized on a straight line basis over its estimated life of ten years, and intangible assets of $570,750 remaining from a prior acquisition in 2000 consisting of developed software and technology with estimated lives at the time of acquisition of 8.5 years.

Amortization of all intangible assets for the three and nine months ended September 30, 2008 was $31,786 and $95,360, respectively, compared to $33,808 and $101,423, respectively, for the same periods in 2007. Intangible assets as of September 30, 2008 consisted of the following:

	Gross Assets	Accumulated Amortization	Net
Patent	$ 600,000	$ 255,000	$ 345,000
Project management tools	570,750	537,176	33,574
Total intangible assets	$ 1,170,750	$ 792,176	$ 378,574

Intangible assets as of December 31, 2007 consisted of the following:

	Gross Assets	Accumulated Amortization	Net
Patent	$ 600,000	$ 210,000	$ 390,000
Project management tools	570,750	486,816	83,934
Total intangible assets	$ 1,170,750	$ 696,816	$ 473,934

Based on definite lived intangible assets recorded at September 30, 2008, and assuming no subsequent impairment of the underlying assets, the annual amortization expense is expected to be as follows:

Year	Amount
2008 (three months remaining)	$ 31,787
2009	76,787
2010	60,000
2011	60,000
2012	60,000
2013 and beyond	90,000
	$ 378,574

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SOCKET MOBILE, INC.
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(Unaudited)

NOTE 6 - Segment Information

The Company operates in one segment - mobile systems solutions for businesses. Mobile systems solutions typically consist of a handheld computer, data collection and connectivity peripherals, and third party vertical applications software. The Company markets its products in the United States and foreign countries through its sales personnel, vertical industry partners, and distributors. Revenues for the geographic areas for the three and nine months ended September 30, 2008 and 2007 are as follows:

Revenues:	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
United States	$ 5,418,380	$ 3,729,356	$ 14,155,852	$ 11,128,236
Europe	1,688,560	1,259,344	5,089,849	4,731,235
Asia and rest of world	911,593	435,516	2,435,265	1,412,902
Total revenues	$ 8,018,533	$ 5,424,216	$ 21,680,966	$ 17,272,373

Export revenues are attributable to countries based on the location of the Company's customers. The Company does not hold long-lived assets in foreign locations.

Major customers who accounted for at least 10% of the Company's total revenues were as follows:

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Tech Data Corp.	13%	23%	14%	24%
Ingram Micro, Inc.	22%	13%	17%	13%
Intermec Technologies Corp.	22%	*	15%	*

* Customer accounts for less than 10% of total revenues for the period

NOTE 7 - Stock-Based Compensation

The Company accounts for share-based awards in accordance with SFAS 123R. SFAS 123R requires all share-based awards to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. Under SFAS 123R, the Company uses a binomial lattice valuation model to estimate the fair value of stock option grants made on or after January 1, 2006. The binomial lattice model incorporates calculations for expected volatility, risk-free interest rates, employee exercise patterns and post-vesting employment termination behavior, and these factors affect the estimate of the fair value of the Company's stock option grants.

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SOCKET MOBILE, INC.
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(Unaudited)

The weighted average per share fair value of options granted during the three and nine months ended September 30, 2008 was estimated at $6.69 and $7.94, respectively, compared to $15.17 and $15.42, respectively, for the three and nine months ended September 30, 2007. The weighted average per share fair values presented have been adjusted to reflect a 1-for-10 reverse stock split. The fair values were determined using a binomial lattice valuation model for options granted on or after January 1, 2006, and a Black-Scholes valuation model for options granted prior to January 1, 2006. Weighted average assumptions for options granted during the three and nine months ended September 30, 2008 and 2007 are shown below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Risk-free interest rate (%)	4.18%	3.90%	4.16%	3.80%
Dividend yield	---	---	---	---
Volatility factor	0.71	1.0	0.75	1.0
Expected option life (years)	4.9	4.7	4.8	4.7

At September 30, 2008, options issued to employees for 1,101,110 shares were outstanding, of which 791,968 were exercisable. At September 30, 2007, options issued to employees for 1,002,155 shares were outstanding, of which 730,660 were exercisable. The options issued and exercisable at September 30, 2008 and 2007 have been adjusted to reflect a 1-for-10 reverse stock split.

Total stock-based compensation expense recognized in the Company's statements of operations for the three and nine months ended September 30, 2008 and 2007 is shown below:

	Three Months Ended September 30,				Nine Months Ended September 30,			
Income Statement Classification		2008		2007		2008		2007
 Cost of revenues	$	11,707	$	19,695	$	31,916	$	62,802
 Research and development		42,796		70,901		150,953		199,379
 Sales and marketing		71,168		94,567		204,752		266,752
 General and administrative		45,970		72,738		177,953		263,696
 Total	$	171,641	$	257,901	$	565,574	$	792,629

The decline in stock-based compensation expense in the three and nine months ended September 30, 2008 compared to the same periods one year ago, reflects older grants with higher valuations, compared to more current grants, becoming fully expensed.

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SOCKET MOBILE, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

NOTE 8 - Net Loss Per Share Applicable to Common Stockholders

The Company calculates earnings per share in accordance with Financial Accounting Standards Board Statement No. 128, *Earnings per Share*. The following table sets forth, on a post reverse stock split basis, the computation of basic and diluted net loss per share:

	Three Months Ended September 30,		Nine Months Ende September 30,	
	2008	2007	2008	200
rator:				
loss	$ (79,765)	$ (898,379)	$ (1,187,440)	$ (2,908
minator:				
eighted average common shares outstanding used in computing net loss per share djusted to reflect a 1-for-10 reverse stock split):				
Basic	3,230,013	3,194,798	3,214,742	3,191
Diluted	3,230,013	3,194,798	3,214,742	3,191
p				
et loss per share:				
Basic	$ (0.02)	$ (0.28)	$ (0.37)	$ (
Diluted	$ (0.02)	$ (0.28)	$ (0.37)	$ (

For the three and nine months ended September 30, 2008 and 2007, the diluted net loss per share is equal to the basic net loss per share because the Company experienced losses in these periods. Thus no potential common shares underlying stock options or warrants have been included in the net loss per share calculation, as their effect is anti-dilutive. Therefore, options to purchase 1,101,110 shares of Common Stock at September 30, 2008, and options and warrants to purchase 1,093,992 shares of Common Stock at September 30, 2007, have been omitted from the diluted net loss per share calculation. The option and warrants amounts presented have been adjusted to reflect a 1-for-10 reverse stock split.

NOTE 9 - Income Taxes

Deferred income tax reflects the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. Deferred tax expense of $7,985 and $23,955 for the three and nine months ended September 30, 2008, respectively, and the corresponding deferred tax liability shown on the Company's balance sheet, is related entirely to the deferred tax liability on the portion of the Company's goodwill amortized for tax purposes. Deferred tax expense for the three and nine months ended September 30, 2007 was $7,985 and $23,958, respectively. Due to the indefinite characteristic of this deferred tax liability, it cannot be offset against deferred tax assets, and furthermore, this deferred tax liability may never reverse. The Company has not generated taxable income in any periods in any jurisdiction, foreign or domestic. The Company maintains a full valuation allowance for all other components of deferred tax assets.

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SOCKET MOBILE, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

On January 1, 2007, the Company adopted Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109," ("FIN 48"). FIN 48 prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements, and provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure, and transition issues. There were no adjustments to the financial statements as a result of the adoption of FIN 48. At December 31, 2007, the Company has an unrecognized tax benefit of approximately $595,000, which did not change significantly during the nine months ended September 30, 2008. The application of FIN 48 does not result in a change to retained earnings, as the unrecognized tax benefit would be fully offset by the application of a valuation allowance. Future changes in the unrecognized tax benefit will have no impact on the effective tax rate due to the existence of the valuation allowance. It is the Company's policy to include interest and penalties related to tax positions as a component of income tax expense. No interest was accrued for the three and nine months ended September 30, 2008.

The Company files its tax returns as prescribed by the tax laws of the jurisdictions in which it operates. The Company is not currently under audit in any of its jurisdictions where income tax returns are filed. The tax years 1992 to 2007 remain open to examination by the major domestic taxing jurisdictions to which the Company is subject, and for the years 2001 to 2007 for the international taxing jurisdictions to which the Company is subject.

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NOTE 10 - Subsequent Events

Reverse Stock Split

On October 22, 2008, the Company's Board of Directors approved a 1-for-10 reverse split of its Common Stock effective at 5 PM Eastern time on October 23, 2008. The Company implemented the reverse stock split under the authority granted to the Board by the Company's stockholders at their annual meeting on April 23, 2008, to effect a reverse stock split of the Company's common stock, par value $0.001 per share, at a ratio within a range of from one-for-five to one-for-ten shares. As a result of the reverse stock split, each ten shares of Common Stock, par value

$0.001 per share, of the Company issued and outstanding were, automatically and without any action on the part of the respective holders thereof, combined and reconstituted as one share of Common Stock, par value $0.001 per share, of the Company. The reverse stock split reduced the number of outstanding shares of Common Stock from approximately 32,300,129 shares to approximately 3,230,013 shares. Holders of a fractional share of Common Stock as a result of the reverse stock split were entitled to receive a cash amount, without interest, equal to the fair market value of that fraction based upon the average of the closing bid prices of the Common Stock as reported on the NASDAQ Capital Market for each of the five trading days immediately preceding the effective date of the reverse stock split. On the Company's balance sheet, the aggregate par value of the issued common stock was reduced by reclassifying the par value amount of the eliminated shares of common stock to additional paid-in capital. All per share amounts, outstanding share amounts (including all common stock equivalents), and authorized share amounts, have been restated in the Condensed Financial Statements and in the Notes to the Condensed Financial Statements for all periods presented to reflect the reverse stock split.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements include statements forecasting future financial results and operating activities, market acceptance of our products, expectations for general market growth of handheld computers and other mobile computing devices, growth in demand for our products, expansion of the markets that we serve, expansion of the distribution channels for our products, adoption of our embedded products by third party manufacturers of electronic devices, and the timing of the introduction and availability of new products, as well as other forecasts discussed under "Management's Discussion and Analysis of Financial Condition and Results of Operations." Words such as "may," "will," "predicts," "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," variations of such words, and similar expressions are intended to identify such forward-looking statements. Such forward-looking statements are based on current expectations, estimates, and projections about our industry, management's beliefs, and assumptions made by management. These forward-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results and outcomes may differ materially from what is expressed or forecasted in any such forward-looking statements. Factors that could cause actual results and outcomes to differ materially include, but are not limited to: the risk of delays in the availability of our products due to technological, market or financial factors including the availability of necessary working capital; our ability to successfully develop, introduce and market future products; the change in gross margins between current and future products; our ability to effectively manage and contain our operating costs; events in the U.S. and world economy, financial markets and credit markets; the availability of announced third party handheld computer hardware and software that our products are intended to work with; product delays associated with new model introductions and product changeovers by the makers of products that our products are intended to work with; continued growth in demand for handheld computers; market acceptance of emerging standards such as Bluetooth and Wireless LAN and of our related connection, data collection, and mobile handheld computer products; the ability of our strategic relationships to benefit our business as expected; our ability to enter into additional distribution relationships; or other factors described in this Form 10-Q including "Part II, Item 1A. Risk Factors" and recent Form 8-K and Form 10-K reports filed with the Securities and Exchange Commission. We assume no obligation to update such forward-looking statements or to update the reasons why actual results could differ materially from those anticipated in such forward-looking statements.

You should read the following discussion in conjunction with the interim condensed financial statements and notes included elsewhere in this report, the Company's annual financial statements in the Form 10-K, and other information contained in other reports and documents filed from time to time with the Securities and Exchange Commission.

Revenues

We produce mobile computing products which are combined with third party application software to create mobile system solutions that serve the Business Mobility market. Mobile systems solutions typically consist of a handheld computer, data collection and connectivity peripherals, and third party vertical applications software. We have historically offered a wide range of data collection, connectivity peripheral, and embedded products for use with mobile computing devices offered by third parties. In January 2007, we began doing business as Socket Mobile to emphasize our commitment to mobile computing, and formally changed our name to Socket Mobile, Inc. in April 2008. In June 2007, we introduced our first mobile handheld computer, the SoMo 650, and began offering this mobile handheld computer and our peripherals for use with third party vertical applications software. Our data collection and connectivity peripheral products are used with a variety of handheld computers, including our SoMo 650 mobile handheld computer, and with tablet computers, notebook computers and handheld computers with integrated phones that use Windows Mobile, Windows XP, Windows Vista, RIM Blackberry, Palm, Symbian 60 and Symbian 80 operating systems.

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Our overall company brand identity and positioning goal is to become the leading provider of easy-to-deploy Business Mobility systems and peripherals. The guiding principles that we follow in developing our mobile handheld and peripheral products for the Business Mobility computing market are stable and expandable computing devices with industry standard expansion form factors, compact design, low battery power consumption to extend time between charges, ease of use, interoperability, and quality. Our focus is business customers in the mobile marketplace. Our mobile handheld computing products have been designed to address the Business Mobility market for a handheld computer that is positioned between a consumer-oriented handheld device and a heavy duty industrial device. Our mobile handheld computer is easy to customize and integrate with peripherals and information systems and has an expected product life cycle of three to five years which meets the needs of businesses for longer deployments than have been available with most consumer-oriented handheld devices.

We work with more than 200 software integration companies that are offering or developing vertical application software for use with handheld computers. Examples of these vertical applications include patient medication administration within the health care industry, retail merchandising such as managing inventory on retail store shelves, sales and field force automation involving the collection and processing of orders or service information from remote locations by sales and service personnel, asset management and inventory control for assets having bar codes or radio frequency identification tags, and mobile point of sale applications. These mobile solutions are designed to improve the productivity of business enterprises by automating manual tasks, improving the quality of information collected, and enhancing mobile productivity by processing and transferring information from remote locations and mobile devices to the business enterprise, and then if required, back to the remote locations and mobile devices.

Most of our products, except our OEM embedded products, are sold through distributors and resellers that serve business customers. Our OEM embedded products are sold directly to the manufacturers of devices in which our products are embedded. The geographic regions we serve include the Americas, Europe, the Middle East, Africa and Asia Pacific. Total revenues for the three and nine months ended September 30, 2008 were $8.0 million and $21.7

million, respectively, which represented increases of 48% and 26% from revenues of $5.4 million and $17.3 million, respectively for the corresponding periods one year ago.

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Our revenues in the comparable three and nine month periods may be classified into three broad product families:

- Mobile handheld computer products;
- Mobile peripheral products, including
  - Data collection products,
  - Connectivity products,
  - Serial interface products, and
- OEM embedded products.

Our *mobile handheld computer products* have been designed to address the Business Mobility market for a handheld computer that is positioned between a consumer-oriented handheld device and a heavy duty industrial device. Our initial model, the SoMo 650 (SoMo is derived from Socket Mobile), was introduced in June 2007 and featured the Microsoft Windows Mobile 5.0 for Pocket PC operating system to ensure a high level of mobile application compatibility and to give workers a familiar computing environment. We began offering Windows Mobile 6 Classic and multiple language support for the SoMo 650 in the second quarter of 2008 giving customers a choice of operating systems and languages to best fit their needs. The SoMo 650 is easy to customize and integrate with peripherals and information systems and has an expected product life cycle of three to five years which meets the needs of businesses for longer deployments than have generally been available with most consumer-oriented handheld devices. Our mobile handheld computer's features include Wireless LAN and Bluetooth, a fast processor, a large, bright screen display, large amounts of SDRAM and flash memory, extended battery life, programmable action buttons to activate peripheral devices, reinforced CompactFlash and SDIO card slots, and a durable case. Additional models are in development that will run the Windows Mobile 5 or Windows Mobile 6 Classic operating system, add additional multiple language support, enable extended outdoor use, and offer specialized capabilities oriented to the needs of specific vertical markets. In the fourth quarter of 2008, we expect to begin shipping a radio-free configured model, our SoMo 650 DX, for high security applications such as those found in the government and financial markets, and our SoMo 650 Rx model with an antibacterial case targeted toward healthcare and other markets that involve hygiene-sensitive environments. The SoMo 650 was specifically designed without an integrated mobile phone as most solutions involving our products use Bluetooth or Wireless LAN connections for data communications and do not require an integrated mobile phone. Mobile handheld computer products represented approximately 19% and 15% of our revenues for the three and nine month periods ended September 30, 2008, respectively, compared to 8% and 3% of our revenues for the same periods one year ago.

Our mobile peripheral products consist of *data collection products*, *connectivity products*, and *serial interface products*, which together represented approximately 44% and 50% of our revenues for the three and nine months ended September 30, 2008, respectively, compared to 64% and 71% of our revenues for the same periods one year ago.

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Our *data collection products* enable the electronic collection of data from bar codes, Radio Frequency IDentification (RFID) tags, or magnetic stripes and consist of:

- bar code scanning products that plug into or connect wirelessly to handheld computers, tablet computers, notebook computers, and handheld computers with integrated phones that use Windows Mobile, Windows XP, Windows Vista, Windows Tablet, RIM Blackberry, Palm, or Symbian 60 or Symbian 80 operating systems, and turn these devices into portable bar code scanners that can be used in various retail and industrial workplaces;
- plug-in radio frequency identification products that read radio frequency identification tags;
- a combination plug-in bar code scanner and radio frequency identification reader; and
- a plug-in magnetic stripe reader.

We have developed extensive bar code scanning software called SocketScan that supports all of our data collection products, and have software developer kits that assist third party developers in integrating our SocketScan software and our hardware products into their applications and solutions. Our bar code scanning products include CompactFlash and SDIO plug-in bar code scanners for linear and two-dimensional bar code scanning, along with a cordless handheld bar code scanner and a ring scanner worn on the index finger, both of which connect to computing systems using the Bluetooth standard for short-range wireless connectivity. Data collection products represented approximately 34% and 38% of our revenues for the three and nine months ended September 30, 2008, respectively, compared to 46% and 52% of our revenues for the same periods one year ago.

Our *connectivity products* are connection devices that can be plugged into standard expansion slots in handheld computers, tablet computers, and notebook computers that use Windows Mobile, Windows XP, or Windows Tablet operating systems. These products allow users to connect their devices via Ethernet or telephone to communicate with other networks and devices such as desktop computers, other handheld, tablet, and notebook computers, handheld computers with integrated phones, and printers. Our connectivity products include:

- modems for telephone connections that connect over a cable, and a cordless modem that utilizes Bluetooth wireless technology to connect a telephone to a Bluetooth-enabled computer or other device;
- Ethernet cards for local area network connections that connect over a cable; and
- accessory products such as batteries and cables.

Connectivity products represented approximately 6% of our revenues for both the three and nine months ended September 30, 2008, respectively, compared to 9% and 11% of our revenues for the same periods one year ago

Our *serial interface products* enable the connection of a mobile computer to electronic devices either as a plug-in card (one, two or four ports) connecting over cables, or wirelessly over a Bluetooth network. Our serial interface products are used primarily with Windows XP and Windows Vista based devices. We recently introduced a USB to serial connector to enable a serial connection through a USB interface, and we expect to introduce a USB to Ethernet adapter in the fourth quarter of 2008. Serial interface products represented approximately 4% and 6% of our revenues in the three and nine months ended September 30, 2008, respectively, compared to 8% of our revenues for each of the same periods one year ago.

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Our *OEM embedded products* consist of Bluetooth and Wireless LAN modules and plug-in cards used primarily by OEMs of handheld computers and other devices to build wireless connection functions into their products using the Bluetooth and Wireless LAN standards for wireless connectivity. Our plug-in cards and modules using the Bluetooth standard for short-range wireless connectivity include extensive communications software enabling the use of these products, as do our plug-in cards for connecting to local wireless networks using the Wireless LAN 802.11b/g (or Wi-Fi) standards. We have recently added Cisco Compatible Extensions (CCX) 4.0 certification to our Wireless LAN software to enable our Wireless LAN products to be compatible with a Cisco Wireless LAN infrastructure. Bluetooth and Wireless LAN connection functions are being built into many third party mobile devices, which may reduce the demand for our plug-in products through expansion slots but may increase the demand for our Bluetooth and Wireless LAN modules and embedded plug-in cards. OEM embedded products represented approximately 37% and 35% of our revenues for the three and nine months ended September 30, 2008, respectively, compared to 28% and 26% of our revenues for the same periods one year ago.

Our revenues by product family for the three and nine months ended September 30, 2008 and 2007, and the corresponding increase or decrease in revenues for the comparable periods are shown in the following table:

(revenues in thousands)	Three Months Ended September 30,			Nine Months Ended September 30,		
Product family:	2008	2007	Increase (Decrease)	2008	2007	Increase (Decrease)
Mobile handheld computer products	$ 1,512	$ 448	238%	$ 3,219	$ 515	525%
Mobile peripheral products:						
Data collection	2,727	2,522	8%	8,288	9,027	(8%)
Connectivity	483	498	(3%)	1,389	1,921	(28%)
Serial products	326	437	(25%)	1,303	1,358	(4%)
OEM embedded products	2,971	1,519	96%	7,482	4,451	68%
	$ 8,019	$ 5,424	48%	$ 21,681	$ 17,272	26%

Total

Our mobile handheld computer product revenues in the three and nine months ended September 30, 2008 were $1,512,000 and $3,219,000, respectively, compared to $448,000 and $515,000, respectively, in the comparable periods one year ago. We began shipping our first mobile handheld computer, the SoMo 650, to customers in our distribution channel in the second quarter of 2007. In the third quarter of 2007, we completed our objectives of ramping up production and fully stocking our distribution channel to enable the commencement of widespread customer evaluation, qualification, and deployment. Increased revenues for our handheld computer in 2008 reflect higher sales volumes due to a growing customer base with larger average unit deployments.

Our data collection product revenues in the three and nine months ended September 30, 2008 were $2.7 million and $8.3 million, a increase of 8% and a decrease of 8% compared to revenues of $2.5 million and $9.0 million, respectively, in the comparable periods one year ago. Increases totaling $0.6 million in the comparable three month periods were due to increased sales volumes of our Cordless Hand Scanner, our CompactFlash In-Hand Scan card, and our Cordless Ring Scanner. Partially offsetting these increases were declines in sales volumes of our SDIO In-Hand Scan card between the comparable three month periods. Decreases of $0.9 million between the comparable nine month periods were from declines in sales volumes of our CompactFlash In-Hand Scan card, our SDIO In-Hand Scan card, and our Cordless Ring Scanner, and were partially offset by increases in sales of our Cordless Hand Scanner. Data collection revenues in the first nine months of 2008 were slowed in the first quarter but began to recover in the second quarter due in part to delayed availability of new handheld computer models originally announced by a major handheld computer manufacturer in the third quarter of 2007, which did not begin shipping until February 2008. Such announcements and delayed timing of product availability typically slow customer deployments of our peripheral products because of the time needed by customers to evaluate or adopt the new handheld computer models.

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Our connectivity product revenues in the three and nine months ended September 30, 2008 were $483,000 and $1,389,000, respectively, declining 3% and 28% compared to revenues of $498,000 and $1,921,000, respectively, in the same periods one year go. Declines between the comparable three month periods were from reduced sales volumes of our Ethernet plug-in products. Declines between the comparable nine month periods were from reduced sales volumes of our Modem plug-in products and Ethernet plug-in products. Reductions in connectivity product revenues are due to reduced corporate deployment of these wired connection solutions in 2008.

Our serial interface product revenues in the three and nine months ended September 30, 2008 were $326,000 and $1,303,000, respectively, a decline of 25% and 4% compared to revenues of $437,000 and $1,358,000, respectively, in the comparable periods one year ago. Revenue declines between the comparable three months were from declines in sales volumes of our standard serial PC card products, our CompactFlash card product, and our cordless Bluetooth serial adapter product. Revenue declines between the comparable nine months were from declines in sales volumes of our CompactFlash card and cordless Bluetooth serial adapter products, partially offset by increases in sales of our standard serial PC card products. Our standard peripheral connection cards are primarily sold to connect peripheral devices or other electronic equipment to notebook computers.

Our OEM embedded product revenues in the three and nine months ended September 30, 2008 were $3.0 million and $7.5 million, respectively, an increase of 96% and 68% compared to $1.5 million and $4.5 million, respectively, in the comparable periods one year ago. Revenue increases of $0.8 million and $2.4 million in sales of our Bluetooth modules in the three and nine months of 2008 were due to a recovery in market conditions that existed in early 2007. In the first quarter of 2007 our customers in the industrial ruggedized market segment experienced pronounced increased competition due to a short-term aggressive price discounting by a major competitor, a trend which adversely affected our related Bluetooth module revenues in the first quarter of 2007, but improved steadily in the following second, third, and fourth quarters of 2007, and through the first nine months of 2008, following cessation of the aggressive discounting by the competition. Additional revenue increases of $0.6 million and $0.7 million in the three and nine month periods were from increased sales volumes of our Wireless LAN plug-in card products. Partially offsetting the increase between the nine month periods was a decline in revenues related to our Bluetooth plug-in cards primarily due to this wireless technology becoming increasingly a standard feature built-in by handheld computer manufacturers.

Gross Margins

Gross margins in the three and nine month periods ended September 30, 2008 were 46% and 48% compared to margins of 48% and 49%, respectively, in each of the comparable periods in 2007. We generally price our products as a markup from our cost, and we offer discount pricing for higher volume purchases. Reductions in overall margins in the three and nine month periods of 2008 compared to the same periods one year ago are due primarily to discounts on volume purchases of our Bluetooth modules by customers in our OEM embedded business segment and increased sales of our mobile handheld computer which began shipping late in the second quarter of 2007. Margins on our mobile handheld computer products are currently below our average product margins. We expect our overall margins to improve in the fourth quarter from third quarter 2008 levels due to an anticipated change in product sales mix.

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Research and Development Expense

Research and development expense for the three months ended September 30, 2008 was $1,102,000, a decrease of 2% compared to research and development expense of $1,123,000 in the corresponding period one year ago. Research and development expense for the nine months ended September 30, 2008 was $3.4 million, a decline of 8% compared to research and development expense of $3.7 million in the corresponding period one year ago. The decrease from the comparable three months is attributable to reductions in equipment costs and consulting and professional fees partially offset by increased outside services expense. Decreases of $0.2 million between the comparable nine month period was attributable to the costs incurred in the first quarter of 2007 related to the development of our SoMo 650 mobile handheld computer, the development of which was begun in the fourth quarter of 2006, with the majority of the development expense concluded by the end of the first quarter of 2007. Additional decreases from the comparable nine months were from reductions in consulting and professional fees related to fewer projects requiring the use of external technical expertise, and from reductions in equipment costs due to higher amounts of depreciation expense related to capitalized tooling in the first quarter of 2007. Partially offsetting these decreases were increases in personnel costs from staffing in-house expertise for technical skills formerly obtained from outside consulting and professional service providers. Research and development expenses in the fourth quarter are expected to remain at levels comparable to the third quarter of 2008.

Sales and Marketing Expense

Sales and marketing expense for the three month period ended September 30, 2008 was $2.0 million, an increase of 10% compared to sales and marketing expense of $1.8 million in the corresponding period one year ago. Sales and marketing expense for the nine month period ended September 30, 2008 was $5.9 million, an increase of 6% compared to sales and marketing expense of $5.5 million in the corresponding period one year ago. Increases between the comparable three and nine months were primarily from increased personnel costs due to the additions of key personnel beginning in the second quarter of 2007, including our Senior VP of Sales & Marketing, as we added sales resources in North America to begin selling our new SoMo 650 mobile handheld computer, which began shipping late in the second quarter of 2007, and to recruit and develop new third party channel partners. Additional increases between the comparable three and nine month periods were from higher levels of advertising and promotional expense, offset by reductions in outside services and travel expense. Sales and marketing expense is expected to increase in the fourth quarter of 2008 from third quarter levels due to increased personnel costs and promotional activities.

General and Administrative Expense

General and administrative expense for the three months ended September 30, 2008 was $610,000, an increase of 8% compared to general and administrative expense of $566,000 in the corresponding period one year ago. General and administrative expense for the nine month period ended September 30, 2008 was $2.0 million, a decrease of 3% compared to general and administrative expense of $2.1 million in the corresponding period one year ago. Increases between the comparable three months were from increased facility and compensation related expenses. The decrease between the comparable nine month periods was primarily from reduced stock-based compensation expenses as older grants with higher valuations compared to more current grants, became fully expensed. General and administrative expenses are expected to increase in the fourth quarter of 2008 from third quarter levels due primarily to increased consulting and professional fees related to the audit of our annual financial statements, historically charged during the fourth and first quarters.

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Amortization of Intangibles

In July 2004 we acquired a patent which covers the design and functioning of plug-in bar code scanners, bar code imagers, and radio frequency identification products. The patent was purchased for $600,000 and has been capitalized as an intangible asset. The patent is being amortized on a straight line basis over a ten-year period. Intangible assets of $571,000 remaining from a prior acquisition in 2000 consist of developed software and technology with estimated lives at the time of acquisition of 8.5 years. Amortization charges for the three and nine months ended September 30, 2008 for all acquired intangibles were $32,000 and $95,000, respectively, compared to $34,000 and $101,000 for the same periods one year ago.

Interest Income and Expense

Interest income reflects interest earned on cash balances. Interest income of $3,500 and $19,600 in the three and nine month periods ended September 30, 2008, respectively, declined from interest income of $30,300 and $97,800, respectively, in the comparable periods one year ago. Lower interest income in the comparable periods reflects lower average cash balances combined with lower average rates of return.

Interest expense of $25,000 and $56,000 for the three and nine months ended September 30, 2008, respectively, increased from interest expense of $15,000 and $21,000, respectively, for the comparable periods one year ago. Interest expense is related to interest on amounts drawn on our bank lines of credit and term loan, and interest on equipment lease financing obligations. Higher interest expense in the comparable periods is due to higher average balances outstanding on our bank lines of credit partially offset by lower interest rates, and higher average amounts outstanding on our bank term loan compared to the same periods one year ago. In the second and third quarter of 2008, average amounts outstanding on our bank lines of credit increased from prior quarters' levels. Prior to the second quarter of 2008 we used our bank lines of credit only at the end of the quarter in the first quarter of 2008 and at the end of each quarter in 2007. The term loan was advanced at the end of the second quarter of 2007 and is being repaid in 36 monthly installments which began in July of 2007.

Taxes

Deferred income tax reflects the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. Deferred tax expense of $8,000 and $24,000 in the three and nine month periods ended September 30, 2008 and 2007, and the corresponding deferred tax liability shown on the Company's balance sheet, is related entirely to the deferred tax liability on the portion of the Company's goodwill amortized for tax purposes. Due to the indefinite characteristic of this deferred tax liability, it cannot be offset against deferred tax assets, and furthermore, this deferred tax liability may never reverse. The Company maintains a full valuation allowance for all other components of deferred tax assets. The Company has not generated taxable income in any periods in any jurisdiction, foreign or domestic.

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In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109" ("FIN 48"), to create a single model to address accounting for uncertainty in tax positions. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted FIN 48 as of January 1, 2007, as required. There were no adjustments to the financial statements as a result of the adoption of FIN 48. For additional information on taxes see Note 9 to the Condensed Financial Statements.

Liquidity and Capital Resources

We were unprofitable in each of the first three quarters of 2008. We were unprofitable in each of the quarters of fiscal years 2007 and 2006. We were profitable in two quarters in 2005, but unprofitable for fiscal year 2005. Fiscal year 2004 was the first profitable year in our history, but only to the extent of $288,000. Prior to 2004, we incurred significant operating losses in each financial period since our inception. We may continue to be unprofitable in the foreseeable future. Historically we have financed our operations through the sale of equity securities, equipment financing, and revolving bank lines of credit. Since our inception we have raised approximately $51 million in equity capital to fund our operations.

Cash used in operating activities was $1.0 million in the first nine months of 2008, compared to cash used in operating activities of $1.5 million in the first nine months of 2007. Cash used in the first nine months of 2008 resulting from our net loss adjusted for non-cash items was $77,000 compared to cash used of $1.4 million in the first nine months of

2007 from our net loss adjusted for non-cash items. Adjustments for non-cash items consisting of depreciation and amortization, amortization of intangibles, gains and losses on foreign currency transactions, changes in deferred rent, deferred tax expense, and stock-based compensation expense, totaled $1.1 million in the first nine months of 2008 compared to $1.4 million in the first nine months of 2007. Changes in working capital balances in the first nine months of 2008 resulted in a use of cash of $0.9 million, and were primarily from increases in accounts receivable due to a combination of the timing of shipments late in the third quarter of 2008 and the timing of collections from key distributors concentrated at the end of the fourth quarter of 2007, and increases in inventories due primarily to stocking higher quantities of our mobile handheld computer and stocking higher quantities of our Bluetooth modules for our OEM customers, partially offset by increases in accounts payable related to the purchases that led to the increased levels of inventories. Changes in working capital balances in the first nine months of 2007 resulted in a source of cash of $39,000, and were primarily from increases in deferred income on shipments to distributors resulting from volume shipments of our mobile handheld computer beginning mid-September, as we began stocking our distribution channel with this product, and from reductions in levels of inventories, partially offset by reductions in accounts payable and accrued expenses due to payments of accrued costs attributable to development of our mobile handheld computer, and from increases in accounts receivable due to shipments made late in the third quarter.

Cash used in investing activities was $0.3 million in the first nine months of 2008 compared to $0.8 million in the first nine months of 2007. Higher amounts of investing activities in the first nine months of 2007 reflect the costs of leasehold improvements related to our corporate headquarters into which we moved at the beginning of the first quarter of 2007. Remaining investing activities in each of the periods reflects the costs of new computer hardware and software, and tooling costs.

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Cash provided from financing activities was $457,000 in the first nine months of 2008, compared to $541,000 during the first nine months of 2007. Financing activities in the first nine months of 2008 consisted primarily of a net increase in the amounts drawn on our bank lines of credit at the end of the quarter, proceeds from the exercise of warrants and stock options primarily in the second quarter of 2008, partially offset by repayments on our bank term loan, which was advanced at the end of June 2007 and is being repaid in 36 monthly installments beginning in July 2007. Financing activities in the first nine months of 2007 consisted primarily of proceeds from the bank term loan advanced at the end of the second quarter of 2007, and proceeds from the exercise of stock options, and payments on capital leases.

Our cash balances at September 30, 2008 were $4.1 million, including cash of $3.0 million drawn against our bank line of credit and a net balance of $0.3 million from the bank term loan, which is being repaid monthly over three years beginning in July 2007. In March 2008, we extended our bank line of credit agreement, which will now expire on March 24, 2010. We believe our existing cash, plus our ability to reduce costs, and our bank line will be sufficient to meet our funding requirements at least through September 30, 2009. To the extent our revenues continue to grow, we anticipate requirements for cash will include funding of higher receivable and inventory balances, and increasing expenses, including more employees to support the growth and increases in salaries, benefits, and related support costs for employees. If we cannot return to profitability, however, we will not be able to support our operations from positive cash flows, and we would use our existing cash to support operating losses. If we are unable to secure the necessary capital to replace that cash, we may need to suspend some or all of our current operations. Should the need arise, there are no assurances that additional capital will be available on acceptable terms, if at all, and any such terms may be dilutive to existing stockholders. Although we do not anticipate the need to raise additional capital at this time to fund our operations, we may raise additional capital if market conditions are appropriate.

Our contractual cash obligations at September 30, 2008 are outlined in the table below:

Payments Due by Period

Off-Balance Sheet Arrangements
We have no off-balance sheet arrangements as defined in Item 303 of Regulation S-K.

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Recent Accounting Pronouncements
In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("SFAS 157"), which establishes a framework for measuring fair value and enhanced disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, "Effective Date of FASB Statement No. 157," which provides for a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value on a recurring basis. We adopted the provisions of SFAS 157 as of January 1, 2008, with respect to our financial assets and liabilities only. The adoption of this statement did not have a material impact on our financial statements. For additional discussion on fair value measurements see Note 1 to the Condensed Financial Statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"), which permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We adopted SFAS 159 as of January 1, 2008. The adoption of SFAS 159 did not have a material impact on our financial statements.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to invested cash. Our cash is invested in short-term money market investments backed by U.S. Treasury notes and other investments that mature within one year and whose principal is not subject to market rate fluctuations. Accordingly, interest rate declines would adversely affect our interest income but would not affect the carrying value of our cash investments. Based on a sensitivity analysis of our cash investments during the quarter ended September 30, 2008, a decline of 1% in interest rates would not have had a material effect on our quarterly interest income.

Our bank credit line facilities of up to $4.0 million have variable interest rates based upon the lender's index rate plus 0.5% for both the domestic line (up to $2.5 million) and the international line (up to $1.5 million). Accordingly, interest rate increases would increase our interest expense on our outstanding credit line balances. We utilized only a portion our credit line facility during the second and third quarters of 2008. In the first quarter of 2008 and in each quarter of fiscal year 2007 we utilized the credit line facility only at the end of the quarter and therefore did not subject ourselves to significant interest rate exposure in such quarters. Based on a sensitivity analysis, an increase of 1% in the interest rate would increase our borrowing costs by $10,000 for each $1 million of borrowings, if outstanding for the entire year, against our bank credit facility or a maximum of $40,000 if we utilized our entire credit line.

Foreign Currency Risk

A substantial majority of our revenue, expense and purchasing activities are transacted in U.S. dollars. However, we require our European distributors to purchase our products in Euros, we pay the expenses of our European employees in Euros and British pounds, and we may enter into selected future purchase commitments with foreign suppliers that may be paid in the local currency of the supplier. We hedge a significant portion of our European receivables balance denominated in Euros to reduce the foreign currency risk associated with these assets, and we have not been subject to significant losses from material foreign currency fluctuations. Based on a sensitivity analysis of our net foreign currency denominated assets and subsidiary expenses at the beginning, during and at the end of the quarter ended September 30, 2008, an adverse change of 10% in exchange rates would result in an increase in our net loss for the third quarter of approximately $58,000, if left unprotected. For the third quarter of 2008 the total net adjustment for the effects of changes in foreign currency on cash balances, collections, payables, and derivatives was a net loss of $10,400. We will continue to monitor, assess, and mitigate through hedging activities, the risk associated with these exposures.

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Item 4T. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1A. Risk Factors

There are no material changes to the risk factors described in Part I, "Item 1A. Risk Factors," in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007, with the exception of the risk factor titled, "*Our Common Stock will become ineligible for listing on the NASDAQ Capital Market if it does not trade at or above $1.00, which would materially adversely affect the liquidity and price of our Common Stock*," which has been deleted from the risk factors presented below to reflect that a reverse stock split of 1-for-10 approved by the Board of Directors on October 22, 2008, effective on October 23, 2008, brought our Common Stock into compliance with the minimum bid price listing requirement for continued listing on the NASDAQ Capital Market effective on November 7, 2008. In addition, the presentation of numerical amounts and percentages in the following risk factors below titled: "*A significant portion of our revenue currently comes from two distributors, and any decrease in revenue from these distributors could harm our business;" "Our operating results could be harmed by economic, political, regulatory and other risks associated with export sales;" "The sale of a substantial number of shares of our Common Stock could cause the market price of our Common Stock to decline;" and "Volatility in the trading price of our Common Stock could negatively impact the price of our Common Stock*," have been updated to reflect third quarter of 2008 information.

The risks described in our Annual Report on Form 10-K and updated in this Report on Form 10-Q, are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, and operating results.

We have a history of operating losses and may not achieve ongoing profitability.

We were unprofitable in each of the first three quarters of 2008 and in each of the quarters in fiscal years 2007 and 2006. We were profitable in two quarters in 2005, but unprofitable for fiscal year 2005. Fiscal year 2004 was the first profitable year in our history, but only to the extent of $288,000. Prior to 2004, we incurred significant operating losses in each financial period since our inception. To achieve ongoing profitability, we must accomplish numerous objectives, including growth in our business and the development of successful new products. We cannot foresee with any certainty whether we will be able to achieve these objectives in the future. Accordingly, we may not generate sufficient net revenue or manage our expenses sufficiently to achieve ongoing profitability. If we cannot achieve ongoing profitability, we will not be able to support our operations from positive cash flows, and we would use our existing cash and bank line of credit to support operating losses. If we are unable to secure the necessary capital to replace that cash, we may need to suspend some or all of our current operations.

We may require additional capital in the future, but that capital may not be available on reasonable terms, if at all, or on terms that would not cause substantial dilution to your stock holdings.

Although we do not anticipate the need to raise additional capital during the next twelve months to fund our operations, we may incur operating losses in future quarters and may need to raise capital to fund these losses. Our forecasts are highly dependent on factors beyond our control, including market acceptance of our products and sales of handheld computers. If capital requirements vary materially from those currently planned, we may require additional capital sooner than expected. There can be no assurance that such capital will be available in sufficient amounts or on terms acceptable to us, if at all. In addition, the availability of our bank line is dependent upon our maintaining minimum levels of tangible net worth. Future operating losses could cause us to lose the availability of our bank line as a result of becoming non-compliant with this covenant.

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If third parties do not produce and sell innovative products with which our products are compatible, or if our own line of mobile handheld computers is not successful, we may not achieve our sales projections.

Our success has been dependent upon the ability of third parties in the mobile personal computer industry to complete development of products that include or are compatible with our technology and then to sell these products into the marketplace. Even if we are successful in marketing and selling our new line of mobile handheld computers, our ability to generate increased revenue depends significantly on the commercial success of Windows mobile products, particularly the standard Pocket PC handhelds, phone-integrated devices, and tablets, and other phone-integrated devices including those from Palm, Nokia, and Blackberry, for use with our plug-in and wireless peripherals, and the adoption of these mobile computer devices for business use. If manufacturers are unable or choose not to ship new products such as Pocket PC and other Windows mobile devices, or experience difficulties with new product transitions that cause delays in the market as we experienced in the past three years, or if these products, including our new line of mobile handheld computers, the first model of which we began shipping in June 2007, fail to achieve or maintain market acceptance, the number of our potential new customers would be reduced and we would not be able to meet our sales expectations.

If we fail to develop and introduce new products rapidly and successfully, we will not be able to compete effectively, and our ability to generate sufficient revenues will be negatively affected.

The market for our products is prone to rapidly changing technology, evolving industry standards and short product life cycles. If we are unsuccessful at developing and introducing new products and services on a timely basis that include the latest technologies conforming to the newest standards and that are appealing to end users, we will not be able to compete effectively, and our ability to generate significant revenues will be seriously harmed.

The development of new products and services can be very difficult and requires high levels of innovation. The development process is also lengthy and costly. Short product life cycles expose our products to the risk of obsolescence and require frequent new product introductions. We will be unable to introduce new products and services into the market on a timely basis and compete successfully, if we fail to:

- identify emerging standards in the field of mobile computing products;
- enhance our products by adding additional features;
- invest significant resources in research and development, sales and marketing, and customer support;
- maintain superior or competitive performance in our products; and
- anticipate our end users' needs and technological trends accurately.

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We cannot be sure that we will have sufficient resources to make adequate investments in research and development or that we will be able to identify trends or make the technological advances necessary to be competitive.

A significant portion of our revenue currently comes from two distributors, and any decrease in revenue from these distributors could harm our business.

A significant portion of our revenue comes from two distributors, Tech Data Corp. and Ingram Micro, Inc., which together represented approximately 31% and 37% of our worldwide revenue in the first nine months of 2008 and fiscal year 2007, respectively. We expect that a significant portion of our revenue will continue to depend on sales to Tech Data Corp. and Ingram Micro, Inc. We do not have long-term commitments from Tech Data Corp. or Ingram Micro, Inc. to carry our products. Either could choose to stop selling some or all of our products at any time, and each of these companies also carries our competitors' products. If we lose our relationship with Tech Data Corp. or Ingram Micro, Inc., we would experience disruption and delays in marketing our products. Additionally, a significant portion of our revenue, 22% and 15% in the third quarter and first nine months of 2008, respectively, came from Intermec Technologies Corp. We do not have a long-term commitment from Intermec Technologies, Corp. to purchase our products, and there are no assurances that sales to Intermec Technologies, Inc. in future quarters will be at comparable levels.

If the market for mobile computers experiences delays, or fails to grow, we will not achieve our sales projections.

Substantially all of our peripheral products are designed for use with mobile personal computers, including handhelds, notebook computers, tablets and handheld computers with integrated phones. If the mobile personal computer industry does not grow, if its growth slows, or if product or operating system changeovers by mobile computer manufacturers and partners cause delays in the market, as we experienced in the past three years, or if the markets for our mobile handheld computers do not grow, we will not achieve our sales projections.

Our sales will be hurt if the new technologies used in our products do not become widely adopted, or are adopted slower than expected.

Many of our products use new technologies, such as 2D bar code scanning and radio frequency identification, which are not yet widely adopted in the market. If these technologies fail to become widespread, or are adopted slower than expected, our sales will suffer.

We could face increased competition in the future, which would adversely affect our financial performance.

The market for mobile handheld computers in which we operate is very competitive. Our future financial performance is contingent on a number of unpredictable factors, including that:

- some of our competitors have greater financial, marketing, and technical resources than we do;
- we periodically face intense price competition, particularly when our competitors have excess inventories and discount their prices to clear their inventories; and

- certain OEMs of personal computers, mobile phones and handheld computers offer built-in functions, such as Bluetooth wireless technology, Wi-Fi, or bar code scanning, that compete with our products.

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Increased competition could result in price reductions, fewer customer orders, reduced margins, and loss of market share. Our failure to compete successfully against current or future competitors could harm our business, operating results and financial condition.

If we do not correctly anticipate demand for our products, our operating results will suffer.

The demand for our products depends on many factors and is difficult to forecast. We expect that it will become more difficult to forecast demand as we introduce and support more products and as competition in the market for our products intensifies. If demand increases beyond forecasted levels, we would have to rapidly increase production at our third party manufacturers. We depend on suppliers to provide additional volumes of components, and suppliers might not be able to increase production rapidly enough to meet unexpected demand. Even if we were able to procure enough components, our third party manufacturers might not be able to produce enough of our devices to meet our customer demand. In addition, rapid increases in production levels to meet unanticipated demand could result in higher costs for manufacturing and supply of components and other expenses. These higher costs could lower our profit margins. Further, if production is increased rapidly, manufacturing yields could decline, which may also lower operating results.

If demand is lower than forecasted levels, we could have excess production resulting in higher inventories of finished products and components, which could lead to write-downs or write-offs of some or all of the excess inventories, and reductions in our cash balances. Lower than forecasted demand could also result in excess manufacturing capacity at our third party manufacturers and in our failure to meet minimum purchase commitments, each of which may lower our operating results.

We rely primarily on distributors, resellers, vertical industry partners, and OEMs to sell our products, and our sales would suffer if any of these third parties stops selling our products effectively.

Because we sell our products primarily through distributors, resellers, vertical industry partners, and OEMs, we are subject to risks associated with channel distribution, such as risks related to their inventory levels and support for our products. Our distribution channels may build up inventories in anticipation of growth in their sales. If such growth in their sales does not occur as anticipated, the inventory build up could contribute to higher levels of product returns. The lack of sales by any one significant participant in our distribution channels could result in excess inventories and adversely affect our operating results.

Our agreements with distributors, resellers, vertical industry partners, and OEMs are generally nonexclusive and may be terminated on short notice by them without cause. Our distributors, resellers, vertical industry partners, and OEMs are not within our control, are not obligated to purchase products from us, and may offer competitive lines of products simultaneously. Sales growth is contingent in part on our ability to enter into additional distribution relationships and expand our sales channels. We cannot predict whether we will be successful in establishing new distribution relationships, expanding our sales channels or maintaining our existing relationships. A failure to enter into new distribution relationships or to expand our sales channels could adversely impact our ability to grow our sales.

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We allow our distribution channels to return a portion of their inventory to us for full credit against other purchases. In addition, in the event we reduce our prices, we credit our distributors for the difference between the purchase price of products remaining in their inventory and our reduced price for such products. Actual returns and price protection may adversely affect future operating results, particularly since we seek to continually introduce new and enhanced products and are likely to face increasing price competition.

We depend on alliances and other business relationships with a small number of third parties, and a disruption in any one of these relationships would hinder our ability to develop and sell our products.

We depend on strategic alliances and business relationships with leading participants in various segments of the communications and mobile handheld computer markets to help us develop and market our products. Our strategic partners may revoke their commitment to our products or services at any time in the future or may develop their own competitive products or services. Accordingly, our strategic relationships may not result in sustained business alliances, successful product or service offerings, or the generation of significant revenues. Failure of one or more of such alliances could result in delay or termination of product development projects, failure to win new customers, or loss of confidence by current or potential customers.

We have devoted significant research and development resources to design activities for Windows-mobile products, Palm and Blackberry devices, handheld computers with integrated phones using Windows Mobile and Symbian System 60 and 80 operating systems, and more recently, to develop our own family of mobile handheld computers. Such design activities have diverted financial and personnel resources from other development projects. These design activities are not undertaken pursuant to any agreement under which Microsoft, Palm, Research In Motion, or Symbian is obligated to continue the collaboration or to support the products produced from the collaboration. Consequently, these organizations may terminate their collaborations with us for a variety of reasons, including our failure to meet agreed-upon standards or for reasons beyond our control, such as changing market conditions, increased competition, discontinued product lines, and product obsolescence.

Our intellectual property and proprietary rights may be insufficient to protect our competitive position.

Our business depends on our ability to protect our intellectual property. We rely primarily on patent, copyright, trademark, trade secret laws, and other restrictions on disclosure to protect our proprietary technologies. We cannot be sure that these measures will provide meaningful protection for our proprietary technologies and processes. We cannot be sure that any patent issued to us will be sufficient to protect our technology. The failure of any patents to provide protection to our technology would make it easier for our competitors to offer similar products. In connection with our participation in the development of various industry standards, we may be required to license certain of our patents to other parties, including our competitors, that develop products based upon the adopted standards.

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We also generally enter into confidentiality agreements with our employees, distributors, and strategic partners, and generally control access to our documentation and other proprietary information. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our products, services, or technology without authorization, develop similar technology independently, or design around our patents.

Effective copyright, trademark, and trade secret protection may be unavailable or limited in certain foreign countries. Furthermore, certain of our customers have entered into agreements with us which provide that the customers have the right to use our proprietary technology in the event we default in our contractual obligations, including product supply obligations, and fail to cure the default within a specified period of time.

We may become subject to claims of intellectual property rights infringement, which could result in substantial liability.

In the course of operating our business, we may receive claims of intellectual property infringement or otherwise become aware of potentially relevant patents or other intellectual property rights held by other parties. Many of our competitors have large intellectual property portfolios, including patents that may cover technologies that are relevant to our business. In addition, many smaller companies, universities, and individuals have obtained or applied for patents in areas of technology that may relate to our business. The industry is moving towards aggressive assertion, licensing, and litigation of patents and other intellectual property rights. In June 2007, we received a letter from Wi-LAN, Inc., accusing certain of our wireless LAN products of infringing two U.S. and one Canadian patent held by Wi-LAN, Inc. In October 2007, Wi-LAN, Inc. filed patent infringement lawsuits against a number of companies alleging that those companies infringe the two U.S. patents by manufacturing, using, or offering for sale products with wireless capability compliant with the IEEE 802.11 standards. Wi-LAN, Inc. is asking for money damages and a court order barring the sale of products that use the patented technology. We have not been named in the lawsuit, and we do not plan to make any changes to our current business at this time. Nonetheless, we may be added to the lawsuit in the future, and even if we are not, the outcome of this lawsuit may result in future changes to our business, including potential increased costs for those of our products that make use of the related technology. In October 2007, we received a letter from WIAV Solutions, LLC, offering to license the wireless technology covered by two U.S. patents held by WIAV Solutions, LLC. The two patents cover implementations of the 802.11 standard. To date we have not entered into discussions to license their technology.

If we are unable to obtain and maintain licenses on favorable terms for intellectual property rights required for the manufacture, sale, and use of our products, particularly those products which must comply with industry standard protocols and specifications to be commercially viable, our results of operations or financial condition could be adversely impacted.

In addition to disputes relating to the validity or alleged infringement of other parties' rights, we may become involved in disputes relating to our assertion of our own intellectual property rights. Whether we are defending the assertion of intellectual property rights against us or asserting our intellectual property rights against others, intellectual property litigation can be complex, costly, protracted, and highly disruptive to business operations by diverting the attention and energies of management and key technical personnel. Plaintiffs in intellectual property cases often seek injunctive relief, and the measures of damages in intellectual property litigation are complex and often subjective or uncertain. Thus, any adverse determinations in this type of litigation could subject us to significant liabilities and costs.

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New industry standards may require us to redesign our products, which could substantially increase our operating expenses.

Standards for the form and functionality of our products are established by standards committees. These independent committees establish standards, which evolve and change over time, for different categories of our products. We must continue to identify and ensure compliance with evolving industry standards so that our products are interoperable and we remain competitive. Unanticipated changes in industry standards could render our products incompatible with products developed by major hardware manufacturers and software developers. Should any major changes, even if anticipated, occur, we would be required to invest significant time and resources to redesign our products to ensure compliance with relevant standards. If our products are not in compliance with prevailing industry standards for a significant period of time, we would miss opportunities to sell our products for use with new hardware components from mobile computer manufacturers and OEMs, thus affecting our business.

Undetected flaws and defects in our products may disrupt product sales and result in expensive and time-consuming remedial action.

Our hardware and software products may contain undetected flaws, which may not be discovered until customers have used the products. From time to time, we may temporarily suspend or delay shipments or divert development resources from other projects to correct a particular product deficiency. Efforts to identify and correct errors and make design changes may be expensive and time consuming. Failure to discover product deficiencies in the future could delay product introductions or shipments, require us to recall previously shipped products to make design modifications, or cause unfavorable publicity, any of which could adversely affect our business and operating results.

Our quarterly operating results may fluctuate in future periods, which could cause our stock price to decline.

We expect to experience quarterly fluctuations in operating results in the future. We generally ship orders as received, and as a result we may have little backlog. Quarterly revenues and operating results therefore depend on the volume and timing of orders received during the quarter, which are difficult to forecast. Historically, we have often recognized a substantial portion of our revenue in the last month of the quarter. This subjects us to the risk that even modest delays in orders may adversely affect our quarterly operating results. Our operating results may also fluctuate due to factors such as:

- the demand for our products;
- the size and timing of customer orders;
- unanticipated delays or problems in our introduction of new products and product enhancements;
- the introduction of new products and product enhancements by our competitors;
- the timing of the introduction of new products that work with our connection products;
- changes in the revenues attributable to royalties and engineering development services;
- product mix;
- timing of software enhancements;
- changes in the level of operating expenses;
- competitive conditions in the industry including competitive pressures resulting in lower average selling prices; and
- timing of distributors' shipments to their customers.

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Because we base our staffing and other operating expenses on anticipated revenues, delays in the receipt of orders can cause significant variations in operating results from quarter to quarter. As a result of any of the foregoing factors, or a combination, our results of operations in any given quarter may be below the expectations of public market analysts or investors, in which case the market price of our Common Stock would be adversely affected.

The loss of one or more of our senior personnel could harm our existing business.

A number of our officers and senior managers have been employed for thirteen to sixteen years by us, including our President, Executive Vice President, Chief Financial Officer, and Chief Technical Officer. Our future success will depend upon the continued service of key officers and senior managers. Competition for officers and senior managers is intense, and there can be no assurance that we will be able to retain our existing senior personnel. The loss of one or more of our officers or key senior managers could adversely affect our ability to compete.

Beginning January 1, 2006 we began to expense options granted under our employee stock plans as compensation, and as a result our net income and earnings per share were negatively affected, we may continue to have net losses as a result of the requirement to expense options, and may find it necessary to change our business practices to attract and retain employees.

Historically, we have used stock options as a key component of our employee compensation packages. We believe that stock options provide an incentive to our employees to maximize long-term stockholder value and, through the use of vesting, encourage valued employees to remain with us. The expensing of employee stock options adversely affected our net income and earnings per share in the first two quarters of 2008 and in each of the quarters of fiscal years 2007 and 2006, will continue to adversely affect future quarters, and will make profitability harder to achieve or make our future profits or net losses worse. In addition, we may decide in response to the effects of expensing stock options on our operating results to reduce the number of stock options granted to employees or to grant options to fewer employees. This could adversely affect our ability to retain existing employees and attract qualified candidates, and also could increase the cash compensation we would have to pay to them.

If we are unable to attract and retain highly skilled sales and marketing and product development personnel, our ability to develop and market new products and product enhancements will be adversely affected.

We believe our ability to achieve increased revenues and to develop successful new products and product enhancements will depend in part upon our ability to attract and retain highly skilled sales and marketing and product development personnel. Our products involve a number of new and evolving technologies, and we frequently need to apply these technologies to the unique requirements of mobile products. Our personnel must be familiar with both the technologies we support and the unique requirements of the products to which our products connect. Competition for such personnel is intense, and we may not be able to attract and retain such key personnel. In addition, our ability to hire and retain such key personnel will depend upon our ability to raise capital or achieve increased revenue levels to fund the costs associated with such key personnel. Failure to attract and retain such key personnel will adversely affect our ability to develop and market new products and product enhancements.

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We may not be able to collect revenues from customers who experience financial difficulties.

Our accounts receivable are derived primarily from distributors and OEMs. We perform ongoing credit evaluations of our customers' financial conditions but generally require no collateral from our customers. Reserves are maintained for potential credit losses, and such losses have historically been within such reserves. However, many of our customers may be thinly capitalized and may be prone to failure in adverse market conditions. Although our collection history has been good, from time to time a customer may not pay us because of financial difficulty, bankruptcy or liquidation. The current global financial crisis may have an impact on our customers' ability to pay us in a timely manner, and consequently, we may experience increased difficulty in collecting our accounts receivable, and we may have to increase our reserves in anticipation of increased uncollectible accounts.

We may be unable to manufacture our products, because we are dependent on a limited number of qualified suppliers for our components.

Several of our component parts, including our serial interface chip, our Ethernet chip, our bar code scanning modules, and our new line of mobile handheld computers, are produced by one or a limited number of suppliers. Shortages could occur in these essential components due to an interruption of supply or increased demand in the industry. If we are unable to procure certain component parts, we could be required to reduce our operations while we seek alternative sources for these components, which could have a material adverse effect on our financial results. To the extent that we acquire extra inventory stocks to protect against possible shortages, we would be exposed to additional risks associated with holding inventory, such as obsolescence, excess quantities, or loss.

Our operating results could be harmed by economic, political, regulatory and other risks associated with export sales.

Export sales (sales to customers outside the United States) accounted for approximately 35% of our revenue in both the first nine months of 2008 and in fiscal year 2007. Accordingly, our operating results are subject to the risks inherent in export sales, including:

- longer payment cycles;
- unexpected changes in regulatory requirements, import and export restrictions and tariffs;
- difficulties in managing foreign operations;
- the burdens of complying with a variety of foreign laws;
- greater difficulty or delay in accounts receivable collection;
- potentially adverse tax consequences; and
- political and economic instability.

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Our export sales are primarily denominated in United States dollars and in Euros for our sales to European distributors. Accordingly, an increase in the value of the United States dollar relative to foreign currencies could make our products more expensive and therefore potentially less competitive in foreign markets. Declines in the value of the

Euro relative to the United States dollar may result in foreign currency losses relating to collection of Euro denominated receivables if left unhedged.

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, and other events beyond our control.

Our corporate headquarters is located near an earthquake fault. The potential impact of a major earthquake on our facilities, infrastructure, and overall business is unknown. Additionally, we may experience electrical power blackouts or natural disasters that could interrupt our business. Should a disaster be widespread, such as a major earthquake, or result in the loss of key personnel, we may not be able to implement our disaster recovery plan in a timely manner. Any losses or damages incurred by us as a result of these events could have a material adverse effect on our business.

Failure to maintain effective internal controls could have a material adverse effect on our business, operating results and stock price.

We have evaluated and will continue to evaluate our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act, which requires an annual management assessment of the design and effectiveness of our internal controls over financial reporting. If we fail to maintain the aze="1" face="Times New Roman" style="font-size:1.0pt;">

Tax-exempt loans	$	7,857	$	485

6.17

%

$

8,173

$

503

6.15

%

$

5,370

$

307

5.72

%

All other loans

353,528

25,779

7.29

%

344,524

24,545

7.12

%

325,177

21,924

6.74

%

Total loans

361,385

26,264

7.27

%

352,697

25,048

7.10

%

330,547

22,231

6.73

%

Taxable securities

93,480

5,474

5.86

%

91,767

4,837

5.27

%

115,041

5,529

4.81

%

Tax-exempt securitites

99,728

6,602

6.62

%

92,692

6,102

6.58

%

72,892

4,882

6.70

%

Total securities

193,208

12,076

6.25

%

184,459

10,939

5.93

%

187,933

10,411

5.54

%

Interest-bearing deposits	
	345
	19
	5.51
%	
	152
	11
	7.24
%	
	873
	25
	2.86
%	

Total interest-earning assets	
	554,938
	38,359
	6.91
%	
	537,308
	35,998

6.70

%

519,353

32,667

6.29

%

Other assets

42,602

40,413

33,308

Total assets		
$	597,540	
$	577,721	
$	552,661	

LIABILITIES:

Savings

$

58,710

428

0.73

%

$

61,958

509

0.82

%

$

64,795

500

0.77

%

Super Now deposits

46,596

611

1.31

%

47,294

655

1.38

%

50,756

438

0.86

%

Money market deposits

23,920

540

2.26

%

23,905

493

2.06

%

29,317

412

1.41

%

Time deposits

198,029

9,372

4.73

%

176,521

7,251

4.11

%

146,391

4,424

3.02

%

Total deposits

327,255

10,951

3.35

%

309,678

8,908

2.88

%

291,259

5,774

1.98

%

Short-term borrowings

36,816

1,639

4.45

%

34,612

1,503

4.34

%

32,114

931

2.90

%

Long-term borrowings

83,490

3,857

4.62

%

83,237

3,799

4.56

%

80,820

3,676

4.55

%

Total borrowings

120,306

5,496

4.57

%

117,849

5,302

4.50

%

112,934

4,607

4.08

%

Total interest-bearing liabilities	447,561	16,447	3.67 %	427,527	14,210	3.32 %
	404,193	10,381	2.57 %			

Demand deposits	
	69,953
	69,668
	69,457

Other liabilities	
	6,924
	5,899
	4,057
Shareholders equity	
	73,102

74,627

74,954

TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	597,540
	$	577,721
	$	552,661
Interest rate spread		

3.24

%

3.38

%

3.72

%

Net interest income/margin

$

21,912

3.95

%

$

21,788

4.06

%

$

22,286

4.29

%

Fees on loans are included with interest on loans. Loan fees are included in interest income as follows: 2007 $453,000, 2006 $478,000, 2005 $491,000

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

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

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

Reconcilement of Taxable Equivalent Net Interest Income

	2007	2006	2005
Total interest income	$ 35,949	$ 33,753	$ 30,903
Total interest expense	16,447	14,210	10,381
Net interest income	19,502	19,543	20,522
Tax equivalent adjustment	2,410	2,245	1,764
Net interest income (fully taxable equivalent)	$ 21,912	$ 21,788	$ 22,286

Rate/Volume Analysis

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

	Year Ended December 31,					
	2007 vs 2006 Increase (Decrease) Due to			2006 vs 2005 Increase (Decrease) Due to		
(In Thousands)	Volume	Rate	Net	Volume	Rate	Net
Interest income:						
Loans, tax-exempt	$ (20)	$ 2	$ (18)	$ 174	$ 22	$ 196
Loans	650	584	1,234	1,342	1,279	2,621
Taxable investment securities	88	549	637	(1,192)	500	(692)
Tax-exempt investment securities	466	34	500	1,304	(84)	1,220
Interest-bearing deposits	12	(4)	8	(32)	18	(14)
Total interest-earning assets	1,196	1,165	2,361	1,596	1,735	3,331
Interest expenses:						
Savings deposits	(30)	(51)	(81)	(23)	32	9
Super Now deposits	(10)	(34)	(44)	(32)	249	217
Money market deposits		47	47	(86)	167	81
Time deposits	344	1,777	2,121	471	2,356	2,827
Short-term borrowings	100	36	136	65	507	572
Long-term borrowings	12	46	58	110	13	123
Total interest-bearing liabilities	416	1,821	2,237	505	3,324	3,829
Change in net interest income	$ 780	$ (656)	$ 124	$ 1,091	$ (1,589)	$ (498)

PROVISION FOR LOAN LOSSES

2007 vs 2006

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

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

Although management believes that it uses the best information available to make such determinations and that the allowance for loan losses is adequate at December 31, 2007, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy or employment and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in interest income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Bank s loan loss allowance. The banking regulators could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

The allowance for loan losses decreased from $4,185,000 at December 31, 2006 to $4,130,000 at December 31, 2007. At December 31, 2007, allowance for loan losses was 1.15% of total loans compared to 1.16% of total loans at December 31, 2006. Management s conclusion is that the allowance for loan losses is adequate to provide for probable losses inherent in its loan portfolio as of the consolidated balance sheet date.

The provision for loan losses totaled $150,000 for the year ended December 31, 2007. The provision for the same period in 2006 was $635,000. Management concluded that the decrease of the provision was appropriate when considering the gross loan growth experienced during 2007 of $94,000 coupled with the low levels of charge-offs and delinquencies during the year. Utilizing both internal and external resources, as noted, senior management has concluded that the allowance for loan losses remains at a level adequate to provide for probable losses inherent in the loan portfolio.

2006 vs 2005

The allowance for loan losses increased 13.8% or $506,000 from fiscal 2005 after net charge-offs of $129,000 contributed to a year-end allowance for loan losses of $4,185,000 or 1.16% of total loans. Based upon this analysis, as well as the others noted above, senior management concluded that the allowance for loan losses was at a level adequate to provide for probable losses inherent in the loan portfolio at December 31, 2006.

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

(In Thousands)	**2007**	**2006**	**2005**	**2004**	**2003**
Balance at beginning of period	$ 4,185	$ 3,679	$ 3,338	$ 3,069	$ 2,953
Charge-offs:					
Real estate		50	132	121	63
Commercial and industrial	103	28	206	50	37
Installment loans to individuals	201	249	108	112	116
Total charge-offs	304	327	446	283	216
Recoveries:					
Real estate	13	68	45	50	42
Commercial and industrial	1	40	8	4	16
Installment loans to individuals	85	90	14	33	19
Total recoveries	99	198	67	87	77
Net charge-offs	205	129	379	196	139
Additions charged to operations	150	635	720	465	255
Balance at end of period	$ 4,130	$ 4,185	$ 3,679	$ 3,338	$ 3,069
Ratio of net charge-offs during the period to average loans outstanding during the period	0.06%	0.04%	0.11%	0.06%	0.05%

NON-INTEREST INCOME

2007 vs 2006

Total non-interest income decreased $1,551,000 from the year ended December 31, 2007 to 2006. Excluding security (loss) gains and the gain on sale of loans, non-interest income increased $114,000. Service charges decreased $120,000 as overdraft protection fees declined and customers migrated to new checking accounts having reduced or no service charges. Earnings on bank-owned life insurance increased $36,000. Insurance commissions decreased $59,000 due to a reduction in the overall commission, from the underwriter, that The M Group receives on each insurance contract written. Management of The M Group continues to pursue new and build upon current relationships.

However, the sales cycle for insurance and investment products can take typically from six months to one year or more to complete. The sales call program continues to expand to other financial institutions, which results in additional revenue for The M Group. The increase in other income was primarily due to increases in revenues from debit card transactions, merchant card commissions, and commissions generated by The M Group for securities transactions.

	2007		2006		Change	
(In Thousands)	Amount	% Total	Amount	% Total	Amount	%
Deposit service charges	$ 2,246	30.03%	$ 2,366	26.20%	$ (120)	(5.07)%
Securities (losses) gains, net	(54)	(0.72)	1,679	18.60	(1,733)	(103.22)
Bank-owned life insurance	410	5.48	374	4.14	36	9.63
Gain on sale of loans	921	12.32	853	9.45	68	7.97
Insurance commissions	2,222	29.72	2,281	25.26	(59)	(2.59)
Other income	1,733	23.17	1,476	16.35	257	17.41
Total non-interest income	$ 7,478	100.00%	$ 9,029	100.00%	$ (1,551)	(17.18)%

2006 vs 2005

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

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

NON-INTEREST EXPENSES

2007 vs 2006

Total non-interest expenses increased $987,000 from the year ended December 31, 2006 to December 31, 2007. Salaries and employee benefits increased by $245,000 and were attributed to several items including standard cost of living wage adjustments for employees, full year impact of the Montoursville branch, and increased benefit costs. Occupancy expense increased due to the new branch in Montoursville, which opened in the third quarter of 2006, and increased cost of maintenance and property taxes. Amortization increase attributed to low income housing partnership that began operation during the fourth quarter of 2006.

	2007		2006		Change	
(In Thousands)	**Amount**	**% Total**	**Amount**	**% Total**	**Amount**	**%**
Salaries and employee benefits	$ 9,078	52.43%	$ 8,833	54.09%	$ 245	2.77%
Occupancy, net	1,306	7.54	1,137	6.96	169	14.86
Furniture and equipment	1,126	6.50	1,201	7.36	(75)	(6.24)
Pennsylvania shares tax	643	3.71	598	3.66	45	7.53
Amortization of investment in limited partnership	761	4.39	245	1.50	516	210.61
Other expenses	4,402	25.43	4,315	26.43	87	2.02
Total non-interest expense	$ 17,316	100.00%	$ 16,329	100.00%	$ 987	6.04%

2006 vs 2005

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

	2006		2005		Change	
(In Thousands)	**Amount**	**% Total**	**Amount**	**% Total**	**Amount**	**%**
Salaries and employee benefits	$ 8,833	54.09%	$ 8,314	55.03%	$ 519	6.24%
Occupancy, net	1,137	6.96	1,089	7.21	48	4.41
Furniture and equipment	1,201	7.36	973	6.44	228	23.43
Pennsylvania shares tax	598	3.66	549	3.63	49	8.93
Amortization of investment in limited partnership	245	1.50	90	0.60	155	172.22
Other expenses	4,315	26.43	4,093	27.09	222	5.42
Total non-interest expense	$ 16,329	100.00%	$ 15,108	100.00%	$ 1,221	8.08%

INCOME TAXES

2007 vs 2006

The provision for income taxes for the year ended December 31, 2007 resulted in an effective income tax rate of 6.7% compared to 16.9% for 2006. This decrease is the result of a shift in the investment portfolio from taxable mortgage-backed bonds to tax-exempt municipal bonds coupled with the receipt of tax credits related to low income housing partnerships.

2006 vs 2005

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

FINANCIAL CONDITION

INVESTMENTS

2007

The estimated fair value of the investment portfolio increased $29,429,000 or 15.77% from December 31, 2006 to 2007, while the amortized cost increased $35,762,000 over the same period. The majority of the changes in value occurred within the state and municipal segment of the portfolio. The amortized cost position in state and political securities increased $14,993,000 as the Bank continued to build call protection, maintain taxable equivalent yields, reduce the effective federal income tax rate, and invest in communities across the Commonwealth of Pennsylvania and the country. The amortized cost position of other debt securities increased $13,919,000 as the Bank began a new leverage transaction to enhance net interest income, return on average assets, and return on average equity. The increased level of unrealized losses, which offset the increase in amortized cost, was the result of changes in the yield curve, not credit quality, as the credit quality of the portfolio remains sound.

2006

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

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

	2007		2006		2005	
(In Thousands)	**Balance**	**% Portfolio**	**Balance**	**% Portfolio**	**Balance**	**% Portfolio**
U.S. Treasury securities:						
Available for Sale	$		$		$	
U.S. Government agencies:						
Held to Maturity	14	0.01%	26	0.01%	28	0.01%
Available for Sale	62,904	29.29%	54,152	29.20%	63,953	34.15%
State and political subdivisions (tax-exempt):						
Held to Maturity						
Available for Sale	107,314	49.98%	103,057	55.56%	89,265	47.66%
State and political subdivisions (taxable):						
Held to Maturity						
Available for Sale	10,501	4.89%	2,889	1.56%	4,826	2.58%

Other bonds, notes and debentures:									
Held to Maturity		263	0.12%		257	0.14%		237	0.13%
Available for Sale		15,767	7.34%		2,024	1.09%		1,719	0.92%
Total bonds, notes and debentures		196,763	91.63%		162,405	87.56%		160,028	85.45%
Corporate stock - Available for Sale		17,969	8.37%		23,078	12.44%		27,255	14.55%
Total	$	214,732	100.00%	$	185,483	100.00%	$	187,283	100.00%

The following table shows the maturities and repricing of investment securities, at amortized cost, at December 31, 2007 and the weighted average yields (for tax-exempt obligations on a fully taxable basis assuming a 34% tax rate) of such:

(In Thousands)		Within One Year		After One But Within Five Years		After Five But Within Ten Years		After Ten Years		Amortized Cost Total
U.S. Treasury securities:										
HTM Amount	$		$		$		$		$	
Yield										
AFS Amount										
Yield										
U.S. Government agencies:										
HTM Amount								14		14
Yield								9.07%		9.07%
AFS Amount				750				61,632		62,382
Yield				5.02%				5.81%		5.80%
State and political subdivisions(tax-exempt):										
HTM Amount										
Yield										
AFS Amount						392		108,355		108,747
Yield						6.24%		4.31%		4.32%
State and political subdivisions(taxable):										
HTM Amount										
Yield										
AFS Amount								10,904		10,904
Yield								5.41%		5.41%
Other bonds, notes and debentures:										
HTM Amount		50		123		90				263
Yield		5.83%		6.37%		5.77%				6.06%
AFS Amount		75		50		3		15,789		15,917
Yield		4.96%		6.45%		5.54%		6.18%		6.18%
Total Amount	$	125	$	923	$	485	$	196,694	$	198,227
Total Yield		5.31%		5.28%		6.15%		4.99%		5.00%
Equity Securities									$	19,776
Total Investment Portfolio Value									$	218,003
Total Investment Portfolio Yield										4.54%

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

2007

Gross loans of $360,478,000 at December 31, 2007 represented an increase of $94,000 from December 31, 2006. The continued emphasis on well collateralized real estate loans resulted in real estate secured loans increasing $1,991,000 from December 31, 2006 to 2007. The success in carrying out this long term strategy has played a significant role in limiting net charge-offs for 2007 to 0.06% of average loans. Commercial and agricultural loans declined due to the before mentioned emphasis on real estate secured loans versus equipment, receivables, or inventory secured loans.

2006

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

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

(In Thousands)	**2007**	**2006**	**2005**	**2004**	**2003**
Commercial and agricultural	$ 35,739	$ 36,995	$ 37,553	$ 31,100	$ 24,520
Real estate mortgage:					
Residential	163,268	158,219	150,000	147,461	147,697
Commercial	132,943	135,404	127,131	123,757	82,896
Construction	16,152	16,749	10,681	8,365	7,652
Installment loans to individuals	13,317	14,035	14,135	14,918	14,003
Less: Net deferred loan fees	941	1,018	1,062	1,096	940
Gross loans	$ 360,478	$ 360,384	$ 338,438	$ 324,505	$ 275,828

The amounts of domestic loans at December 31, 2007 are presented below by category and maturity:

(In Thousands)	**Real Estate**	**Commercial and Other**	**Installment Loans to Individuals**	**Total**
Loans with floating interest rates:				
1 year or less	$ 25,014	$ 9,105	$ 2,258	$ 36,377
1 through 5 years	9,215	1,608	151	10,974
5 through 10 years	28,421	4,421	6	32,848
After 10 years	196,938	1,918	391	199,247
Total floating interest rate loans	259,588	17,052	2,806	279,446
Loans with predetermined interest rates:				
1 year or less	5,609	1,091	1,355	8,055
1 through 5 years	15,843	9,992	8,495	34,330
5 through 10 years	19,578	7,693	646	27,917
After 10 years	10,480	189	61	10,730
Total predetermined interest rate loans	51,510	18,965	10,557	81,032
Total	$ 311,098	$ 36,017	$ 13,363	$ 360,478

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

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

The Bank does not make loans that provide for negative amortization nor do any loans contain conversion features. The Bank does not have any foreign loans outstanding at December 31, 2007.

ALLOWANCE FOR LOAN LOSSES

2007

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

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

Although management believes that it uses the best information available to make such determinations and that the allowance for loan losses is adequate at December 31, 2007, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy or employment and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets and charge-offs, increased loan loss provisions and reductions in interest income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Bank s loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

The allowance for loan losses decreased from $4,185,000 at December 31, 2006 to $4,130,000 at December 31, 2007. At December 31, 2007, allowance for loan losses was 1.15% of total loans compared to 1.16% of total loans at December 31, 2006. This percentage is consistent with the Bank s historical experience and peer banks. Management s conclusion is that the allowance for loan losses is adequate to provide for probable losses inherent in its loan portfolio as of the balance sheet date.

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2006

At December 31, 2006, the allowance for loan losses as a percent of total loans increased to 1.16% from 1.09% at December 31, 2005. Gross loans increased by $21,946,000 from $338,438,000 at December 31, 2005 to $360,384,000 at December 31, 2006.

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 those that have already been considered in its overall judgment of the adequacy of the reserve.

NONPERFORMING LOANS

Non-accrual loans increased to $955,000 at December 31, 2007 primarily due to the addition of a commercial real estate relationship which has filed for bankruptcy. Overall nonperforming loans increased $831,000 to $1,320,000 from fiscal year end 2006.

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

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

	Total Nonperforming Loans		
(In Thousands)	**Nonaccrual**	**90 Days Past Due**	**Total**
2007	$ 955	$ 365	$ 1,320
2006	370	119	489
2005	540	63	603
2004	1,381	345	1,726
2003	827	429	1,256

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

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

1. Economic conditions and the impact on the loan portfolio.
2. Analysis of past loan charge-offs experienced by category and comparison to outstanding loans.
3. Problem loans on overall portfolio quality.

4. Reports of examination of the loan portfolio by the Pennsylvania State Banking Department and the Federal Deposit Insurance Corporation.

Allocation In The Allowance For Loan Losses

(In Thousands)		**Amount**	**Percent Of Loan In Each Category To Total Loans**
December 31, 2007:			
Balance at end of period applicable to:			
Commercial and agricultural	$	823	9.9%
Real estate mortgage:			
Residential		1,031	45.2%
Commercial		1,634	36.8%
Construction		112	4.5%
Installment loans to individuals		228	3.6%
Unallocated		302	
Total	$	4,130	100.0%
December 31, 2006:			
Balance at end of period applicable to:			
Commercial and agricultural	$	679	7.9%
Real estate mortgage:			
Residential		951	43.8%
Commercial		1,972	37.5%
Construction		108	4.6%
Installment loans to individuals		295	6.2%
Unallocated		180	
Total	$	4,185	100.0%
December 31, 2005:			
Balance at end of period applicable to:			
Commercial and agricultural	$	582	10.1%
Real estate mortgage:			
Residential		1,107	44.2%
Commercial		1,482	37.5%
Construction		79	3.1%
Installment loans to individuals		192	5.1%
Unallocated		237	
Total	$	3,679	100.0%
December 31, 2004:			
Balance at end of period applicable to:			
Commercial and agricultural	$	361	9.1%
Real estate mortgage:			
Residential		1,280	46.1%
Commercial		1,399	37.5%
Construction		75	2.5%
Installment loans to individuals		207	4.8%
Unallocated		16	
Total	$	3,338	100.0%
December 31, 2003:			
Balance at end of period applicable to:			
Commercial and agricultural	$	353	8.5%
Real estate mortgage:			

Residential		1,483	53.4%
Commercial		916	29.9%
Construction		77	2.8%
Installment loans to individuals		240	5.4%
Total	$	3,069	100.0%

DEPOSITS

2007 vs 2006

Total average deposits were $397,208,000 for 2007, an increase of $17,862,000 or 4.71% from 2006. Noninterest-bearing deposits increased slightly to $69,953,000. Time deposits increased $21,508,000 or 12.19% as deposits shifted from transaction accounts to time deposits due to the continued rate disparity between time deposits and other deposit types. The rate on time deposits increased due to the actions taken by the FOMC during 2006, which increased the overall rate paid on time deposits. In addition, the Bank utilized brokered time deposits to supplement market area deposit funding with the level of brokered deposits decreasing $16,197,000 to $8,831,000 at December 31, 2007.

2006 vs 2005

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

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

	2007		2006		2005	
(In Thousands)	**Average Amount**	**Rate**	**Average Amount**	**Rate**	**Average Amount**	**Rate**
Noninterest-bearing	$ 69,953	0.00%	$ 69,668	0.00%	$ 69,457	0.00%
Savings	58,710	0.73%	61,958	0.82%	64,795	0.77%
Super Now	46,596	1.31%	47,294	1.38%	50,756	0.86%
Money Market	23,920	2.26%	23,905	2.06%	29,317	1.41%
Time	198,029	4.73%	176,521	4.11%	146,391	3.02%
Total average deposits	$ 397,208	2.76%	$ 379,346	2.35%	$ 360,716	1.60%

SHAREHOLDERS EQUITY

2007

Shareholders equity decreased $4,035,000 to $70,559,000 at December 31, 2007 as net income outpaced dividends paid, accumulated comprehensive income decreased $5,094,000, and $972,000 in treasury stock was strategically purchased as part of the previously announced stock buyback plan. The decrease in accumulated comprehensive income is the result of a decrease in market value, or net unrealized loss, of the investment portfolio at December 31, 2007 as compared to December 31, 2006, and the net excess of the projected benefit obligation over the market value of the plan assets of the defined benefit pension plan. The current level of shareholders equity equates to a book value per share of $18.21 at December 31, 2007 as compared to $19.12 at December 31, 2006 and an equity to asset ratio of 11.23% at December 31, 2007. During the twelve months ended December 31, 2007 cash dividends of $1.79 per share were paid to shareholders. The dividends represented a 3% increase or $0.06 per share over the dividends paid during the comparable period of 2006.

2006

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

Bank regulators have risk based capital guidelines. Under these guidelines the Company and Bank are required to maintain minimum ratios of core capital and total qualifying capital as a percentage of risk weighted assets and certain off-balance sheet items. At December 31, 2007, both the Company s and Bank s required ratios were well above the minimum ratios as follows:

	Company	Bank	Minimum Standards
Tier 1 capital ratio	10.8%	8.8%	4.0%
Total capital ratio	18.0%	15.1%	8.0%

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

RETURN ON EQUITY AND ASSETS

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

	2007	2006	2005
Percentage of net income to:			
Average total assets	1.49%	1.67%	1.97%
Average shareholders equity	12.14%	12.93%	14.54%
Percentage of dividends declared to net income	78.33%	70.51%	57.10%
Percentage of average shareholders equity to average total assets	12.23%	12.92%	13.56%

LIQUIDITY, INTEREST RATE SENSITIVITY AND MARKET RISK

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

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

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

Management monitors and determines the desirable level of liquidity. Consideration is given to loan demand, investment opportunities, deposit pricing and growth potential as well as the current cost of borrowing funds. The Company has a current borrowing capacity at the Federal Home Loan Bank of $220,053,000 with $144,538,000 utilized, leaving $75,515,000 available. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of $29,539,000. The Company s management believes that it has sufficient liquidity to satisfy estimated short-term and long-term funding needs.

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

INTEREST RATE SENSITIVITY

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

The following is a rate shock forecast for the twelve month period ended December 31, 2008 assuming a static balance sheet as of December 31, 2007.

	Parallel Rate Shock in Basis Points				
(In Thousands)	**-200**	**-100**	**Static**	**+100**	**+200**
Net interest income	$ 21,322	$ 21,484	$ 21,134	$ 20,578	$ 19,797
Change from static	188	350		(556)	(1,337)
Percent change from static	0.89%	1.66%		(2.63)%	(6.33)%

The model utilized to create the report presented above makes various estimates at each level of interest rate change regarding cash flow from principal repayment on loans and mortgage-backed securities and or call activity on investment securities. Actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change. In

addition, the limits stated above do not necessarily represent the level of change under which management would undertake specific measures to realign its portfolio in order to reduce the projected level of change. Generally, management believes the Company is well positioned to respond expeditiously when the market interest rate outlook changes.

INFLATION

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

CRITICAL ACCOUNTING POLICIES

The Company s accounting policies are integral to understanding the results reported. The accounting policies are described in detail in Note 1 of the consolidated financial statements. Our most complex accounting policies require management s judgment to ascertain the valuation of assets, liabilities, commitments, and contingencies. We have established detailed policies and control procedures that are intended to ensure valuation methods are well controlled and applied consistently from period to period. In addition, the policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. The following is a brief description of our current accounting policies involving significant management valuation judgments.

Other Than Temporary Impairment of Equity Securities

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

Allowance for Loan Losses

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

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

Consolidated Financial Statements of the Annual Report of Form 10-K.

Goodwill and Other Intangible Assets

As discussed in Note 6 of the Notes to Consolidated Financial Statements of the Annual Report on Form 10-K, the Company must assess goodwill and other intangible assets each year for impairment.

This assessment involves estimating cash flows for future periods. If the future cash flows were less than the recorded goodwill and other intangible assets balances, we would be required to take a charge against earnings to write down the assets to the lower value.

Deferred Tax Assets

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

Pension Benefits

Pension costs and liabilities are dependent on assumptions used in calculating such amounts. These assumptions include discount rates, benefits earned, interest costs, expected return on plan assets, mortality rates, and other factors. In accordance with generally accepted accounting principles, actual results that differ from the assumptions are accumulated and amortized over future periods and, therefore, generally affect recognized expense and the recorded obligation of future periods. While management believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect the Company s pension obligations and future expense. Our pension benefits are described further in Note 11 of Notes to Consolidated Financial Statements of the Annual Report on Form 10-K.

CONTRACTUAL OBLIGATIONS

The Company has various financial obligations, including contractual obligations which may require future cash payments. The following table presents, as of December 31, 2007, significant fixed and determinable contractual obligations to third parties by payment date. Further discussion of the nature of each obligation is included in Notes to the Consolidated Financial Statements of the Annual Report on Form 10-K.

			Payments Due in		
(In Thousands)	**One Year or Less**	**One to Three Years**	**Three to Five Years**	**Over Five Years**	**Total**
Deposits without a stated maturity	$ 203,340	$	$	$	$ 203,340
Time Deposits	157,621	24,372	3,064	625	185,682
Repurchase agreements	17,154				17,154
Short-term borrowings, FHLB	38,160				38,160
Long-term borrowings, FHLB	29,600	15,000	25,500	36,278	106,378
Operating leases	396	614	382	1,427	2,819

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

CAUTIONARY STATEMENT FOR PURPOSES OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Report contains certain forward-looking statements including statements concerning plans, objectives, future events or performance and assumptions and other statements which are other than statements of historical fact.

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

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Market risk for the Company is comprised primarily from interest rate risk exposure and liquidity risk. Interest rate risk and liquidity risk management is performed at the Bank level as well as the Company level. The Company s interest rate sensitivity is monitored by management through selected interest rate risk measures produced internally. Additional information and details are provided in the Interest Sensitivity section of Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations.

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

ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

PENNS WOODS BANCORP, INC.

CONSOLIDATED BALANCE SHEET

(In Thousands, Except Share Data)		**December 31,** 2007		2006
ASSETS:				
Noninterest-bearing balances	$	15,417	$	15,348
Interest-bearing deposits in other financial institutions		16		25
Total cash and cash equivalents		15,433		15,373
Investment securities, available for sale, at fair value		214,455		185,200
Investment securities, held to maturity, (fair value of $279 and $286)		277		283
Loans held for sale		4,214		3,716
Loans		360,478		360,384
Less: Allowance for loan losses		4,130		4,185
Loans, net		356,348		356,199
Premises and equipment, net		6,774		6,737
Accrued interest receivable		3,343		2,939
Bank-owned life insurance		12,375		11,346
Investment in limited partnerships		5,439		4,950
Goodwill		3,032		3,032
Other assets		6,448		2,510
TOTAL ASSETS	$	628,138	$	592,285
LIABILITIES:				
Interest-bearing deposits	$	314,351	$	322,031
Noninterest-bearing deposits		74,671		73,160
Total deposits		389,022		395,191
Short-term borrowings		55,315		34,697
Long-term borrowings, Federal Home Loan Bank (FHLB)		106,378		82,878
Accrued interest payable		1,744		1,532
Other liabilities		5,120		3,393
TOTAL LIABILITIES		557,579		517,691
SHAREHOLDERS EQUITY:				
Common stock, par value $8.33, 10,000,000 shares authorized; 4,006,934 and 4,003,514 shares issued		33,391		33,362
Additional paid-in capital		17,888		17,810
Retained earnings		27,707		25,783
Accumulated other comprehensive (loss) income:				
Net unrealized (loss) gain on available-for-sale securities		(2,159)		2,139
Defined benefit plan		(1,375)		(579)
Less: Treasury stock at cost, 131,302 and 102,772 shares		(4,893)		(3,921)
TOTAL SHAREHOLDERS EQUITY		70,559		74,594
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	628,138	$	592,285

See Accompanying Notes to the Consolidated Financial Statements

PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF INCOME

(In Thousands, Except Per Share Data)	**Year Ended December 31, 2007**	**2006**	**2005**
INTEREST AND DIVIDEND INCOME:			
Loans including fees	$ 26,099	$ 24,878	$ 22,126
Investment Securities:			
Taxable	4,098	3,577	4,351
Tax-exempt	4,357	4,027	3,223
Dividend and other interest income	1,395	1,271	1,203
TOTAL INTEREST AND DIVIDEND INCOME	35,949	33,753	30,903
INTEREST EXPENSE:			
Deposits	10,951	8,908	5,774
Short-term borrowings	1,639	1,503	931
Long-term borrowings	3,857	3,799	3,676
TOTAL INTEREST EXPENSE	16,447	14,210	10,381
NET INTEREST INCOME	19,502	19,543	20,522
PROVISION FOR LOAN LOSSES	150	635	720
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	19,352	18,908	19,802
NON-INTEREST INCOME:			
Service charges	2,246	2,366	2,228
Securities (losses) gains, net	(54)	1,679	2,190
Bank-owned life insurance	410	374	568
Gain on sale of loans	921	853	864
Insurance commissions	2,222	2,281	2,327
Other income	1,733	1,476	1,254
TOTAL NON-INTEREST INCOME	7,478	9,029	9,431
NON-INTEREST EXPENSES:			
Salaries and employee benefits	9,078	8,833	8,314
Occupancy expense, net	1,306	1,137	1,089
Furniture and equipment expense	1,126	1,201	973
Pennsylvania shares tax expense	643	598	549
Amortization of investment in limited partnerships	761	245	90
Other expenses	4,402	4,315	4,093
TOTAL NON-INTEREST EXPENSES	17,316	16,329	15,108
INCOME BEFORE INCOME TAX PROVISION	9,514	11,608	14,125
INCOME TAX PROVISION	637	1,961	3,224
NET INCOME	$ 8,877	$ 9,647	$ 10,901
NET INCOME PER SHARE - BASIC	$ 2.28	$ 2.45	$ 2.75

NET INCOME PER SHARE - DILUTED	$ 2.28	$ 2.45	$ 2.74
WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC	3,886,277	3,934,138	3,971,926
WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED	3,886,514	3,934,617	3,974,055

See Accompanying Notes to the Consolidated Financial Statements.

PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS EQUITY

(In Thousands, Except Per Share Data)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance, December 31, 2004	3,998,204	$ 33,318	$ 17,700	$ 18,262	$ 4,331	$ (446)	$ 73,165
Stock split fractional shares	(293)	(2)	2				
Comprehensive income:							
Net income				10,901			10,901
Other comprehensive loss					(3,481)		(3,481)
Total comprehensive income							7,420
Dividends declared ($1.56 per share)				(6,225)			(6,225)
Stock options exercised	4,248	35	70				105
Purchase of treasury stock (14,000 shares)						(546)	(546)
Balance, December 31, 2005	4,002,159	33,351	17,772	22,938	850	(992)	73,919
Comprehensive income:							
Net income				9,647			9,647
Other comprehensive income					1,289		1,289
Total comprehensive income							10,936
Cumulative effect of change in accounting for pension obligations, net of tax bemefit of $298					(579)		(579)
Dividends declared ($1.73 per share)				(6,802)			(6,802)
Common shares issued for employee stock purchase plan	1,355	11	38				49
Purchase of treasury stock (76,400 shares)						(2,929)	(2,929)
Balance, December 31, 2006	4,003,514	33,362	17,810	25,783	1,560	(3,921)	74,594
Comprehensive income:							
Net income				8,877			8,877
Other comprehensive loss					(5,094)		(5,094)
Total comprehensive income							3,783
Dividends declared ($1.79 per share)				(6,953)			(6,953)
Purchase of treasury stock (28,530 shares)						(972)	(972)
Stock options exercised	330	3	5				8
Common shares issued for employee stock purchase plan	3,090	26	73				99
Balance, December 31, 2007	4,006,934	$ 33,391	$ 17,888	$ 27,707	$ (3,534)	$ (4,893)	$ 70,559

PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	For the years ended 2007	2006	2005
Net Income	$ 8,877	$ 9,647	$ 10,901
Other Comprehensive (loss) income, net of tax:			

Change in unrealized gain (loss) on available for sale securities		(4,334)		2,397		(2,036)
Net realized (gain) loss included in net income, net of (benefit) taxes of $(18), $571, and $745		36		(1,108)		(1,445)
		(4,298)		1,289		(3,481)
Defined benefit pension plans:						
Net transition asset		(2)				
Prior service cost		17				
Net loss		(811)				
Other comprehensive (loss) income, net of tax		(5,094)		1,289		(3,481)
Comprehensive income	$	3,783	$	10,936	$	7,420

See accompanying notes to the unaudited consolidated financial statements.

PENNS WOODS BANCORP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(In Thousands)	**Year Ended December 31,** **2007**	**2006**	**2005**
OPERATING ACTIVITIES			
Net income	$ 8,877	$ 9,647	$ 10,901
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	680	744	549
Provision for loan losses	150	635	720
Accretion and amortization of investment security discounts and premiums	(1,011)	(784)	(453)
Securities losses (gains), net	54	(1,679)	(2,190)
Originations of loans held for sale	(43,783)	(37,192)	(30,353)
Proceeds of loans held for sale	44,206	37,874	32,296
Gain on sale of loans	(921)	(853)	(864)
Increases in bank-owned life insurance	(410)	(374)	(568)
Other, net	(214)	(29)	254
Net cash provided by operating activities	7,628	7,989	10,292
INVESTING ACTIVITIES			
Investment securities available for sale:			
Proceeds from sales	60,485	76,249	123,546
Proceeds from calls and maturities	5,233	7,477	12,664
Purchases	(98,799)	(78,241)	(141,798)
Investment securities held to maturity:			
Proceeds from calls and maturities	12	25	328
Purchases		(25)	(35)
Net increase in loans	(374)	(22,353)	(14,745)
Acquisition of bank premises and equipment	(717)	(1,072)	(2,076)
Proceeds from the sale of foreclosed assets	65	329	329
Proceeds from bank-owned life insurance death benefit			826
Purchase of bank-owned life insurance	(619)	(254)	
Investment in limited partnership	(1,250)	(1,646)	(3,124)
Proceeds from redemption of regulatory stock	5,081	3,630	4,862
Purchases of regulatory stock	(6,816)	(2,899)	(4,760)
Net cash used for investing activities	(37,699)	(18,780)	(23,983)
FINANCING ACTIVITIES			
Net (decrease) increase in interest-bearing deposits	(7,680)	40,881	(1,636)
Net increase (decrease) in noninterest-bearing deposits	1,511	1,781	(2,671)
Net increase (decrease) in short-term borrowings	20,618	(19,306)	17,528
Proceeds from long-term borrowings, FHLB	40,000		10,000
Repayment of long-term borrowings, FHLB	(16,500)	(1,600)	(1,400)
Dividends paid	(6,953)	(6,802)	(6,225)
Issuance of common stock	99	49	
Stock options exercised	8		105
Purchase of treasury stock	(972)	(2,929)	(546)
Net cash provided by financing activities	30,131	12,074	15,155

NET INCREASE IN CASH AND CASH EQUIVALENTS		60		1,283		1,464
CASH AND CASH EQUIVALENTS, BEGINNING		15,373		14,090		12,626
CASH AND CASH EQUIVALENTS, ENDING	$	15,433	$	15,373	$	14,090
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:						
Interest paid	$	16,235	$	13,786	$	10,123
Income taxes paid		1,610		2,645		2,625
Transfer of loans to foreclosed real estate		75		278		433

See Accompanying Notes to the Consolidated Financial Statements.

PENNS WOODS BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

Nature of Business

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

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

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

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

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

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

Use of Estimates

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

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

Stock Split

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

Cash and Cash Equivalents

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

Restrictions on Cash and Cash Equivalents

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

Investment Securities

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

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

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

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

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

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

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

Loans

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

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

Allowance for Loan Losses

The allowance for loan losses represents the amount which management estimates is adequate to provide for probable losses inherent in its loan portfolio, as of the balance sheet date. The allowance method is used in providing for loan losses. Accordingly, all loan losses are charged to the allowance and all recoveries are credited to it. The allowance for loan losses is established through a provision

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

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

Although management believes that it uses the best information available to make such determinations and that the allowance for loan losses is adequate at December 31, 2007, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy, rising unemployment, or negative performance trends in financial information from borrowers could be indicators of subsequent increased levels of nonperforming assets and possible charge-offs, which would normally require increased loan loss provisions. An integral part of the periodic regulatory examination process is the review of the adequacy of the Bank s loan loss allowance. The regulatory agencies could require the Bank, based on their evaluation of information available at the time of their examination, to provide additional loan loss provisions to further supplement the allowance.

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

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

Loans Held for Sale

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

Foreclosed Assets Held for Sale

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

Premises and Equipment

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

Bank-Owned Life Insurance

The Company has purchased life insurance policies on certain officers and directors. Bank-owned life insurance is recorded at its cash surrender value, or the amount that can be realized. Increases in the cash surrender value are recognized as a component of non-interest income within the Consolidated Statement of Income.

Goodwill

The Company accounts for goodwill in accordance with Statement of Financial Accounting Standards (FAS) No. 142, *Goodwill and Other Intangible Assets.* This statement, among other things, requires a two-step process for testing the impairment of goodwill on at least an annual basis. This approach could cause more volatility in the Company s reported net income because impairment losses, if any, could occur irregularly and in varying amounts. The Company performs an annual impairment analysis of goodwill for its purchased subsidiary, The M Group. Based on the fair value of this reporting unit, estimated using the expected present value of future cash flows, no impairment of goodwill was recognized in 2007 and 2006.

Investments in Limited Partnerships

The Company is a limited partner in four partnerships at December 31, 2007 that provide low income elderly housing in the Company s geographic market area. The carrying value of the Company s investments in limited partnerships was $5,439,000 at December 31, 2007 and $4,950,000 at December 31, 2006. The Company is fully amortizing the investment in the partnership entered into prior to 2005 over the fifteen-year holding period. The partnerships entered into after 2004 are being fully amortized over the ten-year tax credit receipt period utilizing the straight-line method. The partnerships began being amortized once the projects reached the level of occupancy needed to begin the ten year tax credit recognition period. Amortization of limited partnership investments amounted to $761,000 in 2007, $245,000 in 2006, and $90,000 in 2005.

Off-Balance Sheet Financial Instruments

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

Advertising Cost

Advertising costs are generally expensed as incurred.

Income Taxes

The Company adopted the provisions of FIN No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109*, effective January 1, 2007. FIN No. 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. FIN No. 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. Adoption of FIN No. 48 did not have a significant impact on the Company s financial statements.

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

Earnings Per Share

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

Employee Benefits

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

The M Group Products and Income Recognition

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

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

Life insurance commissions are recognized at varying points based on the payment option chosen by the customer. Commissions from monthly and annual payment plans are recognized at the start of each annual period for the life insurance, while quarterly and semi-annual premium payments are recognized quarterly and semi-annually when the earnings process is complete. For example, semi-annual payments on the first of January and July would result in commission income recognition on the first of January and July, while payments on the first of January, April, July, and October would result in commission income recognition on those dates. The potential for chargebacks only exists for

those policies on a monthly payment plan since income is recognized at the beginning of the annual coverage period versus at the time of each monthly payment. No liability is maintained for chargebacks as these are removed from income at the time of the occurrence.

Stock Options

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

Accumulated Other Comprehensive Income

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

Segment Reporting

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

Reclassification of Comparative Amounts

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

Recent Accounting Pronouncements

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

In September 2006, the FASB issued FAS No. 157, *Fair Value Measurements*, which provides enhanced guidance for using fair value to measure assets and liabilities. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The Standard does not expand the use of fair value in any new circumstances. FAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Early adoption is permitted. The adoption of this standard is not expected to have a material effect on the Company s results of operations or financial position.

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

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

In September 2006, the FASB reached consensus on the guidance provided by Emerging Issues Task Force Issue 06-4 (EITF 06-4), *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. The guidance is applicable to endorsement split-dollar life insurance arrangements, whereby the employer owns and controls the insurance policy, that are associated with a postretirement benefit. EITF 06-4 requires that for a split-dollar life insurance arrangement within the scope of the Issue, an employer should recognize a liability for future benefits in accordance with FAS No. 106 (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. The adoption of the EITF on January 1, 2008 will result in an adjustment to retained earnings and an associated liability in the amount of $437,000.

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

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

NOTE 2 - PER SHARE DATA

There are no convertible securities, which would affect the numerator in calculating basic and dilutive earnings per share, therefore, net income as presented on the consolidated statement of income will be

used as the numerator. The following table sets forth the composition of the weighted average common shares (denominator) used in the basic and dilutive per share computation.

	2007	**2006**	**2005**
Weighted average common shares outstanding	4,005,181	4,002,416	3,986,569
Average treasury stock shares	(118,904)	(68,278)	(14,643)
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	3,886,277	3,934,138	3,971,926
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	237	479	2,129
Weighted average common shares and common stock equivalents used to calculate diluted earnings per share	3,886,514	3,934,617	3,974,055

Options to purchase 8,273 shares of common stock at a price of $40.29 were outstanding during 2007 and 9,002 shares of common stock at a price of $40.29 were outstanding during 2006 and 2005. The options were not included in the computation of diluted earnings per share as they were anti-dilutive due to the strike price at December 31, of each period presented being greater than the market value at that time.

NOTE 3 - INVESTMENT SECURITIES

The amortized cost and estimated fair values of investment securities at December 31, 2007 and 2006 are as follows:

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

	2006			
(In Thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
Available for sale (AFS)				
U.S. Government and agency securities	$ 54,949	$ 24	$ (821)	$ 54,152
State and political securities	104,658	1,646	(358)	105,946
Other debt securities	1,998	37	(11)	2,024
Total debt securities	161,605	1,707	(1,190)	162,122
Equity securities	20,353	2,883	(158)	23,078
Total investment securities AFS	$ 181,958	$ 4,590	$ (1,348)	$ 185,200
Held to maturity (HTM)				
U.S. Government and agency securities	$ 26	$ 2	$	$ 28
Other debt securities	257	1		258
Total investment securities HTM	$ 283	$ 3	$	$ 286

The following tables show the Company s gross unrealized losses and estimated 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, 2007 and 2006.

(In Thousands)	2007 Less than Twelve Months Estimated Fair Value	Gross Unrealized Losses	Twelve Months or Greater Estimated Fair Value	Gross Unrealized Losses	Total Estimated Fair Value	Gross Unrealized Losses
U.S. Government and agency securities	$	$	$	$	$	$
State and political securities	60,002	1,705	21,830	712	81,832	2,417
Other debt securities	2,521	357	388	83	2,909	440
Total debt securities	62,523	2,062	22,218	795	84,741	2,857
Equity securities	8,200	1,837	996	466	9,196	2,303
Total	$ 70,723	$ 3,899	$ 23,214	$ 1,261	$ 93,937	$ 5,160

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

At December 31, 2007 there were a total of 173 and 50 individual securities that were in a continuous unrealized loss position for less than twelve months and greater than twelve months, respectively.

The policy of the Company is to recognize other than temporary impairment of equity securities where the fair value has been significantly below cost for four consecutive quarters or if the market value is 50% or less for two consecutive quarters. Certain equity investments were determined to be impaired at December 31, 2007 resulting in a reduction of carrying value and a charge to earnings in the amount of $834,000. For fixed maturity investments with unrealized losses due to interest rates where the Company has the positive intent and ability to hold the investment for a period of time sufficient to allow a market recovery, declines in value below cost are not assumed to be other than temporary. The Company reviews its position quarterly and has asserted that at December 31, 2007, the declines outlined in the above table for debt securities represent temporary declines due to interest rate changes that are not expected to result in the non-collection of principal and interest during the period. In addition, the Company does have the intent and ability to hold those securities either to maturity or to allow a market recovery.

The Company has concluded that any impairment of its investment securities portfolio is not other than temporary.

The amortized cost and estimated fair value of debt securities at December 31, 2007, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(In Thousands)	Available for Sale Amortized Cost	Estimated Fair Value	Held to Maturity Amortized Cost	Estimated Fair Value

Due in one year or less	$	75	$	75	$	50	$	50
Due after one year to five years		800		790		123		124
Due after five years to ten years		395		421		90		90
Due after ten years		196,680		195,200		14		15
Total	$	197,950	$	196,486	$	277	$	279

Total gross proceeds from sales of securities available for sale were $60,485,000, $76,249,000, and $123,546,000 for 2007, 2006, and 2005, respectively. The following table represents gross realized gains and losses on those transactions:

(In Thousands)	**2007**	**2006**	**2005**
Gross realized gains:			
U.S. Government and agency securities	$ 68	$	$ 128
State and political securities	840	1,248	819
Other debt securities	2		
Equity securities	772	1,655	2,209
Total gross realized gains	$ 1,682	$ 2,903	$ 3,156
Gross realized losses:			
U.S. Government and agency securities	$ 902	$ 913	$ 791
State and political securities		302	116
Other debt securities			59
Equity securities	834	9	
Total gross realized losses	$ 1,736	$ 1,224	$ 966

Investment securities with a carrying value of approximately $97,647,000 and $64,821,000 at December 31, 2007 and 2006, respectively, were pledged to secure certain deposits, repurchase agreements, and for other purposes as required by law.

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

NOTE 4   LOANS

Major loan classifications as of December 31, 2007 and 2006 are summarized as follows:

(In Thousands)	**Current**	**Past Due 30 To 90 Days**	**2007 Past Due 90 Days Or More & Still Accruing**	**Non-Accrual**	**Total**
Commercial and agricultural	$ 35,316	$ 236	$ 147	$ 40	$ 35,739
Real estate mortgage:					
Residential	158,424	4,573	110	161	163,268
Commercial	130,692	1,409	88	754	132,943
Construction	16,113	39			16,152
Installment loans to individuals	12,838	459	20		13,317
	353,383	$ 6,716	$ 365	$ 955	361,419
Less: Net deferred loan fees	941				941
Allowance for loan losses	4,130				4,130
Loans, net	$ 348,312				$ 356,348

(In Thousands)	Current	Past Due 30 To 90 Days	2006 Past Due 90 Days Or More & Still Accruing	Non-Accrual	Total
Commercial and agricultural	$ 36,122	$ 764	$ 109	$	$ 36,995
Real estate mortgage:					
Residential	156,976	1,050	8	185	158,219
Commercial	133,813	1,406		185	135,404
Construction	16,695	54			16,749
Installment loans to individuals	13,687	346	2		14,035
	357,293	$ 3,620	$ 119	$ 370	361,402
Less: Net deferred loan fees	1,018				1,018
Allowance for loan losses	4,185				4,185
Loans, net	$ 352,090				$ 356,199

Impaired loans totaled $1,477,000 and $574,000 at December 31, 2007 and 2006, respectively. The portion of the allowance for loan losses allocated for impaired loans was $102,000 and $42,000 at

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December 31, 2007 and 2006. The average recorded investment in impaired loans during the years ended December 31, 2007 and 2006 was approximately $1,130,000 and $504,000, respectively. There were no impaired loans for the year ended December 31, 2005.

The Company recognized interest income on impaired loans in the amount of $42,000 and $72,000 for the years ended December 31, 2007 and 2006, respectively. On a cash basis, interest income on impaired loans amounted to $29,000 and $58,000 for the years ended December 31, 2007 and 2006, respectively.

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

Loans on which the accrual of interest has been discontinued or reduced, exclusive of impaired loans, amounted to approximately $955,000 and $370,000 at December 31, 2007 and 2006, respectively. If interest had been recorded based on the original loan agreement terms and rate of interest for those loans, income would have approximated $87,000, $23,000, and $39,000 for the years ended December 31, 2007, 2006, and 2005, respectively. Interest income on such loans, is recorded as received and amounted to approximately $17,000, $15,000, and $18,000, for the years ended December 31, 2007, 2006, and 2005, respectively.

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

(In Thousands)	**2007**	**2006**	**2005**
Balance, beginning of year	$ 4,185	$ 3,679	$ 3,338
Provision charged to operations	150	635	720
Loans charged off	(304)	(327)	(446)
Recoveries	99	198	67
Balance, end of year	$ 4,130	$ 4,185	$ 3,679

The Company has a concentration of loans to both owners of commercial and residential rental properties at December 31, 2007 and 2006 of 14.43% and 15.38% and 14.56% and 15.82% of total loans , respectively.

The Company grants commercial, industrial, residential, and installment loans to customers throughout north-central Pennsylvania. Although the Company has a diversified loan portfolio at December 31, 2007 and 2006, a substantial portion of its debtors ability to honor their contracts is dependent on the economic conditions within this region.

NOTE 5 - PREMISES AND EQUIPMENT

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

(In Thousands)		**2007**		**2006**
Land	$	1,391	$	1,370
Premises		6,218		6,038
Furniture and equipment		5,356		4,844
Leasehold improvements		815		811
Total		13,780		