

PEOPLES FINANCIAL SERVICES CORP/  
Form 10-K  
March 16, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
FORM 10-K**

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

For the fiscal year ended December 31, 2006,

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number **0-23863**

**PEOPLES FINANCIAL SERVICES CORP.**

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

**PENNSYLVANIA**

*(State of incorporation)*

**23-2391852**

*(IRS Employer Identification No.)*

**50 MAIN STREET, HALLSTEAD, PA**

*(Address of principal executive offices)*

**18822**

*(Zip code)*

**(570) 879-2175**

*(Registrant's telephone number including area code)*

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

Title of each class

Name of each exchange on which registered

**None**

**None**

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

**COMMONSTOCK (\$2 Par Value)**

*(Title of Class)*

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

Yes \_\_\_ No **X**

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes \_\_\_ No **X**

Act. Yes \_\_\_ No **X**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer \_\_\_\_\_ Accelerated filer  Non-accelerated filer \_\_\_\_\_

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

The aggregate market value of voting stock held by non-affiliates of the registrant is **\$85,625,714**

The aggregate dollar amount of the voting stock set forth equals the number of shares of the registrant's Common Stock outstanding, reduced by the amount of Common stock held by executive officers, directors, and shareholders owning in excess of 10% of the registrant's Common Stock, multiplied by the last sale price for the registrant's Common Stock by June 30, 2006. The information provided shall in no way be construed as an admission that the officer, director, or 10% shareholder in the registrant may be deemed an affiliate of the registrant or that such person is the beneficial owner of the shares reported as being held by him and any such inference is hereby disclaimed. The information provided herein is included solely for the record keeping purpose of the Securities and Exchange Commission.

|   |   |   |
|---|---|---|
| Number of shares outstanding as of<br>December 31, 2006 | <b>COMMON STOCK</b><br><b>(\$2 Par Value)</b><br><i>(Title Class)</i> | <b>3,133,874</b><br><i>(Outstanding Shares)</i> |
|---|---|---|

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the 2007 Proxy Statement for the Registrant are incorporated by reference into Part III of this report.

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## **ITEM 1 BUSINESS**

### **BRIEF HISTORY**

Peoples Financial Services Corp. ("PFSC" or the "Company") was incorporated under the laws of the Commonwealth of Pennsylvania on February 6, 1986, and is a one-bank holding company headquartered in Hallstead, Pennsylvania.

The Company is engaged primarily in commercial and retail banking services and in businesses related to banking services through its subsidiaries, Peoples National Bank ("PNB" or the "Bank") and Peoples Advisors, LLC ("Advisors"). PNB was chartered in Hallstead, Pennsylvania in 1905 under the name of The First National Bank of Hallstead. In 1965, the Hop Bottom National Bank (chartered in 1910) merged with the First National Bank of Hallstead to form Peoples National Bank of Susquehanna County. In 2001, the Bank changed its name to Peoples National Bank. Advisors was formed in 2006 as a member-managed limited liability company for the purpose of providing investment advisory services to the general public.

### **OPERATING SEGMENTS**

The Company has one reportable operating segment, Community Banking, which consists of commercial and retail banking, and other non-reportable operating segments, as described in Note 1 of the Notes to Consolidated Financial Statements included on page 55 of this Report. The Segment Reporting information in Note 1 is incorporated by reference into this Item 1.

### **SUPERVISION AND REGULATION**

The Company, PNB and Advisors, are extensively regulated under federal and state law. Generally, these laws and regulations are intended to protect depositors, not shareholders. The following is a summary description of certain provisions of law that affect the regulation of bank holding companies and banks. This discussion is qualified in its entirety by reference to applicable laws and regulations. Changes in law and regulation may have a material effect on the business and prospects of the Company, PNB, and Advisors.

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended, and is subject to regulation, supervision, and examination by the Federal Reserve Board ("FRB"). The Company is required to file annual and quarterly reports with the FRB and to provide the FRB with such additional information as the FRB may require. The FRB also conducts examinations of the Company.

With certain limited exceptions, the Company is required to obtain prior approval from the FRB before acquiring direct or indirect ownership or control of more than 5% of any voting securities or substantially all of the assets of a bank or bank holding company, or before merging or consolidating with another bank holding company. Additionally, with certain exceptions, any person or entity proposing to acquire control through direct or indirect ownership of 25% or more of any voting securities of the Company is required to give 60 days written notice of the acquisition to the FRB, which may prohibit the transaction, and to publish notice to the public.

The Company's banking subsidiary is a federally chartered national banking association regulated by the Office of the Comptroller of the Currency ("OCC"). The OCC may prohibit an institution over which it has supervisory authority from engaging in activities or investments that the agency believes constitute unsafe or unsound banking practices. Federal banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to constitute unsafe or unsound practices.

Enforcement actions may include:

- the appointment of a conservator or receiver;
- the issuance of a cease and desist order;
- the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution affiliated parties;

- the issuance of directives to increase capital;
- the issuance of formal and informal agreements;
- the removal of or restrictions on directors, officers, employees and institution-affiliated parties; and
- the enforcement of any such mechanisms through restraining orders or any other court actions.

PNB is subject to certain restrictions on extensions of credit to executive officers, directors, principal shareholders or any related interests of such persons which generally require that such credit extensions be made on substantially the same terms as are available to third persons dealing with PNB and not involving more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels of the Bank.

### **Limitations on Dividends and Other Payments**

The Company's current ability to pay dividends is largely dependent upon the receipt of dividends from its banking subsidiary, PNB. Both federal and state laws impose restrictions on the ability of the Company to pay dividends. The FRB has issued a policy statement that provides that, as a general matter, insured banks and bank holding companies may pay dividends only out of prior operating earnings. Under the National Bank Act, a national bank, such as PNB, may pay dividends only out of the current year's net profits and the net profits of the last two years. In addition to these specific restrictions, bank regulatory agencies, in general, also have the ability to prohibit proposed dividends by a financial institution that would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice.

### **Permitted Non-Banking Activities**

Generally, a bank holding company may not engage in any activities other than banking, managing, or controlling its bank and other authorized subsidiaries, and providing service to those subsidiaries. With prior approval of the FRB, the Company may acquire more than 5% of the assets or outstanding shares of a company engaging in non-bank activities determined by the FRB to be closely related to the business of banking or of managing or controlling banks. The FRB provides expedited procedures for expansion into approved categories of non-bank activities.

Subsidiary banks of a bank holding company are subject to certain quantitative and qualitative restrictions:

- on extensions of credit to the bank holding company or its subsidiaries;
- on investments in their securities; and
- on the use of their securities as collateral for loans to any borrower.

These regulations and restrictions may limit the Company's ability to obtain funds from PNB for its cash needs, including funds for the payment of dividends, interest and operating expenses. Further, subject to certain exceptions, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, lease or sale of property or furnishing of services. For example, PNB may not generally require a customer to obtain other services from itself or the Company, and may not require that a customer promise not to obtain other services from a competitor as a condition to an extension of credit to the customer.

Under FRB policy, a bank holding company is expected to act as a source of financial strength to its subsidiary banks and to make capital injections into a troubled subsidiary bank, and the FRB may charge the bank holding company with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. A required capital injection may be called for at a time when the holding company does not have the resources to provide it. In addition, depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with the default of or assistance provided to, a commonly controlled FDIC-insured depository institution. Accordingly, in the event that any insured subsidiary of the company causes a loss to the FDIC, other insured subsidiaries of the company could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guarantee liabilities generally are superior in priority to the obligation of the depository institutions to its stockholders due solely to their status as stockholders and obligations to other affiliates.

### **Pennsylvania Law**

As a Pennsylvania bank holding company, the Company is subject to various restrictions on its activities as set forth in Pennsylvania law. This is in addition to those restrictions set forth in federal law. Under Pennsylvania law, a bank holding company that desires to acquire a bank or bank holding company that has its principal place of business in Pennsylvania must obtain permission from the Pennsylvania Department of Banking.

### **Interstate Banking Legislation**

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 were enacted into law on September 29, 1994. The law provides that, among other things, substantially all state law barriers to the acquisition of banks by

out-of-state bank holding companies were eliminated effective September 29, 1995. The law also permits interstate branching by banks effective as of June 1, 1997, subject to the ability of states to opt-out completely or to set an earlier effective date.

**FIRREA (Financial Institution Reform, Recovery, and Enforcement Act)**

FIRREA was enacted into law in order to address the financial condition of the Federal Savings and Loan Insurance Corporation, to restructure the regulation of the thrift industry, and to enhance the supervisory and enforcement powers of the federal bank and thrift regulatory agencies. As the primary federal regulator of the Bank, the OCC is responsible for the supervision of the Bank. When dealing with capital requirements, the OCC and FDIC have the flexibility to impose supervisory agreements on institutions that fail to comply with regulatory requirements. The imposition of a capital plan, termination of deposit insurance, and removal or temporary suspension of an officer, director or other institution-affiliated person may cause enforcement actions.

There are three levels of civil penalties under FIRREA.

- The first tier provides for civil penalties of up to \$5,000 per day for any violation of law or regulation.
- The second tier provides for civil penalties of up to \$25,000 per day if more than a minimal loss or a pattern is involved.
- Finally, civil penalties of up to \$1 million per day may be assessed for knowingly or recklessly causing a substantial loss to an institution or taking action that results in a substantial pecuniary gain or other benefit.

Criminal penalties are increased to \$1 million per violation and may be up to \$5 million for continuing violations or for the actual amount of gain or loss. These penalties may be combined with prison sentences of up to five years.

**FDICIA (Federal Deposit Insurance Corporation Improvement Act of 1991)**

In December 1991, Congress enacted FDICIA which substantially revised the bank regulatory and funding provisions of the Federal Deposit Insurance Act and made significant revisions to several other federal banking statutes. FDICIA provides for, among other things:

- publicly available annual financial condition and management reports for financial institutions, including audits by independent accountants;
- the establishment of uniform accounting standards by federal banking agencies;
- the establishment of a “prompt corrective action” system of regulatory supervision and intervention, based on capitalization levels, with more scrutiny and restrictions placed on depository institutions with lower levels of capital;
- additional grounds for the appointment of a conservator or receiver; and
- restrictions or prohibitions on accepting brokered deposits, except for institutions which significantly exceed minimum capital requirements.

FDICIA also provides for increased funding of the FDIC insurance funds and the implementation of risk-based premiums.

A central feature of FDICIA is the requirement that the federal banking agencies take “prompt corrective action” with respect to depository institutions that do not meet minimum capital requirements. Pursuant to FDICIA, the federal bank regulatory authorities have adopted regulations setting forth a five-tiered system for measuring the capital adequacy of the depository institutions that they supervise. Under these regulations, a depository institution is classified in one of the following capital categories:

- "well capitalized";
- "adequately capitalized";
- "under capitalized";
- "significantly undercapitalized"; and
- "critically undercapitalized".



PNB is currently classified as “well capitalized.” An institution may be deemed by the regulators to be in a capitalization category that is lower than is indicated by its actual capital position if, among other things, it receives an unsatisfactory examination rating with respect to asset quality, management, earnings or liquidity.

FDICIA generally prohibits a depository institution from making any capital distribution (including payment of a cash dividend) or paying any management fees to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. If a depository fails to submit an acceptable plan, it is treated as if it is “significantly undercapitalized”. Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator; generally within 90 days of the date such institution is determined to be critically under capitalized.

FDICIA provides the federal banking agencies with significantly expanded powers to take enforcement action against institutions that fail to comply with capital or other standards. Such actions may include the termination of deposit insurance by the FDIC or the appointment of a receiver or conservator for the institution. FDICIA also limits the circumstances under which the FDIC is permitted to provide financial assistance to an insured institution before appointment of a conservator or receiver.

Under FDICIA, each federal banking agency is required to prescribe, by regulation, non-capital safety and soundness standards for institutions under its authority. The federal banking agencies, including the OCC, have adopted standards covering:

- internal controls;
- information systems and internal audit systems;
- loan documentation;
- credit underwriting;
- interest rate exposure;
- asset growth; and
- compensation fees and benefits.

Any institution that fails to meet these standards may be required by the agency to develop a plan acceptable to the agency, specifying the steps that the institutions will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. The Company, on behalf of PNB, believes that it meets substantially all the standards that have been adopted. FDICIA also imposed new capital standards on insured depository institutions. Before establishing new branch offices, PNB must meet certain minimum capital stock and surplus requirements and must obtain OCC approval.

### **Risk-Based Capital Requirements**

The federal banking regulators have adopted certain risk-based capital guidelines to assist in the assessment of the capital adequacy of a banking organization's operations for both transactions reported on the balance sheet as assets and transactions, such as letters of credit, and recourse agreements, which are recorded as off-balance-sheet items. Under these guidelines, nominal dollar amounts of assets and credit-equivalent amounts of off-balance-sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain US Treasury securities, to 100% for assets with relatively high credit risk, such as business loans.

A banking organization's risk-based capital ratios are obtained by dividing its qualifying capital by its total risk adjusted assets. The regulators measure risk-adjusted assets, which include off-balance-sheet items, against both total qualifying capital (the sum of Tier 1 capital and limited amounts of Tier 2 capital) and Tier 1 capital.

- "Tier 1", or core capital, includes common equity, perpetual preferred stock (excluding auction rate issues) and minority interest in equity accounts of consolidated subsidiaries, less goodwill and other intangibles, subject to certain exceptions.
- "Tier 2", or supplementary capital, includes, among other things, limited life preferred stock, hybrid capital instruments, mandatory convertible securities, qualifying subordinated debt, and the allowance for loan and lease losses, subject to certain limitations and less restricted deductions. The inclusion of elements of Tier 2 capital is subject to certain other requirements and limitations of the federal banking agencies.

Banks and bank holding companies subject to the risk-based capital guidelines are required to maintain a ratio of Tier 1 capital to risk-weighted assets of at least 4% and a ratio of total capital to risk-weighted assets of at least 8%. The appropriate regulatory authority may set higher capital requirements when particular circumstances warrant. As of December 31, 2006, PFSC's ratio of Tier 1 capital to risk-weighted assets stood at 13.99% and its ratio of total capital to risk-weighted assets stood at 14.64%. In addition to risk-based capital, banks and bank holding companies are required to maintain a minimum amount of Tier 1 capital to total assets, referred to as the leverage capital ratio, of at

least 4.00%. As of December 31, 2006, the Company's leverage-capital ratio was 9.77%.

Failure to meet applicable capital guidelines could subject a banking organization to a variety of enforcement actions including:

- limitations on its ability to pay dividends;
- the issuance by the applicable regulatory authority of a capital directive to increase capital, and in the case of depository institutions, the termination of deposit insurance by the FDIC, as well as to the measures described under FDICIA as applicable to under capitalized institutions.

In addition, future changes in regulations or practices could further reduce the amount of capital recognized for purposes of capital adequacy. Such a change could affect the ability of PNB to grow and could restrict the amount of profits, if any, available for the payment of dividends to the Company.

### **Interest Rate Risk**

In August 1995 and May 1996, the federal banking agencies adopted final regulations specifying that the agencies will include, in their evaluations of a bank's capital adequacy, an assessment of the bank's interest rate risk ("IRR") exposure. The standards for measuring the adequacy and effectiveness of a banking organization's IRR management includes a measurement of Board of Directors and senior management oversight, and a determination of whether a banking organization's procedures for comprehensive risk management are appropriate to the circumstances of the specific banking organization. PNB has internal IRR models that are used to measure and monitor IRR. In addition, an outside source also assesses IRR using its model on a quarterly basis. Additionally, the regulatory agencies have been assessing IRR on an informal basis for several years. For these reasons, the Company does not expect the IRR evaluation in the agencies' capital guidelines to result in significant changes in capital requirements for PNB.

### **FDIC Insurance Assessments**

As a FDIC member institution, PNB's deposits are insured to a maximum of \$100,000 (\$250,000 for retirement accounts) per depositor through the Bank Insurance Fund ("BIF") that is administered by the FDIC and each institution is required to pay semi-annual deposit insurance premium assessments to the FDIC. PNB's assessment for 2006 was \$37,678. These figures can be compared to FDIC assessments in 2005 of \$37,634 and in 2004 of \$40,474. Prior to 1997, only thrift institutions were subject to assessments to raise funds to pay the financing corporate bonds. On September 30, 1996, as part of the Omnibus Budget Act, Congress enacted the Deposit Insurance Funds Act of 1996, which recapitalized the Savings Association Insurance Fund ("SAIF") and provided that BIF deposits would be subject to 1/5 of the assessment to which SAIF deposits are subject for FICO bond payments through 1999. Beginning in 2000, BIF deposits and SAIF deposits were subject to the same assessment for FICO bonds. The FICO assessment for PNB for 2006 was \$.0125 for each \$100 of BIF deposits.

The FDIC has adopted a new risk-based deposit insurance assessment system that will require all FDIC-insured institutions to pay quarterly premiums beginning in 2007. Annual premiums will range from 5 and 7 basis points of deposits for well-capitalized banks with the highest examination ratings to 43 basis points for undercapitalized institutions. The Bank will be able to offset the premium with an estimated assessment credit of \$218,000 for premiums paid prior to 1996.

### **Community Reinvestment Act**

The Community Reinvestment Act of 1977, ("CRA") is designed to create a system for bank regulatory agencies to evaluate a depository institution's record in meeting the credit needs of its community. Until May 1995, a depository institution was evaluated for CRA compliance based on twelve assessment factors.

The CRA regulations were completely revised as of July 1, 1995, (the revised CRA regulation) to establish new performance-based standards for use in examining for compliance.

The Bank had its last CRA compliance examination in 2002 and received a "satisfactory" rating.

### **Concentration**

Payment risk is a function of the economic climate in which the Bank's lending activities are conducted. Economic downturns in the economy generally or in a particular sector could cause cash flow problems for customers and make loan payments more difficult. The Bank attempts to minimize this risk by avoiding loan concentrations to a single customer or to a small group of customers whose loss would have a materially adverse effect on the financial condition of the Bank.

### **Monetary Policy**

The earnings of a bank holding company are affected by the policies of regulatory authorities, including the FRB, in connection with the FRB's regulation of the money supply. Various methods employed by the FRB are:

- open market operations in United States Government securities;
- changes in the discount rate on member bank borrowings; and
- changes in reserve requirements against member bank deposits.

These methods are used in varying combinations to influence overall growth and distribution of bank loans, investments, and deposits, and their use may also affect interest rates charged on loans or paid on deposits. The monetary policies of the FRB have had a significant effect on the operating results of commercial banks in the past and are expected to do so in the future.

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## **RECENT LEGISLATION**

### **USA Patriot Act of 2001**

In October 2001, the USA Patriot Act of 2001 was enacted in response to the terrorist attacks in New York, Pennsylvania and Washington D.C., which occurred on September 11, 2001. The Patriot Act is intended to strengthen U.S. law enforcement's and the intelligence communities' abilities to work cohesively to combat terrorism on a variety of fronts. The potential impact of the Patriot Act on financial institutions of all kinds is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

### **Financial Services Modernization Legislation**

In November 1999, the Gramm-Leach-Bliley Act of 1999, or the GLB, was enacted. The GLB repeals provisions of the Glass-Steagall Act which restricted the affiliation of Federal Reserve member banks with firms "engaged principally" in specified securities activities, and which restricted officer, director or employee interlocks between a member bank and any company or person "primarily engaged" in specified securities activities.

The GLB also permits national banks to engage in expanded activities through the formation of financial subsidiaries. A national bank may have a subsidiary engaged in any activity authorized for national banks directly or any financial activity, except for insurance underwriting, insurance investments, real estate investment or development, or merchant banking, which may only be conducted through a subsidiary of a financial holding company. Financial activities include all activities permitted under new sections of the Bank Holding Company Act or permitted by regulation.

To the extent that the GLB permits banks, securities firms and insurance companies to affiliate, the financial services industry may experience further consolidation. The GLB is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis and which unitary savings and loan holding companies already possess. Nevertheless, the GLB may have the result of increasing the amount of competition that the Registrant faces from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than the Registrant has.

### **Sarbanes-Oxley Act of 2002**

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, or the SOA. The stated goals of the SOA are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws.

The SOA is the most far-reaching U.S. securities legislation enacted in some time. The SOA generally applies to all companies, both U.S. and non-U.S., that file or are required to file periodic reports with the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934, or the Exchange Act. The legislation includes provisions, among other things, governing the services that can be provided by a public company's independent auditors and the procedures for approving such services, requiring the chief executive officer and principal accounting officer to certify certain matters relating to the company's periodic filings under the Exchange Act, requiring expedited filings of reports by insiders of their securities transactions and containing other provisions relating to insider conflicts of interest, increasing disclosure requirements relating to critical financial accounting policies and their application, increasing penalties for securities law violations, and creating a new public accounting oversight board, a regulatory body subject to SEC jurisdiction with broad powers to set auditing, quality control and ethics standards for accounting firms.

The Company does not believe that the application of these new rules to the Company will have a material effect on its results of operations.



## **Regulation W**

Transactions between a bank and its “affiliates” are quantitatively and qualitatively restricted under the Federal Reserve Act. The Federal Deposit Insurance Act applies Sections 23A and 23B to insured nonmember banks in the same manner and to the same extent as if they were members of the Federal Reserve System. The Federal Reserve Board has also recently issued Regulation W, which codifies prior regulations under Sections 23A and 23B of the Federal Reserve Act and interpretative guidance with respect to affiliate transactions. Regulation W incorporates the exemption from the affiliate transaction rules but expands the exemption to cover the purchase of any type of loan or extension of credit from an affiliate. Affiliates of a bank include, among other entities, the bank’s holding company and companies that are under common control with the bank. The Company is considered to be an affiliate of the Bank. In general, subject to certain specified exemptions, a bank or its subsidiaries are limited in their ability to engage in “covered transactions” with affiliates:

- to an amount equal to 10% of the bank's capital and surplus, in the case of covered transactions with any one affiliate; and
- to an amount equal to 20% of the bank's capital and surplus, in the case of covered transactions with all affiliates.

In addition, a bank and its subsidiaries may engage in covered transactions and other specified transactions only on terms and under circumstances that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with nonaffiliated companies. A “covered transaction” includes:

- a loan or extension of credit to an affiliate;
- a purchase of, or an investment in, securities issued by an affiliate;
- a purchase of assets from an affiliate, with some exceptions;
- the acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any party; and
- the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

Regulation W generally excludes all non-bank and non-savings association subsidiaries of banks from treatment as affiliates, except to the extent that the Federal Reserve Board decides to treat these subsidiaries as affiliates.

Concurrently with the adoption of Regulation W, the Federal Reserve Board has proposed a regulation which would further limit the amount of loans that could be purchased by a bank from an affiliate to not more than 100% of the bank’s capital and surplus.

## **Legislation and Regulatory Changes**

From time to time, legislation is enacted that affects the cost of doing business or limits the activities of a financial institution. We cannot predict the likelihood of any major changes or the impact those changes may have on the Company.

## **MARKET AREAS**

The PNB market areas are in the northeastern part of Pennsylvania with the primary focus being Susquehanna and Wyoming Counties. With the addition of an office in Conklin, Broome County, New York in 2003, and offices in the Village of Deposit and Town of Chenango, both in Broome County, New York, in 2005, Broome County is part of the Bank’s market area, particularly the Southern Tier that encompasses the towns of Conklin, Kirkwood, Windsor, and Deposit. In addition, parts of Lackawanna, Wayne, and Bradford Counties in Pennsylvania that border Susquehanna and Wyoming Counties are also considered part of the PNB market area.

The PNB market area is situated between:

- the city of Binghamton, Broome County, New York, located to the north;
- the city of Scranton, Lackawanna County, Pennsylvania, to the south; and
- Wilkes-Barre, Luzerne County, Pennsylvania, to the southwest.



Susquehanna County could best be described as a bedroom county with a high percentage of its residents commuting to work in Broome County, New York, or to the Scranton, Pennsylvania, area. The southern part of Susquehanna County tends to gravitate south for both employment and shopping, while the northern part of the county goes north to Broome County, New York. The western part of Susquehanna County gravitates south and west to and through Wyoming County. Wyoming County is home to a Proctor & Gamble manufacturing facility. This is an economic stimulus to Wyoming County and the surrounding areas.

Our offices are located in counties that would be considered sparsely populated, as they are made up of many small towns and villages. The latest population figures show Susquehanna County at approximately 42,000 and Wyoming County at approximately 30,000 residents. Both counties are experiencing growth, but not robust growth. Broome County has approximately 208,000 residents and the Town of Conklin has approximately 7,000 residents. The economy of Broome County has overall been hit hard and has lost many manufacturing jobs in the past ten years. This trend continues. Fortunately, the new employment centers are in the Town of Conklin and the neighboring Town of Kirkwood. Both towns border Susquehanna County, Pennsylvania. Interstate 81 runs north and south through the eastern half of Susquehanna County and has brought an influx of people from New Jersey and the Philadelphia area. These people have purchased homes and land to build homes that are used as vacation/recreation retreats and, quite often, become retirement homes.

## **BUSINESS**

### **Lending Activities**

PNB provides a full range of retail and commercial banking services designed to meet the borrowing and depository needs of small and medium sized businesses and consumers in its market areas. A significant amount of PNB's loans are to customers located within its service areas. PNB has no foreign loans or highly leveraged transaction loans, as defined by the FRB. A majority of the loans in PNB's portfolio have been originated by PNB. Policies adopted by the Board of Directors are the basis by which PNB conducts its lending activities. These loan policies grant individual lending officers authority to make secured and unsecured loans in specific dollar amounts. Larger loans must be approved by senior officers or by the Board of Directors. PNB's management information systems and loan review policies are designed to monitor lending to ensure adherence to PNB's loan policies.

The commercial loans offered by PNB include:

- commercial real estate loans;
- working capital;
- equipment and other commercial loans;
- construction loans;
- SBA guaranteed loans; and
- agricultural loans.

PNB's commercial real estate loans are used primarily to provide financing for retail operations, manufacturing operations, farming operations, multi-family housing units, and churches. Commercial real estate secured loans are generally written for a term of 15 years or less or amortized over a longer period with balloon payments at shorter intervals. Personal guarantees are obtained on nearly all commercial loans. Credit analysis, loan review, and an effective collections process are also used to minimize any potential losses. PNB employs four full-time commercial lending officers. These four people are augmented by branch managers who are authorized to make smaller, less complex, commercial loans.

Payment risk is a function of the economic climate in which PNB's lending activities are conducted; economic downturns in the economy generally or in a particular sector could cause cash flow problems for customers and make loan payments more difficult. PNB attempts to minimize this risk by avoiding concentrations of credit to single borrowers or borrowers in a particular industry. Interest rate risk would occur if PNB were to make loans at fixed rates in an environment in which rates were rising thereby preventing PNB from making loans at the higher prevailing rates. PNB attempts to mitigate this risk by making adjustable rate commercial loans and, when extending fixed rate commercial loans, fixing loan maturities at five years or less. Finally, collateral risk can occur if PNB's position in collateral taken as security for loan repayment is not adequately secured. PNB attempts to minimize collateral risk by avoiding loan concentrations to particular borrowers, by perfecting liens on collateral and by obtaining appraisals on property prior to extending loans.

Consumer loans offered by PNB include:

- residential real estate loans;
- automobile loans;
- manufactured housing loans;
- personal installment loans secured and unsecured for almost any purpose;
- student loans; and
- home equity loans (fixed-rate term and open ended revolving lines of credit).

PNB offers credit cards as an agent bank through another correspondent bank.

Risks applicable to consumer lending are similar to those applicable to commercial lending. PNB attempts to mitigate payment risk in consumer lending by limiting consumer lending products to a term of five years or less. To the extent that PNB extends unsecured consumer loans, there is greater collateral risk; however, credit checks and borrower history are obtained in all consumer loan transactions.

Residential mortgage products include adjustable-rate as well as conventional fixed-rate loans. Terms vary from 1, 5, and 10-year adjustable rate loans to 5, 10, 15, 20, and 30-year fully amortized fixed rate loans. Bi-weekly payment plans are also available. Personal secured and unsecured revolving lines of credit with variable interest rates and principal amounts ranging from \$1,000 to \$10,000 are offered to credit-worthy customers. The largest segment of PNB's installment loan portfolio is fixed-rate loans. Most are secured either by automobiles, motorcycles, snowmobiles, boats, other personal property, or by liens filed against real estate. These loans are generally available in terms of up to 15 years with automobile loans having maturities of up to 60 months and real estate loans having maturities up to 15 years. Loans secured by other collateral usually require a maturity of less than 60 months. Home equity products include both fixed-rate term products and also an open-end revolving line of credit with a maximum loan-to-value ratio of 80% of current appraisal. A special MGIC program now offered through the Bank, allows for loans of up to 100% of the appreciated value for qualified applicants. Credit checks, credit scoring, and debt-to-income ratios within preset parameters are used to qualify borrowers.

Mortgage loans have historically had a longer average life than commercial or consumer loans. Accordingly, payment and interest rate risks are greater in some respects with mortgage loans than with commercial or consumer lending. Deposits, which are used as the primary source to fund mortgage lending, tend to be of shorter duration than the average maturities on residential mortgage loans and are more susceptible to interest rate changes. Historical records indicate that our mortgage loans, no matter what maturity, have an average life of less than seven years. In 2003, the Bank started selling mortgages in the secondary market. Mortgages are also written with adjustable rates. Mortgage lending is also subject to economic downturns, in that increases in unemployment could adversely affect the ability of borrowers to repay mortgage loans and decreases in property values could affect the value of the real estate serving as collateral for the loan.

Loan growth remained steady in 2006 when compared to 2004 and 2005. Industry standard debt-to-income ratios and credit checks are used to qualify borrowers on all consumer loans. Managers, assistant managers, and customer service officers have retail lending authorities at each of the full-service branch office locations. PNB has centralized loan administration at its operations/administrative offices where mortgage underwriting and loan review and analysis take place.

### **Loan Approval**

Individual loan authorities are established by PNB's Board of Directors upon recommendation by the chief credit officer. In establishing an individual's loan authority, the experience of the lender is taken into consideration, as well as the type of lending in which the individual is involved. The President of PNB, along with members of senior management (loan committee), has the authority to approve new loans over \$250,000 up to \$2,000,000 and all aggregate loans \$325,000 to \$2,500,000 following an analysis and review by credit analysts and commercial lender. The full Board of Directors reviews on a monthly basis, all loans approved by individual lenders and the officers' loan committee. All loan requests which are either complex in nature or exceed \$2,000,000 new or \$2,500,000 aggregate must be analyzed and reviewed by the loan committee and presented with a recommendation to the full Board of Directors for approval or denial.

PNB generally requires that loans secured by first mortgages or real estate have loan-to-value ratios of less than 80% for loans secured by raw land or improved property. In addition, in some instances for qualified borrowers, private mortgage insurance is available for purchase that allows loan-to-value ratios to go as high as 100%. PNB also participates in a guaranteed mortgage insurance program. This allows PNB to make loans on real estate up to 100% of the value of the property. Adjustable rate mortgage products, as well as conventional fixed-rate products, are also

available at PNB.

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### **Deposit Activities**

PNB also offers a full range of deposit and personal banking services insured by the FDIC, including commercial checking and small business checking products, cash management services, retirement accounts such as Individual Retirement Accounts (“IRA”), retail deposit services such as certificates of deposit, money market accounts, savings accounts, a variety of checking account products, automated teller machines (“ATM’s”), point of sale and other electronic services such as automated clearing house (“ACH”) originations, and other personal miscellaneous services.

These miscellaneous services would include:

- safe deposit boxes;
- night depository services;
- traveler’s checks;
- merchant credit cards;
- direct deposit of payroll and other checks;
- U.S. Savings Bonds;
- official bank checks; and
- money orders.

The principal sources of funds for PNB are core deposits that include demand deposits, interest bearing transaction accounts, money market accounts, savings deposits, and certificates of deposit. These deposits are solicited from individuals, businesses, non-profit entities, and government authorities. Substantially all of PNB’s deposits are from the local market areas surrounding each of its offices.

### **Investment Products**

In 1999, PNB entered into an agreement with T.H.E. Financial Services to hire a joint employee to sell investment products. An agent was hired and has an office located in the Bank’s Hallstead Plaza building. In September of 2003, T.H.E. Financial Services was acquired by Financial Network Investment Corporation (FNIC) of Torrance, California. PNB signed a contract dated September 29, 2003 with FNIC. PNB discontinued broker-dealer services with FNIC and contracted with Uvest Financial Services, Charlotte, North Carolina, effective September 6, 2005. In 2005, Peoples Financial Services Corp. formed Peoples Advisors, LLC (“Advisors”) as a member-managed limited liability company under the laws of the Commonwealth of Pennsylvania, to be a wholly owned subsidiary of the Corporation, for the purpose of providing investment advisory services to the general public.

### **Insurance Products**

In April of 2001, PNB purchased a 20% equity interest in Community Bankers Insurance Agency. This investment gives the Bank a referral avenue to provide insurance, broadening our available lines of financial services.

### **Investment Portfolio and Activities**

PNB’s investment portfolio has several objectives.

- A key objective is to provide a balance in PNB's asset mix of loans and investments consistent with its liability structure, and to assist in management of interest rate risk. The investments augment PNB's capital position in the risk-based capital formula, providing the necessary liquidity to meet fluctuations in credit demands of the community and also fluctuations in deposit levels.
- In addition, the portfolio provides collateral for pledging against public funds, and a reasonable allowance for control of tax liabilities.
- Finally, the investment portfolio is designed to provide income for PNB.

In view of the above objectives, the portfolio is treated conservatively by management and only securities that pass those criteria are purchased.

**Competition**

PNB operates in a fairly competitive environment, competing for deposits and loans with commercial banks, thrifts, credit unions, and finance and mortgage companies. Some of these competitors possess substantially greater financial resources than those available to PNB. Also, certain of these institutions have significantly higher lending limits than PNB and may provide various services for their customers that are not presently available at PNB. Financial institutions generally compete on the basis of rates and service. PNB is subject to increasing competition from credit unions, finance companies, and mortgage companies that may not be subject to the same regulatory restrictions and taxations as commercial banks.

PNB will seek to remain competitive with interest rates that it charges on its loans and offers on deposits. It also believes that its success has been, and will continue to be, due to its emphasis on community involvement, customer services, and relationships. With consolidation continuing in the financial industry, and particularly in PNB's markets, smaller profitable banks are gaining opportunities where larger institutions exit markets that are only marginally profitable for them.

The financial services industry in the Company's service area is extremely competitive. The Company's competitors within its service area include banks and bank holding companies with substantially greater resources. Many competitors have substantially higher legal lending limits.

In addition, savings banks, savings and loan associations, credit unions, money market and other mutual funds, mortgage companies, leasing companies, finance companies, and other financial services companies offer products and services similar to those offered by the Company and PNB, on competitive terms.

Many bank holding companies have elected to become financial holding companies under the Gramm-Leach-Bliley Act, which gives them a broader range of products with which we must compete. Although the long-range effects of this development cannot be predicted, most probably it will further narrow the differences and intensify competition among commercial banks, investment banks, insurance firms and other financial services companies.

#### **SEASONALITY**

Management does not feel that the deposits or the business of PNB in general are seasonal in nature. The deposits may, however, vary with local and national economic conditions but should not have a material effect on planning and policy making.

#### **CRITICAL ACCOUNTING POLICIES**

Disclosure of the Company's significant accounting policies is included in Note 1 to the Consolidated Financial Statements. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by management. Additional information is contained in Management's Discussion and Analysis for the most sensitive of these issues, including the provision and allowance for loan losses, which are located in Note 3 to the Consolidated Financial Statements.

Significant estimates are made by management in determining the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate. In estimating the allowance for loan losses, management considers current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan review, financial and managerial strengths of borrowers, adequacy of collateral, if collateral dependent, or present value of future cash flows and other relevant factors.

#### **INTERNET ADDRESS DISCLOSURES**

PNB's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K and amendments to those reports can be found via a link to the SEC Web page through our Website located at [www.peoplesnatbank.com](http://www.peoplesnatbank.com). This website is available free of charge.

PNB has posted its Code of Ethics for the chief executive officer, chief operation and financial officer, and controller. This policy can be found at our Website located at [www.peoplesnatbank.com](http://www.peoplesnatbank.com). Copies are also available upon request and free of charge for Shareholders without Web access.

#### **STATISTICAL DISCLOSURES**

The following statistical disclosures are included in Management's Discussion and Analysis, Item 7 hereof, and are incorporated by reference in this Item 1:

- Interest Rate Sensitivity Analysis;



- Interest Income and Expense, Volume and Rate Analysis;
- Investment Portfolio;
- Loan Maturity and Interest Rate Sensitivity;
- Loan Portfolio;
- Allocation of Allowance for Loan Losses;
- Deposits; and
- Short-term Borrowings.

## **ITEM 1A RISK FACTORS**

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

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

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

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

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

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

### **Competition may decrease our growth or profits.**

We face substantial competition in all phases of our operations from a variety of different competitors, including commercial banks, credit unions, consumer finance companies, insurance companies and money market funds. There is very strong competition among financial services providers in our principal service area. Our competitors may have greater resources, higher lending limits or larger branch systems than we do. Accordingly, they may be able to offer a broader range of products and services as well as better pricing for those products and services than we can. In addition, some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on federally insured financial institutions. As a result, those non-bank competitors may be able to access funding and provide various services more easily or at less cost than we can, adversely affecting our

ability to compete effectively.

**We may be adversely affected by government regulation.**

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

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

We are, and will continue to be, dependent upon the services of our management team. The unexpected loss of services of any key management personnel could have an adverse effect on our business and financial condition because of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

**Environmental liability associated with lending activities could result in losses.**

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

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

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

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

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

**Our legal lending limits are relatively low and restrict our ability to compete for larger customers.**

At December 31, 2006, our lending limit per borrower was approximately \$5.7 million, or approximately 15% of our capital. Accordingly, the size of loans that we can offer to potential borrowers (without participation by other lenders) is less than the size of loans that many of our competitors with larger capitalization are able to offer. Our legal lending limit also impacts the efficiency of our lending operation because it tends to lower our average loan size, which means we have to generate a higher number of transactions to achieve the same portfolio volume. We may engage in loan participations with other banks for loans in excess of our legal lending limits. However, there can be no assurance that such participations will be available at all or on terms which are favorable to us and our customers.

**Market conditions may adversely affect our fee based investment business.**

The Company receives fee based revenues from commissions from the sale of securities and investment advisory fees. In the event of decreased stock market activity, the volume of trading facilitated by Uvest Financial Services will in all likelihood decrease resulting in decreased commission revenue on purchases and sales of securities. In addition, investment advisory fees, which are generally based on a percentage of the total value of an investment portfolio, will decrease in the event of decreases in the values of the investment portfolios, for example, as a result of overall market declines.

**ITEM 1B UNRESOLVED STAFF COMMENTS**

NONE.

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## ITEM 2 PROPERTIES

PNB has four full-service banking offices in Susquehanna County that are located in:

- Borough of Susquehanna Depot;
- Hallstead Plaza, Great Bend Township;
- Borough of Hop Bottom; and
- Montrose, Bridgewater Township.

PNB's presence in Wyoming County, Pennsylvania had been limited to a de novo branch in Nicholson, which opened in 1992, until the purchase of the two Mellon bank offices in 1997. The Wyoming County locations are:

- Borough of Nicholson;
- Meshoppen Township; and
- Tunkhannock Borough.

The administrative/operations office of the Company and PNB is located at 50 Main Street, Hallstead, Pennsylvania. The following departments are located at that office:

- commercial, mortgage and consumer lending operations;
- executive offices;
- marketing department;
- human resources department;
- deposit account support services;
- data processing services; and
- corporate accounting.

PNB began expanding its branch locations into New York in 2002. The latest updates on these expansions are:

- The Bank had an office located in the Price Chopper Super Market in Norwich, Chenango County, New York. This office was purchased from Mohawk Community Bank, Amsterdam, New York, in March of 2002. A decision was made to close this office effective March 31, 2003, because of its distance from Hallstead, high lease payments, and lack of growth opportunity for our Bank in that area.
- Subsequently, real estate was purchased in Conklin, New York, approximately 10 miles from Hallstead. Regulators approved permission to establish an office at that site and the official opening date was March 17, 2003. The office is located at 1026 Conklin Road and is approximately ten miles from the Administrative Office of PNB.
- Also, on December 12, 2002, property was purchased at 108 Second Street, Town of Sanford, Village of Deposit, Broome County, New York. Regulatory approval was received to establish this second New York State office, and the official opening date of this office, which is located approximately 25 miles from the Administrative Office, was April 18, 2005.
- The application was approved for the third New York State office located on Front Street in the Town of Chenango, Broome County. This office, which was officially opened on June 6, 2005, is approximately 20 miles from the Administrative Office.

All offices are owned in fee title by PNB with the exception of the Hallstead Plaza, Meshoppen and Town of Chenango offices. The Hallstead Plaza and Meshoppen offices are subject to ground leases; and the Front Street office is subject to a building lease. Each lease is either long-term expiring in September 2028 or includes renewal options. Current lease payments range from \$2,535 to \$38,496 annually. The leases provide that the Bank pay property taxes, insurance, and maintenance costs. Nine of the ten offices provide drive-up banking services and eight offices have 24-hour ATM services.

## ITEM 3 LEGAL PROCEEDINGS

The Company is a defendant in various lawsuits wherein various amounts are claimed. In the opinion of the Company's management, these suits are without merit and should not result in judgments, which, in the aggregate, would have a material adverse effect on the Company's consolidated financial statements.

**ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

NONE.

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**PART II****ITEM 5 MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

The Company's Common Stock is not listed on an exchange or quoted on the National Association of Securities Dealers, Inc. Automated Quotation system (NASDAQ). The Company's common stock is traded sporadically in the over-the-counter market and, accordingly, there is no established public trading market at this time. The Company's stock is listed on the OTC Bulletin Board under the symbol PFIS. The cusip number is 711040-10-5. The investment firms of Ferris, Baker Watts, Incorporated from Baltimore, Maryland, and Ryan Beck from Livingston, New Jersey, make a limited market in the Company's common stock. The Company, and previously the Bank, has continuously paid dividends for more than 90 years and it is the intention to pay dividends in the future. However, future dividends must necessarily depend upon earnings, financial condition, appropriate legal restrictions, and other factors at the time that the Board of Directors considers dividend payments. As of December 31, 2006, there were 56,467 outstanding options to purchase the Company's common stock. See Note 8 of the Consolidated Financial Statements for more information. Book value of common stock at December 31, 2006, was \$13.16 and on December 31, 2005, it was \$12.55. As of December 31, 2006, the Company had approximately 1,036 shareholders of record. At such date, 3,133,874 shares of Common Stock were outstanding.

The following table reflects high and low bid prices for shares of the Company's Common Stock to the extent such information is available, and the dividends declared with respect thereto during the preceding two years.

**COMPANY STOCK**

|                | <b>2006</b>        |             |                  | <b>2005</b>        |             |                  |
|----------------|--------------------|-------------|------------------|--------------------|-------------|------------------|
|                | <b>Price Range</b> |             | <b>Dividends</b> | <b>Price Range</b> |             | <b>Dividends</b> |
|                | <b>Low</b>         | <b>High</b> | <b>Declared</b>  | <b>Low</b>         | <b>High</b> | <b>Declared</b>  |
| First Quarter  | \$ 29.05           | \$ 31.50    | \$ .19           | \$ 34.00           | \$ 36.25    | \$ .19           |
| Second Quarter | \$ 28.90           | \$ 29.25    | \$ .19           | \$ 32.50           | \$ 34.00    | \$ 1.19          |
| Third Quarter  | \$ 26.35           | \$ 28.90    | \$ .19           | \$ 30.25           | \$ 32.75    | \$ .19           |
| Fourth Quarter | \$ 26.00           | \$ 26.50    | \$ .19           | \$ 30.75           | \$ 32.30    | \$ .19           |



The following table discloses the number of outstanding options, warrants and rights granted by the Company to participants in equity compensation plans, as well as the number of securities remaining available for future issuance under these plans. The table provides this information separately for equity compensation plans that have and have not been approved by security holders.

|  | (a)   | (b)   | (c)   |
|--|---|---|---|
|  | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans {excluding securities reflected in column (a) }* |
| Equity compensation plans approved by stockholders     | 56,467  | \$ 20.03  | 89,251  |
| Equity compensation plans not approved by stockholders | 0   | 0   | 0   |
| Total  | 56,467  | \$ 20.03  | 89,251  |

\* Securities for future issuance are reserved and issued at the discretion of the Board of Directors on an annual basis.

The following table discloses the purchases made by the Company of shares of its common stock in the fourth quarter of 2006.

| MONTH                                | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Maximum number of shares that may yet be purchased under the plans or programs (1) |
|--------------------------------------|----------------------------------|------------------------------|--|--|
| October 1, 2006 - October 31, 2006   | 0                                | \$ 0                         | 0  | 89,251   |
| November 1, 2006 - November 30, 2006 | 0                                | 0                            | 0  | 89,251   |
| December 1, 2006 - December 31, 2006 | 0                                | 0                            | 0  | 89,251   |
| Total                                | 0                                | \$ 0                         | 0  |  |

(1) On December 27, 1995, the Board of Directors authorized the repurchase of 187,500 shares of the Corporation's common stock from shareholders. On July 2, 2001, the Board of Directors authorized the repurchase of an additional 5%, or 158,931 shares of the Corporation's common stock outstanding. Neither repurchase program stipulated an expiration date.

The performance graph formerly included in the Company's Proxy Statement can now be found in the Company's Annual Report to its shareholders.



**ITEM 6 SELECTED FINANCIAL DATA**

| <b>Consolidated Financial<br/>Highlights</b>         | <b>At and For the Years Ended December 31,</b> |             |             |             |             |
|--|--|-------------|-------------|-------------|-------------|
|  | <b>2006</b>                                    | <b>2005</b> | <b>2004</b> | <b>2003</b> | <b>2002</b> |
| <b>(Dollars in Thousands, except Per Share Data)</b> |  |             |             |             |             |
| Net Income   | \$ 4,129                                       | \$ 4,476    | \$ 4,453    | \$ 5,564    | \$ 5,015    |
| Return of Average Assets                             | 1.03%  | 1.16%       | 1.18%       | 1.54%       | 1.52%       |
| Return on Average Equity                             | 10.32%   | 11.37%      | 10.84%      | 14.18%      | 14.30%      |
| <b>Shareholders' Value</b>                           |  |             |             |             |             |
| Earnings per Share, Basic                            | \$ 1.31  | \$ 1.42     | \$ 1.41     | \$ 1.76     | \$ 1.59     |
| Earnings per Share, Diluted                          | 1.31   | 1.41        | 1.40        | 1.75        | 1.59        |
| Regular Cash Dividends                               | 0.76   | 0.76        | 0.73        | 0.65        | 0.59        |
| Special Cash Dividends                               | 0.00   | 1.00        | 0.00        | 0.00        | 0.00        |
| Book Value   | 13.16  | 12.55       | 13.42       | 12.98       | 12.17       |
| Market Value   | 26.00  | 31.45       | 36.00       | 32.40       | 20.00       |
| Market Value/Book Value Ratio                        | 197.57%  | 250.60%     | 268.26%     | 249.61%     | 164.38%     |
| Price Earnings Multiple                              | 19.85X   | 22.14X      | 25.59X      | 18.41X      | 12.57X      |
| Dividend Payout Ratio                                | 57.93%   | 53.50%      | 51.91%      | 36.96%      | 36.89%      |
| Dividend Yield                                       | 2.94%  | 2.42%       | 2.03%       | 2.07%       | 3.03%       |
| <b>Safety and Soundness</b>                          |  |             |             |             |             |
| Stockholders' Equity/Asset Ratio                     | 9.91%  | 10.13%      | 11.16%      | 11.06%      | 11.05%      |
| Allowance for Loan Loss as a<br>Percent of Loans     | 0.66%  | 0.92%       | 1.12%       | 0.89%       | 0.87%       |
| Net Charge Offs/Total Loans<br>Allowance for Loan    | 0.33%  | 0.29%       | 0.17%       | 0.06%       | 0.03%       |
| Loss/Nonaccrual Loans<br>Allowance for Loan          | 402.70%  | 206.62%     | 132.77%     | 212.70%     | 567.45%     |
| Loss/Non-performing Loans                            | 248.89%  | 183.74%     | 116.29%     | 192.20%     | 367.87%     |
| <b>Balance Sheet Highlights</b>                      |  |             |             |             |             |
| Total Assets   | \$ 416,268                                     | \$ 391,198  | \$ 379,375  | \$ 371,289  | \$ 346,842  |
| Total Investments                                    | 110,302  | 108,313     | 113,598     | 116,126     | 105,972     |
| Net Loans  | 269,383  | 256,870     | 242,075     | 234,274     | 219,437     |
| Allowance for Loan Losses                            | 1,792  | 2,375       | 2,739       | 2,093       | 1,935       |
| Short-term Borrowings                                | 12,574   | 17,842      | 14,614      | 7,085       | 13,113      |
| Long-term Borrowings                                 | 36,525   | 34,770      | 46,034      | 41,952      | 34,744      |
| Total Deposits                                       | 323,613  | 296,962     | 274,775     | 279,700     | 259,187     |
| Stockholders' Equity                                 | \$ 41,240                                      | \$ 39,616   | \$ 42,354   | \$ 41,076   | \$ 38,323   |

## **ITEM 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This consolidated review and analysis of Peoples Financial Services Corp. (the Company) is intended to assist the reader in evaluating the Company's performance for the years-ending December 31, 2006, 2005, and 2004. The information should be read in conjunction with the consolidated financial statements and the accompanying notes to those statements.

Peoples Financial Services Corp. (the Company) is the one-bank holding company of Peoples National Bank (the Bank), which is wholly owned by the Company. The Company and the Bank derive their primary income from the operation of a commercial bank, including earning interest on loans and investment securities. The Bank incurs interest expense in relation to deposits and other borrowings. The Bank operates ten full-service branches in the Hallstead Shopping Plaza, Hop Bottom, Montrose, Susquehanna, Nicholson, Tunkhannock, and Meshoppen, Pennsylvania and Conklin, Village of Deposit and Town of Chenango, Broome County, New York. The Bank has on-site automated teller machines at all offices except Hop Bottom and Meshoppen. The administrative offices and operations offices are located in Hallstead, Pennsylvania. Principal market areas are Susquehanna and Wyoming Counties in Pennsylvania and the Southern Tier of Broome County, New York and the bordering areas of those counties. As of December 31, 2006, the Bank employed 106 full-time employees and 16 part-time employees.

### **Forward Looking Statements**

When used in this discussion, the words "believes", "anticipates", "contemplated", "expects", or similar expressions are intended to identify forward looking statements. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Those risks and uncertainties include changes in interest rates, the ability to control costs and expenses, and general economic conditions. The Company undertakes no obligation to publicly release the results of any revisions to those forward looking statements that may be made to reflect events or circumstances after this date or to reflect the occurrence of unanticipated events.

### **Critical Accounting Policies**

Note 1 to the Company's consolidated financial statements lists significant accounting policies used in the development and presentation of its financial statements. This discussion and analysis, the significant accounting policies, and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for an understanding and evaluation of the Company and its results of operations.

The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States, which require the Bank to make estimates and assumptions. The Bank believes that its determination of the allowance for loan losses involves a higher degree of judgment and complexity than the Bank's other significant accounting policies. Further, these estimates can be materially impacted by changes in market conditions or the actual or perceived financial condition of the Bank's borrowers, subjecting the Bank to significant volatility of earnings.

The allowance for loan losses is established through the provision for loan losses, which is a charge against earnings. Provisions for loan losses are made to reserve for estimated probable losses on loans. The allowance for loan losses is a significant estimate and is regularly evaluated by the Bank for adequacy by taking into consideration factors such as changes in the nature and volume of the loan portfolio, trends in actual and forecasted credit quality, including delinquency, charge-off and bankruptcy rates, and current economic conditions that may affect a borrower's ability to pay. The use of different estimates of assumptions could produce a different provision for loan losses. For additional discussion concerning the Bank's allowance for loan losses and related matters, see "Provision for Loan Losses".



Prior to January 1, 2006 and as previously permitted by SFAS No. 123, the Company accounted for stock-based compensation in accordance with Accounting Principles Board Opinion (APB) No. 25. Under APB No. 25, no compensation expense was recognized in the income statement related to any option granted under the Company stock option plans. The pro forma impact to net income and earnings per share that would have occurred if compensation expense had been recognized, based on the estimated fair value of the options on the date of the grant, is disclosed in the notes to the consolidated financial statements for 2005 and 2004. In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123(R), "Share-Based Payment." Statement No. 123(R) replaced Statement No. 123, "Accounting for Stock-Based Compensation," and superseded APB Opinion No. 25, "Accounting for Stock Issued to Employees." Statement No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. Public companies were required to adopt the new standard using a modified prospective method and were given the option of restating prior periods using the modified retrospective method. The Bank did not elect to use the modified retrospective method. Under the modified prospective method, companies are required to record compensation cost for new and modified awards over the related vesting period of such awards prospectively and record compensation cost prospectively for the unvested portion, at the date of adoption, of previously issued and outstanding awards over the remaining vesting period of such awards. No change to prior periods presented is permitted under the modified prospective method. Statement No. 123(R) became effective for annual reporting periods beginning after December 15, 2005. Adopting Statement No. 123(R) on January 1, 2006 using the modified prospective method, the Company incurred total stock-based compensation expense, net of related tax effects, in the amount of \$3,000 for the year-ending December 31, 2006.

## RESULTS OF OPERATIONS

### Net Interest Income

Net interest income is the main source of the Company's income. It is the difference between interest earned on assets and interest paid on liabilities. The discussion of net interest income should be read in conjunction with Table 2: "Distribution of Assets, Liabilities and Stockholders' Equity; Interest Rates and Interest Differential", and Table 3: "Rate/Volume Analysis of Changes in Net Interest Income."

The following table shows the net interest income on a fully-tax-equivalent basis for each of the three years-ending December 2006, 2005, and 2004.

TABLE 1

### NET INTEREST INCOME

| (In Thousands)                                   | Year-Ended December 31, |           |           |
|--|-------------------------|-----------|-----------|
|  | 2006                    | 2005      | 2004      |
| Total Interest Income                            | \$ 22,698               | \$ 20,672 | \$ 19,759 |
| Tax Equivalent Adjustment                        | 1,203                   | 1,174     | 1,175     |
| Total Tax Equivalent Interest Income             | 23,901                  | 21,846    | 20,934    |
| Total Interest Expense                           | 10,797                  | 8,248     | 7,084     |
| Net Interest Income (Fully Tax Equivalent Basis) | \$ 13,104               | \$ 13,598 | \$ 13,850 |

Table 2 includes the average balances, interest income and expense, and the average rates earned and paid for assets and liabilities. For yield calculation purposes, non-accruing loans are included in average loan balances. Table 3 analyzes the components contributing to the changes in net interest income and indicates the impact in either changes in rate or changes in volume.



**Distribution of Assets, Liabilities and Stockholders' Equity****Interest Rates and Interest Differential**

TABLE 2

| (Dollars in Thousands)                      | Year-Ended<br>December 31, 2006 |           |                | Year-Ended<br>December 31, 2005 |           |                | Year-Ended<br>December 31, 2004 |           |                |
|---|---------------------------------|-----------|----------------|---------------------------------|-----------|----------------|---------------------------------|-----------|----------------|
|   | Average<br>Balance              | Interest  | Yield/<br>Rate | Average<br>Balance              | Interest  | Yield/<br>Rate | Average<br>Balance              | Interest  | Yield/<br>Rate |
| <b>ASSETS</b>                               |                                 |           |                |                                 |           |                |                                 |           |                |
| Loans                                       |                                 |           |                |                                 |           |                |                                 |           |                |
| Real Estate                                 | \$ 110,972                      | \$ 7,136  | 6.43%          | \$ 108,887                      | \$ 6,814  | 6.26%          | \$ 107,956                      | \$ 6,845  | 6.34%          |
| Installment                                 | 17,210                          | 1,417     | 8.23%          | 17,587                          | 1,304     | 7.41%          | 17,561                          | 1,178     | 6.71%          |
| Commercial                                  | 118,904                         | 8,532     | 7.18%          | 104,317                         | 7,058     | 6.77%          | 99,935                          | 6,208     | 6.21%          |
| Tax Exempt                                  | 20,051                          | 853       | 6.45%          | 19,136                          | 757       | 5.99%          | 14,937                          | 593       | 6.02%          |
| Other Loans                                 | 473                             | 58        | 12.26%         | 632                             | 53        | 8.39%          | 648                             | 47        | 7.25%          |
| Total Loans                                 | 267,610                         | 17,996    | 6.89%          | 250,559                         | 15,986    | 6.54%          | 241,037                         | 14,871    | 6.30%          |
| Investment Securities (AFS)                 |                                 |           |                |                                 |           |                |                                 |           |                |
| Taxable                                     | 65,202                          | 3,032     | 4.65%          | 72,358                          | 3,086     | 4.26%          | 72,816                          | 3,152     | 4.33%          |
| Non-Taxable                                 | 39,435                          | 1,484     | 5.70%          | 39,386                          | 1,523     | 5.86%          | 41,257                          | 1,687     | 6.20%          |
| Total Securities                            | 104,637                         | 4,516     | 5.05%          | 111,744                         | 4,609     | 4.83%          | 114,073                         | 4,839     | 5.00%          |
| Time Deposits With                          |                                 |           |                |                                 |           |                |                                 |           |                |
| Other Banks                                 | 932                             | 53        | 5.69%          | 0                               | 0         | 0.00%          | 0                               | 0         | 0.00%          |
| Fed Funds Sold                              | 2,467                           | 133       | 5.39%          | 2,093                           | 77        | 3.68%          | 3,796                           | 49        | 1.29%          |
| Total Earning Assets                        | 375,646                         | 22,698    | 6.36%          | 364,396                         | 20,672    | 6.00%          | 358,906                         | 19,759    | 5.83%          |
| Less: Allowance for                         |                                 |           |                |                                 |           |                |                                 |           |                |
| Loan Losses                                 | (2,344)                         |           |                | (2,601)                         |           |                | (2,398)                         |           |                |
| Cash and Due from                           |                                 |           |                |                                 |           |                |                                 |           |                |
| Banks                                       | 6,768                           |           |                | 6,526                           |           |                | 6,535                           |           |                |
| Premises and                                |                                 |           |                |                                 |           |                |                                 |           |                |
| Equipment, Net                              | 7,816                           |           |                | 5,565                           |           |                | 4,644                           |           |                |
| Other Assets                                | 12,899                          |           |                | 12,167                          |           |                | 11,130                          |           |                |
| Total Assets                                | \$ 400,785                      |           |                | \$ 386,053                      |           |                | \$ 378,817                      |           |                |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                                 |           |                |                                 |           |                |                                 |           |                |
| Deposits                                    |                                 |           |                |                                 |           |                |                                 |           |                |
| Interest Bearing                            |                                 |           |                |                                 |           |                |                                 |           |                |
| Demand                                      | 25,462                          | 262       | 1.03%          | 24,207                          | \$ 169    | 0.70%          | 26,282                          | 190       | 0.72%          |
| Regular Savings                             | 95,360                          | 3,135     | 3.29%          | 72,597                          | 1,258     | 1.73%          | 63,414                          | 637       | 1.00%          |
| Money Market                                |                                 |           |                |                                 |           |                |                                 |           |                |
| Savings                                     | 37,747                          | 1,446     | 3.83%          | 37,232                          | 911       | 2.45%          | 39,778                          | 559       | 1.41%          |
| Time  | 102,195                         | 3,905     | 3.82%          | 107,115                         | 3,448     | 3.22%          | 111,431                         | 3,392     | 3.04%          |
| Total Interest Bearing                      |                                 |           |                |                                 |           |                |                                 |           |                |
| Deposits                                    | 260,764                         | 8,748     | 3.35%          | 241,151                         | 5,786     | 2.40%          | 240,905                         | 4,778     | 1.98%          |
| Other Borrowings                            | 48,878                          | 2,049     | 4.19%          | 57,987                          | 2,462     | 4.25%          | 53,957                          | 2,306     | 4.27%          |
| Total Interest Bearing                      |                                 |           |                |                                 |           |                |                                 |           |                |
| Liabilities                                 | 309,642                         | 10,797    | 3.49%          | 299,138                         | 8,248     | 2.76%          | 294,862                         | 7,084     | 2.40%          |
| Net Interest Spread                         |                                 | \$ 11,901 | 2.88%          |                                 | \$ 12,424 | 3.24%          |                                 | \$ 12,675 | 3.43%          |
| Non-Interest Bearing                        |                                 |           |                |                                 |           |                |                                 |           |                |



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|   |            |            |            |       |
|---|------------|------------|------------|-------|
| Demand Deposits                               | 49,888     | 45,574     | 41,315     |       |
| Accrued Expenses and<br>Other Liabilities     | 2,135      | 1,959      | 1,554      |       |
| Stockholder's Equity                          | 39,120     | 39,382     | 41,086     |       |
| Total Liabilities and<br>Stockholder's Equity | \$ 400,785 | \$ 386,053 | \$ 378,817 |       |
| Interest<br>Income/Earning<br>Assets          |            | 6.36%      | 6.00%      | 5.83% |
| Interest<br>Expense/Earning<br>Assets         |            | 2.87%      | 2.26%      | 1.97% |
| Net Interest Margin                           |            | 3.49%      | 3.73%      | 3.86% |

TABLE 3

**Rate/Volume Analysis of Changes in Net Interest Income**  
**2006 to 2005**

| (In Thousands)                              | 2006 to 2005           |                       |        | 2005 to 2004           |                          |        |
|---|------------------------|-----------------------|--------|------------------------|--------------------------|--------|
|   | Increase<br>(Decrease) | Change<br>Due to Rate | Volume | Increase<br>(Decrease) | Change<br>Due<br>to Rate | Volume |
| <b>Interest Income</b>                      |                        |                       |        |                        |                          |        |
| Real Estate Loans                           | \$ 322                 | \$ 183                | \$ 139 | \$ (31)                | \$ (91)                  | \$ 60  |
| Installment Loans                           | 113                    | 144                   | (31)   | 126                    | 124                      | 2      |
| Commercial Loans                            | 1,474                  | 427                   | 1,047  | 850                    | 554                      | 296    |
| Tax Exempt Loans                            | 96                     | 37                    | 59     | 164                    | (2)                      | 166    |
| Other Loans                                 | 5                      | 24                    | (19)   | 6                      | 7                        | (1)    |
| Total Loans                                 | 2,010                  | 815                   | 1,195  | 1,115                  | 592                      | 523    |
| <b>Investment Securities<br/>(AFS)</b>      |                        |                       |        |                        |                          |        |
| Taxable                                     | (54)                   | 279                   | (333)  | (66)                   | (46)                     | (20)   |
| Non-Taxable                                 | (39)                   | (42)                  | 3      | (164)                  | (92)                     | (72)   |
| Total Securities (AFS)                      | (93)                   | 237                   | (330)  | (230)                  | (138)                    | (92)   |
| <b>Time Deposits with Other<br/>Banks</b>   |                        |                       |        |                        |                          |        |
| Fed Funds Sold                              | 53                     | 0                     | 53     | 0                      | 0                        | 0      |
| Fed Funds Sold                              | 56                     | 36                    | 20     | 28                     | 91                       | (63)   |
| Total Interest Income                       | 2,026                  | 1,088                 | 938    | 913                    | 545                      | 368    |
| <b>Interest Expense</b>                     |                        |                       |        |                        |                          |        |
| <b>Interest Bearing Demand<br/>Deposits</b> |                        |                       |        |                        |                          |        |
| Regular Savings Deposits                    | 93                     | 80                    | 13     | (21)                   | (7)                      | (14)   |
| Money Market Savings<br>Deposits            | 1,877                  | 1,129                 | 748    | 621                    | 462                      | 159    |
| Time Deposits                               | 535                    | 515                   | 20     | 352                    | 414                      | (62)   |
| Total Interest Bearing<br>Deposits          | 457                    | 645                   | (188)  | 56                     | 195                      | (139)  |
| Other Borrowings                            | 2,962                  | 2,369                 | 593    | 1,008                  | 1,064                    | (56)   |
| Total Interest Expense                      | (413)                  | (31)                  | (382)  | 156                    | (15)                     | 171    |
| Total Interest Expense                      | 2,549                  | 2,338                 | 211    | 1,164                  | 1,049                    | 115    |
| Net Interest Spread                         | \$ (523)               | \$ (1,250)            | \$ 727 | \$ (251)               | \$ (504)                 | \$ 253 |

Interest income on total loans increased in 2006. This increase of \$2,010,000 is shown in Table 3 and is an increase of \$815,000 over the prior year's increase, 2005 to 2004, of \$1,115,000. Although higher interest rates had a positive impact on the Bank's interest income contributing \$815,000 to the increase in our year-to-year comparisons of loan income, loan growth had the larger impact on the bottom line by contributing \$1,195,000 to loan income growth. To view the loan portfolio growth numbers see Table 2 which shows the average balance in loans grew from \$250,559,000 in 2005 to \$267,610,000 in 2006.

In 2006, interest income on taxable investments decreased \$54,000 year over year from 2005. Table 3 shows that higher rates added \$279,000 to interest income, but the decrease in volume in the taxable portfolio resulted in a decrease in income of \$333,000. The average taxable investments as shown in Table 2, were \$65,202,000 in 2006 compared to \$72,358,000 in 2005.

Interest income on non-taxable investments decreased \$39,000 year over year with a \$42,000 loss due to lower rates and a slight increase of \$3,000 due to volume. The average balances on non-taxable investments were \$39,386,000 in 2005 compared to \$39,435,000 in 2006. Interest income from federal funds sold increased \$56,000 from 2005 to 2006 because of higher interest rates and higher balances as shown in Table 3. Average federal funds sold were \$2,093,000 in 2005 compared to \$2,467,000 in 2006. Interest income from time deposits with other banks increased \$53,000 in 2006 strictly due to growth as there were none held during 2005.

On the overall interest expense side, expenses increased by \$2,549,000. Of the total increase, \$2,338,000 is attributable to higher rates while \$211,000 is attributable to growth. To break this down further, the deposit interest costs increased overall by \$2,962,000 with \$2,369,000 of the increase due to rate while the costs for other borrowed funds decreased overall by \$413,000 with \$31,000 of that decrease due to rate and the additional decrease of \$382,000 due to loss of volume. In 2006, the average balance of deposits was \$260,764,000 compared to the 2005 average balance of \$241,151,000. The average balance of borrowed funds was \$48,878,000 in 2006. The year to year differences as shown in Table 3 indicate that interest expense increases changed by \$1,385,000 with 2005 to 2004 being an increase of \$1,164,000 and 2006 to 2005 being an increase of \$2,549,000.

The last line in Table 3 shows the net interest spread decrease of \$523,000 for 2006 compared to a decrease of \$251,000 in the 2005 to 2004. The loss of \$523,000 in net interest spread in 2006 is due to the impact of interest rates which caused a decrease of \$1,250,000 while growth contributed a positive influence of \$727,000.

### PROVISION FOR LOAN LOSS

The provision and allowance for loan losses are based on management's ongoing assessment of the Company's credit exposure and consideration of other relevant factors. The allowance for loan losses is a valuation reserve that is available to absorb future loan charge-offs. The provision for loan losses is the amount charged to earnings on an annual basis. The factors considered in management's assessment of the reasonableness of the allowance for loan losses include prevailing and anticipated economic conditions, assigned risk ratings on loan exposures, the results of examinations and appraisals of the loan portfolio conducted by federal regulatory authorities and an independent loan review firm, the diversification and size of the loan portfolio, the level of and inherent risk in non-performing assets, and any other factors deemed relevant by management.

The provision for loan losses was \$302,000, \$392,000 and \$1,050,000 for the years 2006, 2005, and 2004, respectively. Net charge-offs for 2006 were \$885,000 compared to \$756,000 in 2005. As of December 31, 2006, the allowance for loan loss was .66% of loans and at December 31, 2005, the ratio was .92% of loans. After allocation of reserves to all non-accrual and special-mention loans, as well as applying a percentage to outstanding loans based on the loss history of such loans in each category, the opinion of management was that the allowance for loan loss was proper and sufficient. The ratio of allowance for loan loss to non-performing loans was 248.89% at year-end 2006 compared to 183.74% at year-end 2005 and 116.29% at year-end 2004.

The following table analyzes the increase in total other income by comparing the years-ending 2006, 2005 and 2004.

TABLE 4

### NON-INTEREST INCOME

|                                | Year Ended December 31, |          |          | Variance 2006          |                         | Variance 2005          |                         |
|--------------------------------|-------------------------|----------|----------|------------------------|-------------------------|------------------------|-------------------------|
|                                | 2006                    | 2005     | 2004     | Amount<br>Of<br>Change | Percent<br>Of<br>Change | Amount<br>Of<br>Change | Percent<br>Of<br>Change |
| (Dollars in Thousands)         |                         |          |          |                        |                         |                        |                         |
| Customer Service Fees          | \$ 1,770                | \$ 1,749 | \$ 1,489 | \$ 21                  | 1.20 %                  | \$ 260                 | 17.46 %                 |
| Investment Division Commission |                         |          |          |                        |                         |                        |                         |
| Income                         | 260                     | 201      | 426      | 59                     | 29.35 %                 | (225)                  | (52.82)%                |
| Earnings on Investment on Life |                         |          |          |                        |                         |                        |                         |
| Insurance                      | 281                     | 263      | 236      | 18                     | 6.84 %                  | 27                     | 11.44 %                 |
| Other Income                   | 437                     | 382      | 429      | 55                     | 14.40 %                 | (47)                   | (10.96)%                |
| Gains on Security Sales        | 42                      | 222      | 296      | (180)                  | (81.08 %)               | (74)                   | (25.00)%                |
| Impairment of Securities       | 0                       | 0        | (1,144)  | 0                      | 0 %                     | 1,144                  | 100.00 %                |
| TOTAL Other Income             | \$ 2,790                | \$ 2,817 | \$ 1,732 | \$ (27)                | (0.96%)                 | \$ 1,085               | 62.64 %                 |

**OTHER INCOME**

**Non-Interest Income**

There was an overall decrease in non-interest income of \$27,000 in 2006. The decrease of .96% in 2006 is due to fewer available gains through the sale of investment securities. Unlike prior years, when investment sales were initiated in 2006, market yields were often higher than the yield on the security sold, the result being an incurred loss on the security sales.

For comparison, there was an overall increase in non-interest income of \$1,085,000 in 2005. The increase of 62.64% in 2005 was due to an other-than-temporary security impairment incurred in the fourth quarter of 2004. At the time, the Company owned four preferred equity securities issued by FNMA and FHLMC with aggregate market value depreciation of 20% or more from the Company's amortized cost basis of \$5,000,000. Management had been closely monitoring the market valuations of those preferred equity securities and determined that due to adverse financial events surrounding those agencies that the best course of action, at the time, would be to record an other-than-temporary impairment on those securities in that reporting period under guidance provided by the Financial Accounting Standards Board (FASB). Thus, an impairment charge of \$1,144,000 was recorded in non-interest income in the fourth quarter of 2004. Without that impairment charge in 2004, non-interest income would show an overall decrease of \$59,000, or 2.05%, in 2005.

Non-interest income includes items that are not related to interest rates, but rather to services rendered and activities conducted in conjunction with the operation of a commercial bank. Service charges earned on deposit accounts is the largest single item in this category and represents fees related to deposit accounts including overdraft fees, minimum balance fees, and transaction fees. In 2006, service charges and fees increased \$21,000, or 1.20% compared to an increase of \$260,000 in 2005, when compared to 2004, or 17.46%.

One component of customer service fees which reflects a decrease is income realized on overdrafts which were \$1,189,000 in 2006 compared to \$1,212,000 in 2005, a decrease of \$23,000, or 1.9%. This decrease was due to a processing change in 2006. The actual overdraft fees continued to increase in 2006 while the fees which were refunded increased at a greater rate, thus causing the overall decrease. The decrease in overdraft income realized was compensated for through income recognized from debit cards. Debit card fee income increased to \$290,000 in 2006 compared to \$218,000 in 2005, an increase of \$72,000, or 33.03%. The increase was due to the recognition of transaction fees from customer use of debit cards. Prior to February of 2006, the Company utilized the services of a third party processor to clear debit card transactions. This third party processor was entitled to a portion of the associated transaction fees. As of February 2006, the Company no longer uses this third party processor and now handles these transactions internally, thus retaining 100% of the transaction fees.

In 2005, a component of non-interest income, which reflected a significant increase over the prior year, was income realized on overdrafts which was \$1,212,000 in 2005, compared to \$974,000 in 2004. The Company entered into an overdraft privilege program in June of 2004 which significantly increased the amount of overdraft fees recognized by the Company.

Commissions earned by the Investment Division were \$260,000 in 2006, compared to \$201,000 in 2005, an increase of \$59,000, or 29.35%. As the Investment Division continues to grow and become more established, so does the commissions earned on the assets managed. It is the goal of the Company to continue to grow and cultivate this area. Also contributing to the increase in commissions in 2006 was the increase experienced in the overall stock market as well as the relative stability of the bond market.

By comparison, commissions earned by the Investment Division in 2005 were \$201,000, compared to \$426,000 in 2004, a decrease of \$225,000, or 52.82%. In 2005, the Bank scaled back the underwriting of annuities by its Licensed Bank Employees the result of which was a sharp decrease in related earnings.

Earnings on investment in life insurance were \$281,000 in 2006, compared to \$263,000 in 2005, an increase of \$18,000, or 6.84%. This was due to the overall increase in the crediting rate applied to the balances held in BOLI. One of the BOLI products owned by the Company increased by 151 basis points during the latter seven months of 2006, one increased by 25 basis points for the final three months of 2006 and the third BOLI product decreased by 40 basis points. Each BOLI instrument owned by the Company has a value of between \$2 million and \$2.6 million.

Earnings on investment in life insurance were \$263,000 in 2005, compared to \$236,000 in 2004, an increase of \$27,000, or 11.44%. This was due to the purchase of an additional \$2,000,000 in Bank Owned Life Insurance (BOLI) in June of 2004 and the associated earnings on the additional BOLI for the full twelve months in 2005, as opposed to seven months of earnings in 2004 on that same BOLI policy.

Other income was \$437,000 in 2006, compared to \$382,000 in 2005, an increase of \$55,000, or 14.40%. This was primarily due to income recognized through the operation of the insurance agency which was \$13,000 in 2006, compared to a loss of \$16,000 in 2005. This increase accounts for the majority of the overall increase in other income in 2006.

Other income was \$382,000 in 2005, compared to \$429,000 in 2004, a decrease of \$47,000, or 10.96%. This was primarily due to the decrease of funds received as settlement of the net fraud claim involving certificates of deposit invested in through Entrust Group and Bentley Financial Services, Inc. to \$27,000 in 2005. Related receipts in 2004 totaled \$110,000.

In 2006, The Company had \$42,000 in realized gains through sales of available-for-sale securities compared to \$222,000 in 2005. This is a decrease of \$180,000, or 81.08%. Comparing 2005 to 2004, the Company had \$222,000 in realized gains through sales of available-for-sale securities compared to \$296,000 in 2004. This is a decrease of \$74,000, or 25.00%.

TABLE 5

**NON-INTEREST EXPENSE**

| (Dollars in Thousands)                 | Year Ended   |          |          | Variance 2006 |              | Variance 2005 |              |
|--|--------------|----------|----------|---------------|--------------|---------------|--------------|
|  | December 31, |          |          | Amount        | Percent      | Amount        | Percent      |
|  | 2006         | 2005     | 2004     | Of<br>Change  | Of<br>Change | Of<br>Change  | Of<br>Change |
| Salaries and Benefits                  | \$ 4,498     | \$ 4,199 | \$ 3,848 | \$ 299        | 7.12%        | \$ 351        | 9.12%        |
| Occupancy Expenses                     | 674          | 564      | 489      | 110           | 19.50%       | 75            | 15.34%       |
| Furniture and Equipment Expense        | 484          | 427      | 336      | 57            | 13.35%       | 91            | 27.08%       |
| FDIC Insurance and Assessments         | 127          | 141      | 140      | (14)          | (9.93%)      | 1             | .71%         |
| Professional Fees and Outside Services | 337          | 471      | 297      | (134)         | (28.45%)     | 174           | 58.59%       |
| Prepayment Penalty - FHLB              | 0            | 808      | 0        | (808)         | (100.00%)    | 808           | 100.00%      |
| Computer Services and Supplies         | 774          | 778      | 617      | (4)           | (0.51%)      | 161           | 26.09%       |
| Taxes, Other Than Payroll and Income   | 370          | 324      | 383      | 46            | 14.20%       | (59)          | (15.40%)     |
| Other Operating Expenses               | 2,224        | 1,676    | 1,780    | 548           | 32.70%       | (104)         | (5.84%)      |
| Total Non-Interest Expense             | \$ 9,488     | \$ 9,388 | \$ 7,890 | \$ 100        | 1.07%        | \$ 1,498      | 18.99%       |

**OTHER EXPENSES****Non-Interest Expense**

Total non-interest expense increased \$100,000 from \$9,388,000 in 2005 to \$9,488,000 in 2006. This is an increase of 1.07%.

Non-interest expense includes all other expenses associated with the Company. Salaries and related benefits is the largest expense in this category and it increased \$299,000, or 7.12%, over year-end 2005. The full-time equivalent number of employees was 109 as of December 31, 2006, compared to 114 as of December 31, 2005. Normal yearly pay increases and increased health insurance costs contributed to the overall increase in salary and benefit expense.

For comparison, salaries and related benefits increased \$351,000, or 9.12%, in 2005 over year-end 2004. The full-time equivalent number of employees was 114 as of December 31, 2005, compared to 104 as of December 31, 2004 due to the addition of staff in 2005 when compared to 2004. A portion of the additional staff was hired in conjunction with 2005 branch expansion. In addition to the increased staff size, normal yearly pay increases and increased health insurance costs contributed to the overall increase in salary and benefit expense.



Occupancy expense increased 19.50%, or \$110,000, in 2006. Every category of expense related to building occupancy increased in 2006 when compared to 2005. These categories include utilities, property taxes, repairs and depreciation. Two new offices located in New York State were opened in 2005, one in April and the second in June. Thus, 2006 was the first full year of operation for those offices and a full year of occupancy costs were incurred in 2006 versus a partial year for each of those offices in 2005.

This compares to 2005 when occupancy expense increased 15.34%, or \$75,000, as compared to 2004. The increase in 2005 was attributed to various factors which included; increased heating costs associated with the rise in energy prices experienced during the winter months of 2005, increased depreciation expense incurred on buildings and improvements placed in service for the Deposit, New York and Town of Chenango, New York offices opened in 2005 and lastly, additional property tax and lease costs associated with those offices.

Furniture and equipment expense increased in 2006 to \$484,000, or 13.35%, compared to 2005 at \$427,000. The increase in 2006 is associated with increased depreciation expense incurred. Flooding occurred in the region in June 2006, and significant damages were experienced as a result. Six of the Company's twelve offices were affected and as such, unexpected investment was made in new furniture and equipment. Much of the furniture and equipment replaced was older, and in some cases, fully depreciated. The new furniture and equipment booked in 2006 caused the related depreciation expense to increase significantly. Depreciation expense on furniture and equipment was \$392,000 in 2006, compared to \$328,000 in 2005, an increase of \$64,000, or 19.51%.

For comparison, furniture and equipment expense increased in 2005 to \$427,000, or 27.08%, compared to 2004 at \$336,000. The increase in 2005 was associated with depreciation expense incurred on additional computer software and equipment, as well as equipment and furnishings for the new Deposit, New York and Town of Chenango, New York offices placed in service in 2005.

Professional fees and outside services were \$337,000 in 2006 which compares to \$471,000 in 2005, a decrease of \$134,000, or 28.45%. The decrease in 2006 is due to fewer costs associated with Sarbanes-Oxley Section 404 compliance in 2006 when compared to 2005. Professional fees were budgeted at \$347,000 for 2006.

For comparison, professional fees and outside services were \$471,000 in 2005 which compared to \$297,000 in 2004. The increase in 2005 was due to increased costs incurred by the Company in relation to testing and compliance with section 404 of the Sarbanes-Oxley Act of 2002 and consulting performed in connection with the new overdraft privilege program which was implemented in June 2004, as well as various consulting and legal services incurred in 2005, which were not incurred in 2004.

Computer services and supplies is another component of other expenses. This category covers the expense of data processing for the Company. In 2006, the expense was \$774,000 compared to \$778,000 in 2005 a decrease of \$4,000, or .51%. These costs are in line with previous years' expenditures.

For comparison, in 2005, computer services and supplies was \$778,000 compared to \$617,000 in 2004. The increase was due to costs associated with maintenance agreements for various computer equipment utilized in the operation of the Bank. With the introduction of an on-line teller system and internet banking services in 2005, the associated costs rose between those two periods.

Taxes, other than payroll and income, are another significant component of non-interest expense. In 2006, this expense increased by \$46,000, or 14.20%, to \$370,000, compared to 2005 at \$324,000. Shares tax will grow as a proportion of the overall growth in Company assets. The Company is currently looking into alternative ways to limit this tax burden going forward.

For comparison, taxes, other than payroll and income, decreased in 2005, to \$324,000, compared to \$383,000 in 2004, a decrease of \$59,000, or 15.40%. In 2005, shares tax owed to Pennsylvania was curtailed through credits received in conjunction with educational grants made to the Community Foundation of Susquehanna County in the amount of \$90,000 which act as direct credits to the tax owed.

Every other non-interest expense is in the category of other. In 2006, this expense increased \$548,000, or 32.70%, and the total for 2006 is \$2,224,000. The remaining components in this figure were: the amortization of premiums on the purchase of the Tunkhannock, Meshoppen, and Conklin branch offices at \$299,000; directors' and associate directors' fees and company education costs of \$326,000; stationary, printing and supplies, \$247,000; postage at \$152,000; and advertising at \$167,000. All were deemed to be in line with budget expectations.

Of the \$548,000 increase experienced in other non-interest expense in 2006, \$192,000 of this increase was directly attributed to flood expenses incurred as the result of regional flooding in June 2006. As previously stated, six of the Company's twelve offices suffered as a result of the

flooding. Events of this nature are deemed to be non-recurring.

This compares to 2005 when this expense decreased \$104,000, or 5.84%, to \$1,676,000. In 2005 these costs were: the amortization of premiums on the purchase of the Tunkhannock, Meshoppen, and Conklin branch offices at \$262,000; directors' and associate directors' fees and company education costs of \$297,000; stationary, printing and supplies, \$216,000; postage at \$152,000; and advertising at \$151,000. Again all were deemed to be in line with budget expectations.

Other non-interest expense was negatively impacted as the result of a prepayment penalty associated with the early retirement of long-term debt at the Federal Home Loan Bank of Pittsburgh. The penalty was incurred in conjunction with the prepayment of \$10,000,000 in term borrowings and was in the amount of \$808,000. This was a one-time charge in 2005, which was not incurred in 2006 or 2004.

## **FEDERAL INCOME TAXES**

The provision for income taxes was \$772,000 in 2006, compared to \$985,000 in 2005 and \$1,014,000 in 2004. The effective tax rate, which is the ratio of income tax expense to income before taxes, was 16% in 2006, 18% in 2005, and 19% in 2004. The tax rate for all periods was substantially less than the federal statutory rate of 34% primarily due to tax-exempt securities and tax-exempt loan income. The effective tax rate declined in 2006 and 2005 from 2004 due to lower pre-tax income and higher tax exempt income. Please refer to Note 9 of the Notes to Consolidated Financial Statements included as part of this report for further analysis of federal income tax expense for 2006.

## **QUARTERLY RESULTS**

Table 6 shows the quarterly results of operations for the Company for 2006. Interest income increased steadily throughout 2006. This was due to the Federal Reserve Bank's rate increases which were implemented in 25 basis point increments to Fed Funds as well as a corresponding 25 basis point increase to the Prime Rate at each of the four meetings of the Federal Reserve's Open Market Committee (FOMC) which led up to the halfway point of 2006. By June 30, 2006, the overnight funds rate had increased for the fourth and final time in this most recent tightening cycle to 5.25% from 4.25% at the end of 2005 and the Prime Rate had increased to 8.25% from 7.25% at the end of 2005. Many of the Bank's loans are tied directly to Prime and this, along with an overall 4.90% increase in loan balances, accounts for the increase in interest income.

Interest expense has also increased in the first three quarters of 2006 due to the reasons outlined in the previous paragraph. Many deposit accounts are tied to indexes which reflect closely the short-end of the yield curve (Fed Funds) and therefore, as rates go up in 25 basis point increments, so does the resulting interest expense. As with loans, the 8.97% increase in interest-bearing deposits played a key role in the increased interest expense in 2005. This was especially true in regard to the Company's certificate of savings account which increased 87.37% to \$78,549,000 as of December 31, 2006, an increase of \$36,627,000, from the December 31, 2005 balance of \$41,922,000. The rate paid on the certificate of savings also increased in 2006, ending the year at 4.88% as compared to 3.91% as of December 31, 2005. This was in direct correlation to the 100 basis point Fed Fund increase implemented by the FOMC.

Table 6 also shows that fewer gains were taken in sales of available-for-sale securities in 2006 when compared to 2005. This was due in part to increasing yields in the bond markets which increased with Federal Reserve rate increases. When this occurs, yields within the Bank's portfolio become less attractive and the marketability or market value of bonds in the investment portfolio decrease. The result is that the Bank had fewer securities sold at a gain. These gains were further offset by other securities which were sold at a loss.

Other income remained steady throughout 2006 as did other expenses. As a result, earnings per common share remained stable throughout 2006 with a slight increase in the fourth quarter. Earnings per common share remained stable throughout 2006.

TABLE 6

**Quarterly Results of Operations**

(In Thousands, Except for Per Share Data)

|                            | <b>Quarter Ended 2006</b> |               |               |               |  |  |  |
|----------------------------|---------------------------|---------------|---------------|---------------|--|--|--|
|                            | <b>31-Mar</b>             | <b>30-Jun</b> | <b>30-Sep</b> | <b>31-Dec</b> |  |  |  |
| Interest Income            | \$ 5,395                  | \$ 5,661      | \$ 5,866      | \$ 5,776      |  |  |  |
| Interest Expense           | (2,383)                   | (2,594)       | (2,822)       | (2,998)       |  |  |  |
| Net Interest Income        | 3,012                     | 3,067         | 3,044         | 2,778         |  |  |  |
| Provision for Loan Loss    | (60)                      | (60)          | (60)          | (122)         |  |  |  |
| Securities Gains/Losses    | (17)                      | 8             | 15            | 36            |  |  |  |
| Other Income               | 672                       | 645           | 675           | 756           |  |  |  |
| Other Expense              | (2,334)                   | (2,493)       | (2,510)       | (2,151)       |  |  |  |
| Income Before taxes        | 1,273                     | 1,167         | 1,164         | 1,297         |  |  |  |
| Income Taxes               | (228)                     | (175)         | (179)         | (190)         |  |  |  |
| Net Income                 | \$ 1,045                  | \$ 992        | \$ 985        | \$ 1,107      |  |  |  |
| Basic Earnings per share   | \$ 0.33                   | \$ 0.32       | \$ 0.31       | \$ 0.35       |  |  |  |
| Diluted Earnings per share | \$ 0.33                   | \$ 0.31       | \$ 0.31       | \$ 0.35       |  |  |  |
|                            |                           |               |               |               |  |  |  |
|                            | <b>Quarter Ended 2005</b> |               |               |               |  |  |  |
|                            | <b>31-Mar</b>             | <b>30-Jun</b> | <b>30-Sep</b> | <b>31-Dec</b> |  |  |  |
| Interest Income            | \$ 5,007                  | \$ 5,151      | \$ 5,284      | \$ 5,230      |  |  |  |
| Interest Expense           | (1,875)                   | (1,997)       | (2,178)       | (2,198)       |  |  |  |
| Net Interest Income        | 3,132                     | 3,154         | 3,106         | 3,032         |  |  |  |
| Provision for Loan Loss    | 0                         | 0             | 0             | (392)         |  |  |  |
| Securities Gains/Losses    | 25                        | 109           | 53            | 35            |  |  |  |
| Other Income               | 612                       | 624           | 658           | 701           |  |  |  |
| Other Expense              | (2,168)                   | (2,384)       | (3,045)       | (1,791)       |  |  |  |
| Income Before taxes        | 1,601                     | 1,503         | 772           | 1,585         |  |  |  |
| Income Taxes               | (327)                     | (315)         | (52)          | (291)         |  |  |  |
| Net Income                 | \$ 1,274                  | \$ 1,188      | \$ 720        | \$ 1,294      |  |  |  |
| Basic Earnings per share   | \$ 0.40                   | \$ 0.38       | \$ 0.23       | \$ 0.41       |  |  |  |
| Diluted Earnings per share | \$ 0.40                   | \$ 0.38       | \$ 0.22       | \$ 0.41       |  |  |  |

**RETURN ON AVERAGE ASSETS AND AVERAGE EQUITY**

Return on average assets (ROA) measures the Company's net income in relation to its total average assets. The Company's ROA for 2006 was 1.03%, compared to 1.16% in 2005.

Return on average equity (ROE) indicates how effectively the Company can generate net income on the capital invested by its stockholders. ROE is calculated by dividing net income by average stockholders' equity. For purposes of calculating ROE as of December 31, 2006, average stockholders' equity does not include the effect of unrealized gains (losses), net of income taxes, on securities available for sale, reflected as accumulated other comprehensive income. Reference should be made to Note 2 in the Notes to Consolidated Financial Statements for an analysis of securities available for sale. The Company's ROE for 2006 was 10.32%, compared to 11.37% for 2005.

**FINANCIAL CONDITION**

The Company's financial condition can be evaluated in terms of trends in its sources and uses of funds. The following table illustrates how the Company has managed its sources and uses of funds that are directly affected by outside economic factors, such as interest rate fluctuations:



TABLE 7

**Sources, Uses of Funds**

(In Thousands)

| Funding Uses                     | 2006            |                            |          | 2005            |                            |          | 2004            |
|----------------------------------|-----------------|----------------------------|----------|-----------------|----------------------------|----------|-----------------|
|                                  | Average Balance | Increase (Decrease) Amount | Percent  | Average Balance | Increase (Decrease) Amount | Percent  | Average Balance |
| Real Estate Loans                | \$ 110,972      | \$ 2,085                   | 1.91 %   | \$ 108,887      | \$ 931                     | 0.86 %   | \$ 107,956      |
| Consumer Loans                   | 17,210          | (377)                      | (2.14)%  | 17,587          | 26                         | 0.15 %   | 17,561          |
| Commercial Loans                 | 118,904         | 14,587                     | 13.98 %  | 104,317         | 4,382                      | 4.38 %   | 99,935          |
| Tax Exempt Loans                 | 20,051          | 915                        | 4.78 %   | 19,136          | 4,199                      | 28.11 %  | 14,937          |
| Other Loans                      | 473             | (159)                      | (25.16)% | 632             | (16)                       | (2.47)%  | 648             |
| Total Loans                      | 267,610         |                            |          | 250,559         |                            |          | 241,037         |
| Less Allowance for Loan Loss     | (2,344)         |                            |          | (2,601)         |                            |          | (2,398)         |
| Total Loans with Loan Loss       | 265,266         | 17,308                     | 6.98     | 247,958         | 9,319                      | 3.91 %   | 238,639         |
| Taxable Securities (Include CDS) | 66,134          | (6,224)                    | (8.60)%  | 72,358          | (458)                      | (0.63)%  | 72,816          |
| Non-Taxable Securities           | 39,435          | 49                         | 0.12 %   | 39,386          | (1,871)                    | (4.53)%  | 41,257          |
| Total Securities                 | 105,569         | (6,175)                    | (5.53)%  | 111,744         | (2,329)                    | (2.04)%  | 114,073         |
| Fed Funds Sold                   | 2,467           | 374                        | 17.87 %  | 2,093           | (1,703)                    | (44.86)% | 3,796           |
| Total Uses                       | \$ 373,302      | \$ 11,507                  | 3.18 %   | \$ 361,795      | \$ 5,287                   | 1.48 %   | \$ 356,508      |

| Funding Sources                   | 2006            |                            |          | 2005            |                            |         | 2004            |
|-----------------------------------|-----------------|----------------------------|----------|-----------------|----------------------------|---------|-----------------|
|                                   | Average Balance | Increase/(Decrease) Amount | Percent  | Average Balance | Increase/(Decrease) Amount | Percent | Average Balance |
| Interest Bearing Demand Deposits  | \$ 25,462       | \$ 1,255                   | 5.18 %   | \$ 24,207       | \$ (2,075)                 | (7.90)% | \$ 26,282       |
| Regular Savings Deposits          | 95,360          | 22,763                     | 31.36 %  | 72,597          | 9,183                      | 14.48 % | 63,414          |
| Money Market Savings Deposits     | 37,747          | 515                        | 1.38 %   | 37,232          | (2,546)                    | (6.40)% | 39,778          |
| Time Deposits                     | 102,195         | (4,920)                    | (4.59)%  | 107,115         | (4,316)                    | (3.87)% | 111,431         |
| Total Interest Bearing Deposits   | 260,764         | 19,613                     | 8.13 %   | 241,151         | 246                        | 0.10 %  | 240,905         |
| Other Borrowings                  |                 |                            |          |                 |                            |         |                 |
| Short-Term Funds Borrowed         | 12,603          | 556                        | 4.62 %   | 12,047          | 2,238                      | 22.82 % | 9,809           |
| Long-Term Funds Borrowed          | 36,275          | (9,665)                    | (21.04)% | 45,940          | 1,792                      | 4.06 %  | 44,148          |
| Total Funds Borrowed              | 48,878          | (9,109)                    | (15.71)% | 57,987          | 4,030                      | 7.47 %  | 53,957          |
| Total Deposits and Funds Borrowed | 309,642         | 10,504                     | 3.51 %   | 299,138         | 4,276                      | 1.45 %  | 294,862         |
| Other Sources, net                | 63,660          | 1,003                      | 1.60 %   | 62,657          | 1,011                      | 1.64 %  | 61,646          |
| Total Sources                     | \$ 373,302      | \$ 11,507                  | 3.18 %   | \$ 361,795      | \$ 5,287                   | 1.48 %  | \$ 356,508      |





Total assets increased 6.41% to \$416,268,000 in the year-ending December 31, 2006. The increase in total assets is attributable to increases in the loan portfolio which increased 4.87% to \$269,383,000 as of December 31, 2006. Of this loan growth, the most significant increase was in commercial loans which grew by \$8,877,000 or 6.72% and real estate loans which increased \$3,849,000 or 3.53%. The loan growth was fueled by the overall growth in deposits which increased by \$26,651,000, or 8.97%. The growth in deposits was somewhat offset on the liability side by the decrease in short-term borrowings of \$5,268,000, or 29.53%. In 2005, total assets increased 3.12% to \$391,198,000.

Investments at year-end 2006 totaled \$110,302,000 compared to \$108,313,000 on December 31, 2005, an increase of \$1,989,000, or 1.84%.

Long-term borrowings increased to \$36,525,000 at year-end 2006 compared to \$34,770,000 the previous year.

### Loan Portfolio Types

In 2006, loans to commercial borrowers helped fuel the growth in net loans. Residential mortgage loans increased only slightly with lower interest rates and mortgage finance companies making growth in this part of our loan portfolio tougher.

TABLE 8

### Loan Portfolio

(In Thousands)

|                                  | Dec 2006   | Dec 2005   | Dec 2004   | Dec 2003   | Dec 2002   |
|----------------------------------|------------|------------|------------|------------|------------|
| Commercial                       | \$ 140,931 | \$ 132,054 | \$ 119,641 | \$ 112,617 | \$ 95,113  |
| Residential Real Estate Mortgage | 112,883    | 109,034    | 106,454    | 105,949    | 107,756    |
| Consumer                         | 16,947     | 17,780     | 18,375     | 17,525     | 18,385     |
| Total Loans                      | 270,761    | 258,868    | 244,470    | 236,091    | 221,254    |
| Deferred Loan Fees               | 414        | 377        | 344        | 276        | 118        |
| Total Loans, net of Deferred     | 271,175    | 259,245    | 244,814    | 236,367    | 221,372    |
| Allowance for Loan Loss          | (1,792)    | (2,375)    | (2,739)    | (2,093)    | (1,935)    |
| Net Loans                        | \$ 269,383 | \$ 256,870 | \$ 242,075 | \$ 234,274 | \$ 219,437 |

Loans continued to increase in 2006, ending the year with \$269,383,000 in net loans compared to \$256,870,000 at year-end 2005, an increase of 4.87%. Commercial loans grew 6.72% to close the year at \$140,931,000, compared to \$132,054,000 at year-end 2005.

Mortgages were up 3.53% to \$112,883,000, compared to \$109,034,000 on December 31, 2005, an increase of \$3,849,000. Although our mortgage portfolio grew modestly in 2006, there was an additional \$3,090,000 sold to the FHLB of Pittsburgh. The Bank will continue to sell mortgages on the secondary market in order to attract and retain mortgage loans by offering more competitive rates and terms.

The continued growth in commercial lending was due, in part, to a concerted effort on our part to continue to increase our exposure to this business segment.

### Loan Maturities

Table 9 shows the breakdown in maturity and type of our loan portfolio, net of non-accrual loans.

The Bank has 9.66% of its loans maturing within the next year. Of those maturing within one year, the majority are commercial loans with the remainder split between mortgages and consumer loans. In the one-to-five year maturity

range, the Bank has 21.79% of its loan portfolio maturing. The over-five-year maturity group makes up 68.55% of the portfolio.

For comparison, at December 31, 2005, the Bank had 15.93% of its loans maturing within one year. Of those maturing within one year, the majority again were commercial loans with the remainder split between mortgages and consumer loans. In the one-to-five year maturity range, the Bank had 22.63% of its portfolio. The over-five-year maturity group made up 61.44% of the portfolio.

TABLE 9  
(In Thousands)

|                                      | One Year Or<br>Less | Over One Year<br>Within Five<br>Years | Over Five Years | Total Loans |
|--------------------------------------|---------------------|---------------------------------------|-----------------|-------------|
| Commercial                           | \$ 16,079           | \$ 33,271                             | \$ 91,136       | \$ 140,486  |
| Real-Estate Construction             | 0                   | 0                                     | 0               | 0           |
| Real-Estate Mortgage                 | 5,160               | 18,267                                | 89,456          | 112,883     |
| Installment                          | 4,956               | 7,339                                 | 4,652           | 16,947      |
| Total                                | \$ 26,195           | \$ 58,877                             | \$ 185,244      | \$ 270,316  |
| Total Loans with Predetermined Rates | 17,262              | 30,081                                | 32,029          | 79,372      |
| Total Loans with Variable Rates      | 8,933               | 28,796                                | 153,215         | 190,944     |
| Total                                | \$ 26,195           | \$ 58,877                             | \$ 185,244      | \$ 270,316  |

Table 10 reflects the Company's non-performing loans, which include non-accrual and past due loans 90 days or more and still accruing, for each of the past five years. A commercial loan is generally placed on non-accrual when the contractual payment of principal or interest has become 90 days past due or when management has serious doubts about further collectibility of principal or interest even though the loan is currently performing. Consumer loans, including mortgages, are generally placed on non-accrual at 120 days. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. Foreclosed assets increased significantly in 2006 due to the foreclosure on a large commercial real estate loan.

TABLE 10

**Non-performing Loans**

(Dollars in Thousands)

|  | December 31, |          |          |          |        |
|--|--------------|----------|----------|----------|--------|
|  | 2006         | 2005     | 2004     | 2003     | 2002   |
| Non-accrual and Restructured<br>Loans Past Due 90 or More Days,<br>Accruing Interest | \$ 445       | \$ 1,105 | \$ 2,063 | \$ 984   | \$ 341 |
| Total Nonperforming Loans  | 720          | 1,105    | 2,193    | 1,089    | 526    |
| Foreclosed Assets  | 5,062        | 117      | 257      | 115      | 154    |
| Total Nonperforming Assets   | \$ 5,782     | \$ 1,222 | \$ 2,450 | \$ 1,204 | \$ 680 |
| Nonperforming Loans to Total<br>Loans at Period-end                                  | 0.27%        | 0.43%    | 0.91%    | 0.47%    | 0.24%  |
| Nonperforming Assets to<br>Period-end Loans and Foreclosed<br>Assets                 | 2.15%        | 0.47%    | 1.01%    | 0.52%    | 0.31%  |
| Interest Income That Would Have<br>Been Recorded Under<br>Original Terms             | \$ 84        | \$ 59    | \$ 94    | \$ 62    | \$ 66  |
| Interest Income Recorded During<br>the Period  | \$ 7         | \$ 9     | \$ 29    | \$ 3     | \$ 17  |
| Commitments To Lend Additional<br>funds  | \$ 0         | \$ 0     | \$ 0     | \$ 0     | \$ 0   |



**Allowance for Loan Losses**

The balance in the allowance for loan losses is based on management's assessment of the risk in the loan portfolio. Allocations to specific commercial loans are made in adherence to SFAS 114, Accounting by Creditors for Impairments of a Loan. These allocations are based upon the present value of expected future cash flows or the fair value of the underlying collateral. In addition, management reviews the other components of the loan portfolio through the loan review function and assigns internal grades to loans based upon the perceived risks inherent in each loan. In that determination, management reviews a number of factors including historical analysis of similar credits, delinquency reports, ratio analysis as compared to peers, concentration of credit risks, local economic conditions, and regulatory evaluation of the allowance for loan losses. This evaluation is reviewed monthly by management and by the Board of Directors. Management believes that on December 31, 2006, the allowance for loan losses was adequate to absorb potential losses in the loan portfolio. However, this judgment is subjective and a significant degradation in loan quality could require a change in the estimates and therefore, a change in net income.

In 2006, asset quality remained high and past dues continued to remain level. Although trends continued to be positive, the Bank allotted \$302,000 for provision for loan losses in 2006. The provision was due in part to the Bank down grading a large commercial loan to non-accrual and impaired status.

The following is a summary of loans charged off, recoveries and provisions to the allowance for loan losses for the periods presented.

TABLE 11

**Summary of Loan Loss Experience**

(Dollars in Thousands)

|  | Dec 2006   | Dec 2005   | Year ended,<br>Dec 2004 | Dec 2003   | Dec 2002   |
|--|------------|------------|-------------------------|------------|------------|
| Average Total Loans                                      | \$ 267,610 | \$ 250,559 | \$ 241,037              | \$ 229,293 | \$ 210,919 |
| Balance at Beginning of Period                           | \$ 2,375   | \$ 2,739   | \$ 2,093                | \$ 1,935   | \$ 1,816   |
| Charge Offs  |            |            |                         |            |            |
| Commercial   | 797        | 633        | 335                     | 94         | 19         |
| Residential Real Estate                                  | 21         | 31         | 0                       | 10         | 5          |
| Installment  | 98         | 129        | 108                     | 81         | 92         |
| Total Charge Offs  | 916        | 793        | 443                     | 185        | 116        |
| Recoveries   |            |            |                         |            |            |
| Commercial   | 5          | 0          | 12                      | 21         | 24         |
| Residential Real Estate                                  | 5          | 0          | 0                       | 5          | 1          |
| Installment  | 21         | 37         | 27                      | 28         | 30         |
| Total Recoveries   | 31         | 37         | 39                      | 54         | 55         |
| Net Charge-Offs  | 885        | 756        | 404                     | 131        | 61         |
| Provision for Loan Losses                                | 302        | 392        | 1050                    | 289        | 180        |
| Balance at End of Period                                 | \$ 1,792   | \$ 2,375   | \$ 2,739                | \$ 2,093   | \$ 1,935   |
| Allowance for Credit Losses to<br>Period-end Total Loans | 0.66%      | 0.92%      | 1.12%                   | 0.89%      | 0.87%      |
| Allowance for Credit Losses to<br>Non-accrual Loans      | 402.70%    | 206.62%    | 132.77%                 | 212.70%    | 567.45%    |
| Net Charge-Offs to Average<br>Loans                      | 0.33%      | 0.29%      | 0.17%                   | 0.06%      | 0.03%      |



TABLE 12

The following table details the allocation of the allowance for loan losses to various categories:

**Allocation of Allowance**

| (Dollars in Thousands)             | Dec 2006 | % of Loan                 | Dec 2005 | % of Loan                 | Dec 2004 | % of Loan                 |
|------------------------------------|----------|---------------------------|----------|---------------------------|----------|---------------------------|
|                                    |          | Type<br>to Total<br>Loans |          | Type<br>to Total<br>Loans |          | Type<br>to Total<br>Loans |
| Commercial                         | \$ 1,429 | 52.05%                    | \$ 2,035 | 58.56%                    | \$ 2,366 | 48.94%                    |
| Real Estate Mortgage               | 274      | 41.69%                    | 286      | 38.11%                    | 272      | 43.54%                    |
| Consumer                           | 89       | 6.26%                     | 54       | 3.33%                     | 101      | 7.52%                     |
| Unallocated                        | 0        | N/A                       | 0        | N/A                       | 0        | N/A                       |
| Total Allowance for<br>Loan Losses | \$ 1,792 | 100.00%                   | \$ 2,375 | 100.00%                   | \$ 2,739 | 100.00%                   |

| (Dollars In Thousands)          | Dec 2003 | % of Loan Type | Dec 2002 | % of Loan Type |
|---------------------------------|----------|----------------|----------|----------------|
|                                 |          | to Total loans |          | to Total Loans |
| Commercial                      | \$ 1,677 | 47.70%         | \$ 1,447 | 42.54%         |
| Real Estate Mortgage            | 283      | 44.88%         | 296      | 48.77%         |
| Consumer                        | 133      | 7.42%          | 192      | 8.69%          |
| Unallocated                     | 0        | N/A            | 0        | N/A            |
| Total Allowance for Loan Losses | \$ 2,093 | 100.00%        | \$ 1,935 | 100.00%        |

Management believes the allowance is adequate to cover the inherent risks associated with the loan portfolio. While allocations have been established for particular loan categories, management considers the entire allowance to be available to absorb losses in any category.

**SECURITIES**

The Company's securities portfolio is classified, in its entirety, as "available-for-sale" as shown in Table 13. Management believes that a portfolio classification of all available-for-sale allows complete flexibility in the investment portfolio. Using this classification, the Company intends to hold these securities for an indefinite amount of time but not necessarily to maturity. Such securities are carried at fair value with the unrealized holding gains or losses, net of taxes, reported as a component of the Company's stockholders' equity on the balance sheet. The portfolio is structured to provide maximum return on investments while providing a consistent source of liquidity and meeting strict risk standards.

Securities available-for-sale increased by \$1,989,000 in 2006. The securities available-for-sale portfolio is comprised of U.S. Government Agency securities, mortgage-backed securities, high-grade municipal securities, corporate-debt securities, and equity securities. At December 31, 2006, the unrealized loss on securities available-for-sale included in stockholders' equity totaled \$395,000, net of tax, compared to unrealized losses of \$961,000, net of tax, at December 31, 2005. The weighted-average maturity of the securities available-for-sale portfolio was nine years at December 31, 2006, with a weighted-average yield of 4.70%.

Table 13 shows the amortized cost and average yield of securities by maturity or call date at December 31, 2006.

TABLE 13

**Securities by Maturities  
(Amortized Cost)**

| (Dollars In Thousands) | 1 Year or Less |               | 1-5 Years  |               | 5-10 Years |               | Over 10 Years |               | Total      |               |
|------------------------|----------------|---------------|------------|---------------|------------|---------------|---------------|---------------|------------|---------------|
|                        | Book Value     | Average Yield | Book Value | Average Yield | Book Value | Average Yield | Book Value    | Average Yield | Book Value | Average Yield |
| Available-for-Sale     |                |               |            |               |            |               |               |               |            |               |
| US Government Agency   | \$ 6,027       | 5.36%         | \$ 5,083   | 5.39%         | \$ 0       | 0.00%         | \$ 0          | 0.00%         | \$ 11,110  | 5.37%         |
| State/County/Municipal |                |               |            |               |            |               |               |               |            |               |
| Obligations            | 0              | 0.00%         | 14,423     | 3.57%         | 8,761      | 3.84%         | 7,246         | 4.14%         | 30,430     | 3.78%         |
| Mortgage-Backed        |                |               |            |               |            |               |               |               |            |               |
| Securities             | 6,104          | 5.10%         | 20,517     | 4.99%         | 18,477     | 5.06%         | 13,440        | 5.58%         | 58,538     | 5.16%         |
| Corporate/Other        |                |               |            |               |            |               |               |               |            |               |
| Securities             | 0              | 0.00%         | 2,404      | 3.50%         | 1,000      | 3.44%         | 0             | 0.00%         | 3,404      | 3.48%         |
| Preferred Equity       |                |               |            |               |            |               |               |               |            |               |
| Securities             | 0              | 0.00%         | 0          | 0.00%         | 0          | 0.00%         | 2,366         | 5.12%         | 2,366      | 5.12%         |
| Common Equity          |                |               |            |               |            |               |               |               |            |               |
| Securities             | 0              | 0.00%         | 0          | 0.00%         | 0          | 0.00%         | 5,052         | 4.19%         | 5,052      | 4.19%         |
| <b>TOTAL</b>           |                |               |            |               |            |               |               |               |            |               |
| Available-for-Sale     | \$ 12,131      | 5.23%         | \$ 42,427  | 4.47%         | \$ 28,238  | 4.62%         | \$ 28,104     | 4.90%         | \$ 110,900 | 4.70%         |

Table 14 shows the balance of securities for the past three years on December 31. More details on securities can be found in Note 3 of the Consolidated Financial Statements.

TABLE 14

**Securities (Fair Value)**

| (In Thousands)                      | December 31, |            |            |
|-------------------------------------|--------------|------------|------------|
|                                     | 2006         | 2005       | 2004       |
| U. S. Government/Agency Obligations | \$ 11,118    | \$ 24,604  | \$ 23,207  |
| State/Municipal Obligations         | 30,338       | 40,477     | 40,961     |
| Mortgage-backed Securities          | 57,847       | 25,563     | 23,363     |
| Other Securities                    | 10,999       | 17,669     | 26,067     |
| Total Securities Available-for-Sale | \$ 110,302   | \$ 108,313 | \$ 113,598 |

**DEPOSITS**

Table 15 shows average deposits and other borrowings balances rates for 2006, 2005 and 2004. The Company experienced growth of \$19,613,000 in average interest bearing deposits and \$4,314,000 in average non-interest bearing deposits during 2006 compared to \$246,000 in average interest bearing deposits and \$4,259,000 in average non-interest bearing deposits in 2005. Average savings accounts increased \$22,763,000 during 2006 due to the increased popularity of the certificate savings product compared to \$9,183,000 in growth in 2005. Average time deposits decreased in 2006, 2005, and 2004 with those decreases totaling \$4,920,000, \$4,316,000, and \$3,525,000, respectively. In 2006, average other borrowings decreased \$9,109,000 compared to an increase in average borrowings in 2005 of \$4,030,000.





TABLE 15

**Average Deposits and Other Borrowings**

(Dollars in Thousands)

|                      | 2006       |       |           | 2005       |       |            | 2004       |       |
|----------------------|------------|-------|-----------|------------|-------|------------|------------|-------|
|                      | Amount     | Rate  | Diff \$   | Amount     | Rate  | Diff \$    | Amount     | Rate  |
| Interest Bearing     |            |       |           |            |       |            |            |       |
| Demand Deposits      | \$ 25,462  | 1.03% | \$ 1,255  | \$ 24,207  | 0.70% | \$ (2,075) | \$ 26,282  | 0.72% |
| Savings Deposits     | 95,360     | 3.29% | 22,763    | 72,597     | 1.73% | 9,183      | 63,414     | 1.00% |
| Money Market         |            |       |           |            |       |            |            |       |
| Savings              | 37,747     | 3.83% | 515       | 37,232     | 2.45% | (2,546)    | 39,778     | 1.41% |
| Time Deposits        | 102,195    | 3.82% | (4,920)   | 107,115    | 3.22% | (4,316)    | 111,431    | 3.04% |
| Total Interest       |            |       |           |            |       |            |            |       |
| Bearing Deposits     | 260,764    | 3.35% | 19,613    | 241,151    | 2.40% | 246        | 240,905    | 1.98% |
| Other Borrowings     | 48,878     | 4.19% | (9,109)   | 57,987     | 4.25% | 4,030      | 53,957     | 4.27% |
| Total Interest       |            |       |           |            |       |            |            |       |
| Bearing Liabilities  | 309,642    | 3.49% | 10,504    | 299,138    | 2.76% | 4,276      | 294,862    | 2.40% |
| Non-Interest Bearing |            |       |           |            |       |            |            |       |
| Demand Deposits      | 49,888     |       | 4,314     | 45,574     |       | 4,259      | 41,315     |       |
| Total                | \$ 359,530 | 3.01% | \$ 14,818 | \$ 344,712 | 2.98% | \$ 8,535   | \$ 336,177 | 2.11% |

**MATURITIES OF TIME DEPOSITS**

The maturities on the time deposits of \$100,000 and over are distributed over all four categories, showing no particular period with a concentration that would pose a liquidity risk to the Bank. Table 16 shows the dollar amount of large time deposits in each time category as well as the overall percentage of each category.

TABLE 16

**Maturities**

(Dollars in Thousands)

|                                       | December 31, 2006 |         |
|---------------------------------------|-------------------|---------|
|                                       | Amount            | Percent |
| Three Months or Less                  | \$ 4,555          | 26.92%  |
| Over Three Month through Six Months   | 5,349             | 31.61%  |
| Over Six Months through Twelve Months | 2,375             | 14.03%  |
| Over Twelve Months                    | 4,644             | 27.44%  |
| Total                                 | \$ 16,923         | 100.00% |

**SHORT AND LONG-TERM BORROWINGS**

Short-term borrowings, which are overnight or less than 30-day borrowings, consist of securities sold under agreements to repurchase, Federal Home Loan Bank advances, and U.S. Treasury tax and loan notes. Long-term borrowings consist of notes from the Federal Home Loan Bank. These notes are secured under terms of a blanket collateral agreement by a pledge of qualifying investment and mortgage-backed securities, certain mortgage loans and a lien on FHLB stock. For more details on short and long-term borrowings see Note 6 and 7 of the Notes to Consolidated Financial Statements.

TABLE 17

**Borrowed Funds**

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(In Thousands)

|                             | December 31, |           |
|-----------------------------|--------------|-----------|
|                             | 2006         | 2005      |
| Other Short-Term Borrowings | \$ 12,574    | \$ 17,842 |
| FHLB Long-Term Borrowings   | 36,525       | 34,770    |
| Total                       | \$ 49,099    | \$ 52,612 |

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**CAPITAL ACCOUNTS**

Total stockholders' equity increased 4.10%, or \$1,624,000, from year-end 2005 to finish at \$41,240,000. A common ratio used to determine the effective use of capital is the return on average equity. For the year-ended December 31, 2006, this ratio was 10.32%, compared to 11.37% at December 31, 2005. The Bank's goal is to maintain a strong capital position as well as to make the best use of capital in the overall growth of the organization. At year-end 2006, the equity-to-assets ratio was 9.91%, compared to 10.13% at year-end 2005. It is the goal of management to implement ways to better leverage our capital with a capital-to-assets ratio closer to 8%.

Compare these results to 2005 when total stockholders' equity decreased 6.46%, or \$2,738,000, over year-end 2004. The decrease to stockholders' equity was the result of a special \$1.00 per share dividend that was paid to all stockholders of record as of April 15, 2005. The special dividend was paid in commemoration of the Bank's 100<sup>th</sup> Anniversary and was in the amount of \$3,151,000. The return on average equity for the year-ending December 31, 2005 ratio was 11.37%, compared to 10.84% at December 31, 2004. At year-end 2005, the equity-to-assets ratio was 10.13% compared to 11.16% at year-end 2004.

Retained earnings increased capital by \$4,129,000 in 2006 and dividends reduced that number by \$2,392,000. The investment portfolio increased in value by \$566,000, net of tax in 2006. Since all of our investments are available-for-sale, changes in market values adjusted for taxes are reflected in the equity portion of the balance sheet. A total of \$682,000 in net treasury stock purchases reduced the capital account to equal the total net change. From time to time, the Company has purchased PFSC stock in the open market or from individuals to leverage the capital account and to provide stock for our dividend reinvestment plan and stock compensation plan. During the year 2006, 26,579 shares were purchased in this manner. There were 4,783 shares issued from the treasury stock account by individuals exercising options and for the dividend reinvestment plan during 2006. The investment banking firms of Ferris, Baker Watts, Incorporated and Ryan Beck & Co. have been known to make markets in PFSC common stock.

Net Income increased capital by \$4,476,000 in 2005 and dividends reduced that number by \$5,542,000. The investment portfolio depreciated in value by \$1,579,000 in 2005. Again, since all of our investments were available-for-sale, changes in market values adjusted for taxes are reflected in the equity portion of the balance sheet. A total of \$93,000 in net treasury stock purchases reduced the capital account to equal the total net change.

The following table represents the Company's capital position as it compares to the regulatory guidelines at December 31, 2006.

TABLE 18

**Capital Ratios**

|   | December 31<br>2006 | December 31<br>2005 | Regulatory<br>Requirement |
|---|---------------------|---------------------|---------------------------|
| Tier 1 capital to risk-weighted assets          | 13.99%              | 13.93%              | 4.00%                     |
| Total capital to risk-weighted assets           | 14.64%              | 14.78%              | 8.00%                     |
| Tier 1 capital to average assets-leverage ratio | 9.77%               | 10.10%              | 4.00%                     |

**INTEREST RATE SENSITIVITY**

The operations of the Company do not subject it to foreign currency risk or commodity price risk. The Company does not utilize interest rate swaps, caps, or hedging transactions. In addition, the Company has no market risk sensitive instruments entered into for trading purposes. However, the Company is subject to interest rate risk and employs several different methods to manage and monitor the risk.



Interest rate sensitivity refers to the relationship between market interest rates and the earnings volatility of the Company due to the repricing characteristics of assets and liabilities. The responsibility for monitoring interest rate sensitivity and policy decisions has been given to the Asset/Liability Committee (ALCO) of the Bank. The tools used to monitor sensitivity are the Statement of Interest Sensitivity Gap and the Interest Rate Shock Analysis. The Bank uses a software model to measure and analyze interest rate risk. In addition, an outside source does a quarterly analysis to make sure our internal analysis is current and correct. The Statement of Interest Sensitivity Gap is a good assessment of current position and is a very useful tool for the ALCO in performing its job. This report is monitored in an effort to “match” maturities or repricing opportunities of assets and liabilities in order to attain the maximum interest within risk tolerance policy guidelines. The statement does, although, have inherent limitations in that certain assets and liabilities may react to changes in interest rates in different ways with some categories reacting in advance of changes and some lagging behind the changes. In addition, there are estimates used in determining the actual propensity to change of certain items such as deposits without maturities.

The following sets forth the Company’s interest sensitivity analysis as of December 31, 2006:

TABLE 19

**Statement of Interest Sensitivity Gap**

(Dollars in Thousands)

|                                       | <b>Maturity or Repricing In:</b> |                   |                    |                  |                     |
|---------------------------------------|----------------------------------|-------------------|--------------------|------------------|---------------------|
|                                       | <b>3 Months</b>                  | <b>3-6 Months</b> | <b>6-12 Months</b> | <b>1-5 Years</b> | <b>Over 5 Years</b> |
| <b>RATE SENSITIVE ASSETS</b>          |                                  |                   |                    |                  |                     |
| Loans                                 | \$ 61,954                        | \$ 5,485          | \$ 22,284          | \$ 101,630       | \$ 79,893           |
| Securities                            | 9,694                            | 2,978             | 1,922              | 42,705           | 53,003              |
| Federal Funds Sold                    | 2,227                            | 0                 | 0                  | 0                | 0                   |
| Total Rate Sensitive Assets           | 73,875                           | 8,463             | 24,206             | 144,335          | 132,896             |
| Cumulative Rate Sensitive Assets      | \$ 73,875                        | \$ 82,338         | \$ 106,544         | \$ 250,879       | \$ 383,775          |
| <b>RATE SENSITIVE LIABILITIES</b>     |                                  |                   |                    |                  |                     |
| Interest Bearing Checking             | 251                              | 251               | 503                | 4,019            | 23,863              |
| Money Market Deposits                 | 328                              | 328               | 655                | 5,241            | 31,121              |
| Regular Savings                       | 1,276                            | 939               | 1,877              | 15,018           | 89,172              |
| CDs and IRAs                          | 25,240                           | 22,932            | 17,162             | 28,006           | 4,491               |
| Short-term Borrowings                 | 12,613                           | 0                 | 0                  | 0                | 0                   |
| Long-term Borrowings                  | 7,500                            | 0                 | 0                  | 4,962            | 24,063              |
| Total Rate Sensitive Liabilities      | 47,208                           | 24,450            | 20,197             | 57,246           | 172,710             |
| Cumulative Rate Sensitive Liabilities | \$ 47,208                        | \$ 71,658         | \$ 91,855          | \$ 149,101       | \$ 321,811          |
| Period Gap                            | \$ 26,667                        | (\$15,987)        | \$ 4,009           | \$ 87,089        | (\$39,814)          |
| Cumulative Gap                        | \$ 26,667                        | \$ 10,680         | \$ 14,689          | \$ 101,778       | \$ 61,964           |
| Cumulative RSA to RSL                 | 156.49%                          | 114.90%           | 115.99%            | 168.26%          | 119.25%             |
| Cumulative Gap to Total Assets        | 6.41%                            | 2.57%             | 3.53%              | 24.45%           | 14.88%              |

The measured pace of tightening by the Federal Reserve’s Open Market Committee (FOMC), which started on June 30, 2004, continued through the first half of 2006. For the year-ended December 31, 2006, the overnight Fed Funds Rate was increased in 25 basis point increments four times, ending the year at 5.25%. The effect of the tightening has

been an inverted yield curve throughout much of 2006. While the short end of the curve has moved up in conjunction with the Fed Funds Rate, the long end of the curve, which is not controlled by the FOMC, has not moved upward. The result of this inversion is that the net interest margin in 2006 decreased to 3.49% when compared to the net interest margin of 3.73% for the year-ended December 31, 2005. Compare these results to 2005 when the Fed Funds rate was increased 200 basis points. The result was a net interest margin that fell to 3.73% for the year-ended December 31, 2005 compared to 3.86% for the year 2004.

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**LIQUIDITY**

The liquidity of the Company is reflected in its capacity to have sufficient amounts of cash available to fund the needs of customer withdrawal requests, accommodate loan demand, and maintain regulatory reserve requirements; that is to conduct banking business. Additional liquidity is obtained by either increasing liabilities or by decreasing assets. The primary source for increasing liabilities is the generation of additional deposit accounts, which are managed through our system of branches. In addition, loan payments on existing loans or investments available-for-sale can generate additional liquidity. Other sources include income from operations, decreases in federal funds sold or interest-bearing deposits in other banks, securities sold under agreements to repurchase, and borrowings from the Federal Home Loan Bank. On December 31, 2006, the Bank had a borrowing capacity from the Federal Home Loan Bank of approximately \$179,163,000. During the Year 2006, increases in deposits provided the majority of additional cash with operating activities also contributing to liquidity. The funds were used primarily to grant loans to customers, purchase additional investment securities, and to pay dividends to our shareholders.

The following table represents the aggregate on-and-off balance sheet contractual obligations to make future payments.

Table 20

**Contractual Obligations**

(In Thousands)

**December 31, 2006**

|                  | <b>Less than 1<br/>year</b> | <b>1-3 Years</b> | <b>4-5 Years</b> | <b>Over 5<br/>years</b> | <b>Total</b> |
|------------------|-----------------------------|------------------|------------------|-------------------------|--------------|
| Time Deposits    | \$ 67,784                   | \$ 18,003        | \$ 8,468         | \$ 3,576                | \$ 97,831    |
| Long-term Debt   | 9,051                       | 1,730            | 3,711            | 22,033                  | 36,525       |
| Operating Leases | 68                          | 99               | 84               | 426                     | 677          |
|                  | \$ 76,903                   | \$ 19,832        | \$ 12,263        | \$ 26,035               | \$ 135,033   |

The Company is not aware of any known trends or any known demands, commitments, events or uncertainties, which would result in any material increase or decrease in liquidity.

**OFF-BALANCE-SHEET ARRANGEMENTS**

The financial statements do not reflect various off-balance sheet arrangements that are made in the normal course of business, which may involve some liquidity risk. These commitments consist mainly of unfunded loans and letters of credit made under the same standards as on-balance-sheet instruments. Unused commitments, at December 31, 2006, totaled \$34,913,000. Because these instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk. Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

The Company has no investment in or financial relationship with any unconsolidated entities that are reasonably likely to have a material effect on liquidity or the availability of capital resources.

**SUBSEQUENT EVENTS**

NONE

**EFFECTS OF INFLATION**

The majority of assets and liabilities of a financial institution are monetary in nature and, therefore, differ greatly from commercial and industrial companies that have significant investments in fixed assets or inventories. The precise



impact of inflation upon the Company is difficult to measure. Inflation may affect the borrowing needs of consumers, thereby impacting the growth rate of the Company's assets. Inflation may also affect the general level of interest rates, which can have a direct bearing on the Company.

Management believes that the most significant impact on financial results is the Company's ability to react to changes in interest rates. As discussed previously, management is attempting to maintain a position that is within conservative parameters for interest sensitive assets and liabilities in order to be protected against wide interest rate fluctuations.

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## **ITEM 7A QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

As previously stated in this document, the Federal Reserve Bank raised the Fed Funds Rate a total of four times in 2006, all of which were 25 basis point increases. While short-term rates have been increasing since June of 2004, longer rates have remained somewhat stationary. This has caused an inversion of the yield curve which in the long run can have an effect of slowing the Bank's earnings growth. This is due to the payment of higher, short-term deposit interest while at the same time experiencing little or no additional interest income from longer maturity loans. With this being said, the Bank monitors this interest sensitivity on a monthly basis. The model used by the Bank shows interest rate sensitivity exceptions in the twelve-month period testing at the positive 100, 200 and 300 basis point scenario and the negative 300 basis point scenario. The results of the latest simulation follow. The simulation shows a possible decrease in net interest income of 3.02%, or \$414,000, in a +200 basis point rate shock scenario over a one-year period. An increase of 1.51% or \$207,000 is shown in the model at a -200 basis point rate shock. The Bank will continue to monitor this rate sensitivity going forward. See previous discussion on Interest Rate Sensitivity.

Equity value at risk is monitored regularly and is within established policy limits.

The Company is not a party to any forward contract, interest rate swap, option interest, or similar derivations instruments. The Company does not deal in foreign currency.

## ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Peoples Financial Services Corp.  
Hallstead, Pennsylvania

We have audited the accompanying consolidated balance sheets of Peoples Financial Services Corp. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Peoples Financial Services Corp. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, Peoples Financial Services Corp. and subsidiaries changed its method of accounting for stock based compensation in accordance with Statement of Financial Accounting Standards No. 123(R) on January 1, 2006.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Peoples Financial Services Corp.'s internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 13, 2007 expressed an unqualified opinion on management's assessment of internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting.

/s/ Beard Miller Company LLP

Beard Miller Company LLP  
Allentown, Pennsylvania  
March 13, 2007



*Peoples Financial Services Corp. and Subsidiaries***Consolidated Balance Sheets**

|   | <b>December 31,</b>                      |                   |
|---|--|-------------------|
|   | <b>2006</b>                              | <b>2005</b>       |
|   | <b>(In Thousands, Except Share Data)</b> |                   |
| <b>ASSETS</b>   |  |                   |
| Cash and due from banks   | \$ 7,527                                 | \$ 6,457          |
| Interest bearing deposits in other banks  | 2,626                                    | 239               |
| Federal funds sold  | 2,227                                    | 0                 |
| <br>  |  |                   |
| Cash and Cash Equivalents   | <b>12,380</b>                            | 6,696             |
| Securities available for sale   | <b>110,302</b>                           | 108,313           |
| Loans receivable, net of allowance for loan losses 2006 \$1,792;<br>and 2005 \$2,375  | <b>269,383</b>                           | 256,870           |
| Premises and equipment, net   | <b>6,183</b>                             | 5,837             |
| Accrued interest receivable   | <b>1,855</b>                             | 1,827             |
| Intangible assets   | <b>1,331</b>                             | 1,630             |
| Other real estate owned   | <b>5,062</b>                             | 117               |
| Other assets  | <b>9,772</b>                             | 9,908             |
| <b>Total Assets</b>   | <b>\$ 416,268</b>                        | <b>\$ 391,198</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |  |                   |
| <b>LIABILITIES</b>  |  |                   |
| Deposits:   |  |                   |
| Non-interest bearing  | \$ 50,940                                | \$ 46,777         |
| Interest-bearing  | 272,673                                  | 250,185           |
| <b>Total Deposits</b>   | <b>323,613</b>                           | 296,962           |
| <br>  |  |                   |
| Short-term borrowings   | <b>12,574</b>                            | 17,842            |
| Long-term borrowings  | <b>36,525</b>                            | 34,770            |
| Accrued interest payable  | <b>703</b>                               | 622               |
| Other liabilities   | <b>1,613</b>                             | 1,386             |
| <b>Total Liabilities</b>  | <b>375,028</b>                           | 351,582           |
| <br>  |  |                   |
| <b>STOCKHOLDERS' EQUITY</b>   |  |                   |
| Common stock, par value \$2 per share; authorized 12,500,000 shares;<br>issued 3,341,251 shares; outstanding 3,133,874 shares and 3,155,670<br>shares December 31, 2006 and December 31, 2005, respectively | <b>6,683</b>                             | 6,683             |
| Surplus   | <b>3,046</b>                             | 2,995             |
| Retained earnings   | <b>36,336</b>                            | 34,599            |
| Accumulated other comprehensive loss  | <b>(395)</b>                             | (961)             |
| Treasury stock, at cost, 207,377 and 185,581 shares at December 31,<br>2006 and December 31, 2005, respectively   | <b>(4,430)</b>                           | (3,700)           |
| <b>Total Stockholders' Equity</b>   | <b>41,240</b>                            | 39,616            |
| <br>  |  |                   |
| <b>Total Liabilities and Stockholders' Equity</b>   | <b>\$ 416,268</b>                        | <b>\$ 391,198</b> |

See notes to consolidated financial statements

*Peoples Financial Services Corp. and Subsidiaries***Consolidated Statements of Income**

|  | <b>Years Ended December 31,</b>              |               |             |               |             |               |
|--|--|---------------|-------------|---------------|-------------|---------------|
|  | <b>2006</b>                                  |               | <b>2005</b> |               | <b>2004</b> |               |
|  | <b>(In Thousands, Except Per Share Data)</b> |               |             |               |             |               |
| <b>INTEREST INCOME</b>                                       |  |               |             |               |             |               |
| Loans receivable, including fees                             | \$   | 17,996        | \$          | 15,986        | \$          | 14,871        |
| Securities:  |  |               |             |               |             |               |
| Taxable  |  | 3,032         |             | 3,086         |             | 3,152         |
| Tax-exempt   |  | 1,484         |             | 1,523         |             | 1,687         |
| Other  |  | 186           |             | 77            |             | 49            |
| <b>Total Interest Income</b>                                 |  | <b>22,698</b> |             | <b>20,672</b> |             | <b>19,759</b> |
| <b>INTEREST EXPENSE</b>                                      |  |               |             |               |             |               |
| Deposits   |  | 8,748         |             | 5,786         |             | 4,778         |
| Short-term borrowings  |  | 524           |             | 319           |             | 133           |
| Long-term borrowings   |  | 1,525         |             | 2,143         |             | 2,173         |
| <b>Total Interest Expense</b>                                |  | <b>10,797</b> |             | <b>8,248</b>  |             | <b>7,084</b>  |
| <b>Net Interest Income</b>                                   |  | <b>11,901</b> |             | <b>12,424</b> |             | <b>12,675</b> |
| <b>PROVISION FOR LOAN LOSSES</b>                             |  |               |             |               |             |               |
| <b>Net Interest Income after Provision for Loan Losses</b>   |  | <b>11,599</b> |             | <b>12,032</b> |             | <b>11,625</b> |
| <b>OTHER INCOME</b>  |  |               |             |               |             |               |
| Customer service fees  |  | 1,770         |             | 1,749         |             | 1,489         |
| Investment division commission income                        |  | 260           |             | 201           |             | 426           |
| Earnings on investment in life insurance                     |  | 281           |             | 263           |             | 236           |
| Other income   |  | 437           |             | 382           |             | 429           |
| Net realized gains on sales of securities available for sale |  | 42            |             | 222           |             | 296           |
| Impairment of security                                       |  | 0             |             | 0             |             | (1,144)       |
| <b>Total Other Income</b>                                    |  | <b>2,790</b>  |             | <b>2,817</b>  |             | <b>1,732</b>  |
| <b>OTHER EXPENSES</b>  |  |               |             |               |             |               |
| Salaries and employee benefits                               |  | 4,498         |             | 4,199         |             | 3,848         |
| Occupancy  |  | 674           |             | 564           |             | 489           |
| Equipment  |  | 484           |             | 427           |             | 336           |
| FDIC insurance and assessments                               |  | 127           |             | 141           |             | 140           |
| Professional fees and outside services                       |  | 337           |             | 471           |             | 297           |
| Prepayment penalty - FHLB                                    |  | 0             |             | 808           |             | 0             |
| Computer service and supplies                                |  | 774           |             | 778           |             | 617           |
| Taxes, other than payroll and income                         |  | 370           |             | 324           |             | 383           |
| Amortization expense - deposit acquisition premiums          |  | 299           |             | 262           |             | 262           |
| Other  |  | 1,925         |             | 1,414         |             | 1,518         |
| <b>Total Other Expenses</b>                                  |  | <b>9,488</b>  |             | <b>9,388</b>  |             | <b>7,890</b>  |
| <b>Income before Income Taxes</b>                            |  | <b>4,901</b>  |             | <b>5,461</b>  |             | <b>5,467</b>  |
| <b>FEDERAL INCOME TAXES</b>                                  |  |               |             |               |             |               |
| <b>Net Income</b>  | \$   | <b>4,129</b>  | \$          | <b>4,476</b>  | \$          | <b>4,453</b>  |
| <b>EARNINGS PER SHARE</b>                                    |  |               |             |               |             |               |
| Basic  | \$   | <b>1.31</b>   | \$          | <b>1.42</b>   | \$          | <b>1.41</b>   |
| Diluted  | \$   | <b>1.31</b>   | \$          | <b>1.41</b>   | \$          | <b>1.40</b>   |

*See notes to consolidated financial statements*

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*Peoples Financial Services Corp. and Subsidiaries***Consolidated Statements of Stockholders' Equity  
Years Ended December 31, 2006, 2005 and 2004**

|  | Common<br>Stock                   | Surplus  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income(Loss) | Treasury<br>Stock | Total     |
|--|-----------------------------------|----------|----------------------|---|-------------------|-----------|
|  | (In Thousands, Except Share Data) |          |                      |   |                   |           |
| <b>Balance - December 31, 2003</b>   | \$ 6,683                          | \$ 2,618 | \$ 33,523            | \$ 995  | \$ (2,743)        | \$ 41,076 |
| Comprehensive income:  |                                   |          |                      |   |                   |           |
| Net income   | 0                                 | 0        | 4,453                | 0   | 0                 | 4,453     |
| Net change in unrealized gains (losses) on securities available for sale, net of reclassification adjustment and taxes | 0                                 | 0        | 0                    | (377)   | 0                 | (377)     |
| <b>Total Comprehensive Income</b>  |                                   |          |                      |   |                   | 4,076     |
| Cash dividends declared, (\$.73 per share)   | 0                                 | 0        | (2,311)              | 0   | 0                 | (2,311)   |
| Shares issued from treasury related to stock purchase plans (13,920 shares)  | 0                                 | 203      | 0                    | 0   | 123               | 326       |
| Purchase of treasury stock (23,742 shares)   | 0                                 | 0        | 0                    | 0   | (813)             | (813)     |
| <b>Balance - December 31, 2004</b>   | 6,683                             | 2,821    | 35,665               | 618   | (3,433)           | 42,354    |
| Comprehensive income:  |                                   |          |                      |   |                   |           |
| Net income   | 0                                 | 0        | 4,476                | 0   | 0                 | 4,476     |
| Net change in unrealized gains (losses) on securities available for sale, net of reclassification adjustment and taxes | 0                                 | 0        | 0                    | (1,579)   | 0                 | (1,579)   |
| <b>Total Comprehensive Income</b>  |                                   |          |                      |   |                   | 2,897     |
| Cash dividends declared, (\$1.76 per share)  | 0                                 | 0        | (5,542)              | 0   | 0                 | (5,542)   |
| Shares issued from treasury related to stock purchase plans (10,084 shares)  | 0                                 | 174      | 0                    | 0   | 89                | 263       |
| Purchase of treasury stock (10,215 shares)   | 0                                 | 0        | 0                    | 0   | (356)             | (356)     |



|  |              |                 |                  |                 |                   |                  |
|--|--------------|-----------------|------------------|-----------------|-------------------|------------------|
| <b>Balance - December 31, 2005</b>   | <b>6,683</b> | <b>2,995</b>    | <b>34,599</b>    | <b>(961)</b>    | <b>(3,700)</b>    | <b>39,616</b>    |
| <b>Comprehensive income:</b>   |              |                 |                  |                 |                   |                  |
| <b>Net income</b>  | <b>0</b>     | <b>0</b>        | <b>4,129</b>     | <b>0</b>        | <b>0</b>          | <b>4,129</b>     |
| <b>Net change in<br/>unrealized gains losses)<br/>on securities available<br/>for sale, net of<br/>reclassification<br/>adjustment and taxes</b> | <b>0</b>     | <b>0</b>        | <b>0</b>         | <b>566</b>      | <b>0</b>          | <b>566</b>       |
| <b>Total Comprehensive<br/>Income</b>  |              |                 |                  |                 |                   | <b>4,695</b>     |
| <b>Stock option expense</b>  | <b>0</b>     | <b>3</b>        | <b>0</b>         | <b>0</b>        | <b>0</b>          | <b>3</b>         |
| <b>Cash dividends declared,<br/>(\$0.76 per share)</b>   | <b>0</b>     | <b>0</b>        | <b>(2,392)</b>   | <b>0</b>        | <b>0</b>          | <b>(2,392)</b>   |
| <b>Shares issued from treasury<br/>related to stock purchase<br/>plans (4,783 shares)</b>  | <b>0</b>     | <b>48</b>       | <b>0</b>         | <b>0</b>        | <b>53</b>         | <b>101</b>       |
| <b>Purchase of treasury stock<br/>(26,579 shares)</b>  | <b>0</b>     | <b>0</b>        | <b>0</b>         | <b>0</b>        | <b>(783)</b>      | <b>(783)</b>     |
| <b>Balance - December 31, 2006\$</b>   | <b>6,683</b> | <b>\$ 3,046</b> | <b>\$ 36,336</b> | <b>\$ (395)</b> | <b>\$ (4,430)</b> | <b>\$ 41,240</b> |

*See notes to consolidated financial statements*

*Peoples Financial Services Corp. and Subsidiaries***CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | Years Ended December 31, |                 |                 |
|---|--------------------------|-----------------|-----------------|
|   | 2006                     | 2005            | 2004            |
|   | (In Thousands)           |                 |                 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>   |                          |                 |                 |
| Net income  | \$ 4,129                 | \$ 4,476        | \$ 4,453        |
| Adjustments to reconcile net income to net cash provided by operating activities:     |                          |                 |                 |
| Depreciation and amortization   | 900                      | 753             | 654             |
| Provision for loan losses   | 302                      | 392             | 1,050           |
| Losses on sales or retirements of equipment   | 9                        | 0               | 0               |
| Gain on sale of other real estate owned   | (59)                     | (85)            | 0               |
| Net amortization of securities premiums and discounts                                 | 417                      | 578             | 565             |
| Net realized gains on sales of securities   | (42)                     | (222)           | (296)           |
| Stock option expense  | 3                        | 0               | 0               |
| Deferred income taxes (benefit)   | 14                       | 274             | (300)           |
| Earnings on investment in life insurance  | (281)                    | (263)           | (236)           |
| Impairment of security  | 0                        | 0               | 1,144           |
| Proceeds from the sale of loans   | 3,037                    | 2,076           | 3,429           |
| Net gain on sale of loans   | (27)                     | (33)            | (50)            |
| Loans originated for sale   | (3,090)                  | (2,180)         | (3,379)         |
| (Increase) decrease in assets:  |                          |                 |                 |
| Accrued interest receivable   | (28)                     | 160             | 60              |
| Other assets  | 110                      | (459)           | 154             |
| Increase (decrease) in liabilities:   |                          |                 |                 |
| Accrued interest payable  | 81                       | 72              | (54)            |
| Other liabilities   | 227                      | 338             | 176             |
| <b>Net Cash Provided by Operating Activities</b>                                      | <b>5,702</b>             | <b>5,877</b>    | <b>7,370</b>    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>   |                          |                 |                 |
| Proceeds from sale of available for sale securities                                   | 60,977                   | 27,122          | 28,121          |
| Proceeds from maturities of and principal repayments on available for sale securities | 12,555                   | 16,960          | 13,209          |
| Purchase of available for sale securities   | (73,973)                 | (41,545)        | (40,786)        |
| Net increase in loans   | (18,868)                 | (15,157)        | (9,407)         |
| Purchase of investment in life insurance  | 0                        | 0               | (2,000)         |
| Purchase of premises and equipment  | (1,016)                  | (1,424)         | (860)           |
| Proceeds from sale or retirements of equipment  | 60                       | 0               | 0               |
| Proceeds from sale of other real estate   | 183                      | 342             | 414             |
| <b>Net Cash Used in Investing Activities</b>  | <b>(20,082)</b>          | <b>(13,702)</b> | <b>(11,309)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>   |                          |                 |                 |

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|   |                  |          |          |
|---|------------------|----------|----------|
| Increase (decrease) in deposits                         | <b>26,651</b>    | 22,187   | (4,925)  |
| Proceeds from long-term borrowings                      | <b>3,100</b>     | 12,200   | 5,000    |
| Repayment of long-term borrowings                       | <b>(1,345)</b>   | (23,464) | (918)    |
| Net increase (decrease) in short-term borrowings        | <b>(5,268)</b>   | 3,228    | 7,529    |
| Proceeds from sale of treasury stock                    | <b>101</b>       | 263      | 326      |
| Purchase of treasury stock                              | <b>(783)</b>     | (356)    | (813)    |
| Cash dividends paid                                     | <b>(2,392)</b>   | (5,542)  | (2,311)  |
| <b>Net Cash Provided by Financing Activities</b>        | <b>20,064</b>    | 8,516    | 3,888    |
| <b>Increase (Decrease) in Cash and Cash Equivalents</b> | <b>5,684</b>     | 691      | (51)     |
| <b>CASH AND CASH EQUIVALENTS - BEGINNING</b>            | <b>6,696</b>     | 6,005    | 6,056    |
| <b>CASH AND CASH EQUIVALENTS - ENDING</b>               | <b>\$ 12,380</b> | \$ 6,696 | \$ 6,005 |

*See notes to consolidated financial statements*

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*Peoples Financial Services Corp. and Subsidiaries*

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**CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)**

|  | <b>2006</b> | <b>Years Ended December 31,<br/>2005</b> | <b>2004</b> |
|--|-------------|--|-------------|
|  |             | <b>(In Thousands)</b>                    |             |
| <b>SUPPLEMENTARY CASH FLOWS INFORMATION</b>                                    |             |  |             |
| Interest paid  | \$ 10,716   | \$ 8,176                                 | \$ 7,138    |
| Income taxes paid  | \$ 605      | \$ 957                                   | \$ 1,200    |
| <b>SUPPLEMENTARY DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES</b> |             |  |             |
| Foreclosed real estate acquired in settlement of loans                         | \$ 5,068    | \$ 117                                   | \$ 556      |
| Securities acquired in settlement of loans                                     | \$ 1,065    | \$ 0                                     | \$ 0        |

*See notes to consolidated financial statements*46

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*Peoples Financial Services Corp. and Subsidiaries*

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation**

The consolidated financial statements include the accounts of Peoples Financial Services Corp. and its wholly-owned subsidiaries, Peoples National Bank (the “Bank”) and Peoples Advisors, LLC (the “Company”). All significant intercompany accounts and transactions have been eliminated in consolidation.

**Nature of Operations**

The Company provides a variety of financial services, through the Bank, to individuals, small businesses and municipalities through its seven Pennsylvania offices located in Hallstead, Hop Bottom, Susquehanna, Montrose, Nicholson, Meshoppen and Tunkhannock, which are small communities in a rural setting. In 2002, the Company started operating in New York with an office located in Norwich. The Company opened an office in Conklin, New York, in March 2003 at which time the Norwich office was closed and its deposits transferred to the Conklin office. The Company opened two new offices in 2005, Deposit, New York, April 2005, and the Town of Chenango, New York, June 2005. The Bank’s primary deposits are checking accounts, savings accounts and certificates of deposit. Its primary lending products are single-family residential loans and loans to small businesses. As a national bank, the Bank is subject to regulation of the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. The Company is subject to regulation of the Federal Reserve Bank. Peoples Advisors, LLC is a member-managed liability company under the laws of the Commonwealth of Pennsylvania for the purpose of providing investment advisory services to the general public.

**Estimates**

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

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans.

**Significant Group Concentrations of Credit Risk**

Most of the Company’s activities are with customers located primarily in northern Lackawanna, Susquehanna and Wyoming Counties of Pennsylvania, and Broome County of New York. Note 2 discusses the types of securities in which the Company invests. The concentrations of credit by type of loan are set forth in Note 3. The Company does not have any significant concentrations to any one industry or customer. Although the Company has a diversified loan portfolio, its debtors’ ability to honor their contracts is influenced by the region’s economy.



*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Presentation of Cash Flows**

For purposes of cash flows, cash and cash equivalents include cash on hand and amounts due from banks, interest-bearing deposits in other banks and federal funds sold.

**Securities**

Securities classified as available-for-sale are those securities that the Company intends to hold for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Securities available-for-sale are carried at fair value. Unrealized gains or losses are reported as increases or decreases in other comprehensive income, net of the related deferred tax effect. Realized gains or losses, determined on the basis of the cost of the specific securities sold, are included in earnings. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

Common equity securities include restricted investments, primarily Federal Home Loan Bank and Federal Reserve Bank stock which are carried at cost and investments in bank stocks which are carried at fair value. Federal law requires a member institution of the Federal Home Loan Bank and the Federal Reserve Bank to hold stock according to a predetermined formula.

Declines in the fair value of available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

**Loans Receivable**

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized over the contractual life of the related loan as an adjustment to the yield.

The accrual of interest is generally discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on non-accrual loans generally is either applied against principal or reported as interest income, according to management's judgment as to the collectibility of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period

of time and the ultimate collectibility of the total contractual principal and interest is no longer in doubt.



*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Loans Held for Sale**

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by aggregate outstanding commitments from investors or current investor yield requirements. Net unrealized losses are recognized through a valuation allowance by charges to income. The Company had mortgages of \$80,000 and \$137,000 held for sale at December 31, 2006 and 2005, respectively.

**Allowance for Loan Losses**

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on the Bank's past loan loss experience, known or inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value for that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank

does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****Premises and Equipment**

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line and various accelerated methods over the following estimated useful lives of the related assets:

|                                   | <b>Years</b> |
|-----------------------------------|--------------|
| Buildings and improvements        | 7 - 40       |
| Furniture, fixtures and equipment | 3 - 10       |

Maintenance, repairs and minor replacements are expensed when incurred. Gains and losses on routine dispositions are reflected in current operations.

**Transfers of Financial Assets**

Transfers of financial assets, which include loan participation sales, are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Intangible Assets**

The Bank has core deposit acquisition premiums which are being amortized over an estimated life of fifteen years using the straight-line method. These intangible assets were \$1,331,000 and \$1,630,000, net of accumulated amortization of \$2,556,000 and \$2,257,000 at December 31, 2006 and 2005, respectively. Amortization expense was \$299,000 for 2006 and \$262,000 for 2005 and 2004. Amortization expense is estimated to be \$258,000 per year for the next five years. The fluctuation in the 2006 expense and the future expense is due to impairment on the Norwich Branch deposit acquisition recognized in fourth quarter of 2006 which totaled \$38,000.

**Foreclosed Assets**

Foreclosed assets are comprised of property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure and loans classified as in-substance foreclosure. The Company includes such properties in other assets. A loan is classified as in-substance foreclosure when the Company has taken possession of the collateral regardless of whether formal foreclosure proceedings take place. Foreclosed assets initially are recorded at fair value, net of estimated selling costs, at the date of foreclosure establishing a new cost basis. Subsequent declines in the recorded value of the property prior to its disposal and costs to maintain the assets are included in other expense. In addition, any gain or loss realized upon disposal is included in other income or expense.



*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Bank Owned Life Insurance**

The Company invests in bank owned life insurance (“BOLI”) as a source of funding for employee benefit expenses. BOLI involves the purchasing of life insurance by the Bank on a chosen group of employees. The Company is the owner and beneficiary of the policies. This life insurance investment is carried at the cash surrender value of the underlying policies and is included in other assets in the amount of \$7,317,000 and \$7,036,000 at December 31, 2006 and 2005, respectively.

**Income Taxes**

Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. Peoples Financial Services Corp. and its subsidiaries file a consolidated federal income tax return.

**Advertising**

The Company follows the policy of charging marketing and advertising costs to expense as incurred. Advertising expense for the years-ended December 31, 2006, 2005 and 2004 was \$167,000, \$151,000, and \$123,000, respectively.

**Earnings per Common Share**

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

*Peoples Financial Services Corp. and Subsidiaries***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****Earnings per Common Share (Continued)**

The following table shows the amounts used in computing earnings per share for the years-ended December 31, 2006, 2005 and 2004:

|   | <b>Income<br/>Numerator</b>                  | <b>Common<br/>Shares<br/>Denominator</b> | <b>EPS</b> |
|---|--|--|------------|
|   | <b>(In Thousands, Except Per Share Data)</b> |  |            |
| <b>2006:</b>  |  |  |            |
| Basic EPS   | \$ 4,129                                     | 3,144                                    | \$ 1.31    |
| Dilutive effect of potential common stock,<br>stock options | 0  | 12                                       | .00        |
| Diluted EPS   | \$ 4,129                                     | 3,156                                    | \$ 1.31    |
| <b>2005:</b>  |  |  |            |
| Basic EPS   | \$ 4,476                                     | 3,151                                    | \$ 1.42    |
| Dilutive effect of potential common stock,<br>stock options | 0  | 17                                       | .01        |
| Diluted EPS   | \$ 4,476                                     | 3,168                                    | \$ 1.41    |
| <b>2004:</b>  |  |  |            |
| Basic EPS   | \$ 4,453                                     | 3,166                                    | \$ 1.41    |
| Dilutive effect of potential common stock,<br>stock options | 0  | 21                                       | .01        |
| Diluted EPS   | \$ 4,453                                     | 3,187                                    | \$ 1.40    |

**Comprehensive Income**

Accounting principles generally accepted in the United States of America require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

*Peoples Financial Services Corp. and Subsidiaries***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****Comprehensive Income (Continued)**

The components of other comprehensive income and related tax effects for the years-ended December 31, 2006, 2005 and 2004 are as follows:

|   | <b>2006</b> | <b>2005</b>           | <b>2004</b> |
|---|-------------|-----------------------|-------------|
|   |             | <b>(In Thousands)</b> |             |
| Unrealized holding gains (losses) on available for sale securities    | \$ 900      | \$ (2,170)            | \$ (1,420)  |
| Reclassification adjustment for (gains) losses realized in net income | (42)        | (222)                 | 848         |
| <b>Net Unrealized Gains (Losses)</b>                                  | 858         | (2,392)               | (572)       |
| Tax effect  | (292)       | 813                   | 195         |
| <b>Net of Tax Amount</b>  | \$ 566      | \$ (1,579)            | \$ (377)    |

**Stock-Based Compensation**

Prior to January 1, 2006, the Company's stock option plan was accounted for under the recognition and measurement provisions of APB Opinion No. 25 (Opinion 25), *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock Based Compensation* (as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*) (collectively SFAS 123). No stock-based employee compensation cost was recognized in the Company's consolidated statements of income through December 31, 2005, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), *Share-Based Payment* (SFAS 123(R)), using the modified-prospective transition method. Under that transition method, compensation cost recognized in 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006 based on the grant date fair value calculated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005, based on a grant-date fair value estimated in accordance with the provisions of SFAS 123(R). As of December 31, 2005, 4,350 stock options were not fully vested.

As of December 31, 2006, the Company had 4,100 stock options not fully vested and there was approximately \$4,000 of total unrecognized compensation cost related to these non-vested options. The cost is expected to be recognized monthly on a straight-line basis through December 31, 2008. For the year ended December 31, 2006 there were no stock options granted. For the year ended December 31, 2006 there was stock option expense of \$3,000 included in salaries and employee benefits in the accompanying consolidated statement of income related to share based payments granted prior to, but not yet vested as of January 1, 2006. Therefore, as a result of adopting Statement No. 123(R) the

Company's net income for the year ended December 31, 2006 was \$3,000 lower than if the Company had continued to account for share-based compensation under Opinion No. 25. Basic earnings per share and diluted earnings per share for the year ended December 31, 2006 were not affected by the adoption.



*Peoples Financial Services Corp. and Subsidiaries***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****Stock-Based Compensation (Continued)**

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to options granted under the Company's stock option plan for the years ended December 31, 2005 and 2004. For purposes of this pro forma disclosure, the value of the options is estimated using the Black-Scholes option-pricing model and is being amortized to expense over the options' vesting periods. The following weighted average assumptions were used with the Black-Scholes model for 2005 and 2004, respectively: risk free interest rate of 4.31% and 3.89%; volatility of 20%; dividend yield of 2.47% and 2.14%; and an expected life of six years. The weighted-average fair value of options granted was \$6.43 per share in 2005 and \$6.99 per share in 2004.

|  | <b>2005</b>                                     | <b>2004</b> |
|--|---|-------------|
|  | <b>(In Thousands, except Per Share Amounts)</b> |             |
| Net income as reported   | \$ 4,476  | \$ 4,453    |
| Total stock-based compensation cost, net of tax, which would have been included in the determination of net income if the fair value based method had been applied to all awards | (26)  | (31)        |
| Pro forma net income   | \$ 4,450  | \$ 4,422    |
| Basic earnings per share:  |   |             |
| As reported  | \$ 1.42   | \$ 1.41     |
| Pro forma  | \$ 1.41   | \$ 1.40     |
| Diluted earnings per share:  |   |             |
| As reported  | \$ 1.41   | \$ 1.40     |
| Pro forma  | \$ 1.40   | \$ 1.39     |

*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Segment Reporting**

The Bank acts as an independent community financial services provider and offers traditional banking and related financial services to individual, business and government customers. Through its branch and automated teller machine network, the Bank offers a full array of commercial and retail financial services, including: the taking of time, savings and demand deposits; the making of commercial, consumer and mortgage loans; and the providing of other financial services.

Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial and retail operations of the Bank. As such, discrete information is not available and segment reporting would not be meaningful.

Peoples Advisors, LLC provides investment advisory services to the general public. This company is included in the banking and financial services segment of the Bank.

**Off-Balance Sheet Financial Instruments**

In the ordinary course of business, the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the consolidated financial statements when they are funded.

**New Accounting Standards**

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments" ("SFAS 155"). SFAS No. 155 amends FASB Statement No. 133 and FASB Statement No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company is required to adopt the provisions of SFAS No. 155, as applicable, beginning in fiscal year 2007. Management does not believe the adoption of SFAS No. 155 will have a material impact on the Company's consolidated financial position and results of operations.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets — An Amendment of FASB Statement No. 140" ("SFAS 156"). SFAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. The statement permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. SFAS 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006, which for the Company will be as of the beginning of fiscal 2007. The Company does not believe that the adoption of SFAS 156 will have a significant effect on its consolidated financial statements.



*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**New Accounting Standards (Continued)**

In February 2006, the FASB issued FASB Staff Position No. FAS 123(R)-4, "Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event." This position amends SFAS 123(R) to incorporate that a cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control does not meet certain conditions in SFAS 123(R) until it becomes probable that the event will occur. The guidance in this FASB Staff Position was applied upon initial adoption of Statement 123(R) on January 1, 2006. The adoption did not have a material impact on the consolidated statements.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, "Accounting for the Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109" ("FIN 48"), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that companies recognize in their financial statements the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company analyzed FIN 48 and determined it will have no impact on the reported consolidated results of operations or financial condition.

In September 2006, the FASB issued FASB Statement No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. FASB Statement No. 157 applies to other accounting pronouncements that require or permit fair value measurements. The new guidance is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years. We are currently evaluating the potential impact, if any, of the adoption of FASB Statement No. 157 on our consolidated financial position, results of operations and cash flows.

On September 13, 2006, the Securities and Exchange Commission "SEC" issued Staff Accounting Bulletin No. 108 ("SAB 108"). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a potential current year misstatement. Prior to SAB 108, companies might evaluate the materiality of financial statement misstatements using either the income statement or balance sheet approach, with the income statement approach focusing on new misstatements added in the current year, and the balance sheet approach focusing on the cumulative amount of misstatement present in a company's balance sheet. Misstatements that would be material under one approach could be viewed as immaterial under another approach, and not be corrected. SAB 108 now requires that companies view financial statement misstatements as material if they are material according to either the income statement or balance sheet approach. SAB 108 is applicable to all Company consolidated financial statements issued after November 15, 2006 and did not have a significant impact on the Company's consolidated financial statements.

*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**New Accounting Standards (Continued)**

In October 2006, the FASB issued FASB Staff Position No. 123(R)-5, "Amendment of FASB Staff Position FAS 123(R)-1" ("FSP 123(R)-5"). FSP 123(R)-5 amends FSP 123(R)-1 for equity instruments that were originally issued as employee compensation and then modified, with such modification made solely to reflect an equity restructuring that occurs when the holders are no longer employees. The provisions of FSP 123(R)-5 are effective for fiscal years beginning after October 10, 2006. The Company analyzed FSP 123(R)-5 and determined it will have no impact on the reported consolidated results of operations, financial condition or cash flows.

**Reclassifications**

Certain amounts in the 2005 and 2004 financial statements have been reclassified to conform with 2006 presentation. Those reclassifications had no effect on net income.

*Peoples Financial Services Corp. and Subsidiaries***NOTE 2 - SECURITIES**

At December 31, 2006 and 2005, the amortized cost and fair values of securities available-for-sale are as follows:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value     |
|---|-------------------|------------------------------|-------------------------------|-------------------|
|   | (In Thousands)    |                              |                               |                   |
| <b>December 31, 2006:</b>                       |                   |                              |                               |                   |
| U.S. Government agencies and corporations       | \$ 11,110         | \$ 8                         | \$ 0                          | \$ 11,118         |
| Obligations of state and political subdivisions | 30,430            | 96                           | (188)                         | 30,338            |
| Corporate debt securities                       | 3,404             | 0                            | (147)                         | 3,257             |
| Mortgage-backed securities                      | 58,538            | 62                           | (753)                         | 57,847            |
| Preferred equity securities                     | 2,366             | 167                          | 0                             | 2,533             |
| Common equity securities                        | 5,052             | 157                          | 0                             | 5,209             |
| <b>Total</b>                                    | <b>\$ 110,900</b> | <b>\$ 490</b>                | <b>\$ (1,088)</b>             | <b>\$ 110,302</b> |
| <b>December 31, 2005:</b>                       |                   |                              |                               |                   |
| U.S. Government agencies and corporations       | \$ 25,077         | \$ 2                         | \$ (475)                      | \$ 24,604         |
| Obligations of state and political subdivisions | 40,420            | 440                          | (383)                         | 40,477            |
| Corporate debt securities                       | 10,986            | 73                           | (143)                         | 10,916            |
| Mortgage-backed securities                      | 26,366            | 23                           | (826)                         | 25,563            |
| Preferred equity securities                     | 2,366             | 0                            | (240)                         | 2,126             |
| Common equity securities                        | 4,554             | 73                           | 0                             | 4,627             |
| <b>Total</b>                                    | <b>\$ 109,769</b> | <b>\$ 611</b>                | <b>\$ (2,067)</b>             | <b>\$ 108,313</b> |

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

|  | Amortized<br>Cost | Fair<br>Value |
|--|-------------------|---------------|
|  | (In Thousands)    |               |
| Due in one year or less                | \$ 6,003          | \$ 6,004      |
| Due after one year through five years  | 7,511             | 7,440         |
| Due after five years through ten years | 3,884             | 3,864         |
| Due after ten years                    | 27,546            | 27,405        |
|  | 44,944            | 44,713        |
| Mortgage-backed securities             | 58,538            | 57,847        |
| Equity securities                      | 7,418             | 7,742         |

\$ 110,900 \$ 110,302

*Peoples Financial Services Corp. and Subsidiaries***NOTE 2 - SECURITIES (CONTINUED)**

Proceeds from sale of available-for-sale securities during 2006, 2005 and 2004 were \$60,977,000, \$27,122,000, and \$28,121,000, respectively. Gross gains realized on these sales were \$663,000, \$463,000, and \$312,000, respectively. Gross losses on these sales were \$621,000, \$241,000, and \$16,000, respectively.

Securities with a carrying value of \$32,842,000 and \$33,389,000 at December 31, 2006 and 2005, respectively, were pledged to secure public deposits and repurchase agreements as required or permitted by law.

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

**December 31, 2006:**

|   | Less Than 12 Months |                   | 12 Months or More |                   | Total            |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value       | Unrealized Losses |
| U.S. Government agencies and corporations       | \$ 1,000            | \$ 0              | \$ 0              | \$ 0              | \$ 1,000         | \$ 0              |
| Obligations of state and political subdivisions | 7,850               | (38)              | 10,920            | (150)             | 18,770           | (188)             |
| Corporate debt securities                       | 0                   | 0                 | 3,257             | (147)             | 3,257            | (147)             |
| Mortgage-backed securities                      | 13,686              | (49)              | 22,228            | (704)             | 35,914           | (753)             |
| <b>Total Temporarily Impaired Securities</b>    | <b>\$ 22,536</b>    | <b>\$ (87)</b>    | <b>\$ 36,405</b>  | <b>\$ (1,001)</b> | <b>\$ 58,941</b> | <b>\$ (1,088)</b> |

**December 31, 2005:**

|   | Less Than 12 Months |                   | 12 Months or More |                   | Total            |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value       | Unrealized Losses |
| U.S. Government agencies and corporations       | \$ 8,895            | \$ (98)           | \$ 14,123         | \$ (377)          | \$ 23,018        | \$ (475)          |
| Obligations of state and political subdivisions | 12,360              | (178)             | 10,772            | (205)             | 23,132           | (383)             |
| Corporate debt securities                       | 996                 | (40)              | 2,343             | (103)             | 3,339            | (143)             |
| Mortgage-backed securities                      | 13,974              | (307)             | 10,378            | (519)             | 24,352           | (826)             |
| Preferred equity securities                     | 2,126               | (240)             | 0                 | 0                 | 2,126            | (240)             |
| <b>Total Temporarily Impaired Securities</b>    | <b>\$ 38,351</b>    | <b>\$ (863)</b>   | <b>\$ 37,616</b>  | <b>\$ (1,204)</b> | <b>\$ 75,967</b> | <b>\$ (2,067)</b> |





*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 2 - SECURITIES (CONTINUED)**

In management's opinion, the unrealized losses reflect changes in interest rates subsequent to the acquisition of specific securities. At December 31, 2006 and 2005, the Company had 92 and 122 securities, respectively, in an unrealized loss position. The Company has the intent and the ability to hold such securities until maturity or market price recovery. Management believes that the unrealized losses represent temporary impairment of the securities.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

At December 31, 2004, the Company held four preferred equity securities issued by FNMA and FHLMC with aggregate market value depreciation of 20% or more from the Company's amortized costs basis of \$5,000,000. Management had been closely monitoring the market valuations of these preferred equity securities and adverse financial events regarding these agencies, and had concluded that these equity securities were other-than-temporarily impaired as of December 31, 2004. An impairment charge of \$1,144,000 pre-tax (\$755,000 after tax) was recorded in the fourth quarter of 2004.

*Peoples Financial Services Corp. and Subsidiaries***NOTE 3 - LOANS RECEIVABLE**

The composition of loans receivable at December 31, 2006 and 2005 is as follows:

|  | <b>December 31,</b>   |             |
|--|-----------------------|-------------|
|  | <b>2006</b>           | <b>2005</b> |
|  | <b>(In Thousands)</b> |             |
| Commercial                                   | \$ 60,326             | \$ 60,599   |
| Real estate:                                 |                       |             |
| Commercial                                   | 80,605                | 71,455      |
| Residential                                  | 112,883               | 109,034     |
| Consumer                                     | 16,947                | 17,780      |
|  | 270,761               | 258,868     |
| Unearned net loan origination fees and costs | 414                   | 377         |
| Allowance for loan losses                    | (1,792)               | (2,375)     |
|  | \$ 269,383            | \$ 256,870  |

A summary of the transactions in the allowance for loan losses is as follows:

|                           | <b>Years Ended December 31,</b> |             |             |
|---------------------------|---------------------------------|-------------|-------------|
|                           | <b>2006</b>                     | <b>2005</b> | <b>2004</b> |
|                           | <b>(In Thousands)</b>           |             |             |
| Balance, beginning        | \$ 2,375                        | \$ 2,739    | \$ 2,093    |
| Provision for loan losses | 302                             | 392         | 1,050       |
| Recoveries                | 31                              | 37          | 39          |
| Loans charged off         | (916)                           | (793)       | (443)       |
| Balance, ending           | \$ 1,792                        | \$ 2,375    | \$ 2,739    |

The total recorded investment in impaired loans was \$445,000 and \$1,105,000 at December 31, 2006 and 2005, respectively. Impaired loans, not requiring an allowance for loan losses, were \$445,000 and \$88,000 at December 31, 2006 and 2005, respectively. Impaired loans requiring an allowance for loan losses were \$0 and \$1,017,000 at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the related allowance for loan losses associated with these loans was \$0 and \$698,000, respectively. For the years-ended December 31, 2006, 2005 and 2004, the average balance of these impaired loans was \$449,000, \$1,113,000, and \$1,598,000, respectively. The Company recognizes income on impaired loans under the cash basis when the collateral on the loan is sufficient to cover the outstanding obligation to the Company. If these factors do not exist, the Company will record all payments as a reduction of principal on such loans. Interest income recognized for the time that the loans were impaired was \$7,000, \$9,000, and \$29,000 in 2006, 2005 and 2004, respectively.



*Peoples Financial Services Corp. and Subsidiaries***NOTE 3 - LOANS RECEIVABLE (CONTINUED)**

Loans on which the accrual of interest has been discontinued amounted to \$445,000 and \$1,105,000 at December 31, 2006 and 2005, respectively. Loan balances past due 90 days or more and still accruing interest, but which management expects will eventually be paid in full, amounted to \$275,000 and \$0 at December 31, 2006 and 2005, respectively.

Loans outstanding to directors, executive officers, principal stockholders or to their affiliates totaled \$390,000 and \$436,000 at December 31, 2006 and 2005, respectively. Advances and repayments during 2006 totaled \$110,000 and \$156,000, respectively. These loans are made during the ordinary course of business at the Company's normal credit terms. There were no related party loans that were classified as non-accrual, past due, restructured or considered a potential credit risk at December 31, 2006 and 2005.

The Company has entered an agreement to sell residential mortgages to the FHLB of Pittsburgh ("FHLB"). The minimum to be sold under the agreement is \$5,000,000 and \$7,818,000 has been sold under this agreement as of December 31, 2006. The agreement includes a maximum credit enhancement of \$178,000 which the Company may be required to pay if realized losses on any of the sold mortgages exceed the amount held in the FHLB's Spread Account. The FHLB is funding the Spread Account at 0.25% of the outstanding balance of loans sold. The Company's historical losses on residential mortgages have been lower than the amount being funded to the Spread Account. As such, the Company does not anticipate recognizing any losses and accordingly, has not recorded a liability for the credit enhancement. As compensation for the credit enhancement, the FHLB is paying the Company 0.10% of the outstanding loan balance in the portfolio on a monthly basis.

The Company retains the servicing on the loans sold to the FHLB and receives a fee based upon the principal balance outstanding. During the years ended 2006 and 2005, the Company recognized \$47,000 and \$11,000 respectively of servicing assets and amortized \$25,000 and \$1,000 respectively. The balance outstanding was \$32,000 and \$10,000 at December 31, 2006 and 2005, respectively. The fair value of the servicing assets was \$32,000 and \$10,000 at December 31, 2006 and 2005, respectively, and was based on market quotes for pools of the mortgages stratified by rate and maturity date.

**NOTE 4 - PREMISES AND EQUIPMENT**

Premises and equipment at December 31, 2006 and 2005 are comprised of the following:

|                                   | <b>2006</b>           |         | <b>2005</b> |
|-----------------------------------|-----------------------|---------|-------------|
|                                   | <b>(In Thousands)</b> |         |             |
| Land                              | \$                    | 398     | \$ 398      |
| Building and improvements         |                       | 6,414   | 6,041       |
| Furniture, fixtures and equipment |                       | 5,567   | 5,156       |
|                                   |                       | 12,379  | 11,595      |
| Accumulated depreciation          |                       | (6,196) | (5,758)     |

\$ 6,183 \$ 5,837

Depreciation expense was \$601,000, \$491,000, and \$392,000 for the years-ended December 31, 2006, 2005 and 2004, respectively.

*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 5 - DEPOSITS**

The composition of deposits at December 31, 2006 and 2005 were as follows:

|                      | <b>2006</b>           |    | <b>2005</b> |
|----------------------|-----------------------|----|-------------|
|                      | <b>(In Thousands)</b> |    |             |
| Demand:              |                       |    |             |
| Non-interest bearing | \$ 50,940             | \$ | 46,777      |
| Interest bearing     | 66,560                |    | 64,189      |
| Savings              | 108,282               |    | 78,236      |
| Time:                |                       |    |             |
| \$100,000 and over   | 16,923                |    | 21,624      |
| Less than \$100,000  | 80,908                |    | 86,136      |
|                      | \$ 323,613            | \$ | 296,962     |

At December 31, 2006, the scheduled maturities of time deposits are as follows (in thousands):

|            |           |
|------------|-----------|
| 2007       | \$ 67,784 |
| 2008       | 11,106    |
| 2009       | 6,897     |
| 2010       | 4,189     |
| 2011       | 4,279     |
| Thereafter | 3,576     |
|            | \$ 97,831 |

*Peoples Financial Services Corp. and Subsidiaries***NOTE 6 - SHORT-TERM BORROWINGS**

Securities sold under agreements to repurchase and Federal Home Loan Bank advances generally represent overnight or less than 30-day borrowings. U.S. Treasury tax and loan notes for collections made by the Bank are payable on demand. Short-term borrowings consisted of the following at December 31, 2006 and 2005:

|  | <b>December 31, 2006</b>  |                            |  |                         |
|--|---------------------------|----------------------------|--|-------------------------|
|  | <b>Ending<br/>Balance</b> | <b>Average<br/>Balance</b> | <b>Maximum<br/>Month-End<br/>Balance</b> | <b>Average<br/>Rate</b> |
| <b>(In Thousands)</b>                          |                           |                            |  |                         |
| Securities sold under agreements to repurchase | \$ 11,591                 | \$ 10,946                  | \$ 13,394                                | 4.07%                   |
| Federal Home Loan Bank                         | 0                         | 1,239                      | 6,510                                    | 4.83%                   |
| U.S. Treasury tax and loan notes               | 983                       | 418                        | 1,019                                    | 4.46%                   |
|  | \$ 12,574                 | \$ 12,603                  | \$ 20,923                                | 4.16%                   |

|  | <b>December 31, 2005</b>  |                            |  |                     |
|--|---------------------------|----------------------------|--|---------------------|
|  | <b>Ending<br/>Balance</b> | <b>Average<br/>Balance</b> | <b>Maximum<br/>Month-End<br/>Balance</b> | <b>Average Rate</b> |
| <b>(In Thousands)</b>                          |                           |                            |  |                     |
| Securities sold under agreements to repurchase | \$ 10,030                 | \$ 10,537                  | \$ 13,870                                | 2.58%               |
| Federal Home Loan Bank                         | 7,220                     | 1,114                      | 7,220                                    | 3.21%               |
| U.S. Treasury tax and loan notes               | 592                       | 397                        | 989                                      | 2.83%               |
|  | \$ 17,842                 | \$ 12,048                  | \$ 22,079                                | 2.65%               |

The Bank has an agreement with the Federal Home Loan Bank (FHLB) which allows for borrowings up to a percentage of qualifying assets. At December 31, 2006, the Bank had a maximum borrowing capacity for short-term and long-term advances of approximately \$179,163,000, of which \$36,525,000 was outstanding in long-term borrowings. All advances from FHLB are secured by qualifying assets of the Bank.

Securities sold under repurchase agreements are retained under the Bank's control at its safekeeping agent. The Bank may be required to provide additional collateral based on the fair value of the underlying securities.

The Bank has a \$7,000,000 line of credit for the sale of federal funds with Atlantic Central Bankers Bank of which \$0 was outstanding at December 31, 2006 and 2005. These borrowings are unsecured.





*Peoples Financial Services Corp. and Subsidiaries***NOTE 7 - LONG-TERM BORROWINGS**

Long-term debt consisted of advances from the Federal Home Loan Bank under various notes.

Detail of long-term debt at December 31, 2006 and 2005 is as follows:

| <b>Due</b>     | <b>Convertible</b> | <b>Strike Rate</b> | <b>Current Interest Rate</b> | <b>(In Thousands)</b> |             |
|----------------|--------------------|--------------------|------------------------------|-----------------------|-------------|
|                |                    |                    |                              | <b>2006</b>           | <b>2005</b> |
| September 2011 | N/A                | N/A                | 5.05 %                       | \$ 860                | \$ 0        |
| February 2016  | N/A                | N/A                | 4.86                         | 1,028                 | 0           |
| February 2016  | N/A                | N/A                | 4.86                         | 1,027                 | 0           |
| October 2011   | January 2007       | 8.0                | 4.47                         | 2,500                 | 2,500       |
| January 2007   | January 2007       | 7.5                | 4.06                         | 7,500                 | 7,500       |
| September 2012 | March 2007         | 8.0                | 3.69                         | 5,000                 | 5,000       |
| February 2009  | N/A                | N/A                | 4.80                         | 865                   | 1,235       |
| February 2013  | February 2007      | 8.0                | 3.59                         | 5,000                 | 5,000       |
| February 2008  | N/A                | N/A                | 2.69                         | 737                   | 1,350       |
| June 2014      | March 2007         | 8.0                | 4.47                         | 5,000                 | 5,000       |
| January 2015   | January 2007       | 8.0                | 4.31                         | 5,000                 | 5,000       |
| November 2015  | N/A                | N/A                | 4.67                         | 2,008                 | 2,185       |
|                |                    |                    | \$                           | 36,525                | \$ 34,770   |

On convertible rate notes, the Federal Home Loan Bank has the option to convert the notes at rates ranging from the three-month LIBOR (5.36% at December 31, 2006) plus .13% to plus .28% on a quarterly basis, if greater than the applicable strike rate, commencing on the conversion date. If converted, the Bank has the option to repay these advances at each of the option dates without penalty.

On September 26, 2005, the Bank prepaid \$10 million of fixed rate, high cost Federal Home Loan Bank (FHLB) advances in order to improve future net interest income. The FHLB advances were replaced with lower cost borrowings and certificates of deposits. The Bank expensed prepayment fees of \$808,000 associated with this

transaction.

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**Peoples Financial Services Corp. and Subsidiaries**

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**Note 7 - Long-Term Borrowings (Continued)**

Maturities of long-term debt, by contractual maturity, in years subsequent to December 31, 2006 are as follows (in thousands):

|            |    |        |
|------------|----|--------|
| 2007       | \$ | 9,051  |
| 2008       |    | 1,073  |
| 2009       |    | 657    |
| 2010       |    | 616    |
| 2011       |    | 3,095  |
| Thereafter |    | 22,033 |
|            | \$ | 36,525 |

The notes are secured under terms of a blanket collateral agreement by a pledge of qualifying investment and mortgage-backed securities, certain mortgage loans and a lien on FHLB stock.

*Peoples Financial Services Corp. and Subsidiaries***NOTE 8 - STOCK PURCHASE PLANS**

The Company has a stock option plan covering non-employee directors and a stock incentive plan for all officers and key employees. The Plan is administered by a committee of the Board of Directors. Under the Plan, 187,500 shares of common stock are reserved for possible issuance. The number of shares available is subject to future adjustment in the event of specified changes in the Company's capital structure. Under the Plan, the exercise price cannot be less than 100% of the fair market value on the date of grant. The vesting period of options granted is at the discretion of the Board of Directors. Options granted during 2005, 2004 and 2003 expire in ten years. There are 89,251 shares available for grant under this stock option plan as of December 31, 2006. There were no options granted during 2006.

A summary of transactions under this Plan were as follows:

|                                | <b>2006</b>    |                                       | <b>2005</b>    |                                       | <b>2004</b>    |                                       |
|--------------------------------|----------------|---------------------------------------|----------------|---------------------------------------|----------------|---------------------------------------|
|                                | <b>Options</b> | <b>Weighted<br/>Average<br/>Price</b> | <b>Options</b> | <b>Weighted<br/>Average<br/>Price</b> | <b>Options</b> | <b>Weighted<br/>Average<br/>Price</b> |
| Outstanding, beginning of year | 61,500         | \$ 19.80                              | 64,035         | \$ 18.83                              | 74,127         | \$ 17.38                              |
| Granted                        | 0              | 0                                     | 4,500          | 30.75                                 | 5,050          | 34.10                                 |
| Exercised                      | (4,783)        | 16.40                                 | (6,285)        | 17.04                                 | (13,920)       | 16.68                                 |
| Forfeited                      | (250)          | 34.10                                 | (750)          | 25.46                                 | (1,222)        | 18.63                                 |
| Outstanding, end of year       | 56,467         | \$ 20.03                              | 61,500         | \$ 19.80                              | 64,035         | \$ 18.83                              |
| Exercisable, end of year       | 52,367         | \$ 19.44                              | 57,150         | \$ 19.22                              | 59,435         | \$ 18.16                              |

The weighted-average remaining contractual life of the options outstanding is approximately 4.5 years at December 31, 2006. The weighted-average remaining contractual life of options exercisable at December 31, 2006 is approximately 4 years. Stock options outstanding at December 31, 2006 are exercisable at prices ranging from \$14.80 to \$34.10 a share. At December 31, 2006 the aggregate intrinsic value of options outstanding was \$337,100 and the aggregate intrinsic value of options exercisable was \$343,500.

During 1999, the Company implemented a Dividend Reinvestment and Stock Purchase Plan. Under the Plan, the Company registered with the Securities and Exchange Commission 100,000 shares of the common stock to be sold pursuant to the Plan. Participation is available to all common stockholders. The Plan provides each participant with a simple and convenient method of purchasing additional common shares without payment of any brokerage commission or other service fees. The Plan may purchase shares on the open market if available or they may be issued from treasury shares. A participant in the Plan may elect to reinvest dividends on all or part of their shares to acquire additional common stock. A participant may withdraw from the Plan at any time. Effective in 2005, the Plan was amended to permit stockholders participating in the Plan to purchase additional shares of common stock with voluntary cash payments of a minimum of \$100 and a maximum of \$850 each calendar month. As of December 31, 2006, there are 78,728 remaining shares available for issuance under the Dividend Reinvestment and Stock Purchase

Plan.

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*Peoples Financial Services Corp. and Subsidiaries***NOTE 9 - INCOME TAXES**

The provision for federal income taxes consists of the following:

|          | <b>Years Ended December 31,</b> |             |             |
|----------|---------------------------------|-------------|-------------|
|          | <b>2006</b>                     | <b>2005</b> | <b>2004</b> |
|          | <b>(In Thousands)</b>           |             |             |
| Current  | \$ 758                          | \$ 711      | \$ 1,314    |
| Deferred | 14                              | 274         | (300)       |
|          | \$ 772                          | \$ 985      | \$ 1,014    |

The components of the net deferred tax asset at December 31, 2006 and 2005 are as follows:

|  | <b>2006</b>           | <b>2005</b>     |
|--|-----------------------|-----------------|
|  | <b>(In Thousands)</b> |                 |
| Deferred tax asset:                              |                       |                 |
| Allowance for loan losses                        | \$ 481                | \$ 679          |
| Deferred loan fees                               | 6                     | 7               |
| Deferred compensation                            | 383                   | 323             |
| Other  | 25                    | 46              |
| Impairment on security                           | 216                   | 215             |
| Capital loss carry forward                       | 97                    | 162             |
| Stock option expense                             | 1                     | 0               |
| Alternative minimum tax credit                   | 221                   | 0               |
| Unrealized loss on available for sale securities | 203                   | 495             |
|  | 1,633                 | 1,927           |
| Deferred tax liabilities:                        |                       |                 |
| Depreciation                                     | (213)                 | (230)           |
| Section 481 Adjustment-Prepaid Expenses          | (91)                  | (84)            |
| Section 481 Adjustment-Deferred Loan Costs       | (223)                 | (201)           |
|  | (527)                 | (515)           |
| <b>Net Deferred Tax Asset</b>                    | <b>\$ 1,106</b>       | <b>\$ 1,412</b> |

*Peoples Financial Services Corp. and Subsidiaries***NOTE 9 - INCOME TAXES (CONTINUED)**

A reconciliation of the provision for income taxes and the amount that would have been provided at statutory rates for the years-ended December 31 is as follows:

|                                      | 2006                   |                          | 2005     |                          | 2004     |                          |
|--------------------------------------|------------------------|--------------------------|----------|--------------------------|----------|--------------------------|
|                                      | Amount                 | % of<br>Pretax<br>Income | Amount   | % of<br>Pretax<br>Income | Amount   | % of<br>Pretax<br>Income |
|                                      | (Dollars in Thousands) |                          |          |                          |          |                          |
| Federal income tax at statutory rate | \$ 1,666               | 34%                      | \$ 1,857 | 34%                      | \$ 1,859 | 34%                      |
| Tax exempt interest                  | (866)                  | (18)                     | (778)    | (14)                     | (802)    | (14)                     |
| Non-deductible interest              | 119                    | 2                        | 85       | 2                        | 74       | 2                        |
| Officers' life insurance income      | (112)                  | (2)                      | (98)     | (2)                      | (83)     | (2)                      |
| Other, net                           | (35)                   | (0)                      | (81)     | (2)                      | (34)     | (1)                      |
|                                      | \$ 772                 | 16%                      | \$ 985   | 18%                      | \$ 1,014 | 19%                      |

The income tax provision includes \$14,000, \$75,000, and (\$288,000) in 2006, 2005 and 2004, respectively, of income tax (benefit) expense on net realized securities gains and losses.

**NOTE 10 - EMPLOYEE BENEFIT PLANS**

The Company has an employee stock ownership and profit-sharing plan with 401(k) provisions. The Plan is for the benefit of all employees who meet the eligibility requirements set forth in the Plan. The amount of employer contributions to the plan, including 401(k) matching contributions, is at the discretion of the Board of Directors. Employer ESOP contributions are allocated to participant accounts based on their percentage of total compensation for the Plan year. Shares of Company stock owned by the Plan are included in the earnings per share calculation and dividends on these shares are deducted from undivided profits. During 2006, 2005 and 2004, ESOP contributions to the Plan charged to operations were \$131,000, \$113,000, and \$126,000, respectively. During 2006, 2005 and 2004, employer 401(k) matching contributions to the Plan charged to operations were \$79,000, \$72,000, and \$69,000, respectively. At December 31, 2006, 138,670 shares of the Company's common stock were held in the Plan. In the event a terminated Plan participant desires to sell his or her shares of the Company's stock, or for certain employees who elect to diversify their account balances, the Company may be required to purchase the shares from the participant at their fair market value.

The Bank has deferred compensation agreements with its chief executive officer, chief operating officer and certain directors that provide fixed retirement benefits. The Bank's deferred compensation liability as of December 31, 2006 and 2005 was \$1,125,000 and \$949,000, respectively. The cost charged to operations for these deferred compensation plans was \$177,000, \$146,000, and \$164,000 for the years-ended December 31, 2006, 2005 and 2004, respectively.



**NOTE 11 - CONTINGENCIES**

The Company is a defendant in various lawsuits wherein various amounts are claimed. In the opinion of the Company's management, these suits are without merit and should not result in judgments, which, in the aggregate, would have a material adverse effect on the Company's consolidated financial statements.

*Peoples Financial Services Corp. and Subsidiaries***NOTE 12 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK**

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The contract or notional amounts at December 31, 2006 and 2005 were as follows:

|  | <b>2006</b>           |    | <b>2005</b> |
|--|-----------------------|----|-------------|
|  | <b>(In Thousands)</b> |    |             |
| Commitments to grant loans                 | \$ 4,728              | \$ | 6,137       |
| Unfunded commitments under lines of credit | 27,553                |    | 29,297      |
| Standby letters of credit                  | 2,632                 |    | 2,171       |
|  | \$ 34,913             | \$ | 37,605      |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include personal or commercial real estate, accounts receivable, inventory and equipment.

Outstanding letters of credit written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party.

The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Company requires collateral supporting these letters of credit as deemed necessary. The maximum undiscounted exposure related to these commitments at December 31, 2006 and 2005 was \$2,632,000 and \$2,171,000, respectively and the approximate value of underlying collateral upon liquidation that would be expected to cover this maximum potential exposure was \$740,000 and \$1,320,000, respectively. The current amount of the liability as of December 31, 2006 and 2005 for guarantees under standby letters of credit issued is not material.



*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 13 - REGULATORY MATTERS**

The Bank is required to maintain average cash reserve balances in vault cash and with the Federal Reserve Bank based on a percentage of deposits. The required reserve balance at December 31, 2006 and 2005 was \$782,000 and \$595,000, respectively.

Dividends are paid by the Company from its assets, which are mainly provided by dividends from the Bank. However, certain restrictions exist regarding the ability of the Bank to transfer funds to the Company in the form of cash dividends, loans or advances. Under such restrictions, the Bank may not, without the prior approval of the Comptroller of the Currency, declare dividends in excess of the sum of the current year's earnings (as defined) plus the retained earnings (as defined) from the prior two years.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital to average assets (as defined). Management believes, as of December 31, 2006, that the Company and Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2006, the most recent notification from the Office of the Comptroller of the Currency categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized", the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Bank's category.

*Peoples Financial Services Corp. and Subsidiaries***NOTE 13 - REGULATORY MATTERS (CONTINUED)**

The Company and Bank's actual capital ratios as of December 31, 2006 and 2005, and the minimum ratios required for capital adequacy purposes and to be well capitalized under the prompt corrective action provisions are as follows:

|   | Actual    |        | For Capital Adequacy Purposes |                    | To be Well Capitalized under Prompt Corrective Action Provisions |                     |
|---|-----------|--------|-------------------------------|--------------------|--|---------------------|
|   | Amount    | Ratio  | Amount                        | Ratio              | Amount   | Ratio               |
| <b>As of December 31, 2006:</b>           |           |        |                               |                    |  |                     |
| Total capital (to risk-weighted assets):  |           |        |                               |                    |  |                     |
| Consolidated                              | \$ 42,171 | 14.64% | \$ <sup>3</sup> 23,049        | <sup>3</sup> 8.00% | N/A  | N/A                 |
| Peoples National Bank                     | 38,431    | 13.50  | <sup>3</sup> 22,767           | <sup>3</sup> 8.00  | \$ <sup>3</sup> 28,459   | <sup>3</sup> 10.00% |
| Tier 1 capital (to risk-weighted assets): |           |        |                               |                    |  |                     |
| Consolidated                              | 40,304    | 13.99  | <sup>3</sup> 11,524           | <sup>3</sup> 4.00  | N/A  | N/A                 |
| Peoples National Bank                     | 36,564    | 12.85  | <sup>3</sup> 11,384           | <sup>3</sup> 4.00  | <sup>3</sup> 17,076  | <sup>3</sup> 6.00   |
| Tier 1 capital (to average assets):       |           |        |                               |                    |  |                     |
| Consolidated                              | 40,304    | 9.77   | <sup>3</sup> 16,497           | <sup>3</sup> 4.00  | N/A  | N/A                 |
| Peoples National Bank                     | 36,564    | 8.92   | <sup>3</sup> 16,400           | <sup>3</sup> 4.00  | <sup>3</sup> 20,500  | <sup>3</sup> 5.00   |
| <b>As of December 31, 2005:</b>           |           |        |                               |                    |  |                     |
| Total capital (to risk-weighted assets):  |           |        |                               |                    |  |                     |
| Consolidated                              | \$ 41,163 | 14.78% | \$ <sup>3</sup> 22,281        | <sup>3</sup> 8.00% | N/A  | N/A                 |
| Peoples National Bank                     | 38,507    | 13.92  | <sup>3</sup> 22,123           | <sup>3</sup> 8.00  | \$ <sup>3</sup> 27,654   | <sup>3</sup> 10.00% |
| Tier 1 capital (to risk-weighted assets): |           |        |                               |                    |  |                     |
| Consolidated                              | 38,788    | 13.93  | <sup>3</sup> 11,140           | <sup>3</sup> 4.00  | N/A  | N/A                 |
| Peoples National Bank                     | 36,132    | 13.07  | <sup>3</sup> 11,062           | <sup>3</sup> 4.00  | <sup>3</sup> 16,592  | <sup>3</sup> 6.00   |
| Tier 1 capital (to average assets):       |           |        |                               |                    |  |                     |
| Consolidated                              | 38,788    | 10.10  | <sup>3</sup> 15,361           | <sup>3</sup> 4.00  | N/A  | N/A                 |
| Peoples National Bank                     | 36,132    | 9.41   | <sup>3</sup> 15,361           | <sup>3</sup> 4.00  | <sup>3</sup> 19,202  | <sup>3</sup> 5.00   |

*Peoples Financial Services Corp. and Subsidiaries*

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**NOTE 14 - FAIR VALUE OF FINANCIAL INSTRUMENTS**

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective year ends, and have not been reevaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each year end.

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at December 31, 2006 and 2005:

**Cash and Cash Equivalents**

The carrying amounts of cash and cash equivalents approximate their fair value.

**Securities**

Fair values for securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

**Loans Receivable**

For variable-rate loans that reprice frequently and which entail no significant changes in credit risk, fair values are based on carrying amounts. The fair values of fixed rate loans are estimated using discounted cash flow analyses, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

**Accrued Interest Receivable**

The carrying amount of accrued interest receivable approximates its fair value.

**Deposits**

The fair values for demand deposits, savings accounts and certain money market accounts are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated contractual maturities on such time deposits.

**Accrued Interest Payable**

The carrying amount of accrued interest payable approximates fair value.

*Peoples Financial Services Corp. and Subsidiaries***NOTE 14 - FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)****Short-Term Borrowings**

The carrying amounts of short-term borrowings approximate their fair values.

**Long-Term Borrowings**

The fair values of the Company's long-term debt are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

**Commitments to Extend Credit and Standby Letters of Credit**

These financial instruments are generally not subject to sale, and estimated fair values are not readily available. The carrying value, represented by the net deferred fee arising from the unrecognized commitment or letter of credit and the fair value, determined by discounting the remaining contractual fee over the term of the commitment using fees currently charged to enter into similar agreements with similar risk, are not considered material for disclosure. The contractual amounts of unfunded commitments and letters of credit are presented in Note 12.

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

|                                    | <b>December 31, 2006</b>   |                       | <b>December 31, 2005</b>   |                       |
|------------------------------------|----------------------------|-----------------------|----------------------------|-----------------------|
|                                    | <b>Carrying<br/>Amount</b> | <b>Fair<br/>Value</b> | <b>Carrying<br/>Amount</b> | <b>Fair<br/>Value</b> |
|                                    | <b>(In Thousands)</b>      |                       |                            |                       |
| Financial assets:                  |                            |                       |                            |                       |
| Cash and cash equivalents          | \$ 12,380                  | \$ 12,380             | \$ 6,696                   | \$ 6,696              |
| Securities available-for-sale      | 110,302                    | 110,302               | 108,313                    | 108,313               |
| Loans receivable, net of allowance | 269,383                    | 266,845               | 256,870                    | 241,193               |
| Accrued interest receivable        | 1,855                      | 1,855                 | 1,827                      | 1,827                 |
| Financial liabilities:             |                            |                       |                            |                       |
| Deposits                           | 323,613                    | 323,354               | 296,962                    | 296,425               |
| Short-term borrowings              | 12,574                     | 12,574                | 17,842                     | 17,842                |
| Long-term borrowings               | 36,525                     | 33,221                | 34,770                     | 34,437                |
| Accrued interest payable           | 703                        | 703                   | 622                        | 622                   |



*Peoples Financial Services Corp. and Subsidiaries***NOTE 15 - PARENT COMPANY ONLY FINANCIAL INFORMATION****Balance Sheets**

|   | <b>December 31,</b>   |                  |
|---|-----------------------|------------------|
|   | <b>2006</b>           | <b>2005</b>      |
|   | <b>(In Thousands)</b> |                  |
| <b>ASSETS</b>                                     |                       |                  |
| Cash  | \$ 824                | \$ 214           |
| Investment in bank subsidiary                     | 37,387                | 36,912           |
| Due from subsidiary                               | 387                   | 423              |
| Securities available for sale                     | 2,696                 | 2,092            |
| <b>Total Assets</b>                               | <b>\$ 41,294</b>      | <b>\$ 39,641</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>       |                       |                  |
| Other liabilities                                 | \$ 54                 | \$ 25            |
| Stockholders' equity:                             |                       |                  |
| Common stock                                      | 6,683                 | 6,683            |
| Surplus   | 3,046                 | 2,995            |
| Retained earnings                                 | 36,336                | 34,599           |
| Accumulated other comprehensive loss              | (395)                 | (961)            |
|   | 45,670                | 43,316           |
| Treasury stock                                    | (4,430)               | (3,700)          |
| <b>Total Stockholders' Equity</b>                 | <b>41,240</b>         | <b>39,616</b>    |
| <b>Total Liabilities and Stockholders' Equity</b> | <b>\$ 41,294</b>      | <b>\$ 39,641</b> |

*Peoples Financial Services Corp. and Subsidiaries***NOTE 15 - PARENT COMPANY ONLY FINANCIAL INFORMATION (CONTINUED)****Statements of Income**

|  | <b>Years Ended December 31,</b> |                       |           |              |
|--|---------------------------------|-----------------------|-----------|--------------|
|  | <b>2006</b>                     | <b>2005</b>           |           | <b>2004</b>  |
|  |                                 | <b>(In Thousands)</b> |           |              |
| Dividends from bank subsidiary   | \$ 3,968                        | \$ 7,796              | \$        | 2,611        |
| Other income   | 263                             | 13                    |           | -            |
| Other expenses   | 63                              | 69                    |           | 48           |
|  | 4,168                           | 7,740                 |           | 2,563        |
| Income tax (benefit) expense   | 3                               | (19)                  |           | (16)         |
|  | 4,165                           | 7,759                 |           | 2,579        |
| Equity in undistributed (excess of distributed) net income of subsidiary | (36)                            | (3,283)               |           | 1,874        |
| <b>Net Income</b>  | <b>\$ 4,129</b>                 | <b>\$ 4,476</b>       | <b>\$</b> | <b>4,453</b> |

*Peoples Financial Services Corp. and Subsidiaries***NOTE 15 - PARENT COMPANY ONLY FINANCIAL INFORMATION (CONTINUED)****Statements of Cash Flows**

|   | <b>Years Ended December 31,</b> |                |                |
|---|---------------------------------|----------------|----------------|
|   | <b>2006</b>                     | <b>2005</b>    | <b>2004</b>    |
|   | <b>(In Thousands)</b>           |                |                |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                       |                                 |                |                |
| Net income  | \$ 4,129                        | \$ 4,476       | \$ 4,453       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |                |                |
| Net realized gains on sales of securities   | (192)                           | -              | -              |
| Stock option expense  | 3                               | -              | -              |
| Distributions in excess of (undistributed) net income of subsidiary               | (1,029)                         | 3,283          | (1,874)        |
| Increase (decrease) in due from/to subsidiary                                     | 36                              | 17             | (62)           |
| <b>Net Cash Provided by Operating Activities</b>                                  | <b>2,947</b>                    | <b>7,776</b>   | <b>2,517</b>   |
| <b>Cash Flows Provided by Investing Activities</b>                                |                                 |                |                |
| Proceeds from sale of available for sale securities                               | 889                             | -              | -              |
| Purchase of available-for-sale securities   | (152)                           | (2,019)        | -              |
| <b>Net Cash Provided by (Used In) Investing Activities</b>                        | <b>737</b>                      | <b>(2,019)</b> | <b>-</b>       |
| <b>Cash Flows from Financing Activities</b>                                       |                                 |                |                |
| Cash dividends paid   | (2,392)                         | (5,542)        | (2,311)        |
| Proceeds from sale of treasury stock  | 101                             | 263            | 326            |
| Purchase of treasury stock  | (783)                           | (356)          | (813)          |
| <b>Net Cash Used in Financing Activities</b>                                      | <b>(3,074)</b>                  | <b>(5,635)</b> | <b>(2,798)</b> |
| <b>Increase (Decrease) in Cash and Cash Equivalents</b>                           | <b>610</b>                      | <b>122</b>     | <b>(281)</b>   |
| <b>Cash and Cash Equivalents - Beginning</b>                                      | <b>214</b>                      | <b>92</b>      | <b>373</b>     |
| <b>Cash and Cash Equivalents - Ending</b>   | <b>\$ 824</b>                   | <b>\$ 214</b>  | <b>\$ 92</b>   |

**SUPPLEMENTARY DISCLOSURES OF NON**

**CASH INVESTING AND FINANCING  
ACTIVITIES**

|  |    |       |   |   |
|--|----|-------|---|---|
| Securities acquired through transfer from subsidiary | \$ | 1,065 | - | - |
|--|----|-------|---|---|

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

NONE.

## ITEM 9A CONTROLS AND PROCEDURES

(a) Management's annual report on internal control over financial reporting.

The management of Peoples Financial Services Corp. and Subsidiaries (the "Company") is responsible for designing, implementing, documenting, and maintaining an adequate system of internal control over financial reporting. An adequate system of internal control over financial reporting encompasses the processes and procedures that have been established by management to:

- maintain records that accurately reflect the Company's transactions;
- prepare financial statement and footnote disclosures in accordance with accounting principles generally accepted in the United States, that can be relied upon by external users;
- prevent and detect unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Management is also responsible to perform an annual evaluation of the system of internal control over financial reporting, including an assessment of the effectiveness of that system. Management's assessment is based on the criteria in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO framework identifies five defining characteristics of a system of internal control as follows: an appropriate control environment; an adequate risk assessment process; sufficient control activities; satisfactory communication of pertinent information; and proper monitoring controls.

Management performed an assessment of the effectiveness of its internal control over financial reporting in accordance with the COSO framework. As part of this process, consideration was given to the potential existence of deficiencies in either the design or operating effectiveness of controls. Based on this assessment, management believes that the Company maintained effective internal controls over financial reporting, including disclosure controls and procedures, as of December 31, 2006. Furthermore, during the conduct of its assessment, management identified no material weakness in its financial reporting control system.

The Board of Directors of the Company., through its Audit Committee, provides oversight to management's conduct of the financial reporting process. The Audit Committee, which is composed entirely of independent directors, is also responsible to recommend the appointment of independent public

accountants. The Audit Committee also meets with management, the internal audit staff, and the independent public accountants throughout the year to provide assurance as to the adequacy of the financial reporting process and to monitor the overall scope of the work performed by the internal audit staff and the independent public accountants.

The consolidated financial statements of the Company have been audited by Beard Miller Company LLP, an independent registered public accounting firm, who was engaged to express an opinion as to the fairness of presentation of such financial statements. In connection therewith, Beard Miller Company LLP is required to issue an attestation report on management's assessment of internal control over financial reporting and, in addition, is required to form its own opinion as to the effectiveness of those controls. Their opinion on the fairness of the financial statement presentation, and their attestation and opinion on internal controls over financial reporting are included herein.

(b) Attestation report of the registered public accounting firm.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING  
FIRM

To the Board of Directors and Stockholders  
Peoples Financial Services Corp.  
Hallstead, Pennsylvania

We have audited management's assessment, included in the accompanying Management's Report on Internal Control, that Peoples Financial Services Corp. and Subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

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

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

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



In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Peoples Financial Services Corp. and Subsidiaries as of December 31, 2006 and 2005 and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006, and our report dated March 13, 2007, expressed an unqualified opinion.

/s/ BEARD MILLER COMPANY LLP

Beard Miller Company LLP  
Allentown, Pennsylvania  
March 13, 2007

(c) Changes in internal controls.

There were no changes in the Company's internal controls over financial reporting that occurred during the fourth fiscal quarter ending December 31, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

**ITEM 9B OTHER INFORMATION**

NONE.

**PART III**

**ITEM 10 DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

This item is incorporated by reference under Section "Governance of the Company" under the previously submitted document DEF 14A Proxy Statement filed with the SEC.

**ITEM 11 EXECUTIVE COMPENSATION**

This item is incorporated by reference under Section "Compensation Discussion and Analysis" under the previously submitted document DEF 14A Proxy Statement filed with the SEC.

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

This item is incorporated by reference under Section “Share Ownership of Management and Directors” under the previously submitted document DEF 14A Proxy Statement filed with the SEC.

**ITEM 13 CERTAIN RELATIONSHIPS AND RELATED TRANSACTION, AND DIRECTOR INDEPENDENCE**

This item is incorporated by reference under Section “Compensation Discussion and Analysis” under the previously submitted document DEF 14A Proxy Statement filed with the SEC.

**ITEM 14 PRINCIPAL ACCOUNTANT FEES AND SERVICES**

This item is incorporated by reference under Section “Report of the Audit Committee” under the previously submitted document DEF 14A Proxy Statement filed with the SEC.

## PART IV

### ITEM 15 EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Financial Statement Schedules can be found under Item 8 of this report.

(b) Exhibits required by Item 601 of Regulation S-K:

- (3.1) Articles of Incorporation of Peoples Financial Services Corp. \*;
- (3.2) Bylaws of Peoples Financial Services Corp. as amended \*\*;
- (10.1) Agreement dated January 14, 1997, between John W. Ord and Peoples Financial Services Corp.\*;
- (10.4) Termination Agreement dated January 1, 1997, between Debra E. Dissinger and Peoples Financial Services Corp.\*;
- (10.5) Supplemental Executive Retirement Plan Agreement, dated December 3, 2004, for John W. Ord,\*\*\*;
- (10.6) Supplemental Executive Retirement Plan Agreement, dated December 3, 2004, for Debra E. Dissinger,\*\*\*;
- (10.7) Supplemental Director Retirement Plan Agreement, dated December 3, 2004, for all Non-Employee Directors of the Company,\*\*\*;
- (10.8) Amendment to Supplemental Executive Retirement Plan Agreement, dated December 30, 2005, for John W. Ord,\*\*\*\*;
- (10.9) Amendment to Supplemental Executive Retirement Plan Agreement, dated December 30, 2005, for Debra E. Dissinger,\*\*\*\*;
- (10.10) Amendment to Supplemental Director Retirement Plan Agreement, dated December 30, 2005, for all Non-Employee Directors of the Company,\*\*\*\*;
- (11) The statement regarding computation of per-share earnings required by this exhibit is contained in Note 1 to the consolidated financial statements captioned "Earnings Per Common Share";
- (14) Code of Ethics,\*\*\*\*\*;
- (21) Subsidiaries of Peoples Financial Services Corp.,\*\*\*\*\*;
- (23) Consent of Independent Registered Public Accounting Firm - Beard Miller Company LLP, Filed herewith;
- (31.1) Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), filed herewith;
- (31.2) Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), filed herewith;
- (32.1) Certification of Chief Executive Officer pursuant to Section 1350 of Sarbanes-Oxley Act of 2002, filed herewith; and
- (32.2) Certification of Principal Financial Officer pursuant to Section 1350 of Sarbanes-Oxley Act of 2002, filed herewith.

\* Incorporated by reference to the Corporation's Registration Statement on Form 10 as filed with the U.S. Securities and Exchange Commission on March 4, 1998.

\*\* Incorporated by reference to the Corporation's Exhibit 3.2 on Form 10Q filed with the U.S. Securities and Exchange Commission on November 8, 2004.

\*\*\* Incorporated by reference to the Corporation's Exhibits 10.5, 10.6 and 10.7 on Form 10K filed with the U.S. Securities and Exchange Commission on March 15, 2005.

\*\*\*\* Incorporated by reference to the Corporation's Exhibits 10.8, 10.9, and 10.10 on Form 10K filed with the U.S. Securities and Exchange Commission on March 15, 2006.

\*\*\*\*\* Incorporated by reference to the Corporation's Exhibit 14 on Form 10K filed with the U.S. Securities and Exchange Commission on March 15, 2006.

\*\*\*\*\* Incorporated by reference to the Corporation's Exhibit 21 on Form 10K filed with the U.S. Securities and Exchange Commission on March 15, 2006.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PEOPLES FINANCIAL SERVICES CORP.

BY: /s/John W. Ord  
John W. Ord, Chairman

/s/Richard S. Lochen, Jr.  
Richard S. Lochen, Jr., President/CEO

/s/Debra E. Dissinger  
Debra E. Dissinger, Executive Vice President

/s/Frederick J. Malloy  
Frederick J. Malloy, Principle Accounting Officer

/s/George H. Stover, Jr.  
George H. Stover, Jr., Member, Board of Directors

/s/Thomas F. Chamberlain  
Thomas F. Chamberlain, Member, Board of Directors

/s/Russell D. Shurtleff, Esq.  
Russell D. Shurtleff, Lead Director, Board of Directors

/s/William E. Aubrey II  
William E Aubrey II, Member, Board of Directors