

**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, 2009,

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.)

82 FRANKLIN AVENUE, 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:

COMMON STOCK (\$2 Par Value)

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned 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**
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, a non-accelerated filer or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer ___ Accelerated filer **X** Non-accelerated filer ___ Smaller reporting company ___
(Do not check if smaller reporting company)

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

The aggregate market value of voting stock held by non-affiliates of the registrant is **\$51,233,335** as of June 30, 2009.

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 at June 30, 2009. 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 February 26, 2010	COMMON STOCK (\$2 Par Value) <i>(Title of Class)</i>	3,136,156 <i>(Outstanding Shares)</i>
--	---	---

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 2009 Proxy Statement for the Registrant are incorporated by reference into Part III of this report.

TABLE OF CONTENTS

		Page Number
Part I	Item 1	3
	Item 1A	14
	Item 1B	15
	Item 2	16
	Item 3	16
	Item 4	16
Part II	Item 5	16
	Item 6	18
	Item 7	18
	Item 7A	39
	Item 8	39
		39
		40
		41
		42
		43
		45
	Item 9	69
	Item 9A	69
	Item 9B	71
Part III	Item 10	71
	Item 11	71
	Item 12	71
	Item 13	71
	Item 14	71
Part IV	Item 15	72
		73

PART I

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”), Peoples Advisors, LLC (“Advisors”) and Peoples Financial Capital Corporation. The Bank has two wholly owned subsidiaries, Peoples Financial Leasing, LLC and Peoples Investment Holdings, LLC. 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. Peoples Financial Leasing, LLC, formed in 2007, is a subsidiary of the Bank and provides employee leasing services to the Bank. Peoples Investment Holdings, LLC, formed in 2007, is also a subsidiary of the Bank and its main activities are the maintenance and management of its intangible investments and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware. Finally, Peoples Financial Capital Corporation which was also formed in 2007 is a subsidiary of the Company and its main activities are the maintenance and management of its intangible investments and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware.

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 50 of this Report. The Segment Reporting information in Note 1 is incorporated by reference into this Item 1.

SUPERVISION AND REGULATION

The Company and its subsidiaries 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, 2009, PFSC's ratio of Tier 1 capital to risk-weighted assets stood at 12.30% and its ratio of total capital to risk-weighted assets stood at 13.18%. 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, 2009, the Company's leverage-capital ratio was 9.92%.

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 \$250,000 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. 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 2009 was \$0.0104 for each \$100 of BIF deposits.

The FDIC adopted a risk-based deposit insurance assessment system that requires all FDIC-insured institutions to pay quarterly premiums beginning in 2007. Annual premiums range from 12 and 14 basis points of deposits for well-capitalized banks with the highest examination ratings to 50 basis points for undercapitalized institutions. In 2007 and through the second quarter of 2008, the Bank was able to offset the premium with an assessment credit of \$218,000 for premiums paid prior to 1996. Since the extinguishment of that assessment credit, the Bank has seen an increase in the premium paid to the levels stated for well-capitalized banks and the FDIC assessment for PNB for 2009 was \$0.12659 for each \$100 of BIF deposits.

Entering 2009, the Company anticipated a significant increase in the cost of federal deposit insurance from the previous level of five to seven basis points to between 12 and 14 basis points for the first quarter of 2009 and to between 10 and 14 basis points thereafter. The FDIC has also established a program under which it fully guarantees all non-interest bearing transaction accounts in excess of \$250,000 ("TLGP") and senior unsecured debt of a bank or its holding company. The Bank elected to opt out of the debt guarantee program but opted into the deposit guarantee program. The additional premium paid in 2009 under the TLGP was \$.00108 for each \$100 of transaction account deposits in excess of \$250,000. The FDIC also collected a special assessment of 5 basis points based on total assets less Tier 1 capital as reported in the Call Report dated June 30, 2009. This special assessment was payable on September 30, 2009 and was in the amount of \$210,000.

Finally, in 2009 the FDIC adopted a rule whereby banks would prepay three years of FDIC premiums with the December 31, 2009 assessment. The FDIC assessment through December 31, 2010 is based on the annualized rate of \$0.14892 for each \$100 of BIF deposits and that is increased 3 basis points to \$0.17892 for each \$100 of BIF deposits for the entirety of 2011 and 2012 with a 5 percent growth rate projected for the deposit base.

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 2008 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.

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 rules to the Company 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 co-defies 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. The Bank’s market area was expanded further in 2008 with the addition of the Glenburn Township office. This gave PNB its first physical presence in Lackawanna County, serving the northern end of the county including the Clarks Summit area. In addition, parts of 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.

The majority of 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 28,000 residents. Neither county is experiencing growth. Broome County has approximately 196,000 residents and continues to experience a population decline. The economy of Broome County has lost many manufacturing jobs in the past twenty to twenty-five 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. Lackawanna County has approximately 210,000 residents. 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 value. A special MGIC program now offered through the Bank, allows for loans of up to 95% 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 2009 when compared to 2008 and 2007. 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.

Deposit Activities

PNB offers a full range of deposit and banking services including:

- commercial accounts such as checking products, cash management services remote deposit capture ("RDC"), automated clearing house ("ACH") originations
- retirement accounts such as Individual Retirement Accounts ("IRA")
- consumer interest bearing deposit services such as certificates of deposit, money market accounts, NOW accounts, and savings accounts
- a variety of ancillary checking account products such as automated teller machines ("ATM's"), point of sale ("POS"), as well as other miscellaneous services

These miscellaneous services would include:

- safe deposit boxes;
- night depository services;
- 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 sell investment products. 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.

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.

Although the Company has not done so, 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 these issues, including the provision and allowance for loan losses, which are located in Note 3 to the Consolidated Financial Statements; the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans; determination of other-than-temporary impairment losses on securities, which is located in Note 2 to the Consolidated Financial Statements; the valuation of deferred tax assets, which is located in Note 9 to the consolidated financial statements; and the potential impairment of restricted stock, which is located in Note 1 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. In estimating the valuation of real estate acquired in connection with foreclosure or in satisfaction of loans, management considers current economic conditions and appraised values of collateral, if collateral dependent.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. All of the Company's investment securities classified as available-for-sale are evaluated for OTTI under the rules for accounting for certain investments in debt and equity securities.

In determining OTTI under the rules for accounting for certain debt and equity securities, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than amortized cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on information available to management at a point in time. An OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

When an OTTI occurs under the model, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors shall be recognized in other comprehensive income, net of applicable tax benefit. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment. As of December 31, 2009 the Company does not intend to sell or more likely than not, be required to sell these securities. Management believes that the unrealized losses represent temporary impairment of the securities.

The deferred income taxes reflect temporary difference in the recognition of the revenue and expenses for tax reporting and financial statement purposes, principally because certain items are recognized in different periods for financial reporting tax return purposes. Although realization is not assured, the Company believes it is more likely than not that all deferred tax assets will be realized.

As a member of the Federal Home Loan Bank of Pittsburgh ("FHLB"), the Company is required to purchase and hold stock in the FHLB to satisfy membership and borrowing requirements. This stock is restricted in that it can only be sold to the FHLB or to another member institution, and all sales of FHLB stock must be at par. As a result of these restrictions, FHLB stock is unlike other investment securities insofar as there is no trading market for FHLB stock and the transfer price is determined by FHLB membership rules and not by market participants. As of December 31, 2009 and December 31, 2008, our FHLB stock totaled \$2.771 million and \$2.559 million, respectively.

In December 2008, the FHLB voluntarily suspended dividend payments on its stock, as well as the repurchase of excess stock from members. The FHLB cited a significant reduction in the level of core earnings resulting from lower short-term interest rates, the increased cost of liquidity, and constrained access to the debt markets at attractive rates and maturities as the main reasons for the decision to suspend dividends and the repurchase of excess capital stock. The FHLB last paid a dividend in the third quarter of 2008.

FHLB stock is held as a long-term investment and its value is determined based on the ultimate recoverability of the par value. The Company evaluates impairment quarterly. The decision of whether impairment exists is a matter of judgment that reflects our view of the FHLB's long-term performance, which includes factors such as the following:

- its operating performance;
- the severity and duration of declines in the fair value of its net assets related to its capital stock amount;
- its commitment to make payments required by law or regulation and the level of such payments in relation to its operating performance;
- the impact of legislative and regulatory changes on the FHLB, and accordingly, on the members of FHLB; and
- its liquidity and funding position.

After evaluating all of these considerations, the Company concluded that the par value of its investment in FHLB stock will be recovered. Accordingly, no impairment charge was recorded on these securities for the years ended December 31, 2009 and 2008, respectively. Our evaluation of the factors described above in future periods could result in the recognition of impairment charges on FHLB stock.

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. 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. 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, 2009, our lending limit per borrower was approximately \$6,834,000 or approximately 15% of our unimpaired 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.

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 has three full-service banking offices in Wyoming County that are located in:

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

PNB entered into Lackawanna in 2008 with a de novo branch in Glenburn. The Lackawanna County location is:

- Glenburn Township.

PNB has three full-service banking offices in Broome County, New York that are located in:

- Town of Conklin;
- Town of Chenango; and
- Village of Deposit.

The administrative/operations office of the Company and PNB is located at 82 Franklin Avenue, 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.

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 \$3,296 to \$38,496 annually. The leases provide that the Bank pay property taxes, insurance, and maintenance costs. Ten of the twelve offices provide drive-up banking services and nine offices have 24-hour ATM services.

ITEM 3 LEGAL PROCEEDINGS

The Company is subject to lawsuits and claims arising out of its business. In the opinion of the Company's management, after review and consultation with counsel, any proceedings that may arise 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.

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 Boenning & Scattergood, Inc. from West Conshohocken, Pennsylvania, and Stifel Nicolaus from Livingston, New Jersey, make a limited market in the Company's common stock. The Company, and previously the Bank, have continuously paid dividends for more than 100 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, 2009, there were 27,449 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, 2009, was \$14.34 and on December 31, 2008, it was \$12.69. As of December 31, 2009, the Company had approximately 1,087 shareholders of record. At such date, 3,136,156 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

	2009			2008		
	Price Range		Dividends Declared	Price Range		Dividends Declared
	Low	High		Low	High	
First Quarter	\$ 17.00	\$ 18.50	\$.19	\$ 22.00	\$ 26.30	\$.19
Second Quarter	\$ 16.75	\$ 17.40	\$.19	\$ 22.50	\$ 25.05	\$.19
Third Quarter	\$ 16.90	\$ 17.40	\$.19	\$ 22.35	\$ 25.50	\$.19
Fourth Quarter	\$ 16.80	\$ 18.25	\$.19	\$ 18.05	\$ 24.00	\$.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	27,449	\$ 22.43	65,751
Equity compensation plans not approved by stockholders	0	0	0
Total	27,449	\$ 22.43	65,751

* 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 2009.

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, 2009 – October 31, 2009	0	\$ 0	0	65,751
November 1, 2009 – November 30, 2009	0	0	0	65,751
December 1, 2009 – December 31, 2009	0	0	0	65,751
Total	0	\$ 0	0	65,751

(1) On July 2, 2001, the Board of Directors authorized the repurchase of 158,931 shares of the Corporation's common stock outstanding from shareholders.

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

Consolidated Financial Highlights
(Dollars In Thousands, except Per Share Data)

	At and For the Years Ended December 31,				
	2009	2008	2007	2006	2005
Net Income	\$ 5,049	\$ 3,039	\$ 4,871	\$ 4,129	\$ 4,476
Return on Average Assets	1.07%	0.68%	1.17%	1.03%	1.16%
Return on Average Equity	12.62%	7.53%	11.85%	10.55%	11.37%
Shareholders' Value					
Earnings per Share, Basic	\$ 1.61	\$ 0.97	\$ 1.55	\$ 1.31	\$ 1.42
Earnings per Share, Diluted	1.61	0.97	1.55	1.31	1.41
Regular Cash Dividends	0.76	0.76	0.76	0.76	0.76
Special Cash Dividends	0.00	0.00	0.00	0.00	1.00
Book Value	14.34	12.69	13.64	13.16	12.55
Market Value at End of the Year	18.05	18.05	26.30	26.00	31.45
Market Value/Book Value Ratio	125.87%	142.24%	192.82%	197.57%	250.60%
Price Earnings Multiple	11.21X	18.61X	16.97X	19.85X	22.14X
Dividend Payout Ratio	47.16%	78.35%	48.92%	57.93%	53.50%
Dividend Yield	4.21%	4.21%	2.89%	2.94%	2.42%
Safety and Soundness					
Stockholders' Equity/Asset Ratio	8.71%	8.41%	9.85%	9.91%	10.13%
Allowance for Loan Loss as a Percent of Loans	0.99%	0.95%	0.84%	0.66%	0.92%
			%		
Net Charge Offs/Total Loans	0.42%	0.05%	(0.13)	0.33%	0.29%
Allowance for Loan Loss/Nonaccrual Loans	132.00%	498.67%	620.51%	402.70%	206.62%
Allowance for Loan Loss/Non-performing Loans	100.33%	58.68%	620.51%	248.89%	183.74%
Balance Sheet Highlights					
Total Assets	\$ 516,483	\$ 472,376	\$ 434,434	\$ 416,268	\$ 391,198
Total Investments	130,506	107,589	109,471	107,788	105,778
Net Loans	332,966	313,606	288,601	269,383	256,870
Allowance for Loan Losses	3,337	3,002	2,451	1,792	2,375
Short-term Borrowings	20,439	18,432	22,848	12,574	17,842
Long-term Borrowings	38,750	39,691	38,534	36,525	34,770
Total Deposits	410,038	371,268	327,430	323,613	296,962
Stockholders' Equity	44,970	39,720	42,805	41,240	39,616

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 2009, 2008, and 2007. 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 eleven full-service branches in the Hallstead Shopping Plaza, Hop Bottom, Montrose, Susquehanna, Nicholson, Tunkhannock, Meshoppen, and Glenburn, 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, Wyoming Counties and northern Lackawanna County in Pennsylvania and the Southern Tier of Broome County, New York and the bordering areas of those counties. As of December 31, 2009, the Bank employed 117 full-time employees and 22 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 Company to make estimates and assumptions. The Company believes that its determination of the allowance for loan losses involves a higher degree of judgment and complexity than the Company’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 Company’s borrowers, subjecting the Company 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 Company 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 Company’s allowance for loan losses and related matters, see “Provision for Loan Losses”.

In determining the necessity of recording an other-than-temporary impairment on securities owned by the Company, four main characteristics are considered; the length of time and the extent to which the fair value has been less than amortized cost, the financial condition and near-term prospects of the issuer, whether the market decline was affected by macroeconomic conditions, and whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The Company believes that the unrealized losses, at December 31, 2009 and 2008 represent temporary impairment of the securities.

The deferred income taxes reflect temporary differences in the recognition of the revenue and expenses for tax reporting and financial statement purposes, principally because certain items are recognized in different periods for financial reporting and tax return purposes. Although realization is not assured, the Company believes it is more likely than not that all deferred tax assets will be realized.

Restricted stock which represents required investment in the common stock of correspondent banks is carried at cost and as of December 31, 2009 and 2008, consists of the common stock of Federal Home Loan Bank of Pittsburgh. In December 2008, the FHLB of Pittsburgh notified member banks that it was suspending dividend payments and the repurchase of capital stock.

Management evaluates the restricted stock for impairment in accordance with ASC Topic 942, Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others. Management’s determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary decline in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. Management believes no impairment charge is necessary related to the restricted stock as of December 31, 2009.

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 ended December 2009, 2008, and 2007.

TABLE 1

Net Interest Income
(In Thousands)

	Year-Ended December 31,		
	2009	2008	2007
Total Interest Income	<u>\$ 24,273</u>	<u>\$ 25,479</u>	<u>\$ 24,611</u>
Tax Exempt Loans	<u>496</u>	<u>518</u>	<u>486</u>
Non-Taxable Securities	<u>1,091</u>	<u>892</u>	<u>885</u>
Total Tax Equivalent Adjustment	<u>1,587</u>	<u>1,410</u>	<u>1,371</u>
Total Tax Equivalent Interest Income	<u>25,860</u>	<u>26,889</u>	<u>25,982</u>
Total Interest Expense	<u>7,258</u>	<u>9,154</u>	<u>11,105</u>
Net Interest Income (Fully Tax Equivalent Basis)	<u>\$ 18,602</u>	<u>\$ 17,735</u>	<u>\$ 14,877</u>

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.

TABLE 2

Distribution of Assets, Liabilities and Stockholders' Equity
Interest Rates and Interest Differential
(In Thousands)

	Year Ended December 31, 2009			Year Ended December 31, 2008			Year Ended December 31, 2007		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
ASSETS									
Loans									
Real Estate	\$ 119,062	\$ 7,186	6.04%	\$ 117,635	\$ 7,602	6.46%	\$ 115,490	\$ 7,615	6.59%
Installment	18,236	1,116	6.12%	16,815	1,303	7.75%	17,143	1,442	8.41%
Commercial	161,762	10,143	6.27%	140,903	9,917	7.04%	123,854	9,424	7.61%
Tax Exempt (1)	22,516	962	6.48%	22,913	1,005	6.65%	21,165	943	6.75%
Other Loans	506	39	7.71%	469	44	9.38%	467	57	12.21%
Total Loans (1)	<u>322,082</u>	<u>19,446</u>	<u>6.19%</u>	<u>298,735</u>	<u>19,871</u>	<u>6.83%</u>	<u>278,119</u>	<u>19,481</u>	<u>7.18%</u>
Investment Securities (2)									
Taxable	53,945	2,675	4.96%	67,897	3,771	5.55%	65,438	3,351	5.12%
Non-Taxable (1)	52,326	2,118	6.13%	42,859	1,731	6.12%	44,192	1,717	5.89%
Total Securities (1)	<u>106,271</u>	<u>4,793</u>	<u>5.54%</u>	<u>110,756</u>	<u>5,502</u>	<u>5.77%</u>	<u>109,630</u>	<u>5,068</u>	<u>5.43%</u>
Time Deposits With Other Banks	1,408	17	1.21%	1,186	26	2.19%	315	18	5.71%
Fed Funds Sold	9,617	17	0.18%	6,817	80	1.17%	723	44	6.09%
Total Earning Assets (1)	<u>439,378</u>	<u>24,273</u>	<u>5.89%</u>	<u>417,494</u>	<u>25,479</u>	<u>6.44%</u>	<u>388,787</u>	<u>24,611</u>	<u>6.68%</u>
Less: Allowance for Loan Losses	(2,969)			(2,599)			(2,025)		
Cash and Due from Banks	6,302			6,851			6,639		
Premises and Equipment, Net	6,507			6,227			5,712		
Other Assets	21,642			19,741			17,690		
Total Assets	<u>\$ 470,860</u>			<u>\$ 447,714</u>			<u>\$ 416,803</u>		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Deposits-Interest Bearing									
Demand	\$ 35,697	324	0.91%	\$ 28,871	284	0.98%	\$ 25,341	290	1.14%
Regular Savings	130,652	1,696	1.30%	94,019	1,219	1.30%	106,969	3,311	3.10%
Money Market Savings	32,771	343	1.05%	33,858	600	1.77%	35,355	1,089	3.08%
Time	106,353	2,965	2.79%	132,313	4,923	3.72%	102,643	4,329	4.22%
Total Interest Bearing Deposits	<u>305,473</u>	<u>5,328</u>	<u>1.74%</u>	<u>289,061</u>	<u>7,026</u>	<u>2.43%</u>	<u>270,308</u>	<u>9,019</u>	<u>3.34%</u>
Other Borrowings	59,141	1,930	3.26%	58,368	2,128	3.65%	50,183	2,086	4.16%
Total Interest Bearing Liabilities	<u>364,614</u>	<u>7,258</u>	<u>1.99%</u>	<u>347,429</u>	<u>9,154</u>	<u>2.63%</u>	<u>320,491</u>	<u>11,105</u>	<u>3.46%</u>
Net Interest Spread (1)		<u>\$ 17,015</u>	<u>3.90%</u>		<u>\$ 16,325</u>	<u>3.81%</u>		<u>\$ 13,506</u>	<u>3.22%</u>
Non-Interest Bearing									
Demand Deposits	63,325			56,778			52,613		
Accrued Expenses and Other Liabilities	2,916			3,173			2,604		
Stockholders' Equity	40,005			40,334			41,095		
Total Liabilities and Stockholders' Equity	<u>\$ 470,860</u>			<u>\$ 447,714</u>			<u>\$ 416,803</u>		
Interest Income/Earning Assets (1)			5.89%			6.44%			6.68%
Interest Expense/Earning Assets			1.65%			2.19%			2.86%
Net Interest Margin (1)			4.23%			4.25%			3.82%

(1) Yields on tax exempt assets have been calculated on a fully tax equivalent basis assuming a tax rate of 34%.

(2) Includes investment in restricted stock at cost.

TABLE 3

Rate/Volume Analysis of Changes in Net Interest Income
(In Thousands)

	2009 to 2008			2008 to 2007		
	Increase (Decrease)	Change Due to Rate	Volume	Increase (Decrease)	Change Due to Rate	Volume
Interest Income						
Real Estate Loans	\$ (416)	\$ (502)	\$ 86	\$ (13)	\$ (152)	\$ 139
Installment Loans	(187)	(274)	87	(139)	(114)	(25)
Commercial Loans	226	(1,082)	1,308	493	(707)	1,200
Tax Exempt Loans	(43)	(26)	(17)	62	(15)	77
Other Loans	(5)	(8)	3	(13)	(13)	0
Total Loans	(425)	(1,892)	1,467	390	(1,001)	1,391
Investment Securities						
Taxable	(1,096)	(404)	(692)	420	283	137
Non-Taxable	387	4	383	14	68	(54)
Total Securities	(709)	(400)	(309)	434	351	83
Time Deposits with Other Banks	(9)	(12)	3	8	(11)	19
Fed Funds Sold	(63)	(68)	5	36	(36)	72
Total Interest Income	(1,206)	(2,372)	1,166	868	(697)	1,565
Interest Expense						
Interest Bearing Demand Deposits	40	(22)	62	(6)	(41)	35
Regular Savings Deposits	477	1	476	(2,092)	(1,924)	(168)
Money Market Savings Deposits	(257)	(246)	(11)	(489)	(462)	(27)
Time Deposits	(1,958)	(1,234)	(724)	594	(510)	1,104
Total Interest Bearing Deposits	(1,698)	(1,501)	(197)	(1,993)	(2,937)	944
Other Borrowings	(198)	(223)	25	42	(256)	298
Total Interest Expense	(1,896)	(1,724)	(172)	(1,951)	(3,193)	1,242
Net Interest Spread	\$ 690	\$ (648)	\$ 1,338	\$ 2,819	\$ 2,496	\$ 323

Interest income on total loans decreased in 2009. This decrease of \$425,000 is shown in Table 3. The table shows that there was an increase of \$1,467,000 due to volume and the drop in interest rates contributed a decrease in income of \$1,892,000 in 2009. This compares to an increase of \$1,391,000 due to volume and a decrease of \$1,001,000 due to rates in 2008. Lower interest rates in 2009 had a severe impact on the Bank's interest income mitigated somewhat by loan growth. To view the loan portfolio growth numbers and interest yields see Table 2 which shows the average balance in loans increased from \$298,735,000 in 2008 to \$322,082,000 in 2009 while at the same time the yield on loans dropped from 6.83% in 2008 to 6.19% in 2009.

In 2009, interest income on securities decreased \$709,000 year over year from 2008. Table 3 shows that lower rates took \$400,000 from interest income, and the decrease in the average balance took another \$309,000 from income. The average investments as shown in Table 2 were \$106,271,000 in 2009 compared to \$110,756,000 in 2008. In comparison, in 2008 interest income on securities increased \$434,000 year over year with a \$351,000 gain due to higher rates and an increase of \$83,000 due to volume.

Interest income from federal funds sold decreased \$63,000 from 2008 to 2009 because of lower rates in 2009. The change in interest income from fed funds sold in the previous year, from 2008 to 2007, was largely due to increases in balances rather than rate. Average federal funds sold balance was \$9,617,000 in 2009 compared to \$6,817,000 in 2008. Average federal funds sold were \$723,000 in 2007. Interest income from time deposits with other banks also decreased \$9,000 in 2009 primarily due to lower rates.

On the interest expense side, overall interest expenses decreased by \$1,896,000. Of this total, \$1,724,000 was directly attributable to reductions in interest rates. In 2008, the Bank had significant deposit growth which factored into the increase in interest bearing liabilities at a cost of \$944,000 in additional interest expense for those deposits. However, this cost was offset by \$2,937,000 reduction in deposit costs from interest rate decreases. The average balance in interest bearing deposits was \$305,473,000 in 2009 as compared to \$289,061,000 in 2008. Other borrowed funds costs decreased in 2009. The total decrease was \$198,000 of which \$25,000 was extra expense because of volume and \$223,000 was saved on rate. In 2008, other borrowings expense increased \$42,000. Of this increase, \$298,000 was due to the growth in borrowed funds and \$256,000 was saved due to lower rates. The average balance of borrowed funds was \$59,141,000 in 2009 compared to \$58,368,000 in 2008.

The last line in Table 3 shows that the net interest spread increased \$690,000 in 2009 compared to an increase of \$2,819,000 in 2008. Table 3 shows the negative impact that rates had on net interest income in 2009 compared to the positive impact rates had on net interest income in 2008. Net growth in deposits and loans also remained positive in both years contributing \$1,338,000 in 2009 and \$323,000 in 2008 to income.

PROVISION FOR LOAN LOSSES

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 \$1,735,000, \$713,000 and \$280,000 for the years 2009, 2008, and 2007, respectively. Net charge-offs for 2009 were \$1,400,000 compared to \$162,000 in 2008. As of December 31, 2009, the allowance for loan loss was .99% of loans and at December 31, 2008, the ratio was .95% 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 and other qualitative factors, the opinion of management was that the allowance for loan losses was proper and sufficient. 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. Management believed that certain risks, primarily current economic conditions, warranted an increase in the allowance for loan losses for the year ended December 31, 2009. The ratio of allowance for loan loss to non-performing loans was 100.33% at year end 2009 compared to 58.68% at year end 2008 and 620.51% at year end 2007.

The following table analyzes the increase in total other income by comparing the years 2009, 2008 and 2007.

TABLE 4

Non-Interest Income (In Thousands)

	Year Ended December 31,			Variance 2009		Variance 2008	
	2009	2008	2007	Amount Of Change	Percent Of Change	Amount Of Change	Percent Of Change
Customer Service Fees	\$ 1,950	\$ 2,006	\$ 1,947	\$ (56)	(2.79%)	\$ 59	3.03%
Investment Division Commission Income	341	411	340	(70)	(17.03%)	71	20.88%
Earnings on Investment on Life Insurance	342	296	297	46	15.54%	(1)	(0.34%)
Premiums and fees on mortgage sales	438	148	69	290	195.95%	79	114.49%
Other Income	467	458	557	9	1.97%	(99)	(17.77%)
Gains on Sale of Interest in Insurance Agency	0	0	220	0	0.00%	(220)	(100.00%)
Gains (Losses) on Security Sales Other than Temporary Impairment	(492)	128	(122)	(620)	(484.38%)	250	(204.92%)
	(206)	(5,256)	0	5,050	96.08%	(5,256)	(100.00%)
Total Other Income	\$ 2,840	\$ (1,809)	\$ 3,308	\$ 4,649	256.99%	\$ (5,117)	(154.69%)

OTHER INCOME

Non-Interest Income

There was an overall increase in non-interest income of \$4,649,000 in 2009. This represents an increase of 256.99% in 2009 when compared to a loss of \$1,809,000 in 2008. For comparison, there was an overall decrease in non-interest income of \$5,117,000 or 154.69% in 2008 when compared to \$3,308,000 in 2007.

The non-interest income items that result in these variations are as follows:

Non-interest income includes items that are not related to interest rates on loans and investments, 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 2009, service charges and fees decreased \$56,000 or 2.79% to \$1,950,000 compared to \$2,006,000 for 2008 which was an increase of \$59,000 or 3.03% from the 2007 amount of \$1,947,000.

Commissions earned by the Investment Division were \$341,000 in 2009 compared to \$411,000 in 2008, a decrease of \$70,000 or 17.03%. Investment activity slowed in 2009 as more customers sought the safety of FDIC insurance offered by bank deposits.

By comparison, commissions earned by the Investment Division were \$411,000 in 2008, compared to \$340,000 in 2007, an increase of \$71,000, or 20.88%. As the Investment Division grew and became more established, so did the commissions earned on the assets managed. Additionally, a fee structure implemented in 2006 whereby fees on the front end were sacrificed in lieu of ongoing account management fees was responsible for this increase as the Company began to see positive results from the strategy.

Earnings on investment in life insurance were \$342,000 in 2009, compared to \$296,000 in 2008, an increase of \$46,000 or 15.54%. While there were no additional investments in BOLI, there was a transfer of nearly \$2,000,000 in BOLI investment to a new carrier in which the crediting rates applied to the insurance increased significantly.

Earnings on investment in life insurance amounted to \$296,000 in 2008, compared to \$297,000 in 2007, a decrease of \$1,000, or 0.34%. There were no additional investments to BOLI in 2008 and crediting rates remained steady for that period.

Premiums and fees on mortgage sales was \$438,000 in 2009, compared to \$148,000 in 2008, an increase of \$290,000 or 195.95% when compared to 2008. This was due to a large volume of mortgage loan sales in 2009 at premium levels when compared to 2008. Income recognized through mortgage sales has increased steadily as more customers are attracted by the rates offered by Fannie Mae.

For comparison, Premiums and fees on mortgage sales was \$148,000 in 2008, compared to \$69,000 in 2007, an increase of \$79,000, or 114.49%. This was also due to a larger volume of mortgage loan sales in 2008 at premium levels when compared to 2007.

Other income was \$467,000 in 2009, compared to \$458,000 in 2008, an increase of \$9,000 or 1.97% when compared to 2008. This increase is not considered to be significant.

By comparison, other income was \$458,000 in 2008, compared to \$557,000 in 2007, a decrease of \$99,000, or 17.77%. This was primarily due to income recognized through the operation of the insurance agency which was \$70,000 in 2007. Insurance operations were discontinued in 2007. This decrease accounted for the most significant portion of the overall decrease in other income in 2008.

Gain on sale of interest in insurance agency was \$0 for 2009 and 2008 compared to \$220,000 for 2007. The Company realized a gain through the sale of its 20% interest in Community Bankers Insurance Agency (CBIA) in May of 2007. There was no comparable gain in 2009 or 2008. The Company does not expect the sale of the insurance agency to have a significant impact on future earnings.

In 2009, The Company had losses of \$492,000 realized through sales of available-for-sale securities compared to a gain of \$128,000 in 2008. This is a decrease of \$620,000 or 484.38%. Comparing 2008 to 2007, the Company had \$128,000 in realized gains through sales of available-for-sale securities compared to \$122,000 realized losses in 2007. This was an increase of \$250,000 or 204.92%. The increase experienced in 2008 was due to more favorable market conditions for much of 2008.

As previously mentioned in the discussion of 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) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not, will be required to sell the debt security before its anticipated recovery. As such, a determination was made in 2009 to record other than temporary impairment charges in relation to three equity positions held by the Company in the amount of \$206,000. This compares to 2008 when other than temporary impairment charges were recorded in relation to five equity positions held by the Company in the amount of \$387,000, 2 preferred equity positions held in the FHLMC ("Freddie Mac's) in the amount of \$2,289,000 and 2 corporate bonds in the amount of \$2,580,000. The amount of impairment charged against income for the year ended December 31, 2008 was \$5,256,000. This represents an increase to income when comparing 2009 to 2008 of \$5,050,000 or 96.08%. The charges are not comparable to the same period in 2007. These, as well as all securities will be monitored in future quarters for any further deterioration.

As a result of the Emergency Economic Stabilization Act of 2008 (EESA) the resulting deferred tax asset created by the other-than-temporary impairment of the Company's preferred equity holdings in the FHLMC did not require a valuation allowance to be recognized. The loss was determined to be ordinary for tax purposes under the EESA and any future gains realized from selling those FHLMC holdings would also be treated as ordinary for income tax purposes. See Note 9 for further discussion of the realization of deferred tax assets, included that portion related to capital losses on equity securities.

TABLE 5

Non-Interest Expense
(In Thousands)

	Year Ended December 31,			Variance 2009		Variance 2008	
	2009	2008	2007	Amount Of Change	Percent Of Change	Amount Of Change	Percent Of Change
Salaries and Benefits	\$ 5,532	\$ 4,831	\$ 4,767	\$ 701	14.51%	\$ 64	1.34%
Occupancy Expenses	814	733	788	81	11.05%	(55)	(6.98%)
Furniture and Equipment Expense	546	493	508	53	10.75%	(15)	(2.95%)
FDIC Insurance and Assessments	900	227	151	673	296.48%	76	50.33%
Professional Fees and Outside Services	588	520	371	68	13.08%	149	40.16%
Computer Services and Supplies	1,053	970	785	83	8.56%	185	23.57%
Taxes, Other Than Payroll and Income	346	400	386	(54)	(13.50%)	14	3.63%
Impairment Charge-Other Real Estate	0	0	575	0	0.00%	(575)	(100.00%)
Amortization Expense-Deposit Premiums	258	258	255	0	0.00%	3	1.18%
Stationary and Printing Supplies	357	360	339	(3)	(0.83%)	21	6.19%
Advertising	297	201	154	96	47.76%	47	30.52%
Other Operating Expenses	1,457	1,684	1,487	(227)	(13.48%)	197	13.25%
Total Non-Interest Expense	<u>\$ 12,148</u>	<u>\$ 10,677</u>	<u>\$ 10,566</u>	<u>\$ 1,471</u>	<u>13.78%</u>	<u>\$ 111</u>	<u>1.05%</u>

OTHER EXPENSES**Non-Interest Expense**

Non-interest expense includes all other expenses associated with the Company. Total non-interest expense increased from \$10,677,000 in 2008 to \$12,148,000 in 2009. This is an increase of \$1,471,000 or 13.78%. Details of the components of non-interest expense are listed below:

Salaries and related benefits is the largest expense in this category and it increased \$701,000 or 14.51%, over the 2008 expense. The full-time equivalent number of employees was 125 as of December 31, 2009, compared to 120 as of December 31, 2008. Full year employment costs associated with the Glenburn Township office as compared to 2008 when salaries and benefits for this office were only incurred in the fourth quarter as well as annual pay increases and increased health insurance costs contributed to the overall increase in salary and benefit expenses in 2009. Furthermore, 2009 was a year of transition as a new President and Chief Executive Officer was appointed to the Company. Existing employment clauses within the exiting President and Chief Executive Officer's contract caused the accrual of one additional year's salary in 2009.

For comparison, salaries and related benefits increased \$64,000, or 1.34%, in 2008 over 2007. The full-time equivalent number of employees was 120 as of December 31, 2008, compared to 111 as of December 31, 2007. The jump in full-time equivalent employees was the result of the new office opened in Glenburn Township late in 2008. Aside from the increase to full-time equivalents, normal yearly pay increases and increased health insurance costs contributed to the overall increase in salary and benefit expense for 2008.

Occupancy expense increased 11.05% or \$81,000 in 2009 when compared to fiscal year 2008. The largest increase in occupancy type expenses was the increase to depreciation expense and maintenance related to the new office in Glenburn Township. Such expenses associated with the new office caused an increase to occupancy expense in 2009 of \$60,000 or 18.75% to \$380,000 compared to \$320,000 for the same period in 2008.

For comparison, in 2008 occupancy expense decreased 6.98%, or \$55,000, when compared to 2007. The Company hired a new facilities manager in 2007 and one of the areas of focus was various projects aimed at improving the overall condition of Company facilities. Those projects were not duplicated in 2008, thus a savings of approximately \$55,000.

Furniture and equipment expense also increased in 2009 to \$546,000 or 10.75% compared to 2008 at \$493,000. The increase in 2009 is in large part due to additional depreciation costs associated with equipment in service at the Glenburn Township office. Depreciation expense on furniture and equipment was \$159,000 in 2009, compared to \$122,000 in 2008, an increase of \$37,000 or 30.33%.

For comparison, furniture and equipment expense decreased in 2008 to \$493,000 or 2.95% compared to 2007 which came in at \$508,000. The decrease in 2008 was due to the age of teller equipment which was put in service in 2003. That equipment came at a substantial cost that was fully depreciated midway through 2008 and as a result, related depreciation expense on computer equipment decreased in 2008. Depreciation expense on furniture and equipment was \$386,000 in 2008 compared to \$414,000 in 2007, a decrease of \$28,000, or 6.76%.

FDIC insurance and assessments were \$900,000 in 2009 which compares to \$227,000 in 2008, an increase of \$673,000 or 296.48%. The increase is due to the new risk-based deposit assessment system adopted by the FDIC beginning in 2007 whereby assessment rates were increased for all insured institutions. Under this system, all FDIC insured institutions are required to pay deposit premiums. In addition to the increased assessment rates, the FDIC levied a special one-time assessment which was payable on September 30, 2009 in the amount of \$210,000. Refer to Part I, Item 1 for a discussion of FDIC Insurance and assessments.

For comparison, FDIC insurance and assessments were \$227,000 in 2008 which compared to \$151,000 in 2007, an increase of \$76,000, or 50.33%. This increase was also due to the new risk-based deposit assessment system adopted by the FDIC beginning in 2007. Under this system, all FDIC insured institutions are required to pay deposit premiums. The additional premiums due were offset by credits issued for premiums paid by the Company prior to 1996. Those credits for were fully depleted in the first quarter of 2008. The increase in 2008 was also due to the new risk-based deposit assessment system adopted by the FDIC beginning in 2007.

Professional fees and outside services were \$588,000 in 2009 which compares to \$520,000 in 2008, an increase of \$68,000, or 13.08%. This increase is not deemed to be indicative of any trends as expenses were incurred in 2009 in the amount of \$72,000 which were not included in the budget. These costs were associated with consulting and review engagements.

For comparison, professional fees and outside services were \$520,000 in 2008 which compared to \$371,000 in 2007, an increase of \$149,000, or 40.16%. This increase too was not deemed to be indicative of any trends as expenses were incurred in 2008 in the amount of \$70,000 which were not included in the budget. These costs were associated to various consulting and review engagements as well as costs associated with the Delaware companies. Professional fees and outside services were budgeted at \$377,000 for 2008.

Computer services and supplies is another significant component of other expenses. This category covers the expense of data processing for the Company. In 2009, the expense was \$1,053,000 compared to \$970,000 in 2008, an increase of \$83,000, or 8.56%. This increase is considered to be line with budget expectations for 2009 as the Company works to implement new technologies to its information technologies department. The 2009 budget for this line item was \$1,050,000.

For comparison, in 2008, computer services and supplies were \$970,000 compared to \$785,000 in 2007, an increase of \$185,000, or 23.57%. This increase was considered to be line with budget expectations for 2008.

Taxes, other than payroll and income decreased in 2009 by \$54,000, or 13.50%, to \$346,000, compared to 2008 which totaled \$400,000. This decrease is not considered to be significant and was in line with the budgeted amount of \$340,000 for 2009.

For comparison, taxes, other than payroll and income, increased in 2008, to \$400,000, compared to \$386,000 in 2007, an increase of \$14,000, or 3.63%. This increase was not considered to be significant and it was noted that shares tax owed to Pennsylvania grew as a proportion of the overall growth in Company assets. The Company implemented a strategy in 2007 which limited this tax burden for future periods.

Amortization expense-deposit acquisition premiums remained the same at \$258,000 in 2009.

For comparison, in 2008, amortization expense-deposit acquisition premiums increased by \$3,000 or 1.18%, to \$258,000, compared to 2007 at \$255,000. This increase was not deemed to be material.

Stationary and printing supplies decreased by \$3,000 or 0.83%, to \$357,000 compared to 2008 at \$360,000. A decrease was budgeted for 2009.

Stationary and printing supplies increased by \$21,000 or 6.19% to \$360,000 compared to 2007 at \$339,000. This increase was within budget expectations for 2008.

Advertising expense increased by \$96,000 or 47.76%, to \$297,000 in 2009 compared to 2008 at \$201,000. An increase was budgeted for 2009 as the Company continues to increase its marketing efforts in new markets.

As a comparison, Advertising expense increased by \$47,000 or 30.52% to \$201,000 compared to 2007 at \$154,000. This increase was also within budget expectations for 2008 as the Company contracted with an outside advertising firm to implement a more aggressive marketing and promotional plan than in prior years.

Every other non-interest expense is in the category of other. In 2009, this expense decreased \$227,000 or 13.48% to \$1,457,000 compared to \$1,684,000 in 2008. This line item is made up of various sundry accounts which appear to be in line with budget expectations for 2009.

In 2008, other non-interest expense increased \$197,000 or 13.25% to \$1,684,000 compared to \$1,487,000 in 2007. As with the 2009 results for other non-interest income, this line item is made up of various sundry accounts which appear to have been in line with budget expectations for 2008.

FEDERAL INCOME TAXES

The provision for income taxes in 2009 was \$923,000 compared to \$87,000 in 2008 and \$1,097,000 in 2007. The effective tax rate, which is the ratio of income tax expense to income before taxes, was 15% in 2009, 3% in 2008, and 18% in 2007. 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 although 2008 does not compare to the previous two annual periods due to the other-than-temporary security impairments recognized in that year. As such, the effective tax rate increased in 2009 after decreasing in 2008 relative to 2007. 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 2009.

QUARTERLY RESULTS

Table 6 shows the quarterly results of operations for the Company for 2009 and 2008. Interest income remained steady throughout 2009. This was due primarily to loan balances which increased 6.17% in 2009. This helped to offset market rates and a net interest margin which decreased slightly in 2009, 4.23% as compared to 4.25% in 2008.

Interest expense decreased in the first half of 2009 as deposit balances shifted away from traditionally higher rate time deposits and into lower cost savings deposits that offer customers more flexibility and liquidity in their funds. Average time deposits decreased to \$106,000,000 for 2009 when compared to \$132,000,000 in 2008. Conversely, regular savings deposits saw the average balance rise to \$130,000,000 for 2009 versus \$94,000,000 for 2008.

Provision for possible loan losses saw a spike up in the second quarter of 2009 due to a large commercial credit that had deteriorated to the point that the recoverability of that credit became doubtful.

Table 6 shows that fluctuations were experienced in other-than-temporary security impairments as well as gains and losses through sales of available-for-sale securities in 2009 much the same as was experienced in 2008. This was due to activity in the financial markets which caused the sale of investments at gains or losses as well as the write down of investments in which management questioned the ultimate recoverability.

Other income and other expenses remained relatively stable throughout 2009.

TABLE 6

Quarterly Results of Operations
(In Thousands, Except for Per Share Data)

	Quarter Ended 2009			
	31-Mar	30-Jun	30-Sep	31-Dec
Interest Income	\$ 6,184	\$ 6,108	\$ 5,929	\$ 6,052
Interest Expense	2,131	1,693	1,701	1,733
Net Interest Income	4,053	4,415	4,228	4,319
Provision for Loan Losses	165	1,040	165	365
Securities Gains (Losses)	179	339	(1,169)	159
Other Than Temporary Impairment	(76)	(60)	0	(70)
Other Income	808	1,010	811	909
Other Expense	2,921	3,218	2,942	3,067
Income Before taxes (Benefit)	1,878	1,446	763	1,885
Income Taxes (Benefit)	357	193	(23)	396
Net Income	<u>\$ 1,521</u>	<u>\$ 1,253</u>	<u>\$ 786</u>	<u>\$ 1,489</u>
Basic Earnings per share	\$ 0.49	\$ 0.40	\$ 0.25	\$ 0.47
Diluted Earnings per share	\$ 0.49	\$ 0.40	\$ 0.25	\$ 0.47
	Quarter Ended 2008			
	31-Mar	30-Jun	30-Sep	31-Dec
Interest Income	\$ 6,411	\$ 6,308	\$ 6,323	\$ 6,437
Interest Expense	2,434	2,148	2,156	2,416
Net Interest Income	3,977	4,160	4,167	4,021
Provision for Loan Losses	120	135	165	293
Securities Gains (Losses)	26	(10)	7	105
Other Than Temporary Impairment	(182)	(83)	(4,869)	(122)
Other Income	754	802	866	897
Other Expense	(2,661)	(2,514)	(2,731)	(2,771)
Income (Loss) Before taxes (Benefit)	1,794	2,220	(2,725)	1,837
Income Taxes (Benefit)	(379)	(516)	1,159	(351)
Net (Loss) Income	<u>\$ 1,415</u>	<u>\$ 1,704</u>	<u>\$ (1,566)</u>	<u>\$ 1,486</u>
Basic Earnings (Loss) per share	\$ 0.45	\$ 0.55	\$ (0.50)	\$ 0.47
Diluted Earnings (Loss) per share	\$ 0.45	\$ 0.55	\$ (0.50)	\$ 0.47

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 2009 was 1.07%, compared to 0.68% in 2008.

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. The Company's ROE for 2009 was 12.62%, compared to 7.53% for 2008.

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 7Sources, Uses of Funds
(In Thousands)

Funding Uses	2009			2008			2007
	Average Balance	Increase/(Decrease) Amount	Percent	Average Balance	Increase/(Decrease) Amount	Percent	Average Balance
Real Estate Loans	\$ 119,062	\$ 1,427	1.21%	\$ 117,635	\$ 2,145	1.86%	\$ 115,490
Consumer Loans	18,236	1,421	8.45%	16,815	(328)	(1.91%)	17,143
Commercial Loans	161,762	20,859	14.80%	140,903	17,049	13.77%	123,854
Tax Exempt Loans	22,516	(397)	(1.73%)	22,913	1,748	8.26%	21,165
Other Loans	506	37	7.89%	469	2	0.43%	467
Total Loans	<u>322,082</u>	<u>23,347</u>	<u>7.82%</u>	<u>298,735</u>	<u>20,616</u>	<u>7.41%</u>	<u>278,119</u>
Less Allowance for Loan Loss	(2,969)	(370)	14.24%	(2,599)	(574)	28.35%	(2,025)
Total Loans with Loan Loss	<u>319,113</u>	<u>22,977</u>	<u>7.76%</u>	<u>296,136</u>	<u>20,042</u>	<u>7.26%</u>	<u>276,094</u>
Taxable Securities	53,945	(13,952)	(20.55%)	67,897	2,459	3.76%	65,438
Non-Taxable Securities	52,326	9,467	22.09%	42,859	(1,333)	(3.02%)	44,192
Total Securities	<u>106,271</u>	<u>(4,485)</u>	<u>(4.05%)</u>	<u>110,756</u>	<u>1,126</u>	<u>1.03%</u>	<u>109,630</u>
Time Deposit with Other Banks	1,408	222	18.72%	1,186	871	276.51%	315
Fed Funds Sold	9,617	2,800	41.07%	6,817	6,094	842.88%	723
Total Uses	<u>\$ 436,409</u>	<u>\$ 21,514</u>	<u>5.19%</u>	<u>\$ 414,895</u>	<u>\$ 28,133</u>	<u>7.27%</u>	<u>\$ 386,762</u>

Funding Sources	2009			2008			2007
	Average Balance	Increase/(Decrease) Amount	Percent	Average Balance	Increase/(Decrease) Amount	Percent	Average Balance
Interest Bearing Demand Deposits	\$ 35,697	\$ 6,826	23.64%	\$ 28,871	\$ 3,530	13.93%	\$ 25,341
Regular Savings Deposits	130,652	36,633	38.96%	94,019	(12,950)	(12.11%)	106,969
Money Market Savings Deposits	32,771	(1,087)	(3.21%)	33,858	(1,497)	(4.23%)	35,355
Time Deposits	<u>106,353</u>	<u>(25,960)</u>	<u>(19.62%)</u>	<u>132,313</u>	<u>29,670</u>	<u>28.91%</u>	<u>102,643</u>
Total Interest Bearing Deposits	<u>305,473</u>	<u>16,412</u>	<u>5.68%</u>	<u>289,061</u>	<u>18,753</u>	<u>6.94%</u>	<u>270,308</u>
Other Borrowings							
Short-Term Funds Borrowed	19,940	3,064	18.16%	16,876	4,747	39.14%	12,129
Long-Term Funds Borrowed	39,201	(2,291)	(5.52%)	41,492	3,438	9.03%	38,054
Total Funds Borrowed	<u>59,141</u>	<u>773</u>	<u>1.32%</u>	<u>58,368</u>	<u>8,185</u>	<u>16.31%</u>	<u>50,183</u>
Total Deposits and Funds Borrowed	<u>364,614</u>	<u>17,185</u>	<u>4.95%</u>	<u>347,429</u>	<u>26,938</u>	<u>8.41%</u>	<u>320,491</u>
Other Sources, net	71,795	4,329	6.42%	67,466	1,195	1.80%	66,271
Total Sources	<u>\$ 436,409</u>	<u>\$ 21,514</u>	<u>5.19%</u>	<u>\$ 414,895</u>	<u>\$ 28,133</u>	<u>7.27%</u>	<u>\$ 386,762</u>

Total Sources of funds were up \$21,514,000 in average balances for 2009 which is a 5.19% increase. The primary source of the increase was in savings type deposits with an increase of \$36,633,000 or 38.96%. Interest bearing demand deposits were the other big gainer and ended 2009 with an average balance of \$35,697,000 compared to \$28,871,000 in 2008, an increase of \$6,826,000 or 23.64%. Borrowed Funds were up \$773,000 or 1.32% ending the year with an average balance of \$59,141,000 compared to an average balance of \$58,368,000 for 2008 and an average balance of \$50,183,000 for 2007. In 2009, the Company experienced significant deposit growth from its customer base in relation to natural gas lease contracts. At the same time, short term funding rates were falling significantly based on actions of the Federal Reserve. The Company managed to retain and grow deposits by offering higher rate savings type deposits that satisfied customer needs without undue strain to its net interest margin.

On the Asset side, the increase in funding was used to fill loan demand. The average balance in loans less the loan loss allowance for 2009 was \$319,113,000 compared to an average balance of \$296,136,000 in 2008 and \$276,094,000 in 2007. Real estate loans were \$1,427,000 or 1.21% higher in average balance in 2009 averaging \$119,062,000 compared to an average balance of \$117,635,000 in 2008. Commercial loans were up significantly in 2009 ending the year with an average balance of \$161,762,000 which is an increase of \$20,859,000 or 14.80% over the 2008 average balance of \$140,903,000. Securities ended the 2009 year with an average balance of \$106,271,000 compared to \$110,756,000 million in 2008, a decrease of \$4,485,000 or 4.05%.

Loan Portfolio Types

In 2009, loans to commercial borrowers helped fuel the growth in net loans. Residential mortgage loans decreased 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)

	December 31,				
	2009	2008	2007	2006	2005
Commercial	\$ 198,086	\$ 178,342	\$ 155,796	\$ 140,931	\$ 132,054
Residential Real Estate Mortgage	116,920	120,813	116,922	112,883	109,034
Consumer	20,802	16,988	17,889	16,947	17,780
Total Loans	335,808	316,143	290,607	270,761	258,868
Deferred Loan Fees and Costs	495	465	445	414	377
Total Loans, net of Deferred	336,303	316,608	\$ 291,052	\$ 271,175	\$ 259,245
Allowance for Loan Loss	(3,337)	(3,002)	(2,451)	(1,792)	(2,375)
Net Loans	\$ 332,966	\$ 313,606	\$ 288,601	\$ 269,383	\$ 256,870

Loans continued to increase in 2009, ending the year with \$332,966,000 in net loans compared to \$313,606,000 at year-end 2008, an increase of 6.17%. Commercial loans grew 11.07% to close the year at \$198,086,000, compared to \$178,342,000 at year-end 2008.

Residential mortgages were down 3.22% to \$116,920,000, compared to \$120,813,000 on December 31, 2008 a decrease of \$3,893,000. Although our mortgage portfolio decreased in 2009, there was an additional \$17,312,000 mortgage loans sold to Fannie Mae and FHLB. 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, including non-accrual loans.

The Bank has 9.19% 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 31.95% of its loan portfolio maturing. The over-five-year maturity group makes up 58.86% of the portfolio.

For comparison, at December 31, 2008, the Bank had 9.09% 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 22.61% of its portfolio. The over-five-year maturity group made up 68.30% of the portfolio.

TABLE 9

Loan Maturities
(In Thousands)

	One Year Or Less	Over One Year Within Five Years	Over Five Years	Total Loans
Commercial	\$ 20,166	\$ 67,733	\$ 110,187	\$ 198,086
Real-Estate Construction	0	0	0	0
Real-Estate Mortgage	5,946	25,985	84,989	116,920
Installment	4,747	13,577	2,478	20,802
Total	<u>\$ 30,859</u>	<u>\$ 107,295</u>	<u>\$ 197,654</u>	<u>\$ 335,808</u>
Total Loans with Predetermined Rates	\$ 18,685	\$ 53,100	\$ 18,675	\$ 90,460
Total Loans with Variable Rates	12,174	54,195	178,979	245,348
Total	<u>\$ 30,859</u>	<u>\$ 107,295</u>	<u>\$ 197,654</u>	<u>\$ 335,808</u>

TABLE 10

Non-performing Loans
(In Thousands)

	December 31,				
	2009	2008	2007	2006	2005
Non-accrual	\$ 2,528	\$ 829	\$ 395	\$ 445	\$ 1,105
Restructured	559	4,042	0	0	0
Loans Past Due 90 or More Days, Accruing Interest	239	245	91	275	0
Total Nonperforming Loans	<u>3,326</u>	<u>5,116</u>	<u>486</u>	<u>720</u>	<u>1,105</u>
Foreclosed Assets	5,534	5,171	4,675	5,062	117
Total Nonperforming Assets	<u>\$ 8,860</u>	<u>\$ 10,287</u>	<u>\$ 5,161</u>	<u>\$ 5,782</u>	<u>\$ 1,222</u>
Nonperforming Loans to Total Loans at Period-end	0.99%	1.62%	0.17%	0.27%	0.43%
Nonperforming Assets to Period-end Loans and Foreclosed Assets	2.60%	3.20%	1.75%	2.10%	0.47%
Interest Income That Would Have Been Recorded Under Original Terms	\$ 135	\$ 26	\$ 32	\$ 84	\$ 59
Interest Income Recorded During the Period	\$ 43	\$ 27	\$ 15	\$ 7	\$ 9
Commitments To Lend Additional 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 ASC Topic 310. 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. 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. Management believed that certain risks, primarily current economic conditions, warranted an increase in the allowance for loan losses for the year ended December 31, 2009 and as such, the Company allotted \$1,735,000 for provision for loan losses in 2009. This evaluation is reviewed monthly by management and by the Board of Directors. Management believes that on December 31, 2009, 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.

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
(In Thousands)

	Year Ended,				
	Dec 2009	Dec 2008	Dec 2007	Dec 2006	Dec 2005
Average Total Loans	\$ 322,082	\$ 298,735	\$ 278,119	\$ 267,610	\$ 250,559
Balance at Beginning of Period	\$ 3,002	\$ 2,451	\$ 1,792	\$ 2,375	\$ 2,739
Charge Offs					
Commercial	1,367	142	0	797	633
Residential Real Estate	46	4	0	21	31
Installment	134	100	73	98	129
Total Charge Offs	1,547	246	73	916	793
Recoveries					
Commercial	98	44	422	5	0
Residential Real Estate	3	2	3	5	0
Installment	46	38	27	21	37
Total Recoveries	147	84	452	31	37
Net Charge-Offs (Recoveries)	1,400	162	(379)	885	756
Provision for Loan Losses	1,735	713	280	302	392
Balance at End of Period	\$ 3,337	\$ 3,002	\$ 2,451	\$ 1,792	\$ 2,375
Allowance for Credit Losses to Period-end Total Loans	0.99%	0.95%	0.84%	0.66%	0.92%
Allowance for Credit Losses to Non-accrual Loans	132.00%	498.67%	620.51%	402.70%	206.62%
Net Charge-Offs (Recoveries) to Average Loans	.43%	.05%	(0.14%)	0.33%	0.29%

TABLE 12

Allocation of Allowance
(In Thousands)

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

	Dec 2009		Dec 2008		Dec 2007	
	\$	% of Loan Type to Total Loans	\$	% of Loan Type to Total Loans	\$	% of Loan Type to Total Loans
Commercial	1,979	58.99%	1,598	56.33%	1,428	53.70%
Residential Real Estate Mortgage	610	34.82%	627	38.29%	738	40.15%
Consumer	189	6.19%	153	5.38%	285	6.15%
Non Performing	559	N/A	624	N/A	0	N/A
Total Allowance for Loan Losses	\$ 3,337	100.00%	\$ 3,002	100.00%	\$ 2,451	100.00%

	Dec 2006		Dec 2005	
	\$	% of Loan Type to Total loans	\$	% of Loan Type to Total Loans
Commercial	1,429	52.05%	2,035	58.56%
Residential Real Estate Mortgage	274	41.69%	286	38.11%
Consumer	89	6.26%	54	3.33%
Non Performing	0	N/A	0	N/A
Total Allowance for Loan Losses	\$ 1,792	100.00%	\$ 2,375	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 in the accumulated other comprehensive loss 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 \$22,917,000 in 2009. 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, 2009, the unrealized loss on securities available-for-sale included in stockholders' equity totaled \$2,258,000, net of tax, compared to unrealized losses of \$4,755,000, net of tax, at December 31, 2008. The weighted-average maturity of the securities available-for-sale portfolio was ten years at December 31, 2009, with a weighted-average yield of 3.67%.

At December 31, 2009, the Company had 44 U.S. Government Agency securities, 61 obligations of state and political subdivisions, 5 mortgage-backed securities, 6 corporate debt securities, and 17 common equity securities in an unrealized loss position.

At December 31, 2009, 17 common equity securities had totaled unrealized losses of \$364,000. These securities have traditionally been high-performing stocks. As a result of recent market volatility in financial stocks from news of sub-prime lending problems, as well as concerns surrounding the financial markets, liquidity and credit availability, the fair value of most of the stocks held are "under water" as of December 31, 2009, and as such, are considered to be impaired. The Company does not invest in bank stocks with the intent to turn them over for a profit in the near-term. We invest in those stocks that we believe to have potential to appreciate in value over the long-term, while providing for a reasonable dividend yield. We buy and hold those stocks that we believe have potential to be an acquirer or to be acquired, providing additional value. Stocks can be cyclical in nature and will experience some down periods. Historically, bank stocks have sustained cyclical losses, followed by periods of substantial gains, therefore we believe that both unrealized losses and gains are likely to be temporary, when observing performance in the banking sector.

In management's opinion, the unrealized losses on all other securities reflect changes in interest rates subsequent to the acquisition of specific securities and management believes that these unrealized losses represent a temporary impairment of those securities. As long term rates increase, the underlying value of securities owned by the Company decreases creating an unrealized loss.

Reference should be made to Note 14 of the consolidated financial statements for further discussion of fair value. The fair value of the Company's securities portfolio is classified as Level 1, Level 2 or Level 3. Level 1 inputs are derived from quoted prices within active markets for such securities. The Company currently holds securities at Level 1 fair values of \$1,081,000. Level 2 inputs are derived from quoted prices in inactive markets or from other observable inputs. The Company holds securities at Level 2 fair values of \$129,425,000. Finally, Level 3 inputs are unobservable and based on little or no market activity. No Level 3 securities are currently held by the Company.

Level 1 securities held by the Company consist of the 17 aforementioned equity positions. The fair value of these equity positions is based on quoted prices received from the broker which are indicative of the most recent prices received by sellers of those same positions in an active market.

Level 2 securities held by the Company are debt holdings from various market sectors. A significant sector represented is the municipal markets. The value of this sector has been adversely affected from the downgrades placed on the municipal insurers by the rating agencies. The Company receives pricing for its debt holdings from a third party bond accounting service. The service evaluates pricing using a combination of data from vendors, internal pricing models as well as assistance from their own fixed income analysts and traders. From these multiple sources, the most accurate price is determined and utilized in fair value reporting.

Table 13 shows the amortized cost and average yield of securities by maturity or call date at December 31, 2009. Since the below table is by maturity or call date, it will not match the maturity schedule in the 2009 consolidated financial statements Note 2, which is done by contractual maturity.

TABLE 13

Securities by Maturities (Amortized Cost)
(In Thousands)

	1 Year or Less		1-5 Years		5-10 Years		Over 10 Years		Total	
	Balance	Average Yield	Balance	Average Yield	Balance	Average Yield	Balance	Average Yield	Balance	Average Yield
Available-for-Sale										
US Government Agency	\$ 0	0.00%	\$ 38,026	2.52%	\$ 18,632	3.81%	\$ 4,331	4.50%	\$ 60,989	3.05%
State/County/Municipal										
Obligations	391	3.68%	7,783	3.64%	10,145	3.99%	34,517	4.21%	52,836	4.08%
Taxable Municipals	0	0.00%	723	2.33%	1,003	4.85%	493	5.79%	2,219	4.24%
Mortgage-Backed Securities-										
Residential	1,058	5.43%	2,100	5.48%	677	5.89%	591	6.06%	4,426	5.61%
Collateralized Mortgage										
Obligations	55	2.58%	96	2.59%	41	2.72%	7	2.89%	199	2.62%
Corporate/Other Securities	0	0.00%	1,000	3.00%	9,211	5.72%	1,527	1.47%	11,738	4.94%
Preferred Equity Securities	0	0.00%	0	0.00%	0	0.00%	78	0.00%	78	0.00%
Common Equity Securities	0	0.00%	0	0.00%	0	0.00%	1,442	1.65%	1,442	1.65%
Total Available-for-Sale	<u>\$ 1,504</u>	4.87%	<u>\$ 49,728</u>	2.79%	<u>\$ 39,709</u>	4.24%	<u>\$ 42,986</u>	3.88%	<u>\$ 133,927</u>	3.67%

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,		
	2009	2008	2007
U. S. Government/Agency Obligations	\$ 60,465	\$ 7,958	\$ 2,002
State/Municipal Obligations	51,544	44,715	44,505
Taxable Municipal	2,156	3,060	1,994
Mortgage-backed Securities-Residential	4,637	30,602	42,586
Collateralized Mortgage Obligations	203	2,163	2,582
Corporate/Other Securities	10,334	16,970	11,265
Preferred Equity Securities	85	20	1,841
Common Equity Securities	1,082	2,101	2,696
Total Securities Available-for-Sale	<u>\$ 130,506</u>	<u>\$ 107,589</u>	<u>\$ 109,471</u>

DEPOSITS

Table 15 shows average deposits and other borrowings balances and rates for 2009, 2008 and 2007. The Company experienced growth of \$16,412,000 in average interest bearing deposits and \$6,547,000 in average non-interest bearing deposits during 2009 compared to an increase of \$18,753,000 in average interest bearing deposits and \$4,165,000 in average non-interest bearing deposits in 2008. Average savings accounts increased \$36,633,000 in 2009 compared to a decrease of \$12,950,000 during 2008. Management attributes the growth in savings to the increased use of the certificate of savings product as rates stayed historically low throughout 2009. Average time deposits decreased \$25,960,000 in 2009 compared to an increase of \$29,670,000 in 2008 when compared to 2007. In 2009, average other borrowings increased \$773,000 ending the year with an average balance of \$59,141,000 compared to an average balance of \$58,368,000 in 2008.

TABLE 15Average Deposits and Other Borrowings
(In Thousands)

	2009			2008			2007	
	Amount	Rate	Diff \$	Amount	Rate	Diff \$	Amount	Rate
Interest Bearing Demand								
Deposits	\$ 35,697	.91%	\$ 6,826	\$ 28,871	.98%	\$ 3,530	\$ 25,341	1.14%
Savings Deposits	130,652	1.30%	36,633	94,019	1.30%	(12,950)	106,969	3.10%
Money Market Savings	32,771	1.05%	(1,087)	33,858	1.77%	(1,497)	35,355	3.08%
Time Deposits	106,353	2.79%	(25,960)	132,313	3.72%	29,670	102,643	4.22%
Total Interest Bearing								
Deposits	305,473	1.74%	16,412	289,061	2.43%	18,753	270,308	3.34%
Other Borrowings	59,141	3.26%	773	58,368	3.65%	8,185	50,183	4.16%
Total Interest Bearing								
Liabilities	364,614	1.99%	17,185	347,429	2.63%	26,938	320,491	3.46%
Non-Interest Bearing								
Demand Deposits	63,325		6,547	56,778		4,165	52,613	
Total	<u>\$ 427,939</u>	<u>1.70%</u>	<u>\$ 23,732</u>	<u>\$ 404,207</u>	<u>2.26%</u>	<u>\$ 31,103</u>	<u>\$ 373,104</u>	<u>2.98%</u>

MATURITIES OF TIME DEPOSITS

The maturities on the time deposits of \$100,000 and over are heavily distributed in the three month or less category showing a concentration that could pose a liquidity risk to the Bank. The concentration of short term certificates of deposit are the result of lower savings interest rates and short term special rates on certificates of deposit that came at a time in which the Bank was experiencing a large influx of deposits from customers that had entered into natural gas lease contracts. Management controls this risk through the monthly monitoring procedures of the ALCO committee. Table 16 shows the dollar amount of large time deposits in each time category as well as the overall percentage of each category.

TABLE 16Maturities
(In Thousands)

	December 31, 2009	
	Amount	Percent
Three Months or Less	\$ 4,912	24.05%
Over Three Months through Six Months	2,916	14.27%
Over Six Months through Twelve Months	3,480	17.03%
Over Twelve Months	9,121	44.65%
Total	<u>\$ 20,429</u>	<u>100.00%</u>

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 Notes 6 and 7 of the Notes to Consolidated Financial Statements.

TABLE 17Borrowed Funds
(In Thousands)

	December 31,	
	2009	2008
Other Short-Term Borrowings	\$ 20,439	\$ 18,432
FHLB Long-Term Borrowings	38,750	39,691
Total	<u>\$ 59,189</u>	<u>\$ 58,123</u>

CAPITAL ACCOUNTS

Total stockholders' equity increased 13.22%, or \$5,250,000, from year-end 2008 to finish at \$44,970,000. A common ratio used to determine the effective use of capital is the return on average equity. For the year ended December 31, 2009, this ratio was 12.62%, compared to 7.53% for the year ended December 31, 2008. 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 2009, the equity-to-assets ratio was 8.71%, compared to 8.41% at year-end 2008.

Compare 2009 results to those experienced in 2008 when total stockholders' equity increased 7.21% or \$3,085,000 over year-end 2007. The return on average equity for the year ended December 31, 2008 ratio was 7.53%, compared to 11.38% for the year ended December 31, 2007. At year-end 2008, the equity-to-assets ratio was 8.41% compared to 9.85% at year-end 2007.

Net income increased capital by \$5,049,000 in 2009 and dividends decreased that number by \$2,381,000. The securities portfolio increased in value by \$2,497,000, net of tax in 2009. Since all of our securities are available-for-sale, changes in market values adjusted for taxes are reflected in the equity portion of the balance sheet. A total of \$85,000 in net treasury stock issued increased 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 2009, no shares were purchased in this manner. There were 4,975 shares issued from the treasury stock account by individuals exercising options. The investment banking firms of Boenning & Scattergood Inc. and Stifel Nicolaus have been known to make markets in PFSC common stock.

Net income increased capital by \$3,039,000 in 2008 and dividends reduced that number by \$2,417,000. The securities portfolio decreased in value by \$3,365,000 in 2008. Again, since all of our securities were available-for-sale, changes in market values adjusted for taxes are reflected in the equity portion of the balance sheet. A total of \$272,000 in net treasury stock purchases increased 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, 2009 and 2008.

TABLE 18

Capital Ratios

	<u>December 31 2009</u>	<u>December 31 2008</u>	<u>Regulatory Requirement</u>
Tier 1 capital to risk-weighted assets	12.30%	12.26%	4.00%
Total capital to risk-weighted assets	13.18%	13.10%	8.00%
Tier 1 capital to average assets-leverage ratio	9.92%	9.31%	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 completes a quarterly analysis to confirm that 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, 2009:

TABLE 19

Statement of Interest Sensitivity Gap
(In Thousands)

	Maturity or Repricing In:				
	3 Months	3-6 Months	6-12 Months	1-5 Years	Over 5 Years
RATE SENSITIVE ASSETS					
Interest Bearing Deposits With Other					
Banks	\$ 895	\$ 0	\$ 0	\$ 0	\$ 0
Federal Funds Sold	10,761	0	0	0	0
Securities	10,051	4,669	9,958	42,110	63,718
Loans	36,840	17,522	41,947	179,768	56,889
Total Rate Sensitive Assets	<u>58,547</u>	<u>22,191</u>	<u>51,905</u>	<u>221,878</u>	<u>120,607</u>
Cumulative Rate Sensitive Assets	<u>58,547</u>	<u>80,738</u>	<u>132,643</u>	<u>354,521</u>	<u>475,128</u>
RATE SENSITIVE LIABILITIES					
Interest Bearing Checking	45,146	0	0	0	0
Money Market Deposits	35,986	0	0	0	0
Regular Savings	170,981	0	0	0	0
CDs and IRAs	21,618	11,800	16,768	34,801	1,103
Short-term Borrowings	20,439	0	0	0	0
Long-term Borrowings	224	227	2,963	28,920	6,416
Total Rate Sensitive Liabilities	<u>294,394</u>	<u>12,027</u>	<u>19,731</u>	<u>63,721</u>	<u>7,519</u>
Cumulative Rate Sensitive Liabilities	<u>\$ 294,394</u>	<u>\$ 306,421</u>	<u>\$ 326,152</u>	<u>\$ 389,873</u>	<u>\$ 397,392</u>
Period Gap	\$ (235,847)	\$ 10,164	\$ 32,174	\$ 158,157	\$ 113,088
Cumulative Gap	(235,847)	(225,683)	(193,509)	(35,352)	77,736
Cumulative RSA to RSL	19.89%	26.35%	40.67%	90.93%	119.56%
Cumulative Gap to Total Assets	(45.66%)	(43.70%)	(37.47%)	(6.84%)	15.05%

The Federal Reserve's Open Market Committee (FOMC) remained on hold for the entirety of 2009 with a Fed Funds target rate of 0 to 25 basis points. The effect of this has been a very steep yield curve that has persisted throughout 2009. The overall level of market rates is still historically low, both on the short end and the long end of the curve. The resulting net interest margin in 2009 decreased very slightly to 4.23% when compared to the net interest margin of 4.25% for the year ended December 31, 2008. The asset side of the Company's balance sheet has remained less reactive to rate movements. While this has presented a positive opportunity to the Company in the near-term, it also presents some challenges. As customers seek more competitive rates on their deposits, the Company has remained diligent in offering deposit alternatives for customers. This has helped to mitigate the loss of deposits to competitors.

Compare these results to 2008 when the Fed Funds rate dropped rates aggressively by a total of 425 basis points. This was done in hopes of stemming the tide of negative economic events which began in 2007 with the sub-prime mortgage crisis and continued through 2008 as foreclosure rates skyrocketed and home values plummeted. For the year ended December 31, 2008, the overnight Fed Funds Rate was decreased a total of 425 basis points ending the year at a target rate of 0 to 25 basis points. The overall level of market rates dropped dramatically in 2008, both on the short end and the long end of the curve. The result was a net interest margin that rose to 4.25% for the year ended December 31, 2008 compared to 3.82% for the year ended December 31, 2007.

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 (FHLB). On December 31, 2009, the Bank had a borrowing capacity from the Federal Home Loan Bank of approximately \$152,330,000. During 2009, significant increases in deposits has eliminated, at least in the near term, the Company's dependence on overnight borrowings at the Federal Home Loan Bank and provided the majority of additional cash with operating activities also contributing to liquidity. The additional deposits were used primarily to grant loans to customers.

As evidenced by the sources (uses) of funds (table 7), the interest rate sensitivity analysis (table 19) and the list of contractual obligations (table 20 which follows this section), the Company has increased its short term funding needs dramatically in 2009. This was part of a strategic initiative based on a high demand for competitive rates by deposit holders in a low rate environment. This course of action was made necessary in light of the large sums of money flowing into the region due to natural gas drilling and exploration. Many of the Company's customers were the primary beneficiaries of those funds and the Company felt this was an opportunity to expand current customer relationships as well as attract new customers. As with all low rate environments however, customers were generally unwilling to invest long term. Short term attractive rates were offered by the Company and the result was a concentration in short term obligations and higher rate savings type deposits. The Company feels that it offers a variety of attractive deposit products at competitive rates that will mitigate significant runoff in deposits from occurring. One such product is the certificate of savings product which acts as a hybrid between a core savings product and a short term certificate of deposit. This deposit product offers an interest rate that far outweighs any comparable savings product on the market and a quarterly limit placed on customer withdrawals which provide stability in funding to the Company. This account has proven to be a deposit leader in the past and the Company will rely on it to provide a source of funds. Beyond its own product line up, the Company also has available to it open lines of credit at the FHLB with current availability of approximately \$113,580,000, Atlantic Central Bankers Bank (ACBB) in the amount of \$7,000,000 and the Federal Reserve Bank of Philadelphia (FRB) that amount to \$7,721,000. While the FHLB has been an inexpensive source of funds in the past, current liquidity concerns surrounding the FHLB have prompted the Company to explore additional funding options at the FRB. Collateral standards of the FRB make it feasible to increase available lines and open the Company up to yet another source of funding liquidity. This was accomplished in 2009 and the open lines available at the FRB increased from \$1,500,000 to the current levels.

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, 2009				
	Less than 1 Year	1-3 Years	4-5 Years	Over 5 Years	Total
Time Deposits	\$ 50,186	\$ 20,468	\$ 14,333	\$ 1,103	\$ 86,090
Long-term Debt	3,414	12,206	16,714	6,416	38,750
Operating Leases	90	87	62	126	365
Standby Letters of Credit	9,617	2,074	1,765	2,235	15,691
	<u>\$ 63,307</u>	<u>\$ 34,835</u>	<u>\$ 32,874</u>	<u>\$ 9,880</u>	<u>\$ 140,896</u>

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 beyond those already discussed.

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, 2009, totaled \$54,395,000. 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 even remotely 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.

ITEM 7A QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As previously stated in this document, the Federal Reserve Bank remained on hold at historically low overnight rate levels in 2009. This has caused the steep yield curve to persist which can have an effect of increasing the Bank's earnings growth. This is due to the payment of lower, short-term deposit interest while at the same time experiencing little or no deterioration to interest income from longer maturity loans. With this being said, the Bank monitors this interest sensitivity on a quarterly basis. The results of the latest simulation follow. The simulation shows a possible decrease in net interest income of 23.96%, or \$4,413,000, in a +200 basis point rate shock scenario over a one-year period. An increase of 9.83% or \$1,811,000 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 discussions 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, 2009 and 2008, and the related consolidated statements of income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2009. Peoples Financial Service Corp.'s management is responsible for these consolidated financial statements. 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 audits 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, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Peoples Financial Services Corp.'s internal control over financial reporting as of December 31, 2009, 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 15, 2010 expressed an unqualified opinion.

/s/ ParenteBeard LLC

ParenteBeard LLC
Allentown, Pennsylvania
March 15, 2010

Consolidated Balance Sheets

	December 31,	
	2009	2008
	(In Thousands, Except Share and Per Share Data)	
ASSETS		
Cash and due from banks	\$ 7,259	\$ 6,174
Interest bearing deposits in other banks	895	1,782
Federal funds sold	<u>10,761</u>	<u>10,577</u>
Cash and Cash Equivalents	18,915	18,533
Securities available for sale	130,506	107,589
Loans receivable, net of allowance for loan losses 2009 \$3,337; and 2008 \$3,002	332,966	313,606
Investment in restricted stock, at cost	2,870	2,658
Premises and equipment, net	7,509	7,542
Accrued interest receivable	2,580	2,526
Intangible assets	560	818
Other real estate owned	5,534	5,171
Bank owned life insurance	8,253	7,911
Other assets	6,790	6,022
Total Assets	<u><u>\$ 516,483</u></u>	<u><u>\$ 472,376</u></u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Deposits:		
Non-interest bearing	\$ 71,835	\$ 55,324
Interest-bearing	<u>338,203</u>	<u>315,944</u>
Total Deposits	410,038	371,268
Short-term borrowings	20,439	18,432
Long-term borrowings	38,750	39,691
Accrued interest payable	446	1,649
Other liabilities	<u>1,840</u>	<u>1,616</u>
Total Liabilities	<u><u>471,513</u></u>	<u><u>432,656</u></u>
STOCKHOLDERS' EQUITY		
Common stock, par value \$2 per share; authorized 12,500,000 shares; issued 3,341,251 shares; outstanding 3,136,156 shares and 3,131,181 shares December 31, 2009 and 2008, respectively	6,683	6,683
Surplus	3,098	3,100
Retained earnings	42,043	39,375
Accumulated other comprehensive loss	(2,258)	(4,755)
Treasury stock, at cost, 205,095 and 210,070 shares at December 31, 2009 and 2008, respectively	<u>(4,596)</u>	<u>(4,683)</u>
Total Stockholders' Equity	<u><u>44,970</u></u>	<u><u>39,720</u></u>
Total Liabilities and Stockholders' Equity	<u><u>\$ 516,483</u></u>	<u><u>\$ 472,376</u></u>

See notes to consolidated financial statements

Consolidated Statements of Income

	Years Ended December 31,		
	2009	2008	2007
	(In Thousands, Except Per Share Data)		
INTEREST INCOME			
Loans receivable, including fees	\$ 19,446	\$ 19,871	\$ 19,481
Securities:			
Taxable	2,675	3,771	3,351
Tax-exempt	2,118	1,731	1,717
Other	34	106	62
Total Interest Income	24,273	25,479	24,611
INTEREST EXPENSE			
Deposits	5,328	7,026	9,019
Short-term borrowings	315	390	640
Long-term borrowings	1,615	1,738	1,446
Total Interest Expense	7,258	9,154	11,105
Net Interest Income	17,015	16,325	13,506
PROVISION FOR LOAN LOSSES	1,735	713	280
Net Interest Income after Provision for Loan Losses	15,280	15,612	13,226
OTHER INCOME (LOSS)			
Customer service fees	1,950	2,006	1,947
Investment division commission income	341	411	340
Earnings on investment in life insurance	342	296	297
Premiums and fees on mortgage sales	438	148	69
Other income	467	458	557
Realized gain on sale of interest in insurance agency	0	0	220
Net realized gains (losses) on sales of securities available for sale	(492)	128	(122)
Other than temporary security impairments	(206)	(5,256)	0
Total Other Income (Loss)	2,840	(1,809)	3,308
OTHER EXPENSES			
Salaries and employee benefits	5,532	4,831	4,767
Occupancy	814	733	788
Equipment	546	493	508
FDIC insurance and assessments	900	227	151
Professional fees and outside services	588	520	371
Computer service and supplies	1,053	970	785
Taxes, other than payroll and income	346	400	386
Impairment charge-other real estate owned	0	0	575
Amortization expense – deposit acquisition premiums	258	258	255
Stationary and printing supplies	357	360	339
Advertising	297	201	154
Other	1,457	1,684	1,487
Total Other Expenses	12,148	10,677	10,566
Income before Income Taxes	5,972	3,126	5,968
FEDERAL INCOME TAXES	923	87	1,097
Net Income	\$ 5,049	\$ 3,039	\$ 4,871
EARNINGS PER SHARE			
Basic	\$ 1.61	\$ 0.97	\$ 1.55
Diluted	\$ 1.61	\$ 0.97	\$ 1.55
Dividends Declared Per Share	\$ 0.76	\$ 0.76	\$ 0.76

See notes to consolidated financial statements

Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2009, 2008 and 2007

(In Thousands, Except Share and Per Share Data)	Accumulated					Total
	Common Stock	Surplus	Retained Earnings	Other Comprehensive Loss	Treasury Stock	
Balance - December 31, 2006	\$ 6,683	\$ 3,046	\$ 36,336	\$ (395)	\$ (4,430)	\$ 41,240
Comprehensive income:						
Net income	0	0	4,871	0	0	4,871
Net change in unrealized gains (losses) on securities available for sale, net of reclassification adjustment and taxes	0	0	0	(995)	0	(995)
Total Comprehensive Income						<u>3,876</u>
Stock option expense	0	3	0	0	0	3
Cash dividends declared, (\$0.76 per share)	0	0	(2,383)	0	0	(2,383)
Shares issued from treasury related to stock purchase plans (8,119 shares)	0	34	0	0	129	163
Purchase of treasury stock (3,500 shares)	0	0	0	0	(94)	(94)
Balance - December 31, 2007	<u>6,683</u>	<u>3,083</u>	<u>38,824</u>	<u>(1,390)</u>	<u>(4,395)</u>	<u>42,805</u>
Cumulative effect of adoption of new accounting principle on January 1, 2008 (Note 1)	0	0	(71)	0	0	(71)
Comprehensive loss:						
Net income	0	0	3,039	0	0	3,039
Net change in unrealized gains (losses) on securities available for sale, net of reclassification adjustment and taxes	0	0	0	(3,365)	0	(3,365)
Total Comprehensive Loss						<u>(326)</u>
Stock option expense	0	1	0	0	0	1
Cash dividends declared, (\$0.76 per share)	0	0	(2,417)	0	0	(2,417)
Shares issued from treasury related to stock purchase plans (12,688 shares)	0	16	0	0	218	234
Purchase of treasury stock (20,000 shares)	0	0	0	0	(506)	(506)
Balance - December 31, 2008	<u>6,683</u>	<u>3,100</u>	<u>39,375</u>	<u>(4,755)</u>	<u>(4,683)</u>	<u>39,720</u>
Comprehensive income:						
Net income	0	0	5,049	0	0	5,049
Net change in unrealized gains (losses) on securities available for sale, net of reclassification adjustment and taxes	0	0	0	2,497	0	2,497
Total Comprehensive Income						<u>7,546</u>
Cash dividends declared, (\$0.76 per share)	0	0	(2,381)	0	0	(2,381)
Shares issued from treasury related to stock purchase plans (4,975 shares)	0	(2)	0	0	87	85
Balance - December 31, 2009	<u><u>\$ 6,683</u></u>	<u><u>\$ 3,098</u></u>	<u><u>\$ 42,043</u></u>	<u><u>\$ (2,258)</u></u>	<u><u>\$ (4,596)</u></u>	<u><u>\$ 44,970</u></u>

See notes to consolidated financial statements

Consolidated Statements of Cash Flows

	Years Ended December 31,		
	2009	2008	2007
	(In Thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 5,049	\$ 3,039	\$ 4,871
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	954	871	891
Provision for loan losses	1,735	713	280
Gain on sales or retirements of equipment	(5)	(1)	0
Gain on sale of other real estate owned	0	(15)	0
Impairment charge-other real estate owned	0	0	575
Amortization of securities' premiums and accretion of discounts, net	227	145	380
Amortization of deferred loan costs	261	304	254
Gain on sale of interest in insurance agency	0	0	(220)
(Gain) loss on sales of securities available for sale, net	492	(128)	122
Other than temporary security impairment	206	5,256	0
Stock option expense	0	1	3
Deferred income tax expense (benefit)	1,514	(1,737)	(83)
Net earnings on investment in life insurance	(342)	(296)	(297)
Proceeds from the sale of loans originated for sale	22,010	6,556	6,127
Net gain on sale of loans originated for sale	(284)	(88)	(38)
Loans originated for sale	(23,064)	(6,391)	(6,166)
(Increase) decrease in assets:			
Accrued interest receivable	(54)	(289)	(382)
Other assets	(3,568)	(108)	275
Increase (decrease) in liabilities:			
Accrued interest payable	(1,203)	724	222
Other liabilities	224	(347)	279
Net Cash Provided by Operating Activities	4,152	8,209	7,093
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from sale of interest in insurance agency	0	0	551
Proceeds from sale of available for sale securities	62,172	57,997	60,489
Proceeds from maturities of and principal repayments on available for sale securities	8,274	5,138	16,220
Purchase of available for sale securities	(90,505)	(71,624)	(80,401)
Net increase in loans	(20,510)	(26,198)	(19,993)
Net (increase) decrease in investments in restricted stock	(212)	617	(762)
Purchase of premises and equipment	(658)	(2,283)	(325)
Proceeds from sale or retirements of equipment	0	1	0
Proceeds from sale of other real estate	129	180	130
Net Cash Used in Investing Activities	(41,310)	(36,172)	(24,091)
CASH FLOWS FROM FINANCING ACTIVITIES			
Increase in deposits	38,770	43,838	3,255
Proceeds from long-term borrowings	0	5,000	11,275
Repayment of long-term borrowings	(941)	(3,843)	(9,266)
Net increase (decrease) in short-term borrowings	2,007	(4,416)	10,274
Proceeds from sale of treasury stock	85	234	163
Purchase of treasury stock	0	(506)	(94)
Cash dividends paid	(2,381)	(2,417)	(2,383)
Net Cash Provided by Financing Activities	37,540	37,890	13,224
Increase (Decrease) in Cash and Cash Equivalents	382	9,927	(3,774)
CASH AND CASH EQUIVALENTS - BEGINNING	18,533	8,606	12,380
CASH AND CASH EQUIVALENTS - ENDING	\$ 18,915	\$ 18,533	\$ 8,606

See notes to consolidated financial statements

Consolidated Statement of Cash Flows (Continued)

	Years Ended December 31,		
	2009	2008	2007
	(In Thousands)		
SUPPLEMENTARY CASH FLOWS INFORMATION			
Interest paid	\$ 8,461	\$ 8,430	\$ 10,833
Income taxes paid	<u>\$ 815</u>	<u>\$ 2,130</u>	<u>\$ 805</u>
SUPPLEMENTARY DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES			
Foreclosed real estate acquired in settlement of loans	<u>\$ 492</u>	<u>\$ 99</u>	<u>\$ 318</u>

See notes to consolidated financial statements

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. (the “Company”) and its wholly-owned subsidiaries, Peoples National Bank (the “Bank”), Peoples Advisors, LLC and Peoples Financial Capital Corporation. The Bank has two wholly owned subsidiaries, Peoples Financial Leasing, LLC and Peoples Investment Holdings, LLC. Peoples Financial Capital Corporation, Peoples Investment Holdings, LLC, and Peoples Financial Leasing, LLC were all incorporated in April of 2007. 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 eight Pennsylvania offices located in Hallstead, Hop Bottom, Susquehanna, Montrose, Nicholson, Meshoppen, Tunkhannock and Glenburn Township which are small communities in a rural setting. In October of 2008, the Company opened its eighth Pennsylvania office in Glenburn Township. This office is the Company’s first presence in Lackawanna County. 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. Peoples Financial Leasing, LLC provides employee leasing services to the Bank. Peoples Investment Holdings, LLC is incorporated in the state of Delaware and maintains and manages the intangible investments of the Bank and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware. Peoples Financial Capital Corporation is also incorporated in the state of Delaware and maintains and manages the intangible investments of the Company and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware.

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, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, the valuation of deferred tax assets, the potential impairment of restricted stock, and determination of other-than-temporary impairment losses on securities.

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.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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.

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 OTTI under the rules for accounting for certain debt and equity securities, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than amortized cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery.

Investment in Restricted Stock, at Cost

As a member of the Federal Home Loan Bank of Pittsburgh ("FHLB"), the Company is required to purchase and hold stock in the FHLB to satisfy membership and borrowing requirements. This stock is restricted in that it can only be sold to the FHLB or to another member institution, and all sales of FHLB stock must be at par. As a result of these restrictions, FHLB stock is unlike other investment securities insofar as there is no trading market for FHLB stock and the transfer price is determined by FHLB membership rules and not by market participants. As of December 31, 2009 and December 31, 2008, our FHLB stock totaled \$2,771,000 and \$2,559,000 respectively.

In December 2008, the FHLB voluntarily suspended dividend payments on its stock, as well as the repurchase of excess stock from members. The FHLB cited a significant reduction in the level of core earnings resulting from lower short-term interest rates, the increased cost of liquidity, and constrained access to the debt markets at attractive rates and maturities as the main reasons for the decision to suspend dividends and the repurchase of excess capital stock. The FHLB last paid a dividend in the third quarter of 2008.

FHLB stock is held as a long-term investment and its value is determined based on the ultimate recoverability of the par value. The Company evaluates impairment quarterly. The decision of whether impairment exists is a matter of judgment that reflects our view of the FHLB's long-term performance, which includes factors such as the following:

- Its operating performance;
- The severity and duration of declines in the fair value of its net assets related to its capital stock amount;
- Its commitment to make payments required by law or regulation and the level of such payments in relation to its operating performance;
- The impact of legislative and regulatory changes on the FHLB, and accordingly, on the members of FHLB; and
- Its liquidity and funding position

After evaluating all of these considerations, the Company concluded that the par value of its investment in FHLB stock will be recovered. Accordingly, no impairment charge was recorded on these securities for the year ended December 31, 2009. Our evaluation of the factors described above in future periods could result in the recognition of impairment charges on FHLB stock.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 collectability 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 collectability 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 collectability of the total contractual principal and interest is no longer in doubt.

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 \$770,000 and \$0 held for sale at December 31, 2009 and 2008, 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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:

	<u>Years</u>
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 \$560,000 and \$818,000 net of accumulated amortization of \$3,327,000 and \$3,069,000 at December 31, 2009 and 2008, respectively. Amortization expense was \$258,000 for 2009, \$258,000 for 2008 and \$255,000 for 2007. Amortization expense is estimated to be \$258,000 per year for the next two years and \$44,000 in 2012 as the fifteen-year amortization period expires.

Other Real Estate Owned

Other real estate owned is comprised of property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure and loans classified as in-substance foreclosure. 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.

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.

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, 2009, 2008, and 2007 was \$297,000, \$201,000 and \$154,000, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Earnings per Share

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect 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.

The following table shows the amounts used in computing earnings per share for the years ended December 31, 2009, 2008 and 2007:

	<u>Income Numerator</u>	<u>Common Shares Denominator</u>	<u>EPS</u>
	(In Thousands, Except Per Share Data)		
2009:			
Basic EPS	\$ 5,049	3,134	\$ 1.61
Dilutive effect of potential common stock, stock options (246 options)	<u>0</u>	<u>0</u>	<u>0</u>
Diluted EPS	<u>\$ 5,049</u>	<u>3,134</u>	<u>\$ 1.61</u>
2008:			
Basic EPS	\$ 3,039	3,128	\$.97
Dilutive effect of potential common stock, stock options (4,523 options)	<u>0</u>	<u>5</u>	<u>.00</u>
Diluted EPS	<u>\$ 3,039</u>	<u>3,133</u>	<u>\$.97</u>
2007:			
Basic EPS	\$ 4,871	3,136	\$ 1.55
Dilutive effect of potential common stock, stock options (9,984 options)	<u>0</u>	<u>10</u>	<u>.00</u>
Diluted EPS	<u>\$ 4,871</u>	<u>3,146</u>	<u>\$ 1.55</u>

Stock options for 22,179, 10,900, and 12,250 shares of common stock were anti-dilutive and not considered in computing diluted earnings per share for the years ended December 31, 2009, 2008, and 2007, respectively because they were considered anti-dilutive.

Comprehensive Income (Loss)

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 (loss).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The components of other comprehensive income (loss) and related tax effects for the years ended December 31, 2009, 2008 and 2007 are as follows:

	<u>2009</u>	<u>2008</u>	<u>2007</u>
	(In Thousands)		
Unrealized holding gains (losses) on available for sale securities	\$ 3,084	\$ (10,226)	\$ (1,629)
Reclassification adjustment for (gains) losses realized in net income	492	(128)	122
Reclassification adjustment for other than temporary impairment charges	206	5,256	0
Net Unrealized Gains (Losses)	<u>3,782</u>	<u>(5,098)</u>	<u>(1,507)</u>
Tax effect	<u>(1,285)</u>	<u>1,733</u>	<u>512</u>
Net of Tax Amount	<u>\$ 2,497</u>	<u>\$ (3,365)</u>	<u>\$ (995)</u>

Stock-Based Compensation

As of December 31, 2009 and 2008, all stock options were fully vested and there are no unrecognized compensation costs related to stock options. There were no stock options granted for the years ended December 31, 2009, 2008 and 2007, respectively.

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.

Peoples Financial Leasing, LLC provides employee leasing services to the Bank.

Segment Reporting (Continued)

Peoples Investment Holdings, LLC manages the intangible investments of the Bank and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware.

Peoples Financial Capital Corporation maintains and manages the intangible investments of the Company and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware.

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.

Subsequent Events

Effective April 1, 2009, the Company adopted ASC Topic 855 *Subsequent Events*. This topic establishes general standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. This topic sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements, identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that should be made about events or transactions that occur after the balance sheet date.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

New Accounting Standards

ASC Topic 105

In June 2009, the Financial Accounting Standards Board (FASB) issued ASC Topic 105, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162*. This topic replaces SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, to establish the *FASB Accounting Standards Codification* as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in preparation of financial statements in conformity with generally accepted accounting principles in the United States. This topic is effective for interim and annual periods ending after September 15, 2009. This guidance had no impact on the Company's consolidated financial statements upon adoption. Where applicable, all guidance in these financial statements refers to the codification references. ASC refers to Accounting Standards Codification and ASU refers to Accounting Standards Update.

ASU 2009-05

In August 2009, the FASB issued ASU 2009-05, *Fair Value Measurements and Disclosures (Topic 820): Measuring Liabilities at Fair Value*. The amendments within ASU 2009-05 clarify that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following techniques:

A valuation technique that uses:

- a. The quoted price of the identical liability when traded as an asset.
- b. Quoted prices for similar liabilities when traded as assets.

Another valuation technique that is consistent with the principles of Topic 820.

Two examples would be an income approach, such as a present value technique, or a market approach, such as a technique that is based on the amount at the measurement date that the reporting entity would pay to transfer the identical liability or would receive to enter into the identical liability.

When estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability.

Both a quoted price in an active market for the identical liability at the measurement date and the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements.

This guidance is effective for the first reporting period (including interim periods) beginning after issuance. The Company is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

ASU 2009-12

In September 2009, the FASB issued ASU 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. The amendments within ASU 2009-12:

- Create a practical expedient to measure the fair value of an investment in the scope of the amendments in this ASU on the basis of the net asset value per share of the investment (or its equivalent) determined as of the reporting entity's measurement date.
- Require disclosures by major category of investment about the attributes of those investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees.
- Improve financial reporting by permitting use of a practical expedient, with appropriate disclosures, when measuring the fair value of an alternative investment that does not have a readily determinable fair value.
- Improve transparency by requiring additional disclosures about investments in the scope of the amendments in this ASU to enable users of financial statements to understand the nature and risks of investments and whether the investments are probable of being sold at amounts different from net asset value per share.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

New Accounting Standards (Continued)

The ASU is effective for interim and annual periods ending after December 15, 2009. Early application is permitted in financial statements for earlier interim and annual periods that have not been issued. The adoption of this guidance had no effect on the Company's consolidated financial statements.

ASU 2009-16

In October 2009, the FASB issued ASU 2009-16, *Transfers and Servicing (Topic 860) - Accounting for Transfers of Financial Assets*. This Update amends the Codification for the issuance of FASB Statement No. 166, *Accounting for Transfers of Financial Assets-an amendment of FASB Statement No. 140*.

The amendments in this Update improve financial reporting by eliminating the exceptions for qualifying special-purpose entities from the consolidation guidance and the exception that permitted sale accounting for certain mortgage securitizations when a transferor has not surrendered control over the transferred financial assets. In addition, the amendments require enhanced disclosures about the risks that a transferor continues to be exposed to because of its continuing involvement in transferred financial assets. Comparability and consistency in accounting for transferred financial assets will also be improved through clarifications of the requirements for isolation and limitations on portions of financial assets that are eligible for sale accounting.

This Update is effective at the start of a reporting entity's first fiscal year beginning after November 15, 2009. Early application is not permitted. The Company is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

ASU 2010-01

In January 2010, the FASB issued ASU 2010-01, *Equity (Topic 505) - Accounting for Distributions to Shareholders with Components of Stock and Cash*. The amendments in this Update clarify that the stock portion of a distribution to shareholders that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in earnings per share prospectively and is not a stock dividend. This Update codifies the consensus reached in EITF Issue No. 09-E, "Accounting for Stock Dividends, Including Distributions to Shareholders with Components of Stock and Cash."

This Update is effective for interim and annual periods ending on or after December 15, 2009, and should be applied on a retrospective basis. The Company is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

ASU 2010-06

The FASB has issued ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. This ASU requires some new disclosures and clarifies some existing disclosure requirements about fair value measurement as set forth in Codification Subtopic 820-10. The FASB's objective is to improve these disclosures and, thus, increase the transparency in financial reporting. Specifically, ASU 2010-06 amends Codification. Subtopic 820-10 to now require:

- A reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; and
In the reconciliation for fair value measurements using significant unobservable inputs, a reporting entity should present separately information about purchases, sales, issuances, and settlements.

In addition, ASU 2010-06 clarifies the requirements of the following existing disclosures

- For purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; and
- A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

New Accounting Standards (Continued)

ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Early adoption is permitted. The Company is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

Reclassifications

Certain amounts in the 2008 and 2007 financial statements have been reclassified to conform to 2009 presentation. Those reclassifications had no effect on net income.

NOTE 2 – SECURITIES

At December 31, 2009 and 2008, the amortized cost and fair values of securities available-for-sale are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
December 31, 2009:				
U.S. Government agencies and corporations	\$ 60,989	\$ 103	\$ (627)	\$ 60,465
Obligations of state and political subdivisions	52,836	191	(1,483)	51,544
Taxable obligations of state and political subdivisions	2,219	20	(83)	2,156
Corporate debt securities	11,738	67	(1,471)	10,334
Mortgage-backed securities-residential	4,427	212	(2)	4,637
Collateralized mortgage obligation-residential	198	5	0	203
Preferred equity securities	78	7	(0)	85
Common equity securities	1,442	4	(364)	1,082
Total	\$ 133,927	\$ 609	\$ (4,030)	\$ 130,506
December 31, 2008:				
U.S. Government agencies and corporations	\$ 7,891	\$ 67	\$ 0	\$ 7,958
Obligations of state and political subdivisions	47,914	120	(3,319)	44,715
Taxable obligations of state and political subdivisions	3,166	0	(106)	3,060
Corporate debt securities	20,828	40	(3,898)	16,970
Mortgage-backed securities-residential	30,325	324	(47)	30,602
Collateralized mortgage obligation-residential	2,162	1	0	2,163
Preferred equity securities	78	0	(58)	20
Common equity securities	2,428	25	(352)	2,101
Total	\$ 114,792	\$ 577	\$ (7,780)	\$ 107,589

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SECURITIES (CONTINUED)

The amortized cost and fair value of securities as of December 31, 2009, 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.

	<u>Amortized Cost</u>	<u>Fair Value</u>
	(In Thousands)	
Due in one year or less	\$ 0	\$ 0
Due after one year through five years	40,771	40,366
Due after five years through ten years	31,347	29,908
Due after ten years	55,664	54,225
	<u>127,782</u>	<u>124,499</u>
Mortgage-backed securities-residential	4,427	4,637
Collateralized mortgage obligation-residential	198	203
Equity securities	1,520	1,167
	<u>\$ 133,927</u>	<u>\$ 130,506</u>

Proceeds from sale of available-for-sale securities during 2009, 2008 and 2007 were \$62,172,000, \$57,997,000, and \$60,489,000, respectively. Gross gains realized on these sales were \$879,000, \$412,000, and \$186,000, respectively. Gross losses on these sales were \$1,371,000, \$284,000, and \$308,000, respectively.

Securities with a carrying value of \$63,066,000 and \$43,313,000 at December 31, 2009 and 2008, respectively, were pledged to secure public deposits and repurchase agreements as required or permitted by law.

The following tables show the Company's 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, 2009 and 2008 (in thousands):

December 31, 2009:

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
US Govt./Agency	\$ 49,953	\$ (627)	\$ 0	\$ 0	\$ 49,953	\$ (627)
Obligations of state and political subdivisions	23,138	(322)	8,403	(1,161)	31,541	(1,483)
Taxable obligations of state and political subdivisions	716	(7)	417	(76)	1,133	(83)
Corporate debt securities	0	0	8,809	(1,471)	8,809	(1,471)
Mortgage-backed securities-residential	114	0	121	(2)	235	(2)
Common equity securities	343	(7)	619	(357)	962	(364)
Total Temporarily Impaired Securities	<u>\$ 74,264</u>	<u>\$ (963)</u>	<u>\$ 18,369</u>	<u>\$ (3,067)</u>	<u>\$ 92,633</u>	<u>\$ (4,030)</u>

December 31, 2008:

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
Obligations of state and political subdivisions	\$ 34,301	\$ (2,376)	\$ 2,570	\$ (943)	\$ 36,871	\$ (3,319)
Taxable obligations of state and political subdivisions	3,060	(106)	0	0	3,060	(106)
Corporate debt securities	8,752	(2,878)	7,420	(1,020)	16,172	(3,898)
Mortgage-backed securities-residential	11,242	(41)	1,305	(6)	12,547	(47)
Preferred equity securities	20	(58)	0	0	20	(58)
Common equity securities	166	(37)	687	(315)	853	(352)
Total Temporarily Impaired Securities	<u>\$ 57,541</u>	<u>\$ (5,496)</u>	<u>\$ 11,982</u>	<u>\$ (2,284)</u>	<u>\$ 69,523</u>	<u>\$ (7,780)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SECURITIES (CONTINUED)

At December 31, 2009, the Company had 44 (all less than 12 months) U.S. Government Agency securities with unrealized losses of \$627,000, 61 (47 less than 12 months, 14 greater than 12 months) obligations of state and political subdivisions with unrealized losses of \$1,566,000, 5 (3 less than 12 months, 2 greater than 12 months) mortgage-backed securities with unrealized losses of \$2,000, 6 (all greater than 12 months) corporate debt securities with unrealized losses of \$1,471,000, and 17 (2 less than 12 months, 15 greater than 12 months) common equity securities, with unrealized losses of \$364,000. The majority of the unrealized losses reflect changes in interest rates subsequent to the acquisition of the specific securities and management believes that these unrealized losses represent a temporary impairment of those securities. As long term rates increase, the underlying value of securities owned by the Company decreases, creating an unrealized loss.

The Company recorded other than temporary impairments of \$206,000 for the year ended December 31, 2009. These impairments were the result of writing down three common equity securities. These write-downs were measured based on public market prices. In reaching the determination to record these impairments, management reviewed the facts and circumstances available surrounding the securities, including the duration and amount of the unrealized loss, the financial condition of the issuer and the prospects for a change in market value within a reasonable period of time. Based on its assessment, management determined that the impairment was other-than-temporary and that a charge was appropriate for these securities. The entire charge was credit related and was recorded in operations.

None of the Company's corporate debt securities are private label trust preferred issuances. Rather, this portfolio contains corporate bond issuances in large, national financial institutions. The Company sold a corporate debt security (CIT Group, Inc.) in July 2009 for a \$1,229,000 loss. This security was sold due to a decline in the issuer's rating which occurred in July 2009.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. All of the Company's investment securities classified as available-for-sale are evaluated for OTTI under the rules for accounting for certain investments in debt and equity securities.

In determining OTTI under the rules for accounting for certain debt and equity securities, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than amortized cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on information available to management at a point in time. An OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

When an OTTI occurs under the model, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors shall be recognized in other comprehensive income, net of applicable tax benefit. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment. As of December 31, 2009, the Company does not intend to sell, and more likely than not, will not be required to sell, these securities before recovery. Management believes that the unrealized losses represent temporary impairment of the securities.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - LOANS RECEIVABLE

The composition of loans receivable at December 31, 2009 and 2008 is as follows:

	December 31,	
	2009	2008
	(In Thousands)	
Commercial	\$ 82,287	\$ 71,258
Real estate:		
Commercial	115,799	107,084
Residential	116,920	120,813
Consumer	20,802	16,988
	<u>335,808</u>	316,143
Unearned net loan origination fees and costs	495	465
Allowance for loan losses	(3,337)	(3,002)
	<u>\$ 332,966</u>	<u>\$ 313,606</u>

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

	Years Ended December 31,		
	2009	2008	2007
	(In Thousands)		
Balance, beginning	\$ 3,002	\$ 2,451	\$ 1,792
Provision for loan losses	1,735	713	280
Recoveries	147	84	452
Loans charged off	(1,547)	(246)	(73)
Balance, ending	<u>\$ 3,337</u>	<u>\$ 3,002</u>	<u>\$ 2,451</u>

The total recorded investment in impaired loans was \$3,326,000 and \$5,116,000 at December 31, 2009 and 2008, respectively. The required allowance for loan losses on these loans was \$559,000 and \$624,000 at December 31, 2009 and 2008, respectively. At December 31, 2009, impaired loans of \$2,393,000 required a specific reserve of \$559,000. At December 31, 2009 and 2008, impaired loans of \$933,000 and \$2,324,000 respectively, did not require a specific reserve. For the years ended December 31, 2009, 2008 and 2007, the average balance of these impaired loans was \$4,184,000, \$2,695,000, and \$496,000, 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.

The recorded investment of impaired loans at December 31, 2009 and 2008 included loans on which the accrual of interest has been discontinued of \$2,528,000 and \$602,000 respectively. If interest on non-accrual loans had been accrued throughout the period, interest income for the years ended December 31, 2009, 2008 and 2007, would have increased approximately \$135,000, \$26,000 and \$32,000 respectively. The amount of interest income on these loans that was included in net income for the years ended December 31, 2009, 2008 and 2007 was \$43,000, \$27,000, and \$15,000, respectively.

Loans outstanding to directors, executive officers, principal stockholders or to their affiliates totaled \$2,146,000 and \$2,665,000 at December 31, 2009 and 2008, respectively. Advances and repayments during 2009 totaled \$482,000 and \$1,001,000, 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, or restructured or were considered a potential credit risk at December 31, 2009 and 2008.

The Company has signed a participating member agreement to sell residential mortgages to Fannie Mae. The balance of loans sold as of December 31, 2009 to Fannie Mae is \$27,574,000. The Company continues to service loans that were sold to the FHLB of Pittsburgh ("FHLB"). The agreement, with FHLB, included 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 balance of loans sold as of December 31, 2009 to FHLB is \$7,601,000. 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - LOANS RECEIVABLE (CONTINUED)

The Company retains the servicing on the loans sold to Fannie Mae and FHLB and receives a fee based upon the principal balance outstanding. During the years ended 2009 and 2008, the Company recognized \$242,000 and \$60,000, respectively, of servicing assets and amortized \$76,000 and \$24,000, respectively. The balance outstanding was \$285,000 and \$119,000 at December 31, 2009 and 2008, respectively. The fair value of the servicing assets was \$285,000 and \$119,000 at December 31, 2009 and 2008, 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, 2009 and 2008 are comprised of the following:

	<u>2009</u>	<u>2008</u>
	(In Thousands)	
Land	\$ 805	\$ 805
Building and improvements	8,004	7,567
Furniture, fixtures and equipment	<u>6,784</u>	<u>6,595</u>
	15,593	14,967
Accumulated depreciation	<u>(8,084)</u>	<u>(7,425)</u>
	<u>\$ 7,509</u>	<u>\$ 7,542</u>

Depreciation expense was \$696,000, \$613,000, and \$636,000 for the years ended December 31, 2009, 2008 and 2007, respectively.

NOTE 5 - DEPOSITS

The composition of deposits at December 31, 2009 and 2008 were as follows:

	<u>2009</u>	<u>2008</u>
	(In Thousands)	
Demand:		
Non-interest bearing	\$ 71,835	\$ 55,324
Interest bearing	81,132	64,533
Savings	170,981	87,106
Time:		
\$100,000 and over	20,429	47,622
Less than \$100,000	<u>65,661</u>	<u>116,683</u>
	<u>\$ 410,038</u>	<u>\$ 371,268</u>

At December 31, 2009, the scheduled maturities of time deposits are as follows (in thousands):

2010	\$ 50,186
2011	9,442
2012	11,026
2013	9,727
2014	4,606
Thereafter	<u>1,103</u>
	<u>\$ 86,090</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2009, 2008 and 2007:

At and for the year ended December 31, 2009				
	Ending Balance	Average Balance	Maximum Month-End Balance	Average Rate
(Dollars In Thousands)				
Securities sold under agreements to repurchase	\$ 20,148	\$ 19,271	\$ 21,220	1.62%
Federal Home Loan Bank	0	280	3,670	0.80%
U.S. Treasury tax and loan notes	291	451	668	0.00%
	<u>\$ 20,439</u>	<u>\$ 20,002</u>	<u>\$ 25,558</u>	<u>1.57%</u>

At and for the year ended December 31, 2008				
	Ending Balance	Average Balance	Maximum Month-End Balance	Average Rate
(Dollars In Thousands)				
Securities sold under agreements to repurchase	\$ 17,351	\$ 12,775	\$ 17,351	2.10%
Federal Home Loan Bank	0	3,575	9,950	3.16%
U.S. Treasury tax and loan notes	1,081	524	1,081	1.45%
	<u>\$ 18,432</u>	<u>\$ 16,874</u>	<u>\$ 28,382</u>	<u>2.30%</u>

At and for the year ended December 31, 2007				
	Ending Balance	Average Balance	Maximum Month-End Balance	Average Rate
(Dollars In Thousands)				
Securities sold under agreements to repurchase	\$ 10,281	\$ 10,269	\$ 11,722	3.01%
Federal Home Loan Bank	11,965	6,029	12,716	5.07%
U.S. Treasury tax and loan notes	602	503	1,014	4.39%
	<u>\$ 22,848</u>	<u>\$ 16,801</u>	<u>\$ 25,452</u>	<u>3.79%</u>

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, 2009, the Bank had a maximum borrowing capacity for short-term and long-term advances of approximately \$152,330,000 of which \$38,750,000 was outstanding in short and 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 weighted average interest rate on securities sold under repurchase agreements at December 31, 2009 was 1.62%. Securities owned by the Company provide collateral for U.S. Treasury tax and loan notes.

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, 2009 and 2008. These borrowings are unsecured. The Bank also has a \$7,721,000 line of credit available with the Federal Reserve Bank of Philadelphia of which \$0 was outstanding at December 31, 2009 and 2008. These borrowings are secured with securities owned by the Bank.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7 - LONG-TERM BORROWINGS

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

<u>Due</u>	<u>Convertible</u>	<u>Strike Rate</u>	<u>Current Interest Rate</u>	<u>2009</u>	<u>2008</u>
(Dollars In Thousands)					
February 2009	N/A	N/A	4.80%	\$ 0	\$ 70
August 2010	N/A	N/A	4.85%	2,500	2,500
September 2011	N/A	N/A	5.05%	341	523
October 2011	January 2010	8.0%	4.47%	2,500	2,500
December 2011	N/A	N/A	4.12%	3,000	3,000
September 2012	March 2010	8.0%	3.69%	5,000	5,000
January 2013	February 2010	N/A	2.67%	5,000	5,000
February 2013	March 2010	8.0%	3.59%	5,000	5,000
June 2014	March 2010	8.0%	4.47%	5,000	5,000
January 2015	January 2010	8.0%	4.31%	5,000	5,000
November 2015	N/A	N/A	4.67%	1,423	1,627
February 2016	N/A	N/A	4.86%	740	840
February 2016	N/A	N/A	4.86%	740	841
February 2017	N/A	N/A	4.99%	2,506	2,790
				<u>\$ 38,750</u>	<u>\$ 39,691</u>

On convertible rate notes, the Federal Home Loan Bank has the option to convert the notes at rates ranging from the three-month LIBOR (0.25 % at December 31, 2009) plus .15 % 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.

Maturities of long-term debt, by contractual maturity, in years subsequent to December 31, 2009 are as follows (in thousands):

2010	\$ 3,414
2011	6,409
2012	5,797
2013	10,836
2014	5,878
Thereafter	6,416
	<u>\$ 38,750</u>

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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. There are 65,751 shares available for grant under this stock option plan as of December 31, 2009.

A summary of transactions under this Plan were as follows:

	2009		2008		2007	
	Options	Weighted Average Price	Options	Weighted Average Price	Options	Weighted Average Price
Outstanding, beginning of year	33,549	\$ 21.78	47,593	\$ 20.75	56,467	\$ 20.03
Granted	0	0	0	0	0	0
Exercised	(4,975)	17.10	(12,694)	15.84	(8,119)	16.54
Forfeited	(1,125)	26.63	(1,350)	30.78	(750)	30.78
Outstanding, end of year	<u>27,449</u>	<u>\$ 22.43</u>	<u>33,549</u>	<u>\$ 21.78</u>	<u>47,593</u>	<u>\$ 20.75</u>
Exercisable, end of year	<u>27,449</u>	<u>\$ 22.43</u>	<u>33,549</u>	<u>\$ 21.78</u>	<u>43,743</u>	<u>\$ 20.15</u>

The weighted-average remaining contractual life of the options outstanding is approximately 3 years at December 31, 2009. The weighted-average remaining contractual life of options exercisable at December 31, 2009 is approximately 3 years. Stock options outstanding at December 31, 2009 are exercisable at prices ranging from \$16.50 to \$34.10 a share. At December 31, 2009 the aggregate intrinsic value of options outstanding was \$0 and the aggregate intrinsic value of options exercisable was \$0. At December 31, 2008, the aggregate intrinsic value of options outstanding was \$0 and the aggregate intrinsic value of options exercisable was \$0. At December 31, 2007, the aggregate intrinsic value of options outstanding was \$264,000 and the aggregate intrinsic value of options exercisable was \$269,000. The aggregate intrinsic value of options exercised was \$2,000, \$96,000, and \$29,000 for the years ended December 31, 2009, 2008, and 2007.

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, 2009, there are 65,751 remaining shares available for issuance under the Dividend Reinvestment and Stock Purchase Plan.

NOTE 9 - INCOME TAXES

The Company adopted guidance in ASC Topic 740 regarding accounting for uncertainty in income taxes as of January 1, 2007. The Company has evaluated its tax positions as of January 1, 2007, December 31, 2007, December 31, 2008, and December 31, 2009, respectively. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that has a likelihood of being realized on examination of more than 50 percent. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. Under the "more-likely-than-not" threshold guidelines, the Company believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. As of January 1, 2007, December 31, 2007, December 31, 2008, and December 31, 2009, respectively, the Company had no material unrecognized tax benefits or accrued interest and penalties. The Company's policy is to account for interest as a component of interest expense and penalties as a component of other expense. The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of the Commonwealth of Pennsylvania and State of New York. The Company is no longer subject to examination by U.S. Federal taxing authorities for years before 2006 and for all state income taxes through 2006.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9 - INCOME TAXES (CONTINUED)

The provision for federal income taxes consists of the following:

	Years Ended December 31,		
	2009	2008	2007
	(In Thousands)		
Current	\$ (591)	\$ 1,824	\$ 1,180
Deferred	1,514	(1,737)	(83)
	<u>\$ 923</u>	<u>\$ 87</u>	<u>\$ 1,097</u>

The components of the net deferred tax asset at December 31, 2009 and 2008 are as follows:

	2009	2008
	(In Thousands)	
Deferred tax asset:		
Allowance for loan losses	\$ 753	\$ 734
Deferred loan fees	3	3
Deferred compensation	355	364
Other	92	32
Impairment on securities	413	1,871
Capital loss carry forward	15	152
Stock option expense	2	2
Alternative minimum tax credit	68	0
Impairment charge—other real estate owned	195	195
Unrealized loss on available for sale securities	1,164	2,449
	<u>3,060</u>	<u>5,802</u>
Deferred tax liabilities:		
Depreciation	(346)	(251)
Interest on preferred equity securities	(17)	(17)
Section 481 Adjustment-Prepaid Expenses	(68)	(112)
Section 481 Adjustment-Deferred Loan Costs	(256)	(250)
	<u>(687)</u>	<u>(630)</u>
Net Deferred Tax Asset	<u>\$ 2,373</u>	<u>\$ 5,172</u>

Management believes that future taxable income will satisfy this temporary difference between the current book value of the Company's assets and their taxable base. Core earnings of the Company have remained strong and will continue to support the recognition of the deferred tax asset based on future growth projections.

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:

	2009		2008		2007	
	Amount	% of Pretax Income	Amount	% of Pretax Income	Amount	% of Pretax Income
	(Dollars in Thousands)					
Federal income tax at statutory rate	\$ 2,030	34%	\$ 1,063	34%	\$ 2,029	34%
Tax exempt interest	(1,037)	(17)	(938)	(30)	(907)	(15)
Non-deductible interest	80	1	96	3	116	2
Officers' life insurance income	(115)	(2)	(101)	(3)	(111)	(2)
Other, net	(35)	(1)	(33)	(1)	(30)	(1)
	<u>\$ 923</u>	<u>15%</u>	<u>\$ 87</u>	<u>3%</u>	<u>\$ 1,097</u>	<u>18%</u>

The income tax provision includes (\$167,000), \$44,000, and (\$41,000), in 2009, 2008 and 2007, respectively, of income tax (benefit) expense on net realized securities gains and losses.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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. During 2009, 2008 and 2007, ESOP contributions to the Plan charged to operations were \$204,000, \$151,000, and \$167,000, respectively. During 2009, 2008 and 2007, employer 401(k) matching contributions to the Plan charged to operations were \$99,000, \$94,000 and \$80,000, respectively. At December 31, 2009, 157,326 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 operating officer and certain current and former directors that provide fixed retirement benefits. The Bank's deferred compensation liability as of December 31, 2009 and 2008 was \$1,043,000 and \$1,071,000, respectively. Payments to retired directors totaled \$90,000 for each of the years ended December 31, 2009, 2008 and 2007. The cost charged to operations for these deferred compensation plans was \$62,000, \$58,000, and \$59,000 for the years ended December 31, 2009, 2008 and 2007, respectively.

NOTE 11 – CONTINGENCIES

The Company is subject to lawsuits and claims arising out of its business. In the opinion of the Company's management, after review and consultation with counsel, any proceedings that may arise should not result in judgments, which, in the aggregate, would have a material adverse effect on the Company's consolidated financial statements.

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, 2009 and 2008 were as follows:

	<u>2009</u>	<u>2008</u>
	(In Thousands)	
Commitments to grant loans	\$ 5,714	\$ 8,892
Unfunded commitments under lines of credit	32,990	30,687
Standby letters of credit	15,691	5,259
	<u>\$ 54,395</u>	<u>\$ 44,838</u>

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, 2009 and 2008 was \$15,691,000 and \$5,259,000, respectively and the approximate value of underlying collateral upon liquidation that would be expected to cover this maximum potential exposure was \$12,214,000 and \$4,168,000, respectively. The current amount of the liability as of December 31, 2009 and 2008 for guarantees under standby letters of credit issued is not material.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2009 and 2008 was \$899,000 and \$576,000, 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, 2009, that the Company and Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2009, 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.

The Company and Bank's actual capital ratios as of December 31, 2009 and 2008, 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
As of December 31, 2009:						
Total capital (to risk-weighted assets):						
Consolidated	\$ 50,004	13.18%	\$ ≥30,358	≥8.00%	N/A	N/A
Peoples National Bank	45,560	12.07	≥30,202	≥8.00	\$ ≥37,753	≥10.00%
Tier 1 capital (to risk-weighted assets):						
Consolidated	46,668	12.30	≥15,179	≥4.00	N/A	N/A
Peoples National Bank	42,221	11.18	≥15,101	≥4.00	≥22,652	≥6.00
Tier 1 capital (to average assets):						
Consolidated	46,668	9.92	≥18,812	≥4.00	N/A	N/A
Peoples National Bank	42,221	8.68	≥19,449	≥4.00	≥24,311	≥5.00
As of December 31, 2008:						
Total capital (to risk-weighted assets):						
Consolidated	\$ 46,659	13.10%	\$ ≥28,490	≥8.00%	N/A	N/A
Peoples National Bank	42,402	12.00	≥28,261	≥8.00	\$ ≥35,326	≥10.00%
Tier 1 capital (to risk-weighted assets):						
Consolidated	43,657	12.26	≥14,245	≥4.00	N/A	N/A
Peoples National Bank	39,400	11.15	≥14,130	≥4.00	≥21,196	≥6.00
Tier 1 capital (to average assets):						
Consolidated	43,657	9.31	≥18,765	≥4.00	N/A	N/A
Peoples National Bank	39,400	8.45	≥18,648	≥4.00	≥23,310	≥5.00

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 re-evaluated 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.

In September 2006, the Financial Accounting Standards Board ("FASB") issued ASC Topic 860, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. This topic applies to other accounting pronouncements that require or permit fair value measurements. The Company adopted this topic effective for its fiscal years beginning January 1, 2008.

In December 2007, the FASB issued ASC Topic 320, *Effective Date of ASC Topic 860*. ASC Topic 320 delays the effective date of ASC Topic 860 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. As such, the Company only partially adopted the provisions of ASC Topic 860 in 2008 and began to account and report for non-financial assets and liabilities in 2009. In October 2008, the FASB issued ASC Topic 820, *Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active*, to clarify the application of the provisions of ASC Topic 860 in an inactive market and how an entity would determine fair value in an inactive market. The adoption of ASC Topic 860 and ASC Topic 820 had no impact on the amounts reported in the consolidated financial statements.

ASC 860 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC Topic 860 are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2009 and December 31, 2008 are as follows:

Description	December 31, 2009	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
(In Thousands)				
December 31, 2009 Securities available for sale	\$ 130,506	\$ 1,081	\$ 129,425	\$ 0
December 31, 2008 Securities available for sale	\$ 107,589	\$ 1,010	\$ 105,488	\$ 1,091

The following table presents a reconciliation of the securities available for sale measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2009:

(In Thousands)	2009
Beginning balance, January 1	\$ 1,091
Exchange of common stock available for sale security for common stock in another institution	(1,091)
Ending balance, December 31	\$ 0

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14 - FAIR VALUE OF FINANCIAL INSTRUMENTS

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2009 and December 31, 2008 are as follows:

Description	December 31, 2009	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
(In Thousands)				
December 31, 2009 Impaired loans	\$ 1,834	\$ 0	\$ 0	\$ 1,834
December 31, 2009 Other real estate owned	\$ 5,534	\$ 0	\$ 0	\$ 5,534
December 31, 2008 Impaired loans	\$ 2,168	\$ 0	\$ 0	\$ 2,168
December 31, 2008 Other real estate owned	\$ 5,171	\$ 0	\$ 0	\$ 5,171

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, 2009 and 2008:

Cash and Cash Equivalents (Carried at Cost)

The carrying amounts reported in the balance sheet for cash and short-term instruments approximate those assets' fair values.

Securities Available for Sale (Carried at Fair Value)

The fair value of securities available for sale are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) were used to support fair values of certain Level 3 investments.

Loans Receivable (Carried at Cost)

The fair values of loans, excluding impaired loans with specific loss allowances, are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

Impaired Loans (Generally Carried at Fair Value)

Impaired loans are those for which the Bank has measured and recorded impairment, generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of the loan balances of \$2,393,000, net of a valuation allowance of \$559,000. At December 31, 2008, the fair value consists of the loan balances of \$2,792,000, net of a valuation allowance of \$624,000.

Restricted Investment in Bank Stock (Carried at Cost)

The carrying amount of restricted investment in bank stock (included in securities) approximates fair value, and considers the limited marketability of such securities.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14 - FAIR VALUE OF FINANCIAL INSTRUMENTS

Accrued Interest Receivable and Payable (Carried at Cost)

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

Deposit Liabilities (Carried at Cost)

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Short-Term Borrowings (Carried at Cost)

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

Long-Term Debt (Carried at Cost)

Fair values of FHLB advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

Off-Balance Sheet Financial Instruments (Disclosed at Cost)

Fair values for the Company's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

The estimated fair values of the Company's financial instruments were as follows at December 31, 2009 and 2008.

	<u>December 31, 2009</u>		<u>December 31, 2008</u>	
	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
	(In Thousands)			
Financial assets:				
Cash and cash equivalents	\$ 18,915	\$ 18,915	\$ 18,533	\$ 18,533
Securities available-for-sale	130,506	130,506	107,589	107,589
Loans receivable, net	332,966	383,273	313,606	364,501
Investment in restricted stock	2,870	2,870	2,658	2,658
Accrued interest receivable	2,580	2,580	2,526	2,526
Financial liabilities:				
Deposits	410,038	411,043	371,268	373,147
Short-term borrowings	20,439	20,439	18,432	18,432
Long-term borrowings	38,750	39,255	39,691	40,283
Accrued interest payable	446	446	1,649	1,649
Off-balance sheet items:				
Commitments to grant loans	-	-	-	-
Unfunded commitments under lines of credit	-	-	-	-
Standby letters of credit	-	-	-	-

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 - PARENT COMPANY ONLY FINANCIAL INFORMATION

Balance Sheets

	December 31,	
	2009	2008
	(In Thousands)	
ASSETS		
Cash	\$ 1,285	\$ 918
Investment in bank subsidiary	35,362	30,313
Investment in non-bank subsidiary	5,472	5,576
Due from subsidiaries	1,694	713
Securities available for sale	1,081	2,102
Other assets	155	155
Total Assets	\$ 45,049	\$ 39,777
LIABILITIES AND STOCKHOLDERS' EQUITY		
Other liabilities	\$ 79	\$ 57
Stockholders' equity:		
Common stock	6,683	6,683
Surplus	3,098	3,100
Retained earnings	42,043	39,375
Accumulated other comprehensive loss	(2,258)	(4,755)
	<u>49,566</u>	<u>44,403</u>
Treasury stock	(4,596)	(4,683)
Total Stockholders' Equity	\$ 44,970	\$ 39,720
Total Liabilities and Stockholders' Equity	\$ 45,049	\$ 39,777

Statements of Income

	Years Ended December 31,		
	2009	2008	2007
	(In Thousands)		
Dividends from bank subsidiary	\$ 2,381	\$ 2,729	\$ 2,493
Other income	663	492	166
Other expenses	606	817	78
	<u>2,438</u>	<u>2,404</u>	<u>2,581</u>
Income tax expense	45	0	30
	<u>2,393</u>	<u>2,404</u>	<u>2,551</u>
Undistributed net income of subsidiaries	2,656	635	2,320
Net Income	\$ 5,049	\$ 3,039	\$ 4,871

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 - PARENT COMPANY ONLY FINANCIAL INFORMATION (CONTINUED)

Statement of Cash Flows

	Years Ended December 31,		
	2009	2008	2007
	(In Thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 5,049	\$ 3,039	\$ 4,871
Adjustments to reconcile net income to net cash provided by operating activities:			
Net realized losses (gains) on sales of securities	(263)	14	(63)
Other than temporary security impairment	206	388	0
Stock option expense	0	1	3
Undistributed net income of subsidiaries	(2,656)	(635)	(2,320)
(Increase) decrease in other assets	0	34	(10)
Increase (Decrease) in due from subsidiaries	(716)	(48)	52
Net Cash Provided by Operating Activities	1,620	2,793	2,533
CASH FLOWS PROVIDED BY INVESTING ACTIVITIES			
Proceeds from sale of available for sale securities	1,043	298	479
Purchase of available-for-sale securities	0	(19)	(987)
Net Cash Provided by (Used In) Investing Activities	1,043	279	(508)
CASH FLOWS FROM FINANCING ACTIVITIES			
Cash dividends paid	(2,381)	(2,417)	(2,383)
Proceeds from sale of treasury stock	85	234	163
Purchase of treasury stock	0	(506)	(94)
Net Cash Used in Financing Activities	(2,296)	(2,689)	(2,314)
Increase (Decrease) in Cash and Cash Equivalents	367	383	(289)
CASH AND CASH EQUIVALENTS - BEGINNING	918	535	824
CASH AND CASH EQUIVALENTS - ENDING	\$ 1,285	\$ 918	\$ 535

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; and
- 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 control over financial reporting, including disclosure controls and procedures, as of December 31, 2009. 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 through 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 independent public accountants.

The consolidated financial statements of the Company have been audited by ParenteBeard LLC, 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, ParenteBeard LLC 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 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 Peoples Financial Services Corp. and subsidiaries (the “Company”) internal control over financial reporting as of December 31, 2009, 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 included in the accompanying Management’s Report on Internal Control. Our responsibility is to express an opinion on 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 of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included 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, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, 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, 2009 and 2008 and the related consolidated statements of income, stockholders’ equity, and cash flows for each of the years in the three year period ended December 31, 2009, and our report dated March 15, 2010, expressed an unqualified opinion.

/s/ PARENTEBEARD LLC

ParenteBeard LLC
Allentown, Pennsylvania
March 15, 2010

(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, 2009 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 TRANSACTIONS, 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

- (3.1) Articles of Incorporation of Peoples Financial Services Corp. (1);
- (3.2) Bylaws of Peoples Financial Services Corp. as amended (2);
- (10.4) Termination Agreement dated January 1, 1997, between Debra E. Dissinger and Peoples Financial Services Corp.(1);
- (10.6) Supplemental Executive Retirement Plan Agreement, dated December 3, 2004, for Debra E. Dissinger(3)*;
- (10.7) Supplemental Director Retirement Plan Agreement, dated December 3, 2004, for all Non-Employee Directors of the Company(3)*;
- (10.9) Amendment to Supplemental Executive Retirement Plan Agreement, dated December 30, 2005, for Debra E. Dissinger(4)*;
- (10.10) Amendment to Supplemental Director Retirement Plan Agreement, dated December 30, 2005, for all Non-Employee Directors of the Company(4)*;
- (10.11) Termination Agreement dated January 1, 2007, between Stephen N. Lawrenson and Peoples Financial Services Corp.(6)*;
- (10.12) Termination Agreement dated January 1, 2007, between Joseph M. Ferretti and Peoples Financial Services Corp.(6)*;
- (10.13) Employment Agreement dated February, 2007, between Richard S. Lochen, Jr. and Peoples Financial Services Corp.(5)*;
- (10.14) Termination Agreement dated October 23, 2009, between Frederick J. Malloy and Peoples Financial Services Corp.(9)*;
- (10.15) Employment Agreement dated November 30, 2009, between Alan W. Dakey and Peoples Financial Services Corp.(10)*;
- (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 Share";
- (14) Code of Ethics, as amended(8);
- (21) Subsidiaries of Peoples Financial Services Corp.(7);
- (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.

- (1) Incorporate 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.
- (2) Incorporated by reference to the Corporation's Exhibit 3.2 on Form 10-Q filed with the U.S. Securities and Exchange Commission on November 8, 2004.
- (3) Incorporated by reference to the Corporation's Exhibits 10.6 and 10.7 on Form 10-K filed with the U.S. Securities and Exchange Commission on March 15, 2005.
- (4) Incorporated by reference to the Corporation's Exhibits 10.9, and 10.10 on Form 10-K filed with the U.S. Securities and Exchange Commission on March 15, 2006.
- (5) Incorporated by reference to the Corporation's Exhibit 10.13 on Form 8K filed with the U.S. Securities and Exchange Commission on February 16, 2007.
- (6) Incorporated by reference to the Corporation's Exhibits 10.11 and 10.12 on Form 10-Q filed with the U.S. Securities and Exchange Commission on May 10, 2007.
- (7) Incorporated by reference to the Corporation's Exhibit 21 on Form 10-Q filed with the U.S. Securities and Exchange Commission on August 9, 2007.
- (8) Incorporated by reference to the Corporation's Exhibit 14 as filed on Form 10Q with the U.S. Securities and Exchange Commission on August 11, 2008.
- (9) Incorporated by reference to the Corporation's Exhibit 10.14 on Form 8K filed with the U.S. Securities and Exchange Commission on October 27, 2009.
- (10) Incorporated by reference to the Corporation's Exhibit 10.15 on Form 8K filed with the U.S. Securities and Exchange Commission on November 17, 2009.

* Exhibit is Compensatory.

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/William E. Aubrey II
William E Aubrey II, Chairman, Board of Directors

/s/Alan W. Dakey
Alan W. Dakey, President/CEO

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

/s/Frederick J. Malloy
Frederick J. Malloy, VP/Controller

/s/Richard S. Lochen, Jr.
Richard S. Lochen, Jr. Member, Board of Directors

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

/s/Ronald G. Kukuchka
Ronald G. Kukuchka, Member, Board of Directors

/s/Joseph T. Wright, Jr.
Joseph T. Wright, Jr., Member, Board of Directors

/s/Earle A. Wootton
Earle A. Wootton, Member, Board of Directors

