

***NEFFS BANCORP, INC.***

CONSOLIDATED FINANCIAL REPORT

DECEMBER 31, 2008

***DIRECTORS of the CORPORATION  
and BANK***

Robert B. Heintzelman

John J. Remaley

Duane A. Schleicher

Kevin A. Schmidt

John F. Sharkey, Jr.

John F. Simock

Herman P. Snyder

Mary Ann Wagner

***OFFICERS of the CORPORATION***

John J. Remaley

*President*

Herman P. Snyder

*Vice President*

Kevin A. Schmidt

*Treasurer*

David C. Matulevich

*Secretary*

Michael J. Bailey

*Assistant Secretary*

***OFFICERS of the BANK***

Herman P. Snyder

*Chairman of the Board*

John J. Remaley

*President*

Kevin A. Schmidt

*Executive Vice President*

*and*

*Chief Executive Officer*

Michael J. Bailey

*Cashier and  
Chief Operations Officer*

Carol L. Jones

*Assistant Cashier and  
Operations Officer*

Dear Shareholder:

Opening last year's Annual Shareholders' letter, I began, "If the word "uncertainty" adequately describes the future – whether it is days, weeks, months or years – 2007 proved to be a period of uncertainty." Those same words and phrases could be used to describe banking during 2008, because the profession only deteriorated further into uncertainty. In an attempt to stabilize not only the banks, but the entire economy, the federal government invested billions of its "resources" which ultimately had little effect. We learned new acronyms in the process – "TARP – Troubled Asset Relief Program" being one most-often mentioned, because some of our contemporaries finally admitted that their corporate balance sheets contained figures representing assets of little value, or which might not be assets at all.

Your organization refused the funds distributed under the federal government's program, and reached its new status - nearly \$239,000,000.00 in total assets – and achieving in excess of \$3,000,000.00 in profitability. Several years ago, in a company referred to in a television advertisement, the company executive touted that their profits were "earned the old-fashioned way. They earned it!" Your management team works the same way, and takes pride in recording exceptional results.

The projections for the current year, developed under the guidance of the board of directors, include allowances for the challenges already being experienced. However, with the prudent processes instituted some time ago, high confidence exists, and the uncontrollable outside forces appear to be manageable.

Your confidence, evidenced by your investment in the organization, is sincerely appreciated. If you have not yet done so, why not invite your family, friends and neighbors to participate in furthering the success of the corporation?

Cordially yours,

John J. Remaley  
President & CEO

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# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

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## **TABLE OF CONTENTS**

### **PAGE NO.**

#### **CONSOLIDATED FINANCIAL STATEMENTS:**

Report of Independent Registered Public Accounting Firm	1
Consolidated Statements of Financial Condition	2
Consolidated Statements of Income	3
Consolidated Statements of Stockholders' Equity	4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Statements	6
Selected Financial Data	28
Quarterly Summary of Financial Data	29
Common Stock Information	30
Management's Discussion and Analysis of Financial Condition and Results of Operations	31



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Neffs Bancorp, Inc. and Subsidiary  
Neffs, Pennsylvania

We have audited the accompanying consolidated statements of financial condition of Neffs Bancorp, Inc. and subsidiary as of December 31, 2008 and 2007, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 Neffs Bancorp, Inc. and subsidiary as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

/s/Beard Miller Company LLP

Beard Miller Company LLP  
Allentown, Pennsylvania  
March 19, 2009

# NEFFS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	December 31,	
	2008	2007
	(In Thousands, Except Share Data)	
<b>ASSETS</b>		
Cash and cash equivalents	\$ 2,489	\$ 3,888
Interest bearing deposits with banks	109	118
Federal funds sold	1,379	-
Securities available for sale	37,950	35,680
Securities held to maturity, fair value 2008 \$89,111; 2007 \$87,896	91,557	86,811
Loans receivable, net of allowance for loan losses 2008 \$761; 2007 \$620	100,192	93,990
Premises and equipment, net	2,326	2,347
Restricted investments in bank stock	803	714
Other assets	1,977	2,249
<b>Total Assets</b>	<b>\$238,782</b>	<b>\$225,797</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities:		
Deposits:		
Non-interest bearing	\$ 16,740	\$ 17,205
Interest bearing	176,198	163,186
Total Deposits	192,938	180,391
Federal funds purchased	-	2,249
Other liabilities	1,315	1,327
<b>Total Liabilities</b>	<b>194,253</b>	<b>183,967</b>
Stockholders' equity:		
Common stock, \$1 par value; authorized 2,500,000 shares; issued 200,000 shares; outstanding shares 2008 189,250; 2007 190,755	200	200
Paid-in capital	753	753
Retained earnings	45,836	43,558
Accumulated other comprehensive gain (loss)	442	(373)
Treasury stock, at cost 2008 10,750 shares; 2007 9,245 shares	(2,702)	(2,308)
<b>Total Stockholders' Equity</b>	<b>44,529</b>	<b>41,830</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$238,782</b>	<b>\$225,797</b>

*See notes to consolidated financial statements.*

# NEFFS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,		
	2008	2007	2006
	(Dollars in Thousands, Except per Share Data)		
<b>INTEREST INCOME</b>			
Interest and fees on loans	\$ 6,456	\$ 5,988	\$ 5,419
Interest and dividends on investments:			
Taxable	4,876	4,086	3,546
Exempt from federal income taxes	1,528	1,783	1,975
Interest on federal funds sold and other	12	78	51
<b>Total Interest Income</b>	<b>12,872</b>	<b>11,935</b>	<b>10,991</b>
<b>INTEREST EXPENSE</b>			
Deposits	6,099	6,085	5,115
Federal funds purchased	23	4	14
<b>Total Interest Expense</b>	<b>6,122</b>	<b>6,089</b>	<b>5,129</b>
<b>Net Interest Income</b>	<b>6,750</b>	<b>5,846</b>	<b>5,862</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>145</b>	<b>-</b>	<b>-</b>
<b>Net Interest Income after Provision for Loan Losses</b>	<b>6,605</b>	<b>5,846</b>	<b>5,862</b>
<b>OTHER INCOME</b>			
Service charges on deposit accounts	130	136	144
Other service charges and fees	98	91	66
Other income	49	44	48
<b>Total Other Income</b>	<b>277</b>	<b>271</b>	<b>258</b>
<b>OTHER EXPENSES</b>			
Salaries and employee benefits	1,427	1,367	1,347
Occupancy	190	175	162
Furniture and equipment	233	256	243
Pennsylvania shares tax	423	403	381
Other expenses	743	678	676
<b>Total Other Expenses</b>	<b>3,016</b>	<b>2,879</b>	<b>2,809</b>
<b>Income before Income Taxes</b>	<b>3,866</b>	<b>3,238</b>	<b>3,311</b>
<b>INCOME TAX (BENEFIT) EXPENSE</b>			
Current	724	560	574
Deferred	105	(23)	(86)
<b>Total Income Tax Expense</b>	<b>829</b>	<b>537</b>	<b>488</b>
<b>Net Income</b>	<b>\$ 3,037</b>	<b>\$ 2,701</b>	<b>\$ 2,823</b>
<b>EARNINGS PER SHARE, BASIC</b>	<b>\$ 16.00</b>	<b>\$ 13.79</b>	<b>\$ 14.26</b>
<b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING</b>	<b>189,861</b>	<b>195,893</b>	<b>197,941</b>

*See notes to consolidated financial statements.*

# NEFFS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years Ended December 31, 2008, 2007 and 2006

	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
(Dollars in Thousands, Except per Share Data)						
<b>BALANCE - DECEMBER 31, 2005</b>	200	753	39,603	(844)	(418)	39,294
Comprehensive income:						
Net income	-	-	2,823	-	-	2,823
Change in unrealized net gains (losses) on securities available for sale, net of taxes	-	-	-	(103)	-	(103)
<b>Total Comprehensive Income</b>						2,720
Cash dividends declared on common stock, \$4.00 per share	-	-	(792)	-	-	(792)
<b>BALANCE - DECEMBER 31, 2006</b>	200	753	41,634	(947)	(418)	41,222
Comprehensive income:						
Net income	-	-	2,701	-	-	2,701
Change in unrealized net gains (losses) on securities available for sale, net of taxes	-	-	-	574	-	574
<b>Total Comprehensive Income</b>						3,275
Cash dividends declared on common stock, \$4.00 per share	-	-	(777)	-	-	(777)
Purchase of treasury stock (7,186 shares)	-	-	-	-	(1,890)	(1,890)
<b>BALANCE - DECEMBER 31, 2007</b>	200	753	43,558	(373)	(2,308)	41,830
Comprehensive income:						
Net income	-	-	3,037	-	-	3,037
Change in unrealized net gains (losses) on securities available for sale, net of taxes	-	-	-	815	-	815
<b>Total Comprehensive Income</b>						3,852
Cash dividends declared on common stock, \$4.00 per share	-	-	(759)	-	-	(759)
Purchase of treasury stock (1,505 shares)	-	-	-	-	(394)	(394)
<b>BALANCE - DECEMBER 31, 2008</b>	<b>\$200</b>	<b>\$753</b>	<b>\$45,836</b>	<b>\$442</b>	<b>\$(2,702)</b>	<b>\$44,529</b>

*See notes to consolidated financial statements.*

# NEFFS BANCORP, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOW

	Years Ended December 31,		
	2008	2007	2006
	(In Thousands)		
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income	\$ 3,037	\$ 2,701	\$ 2,823
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	193	205	214
Provision for loan loss	145	-	-
Net amortization (accretion) of securities	(512)	(92)	130
Deferred income tax expense (benefit)	105	(23)	(86)
(Increase) decrease in assets:			
Accrued interest receivable	(86)	7	(204)
Other assets	(167)	67	(52)
Increase (decrease) in liabilities:			
Accrued interest payable	(23)	139	201
Other liabilities	11	(8)	18
<b>Net Cash Provided by Operating Activities</b>	<b>2,703</b>	<b>2,996</b>	<b>3,044</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Net decrease in interest bearing deposits with banks	9	26	19
Net (increase) decrease in federal funds sold	(1,379)	-	2,348
Purchases of securities available for sale	(7,961)	(5,183)	(1,806)
Purchases of securities held to maturity	(39,150)	(12,935)	(10,343)
Proceeds from maturities/calls and principal repayments of securities available for sale	6,851	6,335	6,899
Proceeds from maturities/calls of securities held to maturity	34,991	10,615	4,977
Net increase in restricted investment in bank stock	(89)	(63)	(82)
Net increase in loans	(6,347)	(6,572)	(5,033)
Purchases of premises and equipment	(172)	(47)	(170)
<b>Net Cash Used in Investing Activities</b>	<b>(13,247)</b>	<b>(7,824)</b>	<b>(3,191)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Net increase (decrease) in deposits	12,547	7,290	(175)
Net increase(decrease) in federal funds purchased	(2,249)	1,892	357
Dividends paid	(759)	(777)	(792)
Purchase of treasury stock	(394)	(1,890)	-
<b>Net Cash Provided by (Used in) Financing Activities</b>	<b>9,145</b>	<b>6,515</b>	<b>(610)</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>(1,399)</b>	<b>1,687</b>	<b>(757)</b>
<b>CASH AND CASH EQUIVALENTS - BEGINNING</b>	<b>3,888</b>	<b>2,201</b>	<b>2,958</b>
<b>CASH AND CASH EQUIVALENTS - ENDING</b>	<b>\$ 2,489</b>	<b>\$ 3,888</b>	<b>\$ 2,201</b>
<b>SUPPLEMENTARY CASH FLOWS INFORMATION</b>			
Interest paid	\$ 6,145	\$ 5,950	\$ 4,928
Income taxes paid	\$ 901	\$ 614	\$ 531

*See notes to consolidated financial statements.*

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES**

#### **Basis of Presentation**

The accompanying consolidated financial statements include the accounts of Neffs Bancorp, Inc. (the “Corporation”) and its wholly-owned subsidiary, The Neffs National Bank (the “Bank”). All material intercompany transactions have been eliminated.

#### **Nature of Operations**

The Bank operates from one location in Lehigh County, Pennsylvania. The Bank provides a full range of financial services to individuals, small businesses and corporate customers. The primary source of revenue is interest and fees earned from providing residential mortgages, consumer loans and commercial loans to customers located within the Lehigh Valley. The Bank’s primary deposits are checking accounts, savings accounts and certificates of deposit. As a national bank, the Bank is subject to regulation of the Office of the Comptroller of Currency and the Federal Deposit Insurance Corporation. The Corporation is also subject to regulations of the Federal Reserve Bank.

#### **Estimates**

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and income and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant changes in the near term relate to the determination of the allowance for loan losses, the valuation of deferred tax assets, and the determination of other than temporary impairment of securities.

#### **Significant Concentrations of Credit Risk**

Most of the Corporation’s activities are with customers located within the Lehigh Valley of Pennsylvania. Note 3 discusses the types of securities that the Corporation invests in. Note 4 discusses the types of lending that the Corporation engages in. The Corporation does not have any significant concentrations to any one industry or customer. Although, the Corporation has a diversified loan portfolio, exposure to credit loss can be adversely impacted by downturns in local economic and employment conditions.

#### **Securities**

Securities classified as held to maturity are those debt securities the Corporation has both the intent and ability to hold to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost adjusted for the amortization of premium and accretion of discount, computed by the interest method over the terms of the securities.

Securities classified as available for sale are those debt securities that the Corporation 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 movement in interest rates, changes in the maturity mix of the Corporation'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 (loss), 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 terms of the securities.

# **NEFFS BANCORP, INC. AND SUBSIDIARY**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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Management determines the appropriate classification of debt securities at the time of purchase and re-evaluates such designation as of each balance sheet date.

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

### **Restricted Investment in Bank Stocks**

Restricted stocks include primarily Federal Home Loan Bank stock, which is carried at cost. Federal law requires a member institution of the Federal Home Loan Bank system to hold stock of its district Federal Home Loan Bank according to a predetermined formula.

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 Statement of Position (SOP) 01-6, *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 declines 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 the 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, 2008.

### **Loans**

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. Interest income is accrued on the unpaid principal balance.

The accrual of interest is generally discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual 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 nonaccrual loans generally is either applied against principal or reported as interest income, according to management's judgment as to the collectibility of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectibility of the total contractual principal and interest is no longer in doubt.

### **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.

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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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 Corporation's past loan loss experience, known and 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 material estimates that may be 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 of 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 Corporation 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 net realizable value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual residential and consumer loans for impairment disclosures, unless such loans are subject of a restructuring agreement.

### **Foreclosed Assets**

Foreclosed assets are comprised of property acquired through a foreclosure proceeding or acceptance of a deed in lieu of foreclosure and loans classified as in-substance foreclosure. The Corporation includes such property in other assets. A loan is classified as in-substance foreclosure when the Corporation 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. After foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value minus estimated costs to sell. Revenues and expenses from operations and changes in the valuation allowance are included in other expenses. The Corporation had no foreclosed assets as of December 31, 2008 and December 31, 2007.

### **Transfers of Financial Assets**

Transfers of financial assets, including sales of loan participations, 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 Corporation, (2) the transferee obtains the right (free of conditions that

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### **Premises and Equipment**

Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation is computed on the straight-line method over the estimated useful lives of the premises and equipment. Charges for maintenance and repairs are expensed as incurred.

### **Advertising Costs**

The Corporation follows the policy of charging the costs of advertising to expense as incurred. Total advertising expense for the years ended December 31, 2008, 2007 and 2006 was \$42,000, \$28,000 and \$46,000, respectively.

### **Income Taxes**

Deferred 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. The Corporation files a consolidated federal income tax return.

### **Earnings per Share**

Earnings per share is based on the weighted average shares of common stock outstanding during each year. The Corporation currently maintains a simple capital structure, thus there are no dilutive effects on earnings per share.

### **Employee Benefit Plan**

The Bank has a non-contributory defined contribution pension plan covering all employees having at least one year of service. Contribution amounts are determined annually by the Corporation and are charged to current operating expense. The expense amounted to \$60,000, \$58,000 and \$59,000, for 2008, 2007 and 2006, respectively.

### **Comprehensive Income**

Accounting principles generally 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 statement of financial condition, such items, along with net income, are components of comprehensive income.

### **Cash and Cash Equivalents**

For purposes of reporting cash flows, the Corporation has defined cash and cash equivalents as cash on hand and amounts due from banks, all of which mature within ninety days.

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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### **Treasury Stock**

The acquisition of treasury stock is recorded under the cost method. At the date of subsequent reissue, the treasury stock is reduced by the cost of such stock on the first-in first-out basis with any excess proceeds being credited to paid-in-capital.

### **Segment Reporting**

The Corporation acts as an independent community financial services provider and offers traditional banking and related financial services to individual, business and government customers. The Corporation 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 Corporation. As such, discrete information is not available and segment reporting would not be meaningful.

### **New Accounting Standards**

The Corporation adopted FASB Statement No. 157 “Fair Value Measurements” (SFAS 157) effective January 1, 2008 for financial assets and liabilities that are measured and reported at fair value. There was no impact from the adoption of SFAS 157 on the amounts reported in the consolidated financial statements. The primary effect of SFAS 157 on the Corporation was to expand the required disclosures pertaining to the methods used to determine fair values.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities-Including an Amendment of FASB Statement No. 115.” SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective for our Corporation January 1, 2008. The implementation of this standard did not have a material impact on our consolidated financial position or results of operations because the Corporation did not apply the provisions of FAS 159 to any financial assets or liabilities.

In September 2008, the FASB ratified EITF Issue No. 08-5, “Issuer’s Accounting for Liabilities Measured at Fair Value With a Third-Party Credit Enhancement” (EITF 08-5). EITF 08-5 provides guidance for measuring liabilities issued with an attached third-party credit enhancement (such as a guarantee). It clarifies that the issuer of a liability with a third-party credit enhancement should not include the effect of the credit enhancement in the fair value measurement of the liability. EITF 08-5 is effective for the first reporting period beginning after December 15, 2008. The Corporation does not expect the implementation of this standard to have a material impact on our consolidated financial position or results of operations.

In May 2008, the FASB issued FAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. FAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). FAS No. 162 will become effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. The Corporation does not expect the adoption of FAS No. 162 to have a material effect on its results of operations and financial position.

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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In February 2008, the FASB issued a FASB Staff Position (FSP) FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." This FSP addresses the issue of whether or not these transactions should be viewed as two separate transactions or as one "linked" transaction. The FSP includes a "rebuttable presumption" that presumes linkage of the two transactions unless the presumption can be overcome by meeting certain criteria. The FSP will be effective for fiscal years beginning after November 15, 2008 and will apply only to original transfers made after that date; early adoption will not be allowed. The implementation of this standard did not have a material impact on our consolidated financial position or results of operations.

FASB statement No. 141(R) "Business Combinations" was issued in December of 2007. This Statement establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The Statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determining what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The guidance will become effective as of the beginning of a company's fiscal year beginning after December 15, 2008. This new pronouncement will impact the Corporation's accounting for business combinations beginning January 1, 2009.

FASB statement No. 160 "Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51" was issued in December of 2007. This Statement establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The guidance will become effective as of the beginning of a company's fiscal year beginning after December 15, 2008. The implementation of this standard will not have a material impact on our consolidated financial position or results of operations.

Staff Accounting Bulletin No. 109 (SAB 109), "Written Loan Commitments Recorded at Fair Value Through Earnings" expresses the views of the staff regarding written loan commitments that are accounted for at fair value through earnings under generally accepted accounting principles. To make the staff's views consistent with current authoritative accounting guidance, the SAB revises and rescinds portions of SAB No. 105, "Application of Accounting Principles to Loan Commitments." Specifically, the SAB revises the SEC staff's views on incorporating expected net future cash flows related to loan servicing activities in the fair value measurement of a written loan commitment. The SAB retains the staff's views on incorporating expected net future cash flows related to internally-developed intangible assets in the fair value measurement of a written loan commitment. The staff expects registrants to apply the views in Question 1 of SAB 109 on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Corporation does not expect SAB 109 to have a material impact on its financial statements.

### **NOTE 2 - CASH AND CASH EQUIVALENTS**

Regulations of the Board of Governors of the Federal Reserve System impose uniform reserve requirements on all depository institutions with transaction accounts (checking accounts, NOW accounts, etc.). Reserves are maintained in the form of vault cash or a non-interest bearing balance held with the Federal Reserve Bank. The Bank also, from time to time, maintains deposits with the Federal Reserve Bank and other banks for various services such as check clearing. The reserve requirement at December 31, 2008 and 2007 was \$344,000 and \$400,000, respectively.



# NEFFS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The amortized cost and fair values of securities at December 31, 2008, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)			
Due in one year or less	\$ 100	\$ 107	\$ 1,000	\$ 1,014
Due after one year through five years	-	-	7,795	7,738
Due after five years through ten years	-	-	19,618	20,178
Due after ten years	-	-	62,099	59,111
	100	107	90,512	88,041
Mortgage-backed securities	37,181	37,843	1,045	1,070
	<u>\$37,281</u>	<u>\$37,950</u>	<u>\$91,557</u>	<u>\$89,111</u>

There were no sales of securities during 2008, 2007, and 2006.

The changes in net unrealized holding gains (losses) on securities available for sale that have been included in other comprehensive income (loss) for the years ended December 31, 2008, 2007 and 2006 are as follows:

	2008	2007	2006
	(In Thousands)		
Gross change in unrealized gains (losses) on securities available for sale	\$1,235	\$870	\$(156)
Reclassification adjustment for gains realized in income	-	-	-
<b>Net Unrealized Gains (Losses)</b>	<b>1,235</b>	<b>870</b>	<b>(156)</b>
Tax effect	(420)	(296)	53
<b>Net of Tax Amount</b>	<b>\$815</b>	<b>\$574</b>	<b>\$(103)</b>

Securities with an amortized cost and fair value of approximately \$7,698,000 and \$7,721,000 at December 31, 2008 and \$7,264,000 and \$7,405,000 at December 31, 2007 were pledged to secure public deposits and for other purposes required or permitted by law.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following tables show the Corporation'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, 2008 and 2007:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(In Thousands)						
<b>DECEMBER 31, 2008:</b>						
<b>Securities Available for Sale:</b>						
Mortgage-backed securities	\$ 38	\$ 1	\$5,866	\$ 39	\$5,904	\$ 40
<b>Securities Held to Maturity:</b>						
Obligations of U.S. Government agencies	26,576	1,206	2,572	187	29,148	1,393
Obligations of states and political subdivisions	3,818	44	627	22	4,445	66
Corporate securities	1,613	448	1,165	1,965	2,778	2,413
<b>Total Temporarily Impaired Securities</b>	<b>\$32,045</b>	<b>\$1,699</b>	<b>\$10,230</b>	<b>\$2,213</b>	<b>\$42,275</b>	<b>\$3,912</b>

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(In Thousands)						
<b>DECEMBER 31, 2007:</b>						
<b>Securities Available for Sale:</b>						
Mortgage-backed securities	\$ -	\$ -	\$27,588	\$ 637	\$27,588	\$ 637
<b>Securities Held to Maturity:</b>						
Obligations of U.S. Government agencies	1,909	35	10,069	34	11,978	69
Obligations of states and political subdivisions	-	-	2,104	18	2,104	18
Corporate securities	2,688	249	794	56	3,482	305
Mortgage-backed securities	-	-	248	2	248	2
<b>Total Temporarily Impaired Securities</b>	<b>\$4,597</b>	<b>\$284</b>	<b>\$40,803</b>	<b>\$747</b>	<b>\$45,400</b>	<b>\$1,031</b>

The Corporation had 88 and 111 securities in an unrealized loss position at December 31, 2008 and 2007, respectively. The decline in fair value is due only to interest rate fluctuations. As the Corporation has the intent and ability to hold such investments until maturity or market price recovery, no securities are deemed to be other-than-temporarily impaired. None of the individual unrealized losses are significant.

**NEFFS BANCORP, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**NOTE 4 - LOANS**

The composition of the Corporation's loan portfolio at December 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
	(In Thousands)	
Commercial	\$ 3,627	\$ 4,635
Commercial real estate	26,142	22,779
Residential real estate	43,799	39,221
Real estate construction	873	879
Home equity	19,688	20,043
Other consumer	<u>6,824</u>	<u>7,053</u>
	<b>100,953</b>	94,610
Allowance for loan losses	<u>(761)</u>	<u>(620)</u>
	<u><b>\$100,192</b></u>	<u>\$93,990</u>

**NOTE 5 - ALLOWANCE FOR LOAN LOSSES**

Transactions in the allowance for loan losses are summarized as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(In Thousands)		
Balance, beginning	\$620	\$653	\$657
Provision for loan losses	145	-	-
Recoveries on loans previously charged off	1	5	2
Loans charged off	<u>(5)</u>	<u>(38)</u>	<u>(6)</u>
Balance, ending	<u><b>\$761</b></u>	<u>\$620</u>	<u>\$653</u>

Loans on which the accrual of interest has been discontinued amounted to \$-0- at December 31, 2008 and 2007. Loan balances past due 90 days or more and still accruing interest, but which management expects will eventually be paid in full, amounted to \$483,000 and \$36,000 at December 31, 2008 and 2007, respectively.

There were no impaired loans as of December 31, 2008 and 2007. The average recorded investment in impaired loans during 2008, 2007 and 2006 was \$-0-, \$-0- and \$-0-, respectively.

**NEFFS BANCORP, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 6 - PREMISES AND EQUIPMENT**

The following summarizes premises and equipment at December 31, 2008 and 2007:

	<u>Estimated Useful Lives</u>	<u>2008</u>	<u>2007</u>
		(In Thousands)	
Premises	5-39 years	<b>\$2,845</b>	\$2,813
Furniture, fixtures and equipment	5-10 years	<b>2,136</b>	1,996
		<b>4,981</b>	4,809
Accumulated depreciation		<b>(2,893)</b>	(2,700)
		<b>2,088</b>	2,109
Land		<b>238</b>	238
		<b>\$2,326</b>	\$2,347

**NOTE 7 - INTEREST BEARING DEPOSITS**

Interest bearing deposits include certificates of deposit issued in denominations of \$100,000 or greater which amounted to \$44,312,000 and \$37,185,000 at December 31, 2008 and 2007, respectively.

Interest bearing deposits at December 31, 2008 and 2007 are further detailed as follows:

	<u>2008</u>	<u>2007</u>
	(In Thousands)	
Savings accounts	<b>\$ 48,338</b>	\$ 45,086
NOW accounts	<b>6,038</b>	6,542
Certificates and other time deposits	<b>121,822</b>	111,558
	<b>\$176,198</b>	\$163,186

Time deposits at December 31, 2008 had the following scheduled maturities (in thousands):

2009	<b>\$ 59,059</b>
2010	<b>24,660</b>
2011	<b>9,498</b>
2012	<b>11,001</b>
2013	<b>17,604</b>
	<b>\$121,822</b>

# **NEFFS BANCORP, INC. AND SUBSIDIARY**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

### **NOTE 8 - BORROWING CAPACITY**

The Bank has a line of credit commitment available from Atlantic Central Bankers Bank for borrowings up to \$4,000,000 in federal funds. Borrowings on this line are repaid on a daily basis. There were no borrowings under this line as of December 31, 2008 and \$2,249,000 of borrowings under this line of credit as of December 31, 2007 with interest at 3.86%.

The Bank has maximum borrowing capacity with the Federal Home Loan Bank of \$130,597,000. There were no borrowings outstanding at December 31, 2008 and 2007. Advances from the Federal Home Loan Bank are secured by qualifying assets of the Bank.

### **NOTE 9 - INCOME TAXES**

The components of the net deferred tax asset at December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
	(In Thousands)	
AMT credit carryforward	\$276	\$416
Unrealized losses on securities available for sale	-	192
Allowance for loan losses	208	160
Accrued benefits	<u>23</u>	<u>20</u>
<b>Total Deferred Tax Assets</b>	<u>507</u>	<u>788</u>
Securities accretion	37	37
Unrealized gains on securities available for sale	228	-
Depreciation	<u>20</u>	<u>4</u>
<b>Total Deferred Tax Liabilities</b>	<u>285</u>	<u>41</u>
<b>Net Deferred Tax Asset</b>	<u>\$222</u>	<u>\$747</u>

# NEFFS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The income tax provision for financial reporting purposes differs from the amount computed by applying the statutory income tax rate to income before income taxes. The differences for the years ended December 31, 2008, 2007 and 2006 are as follows:

	2008		2007		2006	
	Amount	% of Pretax Income	Amount	% of Pretax Income	Amount	% of Pretax Income
			(Dollars in Thousands)			
Tax at statutory rate	\$1,315	34 %	\$1,101	34 %	\$1,125	34 %
Increase (decrease) resulting from:						
Tax-exempt interest income	(550)	(14)	(643)	(20)	(714)	(21)
TEFRA interest expense disallowance	64	2	79	3	77	2
	<u>\$ 829</u>	<u>22 %</u>	<u>\$ 537</u>	<u>17 %</u>	<u>\$ 488</u>	<u>15 %</u>

### NOTE 10 - RELATED PARTY TRANSACTIONS

Some of the Corporation's or the Bank's directors, principal officers, principal shareholders and their related interests had transactions with the Bank in the ordinary course of business. All loans and loan commitments were made on substantially the same terms, including collateral and interest rates, as those prevailing at the time for comparable transactions. In the opinion of management, these transactions do not involve more than normal risk of collectibility or present other unfavorable features. It is anticipated that further extensions of such credit will be made in the future.

The following is an analysis of loans to these related parties during 2008 (in thousands):

Balances, January 1, 2008	\$5,243
Advances	1,814
Repayments	<u>(1,676)</u>
Balances, December 31, 2008	<u>\$5,381</u>

### NOTE 11 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Corporation 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. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the statement of financial condition. The contract or notional amounts of these instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Corporation'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 written is represented by the contract or notional amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The following table identifies the contract or notional amount of those instruments at December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
	(In Thousands)	
Commitments to grant loans	\$ 806	\$2,335
Unfunded commitments under lines of credit	4,771	4,053
Letters of credit	<u>594</u>	<u>627</u>
	<u>\$6,171</u>	<u>\$7,015</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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the counterparty. 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 Corporation 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 Corporation requires collateral supporting these letters of credit as deemed necessary. The maximum undiscounted exposure related to these commitments at December 31, 2008 and 2007 was \$594,000 and \$627,000, respectively. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of December 31, 2008 and 2007 for guarantees under standby letters of credit issued is not material.

### NOTE 12 - DIVIDEND RESTRICTIONS

The amount of funds available to a parent from its subsidiary bank is limited for all national banks by restrictions imposed by the Comptroller of the Currency. A national bank is required to obtain the approval of the Comptroller of the Currency if the total of all dividends declared in any calendar year exceeds the Bank's net profits (as defined) for that year combined with its retained net profits for the preceding two calendar years. Under this formula, the Bank can declare dividends in 2009 of approximately \$2,102,000 plus an additional amount equal to the Bank's net profits for 2009, up to the date of any such dividend declaration.

### NOTE 13 - CAPITAL REQUIREMENTS

The Bank is 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

# NEFFS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

discretionary, actions by regulators that, if undertaken, could have a direct material effect on the consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the 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-weighting and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the tables below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 Capital (as defined) to average assets (as defined). Management believes, as of December 31, 2008, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent notification from the regulatory agencies 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 institution's category.

The Bank's actual capital ratios as of December 31, 2008 and 2007, and the maximum 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
	(Dollars in Thousands)					
<b>As of December 31, 2008:</b>						
Total capital (to risk-weighted assets):	\$44,587	38.5	≥9,267	≥8.0	≥11,584	≥10.0 %
Tier 1 capital (to risk-weighted assets):	43,826	37.8	≥4,633	≥4.0	≥ 6,950	≥ 6.0
Tier 1 capital (to average assets):	43,826	18.6	≥9,413	≥4.0	≥11,767	≥ 5.0
<b>As of December 31, 2007:</b>						
Total capital (to risk-weighted assets):	\$42,453	38.5	≥8,825	≥8.0	≥11,031	≥10.0 %
Tier 1 capital (to risk-weighted assets):	41,833	37.9	≥4,412	≥4.0	≥ 6,618	≥ 6.0
Tier 1 capital (to average assets):	41,833	18.7	≥8,952	≥4.0	≥11,190	≥ 5.0

The Federal Reserve Board approved a final rule in February 2006 that expands the definition of a small bank holding company ("BHC") under the Board's Small Bank Holding Company Policy Statement and the Board's risk-based and leverage capital guidelines for bank holding companies. In its revisions to the Policy Statement, the Federal Reserve Board has raised the small BHC asset size threshold from \$150 million to \$500 million and amended the related qualitative criteria for determining eligibility as a small BHC for the purposes of the policy statement and the capital guidelines. The policy statement facilitates the transfer of ownership of small community banks by permitting debt levels at small BHCs that are higher than what would typically be permitted for larger BHCs. Because small BHCs may, consistent with the policy statement, operate at a level of leverage that generally is inconsistent with the capital guidelines, the capital guidelines provide an exemption for small BHCs. Based on the ruling, Neffs Bancorp, Inc. meets the eligibility criteria of a small BHC and is exempt from regulatory capital requirements administered by the federal banking agencies.

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

Below are various estimated fair values at December 31, 2008 and 2007, as required by Statement of Financial Accounting Standards No. 107 ("FAS 107"). Such information, which pertains to the Corporation's financial instruments, is based on the requirements set forth in FAS 107 and does not purport to represent the aggregate net fair value of the Corporation. It is the Corporation's general practice and intent to hold its financial instruments to maturity, except for certain securities designated as securities available for sale, and not to engage in trading activities. Many of the financial instruments lack an available trading market, as characterized by a willing buyer and seller engaging in an exchange transaction. Therefore, the Corporation had to use significant estimations and present value calculations to prepare this disclosure.

Changes in the assumptions or methodologies used to estimate fair values may materially affect the estimated amounts. Further, the fair value estimates are based on various assumptions, methodologies and subjective considerations, which vary widely among different financial institutions and which are subject to change.

The estimated fair value amounts have been measured as of their respective year ends, and have not been reevaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at year end.

The following methods and assumptions were used by the Corporation in estimating financial instrument fair values:

#### **Cash and Due from Banks, Interest Bearing Deposits with Banks and Federal Funds Sold and Purchased**

The statement of financial condition carrying amounts for cash and due from banks, interest bearing deposits with banks and federal funds sold and purchased approximate the estimated fair values of such assets.

#### **Securities**

Fair values for securities held to maturity and securities available for sale are based on quoted market prices, if available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

The carrying amount of restricted investments in bank stocks, such as Federal Reserve Bank stock, Atlantic Central Bankers Bank stock and Federal Home Loan Bank stock, is considered a reasonable estimate of fair value.

SFAS 157 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 SFAS 157 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).

# NEFFS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Description	December 31, 2008	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
(In Thousands)				
Securities Available for sale	\$37,950	\$37,950		

The Corporation's adoption of SFAS 157 applies only to its financial instruments required to be reported at fair value. The adoption did not apply to those non-financial assets and non-financial liabilities for which adoption was delayed until January 1, 2009 in accordance with FSP FAS 157-2.

On October 10, 2008, the FASB issued FSP 157-3, which clarifies the application of FAS 157 in an inactive market and illustrates how an entity would determine fair value when the market for a financial asset is not active. The FSP states that an entity should not automatically conclude that a particular transaction price is determinative of fair value. In a dislocated market, judgment is required to evaluate whether individual transactions are forced liquidations or distressed sales. When relevant observable market information is not available, a valuation approach that incorporates management's judgments about the assumptions that market participants would use in pricing the asset in a current sale transaction would be acceptable. The FSP also indicates that quotes from brokers or pricing services may be relevant inputs when measuring fair value, but are not necessarily determinative in the absence of an active market for the asset. In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence. The FSP is effective immediately and applies to prior periods for which financial statements have not been issued, including interim or annual periods ending on or before September 30, 2008. Accordingly, the Corporation adopted the FSP prospectively, beginning July 1, 2008 and considered this guidance in determining fair value measurements on September 30, 2008.

The Corporation conducts other-than-temporary impairment analysis on a quarterly basis. The initial indication of other-than-temporary impairment for both debt and equity securities is a decline in the market value below the amount recorded for an investment. A decline in value that is considered to be other-than-temporary is recorded as a loss within non-interest income in the consolidated statement of income.

In determining whether an impairment is other than temporary, the Corporation considers a number of factors, including, but not limited to, the length of time and extent to which the market value has been less than cost, recent events specific to the issuer, including investment downgrades by rating agencies and economic conditions of its industry, and the Corporation's intent and ability to retain the security for a period of time sufficient to allow for a recovery in market value or maturity. Among the factors that are considered in determining the Corporation's intent and ability is a review of its capital adequacy, interest rate risk position and liquidity.

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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The Corporation also considers the issuer's financial condition, capital strength and near-term prospects. In addition, for debt securities and perpetual preferred securities that are treated as debt securities for the purpose of other-than-temporary analysis, the Corporation considers the cause of the price decline (general level of interest rates and industry- and issuer-specific factors), current ability to make future payments in a timely manner and the issuer's ability to service debt.

The assessment of a security's ability to recover any decline in market value, the ability of the issuer to meet contractual obligations and the Corporation's intent and ability to retain the security until recovery in value require considerable judgment.

Certain of the corporate debt securities are accounted for under EITF 99-20, Recognition of Interest Income and Impairment on Purchased Beneficial Interests that Continue to Be Held by a Transferor in Securitized Financial Assets. For investments within the scope of EITF 99-20 at acquisition, the Corporation evaluates current available information in estimating the future cash flows of these securities and determines whether there have been favorable or adverse changes in estimated cash flows from the cash flows previously projected. The Corporation considers the structure and term of the pool and the financial condition of the underlying issuers. Specifically, the evaluation incorporates factors such as interest rates and appropriate risk premiums, the timing and amount of interest and principal payments and the allocation of payments to the various note classes. Current estimates of cash flows are based on the most recent trustee reports, announcements of deferrals or defaults, expected future default rates and other relevant market information. At December 31, 2008, the Corporation concluded that no adverse change in cash flows occurred during the year.

The Corporation analyzed the cash flow characteristics of these securities. Based on this analysis and because the Corporation has the intent and ability to hold these securities until recovery of fair value, which may be at maturity; and, for investments within the scope of EITF 99-20, determined that there was no adverse change in the cash flows as viewed by a market participant, the Corporation does not consider the investments in these assets to be other-than-temporarily impaired at December 31, 2008. However, there is a risk that this review could result in recognition of other-than-temporary impairment charges in the future.

We own 4 collateralized debt obligation securities totaling \$3,975,000 par value and \$1,624,000 fair value that are backed by trust preferred securities issued by banks, thrifts, and insurance companies (TRUP CDOs). These securities are included in corporate held to maturity securities. The market for these securities at December 31, 2008 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which TRUP CDOs trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive as no new TRUP CDOs have been issued since 2007. There are currently very few market participants who are willing and or able to transact for these securities.

The market values for these securities (and any securities other than those issued or guaranteed by the US Treasury) are very depressed relative to historical levels. For example, the yield spreads for the broad market of investment grade and high yield corporate bonds reached all time wide levels versus Treasuries at the end of November and remain near those levels today. Thus in today's market, a low market price for a particular bond may only provide evidence of stress in the credit markets in general versus being an indicator of credit problems with a particular issuer.

Given conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, we determined:

- The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at December 31, 2008,

# **NEFFS BANCORP, INC. AND SUBSIDIARY**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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- An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at prior measurement dates and
- Our TRUP CDOs will be classified within Level 3 of the fair value hierarchy because we determined that significant adjustments are required to determine fair value at the measurement date.

Our TRUP CDO valuations were prepared by an independent third party. Their approach to determining fair value involved these steps:

1. The credit quality of the collateral is estimated using average probability of default values for each issuer (adjusted for rating levels)
2. The default probabilities also considered the potential for correlation among issuers within the same industry (e.g. banks with other banks).
3. The loss given default was assumed to be 95% (i.e. a 5 % recovery).
4. The cash flows were forecast for the underlying collateral and applied to each CDO tranche to determine the resulting distribution among the securities
5. The expected cash flows were discounted to calculate the present value of the security
6. The calculations were modeled in several thousand scenarios using a Monte Carlo engine and the average price was used for valuation purposes
7. The effective discount rates on an overall basis range from 6.57% to 23.10% and are highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the CDO and the prepayment assumptions.

As of December 31, 2008, management does not believe any unrealized loss in its other debt securities represents an other-than-temporary impairment. The unrealized losses at December 31, 2008 were primarily interest rate-related.

### **Loans Receivable**

Fair values of variable rate loans subject to frequent repricing and which entail no significant credit risk are based on the carrying amounts. The estimated fair values of other loans are estimated by discounting the future cash flows using interest rates currently offered for loans with similar terms to borrowers of similar credit quality.

### **Accrued Interest Receivable**

The carrying amount of accrued interest is considered a reasonable estimate of fair value.

### **Deposit Liabilities**

For deposits which are payable on demand, the carrying amount is a reasonable estimate of fair value. Fair values of fixed rate time deposits are estimated by discounting the future cash flows using interest rates currently being offered and a schedule of aggregate expected maturities.

### **Accrued Interest Payable**

The carrying amount of accrued interest approximates its fair value.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Off-Balance Sheet Instruments

The fair value of commitments to extend credit and for outstanding letters of credit is estimated using the fees currently charged to enter into similar agreements, taking into account market interest rates, the remaining terms and present credit worthiness of the counterparties.

The estimated fair values of the Corporation's financial instruments at December 31 are as follows:

	2008		2007	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
(In Thousands)				
Financial assets:				
Cash and short-term investments	\$ 2,598	\$ 2,598	\$ 4,006	\$ 4,006
Securities available for sale	37,950	37,950	35,680	35,680
Securities held to maturity	91,557	89,111	86,811	87,896
Loans, net	100,192	104,130	93,990	95,263
Accrued interest receivable	1,496	1,496	1,410	1,410
Federal funds sold	1,379	1,379	-	-
Financial liabilities:				
Deposits	192,938	194,495	180,391	180,955
Accrued interest payable	1,219	1,219	1,242	1,242
Federal funds purchased	-	-	2,249	2,249
Off-balance sheet financial instruments:				
Commitments to extend credit and letters of credit	-	-	-	-

# NEFFS BANCORP, INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 15 - CONDENSED FINANCIAL INFORMATION OF NEFFS BANCORP, INC. (PARENT ONLY)

#### BALANCE SHEETS

	December 31,	
	2008	2007
	(In Thousands)	
<b>ASSETS</b>		
Cash	\$ 8	\$ 53
Investment in subsidiary	44,268	41,459
Premises and equipment	241	245
Other assets	33	94
<b>Total Assets</b>	<b>\$44,550</b>	<b>\$41,851</b>
<b>LIABILITY AND STOCKHOLDERS' EQUITY</b>		
Liability, accounts payable	\$ 21	\$ 21
Stockholders' equity	44,529	41,830
<b>Total Liability and Stockholders' Equity</b>	<b>\$44,550</b>	<b>\$41,851</b>

#### STATEMENTS OF INCOME

	Years Ended December 31,		
	2008	2007	2006
	(In Thousands)		
Dividends from subsidiary	\$ 1,107	\$ 2,667	\$ 792
Rental income	11	13	13
Expenses	(107)	(127)	(111)
<b>Income before Income Taxes and Equity in Undistributed Earnings of Subsidiary</b>	<b>1,011</b>	<b>2,553</b>	<b>694</b>
Income tax benefit	33	39	27
Equity in undistributed earnings of subsidiary	1,044	2,592	721
	<b>1,993</b>	<b>109</b>	<b>2,102</b>
<b>Net Income</b>	<b>\$3,037</b>	<b>\$2,701</b>	<b>\$2,823</b>

**NEFFS BANCORP, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**STATEMENTS OF CASH FLOWS**

	<b>Years Ended December 31,</b>		
	<b>2008</b>	<b>2007</b>	<b>2006</b>
	(In Thousands)		
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income	\$3,037	\$2,701	\$2,823
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	11	9	10
Equity in undistributed earnings of subsidiary	(1,993)	(109)	(2,102)
(Increase) decrease in other assets	61	(32)	(27)
<b>Net Cash Provided by Operating Activities</b>	<b>1,116</b>	<b>2,569</b>	<b>704</b>
<b>CASH FLOWS USED IN INVESTING ACTIVITIES</b>			
Purchases of premises and equipment	(8)	(4)	-
<b>CASH FLOWS USED IN FINANCING ACTIVITIES</b>			
Dividends paid	(759)	(777)	(792)
Purchase of treasury stock	(394)	(1,890)	-
<b>Net Cash Used in Financing Activities</b>	<b>(1,153)</b>	<b>(2,667)</b>	<b>(792)</b>
<b>Net Decrease in Cash</b>	<b>(45)</b>	<b>(102)</b>	<b>(88)</b>
<b>CASH - BEGINNING</b>	<b>53</b>	<b>155</b>	<b>243</b>
<b>CASH - ENDING</b>	<b>\$ 8</b>	<b>\$ 53</b>	<b>\$ 155</b>

# NEFFS BANCORP, INC. AND SUBSIDIARY

## SELECTED FINANCIAL DATA

The following financial information is not covered by the auditor's report and must be read in conjunction with the consolidated financial statements and related notes along with Management's Discussion and Analysis of Financial Condition and Results of Operations.

	<b>At or For the Year Ended December 31,</b>				
	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
Interest Income		(Dollars in Thousands, Except Per Share Data)			
Interest and fees on loans	\$6,456	\$5,988	\$5,419	\$5,001	\$4,747
Interest and dividends on securities	6,404	5,869	5,521	5,371	5,233
Interest on federal funds sold	12	78	51	82	67
Total interest income	<u>12,872</u>	<u>11,935</u>	<u>10,991</u>	<u>10,454</u>	<u>10,047</u>
Interest Expense					
Deposits	6,099	6,085	5,115	4,469	4,082
Short-term borrowings	23	4	14	-	-
Total interest expense	<u>6,122</u>	<u>6,089</u>	<u>5,129</u>	<u>4,469</u>	<u>4,082</u>
Net interest income	6,750	5,846	5,862	5,985	5,965
Provision for loan losses	145	-	-	-	36
Net interest income after provision for loan losses	6,605	5,846	5,862	5,985	5,929
Other operating income	277	271	258	276	268
Other operating expense	3,016	2,879	2,809	2,612	2,385
Income before taxes	<u>3,866</u>	<u>3,238</u>	<u>3,311</u>	<u>3,649</u>	<u>3,812</u>
Applicable income taxes	829	537	488	577	607
Net income	<u>\$3,037</u>	<u>\$2,701</u>	<u>\$2,823</u>	<u>\$3,072</u>	<u>\$3,205</u>
<b>Per Share Data</b>					
Basic earnings	\$16.00	\$13.79	\$14.26	\$15.58	\$16.26
Book value	\$234.53	\$213.53	\$208.25	\$199.34	\$189.33
Dividends declared	\$4.00	\$4.00	\$4.00	\$4.00	\$3.75
Average shares outstanding	189,861	195,893	197,941	197,117	197,091
<b>At End of Period</b>					
Total assets	\$238,782	\$225,797	\$215,876	\$213,547	\$209,803
Securities	129,507	122,491	120,362	120,375	122,794
Loans, net of unearned income	100,192	93,990	87,418	83,042	76,978
Allowance for loan losses	761	620	653	657	663
Deposits	192,938	180,391	173,101	173,276	171,652
Stockholders' equity	44,529	41,830	41,222	39,294	37,316
<b>Key Ratios</b>					
Return on average assets	1.30%	1.21%	1.32%	1.46%	1.57%
Return on average equity	7.09%	6.56%	7.11%	8.08%	8.89%
Net loans to deposit ratio	51.93%	52.10%	50.50%	47.55%	44.46%
Dividend payout ratio (dividends declared divided by net income)	25.01%	29.01%	28.05%	25.66%	23.06%
Equity to asset ratio (average equity divided by average total assets)	18.32%	18.41%	18.61%	17.95%	17.56%

**NEFFS BANCORP, INC. AND SUBSIDIARY****QUARTERLY SUMMARY OF FINANCIAL DATA (unaudited)**

	2008			
	Three Months Ended			
	March 31	June 30	September 30	December 31
	(Dollars in Thousands, Except Per Share Data)			
Interest income	\$3,144	\$3,201	\$3,251	\$3,276
Interest expense	1,597	1,537	1,503	1,485
Net interest income	1,547	1,664	1,748	1,791
Provision for loan losses	15	15	38	77
Other expenses, net of other income	653	706	708	672
Income before income taxes	879	943	1,002	1,042
Income tax expense	174	196	232	227
Net income	\$705	\$747	\$770	\$815
Earnings per share-Basic	\$3.70	\$3.93	\$4.06	\$4.31

	2007			
	Three Months Ended			
	March 31	June 30	September 30	December 31
	(Dollars in Thousands, Except Per Share Data)			
Interest income	\$2,878	\$2,951	\$3,039	\$3,067
Interest expense	1,470	1,505	1,534	1,580
Net interest income	1,408	1,446	1,505	1,487
Provision for loan losses	-	-	-	-
Other expenses, net of other income	655	664	653	636
Income before income taxes	753	782	852	851
Income tax expense	105	117	148	167
Net income	\$648	\$665	\$704	\$684
Earnings per share-Basic	\$3.27	\$3.36	\$3.57	\$3.59

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **COMMON STOCK INFORMATION**

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The Corporation's common stock is currently quoted on the National Quotations Bureau's Electronic Quotation Service ("Pink Sheets") under the trading symbol NEFB. The Corporation's common stock is traded over-the-counter from time to time, primarily in the Corporation's geographic service area, through several local market makers.

The following table sets forth the high and low bid quotations for the Corporation's common stock as reported for each quarterly period of the 2008 and 2007 fiscal years. This information is based on monthly reports from a third party investment broker. There may have been other bids or transactions not known to the Corporation. The quotations reflect inter-dealer prices, do not include retail mark-ups, markdowns or commissions, and may not necessarily represent actual transactions.

### Common Stock Information

	<u>2008</u>	<u>HIGH</u>	<u>LOW</u>	<u>Cash Dividends Per Share</u>
First Quarter		\$255.00	\$255.00	-
Second Quarter		\$260.00	\$260.00	\$2.00
Third Quarter		\$245.00	\$265.00	-
Fourth Quarter		\$221.00	\$235.00	\$2.00
	<u>2007</u>	<u>HIGH</u>	<u>LOW</u>	<u>Cash Dividends Per Share</u>
First Quarter		\$256.00	\$256.00	-
Second Quarter		\$262.00	\$262.00	\$2.00
Third Quarter		\$263.00	\$263.00	-
Fourth Quarter		\$263.00	\$263.00	\$2.00

As of December 31, 2008, Neffs Bancorp, Inc. had 189,250 outstanding shares and approximately 640 stockholders, including beneficial owners whose stock is held in nominee name.

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

**Years Ending December 31, 2008, 2007, and 2006**

The following is management's discussion and analysis of the significant changes in the financial condition and results of operations of Neffs Bancorp, Inc. (the "Corporation") and its wholly owned subsidiary The Neffs National Bank (the "Bank"). The consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. This discussion should be read in conjunction with the financial tables, consolidated financial statements and notes to consolidated financial statements appearing elsewhere in this report. Current performance does not guarantee, assure or may not be indicative of similar performance in the future.

We have made forward-looking statements in this document and in documents that we incorporated by reference that are subject to risk and uncertainties. Forward-looking statements include the information concerning possible or assumed future results of operations of the Corporation and the Bank. When we use words such as "believes", "expects", "anticipates" or other similar expressions, we are making forward-looking statements.

Stockholders should note that many factors, some of which are discussed elsewhere in this document and in the documents that we incorporate by reference, could affect the future financial results of the Bank and could cause those results to differ materially from those expressed in our forward-looking statements contained or incorporated by reference in this document. These factors include the following:

- operating, legal and regulatory risks,
- economic, political and competitive forces affecting our Banking business, and
- the risk that our analysis of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful.

The Corporation undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances that arise after the date of this report. Readers should carefully review the risk factors described in other documents that the Corporation files periodically with the Securities and Exchange Commission.

**Critical Accounting Policies**

Disclosure of the Corporation's significant accounting policies is included in Note 1 of the consolidated financial statements. Certain of these policies are particularly sensitive, requiring significant judgments, estimates and assumptions to be made by management. The allowance for loan losses and other-than-temporary-impairment are the critical accounting policies that require significant management judgment.

Management, in determining the allowance for loan losses, makes significant estimates. 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 reviews, borrowers' perceived financial and managerial strengths, the adequacy of the underlying collateral, if collateral dependent, or present value of future cash flows and other relevant factors. Since the sufficiency of the allowance for loan losses is dependent to a great extent on conditions that may be beyond our control, it is possible that management's estimates of the allowance for loan losses and actual results could differ in the near term. In addition, regulatory authorities, as an integral part of their examination, periodically review the allowance for loan losses. They may require additions to the allowance based upon their judgments about information available to them at the time of examination. Future increases to our allowance for loan losses,

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

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whether due to unexpected changes in economic conditions or otherwise, would adversely affect our future results of operations.

### **OVERVIEW**

The Corporation and its wholly owned subsidiary, The Neffs National Bank, continue to strive to provide quality products and services to the community with a personal touch. During 2008, the Corporation realized improvement in net interest income due to increasing yields on interest earning assets and decreasing cost of funds.

The Corporation's assets increased by 5.8% to \$238,782,000 at December 31, 2008 from \$225,797,000 at December 31, 2007. During the same period, net loans receivable increased \$6,202,000 or 6.6% to \$100,192,000 from \$93,990,000, and deposits increased \$12,547,000 or 7.0% to \$192,938,000 from \$180,391,000. Securities increased \$7,016,000 or 5.7% to \$129,507,000 from \$122,491,000. In 2008, the Corporation recorded net income of \$3,037,000, an increase of 12.4% as compared with \$2,701,000 in 2007.

### **RESULTS OF OPERATIONS**

#### **Net Interest Income and Net Interest Margin**

The single largest component of the Corporation's primary operating income is net interest income. It is the amount by which interest earned on interest earning assets exceeds the interest paid on interest bearing liabilities. The change in interest income from year to year may be due to changes in interest rates, changes in volumes on interest earning assets and liabilities as well as changes in the mix of such assets and liabilities. The Corporation's primary interest earning assets are loans to businesses and individuals and investment securities. Interest bearing liabilities consist primarily of time deposits, NOW deposits and savings deposits. Generally, changes in net interest income are measured by net interest rate spread and net interest margin. Net interest rate spread is equal to the difference between the average rate earned on interest earning assets and the average rate incurred on interest bearing liabilities. Net interest margin represents the difference between interest income (including net loan fees earned) and interest expense calculated as a percentage of average earning assets.

#### **2008 Compared to 2007**

Total interest income increased by \$937,000 or 7.9% to \$12,872,000 for the year ended December 31, 2008 from \$11,935,000 at December 31, 2007. This increase is mainly the result of the average balance of the loan portfolio increasing by \$5.8 million in 2008 over 2007, which generated additional interest and fees on loans throughout 2008. The yield on interest earning assets also increased from 5.55% in 2007 to 5.71% in 2008.

Total interest expense increased by \$33,000 or 0.5% to \$6,122,000 in 2008 from \$6,089,000 in 2007. This increase is mainly the result of the average balance of interest bearing deposits increasing by \$9.7 million in 2008 over 2007 offset by a decreased cost of funds on interest bearing liabilities from 3.72% in 2007 to 3.53% in 2008.

Net interest income increased by \$904,000 or 15.5% to \$6,750,000 in 2008 from \$5,846,000 in 2007. The Corporation's net interest rate spread for 2008 was 2.18% as compared to 1.83% for 2007. The net interest margin for 2008 was 3.00% as compared to 2.72% for 2007.

#### **2007 Compared to 2006**

Total interest income increased by \$944,000 or 8.6% to \$11,935,000 for the year ended December 31, 2007 from \$10,991,000 at December 31, 2006. This increase is mainly the result of the average balance of the loan portfolio increasing by \$6.4 million in 2007 over 2006, which generated additional interest and fees on loans throughout 2007. The yield on interest earning assets also increased from 5.36% in 2006 to 5.55% in 2007.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Total interest expense increased by \$960,000 or 18.7% to \$6,089,000 in 2007 from \$5,129,000 in 2006. This increase in interest expense is due mainly to the increasing interest rate environment experienced throughout 2007. The cost of funds on interest bearing liabilities increased from 3.31% in 2006 to 3.72% in 2007. The average balance of interest bearing liabilities increased \$8.8 million in 2007 from 2006.

Net interest income decreased by \$16,000 or 0.3% to \$5,846,000 in 2007 from \$5,862,000 in 2006. The Corporation's net interest rate spread for 2007 was 1.8% as compared to 2.1% for 2006. The net interest margin for 2007 was 2.72% as compared to 2.86% for 2006.

Following is a summary of the Bank's average balances, yields, interest income, and interest expense, the interest rate spread and the net interest margin for the years ended December 31, 2008, 2007, and 2006.

	2008			Year Ended December 31, 2007			2006		
	Average Balance <sup>1</sup>	Interest	Yield/ Rate	Average Balance <sup>1</sup>	Interest	Yield/ Rate	Average Balance <sup>1</sup>	Interest	Yield/ Rate
(Dollars in Thousands)									
Interest earning assets:									
Loans receivable <sup>2</sup>	\$ 97,774	\$ 6,456	6.60%	\$ 92,006	\$ 5,988	6.51%	\$ 85,565	\$ 5,419	6.33%
Investment securities:									
Taxable	92,674	4,876	5.26%	81,916	4,086	4.99%	75,390	3,546	4.70%
Non-taxable <sup>3</sup>	33,871	1,528	4.51%	39,387	1,783	4.53%	43,817	1,975	4.51%
Other interest earning assets <sup>4</sup>	990	12	1.21%	1,747	78	4.46%	357	51	14.29%
Total interest earning assets	225,309	12,872	5.71%	215,056	11,935	5.55%	205,129	10,991	5.36%
Noninterest earning assets	8,588			8,554			8,155		
Total assets	<u>\$233,897</u>			<u>\$223,610</u>			<u>\$213,284</u>		
Interest bearing liabilities:									
NOW	\$ 5,932	49	0.83%	\$ 6,517	105	1.61%	\$ 7,697	126	1.64%
Savings	47,649	830	1.74%	48,147	926	1.92%	49,428	867	1.75%
Certificates of deposit	118,746	5,220	4.40%	108,275	5,054	4.67%	97,273	4,122	4.24%
Federal funds purchased	861	23	2.67%	562	4	0.71%	343	14	4.08%
Total interest bearing liabilities	173,188	6,122	3.53%	163,501	6,089	3.72%	154,741	5,129	3.31%
Noninterest bearing liabilities:									
Demand deposits	16,393			17,455			17,571		
Other liabilities	1,466			1,494			1,287		
Stockholders' equity	42,850			41,160			39,685		
Total liabilities and stockholders' equity	<u>\$233,897</u>			<u>\$223,610</u>			<u>\$213,284</u>		
Net interest income/spread <sup>5</sup>		<u>\$ 6,750</u>	2.18%		<u>\$ 5,846</u>	1.83%		<u>\$ 5,862</u>	2.05%
Net interest margin <sup>6</sup>			3.00%			2.72%			2.86%

<sup>1</sup> Averages are not computed on daily average. Average balances are computed based on an average of quarter-end balances.

<sup>2</sup> Average balances include non-accrual loans.

<sup>3</sup> There have been no tax equivalent adjustments made to yields.

<sup>4</sup> This reflects average balance for Federal Funds Sold and Purchased and is calculated by utilizing quarterly ending balance. The actual daily balance may differ greatly from this average balance due to the nature of these funds.

<sup>5</sup> Interest rate spread represents the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities.

<sup>6</sup> Net interest margin represents net interest income as a percentage of average interest earning assets.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following table attributes increases and decreases in components of net interest income either to changes in average volume or to changes in average rates for interest earning assets and interest bearing liabilities. Numerous and simultaneous balance and rate changes occur during the year. The amount of change that is not due solely to volume or rate is allocated proportionally to each.

	For Year Ended December 31,					
	2008/2007 Increase/(Decrease)			2007/2006 Increase/(Decrease)		
	Due to Change in			Due to Change in		
	Volume	Rate	Net	Volume	Rate	Net
Interest Income:	(In Thousands)					
Loans receivable	\$ 381	\$ 87	\$ 468	\$ 419	\$ 150	\$ 569
Securities	265	270	535	101	247	348
Other interest earning assets	(9)	(57)	(66)	62	(35)	27
Total interest earning assets	<u>637</u>	<u>300</u>	<u>937</u>	<u>582</u>	<u>362</u>	<u>944</u>
Interest Expense:						
NOW	(5)	(51)	(56)	(19)	(2)	(21)
Savings	(9)	(87)	(96)	(25)	84	59
Certificates of Deposit	460	(293)	167	513	418	931
Federal funds purchased	8	11	19	2	(11)	(9)
Total interest bearing liabilities	<u>454</u>	<u>(420)</u>	<u>34</u>	<u>471</u>	<u>489</u>	<u>960</u>
Net change in net interest income	<u>\$ 183</u>	<u>\$ 720</u>	<u>\$ 903</u>	<u>\$ 111</u>	<u>\$ (127)</u>	<u>\$ (16)</u>

### Provision for Loan Losses

Although the Corporation maintains sound credit practices, loan deterioration may occur resulting in the eventual charge off of the loans as losses. The provision for loan losses and the allowance for loan losses are based upon management's ongoing assessment of the Bank's credit exposure and consideration of other relevant factors. The allowance for loan losses is a valuation that is available to absorb potential yet undetermined future charge offs. The provision for loan losses is the amount charged against the Bank's earnings. Its appropriateness and adequacy are determined based upon several factors including:

- a continuing review of delinquent, classified and non-accrual loans, large loans and overall portfolio quality,
- analytical review of loan charge-off experience, delinquency rates and other relevant historical and peer statistical ratios,
- management's judgment with respect to the nature of the portfolio, concentrations of credit and current and projected economic and business conditions and their impact on the existing portfolio, and
- regular examinations and review of the portfolio by regulatory authorities.

The allowance is allocated to specific loan categories based upon management's classification of loans under the Corporation's internal loan grading system and to pools of other loans that are not individually analyzed. Management makes allocations to specific loans based on the present value of expected future cash flows or the fair value of the underlying collateral for impaired loans and to other classified loans based on various credit risk factors. These factors include collateral values, the financial condition of the borrower and industry and current economic trends.

Allocations to commercial loan pools are developed by internal risk ratings and are based on management's judgment concerning historical loss trends and other relevant factors. Installment and residential mortgage loan allocations are made at a portfolio level based on historical loss experience adjusted for portfolio activity and current conditions. Estimated credit losses are based on the average annual rate of net charge-offs experienced

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

over the previous two or three years on similar loans, adjusted for current condition and trends. While allocations are made to specific loans and pools of loans, the allowance is available for all loan losses.

The provision for loan losses made during 2008 was \$145,000 due mainly to the increase in the loan portfolio and general deteriorating economic conditions. There was no provision made for 2007 or 2006. Management concluded that the for Loan Losses had an adequate balance to justify no provision being made during 2007 and 2006, due to minimal net charge offs and declining non-performing loans.

The Allowance for Loan Losses represented .75% of total loans receivable at December 31, 2008 as compared with .66% and .74% at December 31, 2007, and 2006, respectively. Management regularly assesses the appropriateness and adequacy of the allowance for loan losses in relation to credit exposure associated with individual borrowers, overall trends in the loan portfolio and other relevant factors, and believes the allowance is reasonable and adequate for each of the periods presented. The Corporation has no credit exposure to foreign countries or foreign borrowers. The Corporation also has no exposure to subprime mortgage loans.

The Bank's loan loss experience for each of the five years ended December 31 is presented below.

	Year Ended December 31				
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(Dollars in Thousands)				
Average loans outstanding	<u>\$97,774</u>	<u>\$92,006</u>	<u>\$85,565</u>	<u>\$79,294</u>	<u>\$72,744</u>
Total gross loans at year end	<u>\$100,953</u>	<u>\$94,610</u>	<u>\$88,071</u>	<u>\$83,042</u>	<u>\$76,978</u>
Allowance for loan losses at January 1	\$620	\$653	\$657	\$663	\$637
Losses charged to allowance					
Commercial	-	20	-	-	-
Real estate	-	3	-	-	-
Consumer	<u>5</u>	<u>15</u>	<u>6</u>	<u>13</u>	<u>25</u>
Total losses charged to allowance	<u>5</u>	<u>38</u>	<u>6</u>	<u>13</u>	<u>25</u>
Recoveries credited to allowance					
Commercial	-	-	-	-	-
Real estate	-	3	-	-	-
Consumer	<u>1</u>	<u>2</u>	<u>2</u>	<u>7</u>	<u>15</u>
Total recoveries credited to allowance	<u>1</u>	<u>5</u>	<u>2</u>	<u>7</u>	<u>15</u>
Net charge-offs	<u>4</u>	<u>33</u>	<u>4</u>	<u>6</u>	<u>10</u>
Provision for loan losses	<u>145</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>36</u>
Allowance for loan losses at December 31	<u>\$761</u>	<u>\$620</u>	<u>\$653</u>	<u>\$657</u>	<u>\$663</u>
Ratio of net charge offs to average loans outstanding	0.00%	0.04%	0.00%	0.01%	0.01%
Allowance as a percentage of total gross loans	0.75%	0.66%	0.74%	0.79%	0.86%

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The amount charged to operations and the related balance in the allowance for loan losses is based upon periodic evaluations of the loan portfolio by management. These evaluations consider several factors including, but not limited to, general economic conditions, loan portfolio composition, prior loan loss experience and management's estimates of potential losses.

Management maintains an allowance for loan losses that it considers adequate based on the evaluation process that is performed on a quarterly basis. As part of this process, management considers it appropriate to maintain a portion of the allowance that is based on credit quality trends, loan volume, current economic trends and other uncertainties. This portion of the allowance for loan losses is reflected as the unallocated portion in the table below that indicates the distribution of the allowance as of the end of each of the last five years.

	<u>2008</u>		<u>2007</u>		<u>2006</u>		<u>2005</u>		<u>2004</u>	
	% of		% of		% of		% of		% of	
	<u>Amount</u>	<u>Loan</u>	<u>Amount</u>	<u>Loan</u>	<u>Amount</u>	<u>Loan</u>	<u>Amount</u>	<u>Loan</u>	<u>Amount</u>	<u>Loan</u>
	(Dollars in Thousands)									
Commercial	\$231	29.5%	\$179	29.0%	\$161	26.7%	\$122	25.6%	\$130	23.4%
Real estate	404	44.2%	287	42.4%	281	43.3%	271	45.1%	256	48.7%
Consumer	91	26.3%	131	28.6%	121	30.0%	125	29.3%	135	27.9%
Unallocated	35		23		90		139		142	
Total	<u>\$761</u>	<u>100%</u>	<u>\$620</u>	<u>100%</u>	<u>\$653</u>	<u>100%</u>	<u>\$657</u>	<u>100%</u>	<u>\$663</u>	<u>100%</u>

### Non-Interest Income

#### 2008 Compared to 2007

Non-interest income consists primarily of service charges. Non-interest income for 2008 had an increase of \$6,000 or 2.2% over 2007. This was mainly due to an increase in fees derived from the sale of loan related insurance offset by a decrease in service charges on deposit accounts.

#### 2007 Compared to 2006

Non-interest income consists primarily of service charges. Non-interest income for 2007 had an increase of \$13,000 or 5.0% over 2006. This was mainly due to an increase in fees derived from the sale of loan related insurance offset by a decrease in service charges on deposit accounts.

### Non-Interest Expense

Salary expense and employee benefits represent the largest component, or 47.3%, of non-interest expenses. Non-interest expenses also include an array of other expenses such as:

- occupancy and equipment expenses,
- stationery, printing and Bank supplies,
- advertising,
- outside service providers, relating to data processing and ATM services,
- professional fees for legal, accounting, and consulting services,
- costs associated with the due diligence process of extending and maintaining loans and the collection process,
- Pennsylvania shares tax and FDIC assessment, and
- other types of expenses incurred as part of the normal course of operation of the Bank.

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

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### **2008 Compared to 2007**

Non-interest expenses for 2008 were \$3,016,000, an increase of \$137,000 or 4.8% as compared to non-interest expense of \$2,879,000 for 2007.

Salary and employee benefits represent the largest portion of non-interest expense. For 2008, salary and employee benefits increased by \$60,000, or 4.4%. At December 31, 2008 and 2007 the Bank employed 29 full-time equivalent employees.

Occupancy and equipment expenses decreased by \$8,000 or 1.9% to \$423,000 as compared to \$431,000 at December 31, 2007. This decrease was mainly due to full depreciation of assets with minimal purchase of new assets offset by an increase in building repairs and maintenance.

PA Shares Tax increased by \$20,000 or 5.0% to \$423,000 for 2008. This increase was due mainly to the increase in total equity on which the tax is calculated.

Other expenses increased \$65,000 or 9.6%. This increase was due mainly to an FDIC credit used in 2007 but not available for 2008 along with increases in bank account maintenance expense, advertising expense, and bookkeeping and data processing expense.

### **2007 Compared to 2006**

Non-interest expenses for 2007 were \$2,879,000, an increase of \$70,000 or 2.5% as compared to non-interest expense of \$2,809,000 for 2006.

Salary and employee benefits represent the largest portion of non-interest expense. For 2007, salary and employee benefits increased by \$20,000, or 1.5%. At December 31, 2007 the Bank employed 29 full-time equivalent employees compared to 32 full-time equivalent employees at December 31, 2006.

Occupancy and equipment expenses increased by \$26,000 or 6.4% to \$431,000 as compared to \$405,000 at December 31, 2006. Increased use of internet banking, bill pay and imaging resulted in additional maintenance, repair and depreciation expenses over those reported in 2006.

PA Shares Tax increased by \$22,000 or 5.8% to \$403,000 for 2007. This increase was due mainly to the increase in total equity on which the tax is calculated.

### **Income Taxes**

Income tax expense was \$829,000 for 2008 as compared to \$537,000 for 2007 and \$488,000 for 2006. The 54.4% increase experienced during 2008 resulted from an increase in net income before income taxes and the decrease in interest income on tax-exempt securities. The Corporation's effective income tax rate for 2008, 2007 and 2006 was 21.4%, 16.6% and 14.7%, respectively.

### **Net Income**

#### **2008 Compared to 2007**

Net income for 2008 was \$3,037,000, which is an increase of \$336,000 or 12.4% as compared to 2007. The Bank's net interest income increased in 2008 due to an increase in the Bank's net interest spread and margin as the yield on interest-bearing assets increased more than the cost of interest-bearing deposits.

Basic earnings per share for 2008 increased to \$16.00 from \$13.79 in 2007, due to the increase in the net income for 2008 and the purchase of treasury stock in 2008 and 2007.

# **NEFFS BANCORP, INC. AND SUBSIDIARY**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

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### **2007 Compared to 2006**

Net income for 2007 was \$2,701,000, which is a decline of \$122,000 or 4.3% as compared to 2006. The Bank's net interest income declined in 2007 due to a decrease in the Bank's net interest spread and margin as the cost of interest-bearing deposits increased more than the yield on interest-bearing assets.

Basic earnings per share for 2007 decreased to \$13.79 from \$14.26 in 2006, due to the decline in the net income for 2007.

## **FINANCIAL CONDITION**

### **Securities**

The Corporation's securities portfolio is composed of investments that not only provide interest income, including tax-exempt income, but also provide a source of liquidity. The portfolio allows management to better respond to the Bank's interest sensitivity position, to diversify the earning asset portfolio and provide collateral for public fund deposits. Established policies that address various aspects in managing the portfolio, including but not limited to, concentrations, liquidity, credit quality, interest rate sensitivity and regulatory guidelines are in place.

Although the Bank generally intends to hold its securities portfolio until maturity, a portion of the portfolio is classified as available-for-sale. Securities in the held to maturity category are accounted for at amortized cost. Available for sale securities are accounted for at fair value with unrealized gains or losses, net of income taxes, reported as a separate component of stockholder's equity. The Bank invests in securities for the yield they produce and not to profit from trading. The Bank holds no trading securities in its portfolio.

The securities portfolio at December 31, 2008 totaled \$129,507,000 as compared to \$122,491,000 at December 31, 2007, an increase of \$7,016,000, or 5.7%. Securities available-for-sale increased to \$37,950,000 at December 31, 2008 compared to \$35,680,000 at December 31, 2007. In addition, securities held to maturity increased to \$91,557,000 at December 31, 2008 from \$86,811,000 at December 31, 2007. Other than the U.S. Government and its agencies, the Bank holds no other securities of a single issuer whose aggregate carrying value exceeds 10% of stockholders' equity.

The carrying value of the available-for-sale securities portfolio as of December 31, 2008, includes net unrealized gains of \$669,000 (reflected as accumulated other comprehensive gain of \$442,000 in stockholders' equity, net of deferred income taxes of \$228,000) compared to net unrealized losses of \$565,000 (reflected as accumulated other comprehensive loss of \$373,000 in stockholders' equity, net of deferred income taxes of \$192,000) as of December 31, 2007. This change is due to the change in interest rates.

The Corporation has gross unrealized gains of \$2,135,000 offset by gross unrealized losses of \$3,912,000 for a net unrealized loss of \$1,777,000 at December 31, 2008. The portfolio of securities in an unrealized loss position has an aggregate fair value of \$42,275,000. The unrealized gains and losses are attributed to the current interest rate environment and illiquidity in the market. The unrealized losses are temporary and management has the intent and ability to hold them until maturity or market price recovery. All securities are rated investment grade or better according to the Corporation's policy except for three securities with a combined book value of approximately \$1,340,000 which is 1.0% of the total security portfolios. The securities rated below investment grade are classified as held to maturity. The Corporation has minimal exposure to problem collateralized debt obligations in the mortgage-backed securities portfolio. The problem collateralized debt obligations consist of four securities with a combined book value of \$3,841,000 and market value of \$1,624,000. These securities are classified as held to maturity. As the Corporation has the intent and ability to hold such investments until maturity or market price recovery, no securities are deemed to be other-than-temporarily impaired.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The composition of the securities portfolio for the periods ending December 31, 2008, 2007 and 2006 is presented below.

	December 31		
	2008	2007	2006
Held to maturity securities:	(Dollars in Thousands)		
U.S. Government agencies and corporations	\$52,871	\$43,627	\$38,537
State and political subdivisions	32,300	37,507	42,512
Mortgage-backed securities	1,045	1,240	1,510
Corporate securities	5,341	4,437	1,749
Available for sale securities:			
Mortgage-backed securities	37,843	35,579	35,954
U.S. Treasury Note	107	101	100
Total securities	<u>\$129,507</u>	<u>\$122,491</u>	<u>\$120,362</u>

The following table presents the maturities and average weighted yields of the debt securities portfolio as of December 31, 2008.

	Within one year		After one but within five years		After five but within ten years		After ten years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available for sale:	(Dollars in Thousands)							
Mortgage-backed securities	\$ -	-	\$4,773	4.00%	\$10,768	4.60%	\$22,302	5.15%
U.S. Treasury	107	3.13%	-	-	-	-	-	-
	<u>107</u>		<u>4,773</u>		<u>10,768</u>		<u>22,302</u>	
Held to maturity:								
U.S. Government agencies	-	-	1,500	4.27%	3,496	5.40%	47,875	5.75%
State and political subdivisions <sup>7</sup>	850	6.87%	5,445	6.59%	16,122	7.10%	9,883	7.48%
Mortgage-backed securities	-	-	-	-	-	-	1,045	6.28%
Other securities	150	6.30%	850	6.42%	-	-	4,341	4.75%
	<u>1,000</u>		<u>7,795</u>		<u>19,618</u>		<u>63,144</u>	
Total	<u>\$1,107</u>		<u>\$12,568</u>		<u>\$30,386</u>		<u>\$85,446</u>	

<sup>7</sup> Yields on tax-exempt debt securities have been computed on a fully tax-equivalent basis.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Loans

The loan portfolio comprises a major component of the Corporation's earning assets. Net loans receivable increased \$6,202,000 or 6.6% to \$100,192,000 as of December 31, 2008 from \$93,990,000 at December 31, 2007. Net loans receivable represent 42.0% of total assets and 51.9% of total deposits as of December 31, 2008 as compared to 41.6% and 52.1%, respectively, at December 31, 2007. All of the Corporation's loans are to domestic borrowers.

Loan concentrations are considered to exist when the total amount of loans to any one or a multiple number of borrowers engaged in similar activities or having similar economic characteristics exceeds 10% of loans outstanding in any one category. At December 31, 2008, real estate loans amounted to \$90,502,000 or 89.6% of total loans, and commercial and industrial loans amounted to \$3,627,000 or 3.6% of total loans. Although such loans were not made to one specific borrower or industry, it is important to note that the quality of these loans is affected by the region's economy and real estate market. Management does not believe such a concentration poses a problem to the Bank at this time.

Other than as described herein, management does not believe there are any trends, events, or uncertainties which are reasonably expected to have a material adverse impact on future results of operations, liquidity, or capital resources.

The composition of the total loan portfolio is shown in the table below for the periods presented.

	2008		2007		December 31, (Dollars in Thousands) 2006		2005		2004	
	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
Commercial	\$3,627	3.6%	\$4,635	4.9%	\$4,664	5.3%	\$4,832	5.8%	\$4,095	5.3%
Commercial real estate	26,142	25.9%	22,779	24.1%	18,820	21.4%	16,440	19.8%	13,925	18.1%
Residential real estate	43,799	43.4%	39,221	41.5%	37,088	42.1%	37,057	44.6%	36,115	46.9%
Real estate construction	873	0.9%	879	0.9%	1,053	1.2%	384	0.5%	1,376	1.8%
Home equity	19,688	19.5%	20,043	21.2%	19,176	21.8%	17,072	20.6%	14,560	18.9%
Other consumer	6,824	6.7%	7,053	7.4%	7,270	8.2%	7,257	8.7%	6,907	9.0%
Total loans outstanding	<u>\$100,953</u>	<u>100.0%</u>	<u>\$94,610</u>	<u>100.0%</u>	<u>\$88,071</u>	<u>100.0%</u>	<u>\$83,042</u>	<u>100.0%</u>	<u>\$76,978</u>	<u>100.0%</u>

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The loan maturities and interest sensitivity for a segment of the loan portfolio are reflected in the table below.

	As of December 31, 2008			Total
	Due Under One Year	Due 1- 5 Years	Due Over Five Years	
Maturity of loans receivable:				
		(In Thousands)		
Commercial and commercial real estate	\$8,164	\$11,968	\$ 9,637	\$29,769
Real estate construction	-	-	873	873
Total	<u>\$8,164</u>	<u>\$11,968</u>	<u>\$10,510</u>	<u>\$30,642</u>
		Due 1-5 Years	Due Over Five Years	
Fixed interest rates		\$ 1,341	\$ 3,429	
Floating or adjustable interest rates		10,627	7,081	
Total		<u>\$11,968</u>	<u>\$10,510</u>	

### Credit Risk and Loan Quality

The Corporation continues to strive to minimize credit risk. The Bank's written lending policy requires underwriting, loan documentation and credit analysis standards to be met prior to the approval and funding of any loan. In accordance with that policy, internal loan review monitors the loan portfolio on an ongoing basis. The loan committee then prepares an analysis each quarter of the allowance for loan losses, which is then submitted to the Board of Directors for its assessment as to the adequacy of the allowance.

The lending policy is executed through the tiered assignment of loan limit authorities (secured and unsecured), to individual officers of the Bank, the Loan Committee and the Board of Directors. Although the Corporation maintains sound credit policies, certain loans may deteriorate for a variety of reasons. The Corporation's policy is to place all loans on a non-accrual status upon becoming 90 days delinquent in their payments, unless there is a documented, reasonable expectation of the collection of the delinquent amount. Loans are reviewed monthly as to their delinquency status and on a quarterly basis through review and preparation of a troubled loans report, which is presented to the Board of Directors.

Total nonperforming loans (comprised of non-accruing loans and loans past due for more than 90 days) as of December 31, 2008 were \$483,000 compared to \$36,000 as of December 31, 2007. Total nonperforming loans as a percentage of total loans were .17% at December 31, 2008 as compared to .04% at December 31, 2007. There were no foreclosed assets as of December 31, 2008 or 2007. Lenders continue to work with customers to minimize losses associated with non-accrual and delinquent accounts. In addition, management is not aware of any material potential loan problems that have not been disclosed herein.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Detailed information about the Corporation's nonperforming loans and nonperforming assets for the last five years is shown in the table below.

	2008	2007	December 31, 2006	2005	2004
			(Dollars in Thousands)		
	\$				
Non-accruing loans	-	\$ -	\$ -	\$ -	\$126
Accruing loans past due 90 days or more	173	36	52	67	63
Total nonperforming loans	173	36	52	67	189
Foreclosed real estate/repossessed assets	-	-	71	-	-
Total nonperforming assets	\$173	\$36	\$123	\$67	\$189
Non-accrual loans:					
Interest income that would have been recorded on non-accrual loans	\$ -	\$ -	\$ -	\$ -	\$ 11
Interest income for above loans included in net income for the period	\$ -	\$ -	\$ -	\$ -	\$ -
Ratios:					
Nonperforming loans to total loans	0.17%	0.04%	0.06%	0.08%	0.25%
Allowance for loan losses to nonperforming loans	439.88%	1,722.22%	1,255.77%	980.60%	350.79%
Nonperforming assets to total assets	0.07%	0.02%	0.06%	0.03%	0.09%
Commitments to lend additional funds to Nonperforming loan customers	-	-	-	-	-

### Deposits

Deposits are the major source of the Corporation's funds for lending and other investment purposes. Total deposits at December 31, 2008 were \$192,938,000, an increase of \$12,547,000 or 7.0%, over total deposits of \$180,391,000 as of December 31, 2007. The Corporation experienced the following increase/(decrease) percentages for the year 2008 as compared to 2007.

Non-interest bearing demand deposits	(2.7%)
Interest-bearing demand deposits	(7.7%)
Savings deposits	7.2%
Time deposits	9.2%

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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The following table displays the maturities of time deposits issued in denominations of \$100,000 or more at December 31, 2008.

(In Thousands)	<u>Time Certificates</u>
Three months or less	\$ 3,420
Over three months but within six months	3,955
Over six months but within twelve months	7,127
Over twelve months	29,710
Total	<u>\$44,212</u>

### **Liquidity**

Liquidity represents the Corporation's ability to efficiently manage cash flows at reasonable rates to support possible commitments to borrowers or the demands of depositors. Liquidity is essential to compensate for fluctuations in the balance sheet and provide funds for growth and normal operating expenditures. Liquidity needs may be met by converting assets into cash or obtaining sources of additional funding.

Sources of asset liquidity are provided through cash, amounts due from banks, interest-bearing deposits with banks and federal funds sold, which totaled \$3,977,000 at December 31, 2008 as compared to \$4,006,000 at December 31, 2007. Additional liquidity sources include principal payments on securities in the Bank's securities portfolio and cash flow from its amortizing loan portfolio. Selling securities available-for-sale, selling loans or raising additional capital may be used to meet longer-term liquidity needs. At December 31, 2008, available-for-sale securities totaling \$37,950,000 were available for liquidity purposes as compared with \$36,394,000 at December 31, 2007.

Liability liquidity sources include attracting deposits at competitive rates. Core deposits at December 31, 2008 totaled \$65,078,000 as compared to \$62,191,000 at December 31, 2007. The Bank has a \$4 million federal funds line of credit with its main correspondent bank, Atlantic Central Bankers Bank. The Bank had no federal funds purchased under this line at December 31, 2008 and \$2,249,000 at December 31, 2007. The Bank also has established a line of credit and other credit facilities with the Federal Home Loan Bank, which are reliable sources for short and long-term funds. Maximum borrowing capacity with the Federal Home Loan Bank is approximately \$130,597,000.

Management is not aware of any demands, trends, commitments, or events that would result in the Bank's inability to meet anticipated or unexpected needs.

### **Off-Balance Sheet Arrangements**

The Corporation's financial statements do not reflect off-balance sheet arrangements that are made in the normal course of business. Those off-balance sheet arrangements consist of unfunded loans and letters of credit made under the same standards as on-balance sheet instruments. These commitments at December 31, 2008 totaled \$6,171,000. This consisted of \$806,000 in commercial real estate, construction, land development loans, and one to four family purchase/refinance loans, \$4,734,000 in home equity lines of credit, \$594,000 in standby letters of credit and the remainder in other unused commitments. 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 to the Corporation.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Management believes that any amounts actually drawn upon can be funded in the normal course of operations. The Corporation has no investment in or financial relationship with any unconsolidated entities that are reasonably likely to have a material effect on liquidity or the availability of capital resources.

### Stockholders' Equity and Capital Requirements/Ratios

The net effect of the activity in stockholders' equity resulted in an increase of \$2,699,000 in total stockholders' equity to \$44,529,000 at December 31, 2008 from \$41,830,000 at December 31, 2007. Stockholders' equity increased in 2008 as a result of an increase in retained earnings of \$2,278,000, and a change from an accumulated other comprehensive loss of \$373,000 at December 31, 2007 to an accumulated other comprehensive gain of \$442,000 at December 31, 2008. This was offset by an increase in treasury stock of \$394,000. FAS 115 requires banks to report securities classified as "available-for-sale" at fair value, with unrealized gains or losses, net of deferred income taxes, reported as a separate component of stockholders' equity. The FAS 115 adjustment is not included in the Corporation's calculations of regulatory capital ratios.

The Corporation places a significant emphasis on maintaining a strong capital base. The goals for capital planning are to build a strong capital base to allow for future growth, to support risks inherent in the banking industry, to retain earnings to meet regulatory requirements and to provide an adequate return to stockholders.

Current capital guidelines issued by federal regulatory authorities require the Corporation and the Bank to meet minimum risk-based capital ratios in an effort to make regulatory capital more responsive to the risk exposure related to on and off-balance sheet items.

Risk-based capital provides the basis for which all banks are evaluated in terms of capital adequacy. Risk-based capital guidelines redefine the components of capital, categorize assets into risk classes and include certain off-balance sheet items in the calculation of capital requirements. The components of risk-based capital are segregated as Tier I and Tier II capital. Tier I capital is composed of total stockholders' equity reduced by goodwill and other intangible assets. Tier II capital is comprised of the allowance for loan losses and any qualifying debt obligations. Risk-based capital standards require the Corporation and the Bank to have Tier I capital of at least 4% and total capital (including Tier I capital) of at least 8% of risk-weighted assets.

The Corporation and the Bank are also subject to leverage capital requirements. This requirement compares capital (using the definition of Tier I capital) to average balance sheet assets and is intended to supplement the risk-based capital ratio in measuring capital adequacy. The guidelines set a minimum leverage ratio of 3% for institutions that are highly rated in terms of safety and soundness, and which are not experiencing or anticipating any significant growth. Other institutions are expected to maintain capital levels of at least 1% or 2% above the minimum.

A comparison of the Bank's risk-based capital ratios and leverage ratios is shown in the following table. The Corporation's ratios are not significantly different.

	December 31, 2008	December 31, 2007
	(Dollars in Thousands)	
Tier I, common stockholders' equity	\$43,826	\$41,833
Tier II, allowable portion of allowance for loan losses	761	620
Total capital	<u>\$44,587</u>	<u>\$42,453</u>
Tier I risk-based capital ratio	37.83%	37.92%
Tier II risk-based capital ratio	38.49%	38.49%
Tier I leverage ratio	18.62%	18.69%

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

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At December 31, 2008 and 2007, the Bank exceeded the minimum regulatory capital requirements to be considered a "well capitalized" financial institution under applicable federal regulations.

Banking laws and regulations limit the amount of dividends that may be paid by the Bank to the Corporation without prior approval of the Bank's regulatory agency. These restrictions have not had, and are not expected to have, a significant impact on the Corporation's ability to pay dividends.

### **Effect of Inflation**

The majority of assets and liabilities of the Corporation are monetary in nature and, therefore, differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. The precise impact of inflation upon the Bank is difficult to measure. Inflation may affect the borrowing needs of consumers, thereby impacting the growth rate of the Corporation's assets. Inflation may also affect the general level of interest rates, which can have a direct bearing on the Corporation.

Management believes the most significant impact on the financial results is the Corporation's ability and timing to react to changes in interest rates. On an ongoing basis, management attempts to maintain an essentially balanced position between interest sensitive assets and liabilities, where such balancing is dependent on whether there is a rising or falling interest rate environment.

### **Interest Rate Sensitivity and Market Risk**

In the normal course of conducting business activities, the Corporation is exposed to market risk, principally interest rate risk. Interest rate risk arises from market driven fluctuations in interest rates that may affect cash flows, income, expenses and the values of financial instruments. The Asset/Liability Committee manages interest rate risk.

The operations of the Corporation do not expose it to foreign currency exchange or commodity price risks. Also, the Corporation does not utilize interest rate swaps, caps or other hedging transactions. The Corporation does not own any trading assets.

The principal objective of the asset/liability management activities is to provide consistently higher levels of net interest income while maintaining acceptable levels of interest rate and liquidity risk and facilitating the funding needs of the Corporation. The Corporation utilizes an interest rate sensitivity model as the primary quantitative tool in measuring the amount of interest rate risk that is present. The traditional maturity "gap" analysis, which reflects the volume difference between interest rate sensitive assets and liabilities during a given time period, is reviewed quarterly by management and the Asset/Liability Committee (ALCO) of the Bank. A positive gap occurs when the amount of interest sensitive assets exceeds interest sensitive liabilities. This position would contribute positively to net income in a rising rate environment. Conversely, if the balance sheet is liability sensitive or negatively gapped, this position would contribute positively to net income in a falling rate environment. Management continues to monitor sensitivity in order to avoid overexposure to changing interest rates, while maintaining adequate capital and liquidity levels. Adjustments to the mix of assets and liabilities are made periodically in an effort to give the Bank dependable and steady growth in net interest income regardless of the behavior of interest rates in general.

Another method used by management to review its interest sensitive position is through "simulation". In simulation, the Bank projects the future net interest streams in light of the current gap position. Various interest rate scenarios are used to measure levels of interest income associated with potential changes in our operating environment. Management cannot measure levels of interest income associated with potential changes in the Bank's operating environment. Nor can it predict the direction of interest rates or how the mix of assets and liabilities will change. The use of this information will help formulate strategies to minimize the unfavorable effect on net interest income caused by interest rate changes.

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

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A simple rate “gap” analysis by itself may not be an accurate indicator of how net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. Although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates. In the event of a change in interest rates, prepayments and early withdrawal levels also could deviate significantly from those assumed in calculating the interest rate gap. Because of uncertainties, the Corporation utilizes more than one measurement tool in assessing interest rate sensitivity and market risk.

As of December 31, 2008 the Corporation was less negatively gapped than at December 31, 2007 in terms of its “One Year” gap position. A negative gap position reflects the volume of interest rate sensitive liabilities to be greater than the volume of interest rate sensitive assets. In consideration of interest rates decreasing, it is preferable to be in a negatively gapped position since there are more interest rate sensitive liabilities that are either maturing or whose interest rates will be repricing downward, quicker than the maturity/repricing of the interest rate sensitive assets. This will enhance the Corporation’s bottom line by improving the Corporation’s net interest rate spread since it is expected that interest expense will decrease faster than interest income.

The Corporation’s overall sensitivity to interest rate risk is low due to its non-complex balance sheet. The Corporation has the ability to expedite several strategies to manage interest rate risk, which include but are not limited to selling of residential mortgages, increasing/decreasing deposits via interest rate changes, borrowing from the Federal Home Loan Bank of Pittsburgh and Atlantic Central Bankers Bank, and buying/selling investments.

# NEFFS BANCORP, INC. AND SUBSIDIARY

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following table represents the gap position for the Bank at December 31, 2008. This schedule summarizes how many fixed rate assets and liabilities will pay down over the periods of time defined in the table.

	Maturity/Repricing Intervals					<u>Total</u>
	<u>1-3</u> <u>Months</u>	<u>3-12</u> <u>Months</u>	<u>1-3</u> <u>Years</u>	<u>3-5</u> <u>Years</u>	<u>Over 5</u> <u>Years</u>	
	(In Thousands)					
Federal funds sold	\$ 1,379	\$ -	\$ -	\$ -	\$ -	\$ 1,379
Interest bearing deposits with banks	-	109	-	-	-	109
Other securities	26,542	678	1,703	3,818	57,878	90,619
Mortgage-backed securities	2,600	7,890	5,082	3,709	19,607	38,888
Total securities	29,142	8,568	6,785	7,527	77,485	129,507
Total loans	35,118	21,218	18,034	8,932	17,651	100,953
Total interest earning assets	65,639	29,895	24,819	16,459	95,136	231,948
NOW Accounts	1,328	-	4,710	-	-	6,038
Savings	8,701	-	39,637	-	-	48,338
Total savings deposits	10,029	-	44,347	-	-	54,376
CDs<\$100,000	11,400	33,057	24,031	9,022	-	77,510
CDs>\$100,000	3,420	11,181	10,126	19,585	-	44,312
Total time deposits	14,820	44,238	34,157	28,607	-	121,822
Total interest bearing liabilities	24,849	44,238	78,504	28,607	-	176,198
Rate sensitive gap	\$40,790	\$(14,343)	\$(53,685)	\$(12,148)	\$95,136	\$55,750
Cumulative gap	\$40,790	\$26,447	\$(27,238)	\$(39,386)	\$55,750	-

# ***NEFFS BANCORP, INC. AND SUBSIDIARY***

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

### **Regulatory Activity**

From time to time, various types of federal and state legislation have been proposed that could result in additional regulation of, and restrictions on, the business of the Corporation. It cannot be predicted whether such legislation will be adopted or, if adopted, how such legislation would affect the business of the Corporation. As a consequence of the extensive regulation of commercial banking activities in the United States, the Bank's business is particularly susceptible to being affected by federal regulation and regulations that may increase the cost of doing business. Management is not aware of any other current specific recommendations or proposals by regulatory authorities that will impact the Corporation's or the Bank's, operations, although the general cost of compliance with numerous and multiple federal and state laws and regulations does have, and in the future may have, a negative impact on the Corporation's results of operations.

Further, the business of the Corporation is also affected by the state of the financial services industry in general. As a result of legal and industry changes, management predicts that the industry will continue to experience a certain amount of consolidations and mergers. Management believes that such consolidations and mergers may enhance its competitive position as a community bank.

### **Form 10-K**

The Corporation will provide, without charge to any stockholder, a copy of its 2008 Annual Report on Form 10-K as required to be filed with the Securities and Exchange Commission. Requests should be made in writing to:

Neffs Bancorp, Inc.  
P.O. Box 10  
Neffs, PA 18065