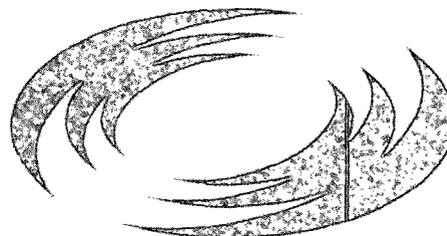
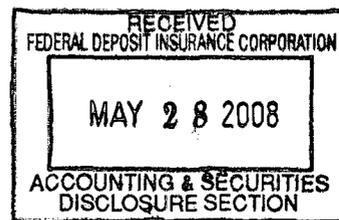


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# **EMBASSY BANK™**

For the Lehigh Valley

## **2007 Annual Report**

**Filings Services**

**JUN 24 2008**

**SNL Financial, LC  
1-800-969-4121**

# Corporate Information

## Board of Directors

### **Frank Banko**

*President, Warren Distributing  
Owner Banko Real Estate Company*

### **Geoffrey F. Boyer, CFP**

*President, Boyer Financial Group*

### **John P. Brew, Jr.**

*Chairman, President & CEO  
BNK Advisory Group, Inc.  
Partner, Chief Bank Strategist of M. RAE*

### **Robert P. Daday**

*Sp. Assistant to the President, PPL*

### **John G. Englesson**

*Principal, Dynamatrics, LLC*

### **Elmer D. Gates**

*Chairman of the Board  
Embassy Bank for the Lehigh Valley*

### **M. Bernadette Holland, CFP**

*Vice President  
Citi Smith Barney*

### **Fredric C. Jacobs, Esquire**

*Sr. Partner, Jacobs and Jacobs*

### **Bernard M. Lesavoy, Esquire**

*Partner, Lesavoy Butz & Seitz LLC*

### **David M. Lobach, Jr.**

*Vice Chairman, CEO & President  
Embassy Bank for the Lehigh Valley*

### **John C. Pittman**

*Owner/CEO  
Sport Stars, Inc.*

### **John T. Yurconic**

*President  
John Yurconic Agency*



## EMBASSY BANK™

For the Lehigh Valley

## Officers

**Elmer D. Gates**, *Chairman of the Board*

### Executive Officers

**David M. Lobach, Jr.**, *Vice Chairman, CEO & President*

**Judith A. Hunsicker**, *Sr. Executive Vice President, COO,  
CFO, Secretary & Treasurer*

**James R. Bartholomew**, *Executive Vice President & SLO  
Commercial Lending*

### Senior Vice Presidents

**Tracy A. Barker**, *Deposit Operations*

**Mark A. Casciano**, *Branch Administration*

**Diane M. Cunningham**, *Consumer Lending*

**Lynne M. Neel**, *Controller & Credit Administration*

**Terry M. Stecker**, *Commercial Lending & Business  
Development*

### Vice Presidents

**David C. Arner**, *Commercial Services*

**Desty A. Bonstein**, *Business Development*

**Jeffrey A. Cella**, *Commercial Lending*

**Diane R. Effting**, *Commercial Lending*

**Scott A. Karwacki**, *Commercial Lending*

**Michael Lahanas**, *Business Development*

**Timothy P. Woodbridge**, *Commercial Lending*

### Assistant Vice Presidents

**Michelle L. Barron**, *Deposit Operations*

**Tracy L. McCarthy**, *Credit Administration*

**Jane M. Rutt**, *Credit Administration*

**Brandi L. Stefanov**, *Customer Satisfaction Manager*

**Jennifer A. Tropeano**, *Consumer Lending*

**Kristin A. Wannisky**, *Marketing*

### Assistant Treasurers

**Carole P. Hay**, *Commercial Loan Administration*

**Molly A. Higgins**, *Customer Satisfaction Manager*

**Bryan D. Lobach**, *Commercial Services*

**Christine L. Pierce**, *Customer Satisfaction Manager*

**Lisa M. Schmidt**, *Commercial Lending*

**Misty K. Wurman**, *Customer Satisfaction Manager*

***Embassy Bank For The Lehigh Valley***

Financial Report

December 31, 2007

# ***Embassy Bank For The Lehigh Valley***

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## Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders  
Embassy Bank For The Lehigh Valley

We have audited the accompanying balance sheets of Embassy Bank For The Lehigh Valley as of December 31, 2007 and 2006, and the related statements of income, stockholders' equity and cash flows for the years then ended. The Bank's management is responsible for these financial statements. Our responsibility is to express an opinion on these 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 Bank is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits 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 Bank'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 financial statements referred to above present fairly, in all material respects, the financial position of Embassy Bank For The Lehigh Valley as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

*Beard Miller Company LLP*

Beard Miller Company LLP  
Allentown, Pennsylvania  
March 26, 2008

# Embassy Bank For The Lehigh Valley

## Balance Sheets

	December 31,	
	2007	2006
	(Dollars in Thousands, Except Share Data)	
<b>Assets</b>		
Cash and due from banks	\$ 3,360	\$ 7,329
Interest-bearing demand deposit with bank	2	29
Federal funds sold	-	3,500
<b>Cash and Cash Equivalents</b>	<b>3,362</b>	<b>10,858</b>
Securities available for sale	49,496	43,097
Restricted investments in bank stock	1,509	1,412
Loans, net of allowance for loan losses 2007 \$2,503; 2006 \$2,426	274,313	233,167
Bank premises and equipment, net of depreciation	2,462	2,006
Deferred taxes	1,202	-
Accrued interest receivable	1,138	1,021
Other assets	536	451
<b>Total Assets</b>	<b>\$334,018</b>	<b>\$292,012</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Deposits:		
Non-interest bearing	\$ 15,150	\$ 15,855
Interest-bearing	251,491	222,287
<b>Total Deposits</b>	<b>266,641</b>	<b>238,142</b>
Securities sold under agreements to repurchase and federal funds purchased	17,965	13,800
Short-term borrowings	6,093	12,935
Long-term borrowings	10,396	-
Accrued interest payable	4,117	3,101
Other liabilities	533	386
<b>Total Liabilities</b>	<b>305,745</b>	<b>268,364</b>
<b>Stockholders' Equity</b>		
Common stock, \$1 par value; authorized 10,000,000 shares; issued and outstanding 2007 6,885,915 shares; 2006 6,628,942 shares	6,886	6,629
Surplus	22,775	20,758
Accumulated deficit	(1,464)	(2,994)
Accumulated other comprehensive income (loss)	76	(745)
<b>Total Stockholders' Equity</b>	<b>28,273</b>	<b>23,648</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$334,018</b>	<b>\$292,012</b>

See notes to financial statements.

# Embassy Bank For The Lehigh Valley

## Statements of Income

	Years Ended December 31,	
	2007	2006
	(In Thousands, Except Per Share Data)	
<b>Interest Income</b>		
Loans receivable, including fees	\$16,350	\$12,824
Securities	2,305	1,958
Federal funds sold	149	119
Other	5	5
<b>Total Interest Income</b>	<b>18,809</b>	<b>14,906</b>
<b>Interest Expense</b>		
Deposits	10,375	7,963
Securities sold under agreements to repurchase and federal funds purchased	727	180
Short-term borrowings	398	575
Long-term borrowings	263	-
<b>Total Interest Expense</b>	<b>11,763</b>	<b>8,718</b>
<b>Net Interest Income</b>	<b>7,046</b>	<b>6,188</b>
<b>Provision for Loan Losses</b>	<b>390</b>	<b>644</b>
<b>Net Interest Income after Provision for Loan Losses</b>	<b>6,656</b>	<b>5,544</b>
<b>Other Income</b>		
Credit card processing fees	211	34
Other service fees	249	185
<b>Total Other Income</b>	<b>460</b>	<b>219</b>
<b>Other Expenses</b>		
Salaries and employee benefits	3,287	2,763
Occupancy and equipment	1,160	856
Credit card processing	208	46
Data processing	512	432
Advertising and promotion	447	438
Professional fees	265	243
FDIC insurance expense	146	-
Insurance expense	53	49
Loan department expense	107	96
Other	642	506
<b>Total Other Expenses</b>	<b>6,827</b>	<b>5,429</b>
<b>Income before Income Taxes</b>	<b>289</b>	<b>334</b>
<b>Income Tax Benefit</b>	<b>(1,241)</b>	<b>-</b>
<b>Net Income</b>	<b>\$ 1,530</b>	<b>\$ 334</b>
<b>Basic Earnings per Share</b>	<b>\$0.23</b>	<b>\$0.05</b>
<b>Diluted Earnings per Share</b>	<b>\$0.21</b>	<b>\$0.05</b>

See notes to financial statements.

# Embassy Bank For The Lehigh Valley

## Statements of Stockholders' Equity Years Ended December 31, 2007 and 2006

	Common Stock	Surplus	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
(In Thousands, Except Share Data)					
<b>BALANCE - DECEMBER 31, 2005</b>	\$6,096	\$16,374	\$(3,328)	\$(1,055)	\$18,087
Comprehensive income:					
Net income	-	-	334	-	334
Change in net unrealized loss on securities available for sale	-	-	-	310	310
<b>Total Comprehensive Income</b>					<b>644</b>
Exercise of stock options, 90,672 shares	60	197	-	-	257
Sale of 473,400 shares of common stock at \$10 per share, net of offering costs of \$74	473	4,187	-	-	4,660
<b>BALANCE - DECEMBER 31, 2006</b>	6,629	20,758	(2,994)	(745)	23,648
Comprehensive income:					
Net income	-	-	1,530	-	1,530
Change in net unrealized loss on securities available for sale, net of income tax effects	-	-	-	821	821
<b>Total Comprehensive Income</b>					<b>2,351</b>
Exercise of stock options, 35,436 shares	35	67	-	-	102
Sale of 221,537 shares of common stock at \$10 per share, net of offering costs of \$43	222	1,950	-	-	2,172
<b>BALANCE - DECEMBER 31, 2007</b>	<b>\$ 6,886</b>	<b>\$ 22,775</b>	<b>\$ (1,464)</b>	<b>\$ 76</b>	<b>\$28,273</b>

See notes to financial statements.

# Embassy Bank For The Lehigh Valley

## Statements of Cash Flows

	Years Ended December 31,	
	2007	2006
	(In Thousands)	
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 1,530	\$ 334
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	390	644
Depreciation and amortization	383	282
Net (accretion) amortization of investment security premiums and discounts	(26)	28
Deferred income taxes	(1,241)	-
Increase in accrued interest receivable	(117)	(191)
Increase in other assets	(85)	(108)
Increase in accrued interest payable	1,016	1,267
Increase in other liabilities	147	155
<b>Net Cash Provided by Operating Activities</b>	<u>1,997</u>	<u>2,411</u>
<b>Cash Flows from Investing Activities</b>		
Purchases of securities available for sale	(11,962)	(5,869)
Maturities, calls and principal repayments of securities available for sale	6,449	5,361
Increase in restricted investments in bank stock	(97)	(180)
Net increase in loans	(41,536)	(56,271)
Purchases of premises and equipment	(839)	(940)
<b>Net Cash Used in Investing Activities</b>	<u>(47,985)</u>	<u>(57,899)</u>
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	28,499	52,239
Net increase in securities sold under agreements to repurchase and federal funds purchased	4,165	9,101
Decrease in short-term borrowed funds	(6,842)	(4,076)
Proceeds from long-term borrowed funds	10,396	-
Proceeds from sale of common stock	2,172	4,660
Proceeds from the exercise of stock options	102	257
<b>Net Cash Provided by Financing Activities</b>	<u>38,492</u>	<u>62,181</u>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	(7,496)	6,693
<b>Cash and Cash Equivalents - Beginning</b>	<u>10,858</u>	<u>4,165</u>
<b>Cash and Cash Equivalents - Ending</b>	<u>\$ 3,362</u>	<u>\$ 10,858</u>
<b>Supplementary Cash Flows Information</b>		
Interest paid	<u>\$ 10,747</u>	<u>\$ 7,451</u>

See notes to financial statements.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

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### **Note 1 - Summary of Significant Accounting Policies**

#### **Organization and Nature of Operations**

Embassy Bank For The Lehigh Valley (the "Bank") was incorporated on May 11, 2001 under the laws of the Commonwealth of Pennsylvania and is a Pennsylvania state chartered bank. The Bank commenced operations on November 6, 2001 and is a full service bank providing personal and business lending and deposit services. As a state chartered bank, the Bank is subject to regulation of the Pennsylvania Department of Banking and the Federal Deposit Insurance Corporation. The area served by the Bank is the Lehigh Valley area of Pennsylvania.

In January 2008, the Bank's Board of Directors approved the formation of a small bank holding company. The Bank is in process of completing the regulatory application process and anticipates that the matter will be presented for shareholder approval at the Bank's annual shareholders' meeting in June 2008.

#### **Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses.

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

Most of the Bank's activities are with customers located in the Lehigh Valley area of Pennsylvania. Note 2 discusses the types of securities in which the Bank invests. The concentrations of credit by type of loan are set forth in Note 3. The Bank does not have any significant concentrations to any one specific industry or customer, with the exception of lending activity to a broad range of lessors of residential and non-residential real estate within the Lehigh Valley. Although the Bank has a diversified loan portfolio, its debtors' ability to honor their contracts is influenced by the region's economy.

#### **Presentation of Cash Flows**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing demand deposits with bank, and federal funds sold. Generally, federal funds are purchased or sold for less than one week periods.

#### **Securities**

Securities classified as available for sale are those securities that the Bank intends to hold for an indefinite period of time but not necessarily to maturity. Securities available for sale are carried at fair value. 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 maturity mix of the Bank's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Unrealized gains and losses are reported as increases or decreases in other comprehensive income. 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.

Declines in the fair value of available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses,

# ***Embassy Bank For The Lehigh Valley***

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## **Notes to Financial Statements**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Securities (Continued)**

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 Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

#### **Restricted Investments in Bank Stock**

Restricted investments in bank stock consists of Federal Home Loan Bank stock (FHLB) and Atlantic Central Bankers Bank stock. Federal law requires a member institution of the FHLB to hold stock of its district FHLB according to a predetermined formula. The restricted stocks are carried at cost.

#### **Loans Receivable**

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

The accrual of interest is 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.

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 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 change.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as 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

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

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### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Allowance for Loan Losses (Continued)**

assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

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

#### **Bank Premises and Equipment**

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the following estimated useful lives of the related assets; furniture, fixtures and equipment for five to ten years, leasehold improvements for ten to fifteen years, computer equipment and data processing software for three to five years, and automobiles for five years.

#### **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 Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

#### **Advertising Costs**

The Bank follows the policy of charging the costs of advertising to expense as incurred.

#### **Income Taxes**

Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and net operating loss carry forwards 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.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Earnings per Share**

Basic earnings per share represents net income divided by the weighted-average common shares outstanding during the period, as adjusted for stock splits. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares (stock options) had been issued. The following table sets forth the computations of basic and diluted earnings per share for the years ended December 31, 2007 and 2006:

Per share data has been adjusted for the effect of the three-for-two stock split declared on October 26, 2007.

	<u>2007</u>	<u>2006</u>
	(Dollars in Thousands, Except per Share Data)	
Net income	<u>\$ 1,530</u>	<u>\$ 334</u>
Weighted average shares outstanding	<u>6,789,360</u>	<u>6,428,163</u>
Dilutive effect of potential common shares, stock options	<u>460,069</u>	<u>485,377</u>
Diluted Weighted-Average Common Shares Outstanding	<u>7,249,429</u>	<u>6,913,540</u>
Basic earnings per share	<u>\$0.23</u>	<u>\$0.05</u>
Diluted earnings per share	<u>\$0.21</u>	<u>\$0.05</u>

#### **Employee Benefit Plan**

The Bank has a 401(k) Plan (the "Plan") for employees. All employees are eligible to participate after they have attained the age of 21 and have also completed 12 consecutive month periods during which at least 1,000 hours of service are completed. The employees may contribute up to the maximum percentage allowable by law of their compensation to the Plan, and the Bank provides a match of fifty percent of the first 8% percent to eligible participating employees. Full vesting in the Plan is prorated equally over a four-year period. The Bank's contributions to the Plan for the years ended December 31, 2007 and 2006 were \$65,000 and \$52,000, respectively.

#### **Off-Balance Sheet Financial Instruments**

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

#### **Comprehensive Income**

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

# Embassy Bank For The Lehigh Valley

## Notes to Financial Statements

### Note 1 - Summary of Significant Accounting Policies (Continued)

#### Comprehensive Income (Continued)

The components of other comprehensive income are as follows for the years ended December 31, 2007 and 2006:

	2007	2006
	(In Thousands)	
Unrealized holding gains on securities available for sale	\$860	\$310
Less: Reclassification adjustment for gains included in net income	-	-
	860	310
Tax effect	(39)	-
	821	310
<b>Net Unrealized Gains</b>	<b>821</b>	<b>310</b>

#### Segment Reporting

The Bank acts as an independent, community, financial services provider, and offers traditional banking and related financial services to individual, business and government customers. The Bank offers a full array of commercial and retail financial services, including the taking of time, savings and demand deposits; the making of commercial, consumer and home equity loans; and the provision of other financial services.

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

#### Stock-Based Compensation

Prior to January 1, 2006, the Bank's stock option plan was accounted for under the recognition and measurement provisions of APB Opinion No. 25 (Opinion 25), *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock Based Compensation*. No stock-based employee compensation cost was recognized in the Bank's statements of income through December 31, 2005, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. Effective January 1, 2006, the Bank adopted the fair value recognition provisions of FASB Statement No. 123(R), *Share Based Payment*. Statement No. 123(R) replaces Statement No. 123, supersedes APB Opinion No. 25 and requires compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. Statement No. 123(R) requires that companies that utilized the minimum value method under Statement No. 123 adopt the new fair value accounting prospectively for new or modified grants on or after January 1, 2006. For the years ended December 31, 2007 and 2006, there were no stock options granted. Prospective adoption means that awards granted in earlier fiscal years continue to be accounted for using the existing accounting, typically APB Opinion No. 25.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **New Accounting Standards**

In March 2007, the FASB ratified EITF Issue No. 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards" ("EITF 06-11"). EITF 06-11 requires companies to recognize the income tax benefit realized from dividends or dividend equivalents that are charged to retained earnings and paid to employees for nonvested equity-classified employee share-based payment awards as an increase to additional paid-in capital. EITF 06-11 is effective for fiscal years beginning after September 15, 2007. The Bank does not expect EITF 06-11 will have a material impact on its financial position, results of operations or cash flows.

In September 2006, the FASB reached consensus on the guidance provided by Emerging Issues Task Force Issue 06-4 ("EITF 06-4"), Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements. The guidance is applicable to endorsements split-dollar life insurance arrangements, hereby the employer owns and controls the insurance policy, that are associated with a postretirement benefit. EITF 06-4 requires that for a split-dollar insurance arrangement within the scope of the issue, an employer should recognize a liability for future benefits in accordance with FASB No. 106 (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board Opinion No. 12 (if the arrangements is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. The Bank does not expect EITF 06-4 will have a material impact on its financial statements.

On September 7, 2006, the Emerging Issues Task Force reached a conclusion on EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance" ("EITF 06-5"). The scope of EITF 06-5 consists of six separate issues relating to accounting for life insurance policies purchased by entities protecting against the loss of "key persons." The six issues are clarifications of previously issued guidance on FASB Technical Bulletin No. 85-4. EITF 06-5 is effective for fiscal years beginning after December 15, 2006. Adoption of EITF 06-5 did not have a material impact on the Bank's financial statements.

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 Bank does not expect SAB 109 to have a material impact on its financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value under U.S. GAAP, and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements. In December 2007, the FASB issued proposed FASB Staff Position (FSP) 157-b, "Effective Date of FASB Statement No. 157," that would permit a one-year deferral in applying the measurement provisions of Statement No. 157 to non-financial assets and non-financial liabilities (non-financial items) that

# ***Embassy Bank For The Lehigh Valley***

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## **Notes to Financial Statements**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **New Accounting Standards (Continued)**

are not recognized or disclosed at fair value in an entity's financial statements on a recurring basis (at least annually). Therefore, if the change in fair value of a non-financial item is not required to be recognized or disclosed in the financial statements on an annual basis or more frequently, the effective date of application of Statement 157 to that item is deferred until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. This deferral does not apply, however, to an entity that applies Statement 157 in interim or annual financial statements before proposed FSP 157-b is finalized. The Bank does not expect that the adoption of FASB No. 157 and FSP 157-b will have a material impact on the Bank's financial position, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 provides companies with an option to report many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective of SFAS No. 159 is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. The FASB believes that SFAS No. 159 helps to mitigate accounting-induced volatility by enabling companies to report related assets and liabilities at fair value, which would likely reduce the need for companies to comply with detailed rules for hedge accounting. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities, and would require entities to display the fair value of those assets and liabilities for which the Bank has chosen to use fair value on the face of the balance sheet. The new statement does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in SFAS No. 157, *Fair Value Measurements*. This statement is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. The Bank is in the process of evaluating the impact, if any, that the adoption of SFAS No. 159 will have on the Bank's financial statements.

#### **Reclassifications**

Certain amounts in the 2006 financial statements have been reclassified to conform to 2007 presentations. Those reclassifications had no effect on net income.

# Embassy Bank For The Lehigh Valley

## Notes to Financial Statements

### Note 2 - Securities Available for Sale

The amortized cost and fair values of securities available for sale are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
	(In Thousands)			
<b>December 31, 2007</b>				
U.S. Government agency securities	\$10,955	\$ 191	\$ -	\$11,146
Taxable municipal bonds	3,909	-	(53)	3,856
Mortgage-backed securities	<u>34,517</u>	<u>255</u>	<u>(278)</u>	<u>34,494</u>
	<u>\$49,381</u>	<u>\$ 446</u>	<u>\$ (331)</u>	<u>\$49,496</u>
<b>December 31, 2006</b>				
U.S. Government agency securities	\$10,944	\$ -	\$ (177)	\$10,767
Taxable municipal bonds	3,907	-	(87)	3,820
Mortgage-backed securities	<u>28,991</u>	<u>89</u>	<u>(570)</u>	<u>28,510</u>
	<u>\$43,842</u>	<u>\$ 89</u>	<u>\$ (834)</u>	<u>\$43,097</u>

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

	<u>Amortized Cost</u>	<u>Fair Value</u>
	(In Thousands)	
Due in less than one year	\$ 500	\$ 500
Due in one to five years	10,964	11,133
Due in five to ten years	3,400	3,369
Mortgage-backed securities	<u>34,517</u>	<u>34,494</u>
	<u>\$49,381</u>	<u>\$49,496</u>

There were no sales of securities during 2007 and 2006.

# Embassy Bank For The Lehigh Valley

## Notes to Financial Statements

### Note 2 - Securities Available for Sale (Continued)

The following table shows the Bank'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, 2007 and 2006:

	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>						
Taxable municipal bonds	\$2,966	\$(25)	\$ 890	\$ (28)	\$ 3,856	\$ (53)
Mortgage-backed securities	5,483	(14)	12,326	(264)	17,809	(278)
	<u>\$8,449</u>	<u>\$(39)</u>	<u>\$13,216</u>	<u>\$(292)</u>	<u>\$21,665</u>	<u>\$(331)</u>
<b>December 31, 2006</b>						
U.S. Government agency securities	\$ -	\$ -	\$10,767	\$(177)	\$10,767	\$(177)
Taxable municipal bonds	-	-	3,820	(87)	3,820	(87)
Mortgage-backed securities	93	(1)	22,574	(569)	22,667	(570)
	<u>\$93</u>	<u>\$(1)</u>	<u>\$37,161</u>	<u>\$(833)</u>	<u>\$37,254</u>	<u>\$(834)</u>

Unrealized losses detailed above relate to U.S. Government agency, taxable municipal and mortgage-backed securities and the decline in fair value is due only to interest rate fluctuations. The Bank had 45 and 58 securities in an unrealized loss position at the end of December 31, 2007 and 2006, respectively. As the Bank 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.

Securities with carrying values of approximately \$28,607,000 and \$14,010,000 at December 31, 2007 and 2006, respectively, were pledged as collateral to secure securities sold under agreements to repurchase, public deposits, and for other purposes required or permitted by law.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

### **Note 3 - Loans Receivable**

The composition of loans receivable at December 31, 2007 and 2006 is as follows:

	<u>2007</u>	<u>2006</u>
	(In Thousands)	
Commercial real estate	\$125,021	\$ 101,737
Commercial construction	2,969	6,183
Commercial	22,583	21,578
Home equity	123,774	103,895
Consumer	<u>2,216</u>	<u>2,006</u>
<b>Total Loans</b>	<b>276,563</b>	<b>235,399</b>
Unearned net loan origination costs	253	194
Allowance for loan losses	<u>(2,503)</u>	<u>(2,426)</u>
<b>Net Loans</b>	<b><u>\$274,313</u></b>	<b><u>\$233,167</u></b>

### **Note 4 - Allowance for Loan Losses**

The changes in the allowance for loan losses for the years ended December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
	(In Thousands)	
Balance, beginning	\$2,426	\$1,782
Provision for loan losses	390	644
Loans charged off	<u>(313)</u>	<u>-</u>
<b>Balance, ending</b>	<b><u>\$2,503</u></b>	<b><u>\$2,426</u></b>

There was no recorded investment in impaired loans at December 31, 2007 and \$205,000 at December 31, 2006. The Bank had no other impaired loans for the years ended December 31, 2007 and 2006, respectively. The impaired loan at December 31, 2006 required an allowance for loan loss of \$180,000. No impaired loan allowance was required at December 31, 2007. No interest income was recognized for the time the loans were impaired during 2006.

As of December 31, 2007, the Bank had no non-accrual loans. As of December 31, 2006, the Bank had two loans in non-accrual status for \$205,000. The Bank had no loans that were past due 90 days or more and still accruing interest at December 31, 2007 and one loan for \$1,000 that was past due 90 days or more and still accruing interest at December 31, 2006. During 2007 the Bank charged off \$313,000 for two impaired commercial loans.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

### **Note 5 - Bank Premises and Equipment**

The components of premises and equipment at December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
	(In Thousands)	
Furniture, fixtures and equipment	\$ 1,206	\$ 945
Leasehold improvements	1,528	1,153
Computer equipment and data processing software	573	423
Automobiles	65	65
Construction in progress	<u>254</u>	<u>201</u>
	3,626	2,787
Accumulated depreciation	<u>(1,164)</u>	<u>(781)</u>
	<u><u>\$2,462</u></u>	<u><u>\$2,006</u></u>

### **Note 6 - Deposits**

The components of deposits at December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
	(In Thousands)	
Demand, non-interest bearing	\$ 15,150	\$ 15,855
Demand and money market, interest-bearing	46,095	64,179
Savings	37,489	4,597
Time, \$100,000 and over	59,421	57,805
Time, other	<u>108,486</u>	<u>95,706</u>
	<u><u>\$266,641</u></u>	<u><u>\$238,142</u></u>

At December 31, 2007, the scheduled maturities of time deposits are as follows (in thousands):

2008	\$159,230
2009	6,164
2010	1,770
2011	368
2012	<u>375</u>
	<u><u>\$167,907</u></u>

# Embassy Bank For The Lehigh Valley

## Notes to Financial Statements

### Note 7 - Securities Sold under Agreements to Repurchase and Federal Funds Purchased

Securities sold under agreements to repurchase and federal funds purchased generally mature within a few days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. Securities sold under these agreements are retained under the Bank's control at its safekeeping agent. The Bank may be required to provide additional collateral based on the fair value of the underlying securities. Information concerning securities sold under agreements to repurchase for the years ended December 31, 2007 and 2006 is summarized as follows:

	2007	2006
	(Dollars in Thousands)	
Balance outstanding at December 31	\$17,965	\$13,800
Weighted average interest rate at the end of the year	4.28%	4.10%
Average daily balance during the year	\$16,913	\$4,438
Weighted average interest rate during the year	4.22%	3.60%
Maximum month-end balance during the year	\$21,248	\$13,800

### Note 8 – Short-term and Long-term Borrowings

The Bank's maximum borrowing capacity with the Federal Home Loan Bank was \$165,794,000. The Bank had short-term borrowings outstanding with the Federal Home Loan Bank totaling \$6,093,000 at December 31, 2007 and \$12,935,000 at December 31, 2006 and long-term borrowings outstanding with the Federal Home Loan Bank totaling \$10,396,000 at December 31, 2007 and \$0 at December 31, 2006.

The components of short-term borrowings at December 31, 2007 are as follows (in thousands):

Maturity Date	Interest Rate	Outstanding
September 2008	4.78%	<u>\$ 6,093</u>

The components of long-term borrowings at December 31, 2007 are as follows (in thousands):

Maturity Date	Interest Rate	Outstanding
April 2009	4.27%	\$ 1,850
August 2009	4.80%	1,428
May 2010	4.75%	7,118
		<u>\$10,396</u>

The components of short-term borrowings at December 31, 2006 are as follows (in thousands):

Maturity Date	Interest Rate	Outstanding
March 2007	5.08%	\$ 2,159
April 2007	5.18%	2,000
September 2007	5.06%	3,776
October 2007	5.24%	5,000
		<u>\$12,935</u>

# ***Embassy Bank For The Lehigh Valley***

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## **Notes to Financial Statements**

### **Note 8 – Short-term and Long-term Borrowings (Continued)**

The Bank also has an open line of credit with Federal Home Loan Bank totaling \$6,300,000. The Bank had no borrowings outstanding at December 31, 2007 and 2006, respectively for this credit line. Advances from the Federal Home Loan Bank are secured by qualifying assets of the Bank.

The Bank has a federal fund line of credit facility with the Atlantic Central Bankers Bank totaling \$6,000,000. The Bank had no borrowings outstanding at December 31, 2007 and 2006, respectively for this credit line. Advances on this line are unsecured.

### **Note 9 - Lease Commitments**

The Bank has a ten-year operating lease agreement for its main banking office, which commenced in June 2002. The Bank has the option to extend the lease agreement for five additional five-year periods. An addendum to this lease commenced in the second quarter 2005 for additional space. The Bank is also required to pay a monthly fee for its portion of certain operating expenses, including real estate taxes, insurance, utilities, maintenance and repairs in addition to the base rent.

In November 2002, an investment group comprised of related parties of the Bank (executive officers and directors) agreed to purchase the office building in which the Bank leases office space as described above. The purchase was consummated on January 10, 2003. The initial lease terms for the Bank's lease were negotiated at arm's length with the former owner in 2001. There were no modifications or amendments to the terms of that lease agreement by the new owners. The lease terms for the additional space in 2005 are comparable to similarly outfitted space in the Bank's market.

The Bank has a five-year operating lease agreement for its Tilghman Street site, which commenced in April 2004. The Bank has the option to extend the lease agreement for four additional five-year periods. The Bank is also required to pay a monthly fee for its portion of certain operating expenses, including real estate taxes, insurance, utilities, maintenance and repairs in addition to the base rent.

In March 2006, the Bank entered into a lease agreement with a related party of the Bank (director) for a five-year operating lease agreement for its West Broad Street site, which commenced in September 2006. The Bank has the option to extend the lease agreement for four additional five-year periods and a final renewal option of four years, eleven months.

In July 2005, the Bank entered into a land lease agreement for a branch location on Cedar Crest Boulevard in Allentown. The agreement is contingent upon completing proper due diligence of the site, including title, survey, and environmental matters, planning and zoning approvals, and proper banking regulatory approvals. This lease commenced in March 2007.

In October 2005, the Bank entered into a seven year operating lease agreement for its Hamilton Boulevard branch location in Trexlertown, which commenced in January 2007. The Bank has the option to extend the lease agreement for one additional five-year period and a final renewal option of four years, ten months. The Bank is also required to pay a monthly fee for its portion of certain operating expenses, including real estate taxes, insurance, utilities, maintenance and repairs in addition to the base rent.

Future lease commitments under these leases are included in the table below.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

### **Note 9 - Lease Commitments (Continued)**

Future minimum lease payments by year and in the aggregate, under all lease agreements, are as follows (in thousands):

	<u>Related Parties</u>	<u>Third Parties</u>	<u>Total</u>
2008	\$ 301	\$252	\$553
2009	306	194	500
2010	317	175	492
2011	325	175	500
2012	168	192	360
Thereafter	165	1,721	1,886
	<u>\$1,582</u>	<u>\$2,709</u>	<u>\$4,291</u>

Total rent expense was \$558,000 and \$357,000 for the years ended December 31, 2007 and 2006, respectively. Rent expense to related parties was \$306,000 and \$276,000 for the years ended December 31, 2007 and 2006, respectively. Rent expense to third parties was \$252,000 and \$81,000 for the years ended December 31, 2007 and 2006, respectively.

### **Note 10 - Employment Agreements**

Employment agreement terms for the Bank's Chief Executive Officer and Chief Operating Officer were renegotiated and approved by the board in late 2005. The terms provide minimum annual salary, maximum bonuses, minimum stock options and change of control provisions. In addition, the terms of both employment agreements automatically renew annually for five year periods until each executive reaches the age of seventy (70). Upon resignation after a change in the control of the Bank, as defined in the agreement, the individual will receive monetary compensation in the amount set forth in the agreement.

### **Note 11 - Stockholders' Equity**

All historical share and per share information has been retroactively adjusted for the effect of all stock splits declared by the Bank, including the three-for-two stock split declared October 26, 2007.

On December 12, 2005, the Bank commenced the sale of 600,000 shares of its common stock at \$10 per share. The shares were offered through January 10, 2006 exclusively to existing shareholders and thereafter to the general public. On April 18, 2006, the Bank extended the stock offering expiration date from April 30, 2006 to the earlier of July 31, 2006 or when fully subscribed. The offering sold out and was fully subscribed on July 26, 2006 for total net proceeds of \$5,926,000 after stock issuance costs of \$73 thousand.

On December 26, 2006, the Bank commenced the sale of 300,000 shares of its common stock at \$10 per share. The shares were offered through January 31, 2007 exclusively to existing shareholders and thereafter to the general public. In May 2007, the Bank extended the offering to August 31, 2007. As of August 31, 2007, the Bank sold 221,537 shares of its common stock and incurred \$43 thousand in stock issuance costs and the offering was closed.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

### **Note 12 - Stock Option Plan**

In 2001, the Bank adopted the 2001 Option Plan. The Plan authorizes the Board of Directors to grant options to officers, other employees and directors of the Bank. In 2004, the shareholders voted to increase the number of shares for which options may be granted to 1,518,750, as adjusted for the stock splits in 2004, 2005 and 2007. The shares granted under the Plan to directors are non-qualified options. The shares granted under the Plan to officers and other employees are "incentive stock options," and are subject to the limitations under Section 422 of the Internal Revenue Code. Shares subject to options under the Plan may be either from authorized but unissued shares of the Bank or shares purchased in the open market.

All options granted under the Plan are subject to vesting requirements of not less than three years and the term shall not exceed ten years. The exercise price of the options granted shall be the fair market value of a share of common stock at the time of the grant.

All number of options and weighted average exercise prices have been adjusted for the stock splits in 2004, 2005, and 2007. Transactions under the plan are summarized as follows:

	<b>Number of Options</b>	<b>Weighted Average Exercise Price</b>
Outstanding, December 31, 2005	1,044,676	\$ 3.69
Granted	-	-
Exercised	(90,672)	2.84
Forfeited	(450)	10.00
<b>Outstanding, December 31, 2006</b>	<b>953,554</b>	<b>\$ 3.77</b>
Granted	-	-
Exercised	(35,436)	2.88
Forfeited	(300)	10.00
<b>Outstanding, December 31, 2007</b>	<b>917,818</b>	<b>\$ 3.81</b>
<b>Exercisable, December 31, 2007</b>	<b>892,122</b>	<b>\$ 3.63</b>

Stock options outstanding at December 31, 2007 are exercisable at prices ranging from \$2.84 to \$10.00 a share. The weighted-average remaining contractual life of options outstanding at December 31, 2007 is 3.73 years. The weighted average remaining contractual life of options exercisable at December 31, 2007 is 3.64 years. At December 31, 2007, the aggregate intrinsic value of options outstanding was \$5,685,111 and its aggregate intrinsic value of options exercisable was \$5,685,111.

# Embassy Bank For The Lehigh Valley

## Notes to Financial Statements

### Note 12 - Stock Option Plan (Continued)

The following table summarizes information about the range of exercise prices for stock options outstanding at December 31, 2007:

<u>Range of Exercise Price</u>	<u>Weighted Average Exercise Price</u>	<u>Number Outstanding</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>	<u>Number Exercisable</u>
\$2.00 to \$3.00	\$2.84	677,398	3.03	677,398
\$3.01 to \$4.00	3.91	99,044	4.52	99,044
\$6.00 to \$7.00	6.40	64,287	6.00	64,287
\$9.00 to \$10.00	10.00	77,089	7.00	51,393
		<u>917,818</u>		<u>892,122</u>

### Note 13 - Federal Income Taxes

The components of income tax benefit for the years ended December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
	(In Thousands)	
Current	\$ 98	\$ 114
Deferred	(214)	-
Benefit of reduction in deferred tax asset valuation allowance	<u>(1,125)</u>	<u>(114)</u>
	<u>\$ (1,241)</u>	<u>\$ -</u>

A reconciliation of the statutory federal income tax at a rate of 34% to the income tax benefit included in the statement of income for the year ended December 31, 2007 is as follows (in thousands):

Federal income tax at statutory rate	\$ 98
Change in valuation allowance	(1,353)
Other	14
	<u>\$ (1,241)</u>

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement 109, Accounting for Income Taxes. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Bank adopted FIN 48 as of January 1, 2007 and has evaluated its tax positions. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that has a likelihood of being realized on examination of more than 50 percent. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

# Embassy Bank For The Lehigh Valley

## Notes to Financial Statements

### Note 13 - Federal Income Taxes (Continued)

Under the "more likely than not" threshold guidelines, the Bank believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. As of January 1, 2007, the Bank had no material unrecognized tax benefits or accrued interest and penalties. The Bank's policy is to account for interest as a component of interest expense and penalties as a component of other expense. The Bank is subject to U.S. federal income tax. The Bank is no longer subject to examination by U.S. Federal taxing authorities for years before 2003.

The components of the net deferred tax asset at December 31, 2007 and 2006 are as follows:

	2007	2006
	(In Thousands)	
Deferred tax assets:		
Allowance for loan losses	\$840	\$ 814
Net operating loss carryforwards	765	748
Other	68	42
	<u>1,673</u>	<u>1,604</u>
Valuation allowance	0	(1,125)
	<u>1,673</u>	<u>479</u>
<b>Total Deferred Tax Assets, Net of Valuation Allowance</b>	<b>1,673</b>	<b>479</b>
Deferred tax liabilities:		
Premises and equipment	92	92
Prepaid assets	136	0
Cash basis conversion	204	387
Unrealized gain on securities available for sale	39	0
	<u>471</u>	<u>479</u>
<b>Total Deferred Tax Liabilities</b>	<b>471</b>	<b>479</b>
<b>Net Deferred Tax Asset</b>	<b>\$ 1,202</b>	<b>\$ -</b>

The valuation allowance for deferred taxes as of December 31, 2007 and 2006 was \$0- and \$1,125,000, respectively. The net change in the total valuation allowance for the year ended December 31, 2007 was a net decrease of \$1,125,000. Based upon the level of historical taxable income and projections for future taxable income over periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Bank will realize the benefits of these deductible differences.

The Bank has net operating loss carryforwards available for federal income tax purposes of approximately \$2,247,000 which start to expire in 2021 through 2023.

### Note 14 - Transactions with Executive Officers, Directors and Principal Stockholders

The Bank has had, and may be expected to have in the future, banking transactions in the ordinary course of business with its executive officers, directors, principal stockholders, their immediate families and affiliated companies (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others.

Related parties were indebted to the Bank for loans totaling \$7,091,000 and \$4,670,000 at December 31, 2007 and 2006, respectively. During 2007, loans totaling \$3,448,000 were disbursed and loan repayments totaled \$1,027,000.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

### **Note 14 - Transactions with Executive Officers, Directors and Principal Stockholders (Continued)**

Fees paid to related parties for legal services for the years ended December 31, 2007 and 2006 were approximately \$41,000 and \$21,000, respectively. The Bank leases its main banking office from an investment group comprised of related parties and its West Broad Street office also from a related party as described in Note 9.

### **Note 15 - Financial Instruments with Off-Balance Sheet Risk**

The Bank 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. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets.

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

At December 31, 2007 and 2006, the following financial instruments were outstanding whose contract amounts represent credit risk:

	<u>2007</u>	<u>2006</u>
	(In Thousands)	
Commitments to grant loans, fixed	\$2,631	\$ 1,796
Commitments to grant loans, variable	4,974	730
Unfunded commitments under lines of credit, fixed	2,353	1,505
Unfunded commitments under lines of credit, variable	30,058	31,420
Standby letters of credit	<u>1,960</u>	<u>840</u>
	<u>\$41,976</u>	<u>\$36,291</u>

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

Outstanding letters of credit written are conditional commitments issued by the Bank 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 Bank requires collateral supporting these letters of credit as deemed necessary. The maximum undiscounted exposure related to these commitments at December 31, 2007 and 2006 was \$1,960,000 and \$840,000, respectively, and the approximate value of underlying collateral upon liquidation that would be expected to cover this maximum potential exposure was \$1,925,000 and \$725,000, respectively. The current amount of the liability as of December 31, 2007 and 2006 for guarantees under standby letters of credit issued is not material.

# Embassy Bank For The Lehigh Valley

## Notes to Financial Statements

### Note 16 - Regulatory Matters

The Bank is required to maintain cash reserve balances in vault cash and with the Federal Reserve Bank. As of December 31, 2007, the Bank had a \$758,000 minimum reserve balance.

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the minimum capital requirements can initiate certain mandatory and possibly additional discretionary-actions by regulators that, if undertaken, could have a direct material effect on the Bank's 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 Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets and of Tier 1 capital to average assets. Management believes, as of December 31, 2007, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2007, 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 Bank's category.

The Bank's actual capital amounts and ratios at December 31, 2007 and 2006 are presented below:

	Actual		For Capital Adequacy Purposes		To be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollar Amounts in Thousands)						
<b>December 31, 2007:</b>						
Total capital (to risk-weighted assets)	\$29,911	12.0 %	≥ \$19,874	≥8.0 %	≥\$24,843	≥10.0 %
Tier 1 capital (to risk-weighted assets)	27,408	11.0	≥ 9,937	≥4.0	≥ 14,906	≥ 6.0
Tier 1 capital (to average assets)	27,408	8.3	≥ 13,135	≥4.0	≥ 16,418	≥ 5.0
<b>December 31, 2006:</b>						
Total capital (to risk-weighted assets)	\$26,819	12.5 %	≥ \$17,161	≥8.0 %	≥\$21,451	≥10.0 %
Tier 1 capital (to risk-weighted assets)	24,393	11.4	≥ 8,580	≥4.0	≥ 12,871	≥ 6.0
Tier 1 capital (to average assets)	24,393	8.6	≥ 11,367	≥4.0	≥ 14,209	≥ 5.0

The Bank is subject to certain restrictions on the amount of dividends that it may declare due to regulatory considerations. The Pennsylvania Banking Code provides that cash dividends may be declared and paid only out of accumulated net earnings.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

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### **Note 17 - Fair Value of Financial Instruments**

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

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

- For cash and cash equivalents, the carrying amount approximates their fair value.
- For securities, fair values are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities. For restricted securities, fair values are based on carrying values.
- For variable-rate loans that reprice frequently and which entail no significant changes in credit risk, fair values are based on carrying values. The fair value of fixed rate loans are estimated using discounted cash flow analyses, at interest rates currently offered for loans with similar terms to borrowers of similar credit quality.
- Fair values for demand deposits, savings accounts and certain money market deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values of fixed-maturity certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturity of deposits.
- Securities sold under repurchase agreements, federal funds purchased and short-term borrowings are short-term obligations and the carrying value approximates the fair value.
- The fair values of the Bank's long-term debt are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.
- The carrying amounts of accrued interest receivable and payable approximate their fair value.
- The fair value of commitments to extend credit and 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.

# ***Embassy Bank For The Lehigh Valley***

## **Notes to Financial Statements**

### **Note 17 - Fair Value of Financial Instruments (Continued)**

The estimated fair values of the Bank's financial instruments at December 31, 2007 and 2006 were as follows:

	<u>2007</u>		<u>2006</u>	
	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Carrying Amount</u>	<u>Fair Value</u>
	<b>(In Thousands)</b>			
<b>Financial assets:</b>				
Cash and cash equivalents	\$3,362	\$3,362	\$10,858	\$10,858
Securities available for sale	49,496	49,496	43,097	43,097
Restricted investments in bank stock	1,509	1,509	1,412	1,412
Loans receivable, net	274,313	268,893	233,167	230,369
Accrued interest receivable	1,138	1,138	1,021	1,021
<b>Financial liabilities:</b>				
Deposits	266,641	264,651	238,142	232,054
Securities sold under agreements to repurchase and federal funds purchased	17,965	17,965	13,800	13,800
Short-term borrowings	6,093	6,093	12,935	12,935
Long-term borrowings	10,396	10,596	-	-
Accrued interest payable	4,117	4,117	3,101	3,101
<b>Off-balance sheet financial instruments:</b>				
Commitments to extend credit	-	-	-	-
Standby letters of credit	-	-	-	-

# ***Embassy Bank For The Lehigh Valley***

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## **Management's Discussion and Analysis of Financial Condition and Results of Operations of Embassy Bank for the Lehigh Valley**

This discussion and analysis provides an overview of the financial condition and results of operations of Embassy Bank For The Lehigh Valley (the "Bank") for the years ended December 31, 2007 and 2006. This discussion should be read in conjunction with the financial statements and notes to the financial statements appearing elsewhere in this report.

### **Forward-looking Statements**

This discussion contains forward-looking statements within the meaning of the Securities Exchange Act of 1934, as amended, including statements of goals, intentions, and expectations as to future trends, plans, events or results of Bank operations and policies and regarding general economic conditions. These statements are based upon current and anticipated economic conditions, nationally and in the Bank's market, interest rates and interest rate policy, competitive factors and other conditions that, by their nature, are not susceptible to accurate forecast, and are subject to significant uncertainty.

Such forward-looking statements can be identified by the use of forward-looking terminology such as "believes", "expects", "may", "intends", "will", "should", "anticipates", or the negative of any of the foregoing or other variations thereon or comparable terminology, or by discussion of strategy.

No assurance can be given that the future results covered by forward-looking statements will be achieved. Such statements are subject to risks, uncertainties, and other factors that could cause actual results to differ materially from future results expressed or implied by such forward-looking statements. Important factors that could impact the Bank's operating results include, but are not limited to, (i) the effects of changing economic conditions in the Bank's market areas and nationally, (ii) credit risks of commercial, real estate, consumer and other lending activities, (iii) significant changes in interest rates, (iv) changes in federal and state banking laws and regulations which could impact the Bank's operations, and (iv) other external developments which could materially affect the Bank's business and operations.

### **Critical Accounting Policies**

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

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

The allowance for loan losses is established through the provision for loan losses, which is a charge against earnings. Provision for loan losses are made to reserve for estimated probable losses on loans.

# ***Embassy Bank For The Lehigh Valley***

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## **Critical Accounting Policies (Continued)**

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

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 net operating loss carryforwards and their tax basis. Deferred tax assets are reduced by a valuations 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. Based upon the level of historical taxable income and projections for future taxable income over periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Bank will realize the benefits of these deductible differences.

Prior to January 1, 2006, the Bank's stock option plan was accounted for under the recognition and measurement provisions of APB Opinion No. 25 (Opinion 25), Accounting for Stock Issued to Employees, and related Interpretations, as permitted by FASB Statement No. 123, Accounting for Stock Based Compensation. No stock-based employee compensation cost was recognized in the Bank's statements of income through December 31, 2005, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. Effective January 1, 2006, the Bank adopted the fair value recognition provisions of FASB Statement No. 123(R), Share Based Payment. Statement No. 123(R) replaces Statement No. 123, supersedes APB Opinion No. 25 and requires compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. Statement No. 123(R) requires that companies that utilized the minimum value method under Statement No. 123 adopt the new fair value accounting prospectively for new or modified grants on or after January 1, 2006. For the years ended December 31, 2007 and 2006, there were no stock options granted. Prospective adoption means that awards granted in earlier fiscal years continue to be accounted for using the existing accounting, typically APB Opinion No. 25.

## **General**

Embassy Bank For The Lehigh Valley was incorporated under the general corporation laws of the Commonwealth of Pennsylvania on May 11, 2001 and is headquartered in Bethlehem, Pennsylvania. The Bank was formed to serve the community of the Lehigh Valley area.

On November 6, 2001, having received the required approvals from the Commonwealth of Pennsylvania and been accepted for deposit insurance by the FDIC, the Bank commenced operations.

All historical share and per share information below has been retroactively adjusted for the effect of all stock splits declared by the Bank, including the three-for-two stock split declared October 26, 2007.

On August 26, 2004, the Bank commenced the sale of 781,249 shares of its common stock at a price of \$6.40 per share. The shares were offered through October 10, 2004 exclusively to existing shareholders and thereafter to the general public. The offering was fully subscribed in December 2004. Net proceeds of the offering amounted to \$4,980,000 net of offering costs of \$20,000.

# ***Embassy Bank For The Lehigh Valley***

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## **General (Continued)**

On December 12, 2005, the Bank commenced the sale of 600,000 shares of its common stock at \$10 per share. The shares were offered through January 10, 2006 exclusively to existing shareholders and thereafter to the general public. On April 18, 2006, the Bank extended the stock offering expiration date from April 30, 2006 to the earlier of July 31, 2006 or when fully subscribed. The offering sold out and was fully subscribed on July 26, 2006 for total net proceeds of \$5,926,000 after stock issuance costs of \$73 thousand.

On December 26, 2006, the Bank commenced the sale of 300,000 shares of its common stock at \$10 per share. The shares were offered through January 31, 2007 exclusively to existing shareholders and thereafter to the general public. In May 2007, the Bank extended the offering to August 31, 2007. As of August 31, 2007, the Bank sold 221,537 shares of its common stock and incurred \$43 thousand in stock issuance costs and the offering was closed.

## **Overview**

The Bank's assets grew \$42.0 million from \$292.0 million at December 31, 2006 to \$334.0 million at December 31, 2007. The Bank's deposits grew \$28.5 million from \$238.1 million at December 31, 2006 to \$266.6 million at December 31, 2007. During the same period, loans receivable, net of the allowance for loan losses, increased \$41.1 million to \$274.3 million at December 31, 2007 from \$233.1 million at December 31, 2006. The market is very competitive and the Bank is committed to maintaining a high quality portfolio that returns a reasonable market rate. The Bank expects increased lending activity, as the Bank expands its presence in the market and becomes more widely known. The lending staff has been active in contacting new prospects and promoting the Bank's name in the community. Management believes that this will translate into continued growth of a portfolio of quality loans, although there can be no assurance of this.

The Bank reported net income of \$1,530,000 for the year ended December 31, 2007 as compared to net income of \$334,000 for the year ended December 31, 2006. For year ended December 31, 2007, \$1,241,000 of the net income was due to the income tax benefit of the net change in the valuation allowance on deferred taxes.

# ***Embassy Bank For The Lehigh Valley***

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## **Results of Operations**

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

Net interest income is the difference between income on assets and the cost of funds supporting those assets. Earning assets are composed primarily of loans and investments; interest-bearing deposits and borrowings make up the cost of funds. Non-interest bearing deposits and capital are other components representing funding sources. Changes in the volume and mix of assets and funding sources, along with the changes in yields earned and rates paid, determine changes in net interest income.

### **2007 Compared to 2006**

Total interest income for the year ended December 31, 2007 was \$18,809,000 compared to \$14,906,000 for the year ended December 31, 2006. Total interest expense for the year ended December 31, 2007 was \$11,763,000 compared to \$8,718,000 for the year ended December 31, 2006. These increases are the result of increases in interest rates, loan and deposit relationship growth as well as the expansion of the Bank's branches. Net interest income increased to \$7,046,000 for the year ended December 31, 2007 compared to \$6,188,000 for the year ended December 31, 2006.

Generally, changes in net interest income are measured by net interest rate spread and net interest margin. Interest spread is the mathematical difference between the average interest earned on earning assets and interest paid on interest bearing liabilities.

Interest margin represents the net interest yield on earning assets and is derived by dividing net interest income by average earning assets. In a mature financial institution the interest margin gives a reader better indicators of asset earning results when compared to peer groups or industry standards.

The Bank's net interest margin for the year ended December 31, 2007 was 2.32% compared to 2.45% for the year ended December 31, 2006. The decrease in the margin is due primarily to the current market conditions as well as the local competitive rate environment for both deposits and loans. During this difficult market environment, the Bank continued to grow and attract deposits and loans at competitive rates.

The following table includes the average balances, interest income and expense and the average rates earned and paid for assets and liabilities for the periods presented. All average balances are daily average balances.

# Embassy Bank For The Lehigh Valley

## Average Balances, Rates and Interest Income and Expense

	Year Ended December 31, 2007		Year Ended December 31, 2006		Year Ended December 31, 2005	
	Average Balance	Interest Yield	Average Balance	Interest Yield	Average Balance	Interest Yield
<i>(dollars in thousands)</i>						
<b>ASSETS</b>						
Total loans	\$ 253,573	\$ 16,350 6.45%	\$ 206,595	\$ 12,824 6.21%	\$ 141,547	\$ 8,042 5.68%
Investment securities	47,514	2,305 4.85%	43,300	1,958 4.52%	36,730	1,533 4.17%
Federal funds sold	2,905	149 5.13%	2,316	119 5.14%	1,353	45 3.33%
Interest bearing deposits with banks	105	5 4.76%	114	5 4.39%	65	3 4.62%
<b>TOTAL INTEREST EARNING ASSETS</b>	<b>304,097</b>	<b>18,809 6.19%</b>	<b>252,325</b>	<b>14,906 5.91%</b>	<b>179,695</b>	<b>9,623 5.36%</b>
Less allowance for loan losses	(2,489)		(2,061)		(1,426)	
Other assets	7,719		6,396		5,845	
<b>TOTAL ASSETS</b>	<b>\$ 309,327</b>		<b>\$ 256,660</b>		<b>\$ 184,114</b>	
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Interest bearing demand deposits, NOW and money market	\$ 55,596	1,707 3.07%	\$ 58,924	1,815 3.08%	\$ 54,628	1,242 2.27%
Savings	18,146	639 3.52%	4,536	48 1.06%	4,584	50 1.09%
Certificates of deposit	161,550	8,029 4.97%	137,707	6,101 4.43%	89,191	3,160 3.54%
Securities sold under agreements to repurchase and other borrowings	30,454	1,388 4.56%	16,370	754 4.61%	6,251	178 2.85%
<b>TOTAL INTEREST BEARING LIABILITIES</b>	<b>265,746</b>	<b>11,763 4.43%</b>	<b>217,537</b>	<b>8,718 4.01%</b>	<b>154,654</b>	<b>4,630 2.99%</b>
Non-interest bearing demand deposits	14,465		15,207		10,955	
Other liabilities	3,653		2,491		1,335	
Stockholders' equity	25,463		21,425		17,170	
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 309,327</b>		<b>\$ 256,660</b>		<b>\$ 184,114</b>	
Net interest income		\$ 7,046		\$ 6,188		\$ 4,993
Net interest spread		1.76%		1.90%		2.37%
Net interest margin		2.32%		2.45%		2.78%

# Embassy Bank For The Lehigh Valley

## Results of Operations (Continued)

The table below demonstrates the relative impact on net interest income of changes in the volume of interest-earning assets and interest-bearing liabilities and changes in rates earned and paid by the Bank on such assets and liabilities.

(in thousands)	2007 vs. 2006				2006 vs. 2005			
	Increase (decrease) due to changes in:				Increase (decrease) due to changes in:			
	Volume	Rate	Rate/ Volume	Total	Volume	Rate	Rate/ Volume	Total
<b>Interest-earning assets</b>								
Total loans	\$ 2,916	\$ 497	\$ 113	\$ 3,526	\$ 3,696	\$ 744	\$ 341	\$ 4,781
Investment securities	191	142	13	346	274	128	22	424
Federal funds sold	30	-	-	30	32	25	18	75
Interest bearing deposits with banks	-	-	-	-	2	-	-	2
<b>Total net change in income on interest-earning assets</b>	<b>3,137</b>	<b>639</b>	<b>126</b>	<b>3,902</b>	<b>4,004</b>	<b>897</b>	<b>381</b>	<b>5,282</b>
<b>Interest-bearing liabilities:</b>								
Interest bearing demand deposits	(102)	(6)	1	(107)	98	441	34	573
Savings	144	112	335	591	(1)	(1)	-	(2)
Certificates of deposit	1,056	523	349	1,928	1,719	338	883	2,940
Total deposits	1,098	629	685	2,412	1,816	778	917	3,511
Securities sold under agreements to repurchase and other borrowings	649	(8)	(8)	633	288	110	180	578
<b>Total net change in expense on interest-bearing liabilities</b>	<b>1,747</b>	<b>621</b>	<b>677</b>	<b>3,045</b>	<b>2,104</b>	<b>888</b>	<b>1,097</b>	<b>4,089</b>
<b>Change in net interest income</b>	<b>\$ 1,390</b>	<b>\$ 18</b>	<b>\$ (551)</b>	<b>\$ 857</b>	<b>\$ 1,900</b>	<b>\$ 9</b>	<b>\$ (716)</b>	<b>\$ 1,193</b>

## Provision for Loan Losses

The provision for loan losses represents the expense recognized to fund the allowance for loan losses. This amount is based on many factors that reflect management's assessment of the risk in its loan portfolio. Those factors include economic conditions and trends, the value and adequacy of collateral, volume and mix of the portfolio, performance of the portfolio, internal loan processes and capital adequacy of the Bank.

For the year ended December 31, 2007, the provision for loan losses was \$390,000 compared to \$644,000 for the year ended December 31, 2006. The allowance for loan losses as of December 31, 2007 was \$2,503,000, which represents 0.90% of outstanding loans at December 31, 2007, which is comparable to the prior year-end of \$2,426,000 representing 1.03% of outstanding loans. Based principally on current economic conditions, perceived asset quality, loan-loss experience of comparable institutions in the Bank's market area and strong capital position, the allowance is believed to be adequate. The decrease in the percentage of allowance for loan losses to outstanding loans between December 31, 2006 and December 31, 2007 was due to allowance for specific loans at December 31, 2006 that were charged off during 2007. During 2008, as the portfolio grows and other determining factors become more relevant, management's enhanced review process will be used to evaluate the adequacy of the allowance.

# ***Embassy Bank For The Lehigh Valley***

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## **Results of Operations (Continued)**

### **Non-interest Income**

Non-interest income is derived from Bank operations and represents primarily service charge income and fees on deposit relationships. Non-interest income also may include net gains and losses from the sale of available for sale securities. Total non-interest income was \$460,000 for the year ended December 31, 2007 compared to \$219,000 for the year ended December 31, 2006. This increase in non-interest income is due to increased service fees from the increase in the number of deposit accounts as well as the addition of merchant credit card processing services. There were no sales of securities in 2007 and 2006. As the account base grows and the Bank matures and develops additional sources of fee income; non-interest income will be a contributor to the overall profitability of the Bank.

### **Non-interest Expense**

Non-interest expenses represent the normal operating expenses of the Bank. These expenses include salaries, employee benefits, occupancy, equipment, data processing, advertising and other expenses related to the overall operation of the Bank.

Non-interest expenses for the year ended December 31, 2007 were \$6,827,000, compared to \$5,429,000 for the year ended December 31, 2006. The largest component increase was in salaries and benefits, which increased \$524,000 or 19% due primarily to staff additions and increases in annual salaries. At December 31, 2007, the Bank had forty-nine full-time equivalent employees compared to forty-one full-time equivalent employees at December 31, 2006. Occupancy and equipment expense increased \$304,000 or 36% due to the addition of the new branch expenses, and additions of computer equipment and software expenses. Data processing costs increased \$80,000 or 19% due to increased volume of accounts and enhanced network support services. Advertising and marketing expense increased \$9,000 or 2% due to product promotions and advertising of the new branches. Professional fees increased \$22,000 or 9% due to increased costs and expansion of primarily third party auditing, regulatory and consulting services. FDIC insurance expense was \$146,000 for the year ended December 31, 2007 compared to \$0 for the ended December 31, 2006 due to the new method adopted by the SEC for calculating premiums in 2007. Credit card expense increased \$162,000 or 352% due to increased volume. Other expenses increased \$151,000 or 23% due to the Bank's growth.

A breakdown of other non-interest expenses is in the statements of income to the Financial Statements.

### **Income Taxes**

Due to recognition of its deferred taxes at December 31, 2007, the Bank had an income tax benefit of \$1,241,000 for the year ended December 31, 2007. Based upon the level of historical taxable income and projections for future taxable income over periods in which the deferred taxes are deductible, management believes it is more likely than not that the Bank will realize the benefits of these deductible differences. There was no provision for current income taxes for the years ended December 31, 2007 and 2006 due to the utilization of net operating loss carry forwards.

### **Financial Condition**

#### **Securities**

The Bank's securities portfolio is classified, in its entirety, as "available for sale." Management believes that a portfolio classification of available for sale allows complete flexibility in the investment portfolio. Using this classification, the Bank intends to hold these securities for an indefinite amount of time but not necessarily to maturity.

# Embassy Bank For The Lehigh Valley

## Financial Condition (Continued)

### Securities (Continued)

Such securities are carried at fair value with unrealized gains or losses reported as a separate component of stockholders' equity. The portfolio is structured to provide maximum return on investments while providing a consistent source of liquidity and meeting strict risk standards. The Bank holds no high-risk securities or derivatives as of December 31, 2007.

The Bank's securities portfolio was \$49,496,000 at December 31, 2007, a \$6,399,000 increase from securities of \$43,097,000 at December 31, 2006. The Bank's securities have increased due to purchases in the amount of \$11,962,000 offset by investment principal pay-downs and maturities. The carrying value of the securities portfolio as of December 31, 2007 includes a net unrealized gain of \$115,000 as compared to a net unrealized loss of \$745,000 as of December 31, 2006, which is recorded to accumulated other comprehensive income in stockholders' equity. This reduction in the unrealized loss is due to the changes in market interest rates from 2006 to 2007, and therefore no securities are deemed to be other than temporarily impaired.

The following table sets forth the composition of the securities portfolio at fair value as of December 31, 2007, 2006, 2005, 2004, and 2003.

	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
<i>(in thousands)</i>					
U.S. Treasury and agency obligations	\$ 11,146	\$ 10,767	\$ 10,766	\$ 2,008	\$ 8,081
Mortgage-backed securities	34,494	28,510	27,760	31,449	25,819
Taxable municipal securities	3,856	3,820	3,781	-	-
Total Securities Available for Sale	<u>\$ 49,496</u>	<u>\$ 43,097</u>	<u>\$ 42,307</u>	<u>\$ 33,457</u>	<u>\$ 33,900</u>

The following table presents the maturities and average weighted yields of the debt securities portfolio as of December 31, 2007. Maturities of mortgage-backed securities are based on estimated life. Yields are based on amortized cost.

### Securities by Maturities (Amortized Cost)

	<u>1 year or Less</u>		<u>1-5 Years</u>		<u>5-10 Years</u>		<u>Over 10 Years</u>		<u>Total</u>	
	<u>Amount</u>	<u>Average Yield</u>	<u>Amount</u>	<u>Average Yield</u>	<u>Amount</u>	<u>Average Yield</u>	<u>Amount</u>	<u>Average Yield</u>	<u>Amount</u>	<u>Average Yield</u>
<i>(in thousands)</i>										
U.S. Government agency obligations	\$ -	-	\$ 9,964	4.42%	\$ 991	4.70%	\$ -	-	\$ 10,955	4.45%
Taxable Municipal securities	\$ 500	4.45%	\$ 1,000	4.60%	\$ 2,409	4.83%	\$ -	-	\$ 3,909	4.72%
Mortgage-backed securities	<u>\$ 1,003</u>	4.21%	<u>\$ 20,326</u>	4.67%	<u>\$ 9,334</u>	5.71%	<u>\$ 3,854</u>	6.05%	<u>\$ 34,517</u>	5.09%
Total Debt Securities	<u>\$ 1,503</u>	4.29%	<u>\$ 31,290</u>	4.59%	<u>\$ 12,734</u>	5.46%	<u>\$ 3,854</u>	6.05%	<u>\$ 49,381</u>	4.92%

# ***Embassy Bank For The Lehigh Valley***

## **Financial Condition (Continued)**

### **Loans**

The following table sets forth information on the composition of the loan portfolio by type at December 31, 2007, 2006, 2005, 2004 and 2003. All of the Bank's loans are to domestic borrowers.

	December 31, 2007		December 31, 2006		December 31, 2005	
	<u>Balance</u>	<u>Percentage of total Loans</u>	<u>Balance</u>	<u>Percentage of total Loans</u>	<u>Balance</u>	<u>Percentage of total Loans</u>
<i>(in thousands)</i>						
Commercial real estate	\$ 125,021	45.21%	\$ 101,737	43.21%	\$ 77,854	43.46%
Commercial construction	2,969	1.07%	6,183	2.63%	2,626	1.47%
Commercial	22,583	8.17%	21,578	9.17%	16,906	9.44%
Home equity	123,774	44.75%	103,895	44.14%	80,726	45.07%
Consumer	<u>2,216</u>	<u>0.80%</u>	<u>2,006</u>	<u>0.85%</u>	<u>1,003</u>	<u>0.56%</u>
Gross loans	276,563	100.00%	235,399	100.00%	179,115	100.00%
Unearned origination costs	<u>253</u>		<u>194</u>		<u>207</u>	
	<u><u>\$ 276,816</u></u>		<u><u>\$ 235,593</u></u>		<u><u>\$ 179,322</u></u>	
	December 31, 2004		December 31, 2003			
	<u>Balance</u>	<u>Percentage of total Loans</u>	<u>Balance</u>	<u>Percentage of total Loans</u>		
<i>(in thousands)</i>						
Commercial real estate	\$ 47,435	41.87%	\$ 29,017	41.35%		
Commercial construction	1,079	0.95%	1,386	1.97%		
Commercial	15,058	13.29%	8,987	12.81%		
Home equity	48,292	42.63%	29,723	42.35%		
Consumer	<u>1,431</u>	<u>1.26%</u>	<u>1,068</u>	<u>1.52%</u>		
Gross loans	113,295	100.00%	70,181	100.00%		
Unearned origination costs	<u>169</u>		<u>130</u>			
	<u><u>\$ 113,464</u></u>		<u><u>\$ 70,311</u></u>			

# Embassy Bank For The Lehigh Valley

## Financial Condition (Continued)

### Loans (Continued)

The following table shows the maturities of the commercial loan portfolio and the sensitivity of such loans to interest rate fluctuations at December 31, 2007.

	<u>One year or Less</u>	<u>After One Year Through Five Years</u>	<u>After Five Years</u>	<u>Total</u>
<i>(in thousands)</i>				
Commercial real estate	\$ 22,140	\$ 63,921	\$ 38,960	\$ 125,021
Commercial construction	2,136	345	488	2,969
Commercial	10,013	11,342	1,228	22,583
	<u>\$ 34,289</u>	<u>\$ 75,608</u>	<u>\$ 40,676</u>	<u>\$ 150,573</u>
Fixed Rates	\$ 12,428	\$ 69,500	\$ 39,586	\$ 121,514
Variable Rates	21,861	6,108	1,090	29,059
	<u>\$ 34,289</u>	<u>\$ 75,608</u>	<u>\$ 40,676</u>	<u>\$ 150,573</u>

### Credit Risk and Loan Quality

In its lending activities, the Bank seeks to develop sound credit relationships with customers who will grow with the Bank. There has not been an effort to rapidly build the portfolio and earnings at the sacrifice of asset quality. The philosophy of seeking quality credits and building relationships while possibly forgoing income opportunities will continue.

The Bank's loan policy establishes tiered lending authorities to individual officers of the Bank, the Loan Committee and the Board of Directors. At December 31, 2007, the Bank had no loans delinquent beyond ninety days as compared to three loans delinquent, two to the same borrower for \$206,000 at December 31, 2006, one loan delinquent for \$102,000 at December 31, 2005 and no loans delinquent at years ending December 31, 2004, and 2003. At December 31, 2007, the Bank had no loans on non-accrual status compared to two loans on non-accrual status for \$205,000 at December 31, 2006 and no loans on non-accrual status at years ending 2005, 2004, and 2003. At December 31, 2007, the Bank charged off two loans totaling \$313,000 as compared to no loans charged off at years ending 2006, 2005, 2004 and 2003. It is the Bank's policy to discontinue the accrual of interest when a loan is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more. The Bank has had no other real estate owned as acquired through foreclosure.

### Allowance for Loan Losses

Based upon current economic conditions, the composition of the loan portfolio and loan loss experience of comparable institutions in the Bank's market areas, an allowance for loan losses has been provided at 0.90% of outstanding loans. Based on its knowledge of the portfolio and current economic conditions, management believes that as of December 31, 2007, the allowance is adequate to absorb reasonably anticipated losses.

# Embassy Bank For The Lehigh Valley

## Financial Condition (Continued)

### Allowance for Loan Losses (Continued)

As of December 31, 2007, there were no loans where information known to management caused management to have serious doubts as to the ability of the borrower to comply with the current repayment terms.

The activity in the allowance for loan losses is shown in the following table as well as period end loans receivable and the allowance for loan losses as a percent of the total loan portfolio:

	December 31,				
	2007	2006	2005	2004	2003
<i>(in thousands)</i>					
Loans receivable at end of year	\$ 276,816	\$ 235,593	\$ 179,322	\$ 113,464	\$ 70,311
Allowance for loan losses:					
Balance, beginning	\$ 2,426	\$ 1,782	\$ 1,198	\$ 805	\$ 373
Provision for loan losses	390	644	584	393	432
Loans charged off	(313)	-	-	-	-
Recoveries	-	-	-	-	-
Balance at end of year	\$ 2,503	\$ 2,426	\$ 1,782	\$ 1,198	\$ 805
Allowance for loan losses to loans receivable at end of year	0.90%	1.03%	0.99%	1.06%	1.14%

The following table details the allocation of the allowance for loan losses to the various categories. While allocations have been established for particular loan categories, management considers the entire allowance to be available to absorb losses in any category.

#### Allocation of the Allowance for Loan Losses

	December	% of Gross	December						
	2007	Loans	2006	Loans	2005	Loans	2004	Loans	2003
<i>(in thousands)</i>									
Commercial real estate	\$ 1,257	40.29%	\$ 1,041	38.35%	\$ 713	43.46%	\$ 438	41.87%	\$ 255
Commercial construction	47	1.07%	91	2.59%	60	1.47%	36	0.95%	39
Commercial	623	13.03%	806	14.04%	611	9.44%	411	13.29%	296
Home equity	530	44.33%	461	44.15%	382	45.07%	296	42.63%	200
Consumer	46	1.28%	27	0.85%	16	0.56%	17	1.26%	15
Total Allowance for Loan Losses	\$ 2,503	100.00%	\$ 2,426	100.00%	\$ 1,782	100.00%	\$ 1,198	100.00%	\$ 805

# ***Embassy Bank For The Lehigh Valley***

## **Financial Condition (Continued)**

### **Deposits**

The Bank, as growth continues, expects that the principal sources of its funds will be deposits, consisting of demand deposits, NOW accounts, money market accounts, savings accounts, and certificates of deposit from the local market areas surrounding the Bank's office. These accounts provide the Bank with a source of fee income and a relatively stable source of funds.

Total deposits at December 31, 2007 were \$266,641,000, an increase of \$28,499,000, or 11.97%, over total deposits of \$238,142,000 as of December 31, 2006.

The following table reflects the Bank's deposits by category for the periods indicated. All deposits are domestic deposits.

	<u>December 31, 2007</u>	<u>December 31, 2006</u>	<u>December 31, 2005</u>
<i>(in thousands)</i>			
Demand, non-interest bearing	\$ 15,150	\$ 15,855	\$ 11,686
Demand, interest bearing-NOW and money market	46,095	64,179	65,045
Savings	37,489	4,597	4,008
Time, \$100,000 and over	59,421	57,805	32,615
Time, other	108,486	95,706	72,549
Total deposits	<u>\$ 266,641</u>	<u>\$ 238,142</u>	<u>\$ 185,903</u>

The following table sets forth the average balance of the Bank's deposits and the average rates paid on those deposits for the years ended December 31, 2007, 2006, and 2005.

	<b>Years Ended December 31</b>					
	<u>2007</u>		<u>2006</u>		<u>2005</u>	
	<u>Average Amount</u>	<u>Average Rate</u>	<u>Average Amount</u>	<u>Average Rate</u>	<u>Average Amount</u>	<u>Average Rate</u>
<i>(in thousands)</i>						
Interest bearing demand deposits and money market	\$ 55,596	3.07%	\$ 58,924	3.08%	\$ 54,628	2.27%
Savings	18,146	3.52%	4,536	1.06%	4,584	1.09%
Certificates of deposit	161,550	4.97%	137,707	4.43%	89,191	3.54%
Total interest bearing deposits	<u>235,292</u>	<u>4.41%</u>	<u>201,167</u>	<u>3.96%</u>	<u>148,403</u>	<u>3.00%</u>
Non-interest bearing demand deposits	14,465		15,207		10,955	
Total	<u>\$ 249,757</u>		<u>\$ 216,374</u>		<u>\$ 159,358</u>	

# ***Embassy Bank For The Lehigh Valley***

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## **Financial Condition (Continued)**

### **Deposits (Continued)**

The following table displays the maturities and the amounts of the Bank's certificates of deposit of \$100,000 or more as of December 31, 2007.

	<b>December 31, 2007</b>	
<i>(in thousands)</i>		
3 months or less	\$	21,956
Over 3 through 6 months		23,726
Over 6 through 12 months		11,787
Over 12 months		1,952
Total	\$	<u>59,421</u>

### **Liquidity**

Liquidity is a measure of the Bank's ability to meet the demands required for the funding of loans and to meet depositors' requirements for use of their funds. The Bank's sources of liquidity are cash balances, due from banks, Federal funds sold and short-term securities. There are other sources of liquidity that are available to the Bank.

The Bank has borrowing capacity with the Federal Home Loan Bank of Pittsburgh of approximately \$165.8 million of which \$16.5 million was outstanding at December 31, 2007. Advances were \$6,093,000 with interest at 4.78% fixed maturing September 26, 2008, \$1,850,000 with interest at 4.27% fixed maturing April 24, 2009, \$1,428,000 with interest at 4.80% fixed maturing August 10, 2009, and \$7,118,000 with interest at 4.75% fixed maturing May 11, 2010. The Bank also has a line of credit with the Federal Home Loan Bank of Pittsburgh and the Atlantic Central Bankers Bank of approximately \$6.3 million and \$6.0 million, respectively of which none was outstanding at December 31, 2007. Advances from the Federal Home Loan Bank line are secured by qualifying assets of the Bank and advances from the Atlantic Central Bankers Bank line are unsecured.

Because of the composition of the Bank's Balance Sheet, its strong capital base, deposit growth, and borrowing capacity, the Bank remains well positioned with respect to liquidity. While it is desirable to be liquid, it has the effect of a lower interest margin. The majority of funds are invested in loans; however a sizeable portion is invested in short-term investments that generally carry a lower yield.

# ***Embassy Bank For The Lehigh Valley***

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## **Financial Condition (Continued)**

### **Contractual Obligations**

The following table represents the Bank's contractual obligations to make future payments as of December 31, 2007:

	<b>Less Than 1 Year</b>	<b>1-3 Years</b>	<b>4-5 Years</b>	<b>Over 5 Years</b>	<b>Total</b>
<i>(in thousands)</i>					
Time deposits	\$ 159,230	\$ 7,934	\$ 743	\$ -	\$ 167,907
Operating Leases	553	992	860	1,886	4,291
<b>Total</b>	<b>\$ 159,783</b>	<b>\$ 8,926</b>	<b>\$ 1,603</b>	<b>\$ 1,886</b>	<b>\$ 172,198</b>

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

The Bank's financial statements do not reflect various off-balance sheet arrangements that are made in the normal course of business, which may involve some liquidity risk. These commitments consist of un-funded loans and lines of credit and letters of credit made under the same standards as on-balance sheet instruments. These off balance sheet arrangements at December 31, 2007 totaled \$41,976,000. Because these instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk to the Bank.

Management believes that any amounts actually drawn upon can be funded in the normal course of operations.

The Bank 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.

### **Capital Resources and Adequacy**

All historical share and per share information below has been retroactively adjusted for the effect of all stock splits declared by the Bank, including the three-for-two stock split declared October 26, 2007.

On December 12, 2005, the Bank commenced the sale of 600,000 shares of its common stock at \$10 per share. The shares were offered through January 10, 2006 exclusively to existing shareholders and thereafter to the general public. On April 18, 2006, the Bank extended the stock offering expiration date from April 30, 2006 to the earlier of July 31, 2006 or when fully subscribed. The offering sold out and was fully subscribed on July 26, 2006 for total net proceeds of \$5,926,000 after stock issuance costs of \$73 thousand.

On December 26, 2006, the Bank commenced the sale of 300,000 shares of its common stock at \$10 per share. The shares were offered through January 31, 2007 exclusively to existing shareholders and thereafter to the general public. In May 2007, the Bank extended the offering to August 31, 2007. As of August 31, 2007, the Bank sold 221,537 shares of its common stock and incurred \$43 thousand in stock issuance costs and the offering was closed.

# ***Embassy Bank For The Lehigh Valley***

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## **Financial Condition (Continued)**

### **Capital Resources and Adequacy (Continued)**

The following table provides a comparison of the Bank's risk-based capital ratios and leverage ratios:

	<u>December 31, 2007</u>	<u>December 31, 2006</u>
<i>(dollar amounts in thousands)</i>		
Tier I, common stockholders' equity	\$ 27,408	\$ 24,393
Tier II, allowable portion of allowance for loan losses	<u>2,503</u>	<u>2,426</u>
Total capital	<u>\$ 29,911</u>	<u>\$ 26,819</u>
Tier I risk based capital ratio	11.0%	11.4%
Total risk based capital ratio	12.0%	12.5%
Tier I leverage ratio	8.4%	8.6%

Note: Unrealized gains on securities available for sale are excluded from regulatory capital components of risk-based capital and leverage ratios.

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

### **Interest Rate Risk Management**

A principal objective of the Bank's asset/liability management policy is to minimize the Bank's exposure to changes in interest rates by an ongoing review of the maturity and repricing of interest-earning assets and interest-bearing liabilities. The Asset Liability Committee (ALCO Committee) of the Board of Directors oversees this review, which establishes policies to control interest rate sensitivity. Interest rate sensitivity is the volatility of a bank's earnings resulting from a movement in market interest rates. The Bank monitors rate sensitivity in order to reduce vulnerability to interest rate fluctuations while maintaining adequate capital levels and acceptable levels of liquidity. The Bank's asset/liability management policy, along with monthly financial reports, supplies management with guidelines to evaluate and manage rate sensitivity.

GAP, a measure of the difference in volume between interest bearing assets and interest bearing liabilities, is a means of monitoring the sensitivity of a financial institution to changes in interest rates. The chart below provides an indicator of the rate sensitivity of the Bank. NOW and Savings accounts are slotted by their respective estimated decay rates. The Bank is liability sensitive, which means that if interest rates fall, interest income will fall slower than interest expense and net interest income will likely increase. If interest rates rise, interest income will rise slower than interest expense and net interest income will likely decrease.

# ***Embassy Bank For The Lehigh Valley***

## **Financial Condition (Continued)**

### **Interest Rate Risk Management (Continued)**

(in thousands)	<b>0-3 Months</b>	<b>4-12 Months</b>	<b>1-3 Years</b>	<b>4-5 Years</b>	<b>Over 5 Years</b>	<b>Total</b>
<b>Interest-earning assets</b>						
Federal funds sold and interest-bearing deposits	\$ 2	\$ -	\$ -	\$ -	\$ -	\$ 2
Investment securities	6,151	9,915	22,247	6,504	6,188	51,005
Loans, gross	53,651	46,954	84,595	54,853	36,763	276,816
<b>Total interest-earning assets</b>	<b>59,804</b>	<b>56,869</b>	<b>106,842</b>	<b>61,357</b>	<b>42,951</b>	<b>327,823</b>
<b>Interest-bearing liabilities</b>						
NOW and money market accounts	46,095	-	-	-	-	46,095
Savings	37,489	-	-	-	-	37,489
Certificates of deposit	58,956	100,274	7,934	743	-	167,907
Other Borrowed Funds	-	6,093	10,396	-	-	16,489
Repurchase agreements and federal funds purchased	17,965	-	-	-	-	17,965
<b>Total interest-bearing liabilities</b>	<b>160,505</b>	<b>106,367</b>	<b>18,330</b>	<b>743</b>	<b>-</b>	<b>285,945</b>
<b>GAP</b>	<b>\$ (100,701)</b>	<b>\$ (49,498)</b>	<b>\$ 88,512</b>	<b>\$ 60,614</b>	<b>\$ 42,951</b>	<b>\$ 41,878</b>
<b>CUMULATIVE GAP</b>	<b>\$ (100,701)</b>	<b>\$ (150,199)</b>	<b>\$ (61,687)</b>	<b>\$ (1,073)</b>	<b>\$ 41,878</b>	
<b>GAP TO INTEREST EARNING ASSETS</b>	<b>-30.72%</b>	<b>-15.10%</b>	<b>27.00%</b>	<b>18.49%</b>	<b>13.10%</b>	
<b>CUMULATIVE GAP TO INTEREST EARNING ASSETS</b>	<b>-30.72%</b>	<b>-45.82%</b>	<b>-18.82%</b>	<b>-0.33%</b>	<b>12.77%</b>	

# ***Embassy Bank For The Lehigh Valley***

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## **Financial Condition (Continued)**

### **Interest Rate Risk Management (Continued)**

Based on a twelve-month forecast of the balance sheet, the following table sets forth our interest rate risk profile at December 31, 2007. For income simulation purposes, NOW and savings accounts are repriced quarterly. The impact on net interest income, illustrated in the following table would vary substantially if different assumptions were used or if actual experience differs from that indicated by the assumptions.

<u>Change in Interest Rates</u>	<u>Percentage Change in Net Interest Income</u>
Down 100 basis points	8.2%
Down 200 basis points	10.8%
Up 100 basis points	-12.6%
Up 200 basis points	-26.1%

### **Return on Assets and Equity**

The return on average assets for 2007 was 0.49%; the return on average equity for the same period was 6.01%; and the ratio of average shareholders' equity to average total assets was 8.23%.

The return on average assets for 2006 was 0.13%; the return on average equity for the same period was 1.56%; and the ratio of average shareholders' equity to average total assets was 8.35%.

### **Effects of Inflation**

The majority of assets and liabilities of the Bank 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 Bank's assets. Inflation may also affect the general level of interest rates, which can have a direct bearing on the Bank.

### **Quantitative and Qualitative Disclosures about Market Risks**

Not Applicable.



**EMBASSY BANK™**  
For the Lehigh Valley

## *Investor Information*

### **Embassy Bank**

Embassy Bank is a full service bank providing personal and business lending and deposit services.

### **Common Stock Outstanding**

On March 31, 2008, there were 6,888,024 shares of the Bank's common stock outstanding and 1,298 shareholders of record.

### **Transfer Agent**

Registrar and Transfer Company  
10 Commerce Drive  
Cranford, NJ 07016  
1-800-368-5948

### **Embassy Bank for the Lehigh Valley**

P.O. Box 20405  
Lehigh Valley, PA 18002-0405  
610-882-8800 Fax: 610-691-5600  
[www.embassybank.com](http://www.embassybank.com)

### **Annual Meeting**

The Annual meeting of Embassy Bank for the Lehigh Valley is scheduled for 5:30 PM, June 24, 2008 at 100 Gateway Drive, Second Floor, Bethlehem PA. All shareholders are invited to join us for a reception immediately following the meeting.

### **Form 10-K Request**

The Form 10-K Report filed with the Federal Deposit Insurance Corporation, by the Bank, may be obtained without charge, by writing to:

Judith Hunsicker, Chief Operating Officer  
Embassy Bank for the Lehigh Valley  
P.O. Box 20405  
Lehigh Valley, PA 18002-0405

### **Market Price of Common Stock & Dividend Information**

The Bank's common stock is not traded on any exchange and there is no established public trading market for the Bank's common stock. No broker makes a market in Embassy's common stock.

In October 2007, the Bank declared a 3-for-2 stock split. The bank has not declared or paid any cash dividends on its common stock. State and Federal banking laws restrict the payment of dividends. Cash dividends may be declared and paid only out of accumulated net earnings. In any event, the Directors of the Bank intend to follow a policy for the foreseeable future of retaining earnings in order to support anticipated growth.



**EMBASSY BANK™**

For the Lehigh Valley

*Banking Without Borders*

**100 Gateway Drive, Suite 100 (Routes 512 & 22), Bethlehem, PA**

**925 West Broad St., Bethlehem, PA**

**4148 W. Tilghman Street, Allentown, PA**

**6379 Hamilton Blvd., Trexlertown, PA**

**610-882-8800  [www.embassybank.com](http://www.embassybank.com)**

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