SMITH INTERNATIONAL INC
Form 10-Q
May 15, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2003

OR

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

For the transition period from ____ to ____

Commission file number
1-8514

SMITH INTERNATIONAL, INC.
(Exact name of Registrant as specified in its charter)

DELAWARE	95-3822631
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

411 NORTH SAM HOUSTON PARKWAY, SUITE 600 HOUSTON, TEXAS	77060
(Address of principal executive offices)	(Zip Code)

(281) 443-3370
(Registrant's telephone number, including area code)

NOT APPLICABLE
(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [X] No [ ]

The number of shares outstanding of the Registrant's common stock as of May 9, 2003 was 101,971,435.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SMITH INTERNATIONAL, INC.
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

Three Months Ended
March 31,

	2003	2002
Revenues	$ 808,837	$ 827,377
Costs and expenses:		
Costs of revenues	570,494	585,875
Selling expenses	137,128	131,059
General and administrative expenses	38,061	35,995
Total costs and expenses	745,683	752,929
Operating income	63,154	74,448
Interest expense, net	9,692	10,016
Income before income taxes, minority interests and cumulative effect of change in accounting principle	53,462	64,432
Income tax provision	16,840	19,645
Income before minority interests and cumulative effect of change in accounting principle	36,622	44,787
Minority interests	14,907	16,057
Income before cumulative effect of change in accounting principle	21,715	28,730
Cumulative effect of change in accounting principle	(1,154)	--
Net income	$ 20,561	$ 28,730
Basic (See Note 5):		
Earnings per share before cumulative effect of change in accounting principle	$ 0.22	$ 0.29
Cumulative effect of change in accounting principle	(0.01)	--
Earnings per share	$ 0.21	$ 0.29
Diluted (See Note 5):		
Earnings per share before cumulative effect of change in accounting principle	$ 0.22	$ 0.29
Cumulative effect of change in accounting principle	(0.01)	--
Earnings per share	$ 0.21	$ 0.29
Weighted average shares outstanding (See Note 5):		
Basic	99,265	98,840
Diluted	100,267	99,838

The accompanying notes are an integral part of these consolidated condensed financial statements.

SMITH INTERNATIONAL, INC.
CONSOLIDATED CONDENSED BALANCE SHEETS
(In thousands, except par value data)

	March 31, 2003 (Unaudited)	December 2002
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 43,914	$ 86,
Receivables, net	707,885	633,
Inventories, net	658,760	634,
Deferred tax assets, net	25,473	25,
Prepaid expenses and other	54,738	46,
Total current assets	1,490,770	1,426,
Property, Plant and Equipment, net	523,686	519,
Goodwill, net	679,288	620,
Other Assets	198,492	183,
Total Assets	$ 2,892,236	$ 2,749,
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term borrowings and current portion of long-term debt	$ 191,821	$ 159,
Accounts payable	257,736	256,
Accrued payroll costs	46,672	49,
Income taxes payable	54,627	43,
Other	88,180	85,
Total current liabilities	639,036	595,
Long-Term Debt	487,768	441,
Deferred Tax Liabilities	63,648	64,
Other Long-Term Liabilities	74,091	67,
Minority Interests	533,226	517,
Commitments and Contingencies (See Note 13)		
STOCKHOLDERS' EQUITY:		

Preferred stock, $1 par value; 5,000 shares authorized; no shares issued or outstanding in 2003 or 2002	--	
Common stock, $1 par value; 150,000 shares authorized; 101,815 shares issued in 2003 (101,546 shares issued in 2002)	101,815	101,
Additional paid-in capital	351,644	345,
Retained earnings	676,204	655,
Accumulated other comprehensive income	(6,066)	(10,
Less - Treasury securities, at cost; 2,384 common shares	(29,130)	(29,
Total stockholders' equity	1,094,467	1,063,
Total Liabilities and Stockholders' Equity	$ 2,892,236	$ 2,749,

The accompanying notes are an integral part of these consolidated condensed financial statements.

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SMITH INTERNATIONAL, INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months E March 31,	
	2003	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 20,561	$
Adjustments to reconcile net income to net cash provided by operating activities, excluding the net effects of acquisitions:		
Cumulative effect of change in accounting principle	1,154	
Depreciation and amortization	24,384	
Minority interests	14,907	
Provision for losses on receivables	430	
Gain on disposal of property, plant and equipment	(2,110)	
Foreign currency translation losses (gains)	813	
Changes in operating assets and liabilities:		
Receivables	(64,331)	
Inventories	(10,946)	
Accounts payable	(3,297)	
Other current assets and liabilities	(3,374)	
Other non-current assets and liabilities	(8,150)	
Net cash provided by (used in) operating activities	(29,959)	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of businesses, net of cash acquired	(77,769)	
Purchases of property, plant and equipment	(20,699)	
Proceeds from disposal of property, plant and equipment	4,420	

Net cash used in investing activities	(94,048)	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of long-term debt	58,758	
Principal payments of long-term debt	(1,316)	
Net change in short-term borrowings	19,390	
Proceeds from exercise of stock options	4,253	
Net cash provided by (used in) financing activities	81,085	
Effect of exchange rate changes on cash	86	
Decrease in cash and cash equivalents	(42,836)	
Cash and cash equivalents at beginning of period	86,750	
Cash and cash equivalents at end of period	$ 43,914	$
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 16,665	$
Cash paid for income taxes	$ 5,929	$

The accompanying notes are an integral part of these consolidated condensed financial statements.

SMITH INTERNATIONAL, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)

1. BASIS OF PRESENTATION OF INTERIM FINANCIAL STATEMENTS

The accompanying unaudited consolidated condensed financial statements of Smith International, Inc. and subsidiaries (the "Company") were prepared in accordance with U.S. generally accepted accounting principles and all applicable financial statement rules and regulations of the Securities and Exchange Commission (the "Commission") pertaining to interim financial information. These interim financial statements do not include all information or footnote disclosures required by generally accepted accounting principles for complete financial statements and, therefore, should be read in conjunction with the audited financial statements and accompanying notes included in the Company's 2002 Annual Report on Form 10-K and other current filings with the Commission. All adjustments which are, in the opinion of management, of a normal recurring nature and are necessary for a fair presentation of the interim financial statements have been included.

Preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosed amounts of contingent assets and liabilities and the reported amounts of revenues and expenses. If the underlying estimates and assumptions, upon which the financial statements are based, change in future periods, actual amounts may differ from those included in the accompanying consolidated condensed financial statements.

Management believes the consolidated condensed financial statements present fairly the financial position, results of operations and cash flows of the Company as of the dates indicated. The results of operations for the interim periods presented may not be indicative of results for the fiscal year.

2. RECENT ACCOUNTING PRONOUNCEMENTS

On January 1, 2003, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement Obligations," which addresses the financial accounting and reporting for retirement obligations and costs associated with tangible long-lived assets. SFAS No. 143 requires that liabilities for asset retirement obligations be recognized during the periods incurred rather than when expended. The Company's asset retirement obligations principally relate to the removal of leasehold improvements upon exiting certain leased properties, primarily associated with the M-I operations. Upon adoption, the Company recognized a charge of $2.5 million, or $1.2 million after tax and minority interests, to reflect the cumulative amount of expense which was required to be recognized as of January 1, 2003. This amount has been recorded as a cumulative effect of change in accounting principle in the accompanying consolidated condensed statement of operations. Additionally, the Company recorded a $3.7 million long-term liability at the adoption date reflecting the present value of projected future asset retirement obligations. The differential of $1.2 million, which primarily represents the associated capitalized retirement costs, will be charged to earnings over the remaining leasehold period. Neither the amount charged to earnings in the first quarter of 2003 nor the pro forma effect for the three months ended March 31, 2002 (assuming adoption of SFAS No. 143 as of January 1, 2002) were significant to net income or earnings per share amounts.

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board (the "FASB") which are adopted by the Company as of the specified effective date. Unless otherwise discussed, management believes the impact of recently issued standards, which are not yet effective, will not have a material impact on the Company's consolidated financial statements upon adoption.

3. BUSINESS COMBINATION

On January 29, 2003, M-I acquired certain oilfield chemical assets of Dynea International ("Dynea") for cash consideration of $77.8 million. The acquired operations, which are based in Norway, provide a complete line of oilfield specialty chemicals used to eliminate hydrocarbon flow problems encountered during production and transportation.

This acquisition has been recorded using the purchase method of accounting and, accordingly, the acquired operations have been included in the results of operations since the date of acquisition. The excess of the purchase price over the estimated fair value of the net assets acquired has been recorded as goodwill. The purchase price allocation related to this acquisition is based upon preliminary information and is subject to change when additional data concerning final asset and liability valuations is obtained. Material changes in the preliminary allocations are not anticipated by management.

The following unaudited pro forma supplemental information presents consolidated results of operations as if the Company's significant current and prior year acquisitions had occurred on January 1, 2002. The unaudited pro forma data is based on historical information and does not include estimated cost savings; therefore, it does not purport to be indicative of the results of operations had the combinations been in effect at the dates indicated or of future results for the combined entities (in thousands, except per share data):

	Three Months Ended March 31, 2003	Three Months Ended March 31, 2002
Revenues	$ 814,445	$ 854,389
Income before cumulative effect of change in accounting principle	21,813	30,183
Net income	20,659	30,183
Basic:		
Earnings per share before cumulative effect of change in accounting principle	$ 0.22	$ 0.31
Earnings per share	0.21	0.31
Diluted:		
Earnings per share before cumulative effect of change in accounting principle	$ 0.22	$ 0.30
Earnings per share	0.21	0.30

The following schedule summarizes investing activities related to the current year acquisition included in the consolidated statement of cash flows (in thousands):

Fair value of tangible and identifiable intangible assets, net of cash acquired	$ 28,607
Goodwill recorded	57,116
Total liabilities assumed	(7,954)
Cash paid for acquisition of business, net of cash acquired	$ 77,769

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4. OTHER CHARGES

During the first quarter of 2002, the Company recognized certain other charges totaling $7.9 million, or $3.4 million net of tax and minority interests. The first quarter charge included a $4.3 million provision for losses on receivables in Argentina attributable to local economic events. The provision was necessitated by Argentinean legislation, which required the Company to settle certain U.S. dollar-denominated transactions in pesos. The remainder of the charge related to restructuring efforts undertaken in response to activity-level declines, the primary component of which is severance costs incurred in connection with employee terminations. All such restructuring costs were paid in 2002.

In the accompanying consolidated condensed statement of operations for the three months ended March 31, 2002, $5.8 million of the charges are included in general and administrative expenses, $1.7 million are reflected in selling expenses with the remainder recorded as cost of revenues.

5. STOCK SPLIT

On June 6, 2002, the Company's Board of Directors approved a two-for-one stock split, effected in the form of a stock dividend. Stockholders of record as of June 20, 2002 were entitled to the dividend, which was distributed on July 8, 2002. Unless otherwise noted, all prior year share and per share amounts included in the financial statements and related notes have been restated for the effect of the stock split.

6. EARNINGS PER SHARE

Basic earnings per share ("EPS") is computed using the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to the potential dilution of earnings which could have occurred if additional shares were issued for stock option exercises under the treasury stock method. Certain outstanding employee stock options were not included in the computation of diluted earnings per common share, as the exercise price was greater than the average market price for the Company's stock during the corresponding period. The following schedule reconciles the income and shares used in the basic and diluted EPS computations (in thousands, except per share data):

	Three Months Ended March 31, 2003	Three Months Ended March 31, 2002
BASIC EPS BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE:		
Income before cumulative effect of change in accounting principle	$ 21,715	$ 28,730
Weighted average number of common shares outstanding	99,265	98,840
Basic EPS before cumulative effect of change in accounting principle	$ 0.22	$ 0.29
DILUTED EPS BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE:		
Income before cumulative effect of change in accounting principle	$ 21,715	$ 28,730

Weighted average number of common shares outstanding	99,265	98,840
Dilutive effect of stock options	1,002	998
	100,267	99,838
Diluted EPS before cumulative effect of change in accounting principle	$ 0.22	$ 0.29

7. INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out ("FIFO"), last-in, first-out ("LIFO") or average cost methods. Inventory costs, consisting of materials, labor and factory overhead, are as follows (in thousands):

	March 31, 2003	December 31, 2002
Raw materials	$ 57,011	$ 49,880
Work-in-process	54,976	54,201
Products purchased for resale	160,377	155,202
Finished goods	411,400	399,252
	683,764	658,535
Reserves to state certain domestic inventories (FIFO cost of $272,594 and $265,304 in 2003 and 2002, respectively) on a LIFO basis	(25,004)	(24,047)
	$ 658,760	$ 634,488

8. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of the following (in thousands):

	March 31, 2003	December 31, 2002
Land	$ 34,047	$ 33,412
Buildings	130,263	125,589
Machinery and equipment	503,774	506,245
Rental tools	283,272	268,134
	951,356	933,380
Less-Accumulated depreciation	427,670	414,160

	$ 523,686	$ 519,220

9. GOODWILL AND OTHER INTANGIBLE ASSETS

The following schedule presents goodwill, net of amortization, on a segment basis as of March 31, 2003 and December 31, 2002 and the related changes in the carrying amount of goodwill (in thousands):

	Oilfield Segment	Distribution Segment	Consolidated
Balance as of December 31, 2002	$ 582,786	$ 37,289	$ 620,075
Goodwill acquired	57,116	--	57,116
Purchase price and other adjustments	1,710	387	2,097
Balance as of March 31, 2003	$ 641,612	$ 37,676	$ 679,288

The accompanying consolidated condensed balance sheets as of March 31, 2003 and December 31, 2002 include $66.6 million and $60.1 million of intangible assets (net of accumulated amortization of $14.8 million and $13.2 million), respectively, which are classified in other assets. The Company amortizes identifiable intangible assets, generally consisting of patents, trademarks and non-compete agreements, on a straight-line basis over their expected useful lives, which range from three to 27 years.

10. COMPREHENSIVE INCOME

Comprehensive income includes net income and changes in the components of accumulated other comprehensive income during the periods presented. The Company's comprehensive income is as follows (in thousands):

	Three Months Ended March 31,	
	2003	2002
Net income	$ 20,561	$ 28,730
Changes in unrealized fair value of derivatives, net	406	35
Currency translation adjustments	3,963	(467)
Comprehensive income	$ 24,930	$ 28,298

As of March 31, 2003, accumulated other comprehensive income in the accompanying consolidated condensed balance sheet includes $5.3 million of cumulative currency translation losses and $3.5 million of cumulative pension liability adjustments, partially offset by $2.7 million of cumulative changes in the unrealized fair value of derivatives.

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11. STOCK-BASED COMPENSATION

The Company's Board of Directors and its stockholders have authorized an employee stock option plan. As of March 31, 2003, 6.0 million shares were issued and outstanding under the program and an additional 3.3 million shares were authorized for future issuance. Options are generally granted at the fair market value on the date of grant, vest over a four-year period and expire ten years after the date of grant.

Certain option awards granted on December 4, 2001 were subject to stockholder approval which was not obtained until April 24, 2002. Accordingly, these options were granted with a strike price more than five percent below the market value on the date of issuance and do not meet the conditions necessary to qualify as a non-compensatory option grant. Compensation expense related to these grants is being recognized over the four-year vesting period and resulted in the inclusion of $0.1 million of related expense in the accompanying consolidated condensed statement of operations for the three month period ended March 31, 2003.

The Company continues to apply Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for its stock option program, as allowed under SFAS No. 123, "Accounting for Stock-Based Compensation." Therefore, for all options other than those mentioned above, the Company elects to make pro forma disclosures versus recognizing the related compensation expense in the accompanying consolidated condensed financial statements.

Had the Company elected to apply the accounting standards of SFAS No. 123, the Company's net income and earnings per share on a diluted basis would have approximated the pro forma amounts indicated below (in thousands, except per share data):

	Three Months Ended March 31,	
	2003	2002
Net income, as reported	$ 20,561	$ 28,730
Add: Stock-based compensation expense included in reported income, net of related tax effect	68	--
Less: Total stock-based compensation expense determined under the Black-Scholes option-pricing model, net of related tax effect	(2,347)	(1,896)
Pro forma net income	$ 18,282	$ 26,834

Earnings per share:

As reported:		
Basic	$ 0.21	$ 0.29
Diluted	0.21	0.29
Pro forma:		
Basic	$ 0.18	$ 0.27
Diluted	0.18	0.27

In addition to the stock option program described above, the Company maintains a stock grant program. The stock grants are issued at par value and are subject to a four-year cliff-vesting schedule. Compensation expense, calculated as the difference between the market value on the date of grant and the exercise price, is being recognized ratably over the vesting period and resulted in the inclusion of $0.2 million and $0.1 million of related expense in the accompanying consolidated condensed statements of operations for the three month periods ended March 31, 2003 and 2002, respectively.

12. INDUSTRY SEGMENTS

The Company manufactures and markets premium products and services to the oil and gas exploration and production industry, the petrochemical industry and other industrial markets. The Company aggregates its operations into two reportable segments: Oilfield Products and Services and Distribution. The Oilfield Products and Services segment consists of three business units: M-I, Smith Bits and Smith Services. The Distribution segment includes the Wilson business unit. The following table presents financial information for each reportable segment (in thousands):

	Three Months Ended March 31,	
	2003	2002
Revenues:		
Oilfield Products and Services	$ 603,560	$ 592,870
Distribution	205,277	234,507
	$ 808,837	$ 827,377
Operating Income:		
Oilfield Products and Services	$ 68,933	$ 75,939
Distribution	(4,099)	68
General corporate	(1,680)	(1,559)
	$ 63,154	$ 74,448

13. COMMITMENTS AND CONTINGENCIES

Standby Letters of Credit and Guarantees

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds which totaled approximately $75.0 million at March 31, 2003. Management does not expect any material amounts to be drawn on these instruments. The Company has also provided guarantees for loans related to certain joint ventures accounted for by the equity method of accounting. As the net assets of the joint ventures are available to satisfy obligations as they become due, management believes the likelihood is remote that the Company will be required to make payments related to these agreements. The Company's estimated maximum exposure under these contingent guarantees was approximately $12.0 million as of March 31, 2003.

Environmental

The Company routinely establishes and reviews the adequacy of reserves for estimated future environmental clean-up costs for properties currently or previously operated by the Company.

In connection with most business acquisitions, the Company obtains contractual indemnifications from the seller related to environmental matters. These indemnifications generally provide for the reimbursement of environmental clean-up costs incurred by the Company for events occurring or circumstances existing prior to the purchase date, whether the event or circumstance was known or unknown at that time. A substantial portion of the Company's total environmental exposure is associated with its M-I operations, which are subject to various indemnifications from former owners.

As of March 31, 2003, the Company has established an environmental reserve of approximately $12.5 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at March 31, 2003, the Company does not believe that these differences will have a material impact on the Company's financial position or results of operations, subject to the indemnifications in place. During the first quarter of 2003, the Company initiated legal action against M-I's former owners to address issues associated with certain provisions of the environmental indemnification provided. In the event that i) M-I's former owners and other parties to indemnification agreements with the Company do not fulfill their obligations, and ii) costs incurred to remediate the identified properties reach estimated maximum exposure limits, the Company would be required to establish additional environmental reserves of up to $25.0 million, impacting earnings and cash flows in future periods.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

The following "Management's Discussion and Analysis of Financial Condition and Results of Operations" is provided to assist readers in understanding the Company's financial performance during the periods presented and significant trends which may impact the future performance of the Company. This discussion should be read in conjunction with the consolidated condensed financial statements of the Company and the related notes thereto included elsewhere in this Form 10-Q and the consolidated financial statements of the Company, the notes thereto and the related "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the Company's 2002 Annual Report on Form 10-K.

The Company manufactures and markets premium products and services to the oil and gas exploration and production industry, the petrochemical industry and other industrial markets. The Company provides a comprehensive line of technologically-advanced products and engineering services, including drilling and completion fluid systems, solids-control and separation equipment, waste-management services, oilfield production chemicals, three-cone drill bits, diamond drill bits, turbine products, fishing services, drilling tools, underreamers, casing exit and multilateral systems, packers and liner hangers. The Company also offers supply chain management solutions through an extensive branch network providing pipe, valves, fittings and mill, safety and other maintenance products.

The Company's worldwide operations are largely driven by the level of exploration and production activity in major energy-producing areas and the depth and drilling conditions of these projects. Drilling activity levels are primarily influenced by energy prices but may also be affected by expectations related to the worldwide supply of and demand for oil and natural gas, finding and development costs, decline and depletion rates, political actions and uncertainties, environmental concerns, capital expenditure plans of exploration and production companies and the overall level of global economic growth and activity.

The year-over-year increase in the worldwide rig count relates to higher North American activity levels, driven by a 22 percent increase in land-based drilling programs. Drilling activity in the United States and Canada is heavily influenced by natural gas fundamentals, as approximately 80 percent of the North American rig count is currently natural gas-directed. A combination of declining production and higher weather-related demand has reduced U.S. natural gas storage levels to nearly 40 percent below the five-year average, which has favorably impacted commodity prices and North American drilling activity. Activity levels in markets outside of North America, which are primarily influenced by crude oil fundamentals, have remained relatively consistent with the prior year and are forecasted to show modest improvement throughout the remainder of 2003. While worldwide activity levels are currently above the average reported in the first quarter of 2002, various factors, including political and regional instabilities, oil and natural gas storage levels, commodity prices and depletion rates, will likely influence drilling activity on a going forward basis. The Company's business outlook, however, is highly dependent on the general economic environment in the United States and other major world economies, which ultimately impact energy consumption and the resulting demand for our products and services. Further weakness in the global economic environment could result in reduced worldwide drilling activity, adversely impacting the Company's future financial results.

Management also believes the increasing complexity of drilling programs has resulted in a shift in exploration and production spending toward value-added, technology-based products, which reduce operators' overall drilling costs. The Company continues to focus on investing in the development of technology-based products that considerably improve the drilling process through increased efficiency and rates of penetration and reduced formation damage. Management believes the overall savings realized by the use of the Company's premium products, such as polycrystalline diamond drill bits, diamond-enhanced three-cone drill bits and synthetic drilling fluids, compensate for the higher costs of these products over their non-premium counterparts.

RESULTS OF OPERATIONS

Segment Discussion

The Company markets its products and services throughout the world through four business units which are aggregated into two reportable segments. The Oilfield Products and Services segment consists of three business units: M-I, Smith Bits and Smith Services. The Distribution segment includes the Wilson business unit. The revenue discussion below has been summarized by business unit in order to provide additional information in analyzing the Company's operations (dollars in thousands).

	Three Months Ended March 31,		
	2003		
	Amount	%	Amount
Financial Data:			
Revenues:			
M-I	$ 416,289	52	$ 396,656
Smith Bits	92,239	11	89,478
Smith Services	95,032	12	106,736
Oilfield Products and Services	603,560	75	592,870
Distribution	205,277	25	234,507
Total	$ 808,837	100	$ 827,377
Revenues by Area:			
United States	$ 367,315	45	$ 391,948
Canada	86,281	11	88,219
Non-North America	355,241	44	347,210
Total	$ 808,837	100	$ 827,377
Operating Income:			
Oilfield Products and Services	$ 68,933	11	$ 75,939
Distribution	(4,099)	--	68
General corporate	(1,680)	*	(1,559
Total	$ 63,154	8	$ 74,448
Market Data:			
M-I Average Worldwide Rig Count:			
United States	1,052	42	877
Canada	455	18	386
Non-North America	1,008	40	1,001
Total	2,515	100	2,264

*not meaningful

Oilfield Products and Services Segment

Revenues

M-I provides drilling and completion fluid systems, engineering and technical services to the oil and gas industry through its M-I Fluids division, and it manufactures and markets equipment and services for solids-control, separation, pressure control, rig instrumentation and waste-management through its M-I SWACO division. M-I also provides a complete line of oilfield specialty chemicals and related technical services through its Oilfield Production Chemical division, acquired in January 2003. M-I's business operations are largely influenced by the number of offshore drilling programs, which are more revenue-intensive than land-based projects due to the complex nature of the related drilling environment. For the three months ended March 31, 2003, M-I's revenues totaled $416.3 million, five percent above the prior year quarter. The year-over-year variance was largely attributable to incremental revenues from acquisitions completed during the past 12-month period, primarily the Dynea Oilfield Chemical transaction finalized on January 29, 2003. Excluding the impact of acquisitions, revenues increased one percent above the prior year quarter reflecting new contract awards and increased customer activity in certain Eastern Hemisphere markets, primarily the Commonwealth of Independent States and West Africa. Western Hemisphere revenues were slightly below the prior year as the effect of a reduced number of U.S. offshore drilling programs and lower activity levels in certain areas of Latin America was partially offset by incremental revenues associated with increased North American land-based drilling activity.

Smith Bits designs, manufactures and sells three three-cone drill bits, diamond drill bits and turbines for use in the oil and gas industry. Smith Bits reported revenues of $92.2 million for the first quarter of 2003, an increase of three percent from the comparable prior year period. The period-to-period comparison was affected by the sale of several large Eastern Hemisphere export orders during the prior year quarter, which did not recur in the first quarter of 2003, as well as the acquisition of two business operations during the latter half of 2002. Excluding the impact of these items, Smith Bits' revenues increased approximately five percent over the prior year period, attributable to improved North American drilling activity.

Smith Services manufactures and markets products and services used in the oil and gas industry for drilling, workover, well completion and well re-entry. For the three months ended March 31, 2003, Smith Services' revenues totaled $95.0 million, 11 percent below the prior year quarter. The majority of the year-over-year revenue decline related to the more than 40 percent reduction in demand for tubular products in the United States, primarily drill pipe. The remainder of the decline relates to reduced customer spending for completion products and services in certain markets in Latin America and West Africa.

Operating Income

Operating income for the Oilfield Products and Services segment was $68.9 million, a nine percent decline from the prior year quarter. Segment operating margins were 11.4 percent for the first quarter of 2003, 1.4 percentage points below the level reported in the prior year quarter. The year-over-year decline in segment operating income primarily reflected inclusion of higher operating expenses, partially offset by increased gross profit attributable to the improved revenue volumes. Incremental expenses related to five operations acquired over the past 12-month period, higher costs associated with U.S. medical and casualty insurance programs and increased employee profit-sharing accruals accounted for the reported operating expense increase. The year-over-year comparison was also impacted by the recognition of $7.0 million in charges, primarily related to receivable write-downs in Argentina and employee termination costs, in the first quarter of 2002 which did not recur. Excluding the effect of these charges, operating margins declined 2.6 percentage points from the prior year quarter.

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Distribution Segment

Revenues

Wilson markets pipe, valves, fittings and mill, safety and other maintenance products to energy and industrial markets, primarily through an extensive network of supply branches in the United States and Canada. Wilson reported revenues of $205.3 million for the first quarter of 2003, 12 percent below the prior year quarter. Over 70 percent of the revenue variance was reported in Wilson's U.S. industrial and downstream operations attributable to lower spending on major maintenance programs and projects by engineering and construction, refining and petrochemical customers. To a lesser extent, the year-over-year revenue comparison was impacted by reduced tubular product sales in Canada as certain customers now purchase tubular goods directly from the manufacturer.

Operating Income

Operating income for the Distribution segment decreased $4.2 million from the amount reported in the first quarter of 2002. The operating income variance reflects lower gross profit associated with the reported revenue decline, partially offset by a reduction in variable-based operating expenses. As a percentage of revenues, operating income decreased two percentage points from the prior year quarter, as lower sales volumes impacted coverage of fixed sales and administrative support costs.

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Consolidated Results

For the periods indicated, the following table summarizes the results of the Company and presents these results as a percentage of total revenues (dollars in thousands):

	Three Mont	
	2003	
	Amount	%

Revenues	$ 808,837	10
Gross profit	238,343	2
Operating expenses	175,189	2
Operating income	63,154	
Interest expense, net	9,692	
Income before income taxes, minority interests and cumulative effect of change in accounting principle	53,462	
Income tax provision	16,840	
Income before minority interests and cumulative effect of change in accounting principle	36,622	
Minority interests	14,907	
Income before cumulative effect of change in accounting principle	21,715	
Cumulative effect of change in accounting principle	(1,154)	-
Net income	$ 20,561	

Consolidated revenues were $808.8 million for the first quarter of 2003, two percent below the prior year period. The year-over-year comparison was impacted by the inclusion of revenues from five acquisitions completed during the prior 12-month period. Excluding the impact of acquired operations, base revenues fell five percent from the first quarter of 2002, with revenue declines experienced in both the Oilfield and Distribution segments. Approximately 70 percent of the base revenue decline was reported in the Distribution operations associated with a significant decline in customer spending levels in the industrial and downstream market. The base revenue reduction in the Oilfield segment resulted from lower demand for tubular goods in the United States and a reduction in the level of Eastern Hemisphere export orders, partially offset by incremental revenues associated with improved North American activity levels.

Gross profit totaled $238.3 million for the first quarter of 2003, approximately one percent below the prior year period. The decrease in gross profit reflects the lower sales volumes experienced in the Company's Distribution segment. Gross profit margins for the period were 29 percent of revenues, comparable with the levels reported in the prior year quarter due, in part, to a favorable shift in revenue mix. The impact of the increased proportion of consolidated revenues generated in the Oilfield segment, which traditionally generate higher gross profit margins than the Distribution operations, served to offset the minimal margin deterioration reported in the Oilfield segment.

Operating expenses, consisting of selling, general and administrative expenses, increased $8.1 million from the prior year period. Over half of the variance relates to incremental expenses associated with operations acquired during the past 12-month period. To a lesser extent, higher costs associated with U.S. medical and casualty insurance programs and increased employee profit-sharing amounts resulting from reported profitability levels contributed to the period-to-period increase. The reported increase in operating expenses was impacted by the inclusion of $7.5 million of charges, primarily for receivable write-offs in Argentina and employee termination costs recognized in the prior year period which did not recur.

Net interest expense, which represents interest expense less interest income, equaled $9.7 million in the first quarter of 2003. Net interest expense decreased $0.3 million from the prior year period as excess cash flow was utilized to repay outstanding borrowings under revolving credit facilities, resulting in a $35.0 million reduction in average debt levels.

The effective tax rate for the first quarter approximated 32 percent, which is lower than the U.S. statutory rate due to the impact of M-I's U.S. partnership earnings for which the minority partner is directly responsible for their related income taxes. The Company properly consolidates the pre-tax income related to the minority partner's share of U.S. partnership earnings but excludes the related tax provision. The effective tax rate increased one percentage point above the first quarter of 2002, reflecting the lower proportion of M-I U.S. partnership earnings and, to a lesser extent, an unfavorable shift in the geographic mix of pre-tax income toward higher rate jurisdictions.

Minority interests reflect the portion of the results of majority-owned operations, which are applicable to the minority interest partners. Minority interests was $1.2 million below amounts reported in the prior year quarter due to the lower profitability reported in the M-I operations.

The cumulative effect of change in accounting principle represents the impact of adopting Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement Obligations," which was effective January 1, 2003.

LIQUIDITY AND CAPITAL RESOURCES

General

At March 31, 2003, cash and cash equivalents equaled $43.9 million. For the first quarter of 2003, the Company's operations utilized $30.0 million of cash flow which compared to the $39.4 million generated in the prior year period. The current year improvement in North American activity levels has resulted in higher working capital levels, particularly the required investment in accounts receivable and inventories, in contrast to the prior year quarter when declining activity favorably impacted these working capital accounts.

During the first quarter of 2003, cash flows used in investing activities totaled $94.0 million, consisting of amounts required to fund acquisitions and, to a lesser extent, capital expenditures. During the period, the Company acquired the oilfield chemical assets of Dynea International in exchange for cash consideration of $77.8 million. The Company also invested $16.2 million in property, plant and equipment, net of cash proceeds arising from certain asset disposals. The level of cash used for investing activities increased from the prior year period, with the variance related to current year acquisition funding.

In the first three months of 2003, cash flows from operations were not sufficient to fund investing activities, resulting in a $76.8 million increase in outstanding debt levels. Cash flows provided by financing activities, which totaled $81.1 million for the three months ended March 31, 2003, were also impacted by proceeds from the exercise of stock options, which equaled $4.3 million during the period.

The Company's primary internal source of liquidity is cash flow generated from operations. Cash flow generated by operations is primarily influenced by the level of worldwide drilling activity, which affects profitability levels and working capital requirements. Capacity under revolving credit agreements is also available, if necessary, to fund operating or investing activities. As of March 31, 2003, the Company had $344.4 million of funds available under U.S. revolving credit facilities to fund future operating or investing needs of its worldwide operations. The Company also has revolving credit facilities in place outside the United States, which are generally used to finance local operating needs. At March 31, 2003, borrowing capacity of $42.8 million was available under the non-U.S. borrowing facilities.

External sources of liquidity include debt and equity financing in the public capital markets, if needed. The Company carries an investment-grade credit rating with recognized rating agencies, generally providing the Company with access to debt markets. The Company's overall borrowing capacity is, in part, dependent on maintaining compliance with financial covenants under the various credit agreements. As of March 31, 2003, the Company was well within the covenant compliance thresholds under its various loan indentures, as amended, providing the ability to access available borrowing capacity. Management believes funds generated from operations, amounts available under existing credit facilities and external sources of liquidity will be sufficient to finance capital expenditures and working capital needs of the existing operations for the foreseeable future. Management continues to evaluate opportunities to acquire products or businesses complementary to the Company's operations. These acquisitions, if they arise, may involve the use of cash or, depending upon the size and terms of the acquisition, may require debt or equity financing.

Commitments and Contingencies

Standby Letters of Credit and Guarantees

In the normal course of business with customers, vendors and others, the Company is contingently liable for performance under standby letters of credit and bid, performance and surety bonds which totaled approximately $75.0 million at March 31, 2003. Management does not expect any material amounts to be drawn on these instruments. The Company has also provided guarantees for loans related to certain joint ventures accounted for by the equity method of accounting. As the net assets of the joint ventures are available to satisfy obligations as they become due, management believes the likelihood is remote that the Company will be required to make payments related to these agreements. The Company's estimated maximum exposure under these contingent guarantees was approximately $12.0 million as of March 31, 2003.

Environmental

The Company routinely establishes and reviews the adequacy of reserves for estimated future environmental clean-up costs for properties currently or previously operated by the Company.

In connection with most business acquisitions, the Company obtains contractual indemnifications from the seller related to environmental matters.

These indemnifications generally provide for the reimbursement of environmental clean-up costs incurred by the Company for events occurring or circumstances existing prior to the purchase date, whether the event or circumstance was known or unknown at that time. A substantial portion of the Company's total environmental exposure is associated with its M-I operations, which are subject to various indemnifications from former owners.

As of March 31, 2003, the Company has established an environmental reserve of approximately $12.5 million. This amount reflects the future undiscounted estimated exposure related to identified properties, without regard to indemnifications from former owners. While actual future environmental costs may differ from estimated liabilities recorded at March 31, 2003, the Company does not believe that these differences will have a material impact on the Company's financial position or results of operations, subject to the indemnifications in place. During the first quarter of 2003, the Company initiated legal action against M-I's former owners to address issues associated with certain provisions of the environmental indemnification provided. In the event that i) M-I's former owners and other parties to indemnification agreements with the Company do not fulfill their obligations, and ii) costs incurred to remediate the identified properties reach estimated maximum exposure limits, the Company would be required to establish additional environmental reserves of up to $25.0 million, impacting earnings and cash flows in future periods.

Critical Accounting Policies and Estimates

The discussion and analysis of financial condition and results of operations are based upon the Company's consolidated condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The Company evaluates its estimates on an on-going basis, based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. In its 2002 Annual Report on Form 10-K, the Company has described the critical accounting policies that require management's most significant judgments and estimates. There have been no material changes in these critical accounting policies.

Recent Accounting Pronouncements

On January 1, 2003, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement Obligations," which addresses the financial accounting and reporting for retirement obligations and costs associated with tangible long-lived assets. SFAS No. 143 requires that liabilities for asset retirement obligations be recognized during the periods incurred rather than when expended. The Company's asset retirement obligations principally relate to the removal of leasehold improvements upon exiting certain leased properties, primarily associated with the M-I operations. Upon adoption, the Company recognized a charge of $2.5 million, or $1.2 million after tax and minority interests, to reflect the cumulative amount of expense which was required to be recognized as of January 1, 2003. This amount has been recorded as a cumulative effect of change in accounting principle in the accompanying consolidated condensed statement of operations. Additionally, the Company recorded a $3.7 million long-term liability at the adoption date reflecting the present value of projected future asset retirement obligations. The differential of $1.2 million, which primarily represents the associated capitalized retirement costs, will be charged to earnings over the remaining leasehold period. Neither the amount charged to earnings in the first quarter of 2003 nor the pro forma effect for the three months ended March 31, 2002 (assuming adoption of SFAS No. 143 as of January 1, 2002) were significant to net income or earnings per share amounts.

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board (the "FASB") which are adopted by the Company as of the specified effective date. Unless otherwise discussed, management believes the impact of recently issued standards, which are not yet effective, will not have a material impact on the Company's consolidated financial statements upon adoption.

ITEM 3. QUALITATIVE AND QUANTITATIVE MARKET RISK DISCLOSURES

The Company is exposed to certain market risks arising from transactions that are entered into in the normal course of business which are primarily related to interest rate changes and fluctuations in foreign exchange rates. During the reporting period, no events or transactions have occurred which would materially change the information disclosed in the Company's Annual Report on Form 10-K.

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures and internal controls designed to ensure that information required to be disclosed in our filings under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time frame specified in the Commission's rules and regulations. Our principal executive and financial officers have evaluated our disclosure controls and procedures within 90 days prior to the filing of the Quarterly Report on Form 10-Q and have determined that such disclosure controls and procedures are effective.

There were no significant changes in the Company's internal controls or in other factors that could significantly affect those controls subsequent to the evaluation date.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 2. CHANGES IN SECURITIES

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

99.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

99.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

(b) Reports on Form 8-K

The Registrant filed reports on Form 8-K during the quarterly period ended March 31, 2003. All filings were reported under "Item 5. Other Events" and disclosed the following:

1. Form 8-K dated January 29, 2003 relating to a press release announcing the acquisition of the oilfield chemical operations of Dynea International.

2. Form 8-K dated January 30, 2003 relating to a press release announcing the Company's results for the quarter and year ended December 31, 2002.

SIGNATURES

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

SMITH INTERNATIONAL, INC.
Registrant

Date: May 15, 2003

By: /s/ DOUG ROCK

Doug Rock
Chairman of the Board, Chief Executive Officer, President and Chief Operating Officer

Date: May 15, 2003

By: /s/ MARGARET K. DORMAN

Margaret K. Dorman

Senior Vice President,
Chief Financial Officer and
Treasurer
(Principal Accounting Officer)

CERTIFICATION PURSUANT TO RULE 13a-14 OR 15d-14 OF THE SECURITIES EXCHANGE ACT OF 1934, AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Doug Rock, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Smith International, Inc;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 15, 2003	/s/ DOUG ROCK
	Doug Rock Chairman of the Board, Chief Executive Officer, President and Chief Operating Officer

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CERTIFICATION PURSUANT TO RULE 13a-14 OR 15d-14 OF THE SECURITIES EXCHANGE ACT OF 1934, AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Margaret K. Dorman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Smith International, Inc;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

   b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 15, 2003

/s/ MARGARET K. DORMAN

Margaret K. Dorman
Senior Vice President,
Chief Financial Officer and Treasurer

INDEX TO EXHIBITS

EXHIBIT NUMBER	DESCRIPTION
99.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.
99.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

" align="left"> Surplus	**3,064**	3,046
Retained earnings	**36,864**	36,336
Accumulated other comprehensive loss	**(562)**	(395)
Treasury stock at cost 208,777 and 207,377 shares at March 31, 2007 and December 31, 2006, respectively	**(4,497)**	(4,430)
Total stockholders' equity	**41,552**	41,240
Total liabilities and stockholders' equity	**$ 405,591**	$ 416,268

See Notes to Consolidated Financial Statements

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PEOPLES FINANCIAL SERVICES CORP.
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

(In thousands, except per share data)	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
INTEREST INCOME:		
Loans receivable, including fees	**$ 4,677**	$ 4,270
Securities:		
Taxable	**955**	675
Tax exempt	**335**	380
Other	**39**	9
Total interest income	**6,006**	5,334
INTEREST EXPENSE:		
Deposits	**2,352**	1,883
Short-term borrowings	**175**	138
Long-term borrowings	**330**	362
Total interest expense	**2,857**	2,383
Net interest income	**3,149**	2,951
PROVISION FOR LOAN LOSSES	**120**	60
Net interest income after provision for loan losses	**3,029**	2,891
OTHER INCOME:		
Customer service fees	**448**	463
Investment division commission income	**79**	49
Earnings on investment in life insurance	**75**	65
Other income	**170**	102
Net realized gains (losses) on sales of securities available for sale	**29**	(17)
Total other income	**801**	662
OTHER EXPENSES:		
Salaries and employee benefits	**1,181**	1,143
Occupancy	**198**	186
Equipment	**129**	105
FDIC insurance and assessments	**37**	33
Professional fees and outside services	**96**	83
Computer services and supplies	**204**	223
Taxes, other than payroll and income	**93**	82
Other	**502**	425
Total other expenses	**2,440**	2,280
Income before income taxes	**1,390**	1,273
INCOME TAXES	**267**	228
Net income	**$ 1,123**	$ 1,045
Net income per share, basic	**$ 0.36**	$ 0.33
Net income per share, diluted	**$ 0.36**	$ 0.33

See Notes to Consolidated Financial Statements

PEOPLES FINANCIAL SERVICES CORP.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(UNAUDITED)

(In thousands, except share data)	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance, December 31, 2006	**$ 6,683**	**$ 3,046**	**$ 36,336**	**$ (395)**	**$ (4,430)**	**$ 41,240**
Comprehensive income						
Net income	**0**	**0**	**1,123**	**0**	**0**	**1,123**
Net change in unrealized losses on securities available for sale, net of reclassification adjustment and taxes	**0**	**0**	**0**	**(167)**	**0**	**(167)**
Total comprehensive income						**956**
Stock option expense	**0**	**1**	**0**	**0**	**0**	**1**
Cash dividends, ($0.19 per share)	**0**	**0**	**(595)**	**0**	**0**	**(595)**
Treasury stock purchase (3,500 shares)	**0**	**0**	**0**	**0**	**(94)**	**(94)**
Treasury stock issued for stock option plan (2,100 shares)	**0**	**17**	**0**	**0**	**27**	**44**
Balance, March 31, 2007	**$ 6,683**	**$ 3,064**	**$ 36,864**	**$ (562)**	**$ (4,497)**	**$ 41,552**
Balance, December 31, 2005	$ 6,683	$ 2,995	$ 34,599	$ (961)	$ (3,700)	$ 39,616
Comprehensive income						
Net income	0	0	1,045	0	0	1,045
Net change in unrealized losses on securities available for sale, net of reclassification adjustment and taxes	0	0	0	(22)	0	(22)
Total comprehensive income						1,023
Cash dividends, ($0.19 per share)	0	0	(600)	0	0	(600)
Treasury stock purchase (7,300 shares)	0	0	0	0	(230)	(230)
Treasury stock issued for stock option plan (3,725 shares)	0	21	0	0	41	62
Balance, March 31, 2006	$ 6,683	$ 3,016	$ 35,044	$ (983)	$ (3,889)	$ 39,871

See Notes to Consolidated Financial Statements

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PEOPLES FINANCIAL SERVICES CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(In thousands)	Three Months Ended	
	March 31, 2007	March 31, 2006
Cash flows from operating activities		
Net Income	**$ 1,123**	$ 1,045
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**221**	201
Provision for loan losses	**120**	60
(Gain) loss on sale of foreclosed real estate	**4**	(29)
Amortization of securities' premiums and accretion of discounts	**71**	118
Amortization of deferred loan costs	**48**	50
Losses (gains) on sales of securities available for sale, net	**(29)**	17
Stock option expense	**1**	0
Proceeds from the sale of mortgage loans	**1,039**	426
Net gain on sale of loans	**(3)**	(7)
Loans originated for sale	**(1,306)**	(419)
Net earnings on investment in life insurance	**(75)**	(65)
(Increase) decrease in accrued interest receivable	**81**	(80)
(Increase) decrease in other assets	**299**	(17)
Decrease in accrued interest payable	**(94)**	(53)
Decrease in other liabilities	**(478)**	(83)
Net cash provided by operating activities	**1,022**	1,164
Cash flows from investing activities		
Proceeds from sale of available for sale securities	**25,640**	12,328
Proceeds from maturities and principal payments on available for sale securities	**8,679**	1,351
Purchase of available for sale securities	**(23,919)**	(5,718)
Net increase in loans	**(655)**	(7,809)
Purchase of premises and equipment	**(119)**	(297)
Proceeds from sale of other real estate	**15**	54
Net cash provided by (used in) investing activities	**9,641**	(91)
Cash flows from financing activities		
Cash dividends paid	**(595)**	(600)
Increase (decrease) in deposits	**(3,154)**	7,877
Proceeds from long-term borrowings	**3,275**	2,200
Repayment of long-term borrowings	**(7,904)**	(300)
Decrease in short-term borrowings	**(2,634)**	(8,119)
Purchase of treasury stock	**(94)**	(230)
Proceeds from sale of treasury stock	**44**	62
Net cash provided by (used in) financing activities	**(11,062)**	890
Net increase (decrease) in cash and cash equivalents	**(399)**	1,963
Cash and cash equivalents, beginning of period	**12,380**	6,696
Cash and cash equivalents, end of period	**$ 11,981**	$ 8,659
Supplemental disclosures of cash paid		
Interest paid	**$ 2,951**	$ 2,436
Income taxes paid	**$ 0**	$ 0

Non-cash investing and financing activities				
Transfers from loans to real estate through foreclosure	**$**	**36**	$	6

See Notes to Consolidated Financial Statements

NOTE 1. BASIS OF PRESENTATION

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

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information, as well as with instructions for Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal, recurring nature. Operating results for the three-month period ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year-ended December 31, 2007. For further information, refer to the consolidated financial statements and footnotes included in the Company's Annual Report on Form 10-K for the year-ended December 31, 2006.

NOTE 2. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended			
	March 31, 2007		March 31, 2006	
Net income applicable to common stock	$	1,123,000	$	1,045,000
Weighted average common shares outstanding		3,133,304		3,153,948
Effect of dilutive securities, stock options		10,563		14,107
Weighted average common shares outstanding used to calculate diluted earnings per share		3,143,867		3,168,055
Basic earnings per share	$	0.36	$	0.33
Diluted earnings per share	$	0.36	$	0.33

NOTE 3. OTHER COMPREHENSIVE INCOME

The components of other comprehensive income and related tax effects for the three months ended March 31, 2007 and 2006 are as follows:

(In thousands)	Three Months Ended			
	March 31, 2007		March 31, 2006	
Unrealized holding losses on available for sale securities	$	(224)	$	(51)
Less: Reclassification adjustment for gains (losses) realized in net income		29		(17)
Net unrealized losses		(253)		(34)
Tax effect		86		12
Other comprehensive loss	$	(167)	$	(22)

NOTE 4. STOCK BASED COMPENSATION

Prior to January 1, 2006, the Company's stock option plan was accounted for under the recognition and measurement provisions of APB Opinion No. 25 (Opinion 25), *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by FASB Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock Based Compensation* (as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*) (collectively SFAS 123). No stock-based employee compensation cost was recognized in the Company's consolidated statements of income through December 31, 2005, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), Share-Based Payment, using the modified-prospective transition method. Under that transition method, compensation cost recognized in 2006 and thereafter includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006 based on the grant date fair value calculated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005, based on a grant-date fair value estimated in accordance with the provisions of SFAS 123(R). As of December 31, 2006, only 4,100 stock options were not fully vested and no stock options were granted during the three months ended March 31, 2007.

As a result of adopting SFAS 123(R) on January 1, 2006, the Company's earnings before income taxes for the three months ended March 31, 2007, are not materially different than if it had continued to be accounted for as share-based compensation under Opinion 25. As of March 31, 2007, the Company had 4,100 stock options not fully vested and there was $3,500 of total unrecognized compensation cost related to these nonvested options. The cost is expected to be recognized monthly on a straight-line basis through December 31, 2008.

NOTE 5. GUARANTEES

The Company does not issue any guarantees that would require liability recognition or disclosure, other than standby letters of credit. Outstanding letters of credit written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments. The Company had $3,136,000 of standby letters of credit as of March 31, 2007. The Company uses the same credit policies in making conditional obligations as it does for on-balance sheet instruments.

The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Company requires collateral supporting these letters of credit as deemed necessary. The maximum undiscounted exposure related to these commitments at March 31, 2007 was $3,136,000, and the approximate value of underlying collateral upon liquidation that would be expected to cover this maximum potential exposure was $1,794,000. The current amount of the liability as of March 31, 2007 for guarantees under standby letters of credit is not material.

NOTE 6. NEW ACCOUNTING STANDARDS

EITF 06-11

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 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 Company does not expect EITF 06-11 will have a material impact on its financial position, results of operations or cash flows.

EITF 06-10

In March 2007, the FASB ratified Emerging Issues Task Force Issue No. 06-10 "Accounting for Collateral Assignment Split-Dollar Life Insurance Agreements" (EITF 06-10). EITF 06-10 provides guidance for determining a liability for the postretirement benefit obligation as well as recognition and measurement of the associated asset on the basis of the terms of the collateral assignment agreement. EITF 06-10 is effective for fiscal years beginning after December 15, 2007. The Company is currently assessing the impact of EITF 06-10 on its consolidated financial position and results of operations.

EITF 06-5

On September 7, 2006, the EITF reached a conclusion on 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 Company's consolidated financial statements.

SFAS No. 159

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 company 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 Company is in the process of evaluating the impact, if any, that the adoption of SFAS No. 159 will have on the Company's consolidated financial statements.

NOTE 7. SUBSEQUENT EVENT

On April 2, 2007, the Bank formed Peoples Financial Leasing, LLC, a member-managed limited liability company under the laws of the Commonwealth of Pennsylvania, to be a wholly owned subsidiary of the Bank, for the purpose of providing professional and technical services in employee leasing for the Bank.

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

The following discussion and analysis of the consolidated financial statements of the Corporation is presented to provide insight into management's assessment of financial results. The Corporation's two subsidiaries, Peoples National Bank and Peoples Advisors, LLC, provide financial services to individuals and businesses within the Bank's primary market area made up of Susquehanna, Wyoming and Northern Lackawanna Counties in Pennsylvania, and Broome County in New York. The Bank is a member of the Federal Reserve System and subject to regulation, supervision, and examination by the Office of the Comptroller of the Currency. Advisors is a member of the National Association of Securities Dealers (NASD), which also acts as the primary regulator for Advisors.

CAUTIONARY STATEMENT CONCERNING FORWARD LOOKING INFORMATION

Except for historical information, this Report may be deemed to contain "forward looking" information. Examples of forward looking information may include, but are not limited to, (a) projections of or statements regarding future earnings, interest income, other income, earnings or loss per share, asset mix and quality, growth prospects, capital structure and other financial terms, (b) statements of plans and objectives of management or the Board of Directors, (c) statements of future economic performance, and (d) statements of assumptions, such as economic conditions in the market areas served by the Corporation and the Bank, underlying other statements and statements about the Corporation and the Bank or their respective businesses. Such forward looking information can be identified by the use of forward looking terminology such as "believes," "expects," "may," "intends," "will," "should," "anticipates," or the n 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 the forward looking information will be achieved. Such statements are subject to risks, uncertainties, and other factors which could cause actual results to differ materially from future results expressed or implied by such forward looking information. Important factors that could impact operating results include, but are not limited to, (i) the effects of changing economic conditions in both the market areas served by the Corporation and the Bank 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 affect operations, (v) funding costs, and (vi) other external developments which could materially affect business and operations.

CRITICAL ACCOUNTING POLICIES

Disclosure of the Company's significant accounting policies is included in Note 1 to the consolidated financial statements of the Company's Annual Report on Form 10K for the year-ended December 31, 2006. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by Management. Additional information is contained on page 17 of this report for the provision and allowance for loan losses.

OVERVIEW

Net income for the quarter increased 7.46% to $1.123 million as compared to $1.045 million for the first quarter of 2006. Diluted earnings per share increased 9.09% to $.36 per share for the first quarter of 2007 from $.33 per share in the first quarter of 2006. At March 31, 2007, the Company had total assets of $405.591 million, net loans of $270.104 million, and total deposits of $320.459 million.

FINANCIAL CONDITION

***Cash and Cash Equivalents*:**

At March 31, 2007, cash, federal funds sold, and deposits with other banks totaled $11.981 million as compared to $12.380 million on December 31, 2006. The decrease over the first three months of 2007 has been minimal as the decrease in deposits with other banks has been offset by the increase in federal funds as of March 31, 2007.

Management believes the liquidity needs of the Corporation are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources, and the portion of the securities and loan portfolios that mature within one year. The current sources of funds will enable the Corporation to meet all its cash obligations as they come due.

***Securities*:**

Securities totaled $99.607 million on March 31, 2007, decreasing by $10.695 million from the December 31, 2006 total of $110.302 million.

The total securities portfolio is held as available for sale. This strategy was implemented in 1995 to provide more flexibility in using the investment portfolio for liquidity purposes as well as providing more flexibility in selling when market opportunities occur.

Securities available for sale are accounted for at fair value with unrealized gains or losses net of deferred income taxes, reported as a separate component of stockholders' equity. The carrying value of securities as of March 31, 2007 included an unrealized loss of $852 thousand reflected as accumulated other comprehensive loss of $562 thousand in stockholders' equity, net of deferred income taxes of $290 thousand. This compares to an unrealized loss of $598 thousand at December 31, 2006 reflected as accumulated other comprehensive loss of $395 thousand, net of deferred income taxes of $203 thousand.

Management monitors the earnings performance and effectiveness of liquidity of the securities portfolio on a monthly basis through the Asset/Liability Committee ("ALCO"). The ALCO also reviews and manages interest rate risk for the Corporation. Through active balance sheet management and analysis of the securities portfolio, the Corporation maintains sufficient liquidity to satisfy depositor requirements and various credit needs of its customers.

Loans:

Net loans increased $721 thousand, or .27%, to $270.104 million as of March 31, 2007 from $269.383 million as of December 31, 2006. Of the loan growth experienced in the first quarter of 2007, the largest was in residential real estate mortgages which increased $941 thousand, or .83%, to $113.824 million as of March 31, 2007 compared to $112.883 million as of December 31, 2006. Commercial loans, including traditional commercial loans and commercial real estate mortgages, decreased $229 thousand, or .16%, to $140.702 million as of March 31, 2007 compared to $140.931 million at year-end December 31, 2006.

Increasing the loan to deposit ratio is a goal of the Bank, but loan quality is always considered in this effort. Management has continued its efforts to create good underwriting standards for both commercial and consumer credit. Most commercial lending is done primarily with locally owned small businesses.

Deposits:

Deposits are attracted from within the Bank's primary market area through the offering of various deposit instruments including NOW accounts, money market accounts, savings accounts, certificates of deposit, and IRA's. During the three-month period ended March 31, 2007, total deposits decreased $3.154 million, or .97%, to $320.459 million compared to $323.613 million as of December 31, 2006. The decrease was concentrated within NOW accounts and money market deposit accounts.

The trend in the first quarter of 2007 is expected due to the nature of those deposits affected. Early in the calendar year tends to be the period where the Bank experiences an outflow of funds due to various reasons, among them are property tax payments and holiday bills which come due after January 1. The outflow of funds was less evident in the latter half of the first quarter.

Borrowings:

The Bank utilizes borrowings as a source of funds for its asset/liability management. Advances are available from the Federal Home Loan Bank (FHLB) provided certain standards related to credit worthiness have been met. Repurchase and term agreements are also available from the FHLB.

Total short-term borrowings at March 31, 2007 were $9.940 million as compared to $12.574 million as of December 31, 2006, a decrease of $2.634 million, or 20.95%. Long-term borrowings were $31.896 million as of March 31, 2007 compared to $36.525 million as of December 31, 2006, a decrease of $4.629 million, or 12.67%. The decrease in long-term borrowings included the maturity of $7.500 million in term borrowings which was offset by proceeds of new term borrowings in the amount of $3.275 million at the FHLB.

With the increase to the short end of the yield curve, the certificate savings rate offered by the Bank has attracted a large sum of deposits which have lessened the Bank's reliance on overnight, short-term borrowings.

Capital:

The adequacy of the Corporation's capital is reviewed on an ongoing basis with reference to the size, composition and quality of the Corporation's resources and regulatory guidelines. Management seeks to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings. As of March 31, 2007, regulatory capital to total average assets was 9.14% as compared to 8.92% on December 31, 2006. The Company repurchases its stock in the open market or from individuals as warranted to leverage the capital account and to provide stock for its stock option and dividend reinvestment plans. In the three months ended March 31, 2007, the Company purchased 3,500 shares for the treasury at a total cost of $94,500.

The Corporation has complied with the standards of capital adequacy mandated by the banking regulators. The bank regulators have established “risk-based” capital requirements designed to measure capital adequacy. Risk-based capital ratios reflect the relative risks of various assets the banks hold in their portfolios. A weight category of either 0% (lowest risk asset), 20%, 50%, or 100% (highest risk assets) is assigned to each asset on the balance sheet. Capital is being maintained in compliance with risk-based capital guidelines. The Company’s Tier 1 capital to risk weighted asset ratio was 13.13% and the total capital ratio to risk weighted assets ratio was 13.82% at March 31, 2007. The Corporation is deemed to be well-capitalized under regulatory standards.

Liquidity:

Liquidity measures an organization’s ability to meet cash obligations as they come due. The consolidated statements of cash flows presented in the accompanying financial statements included in Part I of this Form 10-Q provide analysis of the Corporation’s cash and cash equivalents. Additionally, management considers that portion of the loan and investment portfolio that matures within one year as part of the Corporation’s liquid assets.

The ALCO addresses the liquidity needs of the Bank to see that sufficient funds are available to meet credit demands and deposit withdrawals, as well as to the placement of available funds in the investment portfolio. In assessing liquidity requirements, equal consideration is given to the current position as well as the future outlook.

Off Balance Sheet Arrangements:

The Company’s consolidated financial statements do not reflect various commitments that are made in the normal course of business, which may involve some liquidity risk. These commitments consist primarily of commitments to grant new loans, unfunded commitments of existing loans and letters of credit made under the same standards as on-balance sheet instruments. Unused commitments on March 31, 2007 totaled $38.657 million, which consisted of $26.829 million in unfunded commitments of existing loans, $8.692 million to grant new loans and $3.136 million in letters of credit. Due to fixed maturity dates and specified conditions within these instruments, many will expire without being drawn upon. Management believes that amounts actually drawn upon can be funded in the normal course of operations and therefore, do not represent a significant liquidity risk to the Company.

Interest Rate Sensitivity:

The management of interest rate sensitivity seeks to avoid fluctuating net interest margins and to provide consistent net interest income through periods of changing interest rates.

The Company’s risk of loss arising from adverse changes in the fair value of financial instruments, or market risk, is composed primarily of interest rate risk. The primary objective of the Company’s asset/liability management activities is to maximize net interest income while maintaining acceptable levels of interest rate risk. The Company’s ALCO is responsible for establishing policies to limit exposure to interest rate risk, and to ensure procedures are established to monitor compliance with those policies. The guidelines established by ALCO are reviewed by the Company’s Board of Directors.

The tools used to monitor sensitivity are the Statement of Interest Sensitivity Gap and the interest rate shock analysis. The Bank uses a software model to measure and to keep track. In addition, an outside source does a quarterly analysis to make sure our internal analysis is current and correct. The Statement of Interest Sensitivity Gap is a good assessment of current position and is a very useful tool for the ALCO in performing its job. This report is monitored in an effort to “match” maturities or repricing opportunities of assets and liabilities, in order to attain the maximum interest within risk tolerance policy guidelines. The statement does, although, have inherent limitations in that certain assets and liabilities may react to changes in interest rates in different ways, with some categories reacting in advance of changes and some lagging behind the changes. In addition, there are estimates used in determining the actual propensity to change of certain items such as deposits without maturities.

The following table sets forth the Company’s interest sensitivity analysis as of March 31, 2007:

INTEREST RATE SENSITIVITY ANALYSIS

(Dollars in thousands)	Maturity or Repricing In:				
	3 Months	**3-6 Months**	**6-12 Months**	**1-5 Years**	**Over 5 Years**
RATE SENSITIVE ASSETS					
Loans	$ 66,497	$ 7,961	$ 16,612	$ 106,068	$ 74,870
Securities	3,805	1,684	3,078	37,810	53,230
Interest bearing deposits in other banks	104	0	0	0	0
Federal funds sold	6,240	0	0	0	0
Total rate sensitive assets	76,646	9,645	19,690	143,878	128,100
Cumulative rate sensitive assets	$ 76,646	$ 86,187	$ 105,877	$ 249,755	$ 377,855
RATE SENSITIVE LIABILITIES					
Interest bearing checking	$ 207	$ 207	$ 415	$ 3,316	$ 18,167
Money market deposits	315	315	630	5,041	27,619
Regular savings	1,526	1,021	2,042	16,338	89,517
CDs and IRAs	27,944	29,661	14,062	26,436	3,905
Short-term borrowings	9,940	0	0	0	0
Long-term borrowings	0	0	580	4,090	27,226
Total rate sensitive liabilities	39,932	31,204	17,729	55,221	166,434
Cumulative rate sensitive liabilities	$ 39,932	$ 71,136	$ 88,865	$ 144,086	$ 310,520
Period gap	$ 36,714	$ (21,559)	$ 1,961	$ 88,657	$ (38,334)
Cumulative gap	$ 36,714	$ 15,155	$ 17,116	$ 105,773	$ 67,439
Cumulative RSA to RSL	191.94%	121.30%	119.26%	173.41%	121.72%
Cumulative gap to total assets	9.05%	3.74%	4.22%	26.08%	16.63%

RESULTS OF OPERATIONS

Net Interest Income:

For the three months ended March 31, 2007, total interest income increased by $672 thousand, or 12.60%, to $6.006 million as compared to $5.334 million for the three months ended March 31, 2006. This increase is attributable to the increase in average loans and average securities to $270.803 million and $108.285 million respectively as of March 31, 2007 as compared to $262.507 million and $102.324 million, respectively, for the same three-month period in 2006. This is an increase of $8.296 million, or 3.16%, in loans and $5.961 million, or 5.83%, in securities when comparing the first quarter of 2007 to the same three-month period in 2006. The yield on loans, on a fully tax equivalent basis, for the first quarter of 2007 was higher at 7.17% compared to 6.77% for the first quarter of 2006. Security yields, on a fully tax equivalent basis, were also up in the first quarter of 2007 at 5.48% compared to 4.96% in the first quarter of 2006. The resulting interest earned on loans was $4.677 million for the three-month period ended March 31, 2007 compared to $4.270 million for the three months ended March 31, 2006, an increase of $407 thousand, or 9.53%. The resulting interest earned on securities was $1.290 million for the three-month period ended March 31, 2007 compared to $1.055 million for the three months ended March 31, 2006, an increase of $235 thousand, or 22.27%. The overall yield on earning assets increased for the three months ended March 31, 2007 to 6.68% as compared to 6.26%, on a fully tax equivalent basis, for the three months ended March 31, 2006.

Total interest expense increased by $474 thousand, or 19.89%, to $2.857 million for the three months ended March 31, 2007 from $2.383 million for the three months ended March 31, 2006. This increase was primarily attributable to the increase in the cost of funds which increased to 3.66% for the three months ended March 31, 2007 as compared to 3.21% for the first quarter of 2006. Average interest bearing liabilities also increased to $316.883 million for the three months ended March 31, 2007 as compared to $300.764 million for the three months ended March 31, 2006. This increase was due to the increase in average savings. Average savings increased to $108.527 million for the three-month period ended March 31, 2007 as compared to $82.692 million for the same period in 2006. The largest contributor to the increase in average savings is the certificate savings product. The rate paid on certificate savings increased for the three months ended March 31, 2007 to 4.68% as compared to 4.55% for the three months ended March 31, 2006 as the average balance for that product was $78.824 million and $47.465 million, respectively.

Net interest income increased by $198 thousand, or 6.71%, to $3.149 million for the three months ended March 31, 2007 from $2.951 million for the three months ended March 31, 2006. The Bank's net interest spread decreased to 3.02% for the three months ended March 31, 2007 from 3.04% for the three months ended March 31, 2006 on a fully tax equivalent basis. The net interest margin increased to 3.65% for the three-month period ended March 31, 2007 from 3.61% for the three-month period ended March 31, 2006 on a fully tax equivalent basis. The yield curve has remained somewhat static since the last increase in overnight rates which was implemented by the Federal Reserve in June of 2006. As such, the Bank has been operating within the resulting flat yield curve and cannot generate traditionally acceptable levels of spread between interest bearing assets and liabilities. The result of which has been a static net interest margin as detailed previously.

Below is the table which sets forth average balances and corresponding yields for the three-month periods ended March 31, 2007 and March 31, 2006:

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

	March 2007			March 2006		
(Dollars in thousands)	Average	Interest	(2)	Average	Interest	(2)
ASSETS	Balance		Yield/Rate	Balance		Yield/Rate
Loans						
Real estate	$ 113,988	$ 1,873	6.66%	$ 109,602	$ 1,737	6.43%
Installment	16,689	347	8.43%	17,376	336	7.84%
Commercial	119,408	2,223	7.55%	114,554	1,972	6.98%
Tax exempt (1)	20,260	333	6.67%	20,498	321	6.36%
Other loans	458	14	12.40%	477	13	11.05%
Total loans	270,803	4,790	7.17%	262,507	4,379	6.77%
Investment securities (AFS)						
Taxable	73,235	955	5.29%	62,664	675	4.37%
Non-taxable (1)	35,050	508	5.87%	39,660	576	5.89%
Total securities	108,285	1,463	5.48%	102,324	1,251	4.96%
Time deposits with other banks	1,278	18	5.71%	0	0	0
Fed funds sold	1,551	21	5.49%	685	9	5.33%
Total earning assets	381,917	$ 6,292	6.68%	365,516	$ 5,639	6.26%
Less: allowance for loan losses	(1,824)			(2,387)		
Cash and due from banks	6,359			6,328		
Premises and equipment, net	5,783			5,666		
Other assets	17,553			12,828		
Total assets	$ 409,788			$ 387,951		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Deposits						
Interest bearing demand	$ 24,852	$ 68	1.11%	$ 24,246	$ 50	0.84%
Regular savings	108,527	960	3.59%	82,692	558	2.74%
Money market savings	35,582	291	3.32%	37,363	324	3.52%
Time	99,809	1,033	4.20%	106,969	951	3.61%
Total interest bearing deposits	268,770	2,352	3.55%	251,270	1,883	3.04%
Other borrowings	48,113	505	4.26%	49,494	500	4.10%
Total interest bearing liabilities	316,883	2,857	3.66%	300,764	2,383	3.21%
Net interest income		$ 3,435	3.02%		$ 3,256	3.04%
Non-interest bearing demand deposits	49,552			46,234		
Accrued expenses and other liabilities	2,414			1,806		

Stockholders' equity		40,939			39,147	
Total liabilities and stockholders' equity	$	409,788		$	387,951	
Interest income/earning assets			6.68%			6.26%
Interest expense/earning assets			3.03%			2.64%
Net interest margin			3.65%			3.61%

(1) Yields on tax-exempt assets have been calculated on a fully tax equivalent basis assuming a tax rate of 34%.
(2) Yields and costs are based on a 365/90 annualization method.

Provision for Loan Losses:

The provision for loan losses for the three months ended March 31, 2007 was $120 thousand, an increase of $60 thousand, or 100.00% as compared to $60 thousand for the three month-period ended March 31, 2006. Changing economic conditions, as well as internal analysis performed on the loan portfolio, have made necessary the increases in the loan loss provision for the quarter ended March 31, 2007. One of the Bank's main goals is to increase the loan to deposit ratio without jeopardizing loan quality. To reach its goal, management has continued its efforts to create strong underwriting standards for both commercial and consumer credit. The Bank's lending consists primarily of retail lending which includes single family residential mortgages and other consumer lending and commercial lending primarily to locally owned small businesses.

In the three-month period ended March 31, 2007, charge-offs totaled $19 thousand while net charge-offs totaled $8 thousand as compared to $21 thousand and $12 thousand, respectively, for the same three-month period in 2006.

Monthly, senior management uses a detailed analysis of the loan portfolio to determine loan loss reserve adequacy. The process considers all "problem loans" including classified, criticized, and monitored loans. Prior loan loss history and current market trends, both nationally and locally, are taken into consideration. A watch list of potential problem loans is maintained and monitored on a monthly basis by the Board of Directors. The Bank has not had, nor presently has, any foreign loans. Based upon this analysis, senior management has concluded that the allowance for loan losses is adequate.

Other Income:

Service charges and fees decreased 3.24%, or $15 thousand, to $448 thousand in the three months ended March 31, 2007, from $463 thousand in the three months ended March 31, 2006. The decrease in service charges and fees is due in part to net overdraft fees which were $300 thousand for the three-month period ended March 31, 2007 compared to $311 thousand for the comparable period in 2006, a decrease of $11 thousand, or 3.54%.

Investment division income was $79 thousand for the three-month period ended March 31, 2007, an increase of $30 thousand, or 61.22%, from the same period in 2006. The increase is due to the change in fee structure for the investment division, which was first discussed in March of 2006. The recognition of commissions on a recurring basis, rather than at account opening only, has contributed to this increase.

Earnings on investment in life insurance (BOLI) has increased to $75 thousand for the three-month period ended March 31, 2007, compared to $65 thousand for the three month-period ended March 31, 2006, an increase of $10 thousand, or 15.38%. The income earned from BOLI has kept pace with the short end of the yield curve and continued to pay a competitive market yield.

Other income was $170 thousand for the three months ended March 31, 2007, an increase of $68 thousand, or 66.67%, from $102 thousand for the comparable period in 2006. Among those items is net-commission income realized from Community Bankers Insurance Agency (CBIA). This item accounted for $65 thousand for the three-month period ended March 31, 2007 as compared to $13 thousand for the same period in 2006, an increase of $52 thousand, or 400.00%.

Gains on security sales were $29 thousand for the three months ended March 31, 2007 compared to losses of $17 thousand for the comparable period in 2006, an increase of $46 thousand. The increase is due to the sale of equity securities through the holding company at a gain. These sales are part of a five year tax strategy to offset capital losses incurred in 2005.

Other Operating Expenses:

Total other expenses increased 7.35%, or $167 thousand, to $2.440 million during the three months ended March 31, 2007 compared to $2.273 million for the comparable period in 2006.

Salaries and benefits increased $38 thousand, or 3.32%, to $1.181 million for the three months ended March 31, 2007 compared to $1.143 million for the same period in 2006 due to normal pay increases. The increase was also partially due to a one time vacation payment to a retiring executive in the amount of $28,000. The full-time equivalent number of employees was 109 as of March 31, 2007 compared to 112 as of March 31, 2006.

Occupancy expense increased $12 thousand, or 6.45%, to $198 thousand for the three months ended March 31, 2007 compared to $186 thousand for the same period in 2006. Costs associated with the maintenance and upkeep of Company offices in the amount of $60 thousand for the first quarter of 2007 when compared to $51 thousand for the same period in 2006 accounted for this difference.

Professional fees and outside services increased $13 thousand, or 15.66%, in the three months ended March 31, 2007 to $96 thousand, compared to $83 thousand for the same three-month period ended March 31, 2006. Increases for the three-month period ended March 31, 2007 were due to costs associated with a professional loan review service incurred in the first quarter of 2007 in the amount of $13 thousand. This service was not incurred in the first quarter of 2006.

Computer services and supplies decreased $19 thousand, or 8.52% for the three months ended March 31, 2007 to $204 thousand compared to $223 thousand for the comparable period in 2006. This decrease was due to costs associated with the Bank's ATM network. As previously discussed in the analysis of customer service fee income, as of February of 2006, the Bank no longer utilizes the services of Midwest Payment Systems in the processing of ATM and debit card transactions. The Company now internally processes those transactions at a reduced cost. Costs associated with ATM and debit card operations were $51 thousand for the three-month period ended March 31, 2007 as compared to $79 thousand for the same three-month period in 2006.

All other operating expenses increased $123 thousand, or 19.28%, to $761 thousand in the first quarter of 2007 compared to $638 thousand for the same period in 2006. The increase in all other operating expense categories, which include equipment, non-income/non-payroll associated taxes, other real estate owned and other standard operating expenses, increased due to various reasons. Advertising costs associated with a one time billboard campaign for $10 thousand, $63 thousand of additional costs associated with foreclosed commercial real estate, $14 thousand in brokerage fees related to the operation of the investment division which were netted from commissions in the prior period, $27 thousand in additional supply costs and $20 thousand in additional depreciation expenses as the result of larger than normal investments in fixed assets in the latter half of 2006 in relation to flood damages incurred by the Company, all contributed to the increase in the first quarter of 2007.

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Income Tax Provision:

The Corporation recorded an income tax provision of $267 thousand, or 19.21% of income before taxes, and $228 thousand, or 17.91% of income before taxes, for the quarters ended March 31, 2007 and 2006, respectively. The increase in the effective tax rate is due to the decrease in taxable security income earned in the first quarter of 2007 when compared to the same period in 2006.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Federal Reserve has now held at an overnight borrowing rate of 5.25% since the last increase in June of 2006. As such, the Company continues to operate with a compressed net interest margin. As of March 31, 2007, the Bank is currently showing slight sensitivity to an upward rate shift scenario. The results of the latest financial simulation follow. The simulation shows a possible decrease in net interest income of 2.70%, or $372 thousand, in a +200 basis point rate shock scenario over a one-year period. An increase of 1.03% or $142 thousand is shown in the model at a -200 basis point rate shock scenario. The net interest income risk position of the Bank remains within the guidelines established by the Bank's asset/liability policy. The Bank continuously monitors its rate sensitivity.

Equity value at risk is monitored regularly and is also within established policy limits. Please refer to the Annual Report on Form 10-K filed with the Securities and Exchange Commission for December 31, 2006, for further discussion of this matter.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

The Company's management, including the Company's Chief Executive Officer and Principal Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15(d)-15(e) under the Securities Exchange Act of 1934, as amended) as of March 31, 2007. Based upon that evaluation, the Chief Executive Officer and Principal Financial Officer concluded that, as of the Evaluation Date, the Company's disclosure controls and procedures were effective in timely alerting them to any material information relating to the Company and its subsidiaries required to be included in the Company's periodic SEC filings.

(b) Changes in internal controls.

There were no changes made in the Company's internal controls over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

Although as stated above, we have not made any significant changes in our internal controls over financial reporting in the most recent fiscal quarter, based on our documentation and testing to date, we have made improvements in the documentation, design and effectiveness of internal controls over financial reporting, including the purchase of internal control software that allows upper management to view reports and to understand the risks and controls within the entire organization or specific areas of the organization. These reports provide up to date information at all times.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

The nature of the Company's business generates a certain amount of litigation involving matters arising out of the ordinary course of business. In the opinion of management, there are no legal proceedings that might have a material effect on the consolidated results of operations, liquidity, or the financial position of the Company at this time.

Item 1A. Risk Factors

No changes from those previously disclosed.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

PEOPLES FINANCIAL SERVICES CORP.
ISSUER PURCHASES OF COMMON STOCK

MONTH	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number of shares that may yet be purchased under the plans or programs (1)
January 1, 2007 - January 31, 2007	0	$ 0	0	89,251
February 1, 2007 - February 28, 2007	3,500	$ 27.00	3,500	85,751
March 1, 2007 - March 31, 2007	0	$ 0	0	85,751
TOTAL	3,500	$ 27.00	3,500	

(1) On July 2, 2001, the Board of Directors authorized the repurchase of 5%, or 158,931 shares, of the Corporation's common stock outstanding. The repurchase program does not stipulate an expiration date.

Item 3. Defaults upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

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Item 6. Exhibits

(3.1) Articles of Incorporation of Peoples Financial Services Corp. *;
(3.2) Bylaws of Peoples Financial Services Corp. as amended **;
(10.1) Agreement dated January 14, 1997, between John W. Ord and Peoples Financial Services Corp.*;
(10.4) Termination Agreement dated January 1, 1997, between Debra E. Dissinger and Peoples Financial Services Corp.*;
(10.5) Supplemental Executive Retirement Plan Agreement, dated December 3, 2004, for John W. Ord***;
(10.6) Supplemental Executive Retirement Plan Agreement, dated December 3, 2004, for Debra E. Dissinger***;
(10.7) Supplemental Director Retirement Plan Agreement, dated December 3, 2004, for all Non-Employee Directors of the Company***;
(10.8) Amendment to Supplemental Executive Retirement Plan Agreement, dated December 30, 2005, for John W. Ord****;
(10.9) Amendment to Supplemental Executive Retirement Plan Agreement, dated December 30, 2005, for Debra E. Dissinger****;
(10.10) Amendment to Supplemental Director Retirement Plan Agreement, dated December 30, 2005, for all Non-Employee Directors of the Company****;
(10.11) Termination Agreement dated January 1, 2007, between Stephen N. Lawrenson and Peoples Financial Services Corp., filed herewith,
(10.12) Termination agreement dated January 1, 2007, between Joseph M. Ferretti and Peoples Financial Services Corp., filed herewith;
(11) The statement regarding computation of per-share earnings required by this exhibit is contained in Note 2 to the consolidated financial statements captioned “Earnings Per Share”;
(14) Code of Ethics*****;
(21) Subsidiaries of Peoples Financial Services Corp.******;
(31.1) Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), filed herewith;
(31.2) Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), filed herewith;
(32.1) Certification of Chief Executive Officer pursuant to Section 1350 of Sarbanes-Oxley Act of 2002, filed herewith; and
(32.2) Certification of Principal Financial Officer pursuant to Section 1350 of Sarbanes-Oxley Act of 2002, filed herewith.

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

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

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

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

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

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

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SIGNATURES

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

PEOPLES FINANCIAL SERVICES CORP.

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

By/s/Frederick J. Malloy
Frederick J. Malloy, AVP/Controller