

FRANKLIN FINANCIAL SERVICES CORP /PA/  
Form 10-Q  
August 09, 2011

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549  
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2011,

OR

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

For the transition period from ..... to .....

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION  
(Exact name of registrant as specified in its charter)

PENNSYLVANIA  
(State or other jurisdiction of  
incorporation or organization)

25-1440803  
(I.R.S. Employer  
Identification No.)

20 SOUTH MAIN STREET (P.O. BOX 6010), CHAMBERSBURG, PA 17201-0819  
(Address of principal executive offices)

717/264-6116  
(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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

There were 3,956,850 outstanding shares of the Registrant's common stock as of July 29, 2011.

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## Part I FINANCIAL INFORMATION

## Item 1 Financial Statements

Consolidated Balance Sheets  
(Dollars in thousands, except per share data)  
(unaudited)

	June 30 2011	December 31 2010
<b>Assets</b>		
Cash and due from banks	\$ 16,775	\$ 11,528
Interest-bearing deposits in other banks	23,844	10,578
Total cash and cash equivalents	40,619	22,106
Investment securities available for sale, at fair value	132,449	117,616
Restricted stock	5,561	6,159
Loans	771,997	748,642
Allowance for loan losses	(10,150 )	(8,801 )
Net Loans	761,847	739,841
Premises and equipment, net	16,343	16,592
Bank owned life insurance	19,931	19,591
Goodwill	9,016	9,016
Other intangible assets	1,782	2,004
Other assets	18,982	18,964
Total assets	\$ 1,006,530	\$ 951,889
<b>Liabilities</b>		
Deposits		
Demand (non-interest bearing)	\$ 105,808	\$ 90,317
Savings and interest checking	480,831	441,819
Time	208,261	202,195
Total Deposits	794,900	734,331
Securities sold under agreements to repurchase	65,261	51,164
Long-term debt	49,304	70,885
Other liabilities	10,870	12,870
Total liabilities	920,335	869,250
<b>Shareholders' equity</b>		
Common stock \$1 par value per share, 15,000,000 shares authorized with 4,351,896 shares issued and 3,955,557 shares outstanding at June 30, 2011 and 4,317,058 shares issued and 3,919,108 shares outstanding at December 31, 2010	4,352	4,317
Capital stock without par value, 5,000,000 shares authorized with no shares issued or outstanding	-	-
Additional paid-in capital	33,709	33,096
Retained earnings	59,470	57,984
Accumulated other comprehensive loss	(4,249 )	(5,642 )
Treasury stock, 396,339 shares and 397,950 shares at cost at June 30, 2011 and December 31, 2010, respectively	(7,087 )	(7,116 )

Total shareholders' equity	86,195	82,639
Total liabilities and shareholders' equity	\$1,006,530	\$ 951,889

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

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Consolidated Statements of Income  
(Dollars in thousands, except per share data)  
(unaudited)

	For the Three Months Ended		For the Six Months Ended	
	June 30		June 30	
	2011	2010	2011	2010
<b>Interest income</b>				
Loans, including fees	\$ 9,483	\$ 9,691	\$ 18,825	\$ 19,242
<b>Interest and dividends on investments:</b>				
Taxable interest	635	758	1,218	1,628
Tax exempt interest	330	397	674	869
Dividend income	26	10	51	27
Deposits and obligations of other banks	19	10	25	16
Total interest income	10,493	10,866	20,793	21,782
<b>Interest expense</b>				
Deposits	1,755	2,204	3,424	4,563
Securities sold under agreements to repurchase	39	40	73	77
Short-term borrowings	-	-	1	-
Long-term debt	614	977	1,315	1,951
Total interest expense	2,408	3,221	4,813	6,591
Net interest income	8,085	7,645	15,980	15,191
Provision for loan losses	1,767	625	2,667	1,250
Net interest income after provision for loan losses	6,318	7,020	13,313	13,941
<b>Noninterest income</b>				
Investment and trust services fees	1,058	1,007	1,990	2,024
Loan service charges	231	272	712	469
Mortgage banking activities	(45 )	11	(35 )	81
Deposit service charges and fees	597	593	1,134	1,171
Other service charges and fees	384	351	745	677
Increase in cash surrender value of life insurance	175	166	340	332
Other	81	22	106	70
OTTI losses on securities	(370 )	-	(370 )	(689 )
Loss recognized in other comprehensive income (before taxes)	(315 )	-	(315 )	(434 )
Net OTTI losses recognized in earnings	(55 )	-	(55 )	(255 )
Securities gains, net	-	20	11	268
Total noninterest income	2,426	2,442	4,948	4,837
<b>Noninterest Expense</b>				
Salaries and benefits	3,883	3,322	7,596	6,762
Net occupancy expense	496	496	1,028	1,019
Furniture and equipment expense	214	191	437	382

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Advertising	351	283	643	583
Legal and professional fees	244	350	515	745
Data processing	487	502	868	879
Pennsylvania bank shares tax	173	152	337	308
Intangible amortization	111	114	224	229
FDIC insurance	256	288	567	580
Other	1,218	827	2,239	1,699
Total noninterest expense	7,433	6,525	14,454	13,186
Income before federal income taxes	1,311	2,937	3,807	5,592
Federal income tax (benefit) expense	(447 )	778	199	1,459
Net income	\$ 1,758	\$ 2,159	\$3,608	\$4,133
Per share				
Basic earnings per share	\$ 0.45	\$ 0.56	\$0.92	\$1.07
Diluted earnings per share	\$ 0.45	\$ 0.56	\$0.92	\$1.07
Cash dividends declared per share	\$ 0.27	\$ 0.27	\$0.54	\$0.54

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

The components of comprehensive income and related tax effects are as follows:

(Dollars in thousands)	For the Three Months Ended		For the Six Months Ended	
	June 30		June 30	
	2011	2010	2011	2010
Net Income	\$ 1,758	\$ 2,159	\$3,608	\$4,133
<b>Securities:</b>				
Unrealized gains (losses) arising during the period	1,254	(690 )	1,992	744
Reclassification adjustment for losses (gains) included in net income	55	(20 )	44	(13 )
Net unrealized gains (losses)	1,309	(710 )	2,036	731
Tax effect	(445 )	241	(693 )	(249 )
Net of tax amount	864	(469 )	1,343	482
<b>Derivatives:</b>				
Unrealized (losses) gains arising during the period	(344 )	(677 )	(279 )	(1,015 )
Reclassification adjustment for losses included in net income	180	174	356	354
Net unrealized (losses) gains	(164 )	(503 )	77	(661 )
Tax effect	56	171	(27 )	226
Net of tax amount	(108 )	(332 )	50	(435 )
<b>Pension:</b>				
Change in plan assets and benefit obligations	-	-	-	(191 )
Reclassification adjustment for losses included in net income	-	-	-	-
Net unrealized losses	-	-	-	(191 )
Tax effect	-	-	-	65
Net of tax amount	-	-	-	(126 )
Total other comprehensive income (loss)	756	(801 )	1,393	(79 )
Total Comprehensive Income	\$ 2,514	\$ 1,358	\$5,001	\$4,054

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



Consolidated Statements of Changes in Shareholders' Equity  
For the Six Months Ended June 30, 2011 and 2010  
(unaudited)

(Dollars in thousands, except per share data)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance at December 31, 2009	\$ 4,299	\$ 32,832	\$ 54,566	\$ (5,138 )	\$ (7,793 )	\$ 78,766
<b>Comprehensive income:</b>						
Net income	-	-	4,133	-	-	4,133
Unrealized gain on securities, net of reclassification adjustments and taxes	-	-	-	482	-	482
Unrealized loss on hedging activities, net of reclassification adjustments and taxes	-	-	-	(435 )	-	(435 )
Pension adjustment, net of tax	-	-	-	(126 )	-	(126 )
Total Comprehensive income	-	-	-	-	-	4,054
Cash dividends declared, \$.54 per share	-	-	(2,089 )	-	-	(2,089 )
Treasury shares issued under stock option plans: 1,051 shares	-	(2 )	-	-	18	16
Treasury shares issued to dividend reinvestment plan: 24,251 shares	-	(24 )	-	-	434	410
Balance at June 30, 2010	\$ 4,299	\$ 32,806	\$ 56,610	\$ (5,217 )	\$ (7,341 )	\$ 81,157
Balance at December 31, 2010	\$ 4,317	\$ 33,096	\$ 57,984	\$ (5,642 )	\$ (7,116 )	\$ 82,639
<b>Comprehensive income:</b>						
Net income	-	-	3,608	-	-	3,608
Unrealized gain on securities, net of reclassification adjustments and taxes	-	-	-	1,343	-	1,343
Unrealized gain on hedging activities, net of reclassification adjustments and taxes	-	-	-	50	-	50
Total Comprehensive income	-	-	-	-	-	5,001
Cash dividends declared, \$.54 per share	-	-	(2,122 )	-	-	(2,122 )
Treasury shares issued under stock option plans: 1,611 shares	-	(2 )	-	-	29	27
Common stock issued to dividend reinvestment plan: 34,837 shares	35	615	-	-	-	650

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Balance at June 30, 2011                    \$ 4,352    \$ 33,709    \$ 59,470    \$ (4,249 )    \$ (7,087 )    \$ 86,195

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

Consolidated Statements of Cash Flows  
(unaudited)

	For the Six Months Ended June 30	
	2011	2010
(Dollars in thousands)		
<b>Cash flows from operating activities</b>		
Net income	\$ 3,608	\$ 4,133
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	704	672
Net amortization of loans and investment securities	332	152
Amortization and net change in mortgage servicing rights valuation	128	73
Amortization of intangibles	224	229
Provision for loan losses	2,667	1,250
Net realized gains on sales of securities	(11 )	(268 )
OTTI losses on securities	55	255
Loans originated for sale	-	(920 )
Proceeds from sale of loans	-	952
Gain on sales of loans	-	(32 )
(Gain) loss on sale or disposal of premises and equipment	-	(4 )
Net gain on sale or disposal of other real estate/other repossessed assets	(22 )	-
Increase in cash surrender value of life insurance	(340 )	(332 )
Contribution to pension plan	(922 )	(525 )
Increase in interest receivable and other assets	126	239
(Decrease) increase in interest payable and other liabilities	(1,084 )	130
Other, net	(584 )	90
<b>Net cash provided by operating activities</b>	<b>4,881</b>	<b>6,094</b>
<b>Cash flows from investing activities</b>		
Proceeds from sales of investment securities available for sale	880	6,378
Proceeds from maturities and paydowns of investment securities available for sale	10,710	15,341
Purchase of investment securities available for sale	(24,676 )	(6,081 )
Net decrease in restricted stock	598	-
Net increase in loans	(25,264 )	(19,447 )
Proceeds from sale of other real estate/other repossessed assets	142	440
Capital expenditures	(398 )	(1,166 )
<b>Net cash used in investing activities</b>	<b>(38,008 )</b>	<b>(4,535 )</b>
<b>Cash flows from financing activities</b>		
Net increase in demand deposits, interest-bearing checking and savings accounts	54,503	46,098
Net increase (decrease) in time deposits	6,066	(54,106 )
Net increase in short-term borrowings	14,097	12,767
Long-term debt payments	(21,581 )	(892 )
Dividends paid	(2,122 )	(2,089 )
Common stock issued to dividend reinvestment plan	650	410
Common stock issued under stock option plans	27	16
<b>Net cash provided by financing activities</b>	<b>51,640</b>	<b>2,204</b>
<b>Increase in cash and cash equivalents</b>	<b>18,513</b>	<b>3,763</b>

Cash and cash equivalents at beginning of period	22,106	33,248
Cash and cash equivalents at end of period	\$ 40,619	\$ 37,011

Supplemental Disclosures of Cash Flow Information

Cash paid during the year for:

Interest on deposits and other borrowed funds	\$ 4,953	\$ 6,874
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Income taxes	\$ 1,750	\$ 2,602
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Noncash Activities

Loans transferred to Other Real Estate	\$ 484	\$ -
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The accompanying notes are an integral part of these financial statements.

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES  
UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Franklin Financial Services Corporation (the Corporation), and its wholly-owned subsidiaries, Farmers and Merchants Trust Company of Chambersburg (the Bank), Franklin Financial Properties Corp., and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank that has one wholly-owned subsidiary, Franklin Realty Services Corporation. Franklin Realty Services Corporation is an inactive real-estate brokerage company. Franklin Financial Properties Corp. holds real estate assets that are leased by the Bank. Franklin Future Fund Inc. is a non-bank investment company. The activities of non-bank entities are not significant to the consolidated totals. All significant intercompany transactions and account balances have been eliminated.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of June 30, 2011, and for all other periods presented have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation's 2010 Annual Report on Form 10-K. The consolidated results of operations for the period ended June 30, 2011 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

The consolidated balance sheet at December 31, 2010 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements.

For purposes of reporting cash flows, cash and cash equivalents include Cash and due from banks, Interest-bearing deposits in other banks and Federal funds sold. Generally, Federal funds are purchased and sold for one-day periods.

Earnings per share is computed based on the weighted average number of shares outstanding during each period end. A reconciliation of the weighted average shares outstanding used to calculate basic earnings per share and diluted earnings per share follows:

(In thousands, except per share data)	For the Three Months Ended		For the Six Months Ended	
	June 30		June 30	
	2011	2010	2011	2010
Weighted average shares outstanding (basic)	3,942	3,880	3,934	3,874
Impact of common stock equivalents	3	3	4	2
Weighted average shares outstanding (diluted)	3,945	3,883	3,938	3,876
Anti-dilutive options excluded from the calculation	70	76	70	76
Net income	\$ 1,758	\$ 2,159	\$3,608	\$4,133
Basic earnings per share	\$ 0.45	\$ 0.56	\$0.92	\$1.07
Diluted earnings per share	\$ 0.45	\$ 0.56	\$0.92	\$1.07

## Note 2 – Recent Accounting Pronouncements

**Presentation of Comprehensive Income.** The provisions of this ASU amend FASB ASC Topic 220, Comprehensive Income, to facilitate the continued alignment of U.S. GAAP with International Accounting Standards. The ASU prohibits the presentation of the components of comprehensive income in the statement of stockholder's equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate, but consecutive, statements of net income and other comprehensive income. Under previous GAAP, all 3 presentations were acceptable. Regardless of the presentation selected, the Reporting Entity is required to represent all reclassifications between other comprehensive and net income on the face of the new statement or statements. The provisions of this ASU are effective for fiscal years and interim periods beginning after December 31, 2011 for public entities. As the two remaining options for presentation existed prior to the issuance of this ASU, early adoption is permitted. The Corporation early adopted ASU 2011-05 effective with the quarter ended June 30, 2011

**Receivables – Troubled Debt Restructurings by Creditors.** The FASB has issued this Update to clarify the accounting principles applied to loan modifications, as defined by FASB ASC Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors. The update clarifies guidance on a creditor's evaluation of whether or not a concession has been granted, with an emphasis on evaluating all aspects of the modification rather than a focus on specific criteria, such as the effective interest rate test, to determine a concession. The Update goes on to provide guidance on specific types of modifications such as changes in the interest rate of the borrowing, and insignificant delays in payments, as well as guidance on the creditor's evaluation of whether or not a debtor is experiencing financial difficulties. For public entities, the amendments in the Update are effective for the first interim or annual periods beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The entity should also disclose information required by ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which had previously been deferred by ASU 2011-01, Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20, for interim and annual periods beginning on or after June 15, 2011. Early adoption is permitted. The Corporation is in the process of analyzing the loan portfolio to properly identify loans that may be determined to be Troubled Debt Restructuring loans. The results of this analysis could increase future charge-off and nonaccrual balances.

## Note 3 – Accumulated Other Comprehensive Income

The components of accumulated other comprehensive loss included in shareholders' equity are as follows:

(Dollars in thousands)	June 30, 2011	December 31, 2010
Net unrealized gains (losses) on securities	\$ 1,010	\$ (1,026 )
Tax effect	(344 )	349
Net of tax amount	666	(677 )
Net unrealized losses on derivatives	(1,675 )	(1,752 )
Tax effect	569	596
Net of tax amount	(1,106 )	(1,156 )
Accumulated pension adjustment	(5,771 )	(5,771 )
Tax effect	1,962	1,962
Net of tax amount	(3,809 )	(3,809 )
Total accumulated other comprehensive loss	\$ (4,249 )	\$ (5,642 )

## Note 4 – Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting these commitments. The Bank had \$27.9 million and \$20.5 million of standby letters of credit as of June 30, 2011 and December 31, 2010, respectively. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of June 30, 2011 and December 31, 2010 for guarantees under standby letters of credit issued was not material.

## Note 5 - Investments

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2011 and December 31, 2010 are:

(Dollars in thousands)

June 30, 2011	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Equity securities	\$3,256	\$182	\$(524)	\$2,914
Obligations of U.S. Government agencies	17,307	94	(27)	17,374
Obligations of state and political subdivisions	39,172	1,610	(27)	40,755
Corporate debt securities	2,537	56	(42)	2,551
Trust Preferred securities	5,884	-	(896)	4,988
Mortgage-backed securities				
Agency	59,371	1,110	(187)	60,294
Non-Agency	3,842	19	(339)	3,522
Asset-backed securities	70	-	(19)	51
	\$131,439	\$3,071	\$(2,061)	\$132,449

(Dollars in thousands)

December 31, 2010	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Equity securities	\$4,126	\$50	\$(538)	\$3,638
Obligations of U.S. Government agencies	14,780	61	(56)	14,785
Obligations of state and political subdivisions	39,477	894	(419)	39,952
Corporate debt securities	2,647	64	(46)	2,665
Trust Preferred securities	5,875	-	(1,678)	4,197
Mortgage-backed securities				
Agency	47,239	1,104	(46)	48,297
Non-Agency	4,424	20	(415)	4,029
Asset-backed securities	74	-	(21)	53
	\$118,642	\$2,193	\$(3,219)	\$117,616

The amortized cost of securities pledged as collateral to secure various funding sources was \$122.4 million at June 30, 2011 and \$108.7 million at December 31, 2010.

The amortized cost and fair value of debt securities as of June 30, 2011, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

(Dollars in thousands)	Amortized cost	Fair Value
Due in one year or less	\$ 4,870	\$ 4,891
Due after one year through five years	16,486	17,018
Due after five years through ten years	14,209	14,828
Due after ten years	29,405	28,982
	64,970	65,719
Mortgage-backed securities	63,213	63,816



\$ 128,183 \$ 129,535

At June 30, 2011, the investment portfolio contained 66 securities with \$33.1 million of temporarily impaired fair value and \$2.1 million in unrealized losses. This position is improved from year-end 2010 when there were 85 securities with an unrealized loss of \$3.2 million. Nearly every sector realized an improvement in the level of unrealized loss with the trust preferred investment category showing the largest improvement as its unrealized loss declined from \$1.7 million at year-end to \$896 thousand at June 30, 2011.

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of June 30, 2011 and December 31, 2010:

(Dollars in thousands)	June 30, 2011								
	Less than 12 months			12 months or more			Total		
	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number
Equity securities	\$ 1	\$ (1 )	1	\$ 1,862	\$ (523 )	20	\$ 1,863	\$ (524 )	21
Obligations of U.S. Government agencies	33	(1 )	1	6,206	(26 )	12	6,239	(27 )	13
Obligations of state and political subdivisions	1,740	(21 )	4	300	(6 )	1	2,040	(27 )	5
Corporate debt securities	-	-	-	1,968	(42 )	2	1,968	(42 )	2
Trust Preferred securities	-	-	-	4,988	(896 )	7	4,988	(896 )	7
Mortgage-backed securities									
Agency	14,034	(187 )	11	-	-	-	14,034	(187 )	11
Non-Agency	-	-	-	1,940	(339 )	4	1,940	(339 )	4
Asset-backed securities	-	-	-	51	(19 )	3	51	(19 )	3
Total temporarily impaired securities	\$ 15,808	\$ (210 )	17	\$ 17,315	\$ (1,851)	49	\$ 33,123	\$ (2,061)	66

(Dollars in thousands)	December 31, 2010								
	Less than 12 months			12 months or more			Total		
	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number
Equity securities	\$ 1	\$ (1 )	1	\$ 3,261	\$ (537 )	20	\$ 3,262	\$ (538 )	21
Obligations of U.S. Government agencies	3,476	(17 )	2	6,433	(39 )	14	9,909	(56 )	16
Obligations of state and political subdivisions	11,861	(405 )	24	292	(14 )	1	12,153	(419 )	25

Corporate debt securities	-	-	-	1,968	(46 )	2	1,968	(46 )	2
Trust Preferred securities	-	-	-	4,196	(1,678)	7	4,196	(1,678)	7
Mortgage-backed securities									
Agency	9,859	(46 )	6	-	-	-	9,859	(46 )	6
Non-Agency	-	-	-	2,676	(415 )	5	2,676	(415 )	5
Asset-backed securities	-	-	-	53	(21 )	3	53	(21 )	3
Total temporarily impaired securities	\$ 25,197	\$ (469 )	33	\$ 18,879	\$ (2,750)	52	\$ 44,076	\$ (3,219)	85

The following table provides additional detail about trust preferred securities as of June 30, 2011:

#### Trust Preferred Securities

(Dollars in thousands)

Deal Name	Single Issuer or Pooled	Class	Amortized		Gross Unrealized Gain (Loss)	Lowest Credit Rating Assigned	Number of Banks Currently Performing	Deferrals and Defaults as % of Original Collateral	Expected Deferral/ Defaults as a Percentage of Remaining Performing Collateral
			Cost	Fair Value					
Huntington Cap Trust	Single	Preferred Stock	\$929	\$781	\$(148)	B	1	None	None
Huntington Cap Trust II	Single	Preferred Stock	874	749	(125)	B	1	None	None
BankAmerica Cap III	Single	Preferred Stock	956	781	(175)	BB	1	None	None
Wachovia Cap Trust II	Single	Preferred Stock	273	249	(24)	Baa2	1	None	None
Corestates Captl Tr II	Single	Preferred Stock	924	822	(102)	Baa1	1	None	None
Chase Cap VI JPM	Single	Preferred Stock	957	822	(135)	BBB	1	None	None
Fleet Cap Tr V	Single	Preferred Stock	971	784	(187)	BB	1	None	None
			\$5,884	\$4,988	\$(896)				

The following table provides additional detail about private label mortgage-backed securities as of June 30, 2011:

#### Private Label Mortgage Backed Securities

(Dollars in thousands)

Description	Origination Date	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
RALI 2003-QS15 A1	8/1/2003	\$ 366	\$ 366	\$ -	ALT A	A1	11.26	\$ -
RALI 2004-QS4 A7	3/1/2004	516	518	2	ALT A	AA	12.53	-
MALT 2004-6 7A1	6/1/2004	681	698	17	ALT A	BB	10.90	-
RALI 2005-QS2 A1	2/1/2005	602	550	(52)	ALT A	CCC	7.31	-
RALI 2006-QS4 A2	4/1/2006	869	715	(154)	ALT A	D	-	218
	5/1/2006	352	283	(69)	Prime	CCC	3.81	-

GSR  
2006-5F 2A1

RALI  
2006-QS8

A1	7/28/2006	456	392	(64 )	ALT A	D	-	172
		\$ 3,842	\$ 3,522	\$ (320 )				\$ 390

For more information concerning investments, refer to the Investment Securities discussion in the Financial Condition section of Management's Discussion and Analysis.

## Note 6 – Loans

A summary of loans outstanding, by primary collateral, at the end of the reporting period is as follows:

(Dollars in thousands)	June 30, 2011	December 31, 2010	Change	
			Amount	%
<b>Residential Real Estate 1-4 Family</b>				
First liens	\$ 142,271	\$ 144,128	\$(1,857 )	(1.3 )
Junior liens and lines of credit	53,719	56,694	(2,975 )	(5.2 )
<b>Total</b>	<b>195,990</b>	<b>200,822</b>	<b>(4,832 )</b>	<b>(2.4 )</b>
<b>Residential real estate - construction</b>	<b>65,367</b>	<b>79,557</b>	<b>(14,190 )</b>	<b>(17.8 )</b>
Commercial, industrial and agricultural real estate	320,724	304,195	16,529	5.4
Commercial, industrial and agricultural	175,064	146,672	28,392	19.4
Consumer	14,852	17,396	(2,544 )	(14.6 )
	771,997	748,642	23,355	3.1
Less: Allowance for loan losses	(10,150 )	(8,801 )	(1,349 )	15.3
<b>Net Loans</b>	<b>\$ 761,847</b>	<b>\$ 739,841</b>	<b>\$22,006</b>	<b>3.0</b>

Included in the loan balances are the following:

Net unamortized deferred loan costs	\$ 539	\$ 567
Unamortized discount on purchased loans	\$ (190 )	\$ (220 )
Loans pledged as collateral for borrowings and commitments from:		
FHLB	\$ 713,750	\$ 648,272
Federal Reserve Bank	48,566	53,682
	\$ 762,316	\$ 701,954

## Note 7 – Loan Quality

The following table presents, by loan segment, the Allowance for Loan Losses (ALL) for the periods ended:

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial		Consumer	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Industrial & Commercial Real Estate	Agricultural Industrial & Agricultural		
ALL at March 31, 2011	\$ 612	\$ 292	\$ 2,342	\$ 4,216	\$ 1,447	\$ 289	\$ 9,198
Charge-offs	(45 )	(172 )	(337 )	(261 )	(41 )	(50 )	(906 )
Recoveries	17	5	-	47	4	18	91
Provision	(55 )	188	387	642	451	154	1,767
ALL at June 30, 2011	\$ 529	\$ 313	\$ 2,392	\$ 4,644	\$ 1,861	\$ 411	\$ 10,150
ALL at December 31, 2010	\$ 600	\$ 352	\$ 2,596	\$ 3,358	\$ 1,578	\$ 317	\$ 8,801
Charge-offs	(152 )	(177 )	(737 )	(422 )	(41 )	(114 )	(1,643 )
Recoveries	28	5	-	240	4	48	325
Provision	53	133	533	1,468	320	160	2,667
ALL at June 30, 2011	\$ 529	\$ 313	\$ 2,392	\$ 4,644	\$ 1,861	\$ 411	\$ 10,150

ALL at December 31, 2009	\$ 550	\$ 278	\$ 3,087	\$ 4,175	\$ 752	\$ 95	\$ 8,937
Charge-offs	(107 )	(165 )	(982 )	(1,736 )	(232 )	(452 )	(3,674 )
Recoveries	19	10	53	18	61	142	303
Provision	138	229	438	901	997	532	3,235
ALL at December 31, 2010	\$ 600	\$ 352	\$ 2,596	\$ 3,358	\$ 1,578	\$ 317	\$ 8,801

The following table presents, by loan segment, loans that were evaluated for the ALL under the specific reserve (individually) and those that were evaluated under the general reserve (collectively) as of June 30, 2011 and December 31, 2010.

(Dollars in thousands)	Residential Real Estate 1-4 Family Junior Liens & First Liens			Commercial Industrial & Commercial Agricultural Industrial & Agricultural Consumer			Total
	Lines of Credit	Construction	Real Estate	Agricultural	Consumer		
<b>June 30, 2011</b>							
Loans evaluated for allowance:							
Individually	\$ 691	\$ 414	\$ 12,705	\$ 21,757	\$ 1,400	\$ -	\$ 36,967
Collectively	141,580	53,305	52,662	298,967	173,664	14,852	735,030
<b>Total</b>	<b>\$ 142,271</b>	<b>\$ 53,719</b>	<b>\$ 65,367</b>	<b>\$ 320,724</b>	<b>\$ 175,064</b>	<b>\$ 14,852</b>	<b>\$ 771,997</b>
<b>ALL established for loans evaluated:</b>							
Individually	\$ 202	\$ 3	\$ 1,211	\$ 3,980	\$ 681	\$ -	\$ 6,077
Collectively	327	310	1,181	664	1,180	411	4,073
<b>ALL at June 30, 2011</b>	<b>\$ 529</b>	<b>\$ 313</b>	<b>\$ 2,392</b>	<b>\$ 4,644</b>	<b>\$ 1,861</b>	<b>\$ 411</b>	<b>\$ 10,150</b>
<b>December 31, 2010</b>							
Loans evaluated for allowance:							
Individually	\$ 965	\$ 408	\$ 7,988	\$ 21,425	\$ 2,398	\$ 3	\$ 33,187
Collectively	143,163	56,286	71,569	282,770	144,274	17,393	715,455
<b>Total</b>	<b>\$ 144,128</b>	<b>\$ 56,694</b>	<b>\$ 79,557</b>	<b>\$ 304,195</b>	<b>\$ 146,672</b>	<b>\$ 17,396</b>	<b>\$ 748,642</b>
<b>ALL established for loans evaluated:</b>							
Individually	\$ 179	\$ 4	\$ 1,566	\$ 2,170	\$ 854	\$ 3	\$ 4,776
Collectively	421	348	1,030	1,188	724	314	4,025
<b>ALL at December 31, 2010</b>	<b>\$ 600</b>	<b>\$ 352</b>	<b>\$ 2,596</b>	<b>\$ 3,358</b>	<b>\$ 1,578</b>	<b>\$ 317</b>	<b>\$ 8,801</b>

The following table shows additional information about those loans considered to be impaired at June 30, 2011 and December 31, 2010:

(Dollars in thousands)	Impaired Loans				
	With No Allowance		With Allowance		
June 30, 2011	Recorded Investment	Unpaid Principal Balance	Recorded Investment	Unpaid Principal Balance	Related Allowance
<b>Residential Real Estate 1-4 Family</b>					
First liens	\$85	\$153	\$537	\$538	\$202
Junior liens and lines of credit	248	248	166	166	3
<b>Total</b>	<b>333</b>	<b>401</b>	<b>703</b>	<b>704</b>	<b>205</b>
<b>Residential real estate - construction</b>	<b>4,471</b>	<b>4,471</b>	<b>8,111</b>	<b>8,234</b>	<b>1,211</b>



Commercial, industrial and agricultural real estate	377	3,499	18,139	18,258	3,980
Commercial, industrial and agricultural	-	-	1,363	1,400	681
Consumer	-	-	-	-	-
<b>Total</b>	<b>\$5,181</b>	<b>\$8,371</b>	<b>\$28,316</b>	<b>\$28,596</b>	<b>\$6,077</b>

December 31, 2010	Impaired Loans				
	With No Allowance		With Allowance		
<b>Residential Real Estate 1-4 Family</b>					
First liens	\$-	\$-	\$965	\$971	\$179
Junior liens and lines of credit	122	122	286	286	4
<b>Total</b>	<b>122</b>	<b>122</b>	<b>1,251</b>	<b>1,257</b>	<b>183</b>
<b>Residential real estate - construction</b>	<b>3,958</b>	<b>3,958</b>	<b>4,030</b>	<b>4,030</b>	<b>1,566</b>
Commercial, industrial and agricultural real estate	7,307	7,378	14,118	14,312	2,170
Commercial, industrial and agricultural	51	52	2,347	2,386	854
Consumer	-	-	3	3	3
<b>Total</b>	<b>\$11,438</b>	<b>\$11,510</b>	<b>\$21,749</b>	<b>\$21,988</b>	<b>\$4,776</b>

The following table shows the average of impaired loans and related interest income for the three and six months ended June 30, 2011:

	Three Months Ended June 30, 2011		Six Months Ended June 30, 2011	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<b>Residential Real Estate 1-4 Family</b>				
First liens	\$556	\$1	\$787	\$11
Junior liens and lines of credit	350	-	326	1
Total	906	1	1,113	12
Residential real estate - construction	10,933	27	10,214	63
Commercial, industrial and agricultural real estate	18,666	38	18,574	155
Commercial, industrial and agricultural	1,323	7	1,827	18
Consumer	-	-	1	-
Total	\$31,828	\$73	\$31,729	\$248

The following table presents a summary of nonperforming assets as of June 30, 2011 and December 31, 2010:

(Dollars in thousands)	June 30, 2011		December 31, 2010	
	Balance	% of Loan Segment	Balance	% of Loan Segment
<b>Nonaccrual loans</b>				
<b>Residential Real Estate 1-4 Family</b>				
First liens	\$676	0.48 %	\$691	0.48 %
Junior liens and lines of credit	307	0.57 %	122	0.22 %
<b>Total</b>	<b>983</b>	<b>0.50 %</b>	<b>813</b>	<b>0.40 %</b>
Residential real estate - construction	10,365	15.86 %	6,500	8.17 %
Commercial, industrial and agricultural real estate	10,661	3.32 %	13,003	4.27 %
Commercial, industrial and agricultural	1,537	0.88 %	1,668	1.14 %
Consumer	-	-	-	-
<b>Total nonaccrual loans</b>	<b>\$23,546</b>		<b>\$21,984</b>	
<b>Loans past due 90 days or more and not included above</b>				
<b>Residential Real Estate 1-4 Family</b>				
First liens	\$1,417		\$1,093	
Junior liens and lines of credit	447		833	
<b>Total</b>	<b>1,864</b>		<b>1,926</b>	
Residential real estate - construction	1,827		911	
Commercial, industrial and agricultural real estate	3,798		2,343	
Commercial, industrial and agricultural	1,653		244	
Consumer	19		125	
<b>Total loans past due 90 days or more and still accruing</b>	<b>9,161</b>		<b>5,549</b>	
<b>Total nonperforming loans</b>	<b>32,707</b>		<b>27,533</b>	
Other real estate	492		618	
<b>Total nonperforming assets</b>	<b>\$33,199</b>		<b>\$28,151</b>	
<b>Restructured Loans (TDRs)</b>				
Performing	\$3,183		\$656	
Non-performing (included above)	2,217		-	
<b>Total TDRs</b>	<b>\$5,400</b>		<b>\$656</b>	
Nonaccrual loans to total gross loans	3.05 %		2.94 %	
Nonperforming loans to total gross loans	4.24 %		3.68 %	
Nonperforming assets to total assets	3.30 %		2.96 %	
Allowance for loan losses to nonperforming loans	31.03 %		31.97 %	

The following table presents the aging of payments of the loan portfolio:

(Dollars in thousands)	Loans Past Due and Still Accruing				Total	Non-Accrual	Total Loans
	Current	30-59 Days	60-89 Days	90 Days+			
June 30, 2011							
Residential Real Estate							
1-4 Family							
First liens	\$ 139,845	\$ -	\$ 333	\$ 1,417	\$ 1,750	\$ 676	\$ 142,271
Junior liens and lines of credit	52,896	-	69	447	516	307	53,719
Total	192,741	-	402	1,864	2,266	983	195,990
Residential real estate - construction	50,622	2,553	-	1,827	4,380	10,365	65,367
Commercial, industrial and agricultural real estate	301,190	938	4,137	3,798	8,873	10,661	320,724
Commercial, industrial and agricultural	171,574	300	-	1,653	1,953	1,537	175,064
Consumer	14,777	-	56	19	75	-	14,852
Total	\$ 730,904	\$ 3,791	\$ 4,595	\$ 9,161	\$ 17,547	\$ 23,546	\$ 771,997
December 31, 2010							
Residential Real Estate							
1-4 Family							
First liens	\$ 140,711	\$ 979	\$ 654	\$ 1,093	\$ 2,726	\$ 691	\$ 144,128
Junior liens and lines of credit	55,723	16	-	833	849	122	56,694
Total	196,434	995	654	1,926	3,575	813	200,822
Residential real estate - construction	72,146	-	-	911	911	6,500	79,557
Commercial, industrial and agricultural real estate	285,050	3,786	13	2,343	6,142	13,003	304,195
Commercial, industrial and agricultural	142,829	1,786	145	244	2,175	1,668	146,672
Consumer	17,077	164	30	125	319	-	17,396
Total	\$ 713,536	\$ 6,731	\$ 842	\$ 5,549	\$ 13,122	\$ 21,984	\$ 748,642

The following table reports the internal credit rating for those loans in the portfolio that are assigned an individual credit rating (primarily commercial loans):

(Dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
Residential Real Estate 1-4 Family					
First liens	\$44,905	\$1,500	\$ 3,098	\$-	\$49,503
Junior liens and lines of credit	9,806	214	414	-	10,434
Total	54,711	1,714	3,512	-	59,937
Residential real estate - construction	45,855	5,791	12,664	-	64,310

Commercial, industrial and agricultural real estate	276,259	24,249	20,216	-	320,724
Commercial, industrial and agricultural	161,194	6,176	7,694	-	175,064
Total	\$538,019	\$37,930	\$44,086	\$-	\$620,035

December 31, 2010

Residential Real Estate 1-4 Family					
First liens	\$40,051	\$1,821	\$3,299	\$-	\$45,171
Junior liens and lines of credit	10,565	68	391	-	11,024
Total	50,616	1,889	3,690	-	56,195
Residential real estate - construction	59,097	6,671	11,892	-	77,660
Commercial, industrial and agricultural real estate					
Commercial, industrial and agricultural	273,279	8,481	22,435	-	304,195
Commercial, industrial and agricultural	132,981	6,383	7,308	-	146,672
Total	\$515,973	\$23,424	\$45,325	\$-	\$584,722

For loans that are not assigned an individual credit rating (primarily consumer and residential mortgage loans), the Bank evaluates credit quality based on the aging status of the loan (previously presented) and the performing status. The following table presents the performance status on selected loans:

(Dollars in thousands)

	June 30, 2011				
	Consumer		Residential Real Estate		Total
	Lines of Credit	Installment	Home Equity Lines	Mortgages	
Performing	\$3,236	\$11,597	\$18,280	\$117,068	\$150,181
Non-performing	-	19	33	1,729	1,781
Total	\$3,236	\$11,616	\$18,313	\$118,797	\$151,962

  

	December 31, 2010				
	Consumer		Residential Real Estate		Total
	Lines of Credit	Installment	Home Equity Lines	Mortgages	
Performing	\$3,231	\$14,040	\$17,939	\$127,236	\$162,446
Non-performing	11	114	99	1,250	1,474
Total	\$3,242	\$14,154	\$18,038	\$128,486	\$163,920

The following table presents information on the Bank's Troubled Debt Restructuring (TDR) loans:

(Dollars in thousands)	Troubled Debt Restructurings		New Troubled Debt Restructurings in YTD Period		Troubled Debt Restructurings that Subsequently Defaulted during YTD Period	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
<b>June 30, 2011</b>						
Commercial, industrial and agricultural	9	\$ 5,400	7	\$4,767	2	\$ 633
Total	9	\$ 5,400	7	\$4,767	2	\$ 633
<b>December 31, 2010</b>						
Commercial, industrial and agricultural	1	\$ 656	-	\$-	-	\$-
Total	1	\$ 656	-	\$-	-	\$-

#### Note 8 – Pensions

The components of pension expense for the periods presented are as follows:

(Dollars in thousands)	Three months ended		Six months ended	
	June 30 2011	June 30 2010	June 30 2011	June 30 2010
<b>Components of net periodic (benefit) cost:</b>				
Service cost	\$84	\$91	\$187	\$183
Interest cost	180	185	362	371
Expected return on plan assets	(188 )	(209 )	(376 )	(419 )
Recognized net actuarial loss	91	43	180	86

Net periodic cost	\$167	\$110	\$353	\$221
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The Bank expects its pension expense to increase in 2011 compared to 2010. The Bank expects to contribute \$1.9 million to its pension plan in 2011. This contribution will meet the minimum funding requirements.

#### Note 9 – Mortgage Servicing Rights

Activity pertaining to mortgage servicing rights and the related valuation allowance follows:

(Dollars in thousands)	Six Months Ended June 30	
	2011	2010
<b>Cost of mortgage servicing rights:</b>		
Beginning balance	\$ 933	\$ 1,190
Originations	-	10
Amortization	(97 )	(134 )
Ending balance	\$ 836	\$ 1,066
<b>Valuation allowance:</b>		
Beginning balance	\$ (330 )	\$ (476 )
Valuation charges	(43 )	-
Valuation reversals	12	60
Ending balance	\$ (361 )	\$ (416 )
Mortgage servicing rights cost	\$ 836	\$ 1,066
Valuation allowance	(361 )	(416 )
Carrying value	\$ 475	\$ 650
Fair value	\$ 475	\$ 650

#### Note 10 – Fair Value Measurements

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

FASB ASC Topic 825, Financial Instruments, requires disclosure of the fair value of financial assets and liabilities, including those financial assets and liabilities that are not measured and reported at fair value on a recurring and non-recurring basis.



The estimated fair value of the Corporation's financial instruments are as follows:

(Dollars in thousands)	June 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets:</b>				
Cash and cash equivalents	\$40,619	\$40,619	\$22,106	\$22,106
Investment securities available for sale	132,449	132,449	117,616	117,616
Restricted stock	5,561	5,561	6,159	6,159
Net loans	761,847	775,491	739,841	750,944
Accrued interest receivable	3,888	3,888	3,662	3,662
Mortgage servicing rights	475	475	603	603
<b>Financial liabilities:</b>				
Deposits	\$794,900	\$798,025	\$734,331	\$737,274
Securities sold under agreements to repurchase	65,261	65,261	51,164	51,164
Long-term debt	49,304	51,752	70,885	74,695
Accrued interest payable	617	617	757	757
Interest rate swaps	1,675	1,675	1,752	1,752

The preceding information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments reported above at June 30, 2011 and December 31, 2010:

**Cash and Cash Equivalents:** For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

**Investment securities available for sale:** The fair value of investment securities is determined in accordance with the methods described under FASB ASC Topic 820, Fair Value Measurements and Disclosures, as discussed in the fair value hierarchy.

**Restricted stock:** The carrying value of restricted stock approximates its fair value based on redemption provisions for the restricted stock.

**Net loans:** The fair value of fixed-rate loans is estimated for each major type of loan (e.g. real estate, commercial, industrial and agricultural and consumer) by discounting the future cash flows associated with such loans using rates currently offered for loans with similar terms to borrowers of comparable credit quality. The model considers scheduled principal maturities, repricing characteristics, prepayment assumptions and interest cash flows. The discount rates used are estimated based upon consideration of a number of factors including the treasury yield curve, expense and service charge factors. For variable rate loans that reprice frequently and have no significant change in credit quality, carrying values approximate the fair value.

**Accrued interest receivable:** The carrying amount is a reasonable estimate of fair value.

**Mortgage servicing rights:** The fair value of mortgage servicing rights, upon initial recognition, is estimated using a valuation model that calculates the present value of estimated future net servicing income. The model incorporates

assumptions, such as loan default rates, costs to service, and prepayment speeds. Mortgage servicing rights are carried at the lower of cost or fair value after initial recognition.

Deposits, Securities sold under agreements to repurchase and Long-term debt: The fair value of demand deposits, savings accounts, and money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-rate certificates of deposit and long-term debt is estimated by discounting the future cash flows using rates approximating those currently offered for certificates of deposit and borrowings with similar remaining maturities. For securities sold under agreements to repurchase, the carrying value approximates a reasonable estimate of the fair value.

Accrued interest payable: The carrying amount is a reasonable estimate of fair value.

Interest rate swaps: The fair value of the interest rate swaps is determined in accordance with the methods described under FASB ASC Topic 820, as discussed below.

#### Fair Value Hierarchy

FASB ASC Topic 820, Fair Value Measurements and Disclosures established a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC Topic 820 are as follows:

Level 1: Valuation is based on unadjusted, quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3: Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Corporation's assumptions regarding what market participants would assume when pricing a financial instrument.

For financial assets and liabilities measured at fair value on a recurring basis, there were no transfers of financial assets or liabilities between Level 1 and Level 2 during the period ending June 30, 2011.

For financial assets and liabilities measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

(Dollars in Thousands)		Fair Value at June 30, 2011			
Asset Description	Level 1	Level 2	Level 3	Total	
Equity securities	\$2,914	\$-	\$-	\$2,914	
Obligations of U.S. Government agencies	-	17,374	-	17,374	
Obligations of state and political subdivisions	-	40,755	-	40,755	
Corporate debt securities	-	2,551	-	2,551	
Trust Preferred Securities	-	4,988	-	4,988	
Mortgage-backed securities					
Agency	-	60,294	-	60,294	
Non-Agency	-	3,522	-	3,522	
Asset-backed securities	-	51	-	51	
Total assets	\$2,914	\$129,535	\$-	\$132,449	
Liability Description					
Interest rate swaps	\$-	\$1,675	\$-	\$1,675	
Total liabilities	\$-	\$1,675	\$-	\$1,675	

(Dollars in Thousands)		Fair Value at December 31, 2010			
Asset Description	Level 1	Level 2	Level 3	Total	
Equity securities	\$3,638	\$-	\$-	\$3,638	
Obligations of U.S. Government agencies	-	14,785	-	14,785	
Obligations of state and political subdivisions	-	39,952	-	39,952	
Corporate debt securities	-	2,665	-	2,665	
Trust Preferred Securities	-	4,197	-	4,197	
Mortgage-backed securities					
Agency	-	48,297	-	48,297	
Non-Agency	-	4,029	-	4,029	
Asset-backed securities	-	53	-	53	
Total assets	\$3,638	\$113,978	\$-	\$117,616	
Liability Description					
Interest rate swaps	\$-	\$1,752	\$-	\$1,752	
Total liabilities	\$-	\$1,752	\$-	\$1,752	

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Corporation used the following methods and significant assumptions to estimate the fair value for assets and liabilities measured on a recurring basis.

Investment securities: Level 1 securities represent equity securities that are valued using quoted market prices from nationally recognized markets. Level 2 securities represent debt securities that are valued using a mathematical model based upon the specific characteristics of a security in relationship to quoted prices for similar securities.

Interest rate swaps: The interest rate swaps are valued using a discounted cash flow model that uses verifiable market environment inputs to calculate the fair value. This method is not dependent on the input of any significant judgments or assumptions by Management.



For financial assets and liabilities measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

(Dollars in Thousands)

Asset Description	Fair Value at June 30, 2011			Total
	Level 1	Level 2	Level 3	
Impaired loans with specific allowance	\$-	\$-	\$22,239	\$22,239
Other real estate owned	-	-	492	492
Mortgage servicing rights	-	-	475	475
Total assets	\$-	\$-	\$23,206	\$23,206

(Dollars in Thousands)

Asset Description	Fair Value at December 31, 2010			Total
	Level 1	Level 2	Level 3	
Impaired loans with specific allowance	\$-	\$-	\$16,973	\$16,973
Other real estate owned	-	-	618	618
Mortgage servicing rights	-	-	603	603
Total assets	\$-	\$-	\$18,194	\$18,194

The Corporation used the following methods and significant assumptions to estimate the fair value of assets and liabilities measured on a nonrecurring basis:

**Impaired loans:** Impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 3 inputs based on customized discounting criteria.

**Other real estate:** The fair value of other real estate, upon initial recognition, is estimated using Level 2 inputs within the fair value hierarchy based on observable market data and Level 3 inputs based on customized discounting criteria. In connection with the measurement and initial recognition of the foregoing assets, the Corporation recognizes charge-offs through the allowance for loan losses. Declines in fair value of other real estate subsequent to initial recognition are recorded in other expenses in the Corporation's statement of operations.

**Mortgage servicing rights:** The fair value of mortgage servicing rights, upon initial recognition, is estimated using a valuation model that calculates the present value of estimated future net servicing income. The model incorporates Level 3 assumptions such as cost to service, discount rate, prepayment speeds, default rates and losses. Mortgage servicing rights are carried at the lower of cost or fair value after initial recognition.

#### Note 11 – Financial Derivatives

The Board of Directors has given Management authorization to enter into derivative activity including interest rate swaps, caps and floors, forward-rate agreements, options and futures contracts in order to hedge interest rate risk. The Bank is exposed to credit risk equal to the positive fair value of a derivative instrument, if any, as a positive fair value indicates that the counterparty to the agreement is financially liable to the Bank. To limit this risk, counterparties must have an investment grade long-term debt rating and individual counterparty credit exposure is limited by Board approved parameters. Management anticipates continuing to use derivatives, as permitted by its Board-approved policy, to manage interest rate risk. In 2008, the Bank entered into two interest rate swap transactions in order to hedge the Corporation's exposure to changes in cash flows attributable to the effect of interest rate changes on variable rate liabilities.



Information regarding the interest rate swaps as of June 30, 2011 follows:

(Dollars in thousands)

	Notional Amount	Maturity Date	Interest Rate		Amount Expected to be Expensed into Earnings within the next 12 Months	
			Fixed	Variable		
\$	10,000	5/30/2013	3.60	%	0.03	% \$ 358
\$	10,000	5/30/2015	3.87	%	0.03	% \$ 385

The variable rate is indexed to the 91-day Treasury Bill auction (discount) rate and resets weekly.

Derivatives with a positive fair value are reflected as other assets in the consolidated balance sheet while those with a negative fair value are reflected as other liabilities. As short-term interest rates decrease, the net expense of the swap increases. As short-term rates increase, the net expense of the swap decreases.

Fair Value of Derivative Instruments in the Consolidated Balance Sheets as of June 30, 2011 and December 31, 2010 are as follows:

Fair Value of Derivative Instruments

(Dollars in thousands)

Date	Type	Balance Sheet	
		Location	Fair Value
June 30, 2011	Interest rate contracts	Other liabilities	\$ 1,675
December 31, 2010	Interest rate contracts	Other liabilities	\$ 1,752

The Effect of Derivative Instruments on the Statement of Income for the Three and Six Months Ended June 30, 2011 and 2010 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships

(Dollars in thousands)

Type / Date	Amount of Gain or (Loss) Recognized in net of tax on Derivative (Effective Portion)	Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion)	Amount of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion)

Interest Rate Contracts

Three months ended:

June 30, 2011	\$ (108 )	Interest Expense	\$ (180 )	Other income (expense)	\$ -
June 30, 2010	\$ (332 )	Interest Expense	\$ (174 )	Other income (expense)	\$ -

Six months ended:

June 30, 2011	\$ 50	Interest Expense	\$ (356 )	Other income (expense)	\$ -
June 30, 2010	\$ (435 )	Interest Expense	\$ (354 )	Other income (expense)	\$ -





Note 12 – Reclassifications

Certain prior period amounts may have been reclassified to conform to the current year presentation. Such reclassifications did not affect reported net income.

Note 13 – Subsequent Events

In July 2011, the Bank recorded a charge-off of \$1.9 million on two commercial real estate secured loans to two related entities. The loans were part of a shared national credit in which the Bank was participating and the action was the result of regulatory direction after review of the credit at the lead bank. Of the \$1.9 million charge-off, \$1.1 million was 30 – 89 days past due and \$800 thousand was 90 days or more past due at June 30, 2011. The \$1.9 million charge-off was specifically reserved in the Bank's June 30, 2011 allowance for loan loss calculation.

## Item 2

Management's Discussion and Analysis of Results of Operations and Financial Condition  
For the Three and Six Month Period Ended June 30, 2011 and 2010

## Forward Looking Statements

Certain statements appearing herein which are not historical in nature are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements refer to a future period or periods, reflecting management's current views as to likely future developments, and use words such as "may," "will," "expect," "believe," "estimate," "anticipate," or similar terms. Because forward-looking statements involve certain risks, uncertainties and other factors over which the Corporation has no direct control, actual results could differ materially from those contemplated in such statements. These factors include (but are not limited to) the following: general economic conditions, changes in interest rates, changes in the Corporation's cost of funds, changes in government monetary policy, changes in government regulation and taxation of financial institutions, changes in the rate of inflation, changes in technology, the intensification of competition within the Corporation's market area, and other similar factors.

## Critical Accounting Policies

Management has identified critical accounting policies for the Corporation to include Allowance for Loan Losses, Mortgage Servicing Rights, Financial Derivatives, Temporary Investment Impairment and Stock-based Compensation. There were no changes to the critical accounting policies disclosed in the 2010 Annual Report on Form 10-K in regards to application or related judgements and estimates used. Please refer to Item 7 of the Corporation's 2010 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

## Results of Operations

## Year-to-Date Summary

At June 30, 2011, for the first time in the Corporation's history, total assets exceeded \$1 billion, with total assets of \$1.01 billion, an increase of \$54.6 million from December 31, 2010. The Corporation reported net income for the first six months of 2011 of \$3.6 million. This is a 12.7% decrease versus net income of \$4.1 million for the same period in 2010. Total revenue (interest income and noninterest income) decreased \$878 thousand year-over-year. Interest income decreased \$989 thousand, due primarily to a decrease in interest on investments, while noninterest income increased due to an increase in loan service charges. Higher salary and benefit expense, as well as prepayment penalties on term loans, contributed to the increase in noninterest expense. The provision for loan losses was \$2.7 millions for the period, \$1.4 million more than in 2010. Diluted earnings per share decreased to \$.92 in 2011 from \$1.07 in 2010. Net loans grew to \$761.8 million and total deposits increased to \$794.9 million.

Other key performance ratios as of, or for the six months ended June 30, 2011 and 2010 (on an annualized basis) are listed below:

	2011		2010	
Return on average equity (ROE)	8.64	%	10.21	%
Return on average assets (ROA)	.74	%	.84	%
Return on average tangible average equity(1)	10.23	%	12.40	%
Return on average tangible average assets(1)	.77	%	.89	%
Net interest margin	3.73	%	3.46	%
Efficiency ratio	66.56	%	64.25	%



(1) The Corporation supplements its traditional GAAP measurements with Non-GAAP measurements. The Non-GAAP measurements include Return on Average Tangible Assets and Return on Average Tangible Equity. As a result of merger transactions, intangible assets (primarily goodwill and core deposit intangibles) were created. The Non-GAAP disclosures are intended to eliminate the effects of the intangible assets and allow for better comparisons to periods when such assets did not exist. The following table shows the adjustments made between the GAAP and NON-GAAP measurements:

GAAP Measurement	Calculation
Return on Average Assets	Net Income / Average Assets
Return on Average Equity	Net Income / Average Equity
Non- GAAP Measurement	Calculation
Return on Average Tangible Assets	Net Income plus Intangible Amortization / Average Assets less Average Intangible Assets
Return on Average Tangible Equity	Net Income plus Intangible Amortization / Average Equity less Average Intangible Assets
Efficiency Ratio	Noninterest Expense / Tax Equivalent Net Interest Income plus Noninterest Income (excluding Security Gains/Losses and Other Than Temporary Impairment)

A more detailed discussion of the operating results for the three months ended June 30, 2011 follows:

Comparison of the three months ended June 30, 2011 to the three months ended June 30, 2010:

#### Net Interest Income

The most important source of the Corporation's earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal categories of interest-earning assets are loans and securities, while deposits, securities sold under agreements to repurchase (Repos), short-term borrowings and long-term debt are the principal categories of interest-bearing liabilities. Demand deposits enhance net interest income because they are noninterest-bearing deposits. For the purpose of this discussion, balance sheet items refer to the average balance for the year and net interest income is adjusted to a fully taxable-equivalent basis. This tax-equivalent adjustment facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Corporation's 34% Federal statutory rate.

Tax equivalent interest income for the second quarter of 2011 remained flat quarter over quarter. Average interest-earning assets increased \$22.6 million from 2010 and the yield on these assets decreased by 12 basis points. The average balance of investment securities decreased \$5.0 million quarter over quarter due to pay downs, maturities and sales in the portfolio, net of investment purchases. Total average loans increased \$12.9 million (1.7%) quarter over quarter. Average commercial loans increased \$39.8 million, but the increase was partially offset by a decrease in the average balance of mortgage and consumer loans. Average mortgage loans decreased \$8.4 million, as the majority of new mortgage originations are sold in the secondary market and the portfolio continues to runoff. Average consumer loans, including home equity loans, decreased \$18.4 million, as consumers continue to borrow less during the economic recession and the indirect lending portfolio continues to run-off as the Bank exited this business in early 2010 and no new loans have been booked.



Interest expense was \$2.4 million for the second quarter, a decrease of \$813 thousand from the 2010 total of \$3.2 million. Average interest-bearing liabilities decreased \$760 thousand to \$797.6 million for 2011 from an average balance of \$798.4 million in 2010. The average cost of these liabilities decreased from 1.62% in 2010 to 1.21% in 2011. Average interest-bearing deposits increased \$35.3 million, due to increases in interest checking and savings accounts (\$34.4 million) and money management deposits (\$39.8 million), but this increase was somewhat offset by decreases in certificates of deposit (\$19.1 million). The cost of interest-bearing deposits decreased from 1.38% to 1.04%. Securities sold under agreements to repurchase (Repos) have decreased \$500 thousand on average over the prior year quarter and the average rate has remained constant at .25%. The average balance of long-term debt decreased by \$35.5 million due to scheduled amortization and maturities, as well as a prepayment of \$15.6 million on three Federal Home Loan Bank of Pittsburgh (FHLB) advances.

The changes in the balance sheet and interest rates resulted in an increase in tax equivalent net interest income of \$440 thousand to \$8.1 million in 2011 compared to \$7.6 million in 2010. The Bank's net interest margin increased from 3.48% to 3.74% in 2011. The increase in the net interest margin is the result of a decrease in the rate on interest-earning liabilities of 40 basis points, while the yield on interest-bearing assets only decreased 12 basis points.

The following table shows a comparative analysis of average balances, asset yields and funding costs for the three months ended June 30, 2011 and 2010. These components drive changes in net interest income.

(Dollars in thousands)	For the Three Months Ended June 30					
	Average balance	2011 Tax Equivalent Interest	Average yield/rate	Average balance	2010 Tax Equivalent Interest	Average yield/rate
<b>Interest-earning assets</b>						
Federal funds sold and interest-bearing balances	\$ 30,284	\$ 19	0.25 %	\$ 15,638	\$ 10	0.26 %
Investment securities	133,179	1,147	3.45 %	138,202	1,344	3.89 %
Loans	767,826	9,925	5.18 %	754,882	9,746	5.15 %
<b>Total interest-earning assets</b>	<b>\$ 931,289</b>	<b>11,091</b>	<b>4.78 %</b>	<b>\$ 908,722</b>	<b>11,100</b>	<b>4.90 %</b>
<b>Interest-bearing liabilities</b>						
Interest-bearing deposits	\$ 675,674	1,755	1.04 %	\$ 640,405	2,204	1.38 %
Securities sold under agreements to repurchase	63,509	39	0.25 %	63,993	40	0.25 %
Long-term debt	58,427	614	4.22 %	93,972	977	4.17 %
<b>Total interest-bearing liabilities</b>	<b>\$ 797,610</b>	<b>2,408</b>	<b>1.21 %</b>	<b>\$ 798,370</b>	<b>3,221</b>	<b>1.62 %</b>
Interest spread			3.57 %			3.28 %
Tax equivalent Net interest income/Net interest margin		8,683	3.74 %		7,879	3.48 %
Tax equivalent adjustment		(598 )			(234 )	
<b>Net interest income</b>		<b>\$ 8,085</b>			<b>\$ 7,645</b>	

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses. Loan balances include nonaccruing loans and are gross of the allowance for loan losses.

Provision for Loan Losses

For the second quarter of 2011, the provision expense was \$1.8 million versus \$625 thousand in 2010. For more information concerning loan quality and the allowance for loan losses, refer to the Loan discussion in the Financial Condition section.



## Noninterest Income

For the second quarter of 2011, noninterest income remained flat from the same period in 2010. Investment and trust service fees increased \$51 thousand due to higher recurring asset management and estate fees. Loan service charges decreased \$41 thousand as mortgage origination fees decreased due to lower consumer demand and commercial loan service charges were lower, as 2010 included a prepayment penalty on a commercial loan. Mortgage banking fees decreased \$56 thousand due to an impairment charge on mortgage servicing rights in 2011, versus none in 2010. Deposit service charges remained flat, while other service charges and fees increased primarily due to an increase in debit card fees. A final rule on the Durbin amendment was issued in June and it establishes a base rate for debit card interchange fees. While technically exempt from the rate cap, the Bank expects market forces will result in lower interchange fees to all community banks. The Bank potentially estimates annual lost revenue of \$400 thousand after the rate cap is implemented on October 1, 2011. The increase in cash surrender value of life insurance and other income remained fairly flat in the second quarter of 2011. Other than temporary impairment charges of \$55 thousand on two bonds were taken in the second quarter of 2011 compared to none in the second quarter of 2010. The Corporation also had no realized gains on the sale of securities in 2011, compared to \$20 thousand in 2010.

The following table presents a comparison of noninterest income for the three months ended June 30, 2011 and 2010:

(Dollars in thousands)	For the Three Months Ended		Change	
	2011	2010	Amount	%
<b>Noninterest Income</b>				
Investment and trust services fees	\$ 1,058	\$ 1,007	\$51	5.1
Loan service charges	231	272	(41 )	(15.1 )
Mortgage banking activities	(45 )	11	(56 )	(509.1 )
Deposit service charges and fees	597	593	4	0.7
Other service charges and fees	384	351	33	9.4
Increase in cash surrender value of life insurance	175	166	9	5.4
Other	81	22	59	268.2
OTTI losses on securities	(370 )	-	(370 )	N/M
Less: Loss recognized in other comprehensive income (before taxes)	(315 )	-	(315 )	N/M
Net OTTI losses recognized in earnings	(55 )	-	(55 )	N/M
Securities gains, net	-	20	(20 )	(100.0 )
<b>Total noninterest income</b>	<b>\$ 2,426</b>	<b>\$ 2,442</b>	<b>\$(16 )</b>	<b>(0.7 )</b>

## Noninterest Expense

Noninterest expense for the second quarter of 2011 totaled \$7.4 million compared to \$6.5 million in the same quarter of 2010. The increase in salaries and benefits was primarily due to annual salary adjustments (\$195 thousand), as well as increases in health insurance expense (\$120 thousand), for an incentive compensation program (\$62 thousand) and pension expense (\$57 thousand). Legal and professional fees decreased due to lower legal fees in 2011, while FDIC insurance decreased \$32 thousand, as the FDIC assessment rate decreased. Other expenses increased \$451 thousand due to a \$172 thousand prepayment penalty on \$12 million of FHLB advances. These advances had a much higher interest rate than what the Bank was earning on invested overnight funds and it will recoup more than this expense through the remainder of 2011 as a result of the prepayment.



The following table presents a comparison of noninterest expense for the three months ended June 30, 2011 and 2010:

(Dollars in thousands)	For the Three Months Ended		Change	
	2011	2010	Amount	%
Noninterest Expense				
Salaries and benefits	\$ 3,883	\$ 3,322	\$ 561	16.9
Net occupancy expense	496	496	0	0.0
Furniture and equipment expense	214	191	23	12.0
Advertising	351	343	8	2.3
Legal and professional fees	244	350	(106 )	(30.3 )
Data processing	487	502	(15 )	(3.0 )
Pennsylvania bank shares tax	173	152	21	13.8
Intangible amortization	111	114	(3 )	(2.6 )
FDIC insurance	256	288	(32 )	(11.1 )
Other	1,218	767	451	58.8
Total noninterest expense	\$ 7,433	\$ 6,525	\$ 908	13.9

#### Income taxes

For the second quarter of 2011 the Corporation recorded a Federal income tax benefit of \$447 thousand compared to income tax expense of \$778 thousand for the same quarter in 2010. During the second quarter of 2011, an internal review discovered that tax-exempt commercial loans booked in the fourth quarter of 2008, during 2009 and 2010 and in the first quarter of 2011 were not properly coded as tax-exempt in the Bank's core processing system. This resulted in the income from these loans being recorded as taxable income and the benefit of the tax-exempt status was not reflected in the Corporation's income tax calculation. After a thorough review of the affected loans to determine the unrecorded tax benefit, and consultation with the Corporation's internal and external audit firms, the Corporation deemed the adjustment to be immaterial to the consolidated financial statements for the current and prior year and therefore, no prior period adjustment was required. The Corporation recorded the past income tax benefits during the second quarter of 2011. The adjustment to income tax expense for the second quarter was a credit of approximately \$660 thousand attributable to the years 2008, 2009 and 2010 and approximately \$95 thousand attributable to the first quarter of 2011.

Comparison of the six months ended June 30, 2011 to the six months ended June 30, 2010:

#### Net Interest Income

Tax equivalent interest income for the first half of 2011 decreased by \$684 thousand compared to 2010. Average interest-earning assets increased \$4.5 million from 2010, but the yield on these assets decreased by 17 basis points. The average balance of investment securities decreased \$13.8 million year over year due to pay downs, maturities and sales in the portfolio, net of investment purchases. Total average loans increased \$10.8 million (1.4%) year over year. Average commercial loans increased \$36.5 million, but the increase was partially offset by a decrease in the average balance of mortgage and consumer loans. Average mortgage loans decreased \$8.2 million, as the majority of new mortgage originations are sold in the secondary market and the portfolio continues to runoff. Average consumer loans, including home equity loans, decreased \$16.7 million, as consumers continue to borrow less during the economic recession and the indirect lending portfolio continues to run-off as the Bank exited this business in early 2010 and no new loans have been booked.



Interest expense was \$4.8 million for the first half of 2011, a decrease of \$1.8 million from the 2010 total of \$6.6 million. Average interest-bearing liabilities decreased \$18.0 million to \$782.4 million for 2011 from an average balance of \$800.3 million in 2010. The average cost of these liabilities decreased from 1.66% in 2010 to 1.24% in 2011. Average interest-bearing deposits increased \$16.6 million, due to increases in interest checking and savings accounts (\$31.9 million) and money management deposits (\$43.0 million), but these increases were offset by decreases in certificates of deposit (\$40.0 million). The cost of interest-bearing deposits decreased from 1.43% to 1.05%. Securities sold under agreements to repurchase have decreased \$3.4 million on average over the prior year and the average rate has remained constant at .25%. The average balance of long-term debt decreased by \$31.5 million due to scheduled amortization and maturities, as well as prepayments of \$15.6 million on three Federal Home Loan Bank of Pittsburgh (FHLB) advances.

The changes in the balance sheet and interest rates resulted in an increase in tax equivalent net interest income of \$1.1 million to \$16.8 million in 2011 compared to \$15.7 million in 2010. The Bank's net interest margin increased from 3.46% to 3.71% in 2011. The increase in the net interest margin is the result of a decrease in the rate on interest-earning liabilities of 42 basis points, while the yield on interest-bearing assets only decreased 17 basis points.

The following table shows a comparative analysis of average balances, asset yields and funding costs for the six months ended June 30, 2011 and 2010. These components drive changes in net interest income.

(Dollars in thousands)	For the Six Months Ended June 30					
	Average balance	2011 Tax Equivalent Interest	Average yield/rate	Average balance	2010 Tax Equivalent Interest	Average yield/rate
<b>Interest-earning assets</b>						
Federal funds sold and interest-bearing balances	\$ 20,650	\$ 25	0.24 %	\$ 13,137	\$ 16	0.25 %
Investment securities	129,471	2,261	3.49 %	143,264	2,919	4.08 %
Loans	761,494	19,318	5.12 %	750,703	19,353	5.16 %
<b>Total interest-earning assets</b>	<b>\$ 911,615</b>	<b>21,604</b>	<b>4.78 %</b>	<b>\$ 907,104</b>	<b>22,288</b>	<b>4.95 %</b>
<b>Interest-bearing liabilities</b>						
Interest-bearing deposits	\$ 660,361	3,424	1.05 %	\$ 643,742	4,563	1.43 %
Securities sold under agreements to repurchase	58,914	73	0.25 %	62,302	77	0.25 %
Short-term borrowings	358	1	0.73 %	111	-	0.64 %
Long-term debt	62,722	1,315	4.23 %	94,194	1,951	4.17 %
<b>Total interest-bearing liabilities</b>	<b>\$ 782,355</b>	<b>4,813</b>	<b>1.24 %</b>	<b>\$ 800,349</b>	<b>6,591</b>	<b>1.66 %</b>
<b>Interest spread</b>			<b>3.54 %</b>			<b>3.29 %</b>
<b>Tax equivalent Net interest income/Net interest margin</b>		<b>16,791</b>	<b>3.71 %</b>		<b>15,697</b>	<b>3.46 %</b>
<b>Tax equivalent adjustment</b>		<b>(811 )</b>			<b>(506 )</b>	
<b>Net interest income</b>		<b>\$ 15,980</b>			<b>\$ 15,191</b>	

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses. Loan balances include nonaccruing loans and are gross of the allowance for loan losses.



## Provision for Loan Losses

For the first six months of 2011, the provision expense was \$2.7 million versus \$1.3 million in 2010. For more information concerning loan quality and the allowance for loan losses, refer to the Loan discussion in the Financial Condition section.

## Noninterest Income

For the first six months of 2011, noninterest income increased slightly to \$4.9 million compared to \$4.8 million in the same period in 2010. Investment and trust service fees decreased \$34 thousand due to lower income from estate fees. Loan service charges increased \$243 thousand from a large prepayment penalty on a commercial loan. This loan was match funded with an FHLB advance and the fee to prepay the FHLB advance is recorded in other expense. Mortgage banking fees decreased year over year as 2011 had a net impairment charge of \$31 thousand compared to a reversal of previously recorded impairment charges of \$60 thousand in 2010. Mortgage servicing income was also less in 2011 compared to 2010 and 2010 contained \$32 thousand in gains on sales of mortgage loans versus none in 2011. Deposit service charges decreased \$37 thousand in the 2011 due to a decrease in retail overdraft fees and a decrease in fees from the Bank's overdraft protection program. Other service charges and fees increased primarily due to a \$35 thousand increase in debit card fees. A final rule on the Durbin amendment was issued in June and it establishes a base rate for debit card interchange fees. While technically exempt from the rate cap, the Bank expects market forces will result in lower interchange fees to all community banks. The Bank potentially estimates annual lost revenue of \$400 thousand after the rate cap is implemented on October 1, 2011. Other income remained fairly flat in 2011. Other than temporary impairment charges of \$55 thousand on two bonds were taken in 2011 compared to \$255 thousand on two bonds in the first half of 2010. The Corporation also had realized gains of \$11 thousand on the sale of equity securities in 2011, compared to \$268 thousand in 2010.

The following table presents a comparison of noninterest income for the six months ended June 30, 2011 and 2010:

(Dollars in thousands)	For the Six Months Ended		Change	
	2011	2010	Amount	%
<b>Noninterest Income</b>				
Investment and trust services fees	\$1,990	\$2,024	\$(34 )	(1.7 )
Loan service charges	712	469	243	51.8
Mortgage banking activities	(35 )	81	(116 )	(143.2 )
Deposit service charges and fees	1,134	1,171	(37 )	(3.2 )
Other service charges and fees	745	677	68	10.0
Increase in cash surrender value of life insurance	340	332	8	2.4
Other	106	70	36	51.4
OTTI losses on securities	(370 )	(689 )	319	(46.3 )
Less: Loss recognized in other comprehensive income (before taxes)	(315 )	(434 )	119	(27.4 )
Net OTTI losses recognized in earnings	(55 )	(255 )	200	(78.4 )
Securities gains, net	11	268	(257 )	(95.9 )
<b>Total noninterest income</b>	<b>\$4,948</b>	<b>\$4,837</b>	<b>\$111</b>	<b>2.3</b>

## Noninterest Expense

Noninterest expense for the first six months of 2011 totaled \$14.5 million compared to \$13.2 million in the same period in 2010. The increase in salaries and benefits was primarily due to annual salary adjustments (\$273 thousand), as well as for increases in pension expense (\$132 thousand), for an incentive compensation program (\$125 thousand) and health insurance expense (\$118 thousand). Legal and professional fees decreased due primarily to lower legal fees in 2011, which are down \$152 thousand compared to 2010. FDIC insurance decreased \$13 thousand, as the FDIC assessment rate decreased. Other expenses increased \$612 thousand due to \$344 thousand in prepayment penalties on three FHLB advances of \$15.6 million. The prepaid advances included \$12 million to prepay term loans with a high interest rate and \$3.6 million than what the Bank was earning on invested overnight funds and it will more than recoup this expense through the remainder of 2011 as a result of the prepayment.

The following table presents a comparison of noninterest expense for the six months ended June 30, 2011 and 2010: (Dollars in thousands)

	For the Six Months Ended		Change	
	2011	2010	Amount	%
Noninterest Expense				
Salaries and benefits	\$ 7,596	\$ 6,762	\$ 834	12.3
Net occupancy expense	1,028	1,019	9	0.9
Furniture and equipment expense	437	382	55	14.4
Advertising	643	655	(12 )	(1.8 )
Legal and professional fees	515	745	(230 )	(30.9 )
Data processing	868	879	(11 )	(1.3 )
Pennsylvania bank shares tax	337	308	29	9.4
Intangible amortization	224	229	(5 )	(2.2 )
FDIC insurance	567	580	(13 )	(2.2 )
Other	2,239	1,627	612	37.6
Total noninterest expense	\$ 14,454	\$ 13,186	\$ 1,268	9.6

## Income taxes

Federal income tax expense was \$199 thousand in 2011 compared to \$1.5 million in 2010. During the second quarter of 2011, an internal review discovered that tax-exempt commercial loans booked in the fourth quarter of 2008, during 2009 and 2010 and in the first quarter of 2011 were not properly coded as tax-exempt in the Bank's core processing system. This resulted in the income from these loans being recorded as taxable income and the benefit of the tax-exempt status was not reflected in the Corporation's income tax calculation. After a thorough review of the affected loans to determine the unrecorded tax benefit, and consultation with the Corporation's internal and external audit firms, the Corporation deemed the adjustment to be immaterial to the consolidated financial statements for the current and prior year and therefore, no prior period adjustment was required. The Corporation recorded the past income tax benefits during the second quarter of 2011. The adjustment to income tax expense for the second quarter was a credit of approximately \$660 thousand attributable to the years 2008, 2009 and 2010 and approximately \$95 thousand attributable to the first quarter of 2011. Due to the income tax benefit recorded in the second quarter, the effective tax rate was only 5.25% for the first six months of 2011. Without the adjustments for past periods, the effective tax rate for 2011 would have been 22.6%. Likewise, had the 2010 adjustment been recognized in 2010, the effective tax rate would have been 22.6% compared to 26.1% as reported. All taxable income for the Corporation is taxed at a rate of 34%.



## Financial Condition

### Summary:

At June 30, 2011, assets totaled \$1.01 billion, an increase of \$54.6 million from the 2010 year-end balance of \$951.9 million. Investment securities increased \$14.8 million, while net loans increased \$22.0 million. Deposits are up \$60.6 million in 2011 due primarily to increases in noninterest-bearing and money management deposits. Shareholders' equity increased \$3.6 million during the first six months as retained earnings increased approximately \$1.5 million, other comprehensive loss improved \$1.4 million and changes to the Corporation's Dividend Reinvestment Program added an additional \$650 thousand in new capital.

### Investment Securities:

The investment portfolio totaled \$132.4 million at June 30, 2011, an increase of \$14.8 million since year-end 2010. The composition of the portfolio has not changed significantly during the year with \$24.7 million of new purchases, primarily agency mortgage backed securities, being added to replace collateral for secured deposits and Repos. The portfolio had a net unrealized gain of \$1.0 million at June 30, 2011 compared to a net unrealized loss of \$1.0 million at year-end 2010. This improvement occurred primarily in the trust preferred category as its unrealized loss decreased by approximately \$800 thousand since year-end.

The equity portfolio is comprised of bank stocks and the Bank and the Corporation each maintain separate equity investment portfolios. The municipal bond portfolio is well diversified geographically (issuers from within 25 states) and is comprised primarily of general obligation bonds (75%), most with credit enhancements in the form of private bond insurance or other credit enhancements. The largest municipal bond exposure is to eighteen issuers in the state of Texas with a fair value of \$7.0 million. The Bank holds corporate bonds with a fair value \$2.6 million (3 issuers) representing financial services companies. The trust preferred investments are comprised of seven single issuer trust preferred securities with an amortized cost of \$5.9 million and a fair value of \$5.0 million. The majority of the mortgage-backed security portfolio is comprised of U.S. Government Agency products. However, the Bank has seven private label mortgage backed securities (PLMBS) with an amortized cost of \$3.8 million and a fair value of \$3.5 million.

(Dollars in thousands)

June 30, 2011	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	\$3,256	\$182	\$(524)	\$2,914
Obligations of U.S. Government agencies	17,307	94	(27)	17,374
Obligations of state and political subdivisions	39,172	1,610	(27)	40,755
Corporate debt securities	2,537	56	(42)	2,551
Trust Preferred securities	5,884	-	(896)	4,988
Mortgage-backed securities				
Agency	59,371	1,110	(187)	60,294
Non-Agency	3,842	19	(339)	3,522
Asset-backed securities	70	-	(19)	51
	\$131,439	\$3,071	\$(2,061)	\$132,449

(Dollars in thousands)

December 31, 2010	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	\$4,126	\$50	\$(538)	\$3,638
Obligations of U.S. Government agencies	14,780	61	(56)	14,785
Obligations of state and political subdivisions	39,477	894	(419)	39,952
Corporate debt securities	2,647	64	(46)	2,665
Trust Preferred securities	5,875	-	(1,678)	4,197
Mortgage-backed securities				
Agency	47,239	1,104	(46)	48,297
Non-Agency	4,424	20	(415)	4,029
Asset-backed securities	74	-	(21)	53
	\$118,642	\$2,193	\$(3,219)	\$117,616

The following table provides additional detail about the Bank's trust preferred securities as of June 30, 2011:

## Trust Preferred Securities

(Dollars in thousands)

Deal Name	Single Issuer or Pooled	Class	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Lowest Credit Rating Assigned	Number of Banks Currently Performing	Deferrals and Defaults as % of Original Collateral	Expected Deferral/ Defaults as a Percentage of Remaining Performing Collateral
Huntington Cap Trust	Single	Preferred Stock	\$929	\$781	\$(148)	B	1	None	None
Huntington Cap Trust II	Single	Preferred Stock	874	749	(125)	B	1	None	None
BankAmerica Cap III	Single	Preferred Stock	956	781	(175)	BB	1	None	None
Wachovia Cap Trust II	Single	Preferred Stock	273	249	(24)	Baa2	1	None	None
Corestates Captl Tr II	Single	Preferred Stock	924	822	(102)	Baa1	1	None	None
	Single		957	822	(135)	BBB	1	None	None

Chase Cap		Preferred							
VI JPM		Stock							
Fleet Cap Tr		Preferred							
V	Single	Stock	971	784	(187)	BB	1	None	None
			\$5,884	\$4,988	\$(896)				

The following table provides additional detail about private label mortgage-backed securities as of June 30, 2011:

Private Label Mortgage Backed Securities									
(Dollars in thousands)									
Description	Origination Date	Amortized Cost	Fair Value	Gross		Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
				Unrealized Gain	Unrealized (Loss)				
RALI 2003-QS15 A1	8/1/2003	\$ 366	\$ 366	\$ -		ALT A	A1	11.26	\$ -
RALI 2004-QS4 A7	3/1/2004	516	518	2		ALT A	AA	12.53	-
MALT 2004-6 7A1	6/1/2004	681	698	17		ALT A	BB	10.90	-
RALI 2005-QS2 A1	2/1/2005	602	550	(52 )		ALT A	CCC	7.31	-
RALI 2006-QS4 A2	4/1/2006	869	715	(154 )		ALT A	D	-	218
GSR 2006-5F 2A1	5/1/2006	352	283	(69 )		Prime	CCC	3.81	-
RALI 2006-QS8 A1	7/28/2006	456	392	(64 )		ALT A	D	-	172
		\$ 3,842	\$ 3,522	\$ (320 )					\$ 390

At June 30, 2011, the investment portfolio contained 66 securities with \$33.1 million of temporarily impaired fair value and \$2.1 million in unrealized losses. This position is improved from year-end 2010 when there were 85 securities with an unrealized loss of \$3.2 million. Nearly every sector realized an improvement in the level of unrealized loss with the trust preferred investment category showing the largest improvement as its unrealized loss declined from \$1.7 million at year-end to \$896 thousand at June 30, 2011.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for “other-than-temporary” impairment. In the case of debt securities, investments considered for “other-than-temporary” impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. Accordingly, the impairments identified on debt and equity securities and subjected to the assessment at June 30, 2011 were deemed to be temporary and required no further adjustment to the financial statements, unless otherwise noted.

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of June 30, 2011 and December 31, 2010:

## June 30, 2011

(Dollars in thousands)	Less than 12 months			12 months or more			Fair Value	Total	
	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number		Unrealized Losses	Number
Equity securities	\$ 1	\$ (1 )	1	\$ 1,862	\$ (523 )	20	\$ 1,863	\$ (524 )	21
Obligations of U.S. Government agencies	33	(1 )	1	6,206	(26 )	12	6,239	(27 )	13
Obligations of state and political subdivisions	1,740	(21 )	4	300	(6 )	1	2,040	(27 )	5
Corporate debt securities	-	-	-	1,968	(42 )	2	1,968	(42 )	2
Trust Preferred securities	-	-	-	4,988	(896 )	7	4,988	(896 )	7
Mortgage-backed securities									
Agency	14,034	(187 )	11	-	-	-	14,034	(187 )	11
Non-Agency	-	-	-	1,940	(339 )	4	1,940	(339 )	4
Asset-backed securities	-	-	-	51	(19 )	3	51	(19 )	3
Total temporarily impaired securities	\$ 15,808	\$ (210 )	17	\$ 17,315	\$ (1,851)	49	\$ 33,123	\$ (2,061)	66

## December 31, 2010

(Dollars in thousands)	Less than 12 months			12 months or more			Fair Value	Total	
	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number		Unrealized Losses	Number
Equity securities	\$ 1	\$ (1 )	1	\$ 3,261	\$ (537 )	20	\$ 3,262	\$ (538 )	21
Obligations of U.S. Government agencies	3,476	(17 )	2	6,433	(39 )	14	9,909	(56 )	16
Obligations of state and political subdivisions	11,861	(405 )	24	292	(14 )	1	12,153	(419 )	25
Corporate debt securities	-	-	-	1,968	(46 )	2	1,968	(46 )	2
Trust Preferred securities	-	-	-	4,196	(1,678)	7	4,196	(1,678)	7
Mortgage-backed securities									
Agency	9,859	(46 )	6	-	-	-	9,859	(46 )	6
Non-Agency	-	-	-	2,676	(415 )	5	2,676	(415 )	5
Asset-backed securities	-	-	-	53	(21 )	3	53	(21 )	3
Total temporarily impaired securities	\$ 25,197	\$ (469 )	33	\$ 18,879	\$ (2,750)	52	\$ 44,076	\$ (3,219)	85

At June 30, 2011, the unrealized loss in the equity portfolio was \$524 thousand on a fair value of \$1.9 million. The fair value of equities with an unrealized loss declined by \$1.4 million since year-end 2010. The reduction in the fair value is due in large part to the sale of more than 38,000 shares of Tower Bancorp during the year with a fair value of approximately \$880 thousand.

The unrealized loss in the trust preferred portfolio is \$896 thousand, \$784 thousand less than at year-end 2010. Trust preferred securities experienced significant declines in value during the economic recession in 2008 and 2009. However, market prices continue to show signs of improvement as evidenced by the lower unrealized loss. Trust-preferred securities can reflect single entity issues or a group of entities (pooled trust preferred). Pooled trust preferred securities have been the subject of significant write-downs due in some cases from the default of one issuer in the pool that then impairs the entire pool. All of the Bank's trust preferred securities are single issue, variable rate notes with long maturities (2027 – 2028) from companies that received money (and in some cases paid back) from the Troubled Asset Relief Program (TARP), continue to pay dividends and have raised capital. At June 30, 2011, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded. See the Trust Preferred Securities table for additional information.

The largest unrealized loss in the MBS portfolio is in the non-agency PLMBS sector with a net unrealized loss of \$320 thousand. Four PLMBS have an unrealized loss of \$339 thousand, offset partially by three bonds with an unrealized gain of \$19 thousand. These bonds were all rated AAA at time of purchase, but have since have experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. As a result of the analysis on PLMBS it was determined that two bonds contained losses that were considered other-than-temporary and an impairment charge of \$55 thousand on as required during the second quarter of 2011. This charge represents the amount that Management believes is attributable to credit issues related to the two bonds. The market for PLMBS continues to be weak and Management believes that this factor accounts for the remaining portion of the unrealized losses that is not attributable to credit issues. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. See the PLMBS table above for additional information.

The following table represents the cumulative credit losses on securities recognized in earnings as of June 30, 2011.

(Dollars in thousands)	Six Months Ended June 30, 2011
Balance of cumulative credit losses on securities, January 1, 2011	\$ 335
Additions for credit losses recorded which were not previously recognized as components of earnings	55
Balance of cumulative credit losses on securities, June 30, 2011	\$ 390

The Bank held \$5.6 million of restricted stock at June 30, 2011. Except for \$30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of \$100 per share. In December 2008, FHLB announced it would suspend its regular cash dividend and the regular repurchase of excess capital stock from its members as part of capital restoration plan. However, FHLB has made unscheduled stock repurchases of approximately \$600 thousand during the year. Despite these purchases, FHLB has not resumed its past practice of redeeming excess capital stock on a regular basis. FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. Management intends to remain a member of the FHLB and believes that it will be able to fully recover the cost basis of this investment.

#### Loans:

Net loans increased \$22.0 million from year-end. Residential real estate loans, comprised of mortgage and home equity loans, decreased \$4.8 million from year-end 2010. First lien loans decreased \$1.9 million due to pay downs in the portfolio and as the Bank sells the majority of new mortgage originations in the secondary market. The Bank originated approximately \$6.9 million in mortgage loans for sale this year through a third party brokerage agreement. The Bank collects a fee for originating these loans, but it does not retain or service the loans. Junior liens and lines of credit decreased \$3.0 million, as there is less demand from consumers for home equity products. Many consumers have seen the equity in their homes decline and are less willing to borrow money in the uncertain economy. Due to these facts, the Bank expects its residential real estate loan portfolio to decline in future periods.

Residential real estate construction loans decreased \$14.2 million from the end of 2010 to \$65.4 million at June 30, 2011. This portfolio is comprised of \$1.5 million to individuals to build their own homes and \$63.9 million to developers to construct residential homes for sale or improve land for the sale of residential building lots. These balances compare to \$6.0 million to individuals and \$73.6 million to developers at year-end. The Bank's exposure to residential construction loans is concentrated primarily in south central Pennsylvania. Real estate construction loans, especially land development loans, frequently provide an interest reserve in order to assist the developer during the development stage when minimal cash flow is generated. All real estate construction loans are underwritten in the same manner, regardless of the use of an interest reserve. At June 30, 2011, the Bank had \$24.5 million in real estate loans with a Bank funded interest reserve and has capitalized \$1.9 million of interest from these reserves on active projects. Real estate construction loans are monitored on a regular basis by either an independent third party inspector or the assigned loan officer depending on loan amount or complexity of the project. This monitoring process includes at a minimum, the submission of invoices and AIA documents of costs incurred by the borrower, on-site inspections, and a signature by the assigned loan officer for disbursement of funds. Year-to-date, the Bank has recognized \$200 thousand of interest income that was funded by interest reserve accounts.





Commercial lending activity continues to be strong and these balances have increased approximately \$45.0 million since year-end. Commercial real estate loans (CRE) increased \$16.5 million during the first half of 2011. The commercial real estate portfolio includes \$110.0 million of owner occupied properties, \$112.6 million of non-owner occupied properties and \$37.2 million secured by farmland. Commercial, industrial and agricultural loans (C&I) increased \$28.4 million, primarily the result of loans to local municipalities (approximately \$11.8 million) and loans to commercial customers to fund business operations (approximately \$15.2 million). Included in the C&I portfolio is \$57.9 million of loans to government municipalities. During the first six months of 2011, the Bank purchased \$6.8 million of loan participations, \$597 thousand of C&I loans, \$2.5 million included in residential real estate construction and \$3.7 million of commercial real estate loans. The Bank expects the amount of commercial loan participations available for purchase in 2011 will be less than the \$17.4 million purchased in 2010 as a result of a general slow down in commercial business activity. At June 30, 2011, the Bank held \$148.9 million in purchased commercial loan participations.

Consumer loans have decreased by approximately \$2.5 million, with most of the decrease occurring in the indirect lending portfolio. The Bank's indirect lending portfolio is approximately \$5 million, down from approximately \$7.2 million at year-end. With the Bank's decision to exit this line of business in the first quarter of 2010, as well as the unwillingness of consumers to increase their debt, the consumer portfolio will continue to run-down.

The following table presents a summary of loans outstanding, by primary collateral, at the end of the reporting period:

(Dollars in thousands)	June 30, 2011	December 31, 2010	Change	
			Amount	%
<b>Residential Real Estate 1-4 Family</b>				
First liens	\$ 142,271	\$ 144,128	\$ (1,857 )	(1.3 )
Junior liens and lines of credit	53,719	56,694	(2,975 )	(5.2 )
<b>Total</b>	<b>195,990</b>	<b>200,822</b>	<b>(4,832 )</b>	<b>(2.4 )</b>
<b>Residential real estate - construction</b>	<b>65,367</b>	<b>79,557</b>	<b>(14,190 )</b>	<b>(17.8 )</b>
Commercial, industrial and agricultural real estate	320,724	304,195	16,529	5.4
Commercial, industrial and agricultural	175,064	146,672	28,392	19.4
Consumer	14,852	17,396	(2,544 )	(14.6 )
	771,997	748,642	23,355	3.1
Less: Allowance for loan losses	(10,150 )	(8,801 )	(1,349 )	15.3
<b>Net Loans</b>	<b>\$ 761,847</b>	<b>\$ 739,841</b>	<b>\$ 22,006</b>	<b>3.0</b>

Included in the loan balances are the following:

Net unamortized deferred loan costs	\$ 539	\$ 567
Unamortized discount on purchased loans	\$ (190 )	\$ (220 )

Loans pledged as collateral for borrowings and commitments from:

FHLB	\$ 713,750	\$ 648,272
Federal Reserve Bank	48,566	53,682
	\$ 762,316	\$ 701,954

Loan Quality:

Management utilizes a risk rating system (1 – 9) to evaluate loan asset quality. It monitors loan asset quality by continually reviewing four measurements: (1) watch list loans (loans risk rated 6 or higher), (2) loan delinquency, (3) foreclosed real estate (other real estate owned or OREO), and (4) net-charge-offs. Management compares trends in these measurements with the Bank's internally established targets, as well as its national and local peer group's average measurements.

Loans that are risk rated 6 (OAEM) or lower are placed on the watch list. At June 30, 2011, there was \$83.8 million on the watch list, up from \$70.0 million at March 31, 2011 and \$69.9 million at December 31, 2010. The watch list is comprised of \$38.6 million of loans with a risk rating of 6 and \$45.2 million of loans with a risk rating of 7. The watch list is a comprehensive list of loans that the Bank has identified as needing increased monitoring, usually because of indications that the borrower is, or is likely to be, in a position of weakening cash flow that may require alternative sources of cash, or collateral liquidation to pay the loan. Included on the watch list are loans that may or may not be delinquent or on nonaccrual, loans that may or may not be considered impaired (including troubled debt restructurings), and potential problem loans. The Bank's Loan Management Committee reviews the watch list and risk ratings on a monthly basis in order to proactively identify and manage loan problems.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all interest and principal payments due according to the originally contracted terms of the loan agreement. Impaired loans totaled \$37.0 million on June 30, 2011 compared to \$31.1 and \$33.2 million at March 31, 2011 and December 31, 2010, respectively. The majority of the impaired loan balance is in commercial and agriculture real estate, \$21.7 million. The Bank has \$8.4 million of impaired loans with no loss reserve and \$28.6

million with an established loss reserve of \$6.1 million. See the Notes to the Consolidated Financial Statements for additional information on impaired loans.

A loan is considered a troubled debt restructuring (TDR) if the creditor (the Bank), for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The Bank has nine loans classified as TDR for \$5.4 million up from 1 TDR loan for \$637 thousand at March 31, 2011. Performing TDR loans totaled \$3.2 million and \$2.2 million are nonperforming. The nonperforming TDR loans consist of loans to 2 borrowers. The Bank has not performed any type of loan workout where it has restructured an existing loan into multiple new loans, for example a performing and nonperforming note. It is possible that the Bank will continue to report higher levels of TDR loans as more businesses experience economic hardship and seek loan concessions. See the Notes to the Consolidated Financial Statements for additional information on TDR loans.

Potential problem loans are loans where the borrowers may or may not be able to comply with current loan terms, but excludes loans that are 90 days or more past due and nonaccrual loans. Potential problem loans totaled \$51.1 million at June 30, 2011 compared to 43.6 million at March 31, 2011 and \$42.4 million at year-end 2010.

Delinquent loans are a result of borrowers' cash flow and/or alternative sources of cash being insufficient to pay loans. The Bank's likelihood of collateral liquidation to repay the loans becomes more probable the further behind a borrower falls, particularly when loans reach 90 days or more past due. Management's primary delinquent loans measurements are loans 30-89 days past due, and nonperforming loans (90 days or more past due or nonaccrual loans). Nonaccrual loans generally represent Management's determination that collateral liquidation is not likely to fully repay both interest and principal.

It is the Bank's policy to evaluate the probable collectability of principal and interest due under the terms of loan contracts for all loans 90-days or more past due or restructured loans. Further, it is the Bank's policy to discontinue accruing interest on loans that are not adequately secured and in the process of collection. When a loan is placed on nonaccrual status, any current year accrued interest is subtracted from its current period income, and any prior year accrued interest is charged-off from the allowance for loan losses.

Loan quality, as measured by nonperforming loans, has continued to deteriorate during 2011 and nonperforming loans increased to \$32.7 million at June 30, 2011 compared to \$27.5 million at year-end 2010. Loans past due 90 days or more and still accruing increased \$3.6 million since year-end with the majority of the increase occurring in commercial and agriculture real estate, and commercial, industrial and agriculture (C&I) loans. Nonaccrual loans increased from year-end 2010, up \$1.6 million to \$23.5 million at June 30, 2011. This increase occurred despite a \$2.2 million nonaccrual loan payoff in January 2011. During the second quarter of 2011, \$3.7 million was added to nonaccrual status related to three loans to one borrower in the residential real estate construction sector. The ratio of nonperforming loans to total gross loans increased from 3.68% at December 31, 2010 to 4.24% at June 30, 2011. If the slow economy continues, it is possible that other loans may become delinquent and nonperforming loans could remain at a high level. See the Notes to the Consolidated Financial Statements for additional information on past due loans and internal loan credit risk ratings.

The following table presents a summary of nonperforming assets:

(Dollars in thousands)	June 30, 2011			December 31, 2010		
	Balance	% of Loan Segment		Balance	% of Loan Segment	
<b>Nonaccrual loans</b>						
<b>Residential Real Estate 1-4 Family</b>						
First liens	\$676	0.48	%	\$691	0.48	%
Junior liens and lines of credit	307	0.57	%	122	0.22	%
<b>Total</b>	<b>983</b>	<b>0.50</b>	<b>%</b>	<b>813</b>	<b>0.40</b>	<b>%</b>
Residential real estate – construction	10,365	15.86	%	6,500	8.17	%
Commercial, industrial and agricultural real estate	10,661	3.32	%	13,003	4.27	%
Commercial, industrial and agricultural	1,537	0.88	%	1,668	1.14	%
Consumer	-	-		-	-	
<b>Total nonaccrual loans</b>	<b>\$23,546</b>			<b>\$21,984</b>		
<b>Loans past due 90 days or more and not included above</b>						
<b>Residential Real Estate 1-4 Family</b>						
First liens	\$1,417			\$1,093		
Junior liens and lines of credit	447			833		
<b>Total</b>	<b>1,864</b>			<b>1,926</b>		
Residential real estate - construction	1,827			911		
Commercial, industrial and agricultural real estate	3,798			2,343		
Commercial, industrial and agricultural	1,653			244		
Consumer	19			125		
<b>Total loans past due 90 days or more and still accruing</b>	<b>9,161</b>			<b>5,549</b>		
<b>Total nonperforming loans</b>	<b>32,707</b>			<b>27,533</b>		
<b>Other real estate</b>	<b>492</b>			<b>618</b>		
<b>Total nonperforming assets</b>	<b>\$33,199</b>			<b>\$28,151</b>		
<b>Restructured Loans (TDRs)</b>						
Performing	\$3,183			\$656		
Non-performing (included above)	2,217			-		
<b>Total TDRs</b>	<b>\$5,400</b>			<b>\$656</b>		
Nonaccrual loans to total gross loans	3.05	%		2.94	%	
Nonperforming loans to total gross loans	4.24	%		3.68	%	
Nonperforming assets to total assets	3.30	%		2.96	%	
Allowance for loan losses to nonperforming loans	31.03	%		31.97	%	

The majority of the nonaccrual loan balance is comprised of six loan relationships totaling \$20.0 million. The following table provides additional information on the most significant nonaccrual accounts:

Significant Nonaccrual Loans  
June 30, 2011

(Dollars in thousands)

	Origination Date	Balance	ALL Reserve	Nonaccrual Date	Collateral	Last Location Appraisal(1)
Credit 1 Residential real estate construction and development, 1-4 family	2006	\$ 2,024	\$ 531	May-09	1st lien residential building lots 2nd & 3rd lien single family residential rental property	PA Nov-10 MD \$ 4,205
Credit 2 Agricultural 4 separate notes	2004 - 2006	1,585	-	Mar-09	1st and 2nd lien on agricultural real estate, farm equipment, livestock and a 70% FSA guarantee on a \$352 thousand note	PA Dec-09 \$ 3,049
Credit 3 Residential real estate construction and development, 1-4 family 18 separate notes	2007 - 2009	3,412	-	Jun-10	Liens (primarily 1st liens) on 4 commercial real estate properties	PA Jan-10 \$ 4,455
Credit 4 Agricultural 7 separate notes	2005 - 2010	2,787	98	Dec-10	1st, 2nd and 3rd lien on 600+ acres of farm real estate, equipment and inventory	PA Jan-10 \$ 4,446
Credit 5 Commercial real estate	2008	6,500	1,595	Dec-10	1st lien on 92 acres undeveloped commercial real estate	PA Jan-11 \$ 5,629

Credit 6	2006	3,730	170	Jun-11	1st lien on 160 acres of undeveloped residential land on 4 separate tracts	PA	Aug-09
Residential real estate construction and development , 1-4 family							\$ 6,193
		\$ 20,038	\$ 2,394				

(1) Appraisal value, as reported, does not reflect the pay-off of any senior liens or any adjustment to reflect the cost to liquidate the collateral.

Credit 2: This credit is now in a bankruptcy reorganization plan. As part of the plan, the borrowers are required to make regular payments to the Bank under a defined amortization schedule that includes a 3- year call option to the Bank. During this 3-year period the borrower is to obtain take-out financing elsewhere. If the refinancing does not occur within the 3-year window, the Bank can begin foreclosure action. This credit is reported as a troubled debt restructuring; however, the borrower is in compliance with the modified terms and the Bank expects that it will be able to return this credit to an accruing status.

Credit 3: In July, the guarantors for this credit collateralized their guarantees with commercial real estate and the Bank believes the loan is now fully secured. In addition, the guarantors paid down principal of \$190 thousand and past due interest of \$49 thousand. The balance of the loan will be amortized over 20 years with a 5-year call option. The loan was returned to accrual status at the end of July.

Credit 6: The Bank is the process of accepting a deed in lieu of foreclosure and it expects this to be completed in the third quarter of 2011. This action would not have an affect on the Bank's nonperforming assets, but would result in a reduction in nonaccrual loans and an increase in other real estate owned.

The Bank holds \$492 thousand of foreclosed real estate, comprised of four loans secured by various types of real estate. At June 30, 2011, the Bank had \$435 thousand of portfolio mortgages in the process of foreclosure.

The following table provides additional information on the foreclosed real estate:

Foreclosed Real Estate  
June 30, 2011

(Dollars in thousands)	Date Acquired	Balance	Collateral	Location	Last Appraisal
Property 1	2009	\$ 41	2 residential building lots	PA	Sep-09
Property 2	2009	138	farmland - 36 acres	PA	Feb-11
Property 3	2010	148	residential property	PA	Jul-10
Property 4	2011	165	commercial real estate	PA	Nov-10
		\$ 492			

Management continually monitors the status of nonperforming loans, the value of any collateral and potential of risk of loss.

Allowance for Loan Losses:

Management performs a monthly evaluation of the adequacy of the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, borrowers' actual or perceived financial and managerial strengths, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. It is Management's general practice to obtain a new appraisal or asset valuation for any loan that it has rated as substandard or higher, including nonaccrual. Management, at its discretion, may determine that additional adjustments to the appraisal or valuation are required. Valuation adjustments will be made as necessary based on other factors, including, but not limited to the economy, deferred maintenance, industry, type of property/equipment etc and the knowledge Management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated when determining the realizable value to the Bank.

Real estate appraisals and collateral valuation are an important part of the Bank's process for determining potential loss on collateral dependent loans and thereby have a direct affect on the determination of loan charge-offs and the calculation of the allowance for loan losses. As long as the loan remains a performing loan, no further updates to appraisals are required. If a loan/relationship migrates to watch list status, an evaluation for impairment is made based on the current information available at the time of downgrade. If a loan reaches an OAEM rating or higher, including nonaccrual, Management determines the need to obtain a new or updated appraisal based on several factors, including general economic conditions and factors specific to the loan. We believe this practice complies with the new regulatory guidance dated December 12, 2010 and could potentially increase the Bank's allowance for loan loss provision, depending on the results of the new appraisals.



Certain factors involved in the evaluation are inherently subjective, as they require material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

The analysis for determining the ALL is consistent with guidance set forth in generally accepted accounting principles (GAAP) and the Interagency Policy Statement on the Allowance for Loan and Lease Losses. The analysis has two components, specific and general allocations. The specific component addresses specific reserves established for impaired loans. A loan is considered to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect all interest and principal payments due according to the originally contracted terms of the loan agreement. Expected cash flow or collateral values discounted for market conditions and selling costs are used to establish specific allocations.

The general component addresses the reserves established for pools of homogenous loans. The general component includes a quantitative and qualitative analysis. The quantitative analysis includes the Bank's historical loan loss experience (weighted towards most recent periods) and other factors derived from economic and market conditions that have been determined to have an affect on the probability and magnitude of a loss. The qualitative analysis utilizes a risk matrix that incorporates qualitative and environmental factors such as: loan volume, management, nonperforming loans, loan review process, credit concentrations, competition, and legal and regulatory issues. Input for these factors is determined on the basis of Management's observation, judgment and experience. As a result of this input, additional loss percentages are assigned to each pool of loans.

The following table shows the loans that were evaluated for the allowance for loan losses under a specific reserve (individually) and those that were evaluated under a general reserve (collectively), and the amount of the allowance established in each category as of June 30, 2011:

(Dollars in thousands)	Residential Real Estate 1-4 Family Junior Liens & First Liens		Commercial Industrial & Commercial Agricultural Industrial & Real Estate Agricultural Consumer				Total
	Lines of Credit	Construction	Real Estate	Agricultural	Consumer		
<b>June 30, 2011</b>							
Loans evaluated for allowance:							
Individually	\$ 691	\$ 414	\$ 12,705	\$ 21,757	\$ 1,400	\$ -	\$ 36,967
Collectively	141,580	53,305	52,662	298,967	173,664	14,852	735,030
<b>Total</b>	<b>\$ 142,271</b>	<b>\$ 53,719</b>	<b>\$ 65,367</b>	<b>\$ 320,724</b>	<b>\$ 175,064</b>	<b>\$ 14,852</b>	<b>\$ 771,997</b>
ALL established for loans evaluated:							
Individually	\$ 202	\$ 3	\$ 1,211	\$ 3,980	\$ 681	\$ -	\$ 6,077
Collectively	327	310	1,181	664	1,180	411	4,073
ALL at June 30, 2011	\$ 529	\$ 313	\$ 2,392	\$ 4,644	\$ 1,861	\$ 411	\$ 10,150

During the second quarter, \$1.8 million was added to the allowance for loan losses (ALL) through the provision for loan loss expense. This compares to a provision expense of \$625 thousand for the second quarter of 2010. The second quarter provision expense includes approximately \$800 thousand for one shared-national-credit that is currently 90 days or more past due. Year-to-date, the provision expense was \$2.7 million compared to \$1.3 million in 2010. The provision expense that was added to the ALL exceeded net charge-offs (\$1.3 million) and the ALL increased from \$8.8 million at year-end 2010 to \$10.2 million at June 30, 2011. The ALL as a percentage of loans improved to 1.31% from 1.18% at December 31, 2010.

Charged-off loans usually result from: (1) a borrower being legally relieved of loan repayment responsibility through bankruptcy, (2) insufficient collateral sale proceeds to repay a loan; or (3) the borrower and/or guarantor does not own

other assets that, if sold, would generate sufficient sale proceeds to repay a loan.

The Bank recorded net loan charges-off of \$1.3 million for the year compared to \$436 thousand for the first six months of 2010. Residential real estate construction loans recorded the largest gross charge-offs for the year of \$737 thousand. The annualized net loan charge-off ratio was .35% compared to .12% for the same period in 2011 and .45% at the end of 2010.

In July 2011, the Bank recorded a charge-off of \$1.9 million on two commercial real estate secured loans to two related entities. The loans were part of a shared national credit in which the Bank was participating and the action was the result of regulatory direction after review of the credit at the lead bank. Of the \$1.9 million charge-off, \$1.1 million was 30 – 89 days past due and \$800 thousand was 90 days or more past due at June 30, 2011. The Corporation had \$1.9 million in specific allocation associated with this relationship at June 30, 2011.

Had the charge-off been recognized in the second quarter of 2011, non-performing loans and non-performing assets both would have dropped by \$833 thousand, and net charge-offs would have increased. The nonperforming loan ratio would have fallen from 4.24% to 4.13% and the nonperforming asset ratio would have decreased from 3.30% to 3.22%. Net charge-offs would have increased by \$1.9 million to \$3.2 million. The net charge-off ratio would have increased from .35% to .42%. In addition, the ratio of the allowance for loan losses to loans would have decreased to 1.07%

The following table presents an analysis of the allowance for loan losses for the periods ended:

(Dollars in thousands)	Residential Real Estate 1-4 Family Junior Liens & Construction			Commercial Industrial & Commercial Agricultural Industrial & Consumer			Total
	First Liens	Lines of Credit	Construction	Real Estate	Agricultural	Consumer	
ALL at March 31, 2011	\$ 612	\$ 292	\$ 2,342	\$ 4,216	\$ 1,447	\$ 289	\$ 9,198
Charge-offs	(45 )	(172 )	(337 )	(261 )	(41 )	(50 )	(906 )
Recoveries	17	5	-	47	4	18	91
Provision	(55 )	188	387	642	451	154	1,767
ALL at June 30, 2011	\$ 529	\$ 313	\$ 2,392	\$ 4,644	\$ 1,861	\$ 411	\$ 10,150
ALL at December 31, 2010	\$ 600	\$ 352	\$ 2,596	\$ 3,358	\$ 1,578	\$ 317	\$ 8,801
Charge-offs	(152 )	(177 )	(737 )	(422 )	(41 )	(114 )	(1,643 )
Recoveries	28	5	-	240	4	48	325
Provision	53	133	533	1,468	320	160	2,667
ALL at June 30, 2011	\$ 529	\$ 313	\$ 2,392	\$ 4,644	\$ 1,861	\$ 411	\$ 10,150
ALL at December 31, 2009	\$ 550	\$ 278	\$ 3,087	\$ 4,175	\$ 752	\$ 95	\$ 8,937
Charge-offs	(107 )	(165 )	(982 )	(1,736 )	(232 )	(452 )	(3,674 )
Recoveries	19	10	53	18	61	142	303
Provision	138	229	438	901	997	532	3,235
ALL at December 31, 2010	\$ 600	\$ 352	\$ 2,596	\$ 3,358	\$ 1,578	\$ 317	\$ 8,801
				June 30, 2011	December 31, 2010	June 30, 2010	
Net loans charged-off as a percentage of average gross loans				0.35	% 0.45	% 0.12	%
Net loans charged-off as a percentage of the provision for loan losses				49.42	% 104.20	% 34.88	%
Allowance as a percentage of loans				1.31	% 1.18	% 1.29	%
Net charge-offs (recoveries)				\$ 1,318	\$ 3,371	\$ 436	



Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy quarterly to the Credit Risk Oversight Committee of the Board of Directors. Management believes that the ALL at June 30, 2011 is adequate.

#### Other Assets:

Other assets include intangible assets, comprised of a core deposit intangible and a customer list that are being amortized over the estimated useful life of the asset.

#### Deposits:

Total deposits increased \$60.6 million during the first half of 2011 to \$794.9 million. Non-interest bearing deposits increased \$15.5 million, while savings and interest-bearing checking increased \$39.0 million and time deposits decreased \$6.1 million. The increase in non-interest bearing checking accounts came from commercial checking accounts (\$3.4 million) and retail checking accounts (\$3.4 million). The Bank's Money Management product increased \$24.2 million due primarily to an increase in the Bank's money market reciprocal deposit product available through Promontory Financial. Retail time deposits decreased since year-end, as customers moved funds to more liquid accounts. Brokered CDs increased \$13.3 million, which includes new brokered CDs of \$9.2 million. As of June 30, 2011, the Bank had \$20.7 million in CDARS reciprocal deposits included in brokered time deposits.

The following table presents a summary of deposits outstanding at:

(Dollars in thousands)	June 30, 2011	December 31, 2010	Change	
			Amount	%
Demand, noninterest-bearing checking	\$ 105,808	\$ 90,317	\$ 15,491	17.2
Interest-bearing checking	114,321	103,918	10,403	10.0
Money market accounts	314,000	289,763	24,237	8.4
Savings accounts	52,510	48,138	4,372	9.1
Total interest-bearing checking and savings	480,831	441,819	39,012	8.8
Retail time deposits	154,183	161,399	(7,216)	(4.5)
Brokered time deposits	54,078	40,796	13,282	32.6
Total time deposits	208,261	202,195	6,066	3.0
Total deposits	\$ 794,900	\$ 734,331	\$ 60,569	8.2
Overdrawn deposit accounts reclassified as loan balances	\$ 163	\$ 74		

#### Borrowings:

The balance of securities sold under agreements to repurchase, which are accounted for as collateralized financings, increased \$14.1 million from year-end and the long-term debt from the FHLB decreased \$21.6 million due to the prepayment of three term loans for \$15.6 million as well as scheduled amortization and maturities.

#### Shareholders' Equity:

Total shareholders' equity increased \$3.6 million to \$86.2 million at June 30, 2011, compared to \$82.6 million at the end of 2010. The increase in retained earnings from the Corporation's net income of \$3.6 million was partially offset by the cash dividend of \$2.1 million. The Corporation's dividend payout ratio is 58.8% compared to 50.6% in

2010. As capital levels become increasingly important during this difficult economic period, the Corporation decided to maintain its current dividend rate for the first three quarters of 2011 as a sign of confidence to its shareholders. Management views the dividend payout as a critical piece of its capital management plan. Additionally, the Corporation continues to explore other sources of capital as part of its capital management plan for the Corporation and the Bank. The Corporation did not repurchase any shares of the Corporation's common stock during the first half of 2011.

Effective September 30, 2010, the Corporation amended its dividend reinvestment plan for shareholders electing to purchase additional shares of the Corporation's common stock by reinvesting cash dividends paid on their shares or through optional cash payments. Under the amended plan, the Corporation has modified the minimum and maximum amounts that may be invested pursuant to the voluntary cash payment option under the plan, provided for the investment of voluntary cash payments as frequently as weekly, permitted participants to make voluntary cash payments via direct draft (ACH transfer); and modified the formula for determining the purchase price with respect to shares purchased under the plan directly from the Corporation. The Corporation also authorized an additional one million (1,000,000) shares of common stock. In the first half of 2011, these changes have added \$650 thousand to capital.

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. At June 30, 2011, the Corporation was well capitalized as defined by the banking regulatory agencies. Regulatory capital ratios for the Corporation and the Bank are shown below:

	June 30, 2011		December 31, 2010		Regulatory Ratios			
					Minimum		Well Capitalized Minimum	
<b>Total Risk Based Capital Ratio (1)</b>								
Franklin Financial Services Corporation	11.82	%	11.73	%	8.00	%	n/a	
Farmers & Merchants Trust Company	11.20	%	11.22	%	8.00	%	10.00	%
<b>Tier 1 Capital Ratio (2)</b>								
Franklin Financial Services Corporation	10.58	%	10.54	%	4.00	%	n/a	
Farmers & Merchants Trust Company	9.95	%	10.02	%	4.00	%	6.00	%
<b>Leverage Ratio (3)</b>								
Franklin Financial Services Corporation	8.10	%	8.16	%	4.00	%	n/a	
Farmers & Merchants Trust Company	7.61	%	7.73	%	4.00	%	5.00	%

(1)Total risk-based capital / total risk-weighted assets, (2)Tier 1 capital / total risk-weighted assets, (3) Tier 1 capital / average quarterly assets

#### Economy

The Corporation's primary market area includes Franklin, Fulton, Cumberland and Huntingdon County, PA. This area is diverse in demographic and economic makeup. County populations range from a low of approximately 15,000 in Fulton County to over 230,000 in Cumberland County. At June 30, 2011, the unemployment rate for Pennsylvania decreased to 7.8% and the national rate was 9.0%, while the unemployment rate in the Corporation's market area ranged from 6.6% in Cumberland County to 10.8% in Fulton County. The unemployment rates for the Bank's market area have remained high during the last three years along with state and national rates. As the recession lingers, housing prices have improved slightly over prior year, while mortgage delinquencies are consistent from the end of 2010.



The following table presents economic data for the Bank's primary market area:

Economic Data

	June 30, 2011	December 31, 2010
<b>Unemployment Rate (seasonally adjusted)</b>		
Market area range (1)	6.6 - 10.8 %	7.3% - 12.5 %
Pennsylvania	7.8 %	8.9 %
United States	9.0 %	9.6 %
<b>Housing Price Index - year over year change</b>		
PA, nonmetropolitan statistical area	-0.7 %	-1.5 %
United States	-3.1 %	-1.2 %
<b>Franklin County Building Permits - year over year change</b>		
Residential, estimated	-2.1 %	26.8 %
Multifamily, estimated	-29.5 %	-10.9 %
<b>Mortgage Delinquency</b>		
Market area range (1)	1.8 - 3.0 %	1.8% - 3.0 %
National	5.30 %	5.30 %

(1) Franklin, Cumberland, Fulton and Huntingdon Counties

Unlike many companies, the assets and liabilities of the Corporation are financial in nature. As such, interest rates and changes in interest rates may have a more significant effect on the Corporation's financial results than on other types of industries. Because of this, the Corporation watches the actions of the Federal Reserve Open Market Committee (FOMC) as it makes decisions about interest rate changes. The Fed continued to hold the fed funds target rate steady at .25% in the first six months of 2011.

#### Regulatory Issues

On July 21, 2010, the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). This legislation is one of the most comprehensive reform bills ever introduced to the financial services industry. Financial service providers from small community banks to the largest Wall Street firms will be affected by this legislation. Many of aspects of this Act will take effect over several years and the Corporation is still reviewing the details of the Act. At this time, it is difficult to predict the extent to which each component of Dodd-Frank will affect the Corporation. However, it is likely that the Act will impose a greater regulatory burden on the Corporation and increase its cost of compliance. Some of the key provisions included in Dodd-Frank that are likely to affect the Corporation are:

**Consumer Financial Protection Bureau (CFPB).** The CFPB has been created to set rules and regulations regarding consumer lending activities. Banks with less than \$10 billion in assets are exempt from examination by the CFPB, but the CFPB can require community banks to submit any information it requests for review. The CFPB will also require new disclosure requirements for all banks.

**FDIC Insurance.** Changes include permanently increasing the insurance limit to \$250,000, changing the assessment base from a deposit-based calculation to an asset-based calculation, and extending unlimited FDIC insurance on certain non-interest bearing depository accounts through December 31, 2012. The new assessment calculation method is effective for the second quarter assessment.



Corporate Checking. The prohibition against paying interest on corporate checking accounts has been lifted effective July 21, 2011. The Bank is currently researching the best way to take advantage of this change. The Bank currently has \$65 million in a sweep Repo product that it currently uses, for all intents and purposes, to pay interest on corporate checking accounts. The net effect on interest expense cannot currently be determined, but will be dependent on the type of product developed and customers' response to it. Any reduction in the Repo product balance will improve the Bank's liquidity by freeing up securities used as collateral.

Debit Card Fees. The Durbin Amendment to Dodd-Frank requires that the amount of any interchange fee charged by a debit card issuer must be reasonable and proportional to the cost incurred by the issuer. On June 29, 2011 the Federal Reserve released its final rule on debit card interchange fees to be effective October 1, 2011. The new rule establishes a base fee cap of 21 cents plus 5 basis points of the transaction amount to cover fraud losses. This rate cap applies only to banks with assets greater than \$10 billion; however, the Bank expects market forces to push the regulated prices down to all banks. If the Bank is subject to the new rate structure, it estimates that the potential loss in revenue on an annual basis to be approximately \$400 thousand.

Mortgage Licensing. Residential mortgage loan originators must register with the Nationwide Mortgage Licensing System and Registry. This registry is a database created by the states to support the licensing of mortgage originators. Employees of agency-related institutions must register prior to originating residential mortgage loans. This requirement will increase compliance costs for the Bank. The Bank has registered all required personnel.

Appraisals. New appraisal guidance sets forth the minimum regulatory standard for appraisals. It requires institutions to utilize strong internal controls to ensure reliable appraisals and evaluations to monitor and periodically update valuations of collateral for existing real estate loans. This is expected to increase compliance costs for the Corporation.

Compensation. At least once every three years, companies must conduct a non-binding shareholder vote (say-on-pay) to approve the compensation of the CEO and the company's "named executive officers". At least once every 6 years, shareholders must also vote on whether to hold the non-binding vote on executive compensation every 1, 2, or 3 years. Additionally, banking regulators have established guidance that prohibits incentive-based compensation arrangements that encourage inappropriate risks that could lead to material financial loss to the institution. Bank compensation plans will be required to be submitted to the appropriate regulator for review and monitoring of compliance. This is expected to increase compliance costs for the Corporation.

## Liquidity

The Corporation must meet the financial needs of the customers that it serves, while providing a satisfactory return on the shareholders' investment. In order to accomplish this, the Corporation must maintain sufficient liquidity in order to respond quickly to the changing level of funds required for both loan and deposit activity. The goal of liquidity management is to meet the ongoing cash flow requirements of depositors who want to withdraw funds and of borrowers who request loan disbursements. The Bank regularly reviews its liquidity position by measuring its projected net cash flows (in and out) at a 30 and 90-day interval. The Bank stresses this measurement by assuming a level of deposit out-flows within 30 days that have not historically been realized. In addition to this forecast, other funding sources are reviewed as a method to provide emergency funding if necessary. The objective of this measurement is to identify the amount of cash that could be raised quickly without the need to liquidate assets. The Bank also stresses its liquidity position utilizing different longer-term scenarios. The varying degrees of stress create pressure on deposit flows in its local market, reduce access to wholesale funding and limit access to funds available through brokered deposit channels. In addition to stressing cash flow, specific liquidity risk indicators are monitored to help identify risk areas. This analysis helps identify and quantify the potential cash surplus/deficit over a variety of time horizons to ensure the Bank has adequate funding resources. The Bank believes it can meet all anticipated liquidity demands.



Historically, the Corporation has satisfied its liquidity needs from earnings, repayment of loans and amortizing investment securities, maturing investment securities, loan sales, deposit growth and its ability to access existing lines of credit. All investments are classified as available for sale; therefore, securities that are not pledged as collateral for borrowings are an additional source of readily available liquidity, either by selling the security or, more preferably, to provide collateral for additional borrowing. However, at June 30, 2011, the Bank had approximately \$124 million (fair value) or 96% of its investment portfolio pledged as collateral. The primary source of liquidity for the Bank is a line of credit with the FHLB. At June 30, 2011, the Bank had approximately \$169 million available on this line of credit.

The Bank also has \$26 million in unsecured lines of credit at three correspondent banks and approximately \$31 million in funding available at the Federal Reserve Discount Window. The Bank also has the ability to access other funding sources including wholesale borrowings and brokered CDs. The Bank's ability to access brokered CDs could be negatively affected if its capital level was to fall below "well capitalized."

#### Off Balance Sheet Commitments and Contractual Obligations

The Corporation's 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 mainly of unfunded loans and letters of credit made under the same standards as on-balance sheet instruments. Because these instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk to the Corporation. Unused commitments and standby letters of credit totaled \$226.2 million and \$219.3 million, respectively, at June 30, 2011 and December 31, 2010.

The Corporation has entered into various contractual obligations to make future payments. These obligations include time deposits, long-term debt, operating leases, deferred compensation and pension payments. These amounts have not changed materially from those reported in the Corporation's 2010 Annual Report on Form 10-K.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

There were no material changes in the Corporation's exposure to market risk during the three months ended June 30, 2011. For more information on market risk refer to the Corporation's 2010 Annual Report on Form 10-K.

### Item 4. Controls and Procedures

#### Evaluation of Controls and Procedures

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2011, the Corporation's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in the Corporation's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

The management of the Corporation is responsible for establishing and maintaining adequate internal control over financial reporting. The Corporation's internal control system is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

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

#### Changes in Internal Controls

During the second quarter, an internal review discovered that tax-exempt commercial loans booked during the fourth quarter of 2008, 2009, 2010 and the first quarter of 2011 were not properly coded as tax-exempt. This resulted in the income from these loans being recorded as taxable income and the benefit of the tax-exempt status was not reflected in the Corporation's income tax calculation. This discovery led Management to the conclusion that there was failure of internal controls designed to prevent such errors. After discovery of the error, Management implemented a new process that requires a member of its Risk Management division to assign the appropriate code to the loan before it is booked, and for another member of its Risk Management division to review the code after the loan is booked. In addition, the Bank's Loan Servicing department has a dual control process to post and review loan data, and the authority to select or change existing coding has been more clearly defined. With the implementation of these new processes, Management believes that it has remediated the control weakness that was identified. During July 2011, the Bank upgraded its core processing system. We are currently reviewing all controls and procedures to ensure compliance with the new system.

Part II – OTHER INFORMATION

Item 1. Legal Proceedings

The nature of the Corporation's business generates a certain amount of litigation involving matters arising in the ordinary course of business. However, in management's opinion, there are no proceedings pending to which the Corporation is a party or to which our property is subject, which, if determined adversely to the Corporation, would be material in relation to our shareholders' equity or financial condition. In addition, no material proceedings are pending or are known to be threatened or contemplated against us by governmental authorities or other parties.

Item 1A. Risk Factors

There were no material changes in the Corporation's risk factors during the six months ended June 30, 2011. For more information, refer to the Corporation's 2010 Annual Report on Form 10-K.

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

The Corporation announced a stock repurchase plan on July 8, 2010 to repurchase up to 100,000 shares of the Corporation's common stock over a 12 month time period. There were no shares purchased in 2011 and this plan expired on July 8, 2011. The Corporation did not issue any unregistered equity securities during the quarter ended June 30, 2011.

Item 3. Defaults by the Company on its Senior Securities

None

Item 4. Removed and Reserved

Item 5. Other Information

None

Item 6. Exhibits

Exhibits

3.1 Articles of Incorporation of the Corporation. (Filed as Exhibit 3.1 to Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.)

3.2 Bylaws of the Corporation. (Filed as Exhibit 99 to Current Report on Form 8-K filed on December 20, 2004 and incorporated herein by reference.)

31.1 Rule 13a – 14(a)/15d-14(a) Certifications – Principal Executive Officer

31.2 Rule 13a – 14(a)/15d-14(a) Certifications – Principal Financial Officer

32.1 Section 1350 Certifications – Principal Executive Officer

32.2 Section 1350 Certifications – Principal Financial Officer

101.INS\*\* – XBRL Instance Document

101.SCH\*\* – XBRL Taxonomy Extension Schema

101.CAL\*\* – XBRL Taxonomy Extension Calculation Linkbase

101.DEF\*\* – XBRL Taxonomy Extention Definition Linkbase

101.LAB\*\* – XBRL Taxonomy Extention Label Linkbase

101.PRE\*\* – XBRL Taxonomy Extention Presentation Linkbase

\*\* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.



FRANKLIN FINANCIAL SERVICES CORPORATION  
and SUBSIDIARIES

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.

Franklin Financial Services Corporation

August 9, 2011

/s/ William E. Snell, Jr.  
William E. Snell, Jr.  
President and Chief Executive Officer  
(Authorized Officer)

August 9, 2011

/s/ Mark R. Hollar  
Mark R. Hollar  
Treasurer and Chief Financial Officer  
(Principal Financial Officer)