FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-Q
August 09, 2010

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

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

For the quarterly period ended June 30, 2010,

OR

o 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 | 25-1440803 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (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 x No o

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 o No o

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.

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

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

There were 3,888,866 outstanding shares of the Registrant's common stock as of July 30, 2010.

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# Part I FINANCIAL INFORMATION

## Item 1 Financial Statements

### Consolidated Balance Sheets
(Amounts in thousands, except share and per share data)
(unaudited)

| | June 30 2010 | December 31 2009 |
|---|---|---|
| Assets | | |
| Cash and due from banks | $ 16,881 | $ 14,336 |
| Interest-bearing deposits in other banks | 20,130 | 18,912 |
| Total cash and cash equivalents | 37,011 | 33,248 |
| Investment securities available for sale | 128,347 | 143,288 |
| Restricted stock | 6,482 | 6,482 |
| Loans | 758,411 | 739,563 |
| Allowance for loan losses | (9,751) | (8,937) |
| Net Loans | 748,660 | 730,626 |
| Premises and equipment, net | 16,282 | 15,741 |
| Bank owned life insurance | 19,251 | 18,919 |
| Goodwill | 9,016 | 9,159 |
| Other intangible assets | 2,232 | 2,461 |
| Other assets | 19,324 | 19,449 |
| Total assets | $ 986,605 | $ 979,373 |
| | | |
| Liabilities | | |
| Deposits | | |
| Demand (non-interest bearing) | $ 90,324 | $ 77,675 |
| Savings and interest-bearing checking | 421,671 | 388,222 |
| Time | 218,362 | 272,468 |
| Total Deposits | 730,357 | 738,365 |
| Securities sold under agreements to repurchase | 68,622 | 55,855 |
| Long-term debt | 93,796 | 94,688 |
| Other liabilities | 12,673 | 11,699 |
| Total liabilities | 905,448 | 900,607 |
| | | |
| Shareholders' equity | | |
| Common stock $1 par value per share, 15,000,000 shares authorized with 4,298,904 shares issued, and 3,888,368 shares and 3,863,066 shares outstanding at June 30, 2010 and December 31, 2009, respectively | 4,299 | 4,299 |
| Capital stock without par value, 5,000,000 shares authorized with no shares issued or outstanding | - | - |
| Additional paid-in capital | 32,806 | 32,832 |
| Retained earnings | 56,610 | 54,566 |
| Accumulated other comprehensive loss | (5,217) | (5,138) |
| Treasury stock, 410,536 shares and 435,838 shares at cost at June 30, 2010 and December 31, 2009, respectively | (7,341) | (7,793) |

| | | | | |
|---|---|---|---|---|
| Total shareholders' equity | | 81,157 | | 78,766 |
| Total liabilities and shareholders' equity | $ | 986,605 | $ | 979,373 |

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

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

| | For the Three Months Ended June 30 | | For the Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Interest income | | | | |
| Loans, including fees | $ 9,691 | $ 9,463 | $ 19,242 | $ 18,655 |
| Interest and dividends on investments: | | | | |
| Taxable interest | 758 | 1,017 | 1,628 | 2,106 |
| Tax exempt interest | 397 | 463 | 869 | 937 |
| Dividend income | 10 | 39 | 27 | 96 |
| Federal funds sold | - | 6 | - | 6 |
| Deposits and obligations of other banks | 10 | 1 | 16 | 1 |
| Total interest income | 10,866 | 10,989 | 21,782 | 21,801 |
| | | | | |
| Interest expense | | | | |
| Deposits | 2,204 | 2,535 | 4,563 | 5,018 |
| Securities sold under agreements to repurchase | 40 | 45 | 77 | 90 |
| Short-term borrowings | - | - | - | 11 |
| Long-term debt | 977 | 1,050 | 1,951 | 2,105 |
| Total interest expense | 3,221 | 3,630 | 6,591 | 7,224 |
| Net interest income | 7,645 | 7,359 | 15,191 | 14,577 |
| Provision for loan losses | 625 | 426 | 1,250 | 1,019 |
| Net interest income after provision for loan losses | 7,020 | 6,933 | 13,941 | 13,558 |
| | | | | |
| Noninterest income | | | | |
| Investment and trust services fees | 1,007 | 862 | 2,024 | 1,757 |
| Loan service charges | 272 | 378 | 469 | 653 |
| Mortgage banking activities | 11 | 118 | 81 | 91 |
| Deposit service charges and fees | 593 | 653 | 1,171 | 1,232 |
| Other service charges and fees | 351 | 339 | 677 | 641 |
| Increase in cash surrender value of life insurance | 166 | 160 | 332 | 324 |
| Other | 22 | 29 | 70 | 325 |
| | | | | |
| OTTI losses on securities | - | (212) | (689) | (421) |
| Loss recognized in other comprehensive income (before taxes) | - | - | (434) | - |
| Net OTTI losses recognized in earnings | - | (212) | (255) | (421) |
| | | | | |
| Securities gains, net | 20 | 42 | 268 | 54 |
| Total noninterest income | 2,442 | 2,369 | 4,837 | 4,656 |
| | | | | |
| Noninterest Expense | | | | |
| Salaries and benefits | 3,322 | 3,126 | 6,762 | 6,279 |
| Net occupancy expense | 496 | 476 | 1,019 | 956 |
| Furniture and equipment expense | 191 | 213 | 382 | 429 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Advertising | | 343 | | 418 | | 655 | | 734 |
| Legal and professional fees | | 350 | | 293 | | 745 | | 545 |
| Data processing | | 502 | | 435 | | 879 | | 836 |
| Pennsylvania bank shares tax | | 152 | | 143 | | 308 | | 288 |
| Intangible amortization | | 114 | | 117 | | 229 | | 234 |
| FDIC insurance | | 288 | | 683 | | 580 | | 914 |
| Other | | 767 | | 1,062 | | 1,627 | | 1,900 |
| Total noninterest expense | | 6,525 | | 6,966 | | 13,186 | | 13,115 |
| Income before federal income taxes | | 2,937 | | 2,336 | | 5,592 | | 5,099 |
| Federal income tax expense | | 778 | | 697 | | 1,459 | | 1,359 |
| Net income | $ | 2,159 | $ | 1,639 | $ | 4,133 | $ | 3,740 |
| | | | | | | | | |
| Per share | | | | | | | | |
| Basic earnings per share | $ | 0.56 | $ | 0.43 | $ | 1.07 | $ | 0.98 |
| Diluted earnings per share | $ | 0.56 | $ | 0.43 | $ | 1.07 | $ | 0.98 |
| Cash dividends declared per share | $ | 0.27 | $ | 0.27 | $ | 0.54 | $ | 0.54 |

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, 2010 and 2009
(unaudited)

| (Dollars in thousands, except share and per share data) | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total |
|---|---|---|---|---|---|---|
| Balance at December 31, 2008 | $ 4,299 | $ 32,883 | $ 52,126 | $ (7,757) | $ (8,492) | $ 73,059 |
| | | | | | | |
| Comprehensive income: | | | | | | |
| Net income | - | - | 3,740 | - | - | 3,740 |
| Unrealized gain on securities, net of reclassification adjustments and taxes | - | - | - | 114 | - | 114 |
| Unrealized gain on hedging activities, net of reclassification adjustments and taxes | - | - | - | 815 | - | 815 |
| Total Comprehensive income | | | | - | | 4,669 |
| | | | | | | |
| Cash dividends declared, $.54 per share | - | - | (2,068) | - | - | (2,068) |
| Acquisition of 5,640 shares of treasury stock | - | - | - | - | (93) | (93) |
| Treasury shares issued to dividend reinvestment plan: 23,496 shares | - | (50) | - | - | 420 | 370 |
| Stock option compensation | - | 20 | - | - | - | 20 |
| Balance at June 30, 2009 | $ 4,299 | $ 32,853 | $ 53,798 | $ (6,828) | $ (8,165) | $ 75,957 |
| | | | | | | |
| Balance at December 31, 2009 | $ 4,299 | $ 32,832 | $ 54,566 | $ (5,138) | $ (7,793) | $ 78,766 |
| | | | | | | |
| Comprehensive income: | | | | | | |
| 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 |

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

Consolidated Statements of Cash Flows
(unaudited)

| | For the Six Months Ended June 30 2010 | 2009 |
|---|---|---|
| (Amounts in thousands) | | |
| Cash flows from operating activities | | |
| Net income | $ 4,133 | $ 3,740 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 672 | 717 |
| Net amortization of loans and investment securities | 152 | 46 |
| Stock option compensation expense | - | 20 |
| Amortization and net change in mortgage servicing rights valuation | 73 | 71 |
| Amortization of intangibles | 229 | 234 |
| Provision for loan losses | 1,250 | 1,019 |
| Net realized gains on sales of securities | (268) | (54) |
| OTTI losses on securities | 255 | 421 |
| 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) | 118 |
| Net gain on sale or disposal of other real estate/other repossessed assets | - | (6) |
| Increase in cash surrender value of life insurance | (332) | (324) |
| Gain from surrender of life insurance policy | - | (276) |
| Contribution to pension plan | (525) | (87) |
| Decrease in interest receivable and other assets | 239 | 841 |
| Increase in interest payable and other liabilities | 130 | 389 |
| Other, net | 90 | 102 |
| Net cash provided by operating activities | 6,094 | 6,971 |
| | | |
| Cash flows from investing activities | | |
| Proceeds from sales of investment securities available for sale | 6,378 | 7,364 |
| Proceeds from maturities and paydowns of investment securities available for sale | 15,341 | 13,976 |
| Purchase of investment securities available for sale | (6,081) | (21,132) |
| Net increase in loans | (19,447) | (28,375) |
| Proceeds from sale of other real estate/other repossessed assets | 440 | 33 |
| Proceeds from surrender of life insurance policy | - | 600 |
| Capital expenditures | (1,166) | (896) |
| Net cash used in investing activities | (4,535) | (28,430) |
| | | |
| Cash flows from financing activities | | |
| Net increase in demand deposits, interesting-bearing checking and savings accounts | 46,098 | 17,021 |
| Net (decrease) increase in time deposits | (54,106) | 65,631 |
| Net increase (decrease) in short-term borrowings | 12,767 | (18,146) |
| Long-term debt payments | (892) | (2,960) |
| Long-term debt advances | - | 260 |
| Dividends paid | (2,089) | (2,068) |
| Common stock issued to dividend reinvestment plan | 410 | 370 |

| | | | | |
|---|---|---|---|---|
| Common stock issued under stock option plans | | 16 | | - |
| Purchase of treasury shares | | - | | (93) |
| Net cash provided by financing activities | | 2,204 | | 60,015 |
| Increase in cash and cash equivalents | | 3,763 | | 38,556 |
| Cash and cash equivalents as of January 1 | | 33,248 | | 16,713 |
| Cash and cash equivalents as of June 30 | $ | 37,011 | $ | 55,269 |
| | | | | |
| Supplemental Disclosures of Cash Flow Information | | | | |
| Cash paid during the year for: | | | | |
| Interest on deposits and other borrowed funds | $ | 6,874 | $ | 7,365 |
| Income taxes | $ | 2,602 | $ | 1,494 |
| Noncash Activities | | | | |
| Loans transferred to Other Real Estate | $ | - | $ | 413 |

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, 2010, 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 2009 Annual Report on Form 10-K. The consolidated results of operations for the period ended June 30, 2010 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, 2009 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:

| | For the Three Months Ended June 30 | | For the Six Months Ended June 30 | |
|---|---|---|---|---|
| (In thousands, except per share data) | 2010 | 2009 | 2010 | 2009 |
| Weighted average shares outstanding (basic) | 3,880 | 3,837 | 3,874 | 3,832 |
| Impact of common stock equivalents | 3 | - | 2 | - |
| Weighted average shares outstanding (diluted) | 3,883 | 3,837 | 3,876 | 3,832 |
| Anti-dilutive options excluded from the calculation | 76 | 109 | 76 | 110 |
| Net income | $ 2,159 | $ 1,639 | $ 4,133 | $ 3,740 |
| Basic earnings per share | $ 0.56 | $ 0.43 | $ 1.07 | $ 0.98 |
| Diluted earnings per share | $ 0.56 | $ 0.43 | $ 1.07 | $ 0.98 |

Note 2 – Recent Accounting Pronouncements

Receivables and the Allowances for Credit Losses. In July 2010, the FASB issued Accounting Standards Update No. (ASU) 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowances for Credit Losses. This Update requires expanded disclosures to help financial statement users understand the nature of credit risks inherent in a creditor's portfolio of financing receivables; how that risk is analyzed and assessed in arriving at the allowance for credit losses; and the changes, and reasons for those changes, in both the receivables and the allowance for credit losses. The disclosures should be prepared on a disaggregated basis and provide a roll-forward schedule of the allowance for credit losses and detailed information on financing receivables including, among other things, recorded balances, nonaccrual status, impairments, credit quality indicators, details for troubled debt restructurings and an aging of past due financing receivables. Disclosures required as of the end of a reporting period are effective for interim and annual reporting periods ending after December 15, 2010. Disclosures required for activity occurring during a reporting period are effective for interim and annual reporting periods beginning after December 15, 2010. This Update is not expected to have a material impact on the Corporation's financial position or consolidated financial statements.

Fair Value Measurements and Disclosures. The FASB has issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. This ASU requires some new disclosures and clarifies some existing disclosure requirements about fair value measurement as set forth in Codification Subtopic 820-10. The FASB's objective is to improve these disclosures and, thus, increase the transparency in financial reporting. Specifically, ASU 2010-06 amends Codification Subtopic 820-10 to now require a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; and in the reconciliation for fair value measurements using significant unobservable inputs, a reporting entity should present separately information about purchases, sales, issuances, and settlements. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The Corporation early adopted ASU 2010-09 effective with the quarter end June 30, 2010.

Transfers and Servicing. In October 2009, the FASB issued ASU 2009-16, Transfers and Servicing (Topic 860) - Accounting for Transfers of Financial Assets. This Update amends the Codification for the issuance of FASB Statement No. 166, Accounting for Transfers of Financial Assets-an amendment of FASB Statement No. 140. The amendments in this Update improve financial reporting by eliminating the exceptions for qualifying special-purpose entities from the consolidation guidance and the exception that permitted sale accounting for certain mortgage securitizations when a transferor has not surrendered control over the transferred financial assets. In addition, the amendments require enhanced disclosures about the risks that a transferor continues to be exposed to because of its continuing involvement in transferred financial assets. Comparability and consistency in accounting for transferred financial assets will also be improved through clarifications of the requirements for isolation and limitations on portions of financial assets that are eligible for sale accounting. This Update was effective January 1, 2010 for the Corporation and there was no material affect on its operating results, financial position or consolidated financial statements.

Note 3 – Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on available-for-sale securities and derivatives and the change in plan assets and benefit obligations on the Bank’s pension plan, net of tax, that are recognized as separate components of shareholders’ equity.

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

| (Amounts in thousands) | For the Three Months Ended June 30 | | For the Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Net Income | $ 2,159 | $ 1,639 | $ 4,133 | $ 3,740 |
| | | | | |
| Securities: | | | | |
| Unrealized (losses) gains arising during the period | (690) | 1,882 | 744 | (196) |
| Reclassification adjustment for losses (gains) included in net income | (20) | 170 | (13) | 367 |
| Net unrealized (losses) gains | (710) | 2,052 | 731 | 171 |
| Tax effect | 241 | (698) | (249) | (57) |
| Net of tax amount | (469) | 1,354 | 482 | 114 |
| | | | | |
| Derivatives: | | | | |
| Unrealized (losses) gains arising during the period | (677) | 777 | (1,015) | 885 |
| Reclassification adjustment for losses included in net income | 174 | 177 | 354 | 350 |
| Net unrealized (losses) gains | (503) | 954 | (661) | 1,235 |
| Tax effect | 171 | (323) | 226 | (420) |
| Net of tax amount | (332) | 631 | (435) | 815 |
| | | | | |
| Pension: | | | | |
| 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 (loss) income | (801) | 1,985 | (79) | 929 |
| Total Comprehensive Income | $ 1,358 | $ 3,624 | $ 4,054 | $ 4,669 |

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

| (Amounts in thousands) | June 30 2010 | December 31 2009 |
|---|---|---|
| Net unrealized losses on securities | $ (1,098) | $ (1,829) |
| Tax effect | 373 | 622 |
| Net of tax amount | (725) | (1,207) |
| | | |
| Net unrealized losses on derivatives | (1,924) | (1,263) |
| Tax effect | 655 | 429 |
| Net of tax amount | (1,269) | (834) |
| | | |
| Accumulated pension adjustment | (4,883) | (4,692) |
| Tax effect | 1,660 | 1,595 |
| Net of tax amount | (3,223) | (3,097) |

| | | | | |
|---|---|---|---|---|
| Total accumulated other comprehensive loss | $ | (5,217) | $ | (5,138) |

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 $28.3 million and $26.7 million of standby letters of credit as of June 30, 2010 and December 31, 2009, 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, 2010 and December 31, 2009 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, 2010 and December 31, 2009 are:

| (Amounts in thousands) June 30, 2010 | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
|---|---|---|---|---|
| Equity securities | $ 5,401 | $ 65 | $ (1,444) | $ 4,022 |
| U.S. Treasury securities and obligations of U.S. Government agencies | 22,723 | 414 | (95) | 23,042 |
| Obligations of state and political subdivisions | 40,852 | 1,186 | (46) | 41,992 |
| Corporate debt securities | 8,611 | 26 | (1,787) | 6,850 |
| Mortgage-backed securities | | | | |
| Agency | 46,726 | 1,408 | (11) | 48,123 |
| Non-Agency | 5,051 | - | (786) | 4,265 |
| Asset-backed securities | 81 | - | (28) | 53 |
| | $ 129,445 | $ 3,099 | $ (4,197) | $ 128,347 |

| (Amounts in thousands) December 31, 2009 | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
|---|---|---|---|---|
| Equity securities | $ 5,400 | $ 37 | $ (1,462) | $ 3,975 |
| U.S. Treasury securities and obligations of U.S. Government agencies | 28,258 | 618 | (161) | 28,715 |
| Obligations of state and political subdivisions | 42,611 | 1,332 | (62) | 43,881 |
| Corporate debt securities | 9,603 | - | (2,343) | 7,260 |
| Mortgage-backed securities | | | | |
| Agency | 53,214 | 1,576 | (47) | 54,743 |
| Non-Agency | 5,947 | - | (1,279) | 4,668 |
| Asset-backed securities | 84 | - | (38) | 46 |
| | $ 145,117 | $ 3,563 | $ (5,392) | $ 143,288 |

The book value of securities pledged as collateral to secure various funding sources was $116.5 million at June 30, 2010 and $134.6 million at December 31, 2009.

The amortized cost and estimated fair value of debt securities as of June 30, 2010, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

| (Amounts in thousands) | Amortized cost | Estimated fair value |
|---|---|---|
| Due in one year or less | $ 3,438 | $ 3,450 |
| Due after one year through five years | 15,043 | 15,324 |
| Due after five years through ten years | 26,228 | 27,171 |
| Due after ten years | 27,558 | 25,992 |
| | 72,267 | 71,937 |
| Mortgage-backed securities | 51,777 | 52,388 |
| | | |
| | $ 124,044 | $ 124,325 |

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, 2010 and December 31, 2009:

| | June 30, 2010 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less than 12 months | | | 12 months or more | | | Total | | |
| (Amounts in thousands) | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Equity securities | $ 1,840 | $ (287) | 2 | $ 1,796 | $ (1,157) | 22 | $ 3,636 | $ (1,444) | 24 |
| U.S. Treasury securities and obligations of U.S. Government agencies | 76 | - | 2 | 9,654 | (95) | 20 | 9,730 | (95) | 22 |
| Obligations of state and political subdivisions | 2,528 | (31) | 7 | 292 | (15) | 1 | 2,820 | (46) | 8 |
| Corporate debt securities | - | - | - | 6,096 | (1,787) | 9 | 6,096 | (1,787) | 9 |
| Mortgage-backed securities | | | | | | | | | |
| Agency | 1,727 | (9) | 3 | 699 | (2) | 1 | 2,426 | (11) | 4 |
| Non-Agency | - | - | - | 4,265 | (786) | 7 | 4,265 | (786) | 7 |
| Asset-backed securities | - | - | - | 53 | (28) | 3 | 53 | (28) | 3 |
| Total temporarily impaired securities | $ 6,171 | $ (327) | 14 | $ 22,855 | $ (3,870) | 63 | $ 29,026 | $ (4,197) | 77 |

| | December 31, 2009 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less than 12 months | | | 12 months or more | | | Total | | |
| (Amounts in thousands) | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Equity securities | $ 2,343 | $ (395) | 7 | $ 1,494 | $ (1,067) | 21 | $ 3,837 | $ (1,462) | 28 |
| U.S. Treasury securities and | 63 | - | 3 | 13,411 | (161) | 27 | 13,474 | (161) | 30 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| obligations of U.S. Government agencies | | | | | | | | | |
| Obligations of state and political subdivisions | 1,843 | (41) | 6 | 285 | (21) | 1 | 2,128 | (62) | 7 |
| Corporate debt securities | 622 | (1) | 5 | 6,537 | (2,342) | 10 | 7,159 | (2,343) | 15 |
| Mortgage-backed securities | | | | | | | | | |
| Agency | 10,812 | (47) | 9 | - | - | - | 10,812 | (47) | 9 |
| Non-Agency | - | - | - | 4,668 | (1,279) | 7 | 4,668 | (1,279) | 7 |
| Asset-backed securities | - | - | - | 46 | (38) | 3 | 46 | (38) | 3 |
| Total temporarily impaired securities | $ 15,683 | $ (484) | 30 | $ 26,441 | $ (4,908) | 69 | $ 42,124 | $ (5,392) | 99 |

The following table reflects additional information about trust preferred securities as of June 30, 2010:

Trust Preferred Securities
June 30, 2010

(Dollars in thousands)

| Deal Name | Single Issuer or Pooled | Class | Amortized Cost | Estimated 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 | $ 926 | $ 595 | $ (331) | Ba1 | 1 | None | None |
| Huntingtn Cap Trust II | Single | Preferred Stock | 870 | 565 | (305) | Ba1 | 1 | None | None |
| BankAmerica Cap III | Single | Preferred Stock | 954 | 673 | (281) | Baa3 | 1 | None | None |
| Wachovia Cap Trust II | Single | Preferred Stock | 272 | 230 | (42) | Baa2 | 1 | None | None |
| Corestates Captl Tr II | Single | Preferred Stock | 921 | 619 | (302) | Baa1 | 1 | None | None |
| Chase Cap VI JPM | Single | Preferred Stock | 955 | 779 | (176) | A2 | 1 | None | None |
| Fleet Cap Tr V | Single | Preferred Stock | 970 | 732 | (238) | Baa3 | 1 | None | None |
| | | | $ 5,868 | $ 4,193 | $ (1,675) | | | | |

The following table provides additional detail about private label mortgage-backed securities as of June 30, 2010:

Private Label Mortgage Backed Securities
June 30, 2010

(Dollars in thousands)

| Decscription | Orgination Date | Amortized Cost | Fair Value | Gross Unrealized Gain (Loss) | Collateral Type | Current Rating | Credit Support % | OTTI Charges |
|---|---|---|---|---|---|---|---|---|
| RALI 2003-QS15 A1 | 8/1/2003 | $ 715 | $ 694 | $ (21) | ALT A | Aa2 | 11.29 | $ - |
| RALI 2004-QS4 A7 | 3/1/2004 | 666 | 652 | (14) | ALT A | AAA | 13.03 | - |
| MALT 2004-6 7A1 | 6/1/2004 | 780 | 650 | (130) | ALT A | AAA | 10.52 | - |
| RALI 2005-QS2 A1 | 2/1/2005 | 730 | 608 | (121) | ALT A | B | 7.70 | - |
| RALI 2006-QS4 A2 | 4/1/2006 | 1,044 | 756 | (288) | ALT A | Caa2 | 0.68 | 142 |
| GSR 2006-5F | 5/1/2006 | 544 | 479 | (65) | Prime | CCC | 4.64 | - |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| 2A1 | | | | | | | | |
| RALI 2006-QS8 A1 | 7/28/2006 | 572 | 426 | (146) | ALT A | Caa2 | 0.00 | 113 |
| | | $ 5,051 | $ 4,265 | $ (786) | | | | $ 255 |

For more information concerning investments, refer to the Investment Securities discussion in the Financial Condition section.

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Note 6 – Pensions

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

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| (Amounts in thousands) | 2010 | 2009 | 2010 | 2009 |
| Components of net periodic (benefit) cost: | | | | |
| Service cost | $ 91 | $ 85 | $ 183 | $ 170 |
| Interest cost | 185 | 181 | 371 | 362 |
| Expected return on plan assets | (209) | (190) | (419) | (380) |
| Amortization of prior service cost | - | (31) | - | (62) |
| Recognized net actuarial loss | 43 | 82 | 86 | 165 |
| Net periodic cost | $ 110 | $ 127 | $ 221 | $ 255 |

The Bank expects its pension expense to decrease slightly in 2010 compared to 2009. The Bank expects to contribute $626 thousand to its pension plan in 2010. This amount will meet the minimum funding requirements.

Note 7 – Mortgage Servicing Rights

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

| | Six Months Ended June 30 | |
|---|---|---|
| (Amounts in thousands) | 2010 | 2009 |
| Cost of mortgage servicing rights: | | |
| Beginning balance | $ 1,190 | $ 1,551 |
| Originations | 10 | 3 |
| Amortization | (134) | (214) |
| Ending balance | $ 1,066 | $ 1,340 |
| | | |
| Valuation allowance: | | |
| Beginning balance | $ (476) | $ (689) |
| Valuation charges | - | - |
| Valuation reversals | 60 | 143 |
| Ending balance | $ (416) | $ (546) |
| | | |
| Mortgage servicing rights cost | $ 1,066 | $ 1,340 |
| Valuation allowance | (416) | (546) |
| Carrying value | $ 650 | $ 794 |
| | | |
| Fair value | $ 650 | $ 794 |

Note 8 – 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:

| | June 30, 2010 | | December 31, 2009 | |
|---|---|---|---|---|
| (Amounts in thousands) | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | | | | |
| Cash and cash equivalents | $ 37,011 | $ 37,011 | $ 33,248 | $ 33,248 |
| Investment securities available for sale | 128,347 | 128,347 | 143,288 | 143,288 |
| Restricted stock | 6,482 | 6,482 | 6,482 | 6,482 |
| Net loans | 748,660 | 753,792 | 730,626 | 742,929 |
| Accrued interest receivable | 3,805 | 3,805 | 3,904 | 3,904 |
| Mortgage servicing rights | 650 | 650 | 714 | 714 |
| Financial liabilities: | | | | |
| Deposits | $ 730,357 | $ 733,021 | $ 738,365 | $ 742,953 |
| Securities sold under agreements to repurchase | 68,622 | 68,622 | 55,855 | 55,855 |
| Long-term debt | 93,796 | 97,523 | 94,688 | 99,013 |
| Accrued interest payable | 1,005 | 1,005 | 1,288 | 1,288 |
| Interest rate swaps | 1,924 | 1,924 | 1,263 | 1,263 |

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 at June 30, 2010 and December 31, 2009:

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 as discussed below.

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 is based on observable market prices when available or the present value of expected future cash flows when not available. Assumptions, such as loan default rates, costs to service, and prepayment speeds significantly affect the estimate of future cash flows. Mortgage servicing rights are carried at the lower of cost or fair value.

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.

Off balance sheet financial instruments: Outstanding commitments to extend credit and commitments under standby letters of credit include fixed and variable rate commercial and consumer commitments. The fair value of the commitments is estimated using the fees currently charged to enter into similar agreements.

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.

Level2: 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.

Level3: 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, 2010.

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, 2010 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Asset Description | | | | |
| Equity securities | $ 4,022 | $ - | $ - | $ 4,022 |
| U.S. Treasury securities and obligations of U.S. | | | | |
| Government agencies | - | 23,042 | - | 23,042 |
| Obligations of state and political subdivisions | - | 41,992 | - | 41,992 |
| Corporate debt securities | - | 6,850 | - | 6,850 |
| Mortgage-backed securities | | | | |
| Agency | - | 48,123 | - | 48,123 |
| Non-Agency | - | 4,265 | - | 4,265 |
| Asset-backed securities | - | 53 | - | 53 |
| Total assets | $ 4,022 | $ 124,325 | $ - | $ 128,347 |
| | | | | |
| Liability Description | | | | |
| Interest rate swaps | $ - | $ 1,924 | $ - | $ 1,924 |
| Total liabilities | $ - | $ 1,924 | $ - | $ 1,924 |

| (Dollars in Thousands) | Fair Value at December 31, 2009 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Asset Description | | | | |
| Equity securities | $ 3,975 | $ - | $ - | $ 3,975 |
| U.S. Treasury securities and obligations of U.S. | | | | |
| Government agencies | - | 28,715 | - | 28,715 |
| Obligations of state and political subdivisions | - | 43,881 | - | 43,881 |
| Corporate debt securities | - | 7,260 | - | 7,260 |
| Mortgage-backed securities | | | | |
| Agency | - | 54,743 | - | 54,743 |
| Non-Agency | - | 4,668 | - | 4,668 |
| Asset-backed securities | - | 46 | - | 46 |
| Total assets | $ 3,975 | $ 139,313 | $ - | $ 143,288 |
| | | | | |
| Liability Description | | | | |
| Interest rate swaps | $ - | $ 1,263 | $ - | $ 1,263 |
| Total liabilities | $ - | $ 1,263 | $ - | $ 1,263 |

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.

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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)

| | Fair Value at June 30, 2010 | | | |
|---|---|---|---|---|
| Asset Description | Level 1 | Level 2 | Level 3 | Total |
| Impaired loans | $ - | $ - | $ 15,690 | 15,690 |
| Other real estate owned | - | - | 229 | 229 |
| Mortgage servicing rights | - | - | 650 | 650 |
| Total assets | $ - | $ - | $ 16,569 | $ 16,569 |

| (Dollars in Thousands) | Fair Value at December 31, 2009 | | | |
|---|---|---|---|---|
| Asset Description | Level 1 | Level 2 | Level 3 | Total |
| Impaired loans | $ - | $ - | $ 7,943 | $ 7,943 |
| Other real estate owned | - | - | 643 | 643 |
| Mortgage servicing rights | - | - | 714 | 714 |
| Total assets | $ - | $ - | $ 9,300 | $ 9,300 |

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.

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.

The following table presents a reconciliation of impaired loans, foreclosed real estate and mortgage servicing rights measured at fair value on a nonrecurring basis, using significant unobservable inputs (Level 3) for the six months ended June 30, 2010:

| (Dollars in Thousands) | Impaired Loans | Foreclosed Real Estate | Mortgage Servicing Rights |
|---|---|---|---|
| Balance - January 1, 2010 | $ 7,943 | $ 643 | $ 714 |
| Charged off | (273) | - | - |
| Settled or otherwise removed | (555) | (414) | - |
| Additions | 9,985 | - | 10 |
| Payments / amortization | (507) | - | (134) |
| (Increase) decrease in valuation allowance | (903) | - | 60 |
| Balance - June 30, 2010 | $ 15,690 | $ 229 | $ 650 |

Note 9 – 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. During 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, 2010 follows:

(Dollars in thousands)

| Notional Amount | Maturity Date | Interest Rate Fixed | Interest Rate Variable | Amount Expected to be Expensed into Earnings within the next 12 Months |
|---|---|---|---|---|
| $ 10,000 | 5/30/2013 | 3.60% | 0.16% | $ 344 |
| $ 10,000 | 5/30/2015 | 3.87% | 0.16% | $ 371 |

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, 2010 and December 31, 2009 are as follows:

Fair Value of Derivative Instruments

(Dollars in thousands)

| Date | Type | Balance Sheet Location | Fair Value |
|---|---|---|---|
| June 30, 2010 | Interest rate contracts | Other liabilities | $ 1,924 |
| December 31, 2009 | Interest rate contracts | Other liabilities | $ 1,263 |

The Effect of Derivative Instruments on the Statement of Income for the Six Months Ended June 30, 2010 and 2009 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships

(Dollars in thousands, net of tax)

| Date / Type | Amount of Gain or (Loss) Recognized in OCI 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 and Amount Excluded from Effectiveness Testing) | Amount of Gain or (Loss) Recognized in Income on Derivatives (Ineffective Portion and Amount Excluded from Effectiveness Testing) |
|---|---|---|---|---|---|
| June 30, 2010: | | | | | |
| Interest rate contracts | $ (435) | Interest Expense | $ (355) | Other income (expense) | $ - |
| | | | | | |
| June 30, 2009: | | | | | |
| Interest rate contracts | $ 815 | Interest Expense | $ (350) | Other income (expense) | $ - |

Note 10 – Reclassifications

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

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Item 2

Management's Discussion and Analysis of Results of Operations and Financial Condition
For the Three and Six Month Periods Ended June 30, 2010 and 2009

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 ris 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 2009 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 2009 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Results of Operations

Year-to-Date Summary

The Corporation reported net income for the first six months ended June 30, 2010 of $4.1 million. This is a 10.5% increase versus net income of $3.7 million for the same period in 2009. Total revenue (interest income and noninterest income) increased $162 thousand year-over-year. Interest income decreased slightly due to decreases in interest income in the investment portfolio, while investment and trust revenue, as well as security gains helped improve noninterest income. Noninterest expense increased due to increased salary and benefit expense and higher legal and professional fees. The provision for loan losses was $1.3 million for the period, $231 thousand more than in 2009. Diluted earnings per share increased to $1.07 in 2010 from $.98 in 2009. Total assets were $986.6 million at June 30, 2010, an increase of $7.2 million from year-end 2009. Net loans grew to $748.7 million, while total deposits decreased to $730.4 million.

Other key performance ratios as of, or for the six months ended June 30, 2010 and 2009 (on an annualized basis) are listed below:

| | 2010 | 2009 |
|---|---|---|
| Return on average equity (ROE) | 10.21% | 9.99% |
| Return on average assets (ROA) | .84% | .80% |
| Return on average tangible average equity(1) | 12.55% | 12.54% |
| Return on average tangible average assets(1) | .89% | .86% |
| Net interest margin | 3.46% | 3.54% |
| Efficiency ratio | 64.25% | 65.18% |

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(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 and six months ended June 30, 2010 follows:

Comparison of the three months ended June 30, 2010 to the three months ended June 30, 2009:

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. All balance sheet amounts in the discussion of net interest income refer to either year-to-date or quarterly average balances.

Interest income for the second quarter of 2010 decreased to $10.9 million from $11.0 million in the second quarter of 2009. Average interest-earning assets increased by $32.6 million from the second quarter of 2009; however, the yield on these assets decreased by 26 basis points. The average balance on investment securities decreased $13.1 million quarter over quarter due to pay downs, maturities and sales in the portfolio, net of investment purchases. Total average loans increased $49.5 million (7.0%) quarter over quarter. Average commercial loans increased $69.6 million (13.8%), but the increase was partially offset by a decrease in the average balance of mortgage and consumer loans. Average mortgage loans decreased $6.1 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 $14.0 million, as consumers continue to borrow less during the economic recession.

Interest expense was $3.2 million for the second quarter, a decrease of $409 thousand from the second quarter of 2009 total of $3.6 million. Average interest-bearing liabilities increased to $798.4 million in the second quarter of 2010 from an average balance of $776.9 million during the same period in 2009, an increase of $21.5 million. The average cost of these liabilities decreased from 1.87% for the second quarter of 2009 to 1.62% for the same period in 2010. Average interest-bearing deposits increased $40.3 million, due to increases in money management accounts

($58.5 million), but these increases were partially offset by decreases in certificates of deposit ($25.3 million). The cost of interest-bearing deposits decreased from 1.69% to 1.38%. Securities sold under agreements to repurchase have decreased $8.2 million 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 $10.7 million due to scheduled amortization and maturities on Federal Home Loan Bank of Pittsburgh (FHLB) advances.

The changes in the balance sheet and interest rates resulted in an increase in net interest income of $286 thousand to $7.6 million for the second quarter of 2010 compared to $7.4 million for the second quarter of 2009. The Bank's net interest margin decreased slightly from 3.49% to 3.48% in 2010. The decrease in the net interest margin is due to the yield on interest-earning assets (mainly variable rate commercial loans) decreasing 26 basis points, while the yield on interest-bearing liabilities only decreased 25 basis points. An extended period of low market interest rates is likely to continue to reduce the net interest margin because liability rates can no longer be significantly reduced.

The following table shows a comparative analysis of average balances, asset yields and funding costs for the three months ended June 30, 2010 and 2009. These components drive changes in net interest income.

| | For the Three Months Ended June 30 | | | | | |
|---|---|---|---|---|---|---|
| | 2010 | | | 2009 | | |
| (Dollars in thousands) | Average balance | Tax Equivalent Interest | Average yield/rate | Average balance | Tax Equivalent Interest | Average yield/rate |
| Interest-earning assets | | | | | | |
| Federal funds sold and interest-bearing balances | $ 15,638 | $ 10 | 0.26% | $ 19,397 | $ 7 | 0.14% |
| Investment securities | 138,202 | 1,344 | 3.89% | 151,333 | 1,729 | 4.57% |
| Loans | 754,882 | 9,746 | 5.15% | 705,369 | 9,524 | 5.38% |
| Total interest-earning assets | $ 908,723 | 11,100 | 4.90% | $ 876,099 | 11,260 | 5.16% |
| | | | | | | |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing deposits | $ 640,405 | 2,204 | 1.38% | $ 600,068 | 2,535 | 1.69% |
| Securities sold under agreements to repurchase | 63,993 | 40 | 0.25% | 72,178 | 45 | 0.25% |
| Long-term debt | 93,972 | 977 | 4.17% | 104,639 | 1,050 | 4.02% |
| Total interest-bearing liabilities | $ 798,370 | 3,221 | 1.62% | $ 776,885 | 3,630 | 1.87% |
| Interest spread | | | 3.28% | | | 3.29% |
| Tax equivalent Net interest income/Net interest margin | | 7,879 | 3.48% | | 7,630 | 3.49% |
| Tax equivalent adjustment | | (234) | | | (271) | |
| Net interest income | | $ 7,645 | | | $ 7,359 | |

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses. Dividend income is reported as taxable income, but is adjusted for the dividend received deduction. Loan balances include nonaccruing loans, loans held for sale, and are gross of the allowance for loan losses. Loan categories are based on an internal classification/purpose and do not necessarily reflect a specific type of collateral, if any.

Provision for Loan Losses

For the second quarter of 2010, the provision expense was $625 thousand versus $426 thousand for the same period in 2009. 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 three months ended June 30, 2010, noninterest income increased slightly by $73 thousand to $2.4 million, the same as in the second quarter of 2009. Investment and trust service fees increased $145 thousand due to increases in nonrecurring income from estate fees. Loan service charges decreased $106 thousand, as the second quarter of 2009 total included a high volume of mortgage production fees from refinancing activity. Mortgage banking fees decreased quarter over quarter due to a net impairment recovery of $143 thousand on mortgage servicing rights in 2009. Deposit service charges decreased $60 thousand in the second quarter of 2010 due to a decrease in account analysis fees and a decrease in fees from the Bank’s overdraft protection program. New regulations effective July 1, 2010 require consumers to opt-in to overdraft protection programs. The affect of this new regulation on future overdraft fees is uncertain at this time. Other service charges and fees, an increase in cash surrender value of life insurance and other income remained flat in the second quarter of 2010. There were no other than temporary impairment charges recognized in the second quarter of 2010, versus $212 thousand on two equity securities in the same quarter in 2009. The Corporation took gains of $20 thousand during the quarter ended June 30, 2010 versus gains of $42 thousand for the same period in 2009.

The following table presents a comparison of noninterest income for the three months ended June 30, 2010 and 2009:

| | For the Three Months Ended June 30 | | Change | |
|---|---|---|---|---|
| (Dollars in thousands) | 2010 | 2009 | Amount | % |
| Noninterest Income | | | | |
| Investment and trust services fees | $ 1,007 | $ 862 | $ 145 | 16.8 |
| Loan service charges | 272 | 378 | (106) | (28.0) |
| Mortgage banking activities | 11 | 118 | (107) | (90.7) |
| Deposit service charges and fees | 593 | 653 | (60) | (9.2) |
| Other service charges and fees | 351 | 339 | 12 | 3.5 |
| Increase in cash surrender value of life insurance | 166 | 160 | 6 | 3.8 |
| Other | 22 | 29 | (7) | (24.1) |
| OTTI losses on securities | - | (212) | 212 | 100.0 |
| Less: Loss recognized in other comprehensive income (before taxes) | - | - | - | - |
| Net OTTI losses recognized in earnings | - | (212) | 212 | 100.0 |
| Securities gains, net | 20 | 42 | (22) | (52.4) |
| Total noninterest income | $ 2,442 | $ 2,369 | $ 73 | 3.1 |

Noninterest Expense

Noninterest expense for the second quarter of 2010 totaled $6.5 million compared to $7.0 million in the second quarter of 2009. The increase in salaries and benefits was due to annual performance increases as well as increased health insurance costs. Net occupancy expense and furniture and equipment expense remained flat, while advertising expense decreased $75 thousand due to the timing of various direct mail and production costs. Legal and professional fees increased over the same period in 2009 due to expenses from litigation involving matters arising in the ordinary course of business and a special audit project. The Pennsylvania bank shares tax expense and intangible amortization expense remained flat quarter over quarter. FDIC insurance decreased $395 thousand as 2009 contained the FDIC special assessment expense of $449 thousand. Other expenses decreased in 2010 as 2009 expenses contained a prepayment penalty of $86 thousand on a high-rate term loan from the FHLB and a write-down of leasehold improvements of $118 thousand from closing a branch location in 2009.

The following table presents a comparison of noninterest expense for the three months ended June 30, 2010 and 2009:

| (Dollars in thousands) | For the Three Months Ended June 30 | | Change | |
|---|---|---|---|---|
| Noninterest Expense | 2010 | 2009 | Amount | % |
| Salaries and benefits | $ 3,322 | $ 3,126 | $ 196 | 6.3 |
| Net occupancy expense | 496 | 476 | 20 | 4.2 |
| Furniture and equipment expense | 191 | 213 | (22) | (10.3) |
| Advertising | 343 | 418 | (75) | (17.9) |
| Legal and professional fees | 350 | 293 | 57 | 19.5 |
| Data processing | 502 | 435 | 67 | 15.4 |
| Pennsylvania bank shares tax | 152 | 143 | 9 | 6.3 |
| Intangible amortization | 114 | 117 | (3) | (2.6) |
| FDIC insurance | 288 | 683 | (395) | (57.8) |
| Other | 767 | 1,062 | (295) | (27.8) |
| Total noninterest expense | $ 6,525 | $ 6,966 | $ (441) | (6.3) |

Income taxes

Federal income tax expense was $778 thousand for the second quarter of 2010 compared to $697 thousand in 2009. The effective tax rate for the second quarter of 2010 was 26.5% and 29.8% for 2009. All taxable income for the Corporation is taxed at a rate of 34%.

Comparison of the six months ended June 30, 2010 to the six months ended June 30, 2009:

Net Interest Income

Interest income for the first half of 2010 was $21.8 million, $19 thousand less than the same period in 2009. Average interest-earning assets increased by $53.3 million from the first half of 2009, however; the yield on these assets decreased by 33 basis points. The average balance on investment securities decreased $8.3 million year over year due to pay downs, maturities and sales in the portfolio, net of investment purchases. Total average loans increased $58.5 million (8.5%) year over year. Average commercial loans increased $80.3 million, but the increase was partially offset by a decrease in the average balance of mortgage and consumer loans. Average mortgage loans decreased $6.9 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 $14.9 million, as consumers continue to borrow less during the economic recession.

Interest expense was $6.6 million for the first six months, a decrease of $633 thousand from the first six months of 2009 total of $7.2 million. Average interest-bearing liabilities increased to $800.3 million from an average balance of $755.5 million during the same period in 2009, an increase of $44.8 million. The average cost of these liabilities decreased from 1.93% to 1.66%. Average interest-bearing deposits increased $69.0 million, due to increases in money management accounts ($51.4 million) while certificates of deposit decreased ($34.6 million), and the cost decreased from 1.76% to 1.43%. Securities sold under agreements to repurchase have decreased $9.9 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 $11.0 million due to scheduled amortization and maturities on FHLB advances.

The changes in the balance sheet and interest rates resulted in an increase in net interest income of $614 thousand to $15.2 million for the first half of 2010 compared to $14.6 million for the first half of 2009. The Bank's net interest margin decreased from 3.54% in 2009 to 3.46% in 2010. The decrease in the net interest margin is due to the yield on interest-earning assets (mainly variable rate commercial loans) decreasing 33 basis points, while the yield on interest-bearing liabilities only decreased 27 basis points. An extended period of low market interest rates is likely to continue to reduce the net interest margin because liability rates can no longer be significantly reduced.

The following table shows a comparative analysis of average balances, asset yields and funding costs for the six months ended June 30, 2010 and 2009. These components drive changes in net interest income.

| | For the Six Months Ended June 30 | | | | | |
|---|---|---|---|---|---|---|
| | 2010 | | | 2009 | | |
| (Dollars in thousands) | Average balance | Tax Equivalent Interest | Average yield/rate | Average balance | Tax Equivalent Interest | Average yield/rate |
| Interest-earning assets | | | | | | |
| Federal funds sold and interest-bearing balances | $ 13,137 | $ 16 | 0.25% | $ 10,011 | $ 7 | 0.14% |
| Investment securities | 143,264 | 2,919 | 4.08% | 151,594 | 3,563 | 4.70% |
| Loans | 750,703 | 19,353 | 5.16% | 692,160 | 18,779 | 5.43% |
| Total interest-earning assets | $ 907,104 | 22,288 | 4.95% | $ 853,765 | 22,349 | 5.28% |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing deposits | $ 643,742 | 4,563 | 1.43% | $ 574,725 | 5,018 | 1.76% |
| Securities sold under agreements to repurchase | 62,302 | 77 | 0.25% | 72,238 | 90 | 0.25% |
| Short-term borrowings | 111 | - | 0.64% | 3,342 | 11 | 0.66% |
| Long-term debt | 94,194 | 1,951 | 4.17% | 105,215 | 2,105 | 4.03% |
| Total interest-bearing liabilities | $ 800,350 | 6,591 | 1.66% | $ 755,520 | 7,224 | 1.93% |
| Interest spread | | | 3.29% | | | 3.35% |
| Tax equivalent Net interest income/Net interest margin | | 15,697 | 3.46% | | 15,125 | 3.54% |
| Tax equivalent adjustment | | (506) | | | (548) | |
| Net interest income | | $ 15,191 | | | $ 14,577 | |

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses. Dividend income is reported as taxable income, but is adjusted for the dividend received deduction. Loan balances include nonaccruing loans, loans held for sale, and are gross of the allowance for loan losses. Loan categories are based on an internal classification/purpose and do not necessarily reflect a specific type of collateral, if any.

Provision for Loan Losses

For the first half of 2010, the provision expense was $1.3 million versus $1.0 million for the same period in 2009. 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 six months ended June 30, 2010, noninterest income increased $181 thousand to $4.8 million, compared to $4.7 million for the first six months of 2009. Investment and trust service fees increased $267 thousand due to increases in income from estate fees. Loan service charges decreased $184 thousand, as the first six months of 2009 total included a high volume of mortgage production fees from refinancing activity. Mortgage banking fees remained flat year over year, while deposit service charges decreased $61 thousand due to a decrease in account analysis fees and a decrease in fees from the Bank's overdraft protection program. New regulations effective July 1, 2010 require consumers to opt-in to overdraft protection programs. The affect of this new regulation on future overdraft fees is uncertain at this time. Other service charges and the increase in cash surrender value of life insurance remained flat in the first half of 2010. Other noninterest income decreased $255 thousand year over year as 2009 included $279 thousand from the surrender of a life insurance policy. Other than temporary impairment charges of $255 thousand were recognized in income on two debt securities in 2010, compared to $421 thousand on four equity securities in 2009. The Corporation took securities gains of $268 thousand during the first half of 2010 versus gains of $54 thousand for the same period in 2009.

The following table presents a comparison of noninterest income for the six months ended June 30, 2010 and 2009:

| | For the Six Months Ended June 30 | | Change | |
|---|---|---|---|---|
| (Dollars in thousands) | 2010 | 2009 | Amount | % |
| Noninterest Income | | | | |
| Investment and trust services fees | $ 2,024 | $ 1,757 | $ 267 | 15.2 |
| Loan service charges | 469 | 653 | (184) | (28.2) |
| Mortgage banking activities | 81 | 91 | (10) | (11.0) |
| Deposit service charges and fees | 1,171 | 1,232 | (61) | (5.0) |
| Other service charges and fees | 677 | 641 | 36 | 5.6 |
| Increase in cash surrender value of life insurance | 332 | 324 | 8 | 2.5 |
| Other | 70 | 325 | (255) | (78.5) |
| OTTI losses on securities | (689) | (421) | (268) | 63.7 |
| Less: Loss recognized in other comprehensive income (before taxes) | (434) | - | (434) | - |
| Net OTTI losses recognized in earnings | (255) | (421) | 166 | 39.4 |
| Securities gains, net | 268 | 54 | 214 | 396.3 |
| Total noninterest income | $ 4,837 | $ 4,656 | $ 181 | 3.9 |

Noninterest Expense

Noninterest expense for the first six months of 2010 totaled $13.2 million compared to $13.1 million in the first half of 2009. The increase in salaries and benefits was due to increased health insurance costs, an accrual for a severance payment and annual performance increases. Net occupancy expense increased in 2010 from the cost of snow removal. Advertising expense decreased $79 thousand due to the timing of various direct mail and production costs, while legal and professional fees increased over the same period in 2009 due to expenses from litigation involving matters arising in the ordinary course of business and a special audit project. The Pennsylvania bank shares tax expense and intangible amortization expense remained flat quarter over quarter. FDIC Insurance decreased $334 thousand as the same period in 2009 contained $449 thousand of expense for the FDIC special assessment. Under recently passed legislation, the method of calculating FDIC insurance premiums will shift for a deposit base assessment to an asset based assessment. This changes is expected to result in a lower deposit assessment rate than under the current system. Other expenses decreased in 2010, as the same period in 2009 contained a prepayment penalty of $86 thousand on a high-rate term loan from the FHLB and a write-down of leasehold improvements of

$118 thousand from closing a branch location in the second quarter of 2009.

The following table presents a comparison of noninterest expense for the six months ended June 30, 2010 and 2009:

| (Dollars in thousands) | For the Six Months Ended June 30 | | Change | |
|---|---|---|---|---|
| Noninterest Expense | 2010 | 2009 | Amount | % |
| Salaries and benefits | $ 6,762 | $ 6,279 | $ 483 | 7.7 |
| Net occupancy expense | 1,019 | 956 | 63 | 6.6 |
| Furniture and equipment expense | 382 | 429 | (47) | (11.0) |
| Advertising | 655 | 734 | (79) | (10.8) |
| Legal and professional fees | 745 | 545 | 200 | 36.7 |
| Data processing | 879 | 836 | 43 | 5.1 |
| Pennsylvania bank shares tax | 308 | 288 | 20 | 6.9 |
| Intangible amortization | 229 | 234 | (5) | (2.1) |
| FDIC insurance | 580 | 914 | (334) | (36.5) |
| Other | 1,627 | 1,900 | (273) | (14.4) |
| Total noninterest expense | $ 13,186 | $ 13,115 | $ 71 | 0.5 |

Income taxes

Federal income tax expense was $1.5 million for the first half of 2010 compared to $1.4 million in 2009. The effective tax rate for the first six months of 2010 was 26.1% and 26.7% for 2009. All taxable income for the Corporation is taxed at a rate of 34%.

Financial Condition

Summary:

At June 30, 2010, assets totaled $986.6 million, an increase of $7.2 million from the 2009 year-end balance of $979.4 million. Net loan growth has been strong, up $18.0 million; however, this growth was offset by a decrease in investment securities. Deposits are down $8.0 million. During the first half of 2010, approximately $32 million of short-term brokered CDs matured. This funding was not replaced and this more than offset core deposit growth during the first half of 2010. Shareholders' equity increased during the first six months as retained earnings increased approximately $2.0 million.

Investment Securities:

The investment portfolio totaled $128.3 million at June 30, 2010, a decrease of $14.9 million since year-end 2009. During 2010, cash flows from maturing investments were used to fund loan growth and offset a slight decrease in deposits during the year.

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 and is comprised primarily of general obligation bonds with credit enhancements in the form of private bond insurance or other credit enhancements. The Bank holds corporate bonds with a fair value $6.8 million with the majority of the bonds representing financial services companies. Included in the corporate bond portfolio are seven single issuer trust preferred bonds with a book value of $5.9 million and a fair value of $4.2 million. The majority of the mortgage-backed security portfolio is comprised of U.S. Government Agency products. However, the Bank has 7 private label mortgage backed securities with an amortized cost of $5.1 million and a fair value of $4.3 million.

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2010 and December 31, 2009 are:

| (Amounts in thousands) June 30, 2010 | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
|---|---|---|---|---|
| Equity securities | $ 5,401 | $ 65 | $ (1,444) | $ 4,022 |
| U.S. Treasury securities and obligations of U.S. Government agencies | 22,723 | 414 | (95) | 23,042 |
| Obligations of state and political subdivisions | 40,852 | 1,186 | (46) | 41,992 |
| Corporate debt securities | 8,611 | 26 | (1,787) | 6,850 |
| Mortgage-backed securities | | | | |
| Agency | 46,726 | 1,408 | (11) | 48,123 |
| Non-Agency | 5,051 | - | (786) | 4,265 |
| Asset-backed securities | 81 | - | (28) | 53 |
| | $ 129,445 | $ 3,099 | $ (4,197) | $ 128,347 |

| (Amounts in thousands) December 31, 2009 | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
|---|---|---|---|---|
| Equity securities | $ 5,400 | $ 37 | $ (1,462) | $ 3,975 |
| U.S. Treasury securities and obligations of U.S. Government agencies | 28,258 | 618 | (161) | 28,715 |
| Obligations of state and political subdivisions | 42,611 | 1,332 | (62) | 43,881 |
| Corporate debt securities | 9,603 | - | (2,343) | 7,260 |
| Mortgage-backed securities | | | | |
| Agency | 53,214 | 1,576 | (47) | 54,743 |
| Non-Agency | 5,947 | - | (1,279) | 4,668 |
| Asset-backed securities | 84 | - | (38) | 46 |
| | $ 145,117 | $ 3,563 | $ (5,392) | $ 143,288 |

At June 30, 2010, the investment portfolio contained 77 securities with $29.0 million of temporarily impaired fair value and $4.2 million in unrealized losses. This position is improved from year-end 2009 when there were 99 securities with an unrealized loss of $5.4 million, but slightly worse than the unrealized loss of $3.9 million at the end of the first quarter. Of the total unrealized loss position, $2.7 million (53 securities) exists within the debt security portfolio. Within this category, the corporate bond portfolio contains 9 securities with an unrealized loss of $1.8 million or 63% of the unrealized loss in the debt security portfolio.

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. Accordingly, the impairments identified on debt securities and subjected to the assessment at June 30, 2010 were deemed to be temporary and required no further adjustment to the financial statements.

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, 2010 and December 31, 2009:

| | June 30, 2010 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less than 12 months | | | 12 months or more | | | Total | | |
| (Amounts in thousands) | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Equity securities | $ 1,840 | $ (287) | 2 | $ 1,796 | $ (1,157) | 22 | $ 3,636 | $ (1,444) | 24 |
| U.S. Treasury securities and obligations of U.S. Government agencies | 76 | - | 2 | 9,654 | (95) | 20 | 9,730 | (95) | 22 |
| Obligations of state and political subdivisions | 2,528 | (31) | 7 | 292 | (15) | 1 | 2,820 | (46) | 8 |
| Corporate debt securities | - | - | - | 6,096 | (1,787) | 9 | 6,096 | (1,787) | 9 |
| Mortgage-backed securities | | | | | | | | | |
| Agency | 1,727 | (9) | 3 | 699 | (2) | 1 | 2,426 | (11) | 4 |
| Non-Agency | - | - | - | 4,265 | (786) | 7 | 4,265 | (786) | 7 |
| Asset-backed securities | - | - | - | 53 | (28) | 3 | 53 | (28) | 3 |
| Total temporarily impaired securities | $ 6,171 | $ (327) | 14 | $ 22,855 | $ (3,870) | 63 | $ 29,026 | $ (4,197) | 77 |

| | December 31, 2009 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less than 12 months | | | 12 months or more | | | Total | | |
| (Amounts in thousands) | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Equity securities | $ 2,343 | $ (395) | 7 | $ 1,494 | $ (1,067) | 21 | $ 3,837 | $ (1,462) | 28 |
| U.S. Treasury securities and obligations of U.S. Government agencies | 63 | - | 3 | 13,411 | (161) | 27 | 13,474 | (161) | 30 |
| Obligations of state and political subdivisions | 1,843 | (41) | 6 | 285 | (21) | 1 | 2,128 | (62) | 7 |
| Corporate debt securities | 622 | (1) | 5 | 6,537 | (2,342) | 10 | 7,159 | (2,343) | 15 |
| Mortgage-backed securities | | | | | | | | | |
| Agency | 10,812 | (47) | 9 | - | - | - | 10,812 | (47) | 9 |
| Non-Agency | - | - | - | 4,668 | (1,279) | 7 | 4,668 | (1,279) | 7 |
| Asset-backed securities | - | - | - | 46 | (38) | 3 | 46 | (38) | 3 |
| Total temporarily impaired securities | $ 15,683 | $ (484) | 30 | $ 26,441 | $ (4,908) | 69 | $ 42,124 | $ (5,392) | 99 |

The loss in the corporate bond portfolio ($1.8 million) is concentrated in trust-preferred securities with an unrealized loss of $1.7 million. Trust preferred securities are typically issued by a subsidiary grantor trust of a bank holding company, which uses the proceeds of the equity issuance to purchase debt issued by the bank holding company. 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. Because of the current financial conditions, most trust preferred securities have realized a significant decline in value, but market prices have continued to improve since the end of 2009. All of the Bank's issues are variable rate notes 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. The holdings and ratings of the trust-preferred securities include issues from: BankAmerica (Baa3), JP Morgan (A2), Wells Fargo (Wachovia and Corestates) (Baa2) and Huntington Bancshares (Ba1). At June 30, 2010, 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. During the second quarter, the Bank sold one corporate bond at a loss of $6 thousand. The following table provides additional detail about the Bank's trust preferred securities:

Trust Preferred Securities
June 30, 2010

(Dollars in thousands)

| Deal Name | Single Issuer or Pooled | Class | Amortized Cost | Estimated Fair Value | Gross Unrealized Gain (Loss) | Lowest Credit Rating Assigned | Number of Banks currently Performing | Deferrals and Defaults as % of Original Collateral | Expected Defe Defaults as Percentage o Remaining Perfo Collateral |
|---|---|---|---|---|---|---|---|---|---|
| Huntington Cap Trust | Single | Preferred Stock | $ 926 | $ 595 | $ (331) | Ba1 | 1 | None | None |
| Huntingtn Cap Trust II | Single | Preferred Stock | 870 | 565 | (305) | Ba1 | 1 | None | None |
| BankAmerica Cap III | Single | Preferred Stock | 954 | 673 | (281) | Baa3 | 1 | None | None |
| Wachovia Cap Trust II | Single | Preferred Stock | 272 | 230 | (42) | Baa2 | 1 | None | None |
| Corestates Captl Tr II | Single | Preferred Stock | 921 | 619 | (302) | Baa1 | 1 | None | None |
| Chase Cap VI JPM | Single | Preferred Stock | 955 | 779 | (176) | A2 | 1 | None | None |
| Fleet Cap Tr V | Single | Preferred Stock | 970 | 732 | (238) | Baa3 | 1 | None | None |
| | | | $ 5,868 | $ 4,193 | $ (1,675) | | | | |

The largest unrealized loss in the mortgage-backed security (MBS) portfolio is in the non-agency private label “Alt-A” sector. Alt-A loans are first-lien residential mortgages that generally conform to traditional credit guidelines; however, loan factors such as the loan-to-value ratio, loan documentation, occupancy status or property type cause these loans not to qualify for standard underwriting programs. The Alt-A product in the Bank’s portfolio is comprised of fixed-rate products that were originated between 2003 and 2006 and were all originally rated AAA. The bonds issued in 2006, during the height of the real estate market, appear to be experiencing the highest delinquency and loss rates. The Bank’s Alt-A investments continue to experience rating declines and some experienced an increase in delinquencies and default rates, and a weakening of the underlying credit support.  All of these bonds, except one, have some type of credit support tranche that will absorb any loss prior to losses at the senior tranche held by the Bank. At June 30, 2010, the bond ratings ranged from CCC to AAA, and credit support levels ranged from 0% to 13.03%.

The Bank monitors the performance of the Alt-A 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 first quarter analysis on the private label MBS portfolio, it was determined that two bonds contained losses that were considered other-than-temporary. Management determined $255 thousand was credit related and therefore, recorded an impairment charge of $255 thousand in earnings during the first quarter of 2010.  The same review process was conducted for the second quarter of 2010 and no additional impairment charges were required.

The market for private label MBS continues to be weak and Management believes that this factor accounts for a portion of the unrealized losses that is not attributable to credit issues. Management will continue to monitor these securities and it is possible that additional write-downs may occur in 2010 if current loss trends continue.

The following table provides additional detail about private label mortgage-backed securities:

Private Label Mortgage Backed Securities
June 30, 2010

| (Dollars in thousands) Decscription | Orgination Date | Amortized Cost | Fair Value | Gross Unrealized Gain (Loss) | Collateral Type | Current Rating | Credit Support % | OTTI Charges |
|---|---|---|---|---|---|---|---|---|
| RALI 2003-QS15 A1 | 8/1/2003 | $ 715 | $ 694 | $ (21) | ALT A | Aa2 | 11.29 | $ - |
| RALI 2004-QS4 A7 | 3/1/2004 | 666 | 652 | (14) | ALT A | AAA | 13.03 | - |
| MALT 2004-6 7A1 | 6/1/2004 | 780 | 650 | (130) | ALT A | AAA | 10.52 | - |
| RALI 2005-QS2 A1 | 2/1/2005 | 730 | 608 | (121) | ALT A | B | 7.70 | - |
| RALI 2006-QS4 A2 | 4/1/2006 | 1,044 | 756 | (288) | ALT A | Caa2 | 0.68 | 142 |
| GSR 2006-5F 2A1 | 5/1/2006 | 544 | 479 | (65) | Prime | CCC | 4.64 | - |
| RALI 2006-QS8 A1 | 7/28/2006 | 572 | 426 | (146) | ALT A | Caa2 | 0.00 | 113 |
| | | $ 5,051 | $ 4,265 | $ (786) | | | | $ 255 |

The following table represents the cumulative credit losses on securities recognized in earnings as of June 30, 2010.

| | Six Months Ended June 30, 2010 |
|---|---|
| Balance of cumulative credit losses on securities, January 1, 2010 | $ - |
| Additions for credit losses recorded which were not previously recognized as components of earnings | 255 |
| Balance of cumulative credit losses on securities, June 30, 2010 | $ 255 |

The Corporation and the Bank each have a portfolio of equity securities that are concentrated in bank stocks. The stocks represent a mix of community, large regional and national bank stocks with a fair value of $4.0 million at June 30, 2010. Unrealized losses on equity securities totaled $1.4 million, falling back to virtually the 2009 year-end level, after showing an improvement at the end of the first quarter. 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. Management's review of the equity portfolio determined that no other-than-temporary impairment charges were required.

The Bank held $6.5 million of restricted stock at June 30, 2010. Except for $30 thousand, this investment represents stock in the FHLB, which the Bank is required to hold to be a member of FHLB, and is carried at cost of $100 per share. In December 2008, FHLB announced it would suspend its cash dividend and the repurchase of excess capital stock from its members due to deterioration in its financial condition. At June 30, 2010, the Bank held approximately $708 thousand in excess FHLB stock that it would not have been required to hold prior to the suspension of the stock repurchase program. During the second quarter, the FHLB announced an amended capital plan effective July 1, 2010 that changes the capital stock calculation and therefore, the amount of capital stock the Bank is required to hold. The above amount of excess stock reflects this change. 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 it 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 have increased $18.0 million since year-end. Residential real estate loans have increased by $1.9 million. Mortgages, home equity loans and lines of credit have decreased approximately $6 million, while commercial loans for residential real estate 1-4 families has increased approximately $8 million. Residential real estate construction remained flat period over period with an ending balance of $84.8 million. This amount is comprised of $1.7 million in loans to individuals to build their own homes and $83.1 million in loans to developers to construct residential homes for sale. This compares with $1.8 million to individuals and $82.8 million to developers at year-end. The Bank expects its mortgage and home equity portfolios to decrease as the majority of new mortgages are sold and there is less demand from consumers for home equity loans as the equity in their homes has decreased and consumers are less willing to borrow money.

Commercial lending activity continues to be strong and these balances have increased approximately $18.7 million since year-end. Commercial real estate loans have increased $8.9 million during the year. Commercial, industrial and agricultural loans increased $9.8 million, primarily the result of loans to commercial customers to fund business operations (approximately $3.0 million) and loans to local municipalities (approximately $4.9 million). During the first half of 2010, the Bank purchased $3.1 million of loan participations, $1.5 million included in commercial real estate and $1.4 million included in residential real estate construction. The Bank expects the amount of commercial loan participations available for purchase in 2010 will be less than the $45.2 million purchased in 2009 as a result of a general slow down in commercial business activity.

Consumer loans have decreased by approximately $2.0 million, much of the decrease occurring in the indirect lending portfolio. The Bank’s indirect lending portfolio is approximately $10 million, down from approximately $13 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:

| | | | | | Change | |
|---|---|---|---|---|---|---|
| (Amounts in thousands) | June 30, 2010 | | December 31, 2009 | | Amount | % |
| Residential Real Estate 1-4 Family | | | | | | |
| First liens | $ | 145,604 | $ | 142,330 | $ 3,274 | 2.3 |
| Junior liens and lines of credit | | 60,134 | | 61,460 | (1,326) | (2.2) |
| Total | | 205,738 | | 203,790 | 1,948 | 1.0 |
| Residential real estate - construction | | 84,820 | | 84,649 | 171 | 0.2 |
| Commercial, industrial and agricultural real estate | | 292,762 | | 283,839 | 8,923 | 3.1 |
| Commercial, industrial and agricultural | | 153,858 | | 144,035 | 9,823 | 6.8 |
| Consumer | | 21,233 | | 23,250 | (2,017) | (8.7) |
| | | 758,411 | | 739,563 | 18,848 | 2.5 |
| Less: Allowance for loan losses | | (9,751) | | (8,937) | (814) | 9.1 |
| Net Loans | $ | 748,660 | $ | 730,626 | $ 18,034 | 2.5 |
| | | | | | | |
| Included in the loan balances are the following: | | | | | | |
| Net unamortized deferred loan costs | $ | 575 | $ | 589 | | |
| Unamortized discount on purchased loans | $ | (257) | $ | (286) | | |
| | | | | | | |
| Loans pledged as collateral for borrowings and commitments from: | | | | | | |
| FHLB | $ | 353,156 | $ | 360,621 | | |
| Federal Reserve Bank | | 115,542 | | 122,723 | | |
| | $ | 468,698 | $ | 483,344 | | |

Loan Quality:

Management monitors loan asset quality by continually reviewing four measurements: (1) watch list loans, (2) delinquent loans (primarily nonaccrual loans and loans past due 90 days or more), (3) foreclosed real estate (commonly referred to as other real estate owned or "OREO"), and (4) net-charge-offs. Management compares trends in these measurements with the Corporation's internally established targets, as well as its national peer group's average measurements.

Watch list loans are adversely criticized/classified loans where borrowers are experiencing weakening cash flow and may be paying loans with alternative sources of cash, for example, savings or the sale of unrelated assets. If this continues, the Corporation has an increasing likelihood that it will need to liquidate collateral for repayment. Watch list loans include loans that may or may not be delinquent, and loans that may or may not be considered impaired, as well as potential problem loans. Potential problem loans are loans representing borrowers that may or may not be able to comply with current loan terms, but exclude loans that are 90 days or more past due and nonaccrual loans. Potential problem loans were $28.1 million at June 30, 2010. Management emphasizes early identification and monitoring of these loans to proactively minimize any risk of loss.

Delinquent loans are a result of borrowers' cash flow and/or alternative sources of cash being insufficient to pay loans. The Corporation'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 breaks down delinquent loans into two categories: (1) loans that are past due 30-89 days, and (2) nonperforming loans that are comprised of loans that are 90 days or more past due or loans for which Management has stopped accruing interest. Nonaccruing loans generally represent Management's determination that collateral liquidation is not likely to fully repay both interest and principal.

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

Loan quality, as measured by nonperforming loans, continued to deteriorate as nonperforming loans increased from $18.3 million at year-end 2009, to $19.4 million at March 31, 2010 and $20.3 million at June 30, 2010. As a result, the nonperforming loan ratio increased slightly from 2.47% at the end of 2009 to 2.67% at June 30, 2010. The addition of one residential real estate construction loan ($3.4 million) during the second quarter and an increase in residential real estate loans ($657 thousand) over the six-month period contributed to the increase in nonaccural loans since year-end. Likewise, consumers continue to struggle with the lingering effects of the recession as overall residential mortgage delinquencies continue to increase. Management expects the trend of increasing delinquencies to continue during 2010.

The following table presents a summary of nonperforming assets:

| (Dollars in thousands) | | 6/30/2010 | | 12/31/2009 |
|---|---|---|---|---|
| Nonaccrual loans | | | | |
| Residential Real Estate 1-4 Family | | | | |
| First Liens | $ | 1,002 | $ | 345 |
| Junior Liens and Lines of Credit | | 122 | | - |
| Total | | 1,124 | | 345 |
| Residential Real Estate - Construction | | 7,217 | | 4,040 |
| Commercial, Industrial and Agricultural Real Estate | | 6,214 | | 5,654 |
| Commercial, Industrial and Agricultural | | 126 | | 124 |
| Consumer | | 16 | | 30 |
| Total nonaccrual loans | $ | 14,697 | $ | 10,193 |
| | | | | |
| Loans past due 90 days or more and not included above | | | | |
| Residential Real Estate 1-4 Family | | | | |
| First Liens | $ | 1,336 | $ | 3,060 |
| Junior Liens and Lines of Credit | | 423 | | 494 |
| Total | | 1,759 | | 3,554 |
| Residential Real Estate - Construction | | 2,417 | | 1,426 |
| Commercial, Industrial and Agricultural Real Estate | | 815 | | 1,926 |
| Commercial, Industrial and Agricultural | | 413 | | 960 |
| Consumer | | 162 | | 195 |
| Total loans past due 90 days or more and still accruing | | 5,566 | | 8,061 |
| Total nonperforming loans | | 20,263 | | 18,254 |
| Repossessed assets | | - | | 18 |
| Foreclosed real estate | | 229 | | 642 |
| Total nonperforming assets | $ | 20,492 | $ | 18,914 |

| | | | | |
|---|---|---|---|---|
| Nonperforming loans to total gross loans | | 2.67% | | 2.47% |
| Nonperforming assets to total assets | | 2.08% | | 1.93% |
| Allowance for loan losses to nonperforming loans | | 48.12% | | 48.96% |
| | | | | |
| Impaired loans | $ | 25,194 | $ | 18,123 |
| Impaired loans with an allowance for loss | $ | 21,482 | $ | 12,833 |
| Allowance for loss on impaired loans | $ | 5,792 | $ | 4,890 |
| | | | | |
| Troubled debt restructurings | $ | 667 | $ | - |

The majority of the nonaccrual loan balance is comprised of five loan relationships totaling $12.7 million. The following table provides additional information on the most significant nonaccrual accounts:

Significant Nonaccrual Loans
June 30, 2010

(Dollars in thousands)

| | Orgin. Date | Balance | ALL Reserve | Nonaccrual Date | Collateral | Location |
|---|---|---|---|---|---|---|
| Borrower 1<br>Construction and land development | 2006 | $ 2,944 | $ 1,095 | 2009 | 1st lien residential building lots | PA |
| 1 -4 family residential property | | | | | 2nd & 3rd lien single family residential rental property | MD |
| Borrower 2<br>Agricultural<br>4 separate notes | 2004 - 2006 | 1,695 | 181 | 2009 | 1st and 2nd lien on agricultural real estate, farm equipment, livestock and a 70% FSA guarantee on a $381 note | PA |
| Borrower 3<br>Manufacturing<br>3 separate notes | 2009 | 3,814 | 2,121 | 2009 | 1st lien commercial real estate, equipment and other business assets | PA |
| Borrower 4<br>Construction and land development | 2006 | 861 | 324 | 2008 | 1st lien raw land | MD |
| 1 -4 family residential property<br>2 separate notes | | | | | Residential building lots and raw land | DE |
| Borrower 5<br>Construction and land development<br>1 -4 family residential property<br>18 separate notes | 2007 - 2009 | 3,412 | 341 | 2010 | Joint and several liability of principals | N/A |
| | | $ 12,726 | $ 4,062 | | | |

Four of these relationships (borrowers 1 – 4) remained relatively unchanged from year-end. These loans include two residential real estate development loans ($3.8 million) one manufacturing loan ($3.8 million) and one agricultural loan ($1.7 million). These loans are all secured, in part, by some type of real estate collateral. In addition, specific reserves have been established against these loans to cover 100% of estimated losses. Management continues to pursue numerous workout options on these credits in an effort to minimize any loss.

Borrower 5 is new to nonaccrual status during the second quarter. This borrower is in the business of providing interim construction financing, primarily for modular homes. The Bank is one of a number of financial institutions that have separately provided financing for this business. Despite filing for bankruptcy at the end of the first quarter of 2010, the account was current and performing until it was placed on nonaccrual status in the second quarter. The Bank has joint and several liability against the principals of the business who have substantial net worth. As part of the bankruptcy process, the principal has petitioned the court for permission to invest cash in the business. In addition, several other banks, in an effort to improve their collateral position have proposed a new financing package, which if approved by the bankruptcy court, would payoff the Bank’s position. Based upon Management’s assessment of the bankruptcy plan and the principals’ personal net worth, it believes that the Bank’s loss will be limited. The Bank is uncertain when the bankruptcy plan and new financing may be approved and it continues to monitor its risk of loss on this account.

The balance of loans 90 days or more past due and still accruing has declined since year-end 2009 as loans have moved to nonaccrual status. Residential real estate construction is the only loan category to show an increase over year-end. This increase is the result of one loan ($959 thousand) that matured and was up for renewal and moved beyond 90 days past due as a result of the maturity date and a temporary delay in renewing the loan. Subsequent to quarter end, this credit was reviewed and renewed with market terms. The Bank holds $229 thousand of foreclosed real estate, comprised of one loan secured by residential real estate and one loan secured by several residential building lots.

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

Foreclosed Real Estate
June 30, 2010

| (Dollars in thousands) | Date Acquired | Balance | Collateral | Location |
|---|---|---|---|---|
| Property 1 | 2009 | $ 91 | 4 residential building lots | PA |
| Property 2 | 2009 | 138 | Residential property | PA |
| | | $ 229 | | |

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. Impaired loans totaled $21.3 million at June 30, 2010. Additional information on impaired loans is included in the nonperforming loan table.

A loan is considered a troubled debt restructuring if the creditor, 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 one loan classified as a troubled debt restructuring for $667 thousand. The loan is currently in compliance with its modified terms. The bank has not performed any type of loan workout where it has restructured an existing loan into multiple new loans.

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.

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 principals (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.

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, 2010 is adequate.

During the first six months of 2010, $1.3 million was added to the allowance of loan losses (ALL) thorough the provision for loan losses expense. The provision expense was $1.0 million for the same period in 2009. For the first six months of 2010, the net increase in the ALL was $814 thousand. Management has continued to add to the ALL to account for continued loan growth and increasing delinquency levels. The ALL as a percentage of loans increased to 1.29% at June 30, 2010 from 1.21% at the December 31, 2009.

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

| (Dollars in thousands) | Six Months Ended June 30 2010 | 2009 | Twelve Months Ended 12/31/2009 |
|---|---|---|---|
| Balance at beginning of year | $ 8,937 | $ 7,357 | $ 7,357 |
| Charge-offs: | | | |
| Residential Real Estate 1-4 Family | | | |
| First Liens | - | - | - |
| Junior Liens and Lines of Credit | (126) | (94) | (94) |
| Total | (126) | (94) | (94) |
| Residential real estate - construction | - | - | (724) |
| Commercial, Industrial and Agricultural Real Estate | (115) | - | (63) |
| Commercial, Industrial and Agricultural | (102) | (200) | (567) |
| Consumer | (214) | (322) | (681) |
| Total charge-offs | (557) | (616) | (2,129) |
| Recoveries: | | | |
| Residential Real Estate 1-4 Family | | | |
| First Liens | 9 | 15 | 25 |
| Junior Liens and Lines of Credit | 1 | - | - |
| Total | 10 | 15 | 25 |
| Residential real estate - construction | - | - | - |
| Commercial, Industrial and Agricultural Real Estate | - | - | - |
| Commercial, Industrial and Agricultural | 45 | 58 | 62 |
| Consumer | 66 | 97 | 184 |
| Total recoveries | 121 | 170 | 271 |
| Net charge-offs | (436) | (446) | (1,858) |
| Provision for loan losses | 1,250 | 1,019 | 3,438 |
| Balance at end of year | $ 9,751 | $ 7,930 | $ 8,937 |
| Ratios: | | | |
| Annualized net loans charged-off as a percentage of average loans | 0.12% | 0.13% | 0.26% |
| Net loans charged-off as a percentage of the provision for loan losses | 34.88% | 43.77% | 54.04% |
| Allowance as a percentage of loans | 1.29% | 1.13% | 1.21% |

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

The Bank recorded net loan charges-off of $436 thousand compared to $446 thousand in the first half of 2009. The annualized net loan charge-off ratio of ..12% is only slightly better than the 2009 six-month ratio of .13%, but is approximately half of the ratio of .26% for all of 2009.

Other Assets:

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

Deposits:

Total deposits decreased $8.0 million during the first six months of 2010 to $730.4 million. Non-interest bearing deposits increased $12.6 million, while savings and interest-bearing checking deposits increased $33.4 million and time deposits decreased $54.1 million. The majority of the increase in non-interest bearing accounts came in commercial checking accounts ($8 million) and retail checking accounts ($3 million). The Bank's Money Management product increased $29.6 million due in part to a promotion in selected markets and higher consumer savings levels. Retail time deposits decreased since year-end, as customers moved funds to more liquid accounts, while brokered CDs declined approximately $32 million due to short-term funding maturing in the first half of 2010. As of June 30, 2010, the Bank had $19.9 million in CDARS reciprocal deposits included in brokered time deposits.

The following table presents a summary of deposits outstanding at:

| | | | Change | |
|---|---|---|---|---|
| (Amounts in thousands) | 6/30/2010 | 12/31/2009 | Amount | % |
| Demand, noninterest-bearing | $ 90,324 | $ 77,675 | $ 12,649 | 16.3 |
| | | | | |
| Interest-bearing checking | 98,237 | 97,636 | 601 | 0.6 |
| Savings: | | | | |
| Money market accounts | 273,236 | 243,600 | 29,636 | 12.2 |
| Passbook and statement savings | 50,198 | 46,986 | 3,212 | 6.8 |
| Total savings and interest checking | 421,671 | 388,222 | 33,449 | 8.6 |
| | | | | |
| Time deposits: | | | | |
| Less than $100,000 | 131,704 | 144,762 | (13,058) | (9.0) |
| $100,000 and over | 53,284 | 62,576 | (9,292) | (14.8) |
| Brokered time deposits: | | | | |
| Less than $100,000 | 13,838 | 21,226 | (7,388) | (34.8) |
| $100,000 and over | 19,536 | 43,904 | (24,368) | (55.5) |
| Total time deposits | 218,362 | 272,468 | (54,106) | (19.9) |
| | | | | |
| Total deposits | $ 730,357 | $ 738,365 | $ (8,008) | (1.1) |
| | | | | |
| Overdrawn deposit accounts reclassified as loan balances | $ 188 | $ 183 | | |

Borrowings:

The balance of securities sold under agreements to repurchase, which are accounted for as collateralized financings, increased $12.8 million from year-end and the long-term debt from the FHLB decreased $892 thousand due to scheduled amortization and maturities.

Shareholders' Equity:

Total shareholders' equity increased $2.4 million to $81.2 million at June 30, 2010, compared to $78.8 million at the end of 2009. The increase in retained earnings from the Corporation's net income of $4.1 million was partially offset by the cash dividend of $2.1 million. The increase of $79 thousand in accumulated other comprehensive loss is mainly the result of a decline in the market value of derivatives. The Corporation's dividend payout ratio of 50.5%, is less than the 55.3% ratio for the first six months of 2009 and the total payout ratio of 62.9% in 2009. 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 2010 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 is currently exploring 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 six months of 2010.

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. At June 30, 2010, the Corporation was well capitalized as defined by the banking regulatory agencies. Regulatory capital ratios for the Corporation and the Bank are shown below:

| | | | Regulatory Ratios | |
|---|---|---|---|---|
| | June 30, 2010 | December 31, 2009 | Minimum | Well Capitalized Minimum |
| Total Risk Based Capital Ratio (1) | | | | |
| Franklin Financial Services Corporation | 11.11% | 10.89% | 8.00% | n/a |
| Farmers & Merchants Trust Company | 10.65% | 10.45% | 8.00% | 10.00% |
| Tier 1 Capital Ratio (2) | | | | |
| Franklin Financial Services Corporation | 9.87% | 9.69% | 4.00% | n/a |
| Farmers & Merchants Trust Company | 9.40% | 9.25% | 4.00% | 6.00% |
| Leverage Ratio (3) | | | | |
| Franklin Financial Services Corporation | 7.73% | 7.50% | 4.00% | n/a |
| Farmers & Merchants Trust Company | 7.35% | 7.13% | 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, 2010, the unemployment rate for Pennsylvania was 9.1% and the national rate was 9.5%, while the unemployment rate in the Corporation's market area ranged from 7.8% in Cumberland County to 12.3% in Fulton County. The unemployment rates for the Bank's market area have increased over the last three years along with state and national rates.

As the recession negatively affected unemployment numbers, it also resulted in a slow down in building permits and housing prices. The largest decline in building permits and housing prices over the last three years occurred in 2009, but building permits have rebounded slightly in 2010 when compared to 2009. Recent statistics from the Federal Reserve show that the national rate of residential mortgages 90 days or more past due is 5.6% compared to rates ranging from 2.0% to 3.7% in the Corporation's market area. The Bank's ratio of first lien residential mortgages past due 90 days or more is .92%.

The following table presents economic data:

Economic Data

| | 6/30/2010 | 12/31/2009 |
|---|---|---|
| Unemployment Rate (seasonally adjusted) | | |
| Market area range (1) | 7.8 - 12.3% | 6.8 - 14.4% |
| Pennsylvania | 9.1% | 8.1% |
| United States | 9.5% | 9.3% |
| | | |
| Housing Price Index - year over year change | | |
| PA, nonmetropolitan statistical area | -4.4% | -3.3% |
| United States | -6.8% | -4.4% |
| | | |
| Franklin County Building Permits - year over year change | | |
| Residential, estimated | 5.2% | -30.0% |
| Multifamily, estimated | 8.4% | -38.9% |
| | | |
| Mortgage Delinquency | | |
| Market area range (1) | 2.2 - 3.9% | 2.0 - 3.7% |
| National | 5.70% | 5.60% |

(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 half of 2010. The effort by the Federal Reserve to reduce short-term rates has had a negative effect on the Corporation's net interest margin. If rates continue to remain low, it is unlikely that the net interest margin will improve significantly in 2010.

Regulatory Issues

On July 21, 2010, the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act. 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 the Act 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 provisions included in the Act that are likely to affect the Corporation are:

- The Consumer Financial Protection Bureau (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.

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- FDIC assessments will be based on bank assets rather than domestic deposits.
- FDIC insurance limits have been permanently increased to $250,000.
- Unlimited deposit insurance coverage for noninterest bearing transactions accounts has been extended for two years through the Transaction Account Guarantee program.
- New trust preferred securities issued by bank holding companies no longer qualify as Tier 1 capital.
- Loan originators must now retain 5% of any loan they sell or securitize, except for mortgages that meet low-risk standards, yet to be developed.
- The Federal Reserve is directed to set interchange rates for debit-card issuers with more than $10 billion in assets that are directly related to the cost of providing the service. The affect of this price-control is expected to flow down to community banks in the form of lower interchange fees. Merchants may now set a minimum transaction amount for the use of debit or credit cards.
- Shareholders of publicly traded community banks must be given a non-binding vote on executive compensation.

The Federal Reserve Board implemented new rules that prohibit financial institutions from charging consumers fees for paying overdrafts on automated teller machine (ATM) and one-time debit card transactions, unless a consumer consents, or opts-in, to the overdraft service for those types of transactions. The new rules are effective July 1, 2010 for accounts opened after this date and effective August 15, 2010 for accounts opened prior to July 1, 2010.

These new rules could result in a reduction of overdraft fee income if a significant number of consumers choose not to opt-in to the overdraft service. During the second quarter, the Bank undertook an aggressive process to notify consumers of this change and to encourage them to consent to the overdraft service so that their current overdraft protection benefit will continue to function as they are accustomed to. The Bank is pleased with the level of opt-in responses it has received, but it is still uncertain as to the affect that this rule change could have on fee income.

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 it 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 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 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. At June 30, 2010, the Bank had approximately $118 million of its investment portfolio pledged as collateral. Another source of liquidity for the Bank is a line of credit with the FHLB. The FHLB system has always been a major source of funding for community banks. The capital level of the FHLB, and the entire FHLB system, has been strained due to the declining value of mortgage related assets. The FHLB has implemented steps to improve its capital position that included a suspension of its dividend and an end to its practice of redeeming members' stock. Both of these actions are not favorable to the Bank. There are no indicators that lead the Bank to believe the FHLB will discontinue its lending function. If that were to occur, it would have a negative effect on the Bank and it is unlikely that the Bank could replace the level of FHLB funding in a short time. Another action that may be considered by FHLB to increase its capital is to have a capital call on its member banks. This would require the member banks to invest more capital into the FHLB when most banks would prefer not make such an investment. At June 30, 2010, the Bank had approximately $95 million available on this line of credit.

In addition, the Bank has $26 million in unsecured lines of credit at three correspondent banks and approximately $73 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 $196.9 million and $219.1 million, respectively, at June 30, 2010 and December 31, 2009.

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 2009 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, 2010. For more information on market risk refer to the Corporation's 2009 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, 2010, 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

There were no changes during the six months ended June 30, 2010 in the Corporation's internal control over financial reporting which materially affected, or which are reasonably likely to affect, the Corporation's internal control over financial reporting.

## 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, 2010. For more information, refer to the Corporation's 2009 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 9, 2009 to repurchase up to 100,000 shares of the Corporation's common stock over a 12 month time period. As of June 30, 2010, 4,179 shares have been purchased under this plan in 2009. No shares have been purchased in 2010.

The Corporation did not issue any unregistered equity securities during the quarter ended June 30, 2010.

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

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

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| August 9, 2010 | /s/ William E. Snell, Jr.<br>William E. Snell, Jr.<br>President and Chief Executive Officer<br>(Authorized Officer) |
| August 9, 2010 | /s/ Mark R. Hollar<br>Mark R. Hollar<br>Treasurer and Chief Financial Officer<br>(Principal Financial Officer) |