

FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-K
March 14, 2012

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-K

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

For the fiscal year ended December 31, 2011

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
(State or other jurisdiction of
incorporation or organization)

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

20 South Main Street, Chambersburg, PA
(Address of principal executive offices)

17201-0819
(Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act

NONE

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$1.00 per share

(Title of class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 periods that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes No

The aggregate market value of the 3,753,976 shares of the Registrant's common stock held by nonaffiliates of the Registrant as of June 30, 2011 based on the price of such shares was \$66,820,773.

There were 4,048,427 outstanding shares of the Registrant's common stock as of February 29, 2012.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive annual proxy statement to be filed, pursuant to Reg. 14A within 120 days after December 31, 2011, are incorporated into Part III.

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Part I

Item 1. Business

General

Franklin Financial Services Corporation (the Corporation) was organized as a Pennsylvania business corporation on June 1, 1983 and is a registered bank holding company under the Bank Holding Company Act of 1956, as amended (the BHCA). On January 16, 1984, pursuant to a plan of reorganization approved by the shareholders of Farmers and Merchants Trust Company of Chambersburg (F&M Trust or the Bank) and the appropriate regulatory agencies, the Corporation acquired all the shares of F&M Trust and issued its own shares to former F&M Trust shareholders on a share-for-share basis.

The Corporation's common stock is thinly traded in the over-the-counter market. The Corporation's stock is listed under the symbol FRAF on the OTC Bulletin Board, an automated quotation service. The Corporation's Internet address is www.franklinfin.com. Electronic copies of the Corporation's 2011 Annual Report on Form 10-K are available free of charge by visiting the Investor Information section of www.franklinfin.com. Electronic copies of quarterly reports on Form 10-Q and current reports on Form 8-K are also available at this Internet address. These reports are posted as soon as reasonably practicable after they are electronically filed with the Securities and Exchange Commission (SEC).

The Corporation conducts substantially all of its business through its direct banking subsidiary, F&M Trust, which is wholly owned. Other direct subsidiaries of the Corporation include Franklin Financial Properties Corp. and Franklin Future Fund Inc. F&M Trust, established in 1906, is a full-service, Pennsylvania-chartered commercial bank and trust company, which is not a member of the Federal Reserve System. F&M Trust operates twenty-five community banking offices in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania, and engages in general commercial, retail banking and trust services normally associated with community banks and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (the FDIC). F&M Trust offers a wide variety of banking services to businesses, individuals, and governmental entities. These services include, but are not necessarily limited to, accepting and maintaining checking, savings, and time deposit accounts, providing investment and trust services, making loans and providing safe deposit facilities. Franklin Financial Properties Corp. is a qualified real estate subsidiary established to hold real estate assets used by F&M Trust in its banking operations. Franklin Future Fund Inc. is a non-bank investment company that makes venture capital investments within the Corporation's primary market area.

The Corporation's banking subsidiary is not dependent upon a single customer or a few customers for a material part of its business. Thus, the loss of any customer or identifiable group of customers would not materially affect the business of the Corporation or the Bank in an adverse manner. Also, none of the Corporation's business is seasonal. The Bank's lending activities consist primarily of commercial real estate, construction and land development, agricultural, commercial and industrial loans, installment and revolving loans to consumers and residential mortgage loans. Secured and unsecured commercial and industrial loans, including accounts receivable and inventory financing, and commercial equipment financing, are made to small and medium-sized businesses, individuals, governmental entities, and non-profit organizations. F&M Trust also participates in Pennsylvania Higher Education Assistance Act student loan programs, Pennsylvania Housing Finance Agency programs and is a Small Business Administration approved lender.

The Bank classifies loans in this report by the type of collateral, primarily residential or commercial and agricultural real estate. Residential real estate loans may be further broken down into consumer or commercial purpose. Consumer purpose residential real estate loans represent traditional residential mortgages and home equity products. Both of these products are underwritten in generally the same manner; however, home equity products may present greater risk since many of these loans are secured by a second lien position where the Bank may or may not hold the first lien position. Commercial purpose residential real estate loans represent loans made to businesses, but are secured by residential real estate. These loans are underwritten as commercial loans and the repayment ability may be dependent on the business operation, despite the residential collateral. In addition to the real estate collateral, it is possible that personal guarantees or UCC filings on business assets provide additional security. In certain situations, the Bank acquires properties

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through foreclosure on delinquent mortgage loans. The Bank holds these properties at their fair value at the date of foreclosure until such time as they are sold.

Commercial and agricultural real estate loans are secured by properties such as hotels, warehouses, apartment buildings, retail sites, and farmland or agricultural related properties. These loans are highly dependent on the business operations for repayment. Compared to residential real estate, this collateral may be more difficult to sell in the event of a delinquency.

Construction loans are made to finance the purchase of land and the construction of residential and commercial buildings, and are secured by mortgages on real estate. These loans are primarily comprised of loans to consumers to build a home, and loans to contractors and developers to construct residential properties for resale or rental. Construction loans present various risks that include, but are not limited to: schedule delays, cost overruns, changes in economic conditions during the construction period, and the inability to sell or rent the property upon completion.

Commercial loans are made to businesses and government municipalities of various sizes for a variety of purposes including operations, property, plant and equipment, and working capital. These loans are highly dependent on the business operations for repayment and are generally secured by business assets and personal guarantees. As such this collateral may be more difficult to sell in the event of a delinquency. Commercial lending, including commercial real estate, is concentrated in the Bank's primary market, but also includes purchased loan participations originated primarily in south-central Pennsylvania.

Consumer loans are comprised of installment, indirect (primarily automobile) and unsecured personal lines of credit. While some of these loans are secured, the collateral behind the loans is often comprised of assets that lose value quickly (e.g. automobiles) and if repossessed, may not fully satisfy the loan in the event of default. Repayment of these loans is highly dependent on the borrowers' financial condition that can be affected by economic factors beyond their control and personal circumstances.

F&M Trust's Investment and Trust Services Department offers all of the personal and corporate trust services normally associated with trust departments including: estate planning and administration, corporate and personal trust fund management, pension, profit sharing and other employee benefit funds management, and custodial services. F&M Trust's Personal Investment Center sells mutual funds, annuities and selected insurance products.

Economic factors affecting banks at the end of 2011 are much as they were at the end of 2010. The economy, while showing small signs of improvement is still struggling in many parts of the country. Unemployment and foreclosure rates remain high, consumer confidence is low, and short-term rates are now expected to remain at historic lows into 2014. As a result, many banks continue to see a compression of the net interest margin due to the low rate environment, and earnings pressure from nonperforming loans. The nation saw 92 bank failures in 2011, down from 157 in 2010. Commercial lending activity was steady in 2011, but consumer lending remained slow as consumers have reduced their borrowing. Residential mortgage lending is expected to be slow again in 2012. The Bank stopped making indirect consumer loans in 2010 and this action has substantially decreased the balance of the consumer loan portfolio. However, the Bank expects lending activity to continue, but at a slower rate until consumer confidence increases. For more economic information about the Corporation's market area, see the Economy discussion in Item 7, Management's Discussion and Analysis.

With short-term interest rates at very low levels during 2011 and the continued financial uncertainty of the economy, consumers have moved deposits to short-term, liquid deposit products. As a result, the Bank has experienced a reduction in longer-term certificates of deposit and an increase in money management accounts. Until short-term rates increase and the economy begins to recover, the Bank expects that customers will continue to prefer shorter, liquid

deposits and certificates of deposit will decline.

The recession has resulted in a growing amount of nonperforming loans. Commercial nonperforming loans have increased as businesses have seen their sales reduced during the recession and real estate developers experienced slower residential property sales. In turn, workers have seen job layoffs or pay reductions and consequently more consumer loan delinquencies. Until business activity starts to recover and

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consumers feel confident in their employment situation, it is expected that nonperforming loans will not change significantly and remain at higher than normal levels.

Competition

The Corporation and its banking subsidiary operate in a highly competitive environment. The principal market of F&M Trust is in south central Pennsylvania, primarily the counties of Franklin, Cumberland, Fulton and Huntingdon. There are approximately 29 competing commercial banks that have offices within the Corporation's primary market area. These banks range from large regional banks to independent community banks. In addition, credit unions, savings and loan associations, mortgage banks, brokerage firms and other competitors with only an Internet site are present in the market. The Bank has 25 community offices and approximately 10% of the total deposits, ranking it third in its market region. The majority of the Bank's loan and deposit customers are in Franklin County. There are 7 commercial bank competitors in Franklin County and the Bank has approximately 28% of the deposit market share.

Because of increasing competition, profit margins in the traditional banking business of lending and gathering deposits have declined and many nonbanking institutions offer services similar to those offered by the Bank. Some competitors have access to resources (e.g., financial and technological) that are unavailable to the Bank, thereby creating a competitive disadvantage for the Bank in terms of product and service pricing and delivery. The Bank utilizes various strategies including its long history of local customer service and convenience as part of a relationship management culture, a wide variety of products and services and, to a lesser extent, the pricing of loans and deposits, to compete. F&M Trust is the largest financial institution headquartered in Franklin County and had total assets of approximately \$986.3 million on December 31, 2011.

Staff

As of December 31, 2011, the Corporation and its banking subsidiary had 274 full-time equivalent employees. The officers of the Corporation are employees of the Bank. Most employees participate in pension, incentive compensation plans, 401(k) plan and employee stock purchase plans and are provided with group life and health insurance. Management considers employee relations to be excellent.

Supervision and Regulation

Various requirements and restrictions under the laws of the United States and under Pennsylvania law affect the Corporation and its subsidiaries.

General

The Corporation is registered as a bank holding company and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System under the Bank Holding Act of 1956, as amended. The Corporation has also made an effective election to be treated as a financial holding company. Financial holding companies are bank holding companies that meet certain minimum capital and other standards and are therefore entitled to engage in financially related activities on an expedited basis; see further discussion below. Bank holding companies are required to file periodic reports with and are subject to examination by the Federal Reserve Board. The Federal Reserve Board has issued regulations under the Bank Holding Company Act that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve Board, pursuant to such regulations, may require the Corporation to stand ready to use its resources to provide adequate capital funds to its

Bank subsidiary during periods of financial stress or adversity.

The Bank Holding Company Act prohibits the Corporation from acquiring direct or indirect control of more than 5% of the outstanding shares of any class of voting stock, or substantially all of the assets of any bank, or from merging or consolidating with another bank holding company, without prior approval of the Federal Reserve Board. Additionally, the Bank Holding Company Act prohibits the Corporation from engaging in or from acquiring ownership or control of more than 5% of the outstanding shares of any class of voting stock of any company engaged in a non-banking business, unless such business is determined by the Federal Reserve Board to be so closely related to banking as to be a proper incident thereto. Federal law and Pennsylvania law also require persons or entities desiring to acquire certain levels of share ownership (generally, 10% or more, or 5% or more for another bank holding company) of the Corporation to first obtain prior approval from the Federal Reserve and the Pennsylvania Department of Banking.

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As a Pennsylvania bank holding company for purposes of the Pennsylvania Banking Code, the Corporation is also subject to regulation and examination by the Pennsylvania Department of Banking.

The Bank is a state chartered bank that is not a member of the Federal Reserve System, and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (FDIC). Accordingly, the Bank's primary federal regulator is the FDIC, and the Bank is subject to extensive regulation and examination by the FDIC and the Pennsylvania Department of Banking. The Bank is also subject to requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, and limitations on the types of investments that may be made and the types of services that may be offered. The Bank is subject to extensive regulation and reporting requirements in a variety of areas, including helping to prevent money laundering, to preserve financial privacy, and to properly report late payments, defaults, and denials of loan applications. The Community Reinvestment Act requires the Bank to help meet the credit needs of the entire community where the Bank operates, including low and moderate-income neighborhoods. The Bank's rating under the Community Reinvestment Act (CRA), assigned by the FDIC pursuant to an examination of the Bank, is important in determining whether the bank may receive approval for, or utilize certain streamlined procedures in, applications to engage in new activities. The Bank's present CRA rating is satisfactory. Various consumer laws and regulations also affect the operations of the Bank. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

Capital Adequacy Guidelines

Bank holding companies are required to comply with the Federal Reserve Board's risk-based capital guidelines. The required minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) is 8%. At least half of the total capital is required to be Tier 1 capital, consisting principally of common shareholders' equity less certain intangible assets. The remainder (Tier 2 capital) may consist of certain preferred stock, a limited amount of subordinated debt, certain hybrid capital instruments and other debt securities, and a limited amount of the general loan loss allowance and deferred tax accounts. The risk-based capital guidelines are required to take adequate account of interest rate risk, concentration of credit risk, and risks of nontraditional activities.

In addition to the risk-based capital guidelines, the Federal Reserve Board requires a bank holding company to maintain a leverage ratio of a minimum level of Tier 1 capital (as determined under the risk-based capital guidelines) equal to 3% of average total consolidated assets for those bank holding companies which have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. All other bank holding companies are required to maintain a ratio of at least 1% to 2% above the stated minimum. The Bank is subject to almost identical capital requirements adopted by the FDIC. In addition to FDIC capital requirements, the Pennsylvania Department of Banking also requires state chartered banks to maintain a 6% leverage capital level and 10% risk based capital, defined substantially the same as the federal regulations.

Prompt Corrective Action Rules

The federal banking agencies have regulations defining the levels at which an insured institution would be considered well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. The applicable federal bank regulator for a depository institution could, under certain circumstances, reclassify a well-capitalized institution as adequately capitalized or require an adequately capitalized or undercapitalized institution to comply with supervisory actions as if it were in the next lower category. Such a

reclassification could be made if the regulatory agency determines that the institution is in an unsafe or unsound condition (which could include unsatisfactory examination ratings). At December 31, 2011, the Corporation and the Bank each satisfied the criteria to be classified as well capitalized within the meaning of applicable regulations.

Regulatory Restrictions on Dividends

Dividend payments by the Bank to the Corporation are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from accumulated net earnings (generally, retained earnings). The Federal Reserve Board

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and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks that are not classified as well capitalized or adequately capitalized may not pay dividends.

Dodd-Frank Wall Street Reform and Consumer Protection Act

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

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

FDIC Insurance. The insurance limit was increased to \$250,000 and unlimited FDIC insurance on certain non-interest bearing depository accounts was extended through December 31, 2012. In addition, the assessment base was changed from a deposit-based calculation to an asset-based calculation.

Corporate Checking. The prohibition against paying interest on corporate checking accounts was lifted effective July 21, 2011. The Bank developed a product that pays interest on corporate checking accounts, but there has been no interest in the product.

Debit Card Fees. The Durbin Amendment to Dodd-Frank requires that the amount of any interchange fee charged by a debit card issuer must be reasonable and proportional to the cost incurred by the issuer. The Federal Reserve is charged with establishing standards for reasonable and proportional fees. This price regulation applies only to banks with assets greater than \$10 billion. This amendment went into effect in July 2011 and to date, it appears that the Bank's debit card fees have been unaffected.

Mortgage Licensing. Residential mortgage loan originators must register with the Nationwide Mortgage Licensing System and Registry. This registry is a database created by the states to support the licensing of mortgage originators. Employees of agency-related institutions must register prior to originating residential mortgage loans. The Corporation complied with this requirement in 2011 and it will increase compliance costs for the Corporation.

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

Compensation. At least once every three years, companies must conduct a non-binding shareholder vote (say-on-pay) to approve the compensation of the CEO and the company's named executive officers. At least once every 6 years, shareholders must also vote on whether to hold the non-binding vote on executive compensation every 1, 2, or 3 years.

Additionally, banking regulators have established guidance that prohibits incentive-based compensation arrangements that encourage inappropriate risks that could lead to material financial loss to the institution. Bank compensation plans will be required to be submitted to the appropriate regulator for review and monitoring of compliance. At the Corporation's 2011 annual meeting of shareholders, it was approved to vote on the say-on-pay question every year. This is expected to increase compliance costs for the Corporation.

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FDIC Insurance

The Bank is a member of the Deposit Insurance Fund (DIF), which is administered by the FDIC. The FDIC insures deposit accounts at the Bank, generally up to a maximum of \$250,000 for each separately insured depositor. In addition, The Dodd-Frank Act, signed July 21, 2010, extends unlimited FDIC insurance to non-interest bearing transaction accounts through December 31, 2012.

The FDIC charges a premium to depository institutions for deposit insurance. This rate is based on the risk category of the institution and the total premium is based on average total assets less average tangible equity. As of December 31, 2011, the Bank's assessment rate was approximately 15 basis points.

On September 29, 2009, the FDIC adopted an Amended Restoration Plan to allow the DIF to return to its statutorily mandated minimum reserve ratio of 1.15 % within 8 years. At the same time, the FDIC adopted higher risk-based assessment rates effective beginning January 1, 2011. It also imposed a prepaid assessment on insured institutions payable December 30, 2009 that required insured institutions to prepay their estimated quarterly risk-based assessment for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. The Bank paid an assessment of approximately \$4.0 million on December 30, 2009 and it was recorded as a pre-paid asset that will be recognized through 2012 or until it is depleted, whichever is earlier.

Despite these actions in 2009 to recapitalize the DIF, Dodd-Frank established a new minimum DIF ratio set at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020 and its efforts to achieve this ratio could greatly influence future premium rates.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. We do not currently know of any practice, condition or violation that might lead to termination of our deposit insurance.

In addition to the FDIC assessments, the Financing Corporation (FICO) is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature from 2017 to 2019. At December 31, 2011, the Bank's annualized FICO assessment was approximately 1 basis point of total deposits.

New Legislation

Congress is often considering new financial industry legislation, and the federal banking agencies routinely propose new regulations. The Corporation cannot predict how any new legislation, or new rules adopted by the federal banking agencies, may affect its business in the future.

Selected Statistical Information

Certain statistical information is included in this report as part of Management's Discussion and Analysis of Financial Condition and Results of Operations.

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Item 1A. Risk Factors

The following is a summary of the primary risks associated with the Corporation's business, financial condition and results of operations, and common stock.

Risk Factors Relating to the Corporation

A focus on real estate related loans may increase the risk of substantial credit losses.

The Bank offers a variety of loan products, including residential mortgage, consumer, construction and commercial loans. The Bank requires real estate as collateral for many of its loans. At December 31, 2011, approximately 75% of its loans were secured by real estate. Loans to fund residential real estate construction are 3% of total loans; loans secured by residential real estate are 25% of the total, and commercial, industrial and agricultural real estate loans total 47% of the total loan portfolio. These real estate loans are located primarily in the Bank's market area of south central Pennsylvania. Real estate values tend to follow changes in general economic cycles. As a result, if a loan becomes delinquent as the result of an economic downturn and the Bank becomes dependent on the real estate collateral as a source of repayment, it is likely that the value of the real estate collateral has also declined. A decline in real estate values means it is possible that the real estate collateral may be insufficient to cover the outstanding balance of a delinquent or foreclosed loan, resulting in a loss to the Bank. In addition, the real estate collateral is concentrated in a small market area of south central Pennsylvania. As a result, localized events that affect real estate prices and collateral values could have a more negative affect on the Bank as compared to other competitors with a more geographically diverse portfolio. As the Bank grows, it is expected that the percentage of real estate loans, specifically commercial real estate, will grow. Risk of loan default is unavoidable in the banking industry, and Management tries to limit exposure to this risk by carefully monitoring the amount of loans in specific industries and by exercising prudent lending practices and securing appropriate collateral. However, this risk cannot be eliminated and substantial credit losses could result in reduced earnings or losses.

The allowance for loan losses may prove to be insufficient to absorb inherent losses in our loan portfolio.

The Bank maintains an allowance for loan losses that Management believes is appropriate to provide for any inherent losses in the loan portfolio. The amount of the allowance is determined through a periodic review and consideration of several factors, including an ongoing review of the quality, size and diversity of our loan portfolio; evaluation of nonperforming loans; historical loan loss experience; and the amount and quality of collateral, including guarantees, securing the loan.

Although Management believes the loan loss allowance is adequate to absorb inherent losses in the loan portfolio, such losses cannot be predicted and the allowance may not be adequate. Excessive loan losses could have a material adverse effect on the Bank's financial condition and results of operations.

The Bank's lending limit is smaller than many of our competitors, which affects the size of the loans it can offer customers.

The Bank's lending limit is approximately \$12.9 million. Accordingly, the size of the loans that can be offered to potential customers is less than the size of loans that many of our competitors with larger lending limits can offer. This limit affects the Bank's ability to seek relationships with larger businesses in its market area. Loan amounts in excess of the lending limits can be accommodated through the sale of participations in such loans to other banks. However, there can be no assurance that the Bank will be successful in attracting or maintaining customers seeking larger loans or that it will be able to engage in participation of such loans or on terms favorable to the Bank.

There is strong competition in the Bank's primary market areas.

The Bank encounters strong competition from other financial institutions in its primary market area, which consists of Franklin, Cumberland, Fulton and Huntingdon County, Pennsylvania. In addition, established financial institutions not already operating in the Bank's primary market area may open branches there at future dates or can compete in the market via the Internet. In the conduct of certain aspects of banking business, the Bank also competes with savings institutions, credit unions, mortgage banking

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companies, consumer finance companies, insurance companies and other institutions, some of which are not subject to the same degree of regulation or restrictions as are imposed upon the Bank. Many of these competitors have substantially greater resources and lending limits and can offer services that the Bank does not provide. In addition, many of these competitors have numerous branch offices located throughout their extended market areas that provide them with a competitive advantage. No assurance can be given that such competition will not have an adverse effect on the Bank's financial condition and results of operations.

Changes in interest rates could have an adverse impact upon our results of operations.

The Bank's profitability is in part a function of the spread between interest rates earned on investments, loans and other interest-earning assets and the interest rates paid on deposits and other interest-bearing liabilities. Recently, interest rate spreads have generally narrowed due to changing market conditions and competitive pricing pressure. Interest rates are highly sensitive to many factors that are beyond the Bank's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, will influence not only the interest received on loans and investment securities and the amount of interest we pay on deposits and borrowings, but will also affect the Bank's ability to originate loans and obtain deposits and the value of our investment portfolio. If the rate of interest paid on deposits and other borrowings increases more than the rate of interest earned on loans and other investments, the Bank's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the rates on loans and other investments fall more quickly than those on deposits and other borrowings. While Management takes measures to guard against interest rate risk, there can be no assurance that such measures will be effective in minimizing the exposure to interest rate risk.

Risk Factors Relating to the Common Stock

There is a limited trading market for the Corporation's common stock.

There is currently only a limited public market for the Corporation's common stock. It is listed on the OTC Bulletin Board, an automated quotation service, under the symbol FRAF. Because it is thinly traded, you may not be able to resell your shares of common stock for a price that is equal to the price that you paid for your shares. The Corporation has no plans to apply to have its common stock listed for trading on any stock exchange or the NASDAQ market.

The Bank's ability to pay dividends to the Corporation is subject to regulatory limitations that may affect the Corporation's ability to pay dividends to its shareholders.

As a holding company, the Corporation is a separate legal entity from the Bank and does not have significant operations of its own. It currently depends upon the Bank's cash and liquidity to pay dividends to its shareholders. The Corporation cannot assure you that in the future the Bank will have the capacity to pay dividends to the Corporation. Various statutes and regulations limit the availability of dividends from the Bank. It is possible; depending upon the Bank's financial condition and other factors, that the Bank's regulators could assert that payment of dividends by the Bank to the Corporation would constitute an unsafe or unsound practice. In the event that the Bank is unable to pay dividends to the Corporation, the Corporation may not be able to pay dividends to its shareholders.

Item 1B. Unresolved Staff Comments

None

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Item 2. Properties

The Corporation's headquarters is located in the main office of F&M Trust at 20 South Main Street, Chambersburg, Pennsylvania. This location also houses a community banking office as well as operational support services for the Bank. The Corporation owns or leases thirty-seven properties in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania, for banking operations, as described below:

| Property | Owned | Leased |
|---------------------------|-------|--------|
| Community Banking Offices | 18 | 7 |
| Remote ATM Sites | 3 | 6 |
| Other Properties | 2 | 1 |

Item 3. Legal Proceedings

The nature of our 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 nor are known to be threatened or contemplated against us by governmental authorities or other parties.

Item 4. Mine Safety Disclosures

Not Applicable

TABLE OF CONTENTS**Part II****Item 5. Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities****Market and Dividend Information**

The Corporation's common stock is thinly traded in the over-the-counter market. The Corporation's common stock is listed under the symbol FRAF on the OTC Bulletin Board, an automated quotation service. Current price information is available from account executives at most brokerage firms as well as the registered market makers of Franklin Financial Services Corporation common stock as listed below under Shareholders' Information.

The range of high and low bid prices is shown in the following table for the years 2011 and 2010, as well as cash dividends declared for those periods.

Market and Dividend Information
Bid Price Range Per Share

| (Dollars per share) | 2011 | | | 2010 | | |
|---------------------|----------|----------|--------------------|----------|----------|--------------------|
| | High | Low | Dividends Declared | High | Low | Dividends Declared |
| First quarter | \$ 17.00 | \$ 15.19 | \$ 0.27 | \$ 17.00 | \$ 15.19 | \$ 0.27 |
| Second quarter | 18.25 | 17.10 | 0.27 | 18.75 | 16.75 | 0.27 |
| Third quarter | 17.50 | 15.10 | 0.27 | 17.50 | 16.50 | 0.27 |
| Fourth quarter | 15.55 | 12.30 | 0.27 | 18.40 | 16.50 | 0.27 |
| | | | \$ 1.08 | | | \$ 1.08 |

The bids reflect interdealer quotations, do not include retail mark-ups, markdowns or commissions, and may not necessarily represent actual transactions. The closing price of Franklin Financial Services Corporation common stock recorded from an actual transaction on December 31, 2011 was \$12.35. The Corporation had 2,071 shareholders of record as of December 31, 2011.

For limitations on the Corporation's ability to pay dividends, see Supervision and Regulation Regulatory Restrictions on Dividends in Item 1 above.

The information related to equity compensation plans is incorporated by reference to the materials set forth under the heading Executive Compensation Compensation Tables in the Corporation's Proxy Statement for the 2012 Annual Meeting of Shareholders.

Common Stock Repurchases:

The Corporation frequently authorizes the repurchase of its common stock through a stock repurchase plan. The common shares of the Corporation are purchased in the open market or in privately negotiated transactions. The Corporation uses the repurchased common stock (Treasury stock) for general corporate purposes including stock dividends and splits, employee benefit and executive compensation plans, and the dividend reinvestment plan.

The Corporation announced a stock repurchase plan on July 8, 2010 to repurchase up to 100,000 shares of the Corporation's common stock over a twelve month time period ending on July 8, 2011. During the 2010 plan year, no shares were repurchased. The Corporation did not authorize a new repurchase plan in 2011 when the 2010 plan expired.

The following graph compares the cumulative total return to shareholders of Franklin Financial with the NASDAQ Total U.S. Index (a broad market index prepared by the Center for Research in Security Prices at the University of Chicago Graduate School of Business) and with the Northeast OTC-BB and Pink Banks Index (an industry-specific index prepared by SNL Financial LC) for the five year period ended December 31, 2011, in each case assuming an initial investment of \$100 on December 31, 2006 and the reinvestment of all dividends.

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Franklin Financial Services Corporation Total Return Performance

| Index | <i>Period Ending</i> | | | | | |
|---|----------------------|----------|----------|----------|----------|----------|
| | 12/31/06 | 12/31/07 | 12/31/08 | 12/31/09 | 12/31/10 | 12/31/11 |
| Franklin Financial Services Corporation | 100.00 | 95.04 | 72.86 | 69.48 | 82.71 | 59.55 |
| NASDAQ Composite | 100.00 | 110.66 | 66.42 | 96.54 | 114.06 | 113.16 |
| SNL Northeast OTC-BB & Pink Banks | 100.00 | 97.38 | 79.32 | 74.53 | 81.15 | 79.44 |

Shareholders Information

Dividend Reinvestment Plan:

Franklin Financial Services Corporation offers a dividend reinvestment program whereby shareholders of the Corporation's common stock may reinvest their dividends in additional shares of the Corporation. Beneficial owners of shares of the Corporation's common stock may participate in the program by making appropriate arrangements through their bank, broker or other nominee. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Dividend Direct Deposit Program:

Franklin Financial Services Corporation offers a dividend direct deposit program whereby shareholders of the Corporation's common stock may choose to have their dividends deposited directly into the bank account of their choice on the dividend payment date. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Annual Meeting:

The Annual Shareholders Meeting will be held on Tuesday, April 24, 2012, at the Orchard Restaurant & Banquet Facility, 1580 Orchard Drive, Chambersburg, Pennsylvania. The Business Meeting will begin at 10:30 a.m. followed by a luncheon.

Websites:

Franklin Financial Services Corporation: www.franklinfin.com

Farmers & Merchants Trust Company: www.fmtrustonline.com

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Stock Information:

The following brokers are registered as market makers of Franklin Financial Services Corporation's common stock:

| | | |
|---------------------------------|---|--------------|
| RBC Wealth Management | 2101 Oregon Pike, Lancaster, PA 17601 | 866/604-1471 |
| Boenning & Scattergood, Inc. | 4 Tower Bridge, 200 Bar Harbor Drive, Suite 300, West Conshohocken, PA 19428 | 800/883-1212 |
| Stifel, Nicolaus & Co. | 20 Ash Street, Suite 400, Conshohocken, PA 19428 | 800/223-6807 |
| Morgan Keegan & Co., Inc. | 3050 Peachtree Road, NW, Suite 704, Atlanta, GA 30305 | 866/353-7522 |

Registrar and Transfer Agent:

The registrar and transfer agent for Franklin Financial Services Corporation is Fulton Financial Advisors, N.A., P.O. Box 4887, Lancaster, PA 17604.

TABLE OF CONTENTS**Item 6. Selected Financial Data**

| | Summary of Selected Financial Data for the Year Ended December 31 | | | | |
|--|--|-----------|-----------|-----------|-----------|
| (Dollars in thousands, except per share) | 2011 | 2010 | 2009 | 2008 | 2007 |
| Summary of operations | | | | | |
| Interest income | \$41,791 | \$43,284 | \$43,757 | \$46,156 | \$49,487 |
| Interest expense | 9,154 | 12,443 | 14,674 | 16,037 | 23,796 |
| Net interest income | 32,637 | 30,841 | 29,083 | 30,119 | 25,691 |
| Provision for loan losses | 7,524 | 3,235 | 3,438 | 1,193 | 990 |
| Net interest income after provision for loan losses | 25,113 | 27,606 | 25,645 | 28,926 | 24,701 |
| Noninterest income | 10,200 | 9,366 | 8,880 | 6,538 | 10,107 |
| Noninterest expense | 28,333 | 26,423 | 25,929 | 23,189 | 22,793 |
| Income before income taxes | 6,980 | 10,549 | 8,596 | 12,275 | 12,015 |
| Income tax | 411 | 2,937 | 2,011 | 3,680 | 2,759 |
| Net income | \$6,569 | \$7,612 | \$6,585 | \$8,595 | \$9,256 |
| Performance measurements | | | | | |
| Return on average assets | 0.66% | 0.78 % | 0.69 % | 1.01 % | 1.14 % |
| Return on average equity | 7.68% | 9.34 % | 8.69 % | 10.99 % | 12.62 % |
| Return on average tangible assets ⁽¹⁾ | 0.70% | 0.82 % | 0.74 % | 1.05 % | 1.18 % |
| Return on average tangible equity ⁽¹⁾ | 9.30% | 11.27 % | 10.79 % | 13.19 % | 15.41 % |
| Efficiency ratio ⁽²⁾ | 63.46% | 63.43 % | 65.35 % | 61.25 % | 61.28 % |
| Net interest margin | 3.73% | 3.53 % | 3.44 % | 4.03 % | 3.67 % |
| Current dividend yield | 8.74% | 5.92 % | 6.61 % | 5.92 % | 4.17 % |
| Dividend payout ratio | 65.05% | 55.10 % | 62.95 % | 47.66 % | 42.77 % |
| Shareholders Value (per common share) | | | | | |
| Diluted earnings per share | \$1.66 | \$1.96 | \$1.71 | \$2.24 | \$2.40 |
| Basic earnings per share | 1.66 | 1.96 | 1.71 | 2.24 | 2.41 |
| Regular cash dividends paid | 1.08 | 1.08 | 1.08 | 1.07 | 1.03 |
| Book value | 21.67 | 21.09 | 20.39 | 19.10 | 20.18 |
| Tangible book value ⁽³⁾ | 19.04 | 18.28 | 17.38 | 15.94 | 17.27 |
| Market value | 12.35 | 18.25 | 16.33 | 18.25 | 24.95 |
| Market value/book value ratio | 56.99% | 86.53 % | 80.09 % | 95.55 % | 123.64 % |
| Price/earnings multiple | 7.44 | 9.31 | 9.55 | 8.15 | 10.40 |
| Balance Sheet Highlights | | | | | |
| Total assets | \$990,248 | \$951,889 | \$979,373 | \$902,460 | \$820,371 |
| Investment securities (includes restricted stock) | 130,323 | 123,775 | 149,770 | 154,041 | 168,906 |
| Loans, net | 756,687 | 739,841 | 730,626 | 668,860 | 564,256 |
| Deposits and customer repurchase agreements | 841,089 | 785,495 | 794,220 | 691,653 | 674,434 |
| Shareholders equity | 87,182 | 82,639 | 78,766 | 73,059 | 77,642 |
| Safety and Soundness | | | | | |
| Leverage ratio (Tier 1) | 8.40% | 8.16 % | 7.50 % | 7.84 % | 8.18 % |
| Risk-based capital ratio (Tier 1) | 12.14% | 11.73 % | 10.89 % | 11.02 % | 12.28 % |

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| | | | | | | | | | |
|--|------------------|-----------|---|-----------|---|-----------|---|-----------|---|
| Common equity ratio | 8.80% | 8.68 | % | 8.04 | % | 8.10 | % | 9.46 | % |
| Tangible common equity ratio ⁽⁴⁾ | 7.82% | 7.61 | % | 6.94 | % | 6.85 | % | 8.21 | % |
| Nonperforming loans/gross loans | 2.94% | 3.68 | % | 2.47 | % | 0.59 | % | 1.01 | % |
| Nonperforming assets/total assets | 2.60% | 2.96 | % | 1.93 | % | 0.44 | % | 0.73 | % |
| Allowance for loan losses as a % of loans | 1.27% | 1.18 | % | 1.21 | % | 1.09 | % | 1.29 | % |
| Net charge-offs/average loans | 0.86% | 0.45 | % | 0.26 | % | 0.19 | % | 0.09 | % |
| Average equity to average asset ratio | 8.63% | 8.36 | % | 7.98 | % | 9.18 | % | 8.98 | % |
| Trust assets under management (market value) | \$481,536 | \$490,420 | | \$460,233 | | \$497,215 | | \$507,920 | |

(1) *Excludes goodwill, intangibles and intangible amortization expense, net of tax*

(2) *Noninterest expense / tax equivalent net interest income plus noninterest income less net securities gains*

(3) *Total shareholders equity less goodwill and intangibles / shares outstanding*

(4) *Total shareholders equity less goodwill and intangibles / total assets less goodwill and intangibles*

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Application of Critical Accounting Policies:

Disclosure of the Corporation's significant accounting policies is included in Note 1 to the consolidated financial statements. These policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by Management. Senior management has discussed the development of such estimates, and related Management Discussion and Analysis disclosure, with the Audit Committee of the Board of Directors. The following accounting policies are the ones identified by management to be critical to the results of operations:

Allowance for Loan Losses The allowance for loan losses is the estimated amount considered adequate to cover credit losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, charged against income. In determining the allowance for loan losses, Management makes significant estimates and, accordingly, has identified this policy as probably the most critical for the Corporation.

Management performs a monthly evaluation of the adequacy of the allowance for loan losses by asset class. 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. This evaluation is inherently subjective, as it requires 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 has two components, specific and general allocations. Expected cash flow or collateral values discounted for market conditions and selling costs are used to establish specific allocations. The Bank's historical loan loss experience and other qualitative factors derived from economic and market conditions are used to establish general allocations for the remainder of the portfolio. The allowance for loan losses was \$9.7 million at December 31, 2011.

Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy assessment quarterly to the Credit Risk Oversight Committee of the Board of Directors.

Mortgage Servicing Rights In the past, the Bank originated fixed rate mortgages that it subsequently sold to the secondary market. However, the Bank retained the rights to service these loans for its customers. As required by FASB Accounting Standard Codification (ASC) Topic 860, "Transferred Financial Assets", upon the sale of mortgage loans, the Bank capitalizes the value allocated to the servicing rights in other assets. The capitalized servicing rights are amortized against noninterest income in proportion to, and over the periods of, the estimated net servicing income of the underlying financial assets.

Capitalized servicing rights are carried at the lower of cost or market and are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. The rights are deemed to be impaired when the fair value of the rights is less than the amortized cost. If impaired, the Bank records a charge against noninterest income from mortgage banking activities through a mortgage servicing rights valuation allowance. The amount charged to the valuation allowance can be reversed in future periods if the rights are determined to no longer be impaired. However, the amount of impairment reversed may not exceed the balance of the valuation allowance.

The fair value of the servicing rights is determined through a discounted cash flow analysis and calculated using a computer-pricing model. The pricing model is based on the objective characteristics of the mortgage servicing portfolio (e.g, loan balance and interest rate) and commonly used industry assumptions (e.g., prepayment speeds, discount rates). The assumptions take into account those that many active purchasers of servicing rights employ in their evaluations of portfolios for sale in the secondary market. The unique characteristics of the secondary servicing market often dictate adjustments to the assumptions over short periods of time. Subjective factors are also considered in the derivation of market values, including levels of supply and demand for servicing, interest rate trends, and perception of risk not incorporated into prepayment assumptions.

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Financial Derivatives As part of its interest rate risk management strategy, the Bank has entered into interest rate swap agreements. A swap agreement is a contract between two parties to exchange cash flows based upon an underlying notional amount. Under the swap agreements, the Bank pays a fixed rate and receives a variable rate from an unrelated financial institution serving as counter-party to the agreements. The swaps are designated as cash flow hedges and are designed to minimize the variability in cash flows of the Bank's variable rate liabilities attributable to changes in interest rates. The swaps in effect convert a portion of a variable rate liability to a fixed rate liability.

The interest rate swaps are recorded on the balance sheet at fair value as an asset or liability. To the extent the swaps are effective in accomplishing their objectives, changes in the fair value are recorded in other comprehensive income. To the extent the swaps are not effective, changes in fair value are recorded in interest expense. Cash flow hedges are determined to be highly effective when the Bank achieves offsetting changes in the cash flows of the risk being hedged. The Bank measures the effectiveness of the hedges on a quarterly basis and it has determined the hedges are highly effective. Fair value is heavily dependent upon the market's expectations for interest rates over the remaining term of the swaps.

Temporary Investment Impairment Investment securities are written down to their net realizable value when there is impairment in value that is considered to be other-than-temporary. The determination of whether or not other-than-temporary impairment exists is a matter of judgment. Management reviews investment securities regularly for possible impairment that is other-than-temporary by analyzing the facts and circumstances of each investment and the expectations for that investment's performance. Other-than-temporary impairment in the value of an investment may be indicated by the length of time and the extent to which market value has been less than cost; the financial condition and near term prospects of the issuer; and whether the Corporation has the intent to sell or is likely to be forced to sell the investment prior to any anticipated recovery in market value.

Stock-based Compensation The Corporation has two stock compensation plans in place consisting of an Employee Stock Purchase Plan (ESPP) and an Incentive Stock Option Plan (ISOP).

The Corporation accounts for stock compensation plans in accordance with FASB Accounting Standards Codification Topic 718, Stock Compensation. ASC Topic 718 requires compensation costs related to share-based payment transactions to be recognized in the financial statements (with limited exceptions). The amount of compensation cost is measured on the grant-date fair value of the equity or liability instruments issued. Compensation cost is recognized over the period that an employee provides services in exchange for the award.

The Corporation calculates the compensation cost of the options by using the Black-Scholes method to determine the fair value of the options granted. In calculating the fair value of the options, the Corporation makes assumptions regarding the risk-free rate of return, the expected volatility of the Corporation's common stock, dividend yield and the expected life of the option. These assumptions are made independently for the ESPP and the ISOP and if changed, would change the compensation cost of the options and net income.

Note 1 of the accompanying financial statements provides additional information about stock option expense.

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GAAP versus Non-GAAP Presentations The Corporation supplements its traditional GAAP measurements with Non-GAAP measurements. The Non-GAAP measurements include Return on Average Tangible Assets, Return on Average Tangible Equity, Tangible Book Value and Tangible Common Equity ratio. As a result of merger transactions, intangible assets (primarily goodwill, core deposit intangibles and customer list) 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. However, not all companies use the same calculation methods for the same non-GAAP measurements and therefore may not be comparable. 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 |
| Book Value | Total Shareholders Equity / Shares Outstanding |
| Common Equity Ratio | Total Shareholders Equity / Total Assets |
| Non-GAAP Measurement | Calculation |
| Return on Average Tangible Assets | Net Income plus Intangible Amortization (net of tax) / Average Assets less Average Intangible Assets |
| Return on Average Tangible Equity | Net Income plus Intangible Amortization (net of tax) / Average Equity less Average Intangible Assets |
| Tangible Book Value | Total Shareholders Equity less Intangible Assets / Shares outstanding |
| Tangible Common Equity Ratio | Total Shareholders Equity less Intangible Assets / Total Assets less Intangible Assets |

Results of Operations:**Management s Overview**

The following discussion and analysis is intended to assist the reader in reviewing the financial information presented and should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein.

Economic factors affecting banks at the end of 2011 are much as they were at the end of 2010. The economy, while showing small signs of improvement is still struggling in many parts of the country. Unemployment and foreclosure rates remain high, consumer confidence is low, and short-term rates are now expected to remain at historic lows into 2014. As a result, many banks continue to see a compression of the net interest margin due to the low rate environment, and earnings pressure from nonperforming loans. The nation saw 92 bank failures in 2011, down from 157 in 2010.

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In 2011, Franklin Financial Services Corporation saw the lingering affects of the recession hit sectors of its market area in the form of loan delinquency and charge-offs, resulting in an unprecedented level of provision for loan loss expense for the year. Despite these events, the Corporation is pleased to report earnings of \$6.6 million for 2011. However, this is \$1.0 million less than in 2010. Diluted earnings per share were \$1.66 for the year compared to \$1.96 per share in 2010. The Corporation is also pleased that it was able to maintain its dividend at \$1.08 per share for the year. The balance sheet grew to \$990.2 million at year-end from \$951.9 million in 2010 with growth coming in both loans and core deposits during the year. Shareholders' equity increased during the year due to retained earnings and an additional \$1.7 million investment by shareholders in the Corporation through the dividend reinvestment plan. Net interest income increased year over year, but this increase was more than offset by the provision for loan loss expense of \$7.5 million. Noninterest income increased slightly in 2011, but much of this increase was due to less securities losses in 2011 compared to 2010, thereby improving the 2011 result. Noninterest expense increased during the year due primarily to salaries and benefits. Net charge-offs increased to .86% in 2011 from .45% in 2010, but the ratio of nonperforming loans fell from 3.68% in 2010 to 2.94% in 2011. Other key performance measurements are presented above in Item 6, Selected Financial Data.

A more detailed discussion of the areas that had the greatest affect on the reported results follows.

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. For the purpose of this discussion, balance sheet items refer to the average balance for the year and net interest income is adjusted to a fully taxable-equivalent basis. This tax-equivalent adjustment facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Corporation's 34% Federal statutory rate. The components of net interest income are detailed in Tables 1, 2 and 3.

2011 versus 2010

Summary: In 2011, tax equivalent net interest income totaled \$34.4 million compared to \$31.9 million the prior year. Interest rates remained low throughout 2011 resulting in a decrease in interest income of \$824 thousand. However, this reduction was more than offset by a \$3.3 million reduction in interest expense. As a result, tax equivalent net interest income increased \$2.5 million in 2011. The Corporation's net interest margin as percentage of earning assets improved from 3.53% in 2010 to 3.73% in 2011 primarily due to lower rates on liabilities.

Assets: Average interest earning assets for 2011 were \$920.3 million, approximately \$16 million more than in 2010. The yield on assets declined again in 2011 as interest rates remained low throughout the year. Lower asset yields drove interest income down by more than the increase produced by higher asset balances. Consequently, tax-equivalent interest income declined \$824 thousand year over year. Table 2 presents information on the affect that changes in volume (balance sheet size) and the changes in rates have on tax-equivalent interest income. Table 3 presents information on the average balance and yields on average earning assets.

The average balance of investment securities in 2011 declined by approximately \$5 million compared to the 2010 average balance. Interest income fell by approximately \$1 million as the cash flow from higher yielding investments was reinvested at lower rates. The Bank has not been actively increasing its investment purchases choosing rather to

reinvest the funds into loans. Investment purchases throughout the year were made primarily to provide collateral needed for secured deposits and Repo accounts.

The loan portfolio grew in 2011 as average loans totaled \$764.6 million compared to \$753.6 million in 2010. For the second straight year, only the commercial loan portfolio showed an increase over the prior year. Like the investment portfolio, the low rate environment has continued to reduce the loan yield, dropping it to 5.09% in 2011 from 5.15% in 2010. Tax equivalent interest income on loans increased year over year primarily due to a larger loan portfolio.

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Commercial loans were the only portfolio sector to grow in 2011. The yield on these loans was 4.83% in 2011 and remained fairly stable from 2010. Commercial lending has remained steady with both new financing opportunities as well as refinancing of existing customers. In an effort to counter the affect of the low rate environment, the Bank has been implementing rate floors on new and renewed credits. Currently, approximately 81% of the commercial portfolio is variable rate and \$184 million of this total has a rate floor. While the rate floors provide an immediate benefit by enhancing interest income, they will delay any potential increase in income as rates rise.

Residential mortgage loans continue to run-off, decreasing approximately \$6 million from the 2010 average balance of \$66.1 to an average of \$60.5 million in 2011. The Bank is retaining fewer of the mortgages it originates and the mortgages retained in 2011 were not sufficient to counter the run-off in the existing portfolio. The yield on these loans declined again in 2011, but the lower 2011 balance is the primary reason for the decline in interest income from mortgage loans. The balance of the residential mortgage portfolio is highly dependent on the volume of new loans retained by the Bank.

Home equity loans and lines of credit declined for the second straight year in 2011. Many consumers have seen their home s equity fall, have experienced a reduction or loss of income, or have reduced their spending. These factors have all contributed to a reduction in home equity lending. The yield on this product improved slightly due to a floor rate on some products. Lower volume was the main contributor to the decline in interest income from home equity products. Until real estate prices recover and consumers begin to have confidence in the economy, home equity lending is expected to be slow.

Liabilities: Average interest-bearing liabilities for 2011 declined slightly during the year to \$788.1 million compared to \$793.8 million in 2010. However, the reduction is due primarily to a significant decline in long-term debt that more than offset the increase in interest bearing deposits. Every deposit category, except time deposits, increased during the year. The Bank continued to reduce the cost of deposits during the year and this had the biggest affect in reducing interest expense on deposits. Table 2 presents information on the affect that changes in volume (balances sheet size) and changes in rates have on tax-equivalent interest expense. Table 3 presents information on the average balance and cost of interest liabilities.

The Money Management product continues to grow and the average balance for 2011 increased by approximately \$37 million. The Bank was able to reduce the rate on this product throughout the year and the reduction in interest expense from lower rates more than offset the growth; therefore, resulting in a decrease in interest expense of \$424 thousand. Despite rate reductions during the year, the product still maintains a competitive yield in a highly liquid product. Due to rate reductions made near the end of 2011, and then again at the start of 2012, the Bank expects the 2012 cost to be less than in 2011.

Time deposits (CDs) declined again for the second straight year. Time deposit balances are comprised of both retail and brokered CDs. Some consumers are unwilling to invest in long-term CDs due to low rates and the decrease in CDs can be partially attributed to maturing funds being moved to Money Management accounts. Those customers who are buying CDs are investing in short-term maturities and the majority of the retail portfolio matures within one year.

Repurchase balances held steady year over year after declining for three straight years. Repos are a cash management product used by corporate customers. The interest expense and rate were also unchanged from 2010.

Long-term debt is comprised of advances from FHLB Pittsburgh. The Bank did not take any new advances in 2011 and the lower balance is reflective of scheduled amortization, maturities and prepayments. The Bank prepaid \$15.6 million in advances during 2011. FHLB advances are the highest cost liability of the Bank. In 2012, 51% of the Bank s

FHLB advances will mature and by the end of 2013, 70% of FHLB advances will have matured. If these funds need replaced, either from FHLB or another source, the cost is expected to be substantially less than the current cost.

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2010 versus 2009

Summary: In 2010, tax equivalent net interest income increased by \$1.6 million to \$31.9 million when compared to the prior year. This represents an increase of 5.4% in 2010 versus a decline of 3.9% in 2009. Interest rates remained low throughout 2010 and this resulted in a decrease in interest income of \$606 thousand. However, this decrease was more than offset by a decrease in interest expense of \$2.2 million. The net interest margin improved from 3.44% in 2009 to 3.53% in 2010, primarily the result of a 31 basis point reduction in funding costs that more than offset a 19 basis point reduction in asset yield.

Assets: Interest earning assets averaged \$903.9 million in 2010, an increase of 2.6% over the 2009 average of \$880.9 million. The asset yield fell from 5.10% in 2009 to 4.91% in 2010 as nearly every earning asset category realized a reduction in yield over the year. Interest income declined slightly to \$44.3 million, a decrease of 1.3% from the 2009 total of \$45.0 million. The affect of a higher volume of earning assets was not enough to offset the negative affect of lower rates on interest income.

Investment securities averaged \$137.3 million for the year, approximately \$15 million less than the prior year average. A smaller portfolio and lower yields have contributed almost equally to a drop in interest income of \$1.3 million in the portfolio. The yield on the portfolio dropped from 4.5% in 2009 to 4.0% in 2010.

The loan portfolio grew in 2010 as average loans totaled \$753.6 million compared to \$710.1 million in 2009. However, only the commercial loan sector increased in 2010 while all other loan categories declined during the year. Despite the increase in total loans, the yield fell from 5.36% to 5.15% in 2010, but interest income on loans increased \$679 thousand as higher volume more than offset the negative affect of lower rates on interest income.

Commercial loans grew by \$64.5 million in 2010 to an average of \$576.3 million. The yield on the commercial loan portfolio fell for the second straight year from 4.97% to 4.85%. A larger portfolio in 2010 contributed the majority of the increase in interest income.

The balance of residential mortgage loans declined in 2010 to an average balance of \$66.1 million. This is approximately \$7 million less than the 2009 average balance. The yield on this portfolio fell to 5.68% in 2010 compared to 6.30% in 2009. Interest income is down \$861 thousand versus 2009 and rate and volume declines contributed equally to the reduction.

Home equity balances fell by in 2010 by \$8.9, to an average of \$89.3 million for the year. Home equity lending has been affected greatly by the slow economy and lack of consumer confidence. The smaller home equity portfolio had a greater negative affect on the interest income than did lower rates.

Liabilities: Interest bearing liabilities averaged \$793.8 million in 2010 an increase of \$13.2 million over the 2009 average. All of the deposit categories recorded an increase over 2009, except for time deposits. Repos and long-term debt also declined year over year. The expense of interest bearing liabilities was \$12.4 million in 2010 compared to \$14.7 million in 2009. Likewise, the cost of these funds fell from 1.88% in 2009 to 1.57% in 2010.

The Money Management product saw a significant increase in balances in 2010, averaging \$272.6 million or 26% higher than the 2009 average. The competitive yield and liquidity offered by this product proved attractive to consumers in 2010. The Bank did see some internal funds transferred as time deposits matured and moved to the Money Management product. The cost of these funds fell from 1.61% in 2009 to 1.32% in 2010, but the higher volume more than offset the savings from lower rates and interest expense increased by approximately 3% year over year.

Partially offsetting the growth in Money Management was a reduction in the average balance of time deposits, which fell by approximately \$25 million to an average of \$221.4 million in 2010. Time deposit balances are comprised of both retail and brokered CDs. The cost of time deposits fell significantly from 2.68% in 2009 to 2.09% in 2010 and this reduction was the largest contributor to lower interest expense on both time deposits and to total interest expense.

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The average balance of Repos fell for the third straight year to an average of \$60.3 million in 2010. As liquidity continued to tighten for many commercial customers, balances in the Repo continued to decline. The rate of this product remained constant at .25% year over year, but interest expense fell due to lower volume.

Long-term debt is comprised of advances from FHLB Pittsburgh. The Bank did not take any new advances in 2010 and the lower balance is reflective of scheduled amortization and maturities. Even though the balance and interest expense declined in 2010, the cost of these funds increased slightly because the rate on maturing funds was less than the weighted rate of the entire portfolio.

Table 1. Net Interest Income

| (Dollars in thousands) | 2011 | % Change | 2010 | % Change | 2009 | % Change |
|------------------------------------|------------------|---------------|-----------|----------|-----------|----------|
| Interest income | \$ 41,791 | -3.4% | \$ 43,284 | -1.1 % | \$ 43,757 | -5.2 % |
| Interest expense | 9,154 | -26.4% | 12,443 | -15.2 % | 14,674 | -8.5 % |
| Net interest income | 32,637 | 5.8% | 30,841 | 6.0 % | 29,083 | -3.4 % |
| Tax equivalent adjustment | 1,730 | | 1,061 | | 1,194 | |
| Tax equivalent net interest income | \$ 34,367 | 7.7% | \$ 31,902 | 5.4 % | \$ 30,277 | -3.9 % |

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Table 2 identifies increases and decreases in tax equivalent net interest income to either changes in average volume or to changes in average rates for interest-earning assets and interest-bearing liabilities. Numerous and simultaneous balance and rate changes occur during the year. The amount of change that is not due solely to volume or rate is allocated proportionally to both.

Table 2. Rate-Volume Analysis of Tax Equivalent Net Interest Income

| (Dollars in thousands) | 2011 Compared to 2010 | | | 2010 Compared to 2009 | | |
|--|-----------------------------|---------|---------|-----------------------------|---------|---------|
| | Increase (Decrease) due to: | | | Increase (Decrease) due to: | | |
| | Volume | Rate | Net | Volume | Rate | Net |
| Interest earned on: | | | | | | |
| Interest-bearing obligations in other banks and Federal funds sold | \$26 | \$ | \$26 | \$(10) | \$13 | \$3 |
| Investment securities: | | | | | | |
| Taxable | (105) | (573) | (678) | (426) | (639) | (1,065) |
| Nontaxable | (85) | (253) | (338) | (213) | (10) | (223) |
| Loans: | | | | | | |
| Commercial, industrial and agricultural | 1,736 | (116) | 1,620 | 3,141 | (616) | 2,525 |
| Residential mortgage | (312) | (151) | (463) | (425) | (436) | (861) |
| Home equity loans and lines | (698) | 276 | (422) | (567) | (77) | (644) |
| Consumer | (528) | (41) | (569) | (318) | (23) | (341) |
| Loans | 198 | (32) | 166 | 1,831 | (1,152) | 679 |
| Total net change in interest income | 34 | (858) | (824) | 1,182 | (1,788) | (606) |
| Interest expense on: | | | | | | |
| Interest-bearing checking | 16 | (58) | (42) | 3 | (9) | (6) |
| Money market deposit accounts | 449 | (873) | (424) | 810 | (701) | 109 |
| Savings accounts | 4 | (20) | (16) | 1 | (17) | (16) |
| Time deposits | (412) | (902) | (1,314) | (622) | (1,340) | (1,962) |
| Securities sold under agreements to repurchase | (1) | | (1) | (17) | | (17) |
| Short-term borrowings | | | | (13) | | (13) |
| Long-term debt | (1,538) | 46 | (1,492) | (477) | 151 | (326) |
| Total net change in interest expense | (1,482) | (1,807) | (3,289) | (315) | (1,916) | (2,231) |
| Increase in net interest income | \$1,516 | \$949 | \$2,465 | \$1,497 | \$128 | \$1,625 |

All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.

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The following table presents average balances, tax-equivalent interest income and expense, and yields earned or rates paid on the assets or liabilities.

Table 3. Analysis of Net Interest Income

All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.

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Provision for Loan Losses

During 2011, the Corporation saw an unprecedented level of net charge-offs, reaching \$6.6 million up from \$3.4 million in 2010. The level of nonperforming assets declined only slightly from the prior year. These factors, coupled with continued loan growth and Management's intention to ensure sufficient coverage for future losses, lead to the decision to add \$7.5 million to the allowance for loan losses via the provision expense in 2011. This amount was more than double the 2010 provision expense of \$3.2 million. Overall, the allowance for loan losses increased \$922 thousand during the year to \$9.7 million at year-end. The ALL as a percentage of total loans increased to 1.27% compared to 1.18% in 2010. Management performs a comprehensive analysis of the loan portfolio considering delinquencies trends and events, current economic conditions, and other relevant factors to determine the adequacy of the allowance for loan losses and the provision for loan losses. For more information, refer to the Loan Quality discussion and Tables 12 - 17.

Noninterest Income

2011 versus 2010

Summary: Noninterest income totaled \$10.2 million compared to \$9.4 million in 2010, an increase of 8.9%. Most categories of noninterest income increased over the prior year and the net loss on securities transactions (losses and impairment charges) was less in 2011 than in 2010.

Investment and Trust Services: These fees are comprised of asset management fees, estate administration and settlement fees, employee benefit plans and commissions from the sale of insurance and investment products through the Bank's Personal Investment Centers. Asset management fees are recurring in nature and are affected by the market value of the assets. Asset management fees increased 4.2% over 2010 primarily due to higher market values during the year. Estate fees were less than the prior year, while fees generated from the Personal Investment Centers increased primarily from commissions on the sale of investments. Trust assets under management were \$481.5 million at year-end, down slightly from the \$490.4 million in 2010. The Bank continues to actively pursue new investment and trust accounts as some larger competitors have implemented a minimum account size that has caused some of these customers to look elsewhere for service.

Loan service charges: For the third consecutive year, this category remained flat at \$1.2 million in 2011 compared to \$1.1 million in 2010 and \$1.2 million in 2009. Nearly all loan origination fees that are not deferred were less than in 2010. Fees earned for originating mortgages for sale in secondary market declined by approximately \$25 thousand as fewer mortgages were closed. Commercial loan service charges increased by \$214 thousand due primarily to prepayment fees. Consumer loan fees, including a debt protection program, totaled \$168 thousand and were nearly the same as fees collected in 2010.

Mortgage banking fees: Mortgage banking activities consist primarily of servicing mortgage loans originated and sold by the Bank. Fees from servicing mortgages declined as the portfolio of mortgages serviced for others (\$65.6 million) continues to pay down. No gain on the sale of mortgages was recorded in 2011 compared to \$32 thousand in 2010. Loans originated for the secondary market are done on a fee basis and these fees are recorded in loan service charges.

For loans that were previously sold with servicing retained, mortgage servicing rights (MSR) are recorded and represent the Bank's rights to receive future fee income from servicing these loans. MSR are measured and carried at the lower of cost or market value and are amortized over the expected life of the asset. In 2011 the MSR amortization was \$203 thousand compared to \$267 thousand in 2010. Net impairment charges on MSR were \$32 thousand in 2011.

In 2010, the Bank recorded a net impairment reversal of \$146 thousand on previously recorded MSR impairment

charges. While the Bank does not expect to originate and sell mortgages with servicing retained in the future, it will retain the existing servicing portfolio until those loans are paid-off. See Note 9 of the accompanying consolidated financial statements for additional information on mortgage servicing rights.

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Deposit fees: This category is comprised primarily of fees from overdrafts, an overdraft protection program, service charges, and account analysis. Total deposit fees fell by \$248 thousand during the year with nearly every fee category showing a reduction from 2010. A reduction in retail overdraft fees of \$178 thousand accounted for most of the decline in this category. The Bank changed some of its overdraft processes so that it would be in compliance with new regulatory guidance and best practices, and these changes contributed to some of this decline. These changes included eliminating overdraft fees on items less than \$5 and expanded counseling on account usage to customers who habitually overdraw their account. Commercial account analysis fees and overdrafts also dropped during the year. After experiencing a decline in 2010 in fees from the Bank's overdraft protection program, fees in 2011 from this program held steady compared to the prior year. In 2010, new regulations required consumers to opt-in to such programs. After an initial decline in fees due to this change, the activity and fees appear to have stabilized.

Debit card and other service charges and fees: Debit card income continues to be one the of best fee generators for the Bank. The Bank expects the upward trend in these fees to continue as more consumers have and use debit cards. Debit card fees are comprised of both a retail and business card program. The business debit card offers a cash back rewards program based on usage and it continues to grow in popularity. In total, debit card fees exceeded \$1 million in 2011, increasing more than 16%. In July 2011, components of the Durbin Act went into effect that restricted interchange fees charged by banks. This price regulation is intended only for banks with assets greater than \$10 billion. Even though the Bank is below the \$10 billion threshold, it was uncertain if this change would eventually filter down to community banks. At this time, it appears as if the two-tier interchange pricing system is working and there has been no affect on the Bank's debit card fees. Other fees and service charges are essentially unchanged from 2010 and are comprised of fees for wire transfers, ATM activity and safe deposit box rentals.

Other: This category increased by \$564 thousand in 2011 due to the recovery of previously incurred legal expenses of \$538 thousand as a prior lawsuit was decided in the Bank's favor.

Securities gains and losses: In 2011, other-than-temporary-impairment charges of \$240 thousand were recorded on three equity securities and two private label mortgage backed securities that were considered other than temporarily impaired. The 2010 OTTI charges included \$406 thousand on the merger of First Chester County Corporation into Tower Bancorp, Inc. and \$335 thousand on two private label mortgage backed securities. Net securities gains were \$157 thousand in 2011 compared to net gains of \$673 thousand in 2010.

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The following table presents a comparison of noninterest income for the years ended December 31, 2011 and 2010:

Table 4. Noninterest Income

| (Dollars in thousands) | December 31 | | Change | |
|--|-----------------|---------|--------|----------|
| | 2011 | 2010 | Amount | % |
| Noninterest Income | | | | |
| Investment and trust services fees | \$3,953 | \$3,844 | \$109 | 2.8 |
| Loan service charges | 1,198 | 1,132 | 66 | 5.8 |
| Mortgage banking activities | (72) | 146 | (218) | (149.3) |
| Deposit service charges and fees | 2,142 | 2,390 | (248) | (10.4) |
| Other service charges and fees | 614 | 508 | 106 | 20.9 |
| Debit card income | 1,024 | 882 | 142 | 16.1 |
| Increase in cash surrender value of life insurance | 682 | 672 | 10 | 1.5 |
| Other | 742 | 178 | 564 | 316.9 |
| OTTI losses on securities | (594) | (1,373) | 779 | 56.7 |
| Less: Loss recognized in other comprehensive income (before taxes) | (354) | (314) | (40) | (12.7) |
| Net OTTI losses recognized in income | (240) | (1,059) | 819 | 77.3 |
| Securities gains (losses), net | 157 | 673 | (516) | 76.7 |
| Total noninterest income | \$10,200 | \$9,366 | \$834 | 8.9 |

2010 versus 2009

Summary: Noninterest income totaled \$9.4 million an increase of 5.5% over the 2009 total of \$8.9 million. An increase in investment and trust service fees and security gains was partially offset by an increase in OTTI charges and the absence of a nonrecurring income event that occurred in 2009, but not in 2010.

Investment and Trust Services: These fees increased to \$3.8 million in 2010, an increase of 9.2% over the 2009 total of \$3.5 million. Compared to 2009, this area saw an increase in both recurring and nonrecurring fee income. Trust assets under management increased \$30 million from 2009 to 2010. Nonrecurring fee income, which is produced by estate administration and settlement fees, also increased in 2010. Income for the sale of investment and insurance products remained stable year over year.

Loan service charges: The category was virtually flat at \$1.1 million in 2010 versus \$1.2 million in 2009. Fees collected as prepayment penalties on commercial loans increased in 2010, but were offset by a reduction in fees earned for the origination of mortgage loans. Mortgages originated for a fee totaled \$22 million in 2010, down from \$38 million in 2009. Consumer loan fees, including fees for a debt protection program, increased slightly in 2010.

Mortgage banking fees: These fees remained stable at \$146 thousand in 2010 compared to \$145 thousand in 2009. However, in 2010 fees from servicing mortgages declined as the portfolio of mortgages serviced for others (\$79.9 million) continues to pay down. Gains on sales of mortgages increased by \$20 thousand in 2010 due to the fact that the Bank was changing its fee-based origination partner during the year and for a short time had to fund and sell mortgages rather than originating for a fee only. In 2010, the Bank had net reversals of \$146 thousand of previously recorded MSR impairment charges. However, this is less than the 2009 net reversal of \$212 thousand. In addition, the amortization of MSR in 2010 was approximately \$100 thousand less than in 2009, thereby enhancing mortgage banking fees. See Note 9 of the accompanying consolidated financial statements for additional information on mortgage servicing rights.

Deposit fees: In 2010, this category produced \$2.4 million in fees compared to \$2.6 million in 2009, a decrease of 7.2%. Commercial account fees remained fairly constant year over year, but an increase in commercial overdraft fees was offset by a decrease in commercial account analysis fees. Retail checking fees and overdraft charges remained constant at approximately \$1.0 million for both years. The Bank's overdraft

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coverage program saw fees decrease by \$154 thousand in 2010. A portion of this decrease can be attributed to new overdraft protection regulations, targeted toward overdraft protection programs that went into effect in mid-2010. Under these new regulations, consumers were required to opt-in to such programs. The Bank made a significant effort to notify customers of this change and to educate them about the benefits and use of overdraft protection programs.

Debit card and other service charges and fees: These fees increased 7.6% from 2009 to \$1.4 million. The largest contributing factor to the increase came from debit card fees. Debit card fees increased \$127 thousand year over year and both business and retail debit card products recorded an increase in fee income over 2009. The business debit card offers a cash back rewards program based on usage and it continues to grow in popularity.

Other: This category decreased significantly as a result of a \$278 thousand gain from life insurance proceeds in 2009 that did not occur in 2010.

Securities gains and losses: In 2010, other-than-temporary-impairment charges of \$1.1 million were recorded on three equity securities and two bond securities that it considered to be other than temporarily impaired. These charges include \$406 thousand on the merger of First Chester County Corporation into Tower Bancorp, Inc. and \$335 thousand on two private label mortgage backed securities. In 2009, \$422 thousand of impairment charges on four equity securities were recorded. Net securities gains were \$673 thousand in 2010 compared to net losses of \$522 thousand in 2009.

The following table presents a comparison of noninterest income for the years ended December 31, 2010 and 2009:

Table 4.1 Noninterest Income

| (Dollars in thousands) | December 31 | | Change | |
|--|-------------|---------|--------|----------|
| | 2010 | 2009 | Amount | % |
| Noninterest Income | | | | |
| Investment and trust services fees | \$3,844 | \$3,519 | \$325 | 9.2 |
| Loan service charges | 1,132 | 1,151 | (19) | (1.7) |
| Mortgage banking activities | 146 | 145 | 1 | (0.7) |
| Deposit service charges and fees | 2,390 | 2,575 | (185) | (7.2) |
| Other service charges and fees | 508 | 537 | (29) | (5.4) |
| Debit card income | 882 | 755 | 127 | 16.8 |
| Increase in cash surrender value of life insurance | 672 | 643 | 29 | 4.5 |
| Other | 178 | 499 | (321) | (64.3) |
| OTTI losses on securities | (1,373) | (422) | (951) | 225.4 |
| Less: Loss recognized in other comprehensive income (before taxes) | (314) | | | N/A |
| Net OTTI losses recognized in income | (1,059) | (422) | (637) | (150.9) |
| Securities gains (losses), net | 673 | (522) | 1,195 | (228.9) |
| Total noninterest income | \$9,366 | \$8,880 | \$486 | 5.5 |

Noninterest Expense

2011 versus 2010

Summary: Noninterest expense increased by 7.2% to \$28.3 million in 2011 from \$26.4 million in 2010. Salary and benefit expense contributed the largest increase (\$1.6 million), but was partially offset by a reduction in legal and professional fees of \$436 thousand.

Salaries and benefits: This category is the largest noninterest expense category and increased 11.8% in 2011 to \$15.2 million. The \$1.6 million increase in this category is comprised of an increase in salaries of \$664 thousand and approximately \$1 million in employee benefits. The increase in salary expense is primarily

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the result of staffing levels and normal salary adjustments. Benefit costs moved up over 2010 due to increases of \$181 thousand in incentive compensation plans, \$282 thousand in health insurance and \$264 thousand for the pension plans. The Bank has taken several actions to control the cost of employee benefits including its participation in a self-insured health insurance plan and closing the pension plan to new participants in 2007. Since participating in the self-insured health insurance plan, the Bank's long-term increases have been less than comparable increases in the market. The low rate environment continues to affect the pension plan and as a result pension expense has increased. The Bank expects its 2012 pension expense to approximate the 2011 amount. See Note 15 of the accompanying consolidated financial statements for additional information on benefit plans.

Advertising: Advertising costs were unchanged at \$1.3 million in both 2011 and 2010. Advertising and promotion efforts continue to focus on brand recognition in our various markets and are less concentrated on specific product promotion. In 2011, a new remote ATM was opened and special promotional efforts were taken to announce and market its opening.

Legal and professional fees: This category consists of fees paid to outside legal counsel, consultants, and audit fees. These fees declined significantly during the year, \$436 thousand (29.0%) less than the year before. The majority of the decrease occurred in the legal fee account that was \$358 thousand less than in 2010. Other professional fees in this category fluctuated slightly from the prior year. In past years, several lawsuits against the Corporation inflated legal expenses. In 2011, the Corporation recovered \$538 thousand in prior period legal fees upon resolution of a lawsuit. This fee was recorded in other income.

Data processing: The largest cost in this category is the expense associated with the Bank's core processing system and accounted for \$970 thousand of the total data processing cost of \$1.5 million. In 2011, the Bank changed its core processing system to FIS and its IBS product. This new system should provide greater operating efficiency and should help reduce the rate of fee increases in future years.

FDIC insurance: The expense for FDIC insurance decreased by \$94 thousand and totaled \$1.1 million for the year. In 2011, the FDIC changed its premium assessment base from a deposit-based calculation to an asset-based calculation. Based on the new method, the Bank's insurance expense decreased despite an increase in deposits.

Other: Other noninterest expense was \$4.2 million in 2011, increasing \$839 thousand from \$3.4 million in 2010. In 2011, the Bank prepaid three high-rate FHLB advances and incurred penalties of \$344 thousand. Prepaying these advances will help future earnings. Increases were also recorded in charitable donations to local organizations, loan collection and foreclosure expense, and expenses related to a new reporting format required by the SEC. Loan collection and foreclosure expense was \$288 thousand in 2011 and the Bank expects that these expenses will be higher in 2012.

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The following table presents a comparison of noninterest expense for the years ended December 31, 2011 and 2010:

Table 5. Noninterest Expense

| (Dollars in thousands) | December 31 | | Change | |
|---------------------------------|-------------|-----------|----------|---------|
| | 2011 | 2010 | Amount | % |
| Noninterest Expense | | | | |
| Salaries and benefits | \$ 15,195 | \$ 13,592 | \$ 1,603 | 11.8 |
| Net occupancy expense | 2,006 | 1,962 | 44 | 2.2 |
| Furniture and equipment expense | 837 | 781 | 56 | 7.2 |
| Advertising | 1,335 | 1,342 | (7) | (0.5) |
| Legal and professional fees | 1,069 | 1,505 | (436) | (29.0) |
| Data processing | 1,462 | 1,617 | (155) | (9.6) |
| Pennsylvania bank shares tax | 681 | 610 | 71 | 11.6 |
| Intangible amortization | 446 | 457 | (11) | (2.4) |
| FDIC insurance | 1,084 | 1,178 | (94) | (8.0) |
| Other | 4,218 | 3,379 | 839 | 24.8 |
| Total noninterest expense | \$ 28,333 | \$ 26,423 | \$ 1,910 | 7.2 |

2010 versus 2009

Summary: Noninterest expense increased modestly by 1.9% (\$494 thousand) to \$26.4 million in 2010. Salary and benefit expense contributed the largest increase (\$879 thousand), but was partially offset by decreases in FDIC insurance premiums, and legal and professional fees.

Salaries and benefits: This category increased 6.9% in 2010 to \$13.6 million. Of the \$879 thousand increase in this category, \$640 thousand is related to salary expense and \$239 thousand is for employee benefits and related items. In 2009, the Bank deferred salary increases for 6 months and suspended all incentive payouts in order to reduce expense in the midst of the recession. In 2010, normal salary adjustments were made as scheduled and incentive payouts were accrued. While achieving its purpose of reducing expense in 2009, the salary deferral exaggerated the increase in salary expense between the years. The Bank also saw its incentive compensation cost increase \$88 thousand, health insurance increased \$85 thousand, training costs were up \$28 thousand, and numerous other categories saw smaller increases. Partially offsetting these increases was a decrease in pension expense of \$115 thousand.

Advertising: Advertising costs were \$1.3 million in both 2010 and 2009. Advertising and promotion efforts focused on brand recognition in our various markets and were less concentrated on specific product promotion. A new community office was opened in 2010, and special promotional efforts were taken to announce and market its opening.

Legal and professional fees: In 2010, these fees declined by \$192 thousand or 11.3%. Reductions were recorded in legal (\$221 thousand), consulting fees (\$21 thousand), and audit fees (\$5 thousand). An ongoing lawsuit stemming from activity at Community, prior to its acquisition by the Corporation, accounted for a large portion of the legal bills in 2010.

Data processing: These expenses were \$1.6 million in 2010, up 5.1% from 2009. The largest cost in this category is the expense associated with the Bank's core processing system and accounted for \$1.1 million of the total expense.

FDIC insurance: The expense for FDIC insurance dropped in 2010 by nearly 16% to \$1.2 million, compared to \$1.4 million the prior year. In 2009, the FDIC charged a one-time special assessment that cost the Bank \$450 thousand. This assessment was not charged in 2010. Partially offsetting this reduction were increases to the standard premium expense from an increase in deposit balances and higher assessment rates.

Other: Other noninterest expense was \$3.4 million in 2010, a decrease of approximately 5.3% from 2009. Nearly all line items in this category remained fairly constant during the year. Contributing to the decrease from 2009 were two nonrecurring events in 2009 that added \$205 thousand of expense in 2009, but

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did not occur again in 2010. However, the Bank did realize an increase in loan collection and foreclosure expense, increasing from \$199 thousand in 2009 to \$244 thousand in 2010; and a \$55 thousand increase in expenses related to forgery and fraud.

The following table presents a comparison of noninterest expense for the years ended December 31, 2010 and 2009:

Table 5.1 Noninterest Expense

| (Dollars in thousands) | December 31 | | Change | |
|---------------------------------|-------------|-----------|--------|---------|
| | 2010 | 2009 | Amount | % |
| Noninterest Expense | | | | |
| Salaries and benefits | \$ 13,592 | \$ 12,713 | \$ 879 | 6.9 |
| Net occupancy expense | 1,962 | 1,898 | 64 | 3.4 |
| Furniture and equipment expense | 781 | 850 | (69) | (8.1) |
| Advertising | 1,342 | 1,226 | 116 | 9.5 |
| Legal and professional fees | 1,505 | 1,697 | (192) | (11.3) |
| Data processing | 1,617 | 1,538 | 79 | 5.1 |
| Pennsylvania bank shares tax | 610 | 573 | 37 | 6.5 |
| Intangible amortization | 457 | 468 | (11) | (2.4) |
| FDIC insurance | 1,178 | 1,397 | (219) | (15.7) |
| Other | 3,379 | 3,569 | (190) | (5.3) |
| Total noninterest expense | \$ 26,423 | \$ 25,929 | \$ 494 | 1.9 |

Provision for Income Taxes

For 2011, the Corporation recorded a Federal income tax expense of \$411 thousand compared to \$2.9 million in 2010 and \$2.0 million in 2009. During the second quarter of 2011, an internal review discovered that tax-exempt commercial loans booked in the fourth quarter of 2008, during 2009, 2010 and the first quarter of 2011 were not properly coded as tax-exempt in the Bank's core processing system. This resulted in the income from these loans being recorded as taxable income and the benefit of the tax-exempt status was not reflected in the Corporation's income tax calculation. After a thorough review of the affected loans to determine the unrecorded tax benefit, and consultation with the Corporation's internal and external audit firms, the Corporation deemed the adjustment to be immaterial to the consolidated financial statements for the current and prior years and therefore, no prior period adjustment was required. The Corporation recorded the past income tax benefits during the second quarter of 2011. The adjustment to income tax expense made in the second quarter was a credit of approximately \$660 thousand attributable to the years 2008, 2009 and 2010 and approximately \$95 thousand attributable to the first quarter of 2011. This adjustment is reflected in the 2011 income tax expense. In addition, lower pre-tax income in 2011, coupled with a higher ratio of tax-exempt income, helped reduce the income tax expense and the effective tax rate for the year. The effective tax rate for 2011, 2010 and 2009 was 5.9%, 27.8% and 23.4% respectively. Had the tax adjustment of \$660 thousand been allocated proportionally to the years it was generated, the effective tax rate for 2011, 2010 and 2009 would have been 15.3%, 24.1% and 20.8%, respectively. For a more comprehensive analysis of Federal income tax expense refer to Note 12 of the accompanying financial statements.

Financial Condition

One method of evaluating the Corporation's condition is in terms of its sources and uses of funds. Assets represent uses of funds while liabilities represent sources of funds. At December 31, 2011, total assets were \$990.2 million, an

increase of 4.0% over the 2010 year-end balance of \$951.9 million. The following discussion on financial condition will reference the average balance sheet in Table 3 unless otherwise noted.

Investment Securities:

The investment portfolio serves as a mechanism to invest funds if funding sources out pace lending activity, to provide liquidity for lending and operations, and provide collateral for deposits and borrowings. The Corporation invests in taxable and tax-free debt securities, and equity securities as part of its investment

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strategy. The mix of taxable and tax-free debt securities are determined by the Bank's Investment Committee and investing decisions are made as a component of balance sheet management. Debt securities include U.S. Government Agencies, U.S. Government Agency mortgage-backed securities, non-agency mortgage-backed securities, state and municipal government bonds, corporate debt and trust preferred securities. The equity portfolio consists of bank stocks only and is considered to be longer-term with a focus on capital appreciation. Tables 6-9 provide additional detail about the investment portfolio. All securities are classified as available for sale and all investment balances refer to fair value.

The following table presents amortized cost and estimated fair value of investment securities by type at December 31 for the past three years:

Table 6. Investment Securities at Amortized Cost and Estimated Fair Value

| (Dollars in thousands) | 2011 | | 2010 | | 2009 | |
|---|------------------|------------------|-----------|------------|-----------|------------|
| | Cost | Fair Value | Cost | Fair Value | Cost | Fair Value |
| Equity Securities | \$2,105 | \$1,759 | \$4,126 | \$3,638 | \$5,400 | \$3,975 |
| Obligations of U.S. Government agencies | 13,159 | 13,229 | 14,780 | 14,785 | 28,258 | 28,715 |
| Obligations of state and political subdivisions | 42,490 | 45,081 | 39,477 | 39,952 | 42,611 | 43,881 |
| Corporate debt securities | 2,484 | 2,414 | 2,647 | 2,665 | 3,741 | 3,616 |
| Trust preferred securities | 5,890 | 4,618 | 5,875 | 4,197 | 5,862 | 3,644 |
| Agency mortgage-backed securities | 54,314 | 55,285 | 47,239 | 48,297 | 53,214 | 54,743 |
| Private-label mortgage-backed securities | 3,366 | 2,867 | 4,424 | 4,029 | 5,947 | 4,668 |
| Asset-backed securities | 66 | 48 | 74 | 53 | 84 | 46 |
| | \$123,874 | \$125,301 | \$118,642 | \$117,616 | \$145,117 | \$143,288 |

The following table presents analysis of investment securities at December 31, 2011 by maturity, and the weighted average yield for each maturity presented. The yields presented in this table are calculated using tax-equivalent interest and the amortized cost.

Table 7. Maturity Distribution of Investment Portfolio

The investment portfolio averaged \$132.5 million for 2011 compared to \$137.3 million in 2010. Despite the decline in the average balance during the year, the portfolio ended 2011 higher than the prior year. As interest rates continue to remain low, cash flow was reinvested in the portfolio at lower rates and the yield on

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the portfolio continued to fall. The yield has fallen from 4.47% in 2009 to 4.03% in 2010 and to 3.41% in 2011. At year-end, the largest components of the portfolio were agency mortgage backed securities (\$55.3 million) and municipal bonds (\$45.1 million). Combined, these sectors comprise 80% of the total portfolio and represent a higher percentage of the portfolio than in 2010 or 2009. The portfolio produced \$31.5 million in cash flow in 2011 while \$37.6 million was invested into the portfolio during the year. The majority of the investment purchases were made to maintain collateral positions. For the year, the Corporation recorded net securities gains of \$157 thousand and other-than-temporary impairment charges of \$240 thousand.

Equities: The equity portfolio is comprised entirely of bank stocks with the Bank and the Corporation each holding separate portfolios. The stocks held in the portfolio range from community banks to large national banks. In 2011, other-than-temporary impairment charges of \$185 thousand were recorded against the equity portfolio.

Municipal Bonds: The Bank's municipal bond portfolio is well diversified geographically and is comprised primarily of general obligation bonds (72% of the portfolio). The portfolio holds ninety-four separate issues within twenty-six states. The largest dollar exposure is to issuers in the state of Texas (\$8.3 million / 18.4%) and Pennsylvania (\$6.4 million / 14.3%). The majority of the bonds have either private bond insurance or have some other type of credit enhancement. The portfolio contains 4 taxable municipal bonds with a fair value of \$3.7 million. When purchasing municipal bonds, the Bank looks primarily to the underlying credit of the issuer as a sign of credit quality and then to any credit enhancement. Approximately \$31 million of the portfolio is rated A or higher by Moody. The Bank owns five issues for \$2.1 million that are not rated by a nationally recognized rating agency.

Corporate Bonds: There are 3 issuers that comprise the holdings in the corporate bond portfolio, all in the financial services sector. These bonds are both fixed and floating rate bonds and have Moody ratings ranging from A1 to B2.

Trust Preferred Bonds: The Bank holds 7 single-issue trust-preferred securities at a cost of \$5.9 million and a fair value of \$4.6 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 deeply subordinated 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 recent financial conditions, most trust preferred securities have realized a significant decline in value, but market prices continue to improve slowly. All of the Bank's issues are single issuer, variable rate notes with long final maturities (2027 - 2028) that continue to pay dividends. The following table provides additional detail about the Bank's trust preferred securities at December 31, 2011.

Table 8. Trust Preferred Securities

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Mortgage-backed Securities: The largest sector of the portfolio continues to be held in mortgage-backed securities (MBS) with \$58.2 million or 46% of the total portfolio. The majority of this sector (\$55.3 million) is comprised of U.S. Government Agency MBS. In addition, the Bank holds 7 private label mortgage-backed securities (PLMBS) with a fair value of \$2.9 million and an amortized cost of \$3.4 million. These PLMBS bonds paid down by more than \$1 million in 2011.

The Bank's PLMBS portfolio is comprised primarily of Alt-A loans. Alt-A loans are first-lien residential mortgages that generally conform to traditional prime 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 product that was originated between 2003 and 2006 and all were originally rated AAA. The bonds issued in 2006 are experiencing the highest delinquency and loss rates. All of these bonds originally had some type of credit support tranche to absorb any loss prior to losses at the senior tranche held by the Bank, but this has eroded completely on some bonds as they have started to experience losses. The Bank recorded other-than-temporary impairment charges of \$55 thousand on two PLMBS bonds in 2011. Based on the performance of some the PLMBS, it appears as if the underwriting standards that were represented in the offering, and resulted in the AAA rating, were not followed. As a result, the Bank purchased some securities based on these misrepresentations, and it is most likely that these securities would not have been purchased had all the information been reported correctly. The Bank is participating in a lawsuit against certain issuers related to these misrepresentations.

The following table provides additional detail about the Bank's PLMBS at December 31, 2011.

Table 8.1 Private Label Mortgage Backed Securities

| <i>(Dollars in thousands)</i> Description | Origination Date | Amortized Cost | Fair Value | Gross Unrealized Gain (Loss) | Collateral Type | Lowest Credit Rating Assigned | Credit Support % | Cumulative OTTI Charges |
|--|---------------------|-------------------|---------------|---------------------------------------|--------------------|--|------------------------|-------------------------------|
| RALI 2003-QS15 A1 | 8/1/2003 | \$ 174 | \$ 175 | \$ 1 | ALT A | A1 | 11.23 | \$ |
| RALI 2004-QS4 A7 | 3/1/2004 | 452 | 451 | (1) | ALT A | AA | 12.28 | |
| MALT 2004-6 7A1 | 6/1/2004 | 642 | 606 | (36) | ALT A | B | 11.20 | |
| RALI 2005-QS2 A1 | 2/1/2005 | 547 | 496 | (51) | ALT A | CCC | 7.24 | |
| RALI 2006-QS4 A2 | 4/1/2006 | 836 | 538 | (298) | ALT A | D | | 218 |
| GSR 2006-5F 2A1 | 5/1/2006 | 275 | 271 | (4) | Prime | C | 2.87 | |
| RALI 2006-QS8 A1 | 7/28/2006 | 440 | 330 | (110) | ALT A | D | | 172 |
| | | \$ 3,366 | \$ 2,867 | \$ (499) | | | | \$ 390 |
| Impairment: | | | | | | | | |

At December 31, 2011, the investment portfolio contained 58 temporarily impaired securities with a fair value of \$32.1 million and \$2.5 million in unrealized losses. The unrealized loss position has improved from year-end 2010 when there were 85 temporarily impaired securities with an unrealized loss of \$3.2 million. The sectors showing the

largest decline in unrealized loss are state and municipal bonds, and trust preferred securities. Despite the improvement in the value of trust preferred securities, they continue to represent 52% of the total portfolio unrealized loss.

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 the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities, and subject to assessment at December 31, 2011, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

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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 December 31, 2011 and 2010:

Table 9. Temporary Impairment

| <i>(Amounts in thousands)</i> | December 31, 2011 | | | | | | | | |
|---|---------------------|-------------------|-------|-------------------|-------------------|-------|------------|-------------------|-------|
| | Less than 12 months | | | 12 months or more | | | Total | | |
| | Fair Value | Unrealized Losses | Count | Fair Value | Unrealized Losses | Count | Fair Value | Unrealized Losses | Count |
| Equity securities | \$394 | \$(111) | 3 | \$864 | \$(246) | 13 | \$1,258 | \$(357) | 16 |
| Obligations of U.S. Government agencies | 6,068 | (3) | 5 | 1,321 | (2) | 5 | 7,389 | (5) | 10 |
| Obligations of state and political subdivisions | 579 | (7) | 1 | | | | 579 | (7) | 1 |
| Corporate debt securities | | | | 1,889 | (119) | 2 | 1,889 | (119) | 2 |
| Trust preferred securities | | | | 4,618 | (1,272) | 7 | 4,618 | (1,272) | 7 |
| Agency mortgage-backed securities | 12,452 | (156) | 12 | 1,174 | (32) | 1 | 13,626 | (188) | 13 |
| Private-label mortgage-backed securities | 1,057 | (36) | 2 | 1,636 | (464) | 4 | 2,693 | (500) | 6 |
| Asset-backed securities | | | | 48 | (18) | 3 | 48 | (18) | 3 |
| Total temporarily impaired securities | \$20,550 | \$(313) | 23 | \$11,550 | \$(2,153) | 35 | \$32,100 | \$(2,466) | 58 |

The unrealized loss in the equity portfolio was \$357 thousand on 16 issues at year-end, an improvement over the unrealized loss of \$538 thousand at year-end 2010. Contributing to this improvement was an other-than-temporary impairment charge of \$185 thousand on equities that was recorded in 2011. The impairment identified on these securities was deemed to be temporary and no adjustments to the financial statements was required.

The unrealized loss in the trust preferred sector was \$1.3 million at year-end compared to \$1.7 million one-year prior. Due to the affect that the recent recession had on the financial performance of many financial institutions, most trust preferred securities realized a significant decline in value. However, market prices continued to show improvement during 2011. All of the Bank's trust preferred securities are variable rate notes with long maturities (2027 - 2028) from companies that received money (and in some cases paid back) from the Troubled Asset Relief Program (TARP), continue to pay dividends and have raised capital. The credit ratings on this portfolio range from B to Baa1 and no bonds have missed or suspended any payments. At December 31, 2011, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded. For additional detail on the Bank's trust preferred securities see Table 8.

The PLMBS sector continues to show an unrealized loss of \$500 thousand on 6 securities. The majority of this sector is comprised of Alt-A PLMBS. These bonds were all rated AAA at time of purchase but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the 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 analysis on PLMBS it was determined that two bonds contained losses

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that were considered other-than-temporary. Management determined \$55 thousand was credit related and therefore, recorded an impairment charge of \$55 thousand against earnings in 2011. The market for PLMBS 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 continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. For additional detail on the Bank's PLMBS see Table 8.1 above.

The Bank held \$5.0 million of restricted stock at the end of 2011. The restricted stock is comprised primarily of an investment in the Federal Home Loan Bank of Pittsburgh (FHLB). FHLB stock is carried at a cost of \$100 per share.

In 2008, FHLB announced a capital restoration plan that resulted in it discontinuing paying dividends and repurchasing excess capital stock from its members. Therefore, the Bank's investment in FHLB is a non-earning asset at this time. It is not known if or when FHLB will be able to restore its dividend or repurchase its stock. However, during 2011, FHLB repurchased \$1.1 million in stock as part of special repurchases. As of December 31, 2011, the Bank held \$1.4 million in FHLB stock in excess of what it would have been required to hold prior to the suspension of the stock repurchase plan. FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. If FHLB stock were deemed to be impaired, the write-down for the Bank could be significant. 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:

For 2011, average gross loans increased slightly to \$764.6 million compared to \$753.6 million in 2010. Commercial loans were the only loan category to show an increase in average outstandings during the year. Both mortgage and consumer loan portfolios decreased on average, year over year. The low interest rate environment continues to have a negative affect on the yield of the loan portfolio as it decreased for the third consecutive year to 5.09% in 2011. The following table shows loans outstanding, by primary collateral, as of December 31 for the past 5 years.

Table 10. Loan Portfolio

| | December 31 | | 2010 | | 2009 | | 2008 | | 2007 |
|---|-----------------|---------------|----------|----------|-----------|----------|-----------|----------|-----------|
| | Balance | % Change | Balance | % Change | Balance | % Change | Balance | % Change | Balance |
| <i>(Dollars in thousands)</i> | | | | | | | | | |
| Residential real estate | | | | | | | | | |
| 1 - 4 family | | | | | | | | | |
| Consumer first lien | \$86,767 | -11.9% | \$98,528 | -11.4% | \$111,252 | -12.1% | \$126,524 | -1.0% | \$127,835 |
| Consumer junior lien and lines of credit | 40,290 | -11.8% | 45,669 | -12.0% | 51,903 | -10.7% | 58,113 | -5.5% | 61,523 |
| Total consumer | 127,057 | -11.9% | 144,197 | -11.6% | 163,155 | -11.6% | 184,637 | -2.5% | 189,358 |
| Commercial first lien | 55,130 | 20.9% | 45,600 | 46.7% | 31,078 | 14.6% | 27,130 | 54.3% | 17,580 |
| Commercial junior liens and lines of credit | 7,846 | -28.8% | 11,025 | 15.4% | 9,557 | 132.1% | 4,118 | 52.6% | 2,698 |
| Total commercial | 62,976 | 11.2% | 56,625 | 39.4% | 40,635 | 30.0% | 31,248 | 54.1% | 20,278 |
| Total residential real estate 1 - 4 family | 190,033 | -5.4% | 200,822 | -1.5% | 203,790 | -5.6% | 215,885 | 3.0% | 209,636 |

| | | | | | | | | | |
|---|------------------|---------------|-----------|--------|-----------|--------|-----------|--------|-----------|
| Residential real estate construction | | | | | | | | | |
| Consumer purpose | 1,381 | -27.2% | 1,897 | 7.5 % | 1,765 | 332.6% | 408 | -9.1 % | 449 |
| Commercial purpose | 19,901 | -74.4% | 77,660 | -6.3 % | 82,884 | 14.5 % | 72,410 | -12.7% | 82,920 |
| Total residential real estate construction | 21,282 | -73.2% | 79,557 | -6.0 % | 84,649 | 16.2 % | 72,818 | -12.7% | 83,369 |
| Commercial, industrial and agricultural real estate | 358,974 | 18.0% | 304,195 | 7.2 % | 283,839 | 23.6 % | 229,673 | 58.0 % | 145,400 |
| Commercial, industrial and agricultural | 182,694 | 24.6% | 146,672 | 1.8 % | 144,035 | 8.8 % | 132,368 | 23.4 % | 107,263 |
| Consumer | 13,427 | -22.8% | 17,396 | -25.2% | 23,250 | -8.7 % | 25,473 | -1.8 % | 25,949 |
| Total loans | 766,410 | 2.4% | 748,642 | 1.2 % | 739,563 | 9.4 % | 676,217 | 18.3 % | 571,617 |
| Less: Allowance for loan losses | (9,723) | 10.5% | (8,801) | -1.5 % | (8,937) | 21.5 % | (7,357) | -0.1 % | (7,361) |
| Net loans | \$756,687 | 2.3% | \$739,841 | 1.3 % | \$730,626 | 9.2 % | \$668,860 | 18.5 % | \$564,256 |

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The Corporation had no foreign loans in any of the years presented.

Residential real estate: This category is comprised of consumer purpose loans secured by residential real estate and to a lesser extent, commercial purpose loans secured by residential real estate. Total residential real estate loans declined by 5% from the 2010 total. The consumer purpose category represents traditional residential mortgage loans and home equity products. Both of these categories declined in 2011. The majority of the mortgages generated by the Bank are not held in the Bank's portfolio, but sold in secondary markets. They are originated for a fee as part of a third party brokerage agreement. In 2011, the Bank originated approximately \$13 million in mortgages for a fee through this brokerage agreement. The Bank sells most of its mortgage production as part of its interest rate risk management function to avoid holding long-term low rate assets, as borrowers tend to be favoring fixed rate mortgages. In 2012, the Bank plans to hold specifically identified mortgages it originates; however, if the volume of new mortgages booked is not sufficient to offset the amortization in the portfolio, the balance will decline again in 2012. The Bank does not originate or hold any loans that would be considered sub-prime or Alt-A.

Home equity lending has been slowed by the recent recession. Many consumers have seen equity in their homes disappear or have been reluctant to borrow due to uncertainty in the economy. Despite low rates, the Bank expects that home equity lending will not pick up significantly until the overall economy improves.

Commercial purpose loans in this category represent loans made for various business needs, but are secured with residential real estate. In addition to the real estate collateral, it is possible that additional security is provided by personal guarantees or UCC filings. These loans are underwritten as commercial loans.

Residential real estate construction: The largest component of this category represents loans to residential real estate developers. This category declined significantly in 2011. The majority of this decrease is offset by the increase in the commercial real estate portfolio as loans were reclassified due to construction loans moving to an amortizing status and to more accurately reflect the collateral or purpose of the loan. The Bank's exposure to residential construction loans is concentrated primarily in south central Pennsylvania. Real estate construction loans, especially land development loans, frequently provide an interest reserve in order to assist the developer during the development stage when minimal cash flow is generated. All real estate construction loans are underwritten in the same manner, regardless of the use of an interest reserve. At December 31, 2011, the Bank had \$23.9 million in real estate loans funded with an interest reserve and has capitalized \$2.2 million of interest from these reserves on active projects. Real estate construction loans are monitored on a regular basis by either an independent third party inspector or the assigned loan officer depending on loan amount or complexity of the project. This monitoring process includes at a minimum, the submission of invoices and AIA documents of costs incurred by the borrower, on-site inspections, and a signature by the assigned loan officer for disbursement of funds. Year-to-date, the Bank has recognized \$426 thousand of interest income that was funded by interest reserve accounts.

Commercial loans and commercial real estate: Commercial lending continues to be the engine that is driving loan growth in the Bank. Loans in this category include commercial, industrial, farm, agricultural, and municipal government loans. Collateral for these loans may include, commercial real estate, farm real estate, equipment or other business assets. Total commercial loans increased to \$541.7 million from \$450.9 million at the end of 2010. In 2011, the Bank approved approximately \$144 million in commercial loans and commitments with approximately \$118 million in new money advances. Low rates continue to make variable rate loans attractive to borrowers. However, these are not as beneficial to the Bank and it has imposed rate floors on most new and refinanced loans during the year. There continues to be strong competition for good quality commercial loans, often focused on rate. The Bank cannot, nor does it always want to compete on rate.

Commercial real estate loans increased 18% year over year, but much of this increase is the result of moving loans out of the commercial construction category as discussed above. The largest sectors (by collateral) in the commercial real estate category are: hotels and motels (\$47.3 million), office buildings (\$33.2 million) and shopping centers (\$23.8 million). Non-real estate related commercial lending (C&I) increased 25% over 2010, growing to \$182.7 million. The largest sectors (by industry) are: manufacturing (\$22.3 million), retail trades (\$18.4 million), and construction (\$17.6 million). The Bank is very active in its market in pursuing commercial lending opportunities, but supplements in-market growth with purchased loan

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participations. The Bank purchases commercial loan participations in an effort to increase its commercial lending and diversify its loan mix, both geographically and by industry sector. Purchased loans are originated primarily within the south central Pennsylvania market and are purchased from only a few select counter parties. These loans usually represent an opportunity to participate in larger credits that are not available in market, with the benefit of lower origination and servicing costs. In 2011, the Bank purchased \$34.8 million of loan participations and commitments, with \$31.6 million secured by real estate collateral. The amount purchased in 2011 is double the amount of participations purchased in 2010. At December 31, 2011, the Bank held \$152.9 million in purchased loan participations in its portfolio compared to \$139.5 million at the prior year-end. The Bank expects that commercial lending will continue to be the primary area of loan growth in the future via in-market and loan participation activity. To enhance these growth opportunities, the Bank continues to partner with two Small Business Development Centers at local universities and is a designated Small Business Administration lender.

At December 31, 2011 high loan to value loans totaled \$57.2 million, 7.5% of gross loans and 62% of risk-based capital. This compares to \$59.1 million with a ratio of 8.0% of gross loans and 71.9% of risk-based capital at December 31, 2010. The largest exposure to high loan to value loans at year-end 2011 is in commercial real estate loans (\$20.4 million), commercial and industrial loans (\$16.2 million), and real estate construction loans (\$9.4 million). Management tracks high loan to value loans as exceptions to its internal lending policy and reports this exposure to the Credit Risk Oversight Committee of the Board of Directors.

Consumer loans: This category is comprised of direct, indirect (primarily automobile) and unsecured personal lines of credit and continues to show a downward trend in outstanding balances. This category declined by approximately \$4 million or 25% from 2010. Most of the decrease occurred in the indirect lending portfolio. The Bank's indirect lending portfolio is \$3.7 million, down from approximately \$7 million at year-end 2010. The Bank exited this line of business in the first quarter of 2010 and no new originations have been booked since then. At the current rate of run-off, the indirect portfolio will be completely paid off by the end of 2012. This portfolio also contains \$3.3 million of unsecured personal lines of credit and this balance is virtually unchanged from the prior year-end. In the other sectors of the consumer portfolio, 2011 originations of \$5.7 million were not sufficient to offset run-off. With exiting the indirect lending business, the unwillingness of consumers to increase their debt, and the highly price competitive nature of consumer lending, the consumer portfolio is expected to continue to run-down throughout 2012.

The following table presents the stated maturities (or earlier call dates) of selected loans as of December 31, 2011. Residential mortgage and consumer loans are excluded from the presentation.

Table 11. Maturities and Interest Rate Terms of Selected Loans

| <i>(Dollars in thousands)</i> | Less than 1 year | 1 5 years | Over 5 years | Total |
|---|---------------------|--------------|-----------------|------------|
| Loans: | | | | |
| Residential real estate construction | \$ 13,236 | \$ 6,967 | \$ 1,079 | \$ 21,282 |
| Commercial, industrial and agricultural real estate | 62,001 | 55,303 | 241,670 | 358,974 |
| Commercial, industrial and agricultural | 62,576 | 38,329 | 81,789 | 182,694 |
| | \$ 137,813 | \$ 100,599 | \$ 324,538 | \$ 562,950 |

Loans with fixed and variable interest rates at December 31, 2011 are shown below:

| <i>(Dollars in thousands)</i> | Less than 1 year | 1 5 years | Over 5 years | Total |
|-------------------------------|---------------------|--------------|-----------------|-------|
|-------------------------------|---------------------|--------------|-----------------|-------|

Loans:

| | | | | |
|---------------------------|------------|------------|------------|------------|
| Loans with fixed rates | \$ 7,681 | \$ 36,268 | \$ 64,953 | \$ 108,902 |
| Loans with variable rates | 130,132 | 64,331 | 259,585 | 454,048 |
| | \$ 137,813 | \$ 100,599 | \$ 324,538 | \$ 562,950 |

Loan Quality:

Management utilizes a risk rating scale ranging from 1 (prime) to 9 (loss) to evaluate loan quality. Risk ratings are assigned primarily to commercial purpose loans. Loans rated 1 - 4 are considered pass credits. Loans that are rated 5 are pass credits, but have been identified as credits that are likely to warrant additional

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attention and monitoring. Loans rated 6 (OAEM) or worse begin to receive enhanced monitoring and reporting by the Bank. The Bank monitors loan quality by continually reviewing four measurements: (1) watch list loans (loans risk rated 6 or worse), (2) delinquent loans (primarily nonaccrual loans and loans past due 90 days or more), (3) other real estate owned (OREO), and (4) net-charge-offs. Management compares trends in these measurements with the Bank's internally established targets, as well as its national peer group.

Loans that are risk rated 6 or worse are placed on the Bank's watch list. The watch list is the Bank's broadest review of loan quality. Loans on the watch list are adversely classified because the borrowers are, or may be experiencing a weakening financial condition that may result in a payment default. If these trends continue, the Bank has an increasing likelihood that it will need to liquidate collateral for repayment. The Bank's watch list includes loans that may or may not be delinquent or on nonaccrual, loans that may or may not be considered impaired, and potential problem loans. At December 31, 2011, there was \$93.5 million on the Bank's watch list comprised entirely of loans rated 6 or 7 (substandard). The Bank has no loans rated 8 (doubtful) or 9 (loss). Potential problem loans are included on the watch list and represent loans where the borrowers may not be able to comply with current loan terms, but excludes loans that are 90 days or more past due, and nonaccrual loans. Potential problem loans were \$71.0 million at year-end compared to \$42.4 million one-year earlier. The Bank's Loan Management Committee reviews the watch list and risk ratings on a monthly basis in order to proactively identify and manage problem loans. See Note 6 in the accompanying financial statements for a note that reports on the initial credit rating for those loans in the portfolio that are assigned an individual credit rating (primarily commercial) and those not assigned an individual credit rating (primarily consumer and residential mortgage loans).

Delinquent loans are a result of borrowers' cash flow and/or alternative sources of cash being insufficient to repay loans. The Bank's likelihood of collateral liquidation to repay the loans becomes more probable the further behind a borrower falls, particularly when loans reach 90 days or more past due. Management monitors the performance status of loans by the use of an aging report. The aging report can provide an early indicator of loans that may become severely delinquent and possibly result in a loss to the Bank. See Note 6 in the accompanying financial statements for a note that presents the aging of payments in the loan portfolio.

Nonaccruing loans generally represent Management's determination that the borrower will be unable to repay the loan in accordance with its contractual terms and that collateral liquidation is not likely to fully repay both interest and principal. It is the Bank's policy to evaluate the probable collectability of principal and interest due under terms of loan contracts for all loans 90-days or more past due or restructured loans. Further, it is the Bank's policy to discontinue accruing interest on loans that are not adequately secured and in the process of collection. Upon determination of nonaccrual status, the Bank 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 the balance of nonperforming loans (nonaccrual and loans past due 90-days or more) shows an improvement. Nonperforming loans have declined by approximately \$5 million since 2010. The reduction is due primarily to a \$3.2 million credit moving off nonaccrual during the year, charge-offs, and moving loans to OREO.

Nevertheless, both categories of nonperforming loans have declined from one year earlier. With the reduction in nonperforming loans, there was a corresponding reduction in the 2011 nonperforming ratios shown below compared to 2010. If Management is successful in its workout efforts on several credits, it is possible that they could be removed from nonaccrual status in 2012. However, it is also possible that other loans may become delinquent and nonperforming loans could remain at a high level due to lengthy workout periods on these loans. OREO, depending on the type of property, can also result in an extended holding period prior to disposal.

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The following table presents a summary of nonperforming assets:

Table 12. Nonperforming Assets

| <i>(Dollars in thousands)</i> | December 31 | | | | |
|---|-----------------|----------|----------|----------|----------|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| Nonaccrual loans | | | | | |
| Residential real estate 1 - 4 family | | | | | |
| First liens | \$1,749 | \$691 | \$345 | \$333 | \$87 |
| Junior liens and lines of credit | 282 | 122 | | | |
| Total | 2,031 | 813 | 345 | 333 | 87 |
| Residential real estate construction | | 6,500 | 4,040 | 1,286 | 449 |
| Commercial, industrial and agricultural real estate | 14,278 | 13,003 | 5,654 | | 78 |
| Commercial, industrial and agricultural Consumer | 1,447 | 1,668 | 124 | 1,252 | 3,635 |
| Total nonaccrual loans | \$17,756 | \$21,984 | \$10,193 | \$2,871 | \$4,249 |
| Loans past due 90 days or more and still accruing | | | | | |
| Residential real estate 1 - 4 family | | | | | |
| First liens | \$2,516 | \$1,093 | \$3,060 | \$411 | \$395 |
| Junior liens and lines of credit | 301 | 833 | 494 | 133 | 12 |
| Total | 2,817 | 1,926 | 3,554 | 544 | 407 |
| Residential real estate construction | 121 | 911 | 1,426 | | |
| Commercial, industrial and agricultural real estate | 1,627 | 2,343 | 1,926 | 429 | 832 |
| Commercial, industrial and agricultural Consumer | 100 | 244 | 960 | 33 | 205 |
| Total loans past due 90 days or more and still accruing | 4,772 | 5,549 | 8,061 | 1,129 | 1,508 |
| Total nonperforming loans | 22,528 | 27,533 | 18,254 | 4,000 | 5,757 |
| Reposessed assets | 6 | | 18 | | |
| Other real estate owned | 3,224 | 618 | 642 | | 207 |
| Total nonperforming assets | \$25,758 | \$28,151 | \$18,914 | \$4,000 | \$5,757 |
| Nonperforming loans to total gross loans | 2.94% | 3.68 % | 2.47 % | 0.59 % | 1.01 % |
| Nonperforming assets to total assets | 2.60% | 2.96 % | 1.93 % | 0.44 % | 0.73 % |
| Allowance for loan losses to nonperforming loans | 43.16% | 31.97 % | 48.96 % | 183.93 % | 127.86 % |

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The majority of the nonaccrual loan balance reported above is comprised of five loans relationships totaling \$12.6 million, or 71% of total nonaccrual loans. Management continually monitors the status of nonperforming loans, the value of any collateral and potential of risk of loss. The following table provides additional information on the most significant nonaccrual accounts:

Table 13. Significant Nonaccrual Loans

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

Credit 1 balance was reduced from \$2.5 million at December 31, 2010 as the result of a \$400 thousand charge-off and a significant pay-down in 2011. The Bank charged-off an additional \$400 thousand on this credit in February 2012.

Credit 2 has paid down slightly since December 31, 2010.

Credit 3 was placed on nonaccrual at December 31, 2010. The balance was reduced due to a charge-off of \$1.3 million during 2011.

Credit 4 was added to nonaccrual in 2011. This credit represents the Bank's portion of a shared national credit and is the restructured portion of the total debt remaining after charging off \$1.9 million.

Credit 5 was added in 2011 and represents 2 loans to related borrowers.

In addition to monitoring nonaccrual loans, the Bank also closely monitors impaired loans and troubled debt restructurings (TDR). 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. The Bank reviews all loans rated 7 or lower, all nonaccrual loans, and all TDR loans for impairment. Impaired loans totaled \$31.2 million at December 31, 2011, down slightly from \$33.2 million at December 31, 2010. The Bank's largest impaired loans, totaling \$12.6 million, are also on nonaccrual status and are reported in the table of significant nonaccrual loans shown above. The Bank has one large impaired credit (\$3.2 million) included in the commercial real estate line that is considered impaired because of its status as a troubled debt restructuring. However, due to a significant pay down at restructuring, the amount of real estate collateral, personal guarantees and its performing status, this credit is not on the nonaccrual list. See Note 6 in the accompanying financial statements for a note that reports on impaired loans.

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A loan is considered a troubled debt restructuring (TDR) if the creditor (the Bank), for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The Bank reviews all loans rated 5 or lower when it is providing a loan restructure, modification or new credit facility to determine if the action is a TDR. In addition, the Bank reviews all consumer loan modifications and/or policy exceptions for TDR status. If a TDR loan is placed on nonaccrual status, it remains on nonaccrual status for at least six months to ensure performance. All TDR loans are in compliance with their modified terms. Included in the TDR total is one note for \$2.6 million that represents a restructured note after charging off \$1.9 million of loans to related parties. The Bank participates in this loan as part of a shared national credit and it is on the nonaccrual list. In addition, the impaired/TDR credit of \$3.2 million discussed previously is reported in the commercial real estate line. All of the TDR loans are commercial purpose loans except for two consumer loans totaling \$93 thousand. See Note 6 in the accompanying financial statements for a note that identifies TDR loans in the portfolio.

The Bank holds \$3.2 million of other real estate owned, comprised of seven properties compared to \$618 thousand and 6 properties at December 31, 2010. The largest borrower (\$2.4 million) was added in 2011 and represents a failed residential real estate development comprised of 4 properties that the Bank received deeds in lieu of foreclosure.

The following table provides additional information on other real estate owned:

Table 14. Other Real Estate Owned

| December 31, 2011 (Dollars in thousands) | Date Acquired | Balance | Collateral | Location | Last Appraisal |
|---|------------------|---------|--|----------|-------------------|
| | | | unimproved and improved real estate for | | |
| Property 1 | 2011 | \$2,383 | residential development on four separate tracts totaling 150 acres | PA | Aug-11 |
| Property 2 | 2011 | 536 | townhouses and residential building lots | PA | Jun-11 |
| Property 3 | 2011 | 23 | residential real estate | PA | Sep-11 |
| Property 4 | 2011 | 9 | residential real estate | PA | Oct-11 |
| Property 5 | 2011 | 93 | residential building lots | MD | Apr-11 |
| Property 6 | 2011 | 42 | residential real estate 2 properties | PA | Dec-10 |
| Property 7 | 2009 | 138 | farmland 36 acres | PA | Feb-11 |
| | | \$3,224 | | | |

At December 31, 2011, the Bank had \$1.0 million of residential properties in the process of foreclosure compared to \$1.4 million at the end of 2010.

Allowance for Loan Losses:

Management performs a monthly evaluation of the adequacy of the allowance for loan losses (ALL). The ALL is determined by a segmenting the loan portfolio based on the loan's collateral. The Bank further classifies the portfolio based on the primary purpose of the loan, either consumer or commercial. When calculating the ALL, 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. The Bank begins enhanced monitoring of all loans rated 6 (OAEM) or worse (commercial loans), and obtains a new appraisal or asset valuation for any loan rated 7 (substandard) or worse, including all nonaccrual loans. 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 factors, including, but not limited to the economy, deferred maintenance, industry, type of property/equipment, age of the appraisal, etc. and the knowledge Management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated and deducted from the valuation in order to determine the net realizable value to the Bank. When determining the allowance for loan loss, certain factors involved in the evaluation are inherently subjective and require material estimates that may be susceptible to significant change, including the amounts and timing of future

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cash flows expected to be received on impaired 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 allowance for loan losses at December 31, 2011 is adequate.

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 for impaired loans. However, it is possible that as a result of the credit analysis, a specific reserve is not required for an impaired loan. See the previous impaired loan discussion for a table that reports impaired loans and the specific reserve established for impaired loans.

The general allocation component addresses the reserves established for pools of homogenous loans. The general component includes a quantitative and qualitative analysis. When calculating the general allocation, the Bank segregates its loan portfolio into the following sectors based primarily on the type of supporting collateral: residential real estate, commercial, industrial or agricultural real estate; commercial and industrial (C&I non-real estate), and consumer. The residential real estate sector is further segregated by first lien loans, junior liens and home equity products, and residential real estate construction. The quantitative analysis uses the Bank's eight quarter rolling historical loan loss experience adjusted for factors derived from current 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.

Real estate appraisals and collateral valuations are an important part of the Bank's process for determining potential loss on collateral dependent loans and thereby have a direct affect on the determination of loan charge-offs and the calculation of the allowance for loan losses. As long as the loan remains a performing loan, no further updates to appraisals are required. If a loan is risk rated 6 or worse, Management determines the need to obtain a new or updated appraisal based on several factors, including general economic conditions and factors specific to the loan. If a loan or relationship migrates to risk rating of 7 or worse, an evaluation for impairment is made based on the current information available at the time of downgrade and a new appraisal or collateral valuation is obtained. We believe this practice complies with the regulatory guidance dated December 12, 2010.

In determining the allowance for loan losses, Management, at its discretion, may determine that additional adjustments to the fair value obtained from an appraisal or collateral valuation are required. Adjustments will be made as necessary based on factors, including, but not limited to the economy, deferred maintenance, industry, type of property or equipment etc., and the knowledge Management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated and deducted from the valuation in order to determine the net realizable value to the Bank. If an appraisal is not available, Management may make its best estimate of the real value of the collateral or use last known market value and apply appropriate discounts. If an adjustment is made to the collateral valuation, this will be documented in the credit file with appropriate support and reported to the Loan Management Committee.

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The following table shows the loans that were evaluated for the allowance for loan losses under a specific reserve (individually) and those that were evaluated under a general reserve (collectively), and the amount of the allowance established in each category as of December 31, 2011:

Table 15. Allowance by Loan Segment

| (Dollars in thousands) | Residential Real Estate 1 4 | | | Commercial | Commercial | Consumer | Total |
|--|-----------------------------|-------------------------|--------------|---------------------------------------|---------------------------|----------|-----------|
| | Family | Junior | Construction | Industrial & Agricultural Real Estate | Industrial & Agricultural | | |
| | First Liens | Liens & Lines of Credit | | | | | |
| Allowance at December 31, 2010 | \$600 | \$352 | \$2,596 | \$3,358 | \$1,578 | \$317 | \$8,801 |
| Charge-offs | (324) | (202) | (2,352) | (3,817) | (115) | (237) | (7,047) |
| Recoveries | 30 | 10 | | 306 | 11 | 88 | 445 |
| Provision | 743 | 148 | 978 | 5,410 | 177 | 68 | 7,524 |
| Allowance at December 31, 2011 | \$1,049 | \$308 | \$1,222 | \$5,257 | \$1,651 | \$236 | \$9,723 |
| Loans evaluated for allowance: | | | | | | | |
| Individually | \$3,899 | \$162 | \$43 | \$21,622 | \$2,308 | \$ | \$28,034 |
| Collectively | 137,998 | 47,974 | 21,239 | 337,352 | 180,386 | 13,427 | 738,376 |
| Total | \$141,897 | \$48,136 | \$21,282 | \$358,974 | \$182,694 | \$13,427 | \$766,410 |
| Allowance established for loans evaluated: | | | | | | | |
| Individually | \$495 | \$3 | \$ | \$1,591 | \$870 | \$ | \$2,959 |
| Collectively | 554 | 305 | 1,222 | 3,666 | 781 | 236 | 6,764 |
| Allowance at December 31, 2011 | \$1,049 | \$308 | \$1,222 | \$5,257 | \$1,651 | \$236 | \$9,723 |

The following table shows the allocation of the allowance for loan losses by loan category as of December 31 for each of the past five years:

Table 16. Allocation of the Allowance for Loan Losses

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The percentage of the loans in each category to total gross loans at year end is as follows:

| | 2011 | 2010 | 2009 | 2008 | 2007 |
|---|-------------|-------|-------|-------|-------|
| Residential real estate 1 4 family | | | | | |
| First liens | 19% | 19 % | 19 % | 23 % | 25 % |
| Junior liens and lines of credit | 6% | 8 % | 9 % | 9 % | 11 % |
| Total | 25% | 27 % | 28 % | 32 % | 36 % |
| Residential real estate construction | 3% | 11 % | 11 % | 11 % | 15 % |
| Commercial, industrial and agricultural real estate | 47% | 40 % | 38 % | 34 % | 25 % |
| Commercial, industrial and agricultural | 24% | 20 % | 20 % | 20 % | 19 % |
| Consumer | 1% | 2 % | 3 % | 3 % | 5 % |
| | 100% | 100 % | 100 % | 100 % | 100 % |

The allocation of the allowance for loan losses is based on estimates and is not intended to imply limitations on the usage of the allowance. The entire allowance is available to absorb any losses without regard to the category in which the loan is classified.

In 2009, the Bank began allocating the allowance for loan losses according to the primary collateral of the loan, or if there was no collateral, by the primary purpose of the loan. In prior years the allocation was made by the primary purpose of the loan. This has resulted in a higher allocation for periods after 2009 for residential real estate development and commercial real estate, that in prior periods was allocated to commercial, industrial and agricultural loans. Data for periods prior to 2009 using the current methodology is not available and therefore, comparisons by line item to periods prior to 2009 may not be accurate.

In 2011, \$7.5 million was added to the allowance for loan losses (ALL) through the provision for loan loss expense compared to \$3.2 million in the prior year. The increase in provision expense was due to a higher level of loan charge-offs and Management's intention to ensure adequate ALL coverage for future losses due to weakening credit quality. As a result of these actions, net of any charge-offs discussed below, the ALL increased by \$922 thousand during 2011. The net loan charge-off ratio increased to .86% for the year compared to .45% for the prior year and the ALL coverage ratio increased to 1.27% compared to 1.18% at the prior year-end.

Charged-off loans usually result from: (1) a borrower being legally relieved of loan repayment responsibility through bankruptcy, (2) insufficient proceeds from the sale of collateral 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 \$6.6 million in 2011, nearly double the 2010 number of \$3.4 million. The largest increase in gross charge-offs was in the residential real estate construction category, and the commercial, industrial and agricultural real estate category. Combined, these two categories accounted for \$6.2 million of the total gross charge-offs and the year over year increase in these categories of \$3.4 million represented more than the entire increase in gross charge-offs in 2010. Driving the increase these categories were charge-offs of \$4.9 million related to 4 relationships. Three of these credits are on nonaccrual status and accounted for \$3.8 million of the \$4.9 million increase, including the \$1.9 million charge-off on the shared national credit previously discussed. In addition, the Bank recorded a charge-off of \$1.3 million on four related credits that were moved to OREO. If nonperforming loans remain at the current level, it is possible that net charge-offs will remain higher than average; however, the Bank expects 2012 net charge-offs to be below the 2011 level. The Bank expects to see a continued reduction in consumer loan charge-offs due to ending its indirect lending activity. The majority of consumer loan charge-offs in past years were attributable to indirect loans.

TABLE OF CONTENTS**Table 17. Historical Allowance for Loan Losses**

| (Dollars in thousands) | December 31 | | | | |
|--|----------------|----------|---------|----------|---------|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| Balance at beginning of year | \$8,801 | \$8,937 | \$7,357 | \$7,361 | \$6,850 |
| Charge-offs: | | | | | |
| Residential real estate 1 - 4 family | | | | | |
| First liens | (324) | (107) | | (224) | (9) |
| Junior liens and lines of credit | (202) | (165) | (94) | | (5) |
| Total | (526) | (272) | (94) | (224) | (14) |
| Residential real estate construction | (2,352) | (982) | (724) | (350) | |
| Commercial, industrial and agricultural real estate | (3,817) | (1,736) | (63) | (28) | |
| Commercial, industrial and agricultural | (115) | (232) | (567) | (335) | (362) |
| Consumer | (237) | (452) | (681) | (496) | (442) |
| Total charge-offs | (7,047) | (3,674) | (2,129) | (1,433) | (818) |
| Recoveries: | | | | | |
| Residential real estate 1 - 4 family | | | | | |
| First liens | 30 | 19 | 25 | 23 | 50 |
| Junior liens and lines of credit | 10 | 10 | | | 3 |
| Total | 40 | 29 | 25 | 23 | 53 |
| Residential real estate construction | | 53 | | | |
| Commercial, industrial and agricultural real estate | 306 | 18 | | 28 | 9 |
| Commercial, industrial and agricultural | 11 | 61 | 61 | 19 | 98 |
| Consumer | 88 | 142 | 185 | 166 | 179 |
| Total recoveries | 445 | 303 | 271 | 236 | 339 |
| Net charge-offs | (6,602) | (3,371) | (1,858) | (1,197) | (479) |
| Provision for loan losses | 7,524 | 3,235 | 3,438 | 1,193 | 990 |
| Balance at end of year | \$9,723 | \$8,801 | \$8,937 | \$7,357 | \$7,361 |
| Ratios: | | | | | |
| Net loans charged-off as a percentage of average gross loans | 0.86% | 0.45 % | 0.26 % | 0.19 % | 0.09 % |
| Net loans charged-off as a percentage of the provision for loan losses | 87.75% | 104.20 % | 54.04 % | 100.34 % | 48.38 % |
| Allowance as a percentage of loans | 1.27% | 1.18 % | 1.21 % | 1.09 % | 1.29 % |

Deposits:

The Bank depends on deposits generated by its community banking offices as its primary source of funds. The Bank offers numerous deposit products including demand deposits, savings, money management accounts, and time deposits (certificates of deposits/CDs). Total deposits at December 31, 2011 were \$788.0 million, up 7% from \$734.3 million on December 31, 2010. The increase occurred in the Bank's core deposit accounts while brokered deposits remained flat year over year. The largest dollar increase over 2010 occurred in the money market accounts, but demand deposits recorded the largest percentage increase. For 2011, total deposits averaged \$778.1 at a cost of .85% compared to \$727.0 million at a cost of 1.16% in 2010. The following table presents a comparison of deposits for the past five years.

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Table 18. Deposits

Demand deposits: Noninterest-bearing demand deposit accounts represent a very valuable funding source to the Bank. Noninterest bearing accounts showed the largest percentage growth (15%) of any deposit category. Every account category showed an increase during the year with the largest increase coming from small business and retail accounts.

Interest-bearing checking: This category saw an increase in both the ending and average balance for the year compared to 2010. The cost of these funds declined to .09% in 2011 compared to .15% in 2010. The largest increase in this category came in retail checking accounts. In July 2011, new legislation went into affect allowing interest to be paid on corporate checking accounts. The Bank developed a product for this, but has had no interest from corporate accounts. Many of the Bank's corporate accounts are in the Bank's Repo product and earn interest through this non-deposit product.

Money market accounts: The Money Management category continued to grow in 2011 with the average balance and the ending balance both increasing 13% over 2010. The cost of this product declined by .30% during the year to 1.02% for 2011. Despite several rate reductions during the year, the yield remained competitive and consumers like the liquidity offered by the product. The Bank has seen some money move from CDs into this product during the year, but the largest growth came in the Bank's product that offers FDIC insurance on the entire balance. This product pays a lower rate than the standard product, but the full FDIC coverage offers added value. This product has been well received by corporate customers and high balance retail customers. The Bank is actively promoting this product to select markets.

Savings: Savings accounts increased \$3.6 million during the year and represents the fourth consecutive year of growth. Likewise, the 2011 average balance increased by a similar amount. The majority of the increase occurred in retail accounts.

Time deposits: Retail time deposits have declined for the third consecutive year. Consumers do not seem to be inclined to invest in longer maturity deposits as they want more liquid accounts and are afraid of missing out on the opportunity to take advantage of rising rate, whenever that may occur. As a result of this sentiment, the Bank has seen some maturing CDs migrate to the Money Management product. In 2012, 62% of the Bank's retail CDs mature.

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The Bank continues to use wholesale CDs as a funding source when good opportunities are available. Once again, wholesale-brokered CD rates were below local market and FHLB rates for much of 2011. However, the Bank did not need additional funding in 2011 and the brokered CD balance was flat year over year. The 2009 year-end balance was inflated as the Bank took some short-term funding near year-end that matured in January 2010. Included in the brokered CD total is \$8.2 million in CDs placed into the CDARS program. CDARS allows a depositor to place a CD with the Bank that exceeds the allowable FDIC insurance limit. CDARS then allocates the deposit between different banks in order to maintain FDIC coverage on the entire balance. The Bank in turn receives a reciprocal CD deposit.

This program allows the Bank to offer full FDIC coverage to large depositors, but with the convenience to the customer of only having to deal with one bank. The Bank solicits these deposits from within its market and it believes they present no greater risk than any other local deposit. However, regulatory guidance requires that these deposits be classified as brokered deposits. In February 2012, the Bank issued \$23 million in brokered CDs as part of a plan to restructure FHLB debt that matures in 2012. These CDs will replace the FHLB debt at a substantially lower cost.

The Bank continues to review different methods of funding growth that include traditional deposits and other wholesale sources. Competition from other local financial institutions, internet banks and brokerages will continue to be a challenge for the Corporation in its efforts to attract new and retain existing deposit accounts. This competition is not expected to lessen in the future.

The following table shows the maturity of outstanding time deposits of \$100,000 or more at December 31, 2011:

Table 19. Time Deposits of \$100,000 or More

| (Dollars in thousands) | Retail Time Deposits | Brokered Time Deposits | Total Time Deposits |
|--------------------------------|----------------------------|------------------------------|------------------------|
| Maturity distribution: | | | |
| Within three months | \$ 8,395 | \$ 1,224 | \$ 9,619 |
| Over three through six months | 6,634 | 4,278 | 10,912 |
| Over six through twelve months | 7,761 | 1,653 | 9,414 |
| Over twelve months | 14,678 | 669 | 15,347 |
| Total | \$ 37,468 | \$ 7,824 | \$ 45,292 |

Borrowings:

Short-term Borrowings: In addition to deposits, the Bank uses securities sold under repurchase agreements (Repo), which are accounted for as collateralized financings, and borrowings from FHLB as additional funding sources. The Bank enters into Repo agreements as part of a cash management product offered to commercial and municipal customers. These are overnight borrowings by the Bank that are collateralized with U.S. Government and U.S. Agency securities. This product had an average balance of \$60.1 million in 2011, virtually unchanged from the 2010 average of \$60.3 million. The average rate on this product remained constant in 2011 at .25%.

Short-term borrowings from the FHLB are in the form of a revolving term commitment. The short-term FHLB borrowings are used as overnight borrowings to fund the short-term liquidity needs of the Bank. These borrowings reprice on a daily basis and the interest rate fluctuates with short-term market interest rates.

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The following table provides additional information about short-term borrowings.

Table 20. Short-Term Borrowings and Securities Sold Under Agreements to Repurchase

| (Dollars in thousands) | 2011 | | 2010 | | 2009 | |
|--------------------------------|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| | Short-Term Borrowings | Repurchase Agreements | Short-Term Borrowings | Repurchase Agreements | Short-Term Borrowings | Repurchase Agreements |
| Ending balance | \$ | \$ 53,103 | \$ | \$ 51,164 | \$ | \$ 55,855 |
| Average balance | 192 | 60,136 | 185 | 60,262 | 2,142 | 67,032 |
| Maximum month-end balance | 1,800 | 71,485 | 1,900 | 68,622 | 9,900 | 74,331 |
| Weighted-average interest rate | 0.74% | 0.25% | 0.66 % | 0.25 % | 0.66 % | 0.25 % |

Long-term Debt: Long-term debt is comprised entirely of FHLB term loans either payable at maturity or amortizing advances. All of the loans have fixed interest rates. These loans are used on an as needed basis to lock in term funding and are sometimes used to fund specific asset transactions. The Bank did not take any new FHLB advances in 2011, but paid off \$15.6 million of advances early. In 2012, 51% of the Bank's FHLB advances will mature and by the end of 2013, 70% of FHLB advances will have matured. See Note 11 of the accompanying consolidated financial statements for more information.

Shareholders Equity:

Shareholders' equity totaled \$87.2 million at December 31, 2011 versus \$82.6 million one year earlier, an increase of \$4.6 million. The Corporation added \$2.3 million to retained earnings after declaring \$4.3 million in dividends. Regular cash dividends per share declared by the Board of Directors in 2011 and 2010 totaled \$1.08 in both years. The dividend payout ratio was 65.1% in 2011. The Corporation decided to keep the per share dividend constant through 2011 as a sign of confidence to its shareholders. The Corporation made no repurchases of its stock in 2011 or 2010.

The Board of Directors regularly authorizes the repurchase of the Corporation's \$1.00 par value common stock. The repurchased shares will be held as treasury shares available for issuance in connection with future stock dividends and stock splits, employee benefit plans, executive compensation plans, the Dividend Reinvestment Plan and other appropriate corporate purposes. The term of the repurchase plans is normally 1 year. The following table provides information regarding approved stock repurchase plans. For additional information on Shareholders' Equity refer to Note 18 of the accompanying consolidated financial statements. The stock repurchase plans that were in place in 2011, and the related activity, is shown below:

| <i>(Amounts in thousands, except share information)</i> | | Shares Repurchased Under Approved Plan | | | | |
|---|-----------------|--|---------|---------|-------|------|
| Plan Approved | Expiration Date | Shares Authorized | 2011 | 2010 | Total | Cost |
| July 8, 2010 | July 8, 2011 | 100,000 | | | | |
| | | Number of Treasury shares held at year-end | 396,174 | 397,950 | | |

Effective September 30, 2010, the Corporation amended its dividend reinvestment plan for shareholders electing to purchase additional shares of the Corporation's common stock by reinvesting cash dividends paid on their shares or through optional cash payments. Under the amended plan, the Corporation has modified the minimum and maximum amounts that may be invested pursuant to the voluntary cash payment option under the plan, provided for the investment of voluntary cash payments as frequently as weekly, permitted participants to make voluntary cash payments via direct draft (ACH transfer); and modified the formula for determining the purchase price with respect to

shares purchased under the plan directly from the Corporation. The Corporation also authorized one million (1,000,000) shares of its currently authorized common stock to be issued under the amended plan.

A strong capital position is important to the Corporation as it provides a solid foundation for the future growth of the Corporation, as well as instills confidence in the Bank by depositors, regulators and investors, and is considered essential by Management. The Corporation is currently exploring other sources of capital as part of its capital management plan for the Corporation and the Bank.

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Common measures of adequate capitalization for banking institutions are capital ratios. These ratios indicate the proportion of permanently committed funds to the total asset base. Guidelines issued by federal and state regulatory authorities require both banks and bank holding companies to meet minimum leverage capital ratios and risk-based capital ratios.

The leverage ratio compares Tier 1 capital to average assets while the risk-based ratio compares Tier 1 and total capital to risk-weighted assets and off-balance-sheet activity in order to make capital levels more sensitive to the risk profiles of individual banks. Tier 1 capital is comprised of common stock, additional paid-in capital, retained earnings and components of other comprehensive income, reduced by goodwill and other intangible assets. Total capital is comprised of Tier 1 capital plus the allowable portion of the allowance for loan losses.

Current regulatory capital guidelines call for a minimum leverage ratio of 4.0% and minimum Tier 1 and total capital ratios of 4.0% and 8.0%, respectively. Well-capitalized banks are determined to have leverage capital ratios greater than or equal to 5.0% and Tier 1 and total capital ratios greater than or equal to 6.0% and 10.0%, respectively. Table 21 presents the capital ratios for the consolidated Corporation at December 31, 2011, 2010 and 2009. At year-end 2011, the Corporation and its banking subsidiary exceeded all regulatory capital requirements. The Corporation is not aware of any future events or transactions, outside its control, that are expected to significantly effect its capital position. The Bank did not participate in the Troubled Asset Relief Program (TARP) established by the Emergency Economic Stabilization Act of 2008 (EESA) that was designed to provide capital injections to banks through the purchase of preferred stock, and it did not participate in the Small Business Lending Fund created in 2011.

For additional information on capital adequacy refer to Note 2 of the accompanying consolidated financial statements.

Table 21. Capital Ratios

| | December 31 | | | |
|---------------------------------|---------------|---------|-------|---|
| | 2011 | 2010 | 2009 | |
| Total risk-based capital ratio | 12.14% | 11.73 % | 10.89 | % |
| Tier 1 risk-based capital ratio | 10.89% | 10.54 % | 9.69 | % |
| Tier 1 leverage ratio | 8.40% | 8.16 % | 7.50 | % |

Local 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. The market area has a diverse economic base and local industries include, warehousing, truck & rail shipping centers, light and heavy manufacturers, health-care, higher education institutions, farming and agriculture, and a varied service sector. The Corporation's primary market area is located in south central Pennsylvania and provides easy access to the major metropolitan markets on the east coast via trucking and rail transportation. Because of this, warehousing and distribution companies continue to find the area attractive. The local economy is not overly dependent on any one industry or business and Management believes that the Bank's primary market area continues to be well suited for growth as the recession eases.

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Unemployment in the Bank's market area has remained virtually unchanged over the past year and ranges from a low of 6.2% in Cumberland County to high of 8.9% in Fulton County. These rates are in line with both state and national averages. The following table provides selected economic data for the Bank's primary market:

Economic Data

| | December 31 | | | |
|--|-------------|-----|-------|--------|
| | 2011 | | 2010 | |
| Unemployment Rate (seasonally adjusted) | | | | |
| Market area range ⁽¹⁾ | 6.7% | 10% | 7.3% | 12.5 % |
| Pennsylvania | 7.9 | % | 8.9 | % |
| United States | 9.0 | % | 9.6 | % |
| Housing Price Index – year over year change | | | | |
| PA, nonmetropolitan statistical area | -3.3 | % | -1.5 | % |
| United States | -4.5 | % | -1.2 | % |
| Franklin County Building Permits – year over year change | | | | |
| Residential, estimated | -34.3 | % | 26.8 | % |
| Multifamily, estimated | -73.4 | % | -10.9 | % |

(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 FOMC held short-term rates at historic lows for all of 2011 and recent comments from the FOMC suggest rates will remain low through 2014.

Liquidity

The Corporation must meet the financial needs of the customers that it serves, while providing a satisfactory return on the shareholders' investment. In order to accomplish this, the Corporation must maintain sufficient liquidity in order to respond quickly to the changing level of funds required for both loan and deposit activity. The goal of liquidity management is to meet the ongoing cash flow requirements of depositors who want to withdraw funds and of borrowers who request loan disbursements. The Bank regularly reviews its liquidity position by measuring its projected net cash flows (in and out) at a 30 and 90-day interval. The Bank stresses this measurement by assuming a level of deposit out-flows that have not historically been realized. In addition to this forecast, other funding sources are reviewed as a method to provide emergency funding if necessary. The objective of this measurement is to identify the amount of cash that could be raised quickly without the need to liquidate assets. The Bank also stresses its liquidity position utilizing different longer-term scenarios. The varying degrees of stress create pressure on deposit flows in its local market, reduce access to wholesale funding and limit access of funds available through brokered deposit channels. In addition to stressing cash flow, specific liquidity risk indicators are monitored to help identify risk areas. This analysis will help identify and quantify the potential cash surplus/deficit over a variety of time horizons to ensure the Bank has adequate funding resources. Assumptions used for liquidity stress testing are subjective. Should an evolving liquidity situation or business cycle present new data, potential assumption changes will be considered. 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 investment securities 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 December 31, 2011, the Bank had approximately \$112 million in its investment portfolio pledged as collateral for deposits

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and Repos. Another source of available liquidity for the Bank is a line of credit with the FHLB. At December 31, 2011, the Bank had approximately \$31 million available on this line of credit and \$26 million of unsecured lines of credit at correspondent banks.

In December 2011, FHLB notified the Bank it was being placed on full collateral delivery status. This status means that the Bank's ability to borrow from FHLB is reduced to the value of the collateral physically delivered to FHLB.

Prior to this change, the Bank's borrowing capacity was determined by the value of all real estate loan collateral pledged to FHLB. This status is determined by an internal scorecard developed by the FHLB in its sole discretion. The

Bank quickly responded to this request and delivered collateral sufficient to provide approximately \$31 million of borrowing capacity above what was required by FHLB. However, this amount is well below the available capacity in prior years.

In addition to delivering the required collateral, the Bank has implemented a plan to address the reduce availability at FHLB. This plan includes, enhancing liquidity by prefunding FHLB maturities with longer term callable CDs, restructuring secured liabilities to free-up securities used as collateral, and delivering more collateral to FHLB and the Federal Reserve to increase borrowing capacity. In addition, 51% of the Bank's FHLB advances mature in 2012 and by the end of 2013, 70% will have matured. With no additional borrowings from FHLB anticipated, every dollar paid-off increases the available funding capacity.

The FHLB scorecard is calculated using a four quarter weighted average and was negatively affected by the level of nonperforming loans and charge-offs in the third quarter. As lower performing quarters roll-off, the Bank's score will improve. However, the Bank expects that it will remain on collateral delivery status throughout 2012. The Bank believes that its plan is sufficient to overcome the temporary reduction in FHLB funding capacity.

The FHLB system has always been a major source of funding for community banks. The capital level of the Pittsburgh FHLB, and the entire FHLB system, has been strained due to the declining value of mortgage related assets. The Pittsburgh FHLB has already 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.

The Bank has established credit at the Federal Reserve Discount Window and as of year-end had the ability to borrow approximately \$23 million.

Off Balance Sheet Commitments

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 loans and lines of credit. Because these unfunded instruments have fixed maturity dates and 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 \$221.6 million and \$28.2 million, respectively, at December 31, 2011, compared to \$198.9 million and \$20.5 million, respectively, at December 31, 2010. See Note 19 of the accompanying consolidated financial statements for more information on commitments and contingencies.

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

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The following table represents the Corporation's aggregate on and off balance sheet contractual obligations to make future payments as of December 31, 2011:

Table 22. Contractual Obligations

| (Amounts in thousands) | 1 year and under | Years 2 | 3 | Years 4 | 5 | Over 5 years | Total |
|-----------------------------------|---------------------|-----------|---|-----------|---|-----------------|------------|
| Time deposits | \$ 99,775 | \$ 58,595 | | \$ 24,136 | | \$ 5,809 | \$ 188,315 |
| Long-term debt | 24,500 | 11,394 | | 10,427 | | 2,015 | 48,336 |
| Operating leases | 445 | 730 | | 698 | | 2,962 | 4,835 |
| Deferred compensation | 64 | 124 | | 120 | | 256 | 564 |
| Estimated future pension payments | 756 | 1,645 | | 1,759 | | 4,725 | 8,885 |
| Total | \$ 125,540 | \$ 72,488 | | \$ 37,140 | | \$ 15,767 | \$ 250,935 |

The Corporation is not aware of any known trends, demands, commitments, events or uncertainties which would result in any material increase or decrease in liquidity. The Corporation has also entered into an interest rate swap agreement as part of its interest rate risk management strategy. See Note 14 of the accompanying financial statements for more information of financial derivatives.

Market Risk

In the course of its normal business operations, the Corporation is exposed to certain market risks. The Corporation has no foreign currency exchange rate risk, no commodity price risk or material equity price risk. However, it is exposed to interest rate risk. All interest rate risk arises in connection with financial instruments entered into for purposes other than trading. Financial instruments, which are sensitive to changes in market interest rates, include fixed and variable-rate loans, fixed-income securities, derivatives, interest-bearing deposits and other borrowings.

Changes in interest rates can have an impact on the Corporation's net interest income and the economic value of equity. The objective of interest rate risk management is to identify and manage the sensitivity of net interest income and economic value of equity to changing interest rates in order to achieve consistent earnings that are not contingent upon favorable trends in interest rates.

The Corporation uses several tools to measure and evaluate interest rate risk. One tool is interest rate sensitivity or gap analysis. Gap analysis classifies assets and liabilities by repricing and maturity characteristics and provides management with an indication of how different interest rate scenarios will impact net interest income. Table 23 presents a gap analysis of the Corporation's balance sheet at December 31, 2011. A positive gap in the under one-year time interval suggests that, all else being equal, the Corporation's near-term earnings would rise in a higher interest rate environment and decline in a lower rate environment. A negative gap suggests the opposite result. At December 31, 2011, the Corporation's cumulative gap position at one year was negative. However, the incremental benefit of future rate decreases has been reduced as the rates paid on the Bank's liabilities have been reduced greatly, leaving little room for future rate decreases. In addition certain liabilities may or may not be repriced with the same magnitude or at the same time as market rates. These circumstances are not captured by a gap analysis.

Another tool for analyzing interest rate risk is financial simulation modeling which captures the affect of not only changing interest rates but also other sources of cash flow variability including loan and securities prepayments and customer preferences. Financial simulation modeling forecasts both net interest income and the economic value of equity under a variety of different interest rate environments that cannot be captured with a gap analysis. The

Corporation regularly measures the effects of yield curve rate changes, including rate ramps, shocks and yield curve twists. The magnitude of each change scenario may vary depending on the current interest rate environment. As part of this simulation, the effect of the rate change is held constant for year two of the simulation. In addition, different rate change scenarios and yield curve structures are utilized depending on the current level of interest rates.

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As indicated in Table 24, the financial simulation analysis indicated that as of December 31, 2011, prospective net interest income over both a one and two-year time period increases with higher market interest rates. This suggests the balance sheet is asset sensitive. As market rates ramp up 2% over the first year, more assets reprice immediately and funding costs lag behind therefore, net interest income improves. In year two of rising rates, liability costs begin to catch up to the repriced assets and the increase in net interest income slows. In a falling rate environment, net interest income falls in year two. Due to the current level of interest rates, most liability costs will not be able to move by a full market rate decrease. However, asset yields have more room for downward movement. Therefore, if rates fall and remain low for a prolonged period, the more net interest income is negatively affected. This is clearly seen in year two when the reduction in net interest income occurs. The Corporation has established limits to the change in net interest income of 10% from the base scenario in year one.

Economic value of equity (EVE) is defined as the estimated discounted present value of assets minus the discounted present value of liabilities and is a surrogate for long-term earnings. EVE measures the degree to which the economic value of a bank changes under different rate scenarios. EVE focuses on a longer-term time horizon and captures all balance sheet cash flows and is more effective in considering embedded options. The discount rates used in the EVE calculation are based on market rates for like assets and liabilities and the balance sheet position is held constant in order to isolate the risk of interest rate changes. The Corporation established limits to the change in EVE sensitivity of 10% per 1% rate change. At December 31, 2011, the Corporation was within this limit for all scenarios.

Computations of prospective effects of hypothetical interest rate changes are based on many assumptions, including relative levels of market interest rates, loan prepayments and deposit repricing. Certain shortcomings are inherent in the computation of discounted present value and, if key relationships do not unfold as assumed, actual values may differ from those presented. Further, the computations do not contemplate any actions Management could undertake in response to changes in market interest rates.

Table 23. Interest Rate Sensitivity Analysis

| <i>(Dollars in Thousands)</i> | 1 90 Days | 91 181 Days | 182 365 Days | 1 5 Years | Beyond 5 Years | Total |
|--|----------------|----------------|-----------------|----------------|-------------------|----------------|
| Interest-earning assets: | | | | | | |
| Interest -bearing deposits in other banks | \$17,212 | \$ | \$ | \$ | \$ | \$17,212 |
| Investment securities and restricted stock | 35,347 | 8,241 | 12,040 | 47,299 | 27,396 | 130,323 |
| Loans | 341,670 | 21,161 | 110,805 | 179,561 | 113,213 | 766,410 |
| Interest rate swaps (receive side) | 20,000 | | | | | 20,000 |
| Total interest-earning assets | 414,229 | 29,402 | 122,845 | 226,860 | 140,609 | 933,945 |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing checking | 117,479 | | | | | 117,479 |
| Money market deposit accounts | 326,219 | | | | | 326,219 |
| Savings | 51,728 | | | | | 51,728 |
| Time | 33,546 | 30,415 | 35,814 | 82,764 | 5,776 | 188,315 |
| Securities sold under agreements to repurchase | 53,103 | | | | | 53,103 |
| Short-term borrowings | | | | | | |
| Long-term debt | 1,358 | 46 | 23,096 | 21,821 | 2,015 | 48,336 |
| Interest rate swaps (pay side) | | | | 20,000 | | 20,000 |

| | | | | | | |
|------------------------------------|--------------------|--------------------|--------------------|------------------|------------------|------------------|
| Total interest-bearing liabilities | \$583,433 | \$30,461 | \$58,910 | \$124,585 | \$7,791 | \$805,180 |
| Interest rate gap | \$(169,204) | \$(1,059) | \$63,935 | \$102,275 | \$132,818 | \$128,765 |
| Cumulative interest rate gap | \$(169,204) | \$(170,263) | \$(106,328) | \$(4,053) | \$128,765 | |

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Note 1: The maturity/repricing distribution of investment securities is based on the maturity date for nonamortizing, noncallable securities; probable exercise/non-exercise of call options for callable securities; and estimated amortization based on industry experience for amortizing securities.

Note 2: Distribution of loans is based on contractual repricing/repayment terms adjusted for expected prepayments based on historical patterns. Loans held for sale are included in the 1 90 day time period.

Note 3: Interest-bearing checking and Savings accounts are included in the first period in which the Bank has the opportunity to reprice the product. Depending on the direction and magnitude of an interest rate change, these products may or may not reprice within the indicated period and may or may not reprice in a complete correlation to the change in a market rate. The MMDA product is distributed in accordance with its contractual repricing terms.

Note 4: Long-term debt reflects Federal Home Loan Bank notes with fixed maturity and amortizing repayment schedules.

Table 24. Sensitivity to Changes in Market Interest Rates

| (Dollars in Thousands) | -100 bps | Unchanged | +200 bps |
|--|-----------|-----------|-----------|
| Change in net interest income, year one: | \$ 34,421 | \$ 34,747 | \$ 35,526 |
| Percentage change | -0.9% | | 2.2% |
| Change in net interest income, year two: | \$ 35,662 | \$ 36,620 | \$ 37,942 |
| Percent change | -2.6% | | 3.6% |

| | -100 bps | Unchanged | +100 bps | +200 bps |
|---|-----------|-----------|-----------|-----------|
| Economic value of portfolio equity (EVE): | \$ 82,828 | \$ 91,959 | \$ 94,442 | \$ 93,156 |
| Percentage change | -9.9% | | 2.7% | 1.3% |

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 may, will, expect, believe, estimate, anticipate, or similar terms. Because forward-looking statements involve certain risks, uncertainties and other factors over which the Corporation has no direct control, actual results could differ materially from those contemplated in such statements. These factors include (but are not limited to) the following: general economic conditions, changes in interest rates, change 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.

Impact of Inflation

The impact of inflation upon financial institutions such as the Corporation differs from its effect upon other commercial enterprises. Unlike most other commercial enterprises, virtually all of the assets of the Corporation are monetary in nature. As a result, interest rates have a more significant impact on the Corporation's performance than do the effects of general levels of inflation. Although inflation (and inflation expectations) may affect the interest rate

environment, it is not possible to measure with any precision the impact of future inflation upon the Corporation.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The information related to this item is included in Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 8. Financial Statements and Supplementary Data

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Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Franklin Financial Services Corporation
Chambersburg, Pennsylvania

We have audited the accompanying consolidated balance sheets of Franklin Financial Services Corporation and its subsidiaries (the Corporation) as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2011. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Franklin Financial Services Corporation and its subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Corporation's internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 9, 2012 expressed an unqualified opinion.

/s/ ParenteBeard LLC
Harrisburg, Pennsylvania
March 9, 2012

TABLE OF CONTENTS**Consolidated Balance Sheets**

| (Amounts in thousands, except share and per share data) | December 31 | |
|--|------------------|-----------|
| | 2011 | 2010 |
| Assets | | |
| Cash and due from banks | \$16,932 | \$11,528 |
| Interest-bearing deposits in other banks | 17,212 | 10,578 |
| Total cash and cash equivalents | 34,144 | 22,106 |
| Investment securities available for sale, at fair value | 125,301 | 117,616 |
| Restricted stock | 5,022 | 6,159 |
| Loans | 766,410 | 748,642 |
| Allowance for loan losses | (9,723) | (8,801) |
| Net Loans | 756,687 | 739,841 |
| Premises and equipment, net | 16,041 | 16,592 |
| Bank owned life insurance | 20,273 | 19,591 |
| Goodwill | 9,016 | 9,016 |
| Other intangible assets | 1,558 | 2,004 |
| Other assets | 22,206 | 18,964 |
| Total assets | \$990,248 | \$951,889 |
| Liabilities | | |
| Deposits | | |
| Demand (noninterest-bearing) | \$104,245 | \$90,317 |
| Money market, savings and interest checking | 495,426 | 441,819 |
| Time | 188,315 | 202,195 |
| Total Deposits | 787,986 | 734,331 |
| Securities sold under agreements to repurchase | 53,103 | 51,164 |
| Long-term debt | 48,336 | 70,885 |
| Other liabilities | 13,641 | 12,870 |
| Total liabilities | 903,066 | 869,250 |
| Shareholders' equity | | |
| Common stock, \$1 par value per share, 15,000,000 shares authorized with 4,419,258 shares issued and 4,023,084 shares outstanding at December 31, 2011 and 4,317,058 shares issued and 3,919,108 shares outstanding at December 31, 2010 | 4,419 | 4,317 |
| Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding | | |
| Additional paid-in capital | 34,698 | 33,096 |
| Retained earnings | 60,280 | 57,984 |
| Accumulated other comprehensive loss | (5,131) | (5,642) |
| Treasury stock, 396,174 and 397,950 shares at cost at December 31, 2011 and 2010, respectively | (7,084) | (7,116) |
| Total shareholders' equity | 87,182 | 82,639 |
| Total liabilities and shareholders' equity | \$990,248 | \$951,889 |

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

TABLE OF CONTENTS**Consolidated Statements of Income**

| (Amounts in thousands, except per share data) | Years ended December 31 | | |
|--|-------------------------|-----------|-----------|
| | 2011 | 2010 | 2009 |
| Interest income | | | |
| Loans, including fees | \$ 37,937 | \$ 38,537 | \$ 37,829 |
| Interest and dividends on investments: | | | |
| Taxable interest | 2,318 | 3,037 | 3,969 |
| Tax exempt interest | 1,395 | 1,625 | 1,779 |
| Dividend income | 82 | 52 | 150 |
| Federal funds sold | | | 12 |
| Deposits and obligations of other banks | 59 | 33 | 18 |
| Total interest income | 41,791 | 43,284 | 43,757 |
| Interest expense | | | |
| Deposits | 6,649 | 8,445 | 10,320 |
| Securities sold under agreements to repurchase | 150 | 151 | 168 |
| Short-term borrowings | 1 | 1 | 14 |
| Long-term debt | 2,354 | 3,846 | 4,172 |
| Total interest expense | 9,154 | 12,443 | 14,674 |
| Net interest income | 32,637 | 30,841 | 29,083 |
| Provision for loan losses | 7,524 | 3,235 | 3,438 |
| Net interest income after provision for loan losses | 25,113 | 27,606 | 25,645 |
| Noninterest income | | | |
| Investment and trust services fees | 3,953 | 3,844 | 3,519 |
| Loan service charges | 1,198 | 1,132 | 1,151 |
| Mortgage banking activities | (72) | 146 | 145 |
| Deposit service charges and fees | 2,142 | 2,390 | 2,575 |
| Other service charges and fees | 614 | 508 | 537 |
| Debit card income | 1,024 | 882 | 755 |
| Increase in cash surrender value of life insurance | 682 | 672 | 643 |
| Other | 742 | 178 | 499 |
| OTTI losses on securities | (594) | (1,373) | (422) |
| Less: Loss recognized in other comprehensive loss (before taxes) | (354) | (314) | |
| Net OTTI losses recognized in earnings | (240) | (1,059) | (422) |
| Securities gains (losses), net | 157 | 673 | (522) |
| Total noninterest income | 10,200 | 9,366 | 8,880 |
| Noninterest expense | | | |
| Salaries and employee benefits | 15,195 | 13,592 | 12,713 |
| Net occupancy expense | 2,006 | 1,962 | 1,898 |
| Furniture and equipment expense | 837 | 781 | 850 |
| Advertising | 1,335 | 1,342 | 1,226 |
| Legal and professional fees | 1,069 | 1,505 | 1,697 |
| Data processing | 1,462 | 1,617 | 1,538 |
| Pennsylvania bank shares tax | 681 | 610 | 573 |
| Intangible amortization | 446 | 457 | 468 |
| FDIC insurance | 1,084 | 1,178 | 1,397 |

| | | | |
|------------------------------------|-----------------|----------|----------|
| Other | 4,218 | 3,379 | 3,569 |
| Total noninterest expense | 28,333 | 26,423 | 25,929 |
| Income before federal income taxes | 6,980 | 10,549 | 8,596 |
| Federal income tax expense | 411 | 2,937 | 2,011 |
| Net income | \$ 6,569 | \$ 7,612 | \$ 6,585 |
| Per share | | | |
| Basic earnings per share | \$ 1.66 | \$ 1.96 | \$ 1.71 |
| Diluted earnings per share | \$ 1.66 | \$ 1.96 | \$ 1.71 |
| Cash dividends declared | \$ 1.08 | \$ 1.08 | \$ 1.08 |

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

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

| (Amounts in thousands) | For years ended December 31 | | |
|---|-----------------------------|----------|---------|
| | 2011 | 2010 | 2009 |
| Net Income | \$6,569 | \$7,612 | \$6,585 |
| Securities: | | | |
| Unrealized gains arising during the period | 2,370 | 417 | 1,698 |
| Reclassification adjustment for net losses included in net income | 83 | 386 | 944 |
| Net unrealized gains | 2,453 | 803 | 2,642 |
| Tax effect | (834) | (273) | (898) |
| Net of tax amount | 1,619 | 530 | 1,744 |
| Derivatives: | | | |
| Unrealized (losses) gains arising during the period | (713) | (1,206) | 497 |
| Reclassification adjustment for losses included in net income | 727 | 718 | 716 |
| Net unrealized gains (losses) | 14 | (488) | 1,213 |
| Tax effect | (6) | 166 | (412) |
| Net of tax amount | 8 | (322) | 801 |
| Pension: | | | |
| Change in plan assets and benefit obligations | (1,691) | (1,078) | 113 |
| Reclassification adjustment for losses included in net income | | | |
| Net unrealized (losses) gains | (1,691) | (1,078) | 113 |
| Tax effect | 575 | 366 | (39) |
| Net of tax amount | (1,116) | (712) | 74 |
| Total other comprehensive income (loss) | 511 | (504) | 2,619 |
| Total Comprehensive Income | \$7,080 | \$7,108 | \$9,204 |

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

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**Consolidated Statements of Changes in Shareholders
Equity
For years ended December 31, 2011, 2010, and 2009:**

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

TABLE OF CONTENTS**Consolidated Statements of Cash Flows**

| (Amounts in thousands) | Years ended December 31 | | |
|---|-------------------------|----------|----------|
| | 2011 | 2010 | 2009 |
| Cash flows from operating activities | | | |
| Net income | \$6,569 | \$7,612 | \$6,585 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 1,407 | 1,344 | 1,419 |
| Net amortization of loans and investment securities | 975 | 410 | 170 |
| Stock option compensation expense | | | 29 |
| Amortization and net change in mortgage servicing rights valuation | 235 | 121 | 157 |
| Amortization of intangibles | 446 | 457 | 468 |
| Provision for loan losses | 7,524 | 3,235 | 3,438 |
| Net realized (gains) losses on sales and calls of securities | (157) | (673) | 522 |
| Impairment writedown on securities recognized in earnings | 240 | 1,059 | 422 |
| Loans originated for sale | | (920) | (647) |
| Proceeds from sale of loans | | 952 | 659 |
| Gain on sales of loans | | (32) | (12) |
| Net (gain) loss on sale or disposal of premises and equipment | | (61) | 120 |
| Net (gain) loss on sale or disposal of other real estate/other repossessed assets | (22) | 15 | (30) |
| Increase in cash surrender value of life insurance | (682) | (672) | (643) |
| Gain from surrender of life insurance policy | | | (278) |
| Contribution to pension plan | (2,112) | (626) | (243) |
| (Increase) decrease in interest receivable and other assets | (78) | 963 | (3,483) |
| Increase (decrease) in interest payable and other liabilities | 699 | (515) | 399 |
| Deferred tax (benefit) expense | (91) | (240) | (742) |
| Other, net | 135 | (71) | 306 |
| Net cash provided by operating activities | 15,088 | 12,358 | 8,616 |
| Cash flows from investing activities | | | |
| Proceeds from sales and calls of investment securities available for sale | 9,772 | 25,322 | 10,217 |
| Proceeds from maturities and paydowns of investment securities available for sale | 21,713 | 29,713 | 38,916 |
| Net decrease in restricted stock | 1,137 | 323 | |
| Purchase of investment securities available for sale | (37,562) | (28,123) | (43,014) |
| Net increase in loans | (28,393) | (13,415) | (66,377) |
| Proceeds from sale of other real estate/other repossessed assets | 517 | 448 | 82 |
| Proceeds from sale or disposal of premises and equipment | | 117 | |
| Proceeds from surrender of life insurance policy | | | 878 |
| Capital expenditures | (742) | (2,122) | (1,521) |
| Net cash (used in) provided by investing activities | (33,558) | 12,263 | (60,819) |
| Cash flows from financing activities | | | |
| Net increase in demand deposits, NOW accounts and savings accounts | 67,535 | 66,239 | 43,525 |
| Net (decrease) increase in time deposits | (13,880) | (70,273) | 67,499 |
| | 1,939 | (4,691) | (27,307) |

| | | | |
|--|-----------------|----------|----------|
| Net increase (decrease) in short-term borrowings and repurchase agreements | | | |
| Long-term debt advances | | | 379 |
| Long-term debt payments | (22,549) | (23,803) | (11,832) |
| Dividends paid | (4,273) | (4,194) | (4,145) |
| Common stock issued under stock option plans | 30 | 26 | |
| Common stock issued from treasury shares | | | 2 |
| Common stock issued under dividend reinvestment plan | 1,706 | 316 | |
| Common stock issued to dividend reinvestment plan | | 617 | 777 |
| Purchase of treasury shares | | | (160) |
| Net cash provided by (used in) financing activities | 30,508 | (35,763) | 68,738 |
| Increase (decrease) in cash and cash equivalents | 12,038 | (11,142) | 16,535 |
| Cash and cash equivalents as of January 1 | 22,106 | 33,248 | 16,713 |
| Cash and cash equivalents as of December 31 | \$34,144 | \$22,106 | \$33,248 |
| Supplemental Disclosures of Cash Flow Information | | | |
| Cash paid during the year for: | | | |
| Interest on deposits and other borrowed funds | \$9,350 | \$12,974 | \$14,866 |
| Income taxes | \$2,425 | \$4,012 | \$2,119 |
| Noncash Activities | | | |
| Loans transferred to Other Real Estate | \$3,726 | \$438 | \$643 |

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

The accounting policies of Franklin Financial Services Corporation and its subsidiaries conform to generally accepted accounting principles and to general industry practices. A summary of the more significant accounting policies, which have been consistently applied in the preparation of the accompanying consolidated financial statements, follows:

Principles of Consolidation 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, Franklin Financial Properties Corp. and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank (the 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 that makes venture capital investments within the Corporation's primary market area. The activities of non-bank entities are not significant to the consolidated totals. All significant intercompany transactions have been eliminated in consolidation. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

Nature of Operations The Corporation conducts substantially all of its business through its subsidiary bank, Farmers and Merchants Trust Company, which serves its customer base through twenty-five community-banking offices located in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania. These counties are considered to be the Corporation's primary market area. The Bank is a community-oriented commercial bank that emphasizes customer service and convenience. As part of its strategy, the Bank has sought to develop a variety of products and services that meet the needs of both its retail and commercial customers. The Corporation and the Bank are subject to the regulations of various federal and state agencies and undergo periodic examinations by these regulatory authorities.

Use of Estimates in the Preparation of Financial Statements The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, and the assessment of other than temporary impairment of investment securities and impairment of restricted stock, the value of mortgage servicing rights and derivatives, and the valuation allowance on the deferred tax asset.

Significant Group Concentrations of Credit Risk Most of the Corporation's activities are with customers located within its primary market area. Note 4 of the consolidated financial statements shows the types of securities in which the Corporation invests. Note 5 of the consolidated financial statements shows the types of lending in which the Corporation engages. The Corporation does not have any significant concentrations of any one industry or customer.

Statement of Cash Flows 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.

Investment Securities Management classifies its securities at the time of purchase as available for sale or held to

maturity. At December 31, 2011 and 2010, all securities were classified as available for sale, meaning that the Corporation intends to hold them for an indefinite period of time, but not necessarily to maturity. Available for sale securities are stated at estimated fair value, adjusted for amortization of premiums and accretion of discounts which are recognized as adjustments of interest income through call date or maturity. The related unrealized holding gains and losses are reported as other comprehensive income or loss, net of tax, until realized. Declines in the fair value of held-to-maturity and available-for-sale securities to amounts below cost that are deemed to be other-than-temporary are reflected in earnings as realized losses. In

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 1. Summary of Significant Accounting Policies
(continued)**

estimating the other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) determines if the Corporation does not intend to sell the security or it if is not more likely than not that the Corporation will be required to sell the security before recovery of its amortized cost. When a determination is made that an other-than-temporary impairment exists but the Corporation does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, the other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income. Realized securities gains and losses are computed using the specific identification method. Gains or losses on the disposition of investment securities are based on the net proceeds and the adjusted carrying amount of the specific security sold. Any decision to sell a security classified as available for sale would be based on various factors, including significant movement in interest rates, changes in maturity or mix of the Bank's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors.

Restricted Stock Restricted stock, which is carried at cost, consists of stock of the Federal Home Loan Bank of Pittsburgh (FHLB) and Atlantic Central Bankers Bank (ACBB). The Bank held \$5.0 million of restricted stock at the end of 2011. With the exception of \$30 thousand, this investment represents stock in the FHLB that the Bank is required to hold in order to be a member of FHLB and is carried at a cost of \$100 per share. Federal law requires a member institution of the FHLB to hold FHLB stock according to a predetermined formula. In December 2008, FHLB announced it would suspend dividends and the regular repurchase of excess capital stock from its members due to deterioration in its financial condition. As a result, the Bank may hold more FHLB stock than would have been previously required. Management evaluates the restricted stock for impairment in accordance with ASC Topic 320. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the banks as compared to the capital stock amount for the banks and the length of time this situation has persisted, (2) commitments by the banks to make payments required by law or regulation and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the banks. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB or ACBB stock and the benefits of 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. Management believes no impairment charge is necessary related to the FHLB or ACBB restricted stock as of December 31, 2011. In February 2012, FHLB declared a .10 percent annualized dividend and repurchased \$250 thousand of the Bank's excess capital stock investment in FHLB.

Financial Derivatives The Corporation uses interest rate swaps, which it has designated as cash-flow hedges, to manage interest rate risk associated with variable-rate funding sources. All such derivatives are recognized on the

balance sheet at estimated fair value in other assets or liabilities as appropriate. To the extent the derivatives are effective and meet the requirements for hedge accounting, changes in fair value are recognized in other comprehensive income with income statement reclassification occurring as the hedged item affects earnings. Conversely, changes in fair value attributable to ineffectiveness or to derivatives that do not qualify as hedges are recognized as they occur in the income statement's interest expense account associated with the hedged item.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies (continued)

Interest rate derivative financial instruments receive hedge accounting treatment only if they are designated as a hedge and are expected to be, and are, effective in substantially reducing interest rate risk arising from the assets and liabilities identified as exposing the Corporation to risk. Those derivative financial instruments that do not meet the hedging criteria discussed below would be classified as trading activities and would be recorded at fair value with changes in fair value recorded in income. Derivative hedge contracts must meet specific effectiveness tests (i.e., over time the change in their fair values due to the designated hedge risk must be within 80 to 125 percent of the opposite change in the fair values of the hedged assets or liabilities). Changes in fair value of the derivative financial instruments must be effective at offsetting changes in the fair value of the hedged items due to the designated hedge risk during the term of the hedge. Further, if the underlying financial instrument differs from the hedged asset or liability, there must be a clear economic relationship between the prices of the two financial instruments. If periodic assessments indicate derivatives no longer provide an effective hedge, the derivatives contracts would be closed out and settled or classified as a trading activity.

Cash flows resulting from the derivative financial instruments that are accounted for as hedges of assets and liabilities are classified in the cash flow statement in the same category as the cash flows of the items being hedged.

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

The accrual of interest is generally discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in a prior year is charged against the allowance for loan losses. Interest received on nonaccrual loans generally is either applied against principal or reported as interest income, according to management's judgment as to the collectibility of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectibility of the total contractual principal and interest is no longer in doubt. Consumer loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loans.

Loans Held for Sale Mortgage loans originated and intended for sale in the secondary market at the time of origination are carried at the lower of cost or estimated fair value (determined on an aggregate basis). All sales are made without recourse. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

Loan Servicing Servicing assets are recognized as separate assets when rights are acquired through sale of financial assets. A portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair

value is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, prepayment speeds, default rates and losses. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the periods of, the estimated future net servicing income of the underlying financial assets. Servicing rights are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. For the purpose of computing impairment, mortgage servicing rights are stratified based on risk characteristics of the underlying loans that are expected to have the most impact on projected prepayments including loan type, interest rate and term. Impairment is recognized through a valuation allowance to the extent that fair value is less than the capitalized amount. If the Corporation later

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies (continued)

determines that all or a portion of the impairment no longer exists, a reduction of the allowance may be recorded as an increase to income. Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income. Loans serviced by the Bank for the benefit of others totaled \$65.6 million, \$79.9 million and \$101.2 million at December 31, 2011, 2010 and 2009, respectively.

Allowance for Loan Losses The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on the Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

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

The Corporation's allowance for possible loan losses consists of two elements: (1) specific valuation allowances established for probable losses on specific loans and (2) historical valuation allowances calculated based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary to reflect the impact general economic conditions and other qualitative risk factors both internal and external to the Corporation.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment using historical charge-offs as the starting point in estimating loss. Accordingly, the Corporation may not separately identify individual consumer and residential loans for impairment disclosures.

Premises and Equipment Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets or the lease term for lease hold improvements, whichever is shorter. When assets are retired or sold, the asset cost and related accumulated depreciation are eliminated from the respective accounts, and any resultant gain or loss is included in net income.

The cost of maintenance and repairs is charged to operating expense as incurred, and the cost of major additions and improvements is capitalized.

Intangible Assets Intangible assets consist of goodwill, core deposit intangibles and a customer list intangible. These assets were recorded from corporate acquisitions. Goodwill is not amortized, nor deductible for tax purposes. However, goodwill is tested for impairment at least annually. Goodwill was tested for impairment by an independent third party as of August 31, 2011 and subsequently reviewed by Management

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies (continued)

as of December 31, 2011. Management determined that goodwill was not impaired at either date. If goodwill is determined to be impaired, an impairment write-down is charged to results of operations in the period in which the impairment is determined. The core deposit intangible is amortized over the estimated life of the acquired deposits.

The customer list is amortized over 10 years using the sum-of-the-years digits method.

Bank Owned Life Insurance The Bank invests in bank owned life insurance (BOLI) as a source of funding for employee benefit expenses. The Bank purchases life insurance coverage on the lives of a select group of employees. The Bank is the owner and beneficiary of the policies and records the investment at the cash surrender value of the underlying policies. Income from the increase in cash surrender value of the policies is included in noninterest income.

Foreclosed Real Estate Foreclosed real estate (OREO) is comprised of property acquired through a foreclosure proceeding or an acceptance of a deed in lieu of foreclosure. Balances are initially reflected at the estimated fair value less any estimated disposition costs, with subsequent adjustments made to reflect further declines in value. Any losses realized upon disposition of the property, and holding costs prior thereto, are charged against income.

Transfers of Financial Assets Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Federal Income Taxes Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance, when in the opinion of management, it is more likely than not that some portion or all deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted through the provision for income taxes for the effects of changes in tax laws and rates on the date of enactment. ASC Topic 740 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more-likely-than-not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. ASC Topic 740, Income Taxes also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties.

Advertising Expenses Advertising costs are expensed as incurred.

Treasury Stock The acquisition of treasury stock is recorded under the cost method. The subsequent disposition or sale of the treasury stock is recorded using the average cost method.

Investment and Trust Services Assets held in a fiduciary capacity are not assets of the Corporation and therefore are not included in the consolidated financial statements. Trust assets under management at December 31, 2011 were \$481.5 million and \$490.4 million at the prior year-end. Revenue from investment and trust services is recognized on the accrual basis.

Off-Balance Sheet Financial Instruments In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit.

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TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 1. Summary of Significant Accounting Policies
(continued)**

Such financial instruments are recorded on the balance sheet when they are funded. The amount of any liability for the credit risk associated with off-balance sheet financial instruments is recorded in other liabilities and was not material to the financial position of the Corporation at December 31, 2011 or 2010.

Stock-Based Compensation The Corporation accounts for stock based compensation in accordance with the ASC Topic 718, Stock Compensation. ASC Topic 718 requires compensation costs related to share-based payment transactions to be recognized in the financial statements (with limited exceptions). The amount of compensation cost is measured based on the grant-date fair value of the equity or liability instruments issued. Compensation cost is recognized over the period that an employee provides services in exchange for the award.

Compensation expense was \$0 in 2011 and 2010, and \$29 thousand in 2009. The 2009 expense is related to options granted in February 2009 under the Corporation's Incentive Stock Option Plan of 2002 and was fully expensed in 2009.

Pension The provision for pension expense was actuarially determined using the projected unit credit actuarial cost method. The funding policy is to contribute an amount sufficient to meet the requirements of ERISA, subject to Internal Revenue Code contribution limitations.

In accordance with ASC Topic 715, Compensation - Retirement Benefits, the Corporation recognizes the plan's over-funded or under-funded status as an asset or liability with an offsetting adjustment to Accumulated Other Comprehensive Income (AOCI). ASC Topic 715 requires the determination of the fair value of a plan's assets at the company's year-end and the recognition of actuarial gains and losses, prior service costs or credits, transition assets or obligations as a component of AOCI. These amounts were previously netted against the plan's funded status in the Corporation's consolidated Balance Sheet. These amounts will be subsequently recognized as components of net periodic benefit costs. Further, actuarial gains and losses that arise in subsequent periods that are not initially recognized as a component of net periodic benefit costs will be recognized as a component of AOCI. Those amounts will subsequently be recorded as component of net periodic benefit costs as they are amortized during future periods.

Earnings per share Earnings per share are computed based on the weighted average number of shares outstanding during each year. The Corporation's basic earnings per share are calculated as net income divided by the weighted average number of shares outstanding. For diluted earnings per share, net income is divided by the weighted average number of shares outstanding plus the incremental number of shares added as a result of converting common stock equivalents, calculated using the treasury stock method. The Corporation's common stock equivalents consist of stock options.

A reconciliation of the weighted average shares outstanding used to calculate basic earnings per share and diluted earnings per share follows:

| | | | |
|--|--------------|-------|-------|
| <i>(In thousands, except per share data)</i> | 2011 | 2010 | 2009 |
| Weighted average shares outstanding (basic) | 3,962 | 3,887 | 3,840 |

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| | | | |
|---|-----------------|----------|----------|
| Impact of common stock equivalents | 1 | 1 | |
| Weighted average shares outstanding (diluted) | 3,963 | 3,888 | 3,840 |
| Anti-dilutive options excluded from calculation | 70 | 74 | 76 |
| Net income | \$ 6,569 | \$ 7,612 | \$ 6,585 |
| Basic earnings per share | \$ 1.66 | \$ 1.96 | \$ 1.71 |
| Diluted earnings per share | \$ 1.66 | \$ 1.96 | \$ 1.71 |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies (continued)

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

Segment Reporting The Bank acts as an independent community financial services provider and offers traditional banking and related financial services to individual, business and government customers. Through its community office and automated teller machine network, the Bank offers a full array of commercial and retail financial services, including the taking of time, savings and demand deposits; the making of commercial, consumer and mortgage loans; and the providing of safe deposit services. The Bank also performs personal, corporate, pension and fiduciary services through its Investment and Trust Services Department and Personal Investment Center.

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

Comprehensive Income Comprehensive income is reflected in the Consolidated Statements of Income and Consolidated Statements of Changes in Shareholders' Equity and includes net income and unrealized gains or losses, net of tax, on investment securities, derivatives and the change in plan assets and benefit obligations on the Bank's pension plan, net of tax.

Recent Accounting Pronouncements:

Testing Goodwill for Impairment. In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-08, Testing Goodwill for Impairment. The purpose of this ASU is to simplify how entities test goodwill for impairment by adding a new first step to the pre-existing goodwill impairment test under Accounting Standards Codification (ASC) Topic 350, Intangibles—Goodwill and other. This amendment gives the entity the option to first assess a variety of qualitative factors such as economic conditions, cash flows, and competition to determine whether it was more likely than not that the fair value of goodwill has fallen below its carrying value. If the entity determines that it is not likely that the fair value has fallen below its carrying value, then the entity will not have to complete the original two-step test under Topic 350. The amendments in this ASU are effective for impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. The Corporation is evaluating the affect of this ASU and does not expect it to have a material affect on the Corporation's financial position or consolidated financial statements.

Presentation of Comprehensive Income. The provisions of this ASU amend FASB ASC Topic 220, Comprehensive Income, to facilitate the continued alignment of U.S. GAAP with International Accounting Standards. The ASU prohibits the presentation of the components of comprehensive income in the statement of shareholder's equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate, but consecutive, statements of net income and other comprehensive income. Under previous GAAP, all 3 presentations were acceptable. Regardless of the presentation selected, the Reporting Entity is required to represent all reclassifications between other comprehensive and net income on the face

of the new statement or statements. The provisions of this ASU are effective for fiscal years and interim periods beginning after December 31, 2011 for public entities. As the two remaining options for presentation existed prior to the issuance of this ASU, early adoption is permitted. The Corporation early adopted this ASU effective with the quarter ended June 30, 2011.

Receivables Troubled Debt Restructurings by Creditors. The FASB has issued this ASU to clarify the accounting principles applied to loan modifications, as defined by FASB ASC Subtopic 310-40, Receivables Troubled Debt Restructurings by Creditors. The Update clarifies guidance on a creditor's evaluation of whether or not a concession has been granted, with an emphasis on evaluating all aspects of the modification rather than a focus on specific criteria, such as the effective interest rate test, to determine a concession. The Update goes on to provide guidance on specific types of modifications such as changes in the interest rate of the borrowing, and insignificant delays in payments, as well as guidance on the creditor's evaluation of whether or not a debtor is experiencing financial difficulties. For public entities, the amendments

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies (continued)

in the Update are effective for the first interim or annual periods beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The entity should also disclose information required by ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which had previously been deferred by ASU 2011-01, Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20, for interim and annual periods beginning on or after June 15, 2011. The Corporation adopted this update effective with the quarter ended September 30, 2011.

Note 2. Regulatory Matters

The Bank is limited as to the amount it may lend to the Corporation, unless such loans are collateralized by specific obligations. State regulations also limit the amount of dividends the Bank can pay to the Corporation and are generally limited to the Bank's accumulated net earnings, which were \$61.4 million at December 31, 2011. In addition, dividends paid by the Bank to the Corporation would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements. The Corporation and the Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Corporation's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgements by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Although not adopted in regulation form, the Pennsylvania Department of Banking utilizes capital standards requiring a minimum leverage capital ratio of 6% and a risk-based capital ratio of 10%, defined substantially the same as those by the FDIC. Management believes, as of December 31, 2011, that the Corporation and the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2011, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

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The table that follows presents the total risk-based, Tier 1 risk-based and Tier 1 leverage requirements for the Corporation and the Bank as defined by the FDIC. Actual capital amounts and ratios are also presented.

| As of December 31, 2011 | | | | | | |
|--|-----------|---------|--------------------------------------|--------|--------------------------------|---------|
| <i>(Dollars in thousands)</i> | Actual | | Minimum to be Adequately Capitalized | | Minimum to be Well Capitalized | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| <u>Total Risk-based Capital Ratio</u> | | | | | | |
| Corporation | \$ 92,296 | 12.14 % | \$ 60,837 | 8.00 % | N/A | N/A |
| Bank | 87,117 | 11.51 % | \$ 60,550 | 8.00 % | \$ 75,688 | 10.00 % |
| <u>Tier 1 Risk-based Capital Ratio</u> | | | | | | |
| Corporation | \$ 82,835 | 10.89 % | \$ 30,419 | 4.00 % | N/A | N/A |
| Bank | 77,656 | 10.26 % | \$ 30,275 | 4.00 % | \$ 45,413 | 6.00 % |
| <u>Tier 1 Leverage Ratio</u> | | | | | | |
| Corporation | \$ 82,835 | 8.40 % | \$ 39,429 | 4.00 % | N/A | N/A |
| Bank | 77,656 | 7.89 % | \$ 39,356 | 4.00 % | \$ 49,195 | 5.00 % |
| As of December 31, 2010 | | | | | | |
| <i>(Dollars in thousands)</i> | Actual | | Minimum to be Adequately Capitalized | | Minimum to be Well Capitalized | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| <u>Total Risk-based Capital Ratio</u> | | | | | | |
| Corporation | \$ 86,356 | 11.73 % | \$ 58,890 | 8.00 % | N/A | N/A |
| Bank | 82,174 | 11.22 % | \$ 58,599 | 8.00 % | \$ 73,249 | 10.00 % |
| <u>Tier 1 Risk-based Capital Ratio</u> | | | | | | |
| Corporation | \$ 77,555 | 10.54 % | \$ 29,445 | 4.00 % | N/A | N/A |
| Bank | 73,373 | 10.02 % | \$ 29,299 | 4.00 % | \$ 43,949 | 6.00 % |
| <u>Tier 1 Leverage Ratio</u> | | | | | | |
| Corporation | \$ 77,555 | 8.16 % | \$ 38,037 | 4.00 % | N/A | N/A |
| Bank | 73,373 | 7.73 % | \$ 37,962 | 4.00 % | \$ 47,452 | 5.00 % |

Note 3. Restricted Cash Balances

The Bank is required to maintain reserves against its deposit liabilities in the form of vault cash and/or balances with the Federal Reserve Bank. Deposit reserves that the Bank was required to hold were approximately \$815 thousand and \$949 thousand at December 31, 2011 and 2010, respectively and were satisfied by the Bank's vault cash. In addition, as compensation for check clearing and other services, a compensatory balance maintained at the Federal Reserve Bank at December 31, 2011 and 2010, was approximately \$900 thousand.

Note 4. Investments

The investment portfolio serves as a mechanism to invest funds if funding sources out pace lending activity, provide liquidity for lending and operations, and provide collateral for deposits and borrowings. The Corporation and Bank invest in taxable and tax-free debt securities and equity securities as part of its investment strategy. The mix of taxable and tax-free debt securities are determined by the Bank's Investment Committee and investing decisions are made as a component of balance sheet management. Debt securities include U.S. Government Agencies, U.S. Government Agency mortgage-backed securities, private label mortgage-backed securities (PLMBS), state and municipal government bonds and corporate debt, including

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Note 4. Investments (continued)

trust preferred securities. The equity portfolio consists of bank stocks only and is considered to be longer-term with a focus on capital appreciation. All securities are classified as available for sale and all investment balances refer to fair value.

Equities: The equity portfolio is comprised entirely of bank stocks with the Bank and the Corporation each holding separate portfolios. The stocks held in the portfolio range from community banks to large national banks. In 2011, other-than-temporary impairment charges of \$185 thousand were recorded against the equity portfolio.

Municipal Bonds: The Bank's municipal bond portfolio is well diversified geographically and is comprised primarily of general obligation bonds (72% of the portfolio). The portfolio holds ninety-four separate issues within twenty-six states. The largest dollar exposure is to issuers in the state of Texas (\$8.3 million / 18.4%) and Pennsylvania (\$6.4 million / 14.3%). The majority of the bonds have either private bond insurance or have some type of other credit enhancement. The portfolio contains 4 taxable municipal bonds with a fair value of \$3.7 million. When purchasing municipal bonds, the Bank looks primarily to the underlying credit of the issuer as a sign of credit quality and then to any credit enhancement. Approximately \$31 million of the portfolio is rated A or higher by Moody. The Bank owns five issues for \$2.1 million that are not rated by a nationally recognized rating agency.

Corporate Bonds: There are 3 issuers that comprise the holdings in the corporate bond portfolio, all in the financial services sector. These bonds are both fixed and floating rate bonds and have Moody ratings ranging from A3 to B2.

Trust Preferred Bonds: The Bank holds 7 single-issue trust-preferred securities at a cost of \$5.9 million and a fair value of \$4.6 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 deeply subordinated 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 recent financial conditions, most trust preferred securities have realized a significant decline in value, but market prices continue to improve slowly. All of the Bank's issues are single issuer, variable rate notes with long final maturities (2027 - 2028) that continue to pay dividends.

Mortgage-backed Securities: The largest sector of the portfolio continues to be held in mortgage-backed securities (MBS) with \$58.2 million or 46% of the total portfolio. The majority of this sector (\$55.3 million) is comprised of U.S. Government Agency MBS. In addition, the Bank holds 7 private label mortgage-backed securities (PLMBS) with a fair value of \$2.9 million and an amortized cost of \$3.4 million. These PLMBS bonds paid down by more than \$1 million in 2011.

The Bank's PLMBS portfolio is comprised primarily of Alt-A loans. Alt-A loans are first-lien residential mortgages that generally conform to traditional prime 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 product that was originated between 2003 and 2006 and all were originally rated AAA. The bonds issued in 2006 are experiencing the highest delinquency and loss rates. All of these bonds originally had some type of credit support tranche to absorb any loss prior to losses

at the senior tranche held by the Bank, but this has eroded completely on some bonds as they have started to experience losses. The Bank recorded other-than-temporary impairment charges of \$55 thousand on two PLMBS bonds in 2011. Based on the performance of some the PLMBS, it appears as if the underwriting standards that were represented in the offering, and resulted in the AAA rating, were not followed. As a result, the Bank purchased some securities based on these misrepresentations, and it is most likely that these securities would not have been purchased had all the information been reported correctly. The Bank is participating in a lawsuit against certain issuers related to these misrepresentations.

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 4. Investments (continued)**

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

| <i>(Amounts in thousands)</i> | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated Fair value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
| 2011 | | | | |
| Equity securities | \$ 2,105 | \$ 11 | \$ (357) | \$ 1,759 |
| Obligations of U.S. Government agencies | 13,159 | 75 | (5) | 13,229 |
| Obligations of state and political subdivisions | 42,490 | 2,598 | (7) | 45,081 |
| Corporate debt securities | 2,484 | 49 | (119) | 2,414 |
| Trust preferred securities | 5,890 | | (1,272) | 4,618 |
| Agency mortgage-backed securities | 54,314 | 1,159 | (188) | 55,285 |
| Private-label mortgage-backed securities | 3,366 | 1 | (500) | 2,867 |
| Asset-backed securities | 66 | | (18) | 48 |
| | \$ 123,874 | \$ 3,893 | \$ (2,466) | \$ 125,301 |

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

At December 31, 2011 and 2010, the amortized cost of investment securities pledged to secure public funds, trust balances, repurchase agreements, deposit and other obligations totaled \$112.1 million and \$108.7 million, respectively.

The amortized cost and estimated fair value of debt securities at December 31, 2011, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

| <i>(Amounts in thousands)</i> | Amortized cost | Estimated fair value |
|-------------------------------|-------------------|----------------------------|
|-------------------------------|-------------------|----------------------------|

| | | |
|--|-------------------|-------------------|
| Due in one year or less | \$ 5,105 | \$ 5,088 |
| Due after one year through five years | 12,705 | 13,234 |
| Due after five years through ten years | 16,112 | 17,107 |
| Due after ten years | 30,167 | 29,961 |
| | 64,089 | 65,390 |
| Mortgage-backed securities | 57,680 | 58,152 |
| | \$ 121,769 | \$ 123,542 |

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TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 4. Investments (continued)**

The composition of the net realized securities gains (losses) for the years ended December 31, 2011, 2010 and 2009 is as follows:

| <i>(Amounts in thousands)</i> | 2011 | 2010 | 2009 |
|--|---------------|--------|----------|
| Gross gains realized | \$ 195 | \$ 846 | \$ 66 |
| Gross losses realized | (38) | (173) | (588) |
| Net gains (losses) realized | \$ 157 | \$ 673 | \$ (522) |
| Tax provision (benefits) applicable to net securities gains (losses) | \$ 53 | \$ 229 | \$ (177) |

Impairment:

At December 31, 2011, the investment portfolio contained 58 temporarily impaired securities with a fair value of \$32.1 million and \$2.5 million in unrealized losses. The unrealized loss position has improved from year-end 2010 when there were 85 temporarily impaired securities with an unrealized loss of \$3.2 million. The sectors showing the largest improvement in unrealized loss are state and municipal bonds, and trust preferred securities. Despite the improvement in the value of trust preferred securities, they continue to represent 52% of the total portfolio unrealized loss.

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 the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities, and subject to assessment at December 31, 2011, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 4. Investments (continued)

The unrealized loss in the equity portfolio was \$357 thousand on 16 issues at year-end, an improvement over the unrealized loss of \$538 thousand at year-end 2010. Contributing to this improvement was an other-than-temporary impairment charge of \$185 thousand on equities that was recorded in 2011. The impairment identified on these securities was deemed to be temporary and no adjustments to the financial statements was required.

The unrealized loss in the trust preferred sector was \$1.3 million at year-end compared to \$1.7 million one-year prior. Due to the affect that the recent recession had on the financial performance of many financial institutions, most trust preferred securities realized a significant decline in value. However, market prices continued to show improvement during 2011. All of the Bank's trust preferred securities are variable rate notes with long maturities (2027 - 2028) from companies that received money (and in some cases paid back) from the Troubled Asset Relief Program (TARP), continue to pay dividends and have raised capital. The credit ratings on this portfolio range from B to Baa1 and no bonds have missed or suspended any payments. The Bank reviews the financial performance of each issuer as part of its impairment analysis. At December 31, 2011, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 4. Investments (continued)

The following table provides additional detail about the Bank's trust preferred securities at December 31, 2011.

Trust Preferred Securities

The PLMBS sector continues to show an unrealized loss of \$500 thousand on 6 securities. The majority of this sector is comprised of Alt-A PLMBS. These bonds were all rated AAA at time of purchase but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the 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 analysis on PLMBS it was determined that two bonds contained losses that were considered other-than-temporary. Management determined \$55 thousand was credit related and therefore, recorded an impairment charge of \$55 thousand against earnings in 2011. The market for PLMBS 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 continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue.

The following table provides additional detail about the Bank's PLMBS at December 31, 2011.

Private Label Mortgage Backed Securities

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 4. Investments (continued)**

The following table represents the cumulative credit losses on securities recognized in earnings as of December 31, 2011.

| (Dollars in thousands) | Twelve Months Ended December 31, 2011 |
|---|--|
| Balance of cumulative credit losses on securities, January 1, 2011 | \$ 335 |
| Additions for credit losses recorded which were not previously recognized as components of earnings | 55 |
| Balance of cumulative credit losses on securities, December 31, 2011 | \$ 390 |

The Bank held \$5.0 million of restricted stock at the end of 2011. The restricted stock is comprised primarily of an investment in the Federal Home Loan Bank of Pittsburgh (FHLB). FHLB stock is carried at a cost of \$100 per share.

In 2008, FHLB announced a capital restoration plan that resulted in it discontinuing paying dividends and repurchasing excess capital stock from its members. Therefore, the Bank's investment in FHLB is a non-earning asset at this time. It is not known if or when FHLB will be able to restore its dividend or repurchase its stock. However, during 2011, FHLB repurchased \$1.1 million in stock as part of special repurchases. As of December 31, 2011, the Bank held \$1.4 million in FHLB stock in excess of what it would have been required to hold prior to the suspension of the stock repurchase plan. FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. If FHLB stock were deemed to be impaired, the write-down for the Bank could be significant. 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. In February 2012, FHLB declared a .10 percent annualized dividend and repurchased \$250 thousand of the Bank's excess capital stock investment in FHLB.

Note 5. Loans

The Bank reports its loan portfolio based on the primary collateral of the loan. It further classifies these loans by the primary purpose, either consumer or commercial. Consumer loans are comprised of installment, home equity and unsecured personal lines of credit. However, the Bank discontinued its indirect lending activities in 2010. The Bank's mortgage loans include long-term loans to individuals and businesses secured by mortgages on the borrower's real property. Construction loans are made to finance the purchase of land and the construction of residential and commercial buildings thereon, and are secured by mortgages on real estate. Commercial loans are made to businesses of various sizes for a variety of purposes including construction, property, plant and equipment, and working capital. Commercial loans also include loans to government municipalities. Commercial lending is concentrated in the Bank's primary market, but also includes purchased loan participations.

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 5. Loans (continued)**

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

| <i>(Amounts in thousands)</i> | December 31, 2011 | December 31, 2010 |
|--|-------------------------|-------------------------|
| Residential Real Estate 1 – 4 Family | | |
| Consumer first liens | \$ 86,767 | \$ 98,528 |
| Consumer junior liens and lines of credit | 40,290 | 45,669 |
| Total consumer | 127,057 | 144,197 |
| Commercial first lien | 55,130 | 45,600 |
| Commercial junior liens and lines of credit | 7,846 | 11,025 |
| Total | 62,976 | 56,625 |
| Total residential real estate 1 – 4 family | 190,033 | 200,822 |
| Residential real estate – construction | | |
| Consumer purpose | 1,381 | 1,897 |
| Commercial purpose | 19,901 | 77,660 |
| Total residential real estate construction | 21,282 | 79,557 |
| Commercial, industrial and agricultural real estate | 358,974 | 304,195 |
| Commercial, industrial and agricultural | 182,694 | 146,672 |
| Consumer | 13,427 | 17,396 |
| | 766,410 | 748,642 |
| Less: Allowance for loan losses | (9,723) | (8,801) |
| Net Loans | \$ 756,687 | \$ 739,841 |
| Included in the loan balances are the following: | | |
| Net unamortized deferred loan costs | \$ 426 | \$ 567 |
| Unamortized discount on purchased loans | \$ (167) | \$ (220) |
| Loans pledged as collateral for borrowings and commitments from: | | |
| FHLB | \$ 679,272 | \$ 648,272 |
| Federal Reserve Bank | 27,435 | 53,682 |
| | \$ 706,707 | \$ 701,954 |

Loans to directors and executive officers and related interests and affiliated enterprises were as follows:

| <i>(Amounts in thousands)</i> | 2011 | 2010 |
|-------------------------------|------------------|----------|
| Balance at beginning of year | \$ 8,072 | \$ 7,798 |
| New loans made | 3,854 | 2,613 |
| Repayments | (1,055) | (2,339) |
| Balance at end of year | \$ 10,871 | \$ 8,072 |

Note 6. Loan Quality

Management utilizes a risk rating scale ranging from 1 (prime) to 9 (loss) to evaluate loan quality. Risk ratings are assigned primarily to commercial purpose loans. Loans rated 1 - 4 are considered pass credits. Loans that are rated 5 are pass credits, but have been identified as credits that are likely to warrant additional attention and monitoring. Loans rated 6 (OAEM) or worse begin to receive enhanced monitoring and reporting by the Bank. The Bank monitors loan quality by continually reviewing four measurements: (1) watch list loans (loans risk rated 6 or worse), (2) delinquent loans (primarily nonaccrual loans and loans past due 90 days or more), (3) other real estate owned (OREO), and (4) net-charge-offs. Management compares trends in these measurements with the Bank's internally established targets, as well as its national peer group.

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TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 6. Loan Quality (continued)**

Loans that are risk rated 6 or worse are placed on the Bank's watch list. The watch list is the Bank's broadest review of loan quality. Loans on the watch list are adversely classified because the borrowers are, or may be experiencing a weakening financial condition that may result in a payment default. If these trends continue, the Bank has an increasing likelihood that it will need to liquidate collateral for repayment. The Bank's watch list includes loans that may or may not be delinquent or on nonaccrual, loans that may or may not be considered impaired, and potential problem loans. At December 31, 2011, there was \$93.5 million on the Bank's watch list comprised entirely of loans rated 6 or 7 (substandard) compared to \$69.9 million on the watch list at the end of 2010. The Bank has no loans rated 8 (doubtful) or 9 (loss). Potential problem loans are included on the watch list and represent loans where the borrowers may not be able to comply with current loan terms, but excludes loans that are 90 days or more past due, and nonaccrual loans. Potential problem loans were \$71.0 million at year-end compared to \$42.4 million one-year earlier. The Bank's Loan Management Committee reviews the watch list and risk ratings on a monthly basis in order to proactively identify and manage problem loans. The following table reports on the initial credit rating for those loans in the portfolio that are assigned an individual credit rating (primarily commercial) as of December 31 2011 and 2010:

| <i>(Dollars in thousands)</i> | Pass | Special Mention | Substandard | Doubtful | Total |
|---|-----------|--------------------|-------------|----------|-----------|
| <u>December 31, 2011</u> | | | | | |
| Residential Real Estate 1 - 4 Family | | | | | |
| First liens | \$45,879 | \$3,733 | \$5,518 | \$ | \$55,130 |
| Junior liens and lines of credit | 7,119 | 377 | 350 | | 7,846 |
| Total | 52,998 | 4,110 | 5,868 | | 62,976 |
| Residential real estate - construction | 17,872 | 941 | 1,088 | | 19,901 |
| Commercial, industrial and agricultural real estate | 291,967 | 41,675 | 25,332 | | 358,974 |
| Commercial, industrial and agricultural | 168,207 | 7,649 | 6,838 | | 182,694 |
| Total | \$531,044 | \$54,375 | \$39,126 | \$ | \$624,545 |
| <u>December 31, 2010</u> | | | | | |
| Residential Real Estate 1 - 4 Family | | | | | |
| First liens | \$40,480 | \$1,821 | \$3,299 | \$ | \$45,600 |
| Junior liens and lines of credit | 10,566 | 68 | 391 | | 11,025 |
| Total | 51,046 | 1,889 | 3,690 | | 56,625 |
| Residential real estate - construction | 59,097 | 6,671 | 11,892 | | 77,660 |
| Commercial, industrial and agricultural real estate | 273,279 | 8,481 | 22,435 | | 304,195 |
| Commercial, industrial and agricultural | 132,981 | 6,383 | 7,308 | | 146,672 |
| Total | \$516,403 | \$23,424 | \$45,325 | \$ | \$585,152 |

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 6. Loan Quality (continued)**

For loans that are not assigned an individual credit rating (primarily consumer and residential mortgage loans), the Bank's initial credit quality evaluation is based on the performing status of the loan. The following table presents the performance status as of December 31, 2011 and 2010:

| <i>(Dollars in thousands)</i> | Performing | Non-performing | Total |
|--------------------------------------|------------|----------------|------------|
| December 31, 2011 | | | |
| Consumer | \$ 13,320 | \$ 107 | \$ 13,427 |
| Residential Real Estate | 125,011 | 2,046 | 127,057 |
| Residential Real Estate Construction | 1,381 | | 1,381 |
| | \$ 139,712 | \$ 2,153 | \$ 141,865 |
| December 31, 2010 | | | |
| Consumer | \$ 17,271 | \$ 125 | \$ 17,396 |
| Residential Real Estate | 142,848 | 1,349 | 144,197 |
| Residential Real Estate Construction | 1,897 | | 1,897 |
| | \$ 162,016 | \$ 1,474 | \$ 163,490 |

Delinquent loans are a result of borrowers' cash flow and/or alternative sources of cash being insufficient to repay loans. The Bank's likelihood of collateral liquidation to repay the loans becomes more probable the further behind a borrower falls, particularly when loans reach 90 days or more past due. Management monitors the performance status of loans by the use of an aging report. The aging report can provide an early indicator of loans that may become severely delinquent and possibly result in a loss to the Bank.

The following table presents the aging of payments in the loan portfolio as of December 31, 2011 and 2010.

| <i>(Dollars in thousands)</i> | Current | Loans Past Due and Still Accruing | | | | | Total | Total |
|---|------------|-----------------------------------|---------|---------|----------|----------|--------------|------------|
| | | 30 Days | 59 Days | 60 Days | 89 Days | 90 Days+ | Non-Accruing | Loans |
| <u>December 31, 2011</u> | | | | | | | | |
| Residential Real Estate 1-4 Family | | | | | | | | |
| First liens | \$ 134,105 | \$ 2,574 | \$ 953 | | \$ 2,516 | \$ 6,043 | \$ 1,749 | \$ 141,897 |
| Junior liens and lines of credit | 46,311 | 1,121 | 121 | | 301 | 1,543 | 282 | 48,136 |
| Total | 180,416 | 3,695 | 1,074 | | 2,817 | 7,586 | 2,031 | 190,033 |
| Residential real estate construction | 21,161 | | | | 121 | 121 | | 21,282 |
| Commercial, industrial and agricultural real estate | 337,462 | 2,961 | 2,646 | | 1,627 | 7,234 | 14,278 | 358,974 |
| Commercial, industrial and | 179,907 | 113 | 1,127 | | 100 | 1,340 | 1,447 | 182,694 |

| | | | | | | | |
|--------------|-----------|---------|---------|---------|----------|----------|-----------|
| agricultural | | | | | | | |
| Consumer | 12,917 | 287 | 116 | 107 | 510 | | 13,427 |
| Total | \$731,863 | \$7,056 | \$4,963 | \$4,772 | \$16,791 | \$17,756 | \$766,410 |

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| <i>(Dollars in thousands)</i> | Current | Loans Past Due and Still Accruing | | | | Total | Non-Accrual | Total Loans |
|--|-----------|-----------------------------------|------------|------------|------------|-----------|-------------|----------------|
| | | 30 Days | 59 Days | 60 Days | 89 Days | | | |
| <u>December 31, 2010</u> | | | | | | | | |
| Residential Real Estate 1 4 Family | | | | | | | | |
| First liens | \$140,711 | \$979 | \$ 654 | \$ 1,093 | \$ 2,726 | \$ 691 | \$ 144,128 | |
| Junior liens and lines of credit | 55,723 | 16 | | 833 | 849 | 122 | 56,694 | |
| Total | 196,434 | 995 | 654 | 1,926 | 3,575 | 813 | 200,822 | |
| Residential real estate construction | 72,146 | | | 911 | 911 | 6,500 | 79,557 | |
| Commercial, industrial and agricultural real estate | 285,050 | 3,786 | 13 | 2,343 | 6,142 | 13,003 | 304,195 | |
| Commercial, industrial and agricultural | 142,829 | 1,786 | 145 | 244 | 2,175 | 1,668 | 146,672 | |
| Consumer | 17,077 | 164 | 30 | 125 | 319 | | 17,396 | |
| Total | \$713,536 | \$6,731 | \$ 842 | \$ 5,549 | \$ 13,122 | \$ 21,984 | \$748,642 | |

Nonaccruing loans generally represent Management's determination that the borrower will be unable to repay the loan in accordance with its contractual terms and that collateral liquidation is not likely to fully repay both interest and principal. It is the Bank's policy to evaluate the probable collectability of principal and interest due under terms of loan contracts for all loans 90-days or more past due or restructured loans. Further, it is the Bank's policy to discontinue accruing interest on loans that are not adequately secured and in the process of collection. Upon determination of nonaccrual status, the Bank 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 the balance of nonperforming loans shows an improvement. Nonperforming loans have declined by approximately \$5 million since 2010. The reduction is due primarily to two large credits moving off nonaccrual during the year, charge-offs, and moving loans to OREO. Nevertheless, both categories of nonperforming loans (nonaccrual and loans past due 90-days or more) have declined from one year earlier. With the reduction in nonperforming loans, there was a corresponding reduction in the 2011 nonperforming ratios shown below compared to 2010. If Management is successful in its workout efforts on several credits, it is possible that they could be removed from nonaccrual status in 2012. However, it is also possible that other loans may become delinquent and nonperforming loans could remain at a high level due to lengthy workout periods on these loans. OREO, depending on the type of property, can also result in an extended holding period prior to disposal.

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 6. Loan Quality (continued)**

The following table presents a summary of nonperforming assets:

| <i>(Dollars in thousands)</i> | 2011 | % | 2010 | % | 2009 | % |
|---|-----------------|-----------------------|----------|-----------------------|----------|-----------------------|
| | Balance | of Loan Segment | Balance | of Loan Segment | Balance | of Loan Segment |
| Nonaccrual loans | | | | | | |
| Residential Real Estate 1 - 4 Family | | | | | | |
| First liens | \$1,749 | 1.2% | \$691 | 0.5 % | \$345 | 0.2 % |
| Junior liens and lines of credit | 282 | 0.6% | 122 | 0.2 % | | |
| Total | 2,031 | 1.1% | 813 | 0.4 % | 345 | 0.2 % |
| Residential real estate - construction | | | 6,500 | 8.2 % | 4,040 | 4.8 % |
| Commercial, industrial and agricultural real estate | 14,278 | 4.0% | 13,003 | 4.3 % | 5,654 | 2.0 % |
| Commercial, industrial and agricultural Consumer | 1,447 | 0.8% | 1,668 | 1.1 % | 124 | 0.1 % |
| Total nonaccrual loans | \$17,756 | | \$21,984 | | \$10,193 | |
| Loans past due 90 days or more and not included above | | | | | | |
| Residential Real Estate 1 - 4 Family | | | | | | |
| First liens | \$2,516 | | \$1,093 | | \$3,060 | |
| Junior liens and lines of credit | 301 | | 833 | | 494 | |
| Total | 2,817 | | 1,926 | | 3,554 | |
| Residential real estate - construction | 121 | | 911 | | 1,426 | |
| Commercial, industrial and agricultural real estate | 1,627 | | 2,343 | | 1,926 | |
| Commercial, industrial and agricultural Consumer | 100 | | 244 | | 960 | |
| Consumer | 107 | | 125 | | 195 | |
| Total loans past due 90 days or more and still accruing | 4,772 | | 5,549 | | 8,061 | |
| Total nonaccrual and loans past due 90 days or more | 22,528 | | 27,533 | | 18,254 | |
| Repossessed assets | 6 | | | | 18 | |
| Foreclosed real estate | 3,224 | | 618 | | 642 | |
| Total nonperforming assets | \$25,758 | | \$28,151 | | \$18,914 | |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 6. Loan Quality (continued)

The majority of the nonaccrual loan balance reported above is comprised of five loans relationships totaling \$12.6 million, or 71% of total nonaccrual loans. Management continually monitors the status of nonperforming loans, the value of any collateral and potential of risk of loss. The following table provides additional information on the most significant nonaccrual accounts:

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

Credit 1 balance was reduced from \$2.5 million at December 31, 2010 as the result of a \$400 thousand charge-off and a significant pay-down in 2011. The Bank charged-off an additional \$400 thousand on this credit in February 2012.

Credit 2 has paid down slightly since December 31, 2010.

Credit 3 was placed on nonaccrual at December 31, 2010. The balance was reduced due to a charge-off of \$1.3 million during 2011.

Credit 4 was added to nonaccrual in 2011. This credit represents the Bank's portion of a shared national credit and is the restructured portion of the total debt remaining after charging off \$1.9 million.

Credit 5 was added in 2011 and represents 2 loans to related borrowers.

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 6. Loan Quality (continued)**

In addition to monitoring nonaccrual loans, the Bank also closely monitors impaired loans and troubled debt restructurings (TDR). 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. The Bank reviews all loans rated 7 or lower, all nonaccrual loans, and all TDR loans for impairment. Impaired loans totaled \$31.2 million at December 31, 2011, down slightly from \$33.2 million at December 31, 2010. The Bank's largest impaired loans, totaling \$12.6 million, are also on nonaccrual status and are reported in the table of significant nonaccrual loans shown above. The Bank has one large impaired credit (\$3.2 million) included in the commercial real estate line that is considered impaired because of its status as a troubled debt restructuring. However, due to a significant pay down at restructuring, the amount of real estate collateral, personal guarantees and its performing status, this credit is not on the nonaccrual list. The following table identifies impaired loans as of December 31, 2011 and 2010:

| <i>(Dollars in thousands)</i> | Impaired Loans With No Allowance | | With Allowance | | Related Allowance |
|---|-------------------------------------|--------------------------------|------------------------|--------------------------------|----------------------|
| | Recorded Investment | Unpaid Principal Balance | Recorded Investment | Unpaid Principal Balance | |
| <u>December 31, 2011</u> | | | | | |
| Residential Real Estate 1 - 4 Family | | | | | |
| First liens | \$ 176 | \$ 177 | \$ 3,723 | \$ 3,867 | \$ 495 |
| Junior liens and lines of credit | 28 | 30 | 134 | 134 | 3 |
| Total | 204 | 207 | 3,857 | 4,001 | 498 |
| Residential real estate - construction | | | 43 | 43 | |
| Commercial, industrial and agricultural real estate | 11,072 | 12,092 | 10,550 | 12,050 | 1,591 |
| Commercial, industrial and agricultural Consumer | 94 | 109 | 2,214 | 2,352 | 870 |
| Total | \$ 11,370 | \$ 12,408 | \$ 16,664 | \$ 18,446 | \$ 2,959 |
| <u>December 31, 2010</u> | | | | | |
| Residential Real Estate 1 - 4 Family | | | | | |
| First liens | \$ | \$ | \$ 965 | \$ 971 | \$ 179 |
| Junior liens and lines of credit | 122 | 122 | 286 | 286 | 4 |
| Total | 122 | 122 | 1,251 | 1,257 | 183 |
| Residential real estate - construction | 3,958 | 3,958 | 4,030 | 4,030 | 1,566 |
| Commercial, industrial and agricultural real estate | 7,307 | 7,378 | 14,118 | 14,312 | 2,170 |
| Commercial, industrial and agricultural Consumer | 51 | 52 | 2,347 | 2,386 | 854 |
| Total | \$ 11,438 | \$ 11,510 | \$ 21,749 | \$ 21,988 | \$ 4,776 |

| | Twelve Months Ended December 31, 2011 | | Twelve Months Ended December 31, 2010 | |
|---|--|----------------------------------|--|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| Residential Real Estate 1 - 4 Family | | | | |
| First liens | \$ 2,170 | \$ 190 | \$ 991 | \$ 41 |
| Junior liens and lines of credit | 317 | 14 | 423 | 2 |
| Total | 2,487 | 204 | 1,414 | 43 |
| Residential real estate - construction | 7,147 | | 7,889 | 37 |
| Commercial, industrial and agricultural real estate | 19,152 | 530 | 22,218 | 731 |
| Commercial, industrial and agricultural | 2,342 | 79 | 2,496 | 95 |
| Consumer | 1 | | 4 | |
| Total | \$ 31,129 | \$ 813 | \$ 34,021 | \$ 906 |

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A loan is considered a troubled debt restructuring (TDR) if the creditor (the Bank), for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The Bank reviews all loans rated 5 or lower when it is providing a loan restructure, modification or new credit facility to determine if the action is a TDR. In addition, the Bank reviews all consumer loan modifications and/or policy exceptions for TDR status. If a TDR loan is placed on nonaccrual status, it remains on nonaccrual status for at least six months to ensure performance. In addition, once a loan is classified as a TDR, it is always classified as a TDR until it pays off, regardless of its performance status. Of the TDR total of \$11.3 million, all loans are in compliance with their modified terms. Included in the TDR total is one note for \$2.6 million that represents a restructured note after charging off \$1.9 million of loans to related borrowers. The Bank participates in this loan as part of a shared national credit and this loan is on the nonaccrual list. In addition, the impaired/TDR credit of \$3.2 million discussed previously is reported in the commercial real estate line. All of the TDR loans are commercial purpose loans except for two consumer loans totaling \$93 thousand.

The following table identifies TDR loans as of December 31, 2011 and 2010:

| <i>(Dollars in thousands)</i> | Troubled Debt Restructurings | | Troubled Debt Restructurings That Have Defaulted on Modified Terms YTD | |
|---|------------------------------|---------------------|--|---------------------|
| | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |
| <u>December 31, 2011</u> | | | | |
| Residential real estate | 2 | \$ 93 | | \$ |
| Commercial, industrial and agricultural real estate | 9 | 8,023 | | |
| Total | 11 | \$ 8,116 | | \$ |
| <u>December 31, 2010</u> | | | | |
| Commercial, industrial and agricultural real estate | 2 | \$ 656 | | |
| Total | 2 | \$ 656 | | \$ |

The following table reports the performing status of TDR loans. The performing status is determined by the loan's compliance with the modified terms.

| | December 31, 2011 | | December 31, 2010 | |
|---|-------------------|---------------|-------------------|---------------|
| | Performing | Nonperforming | Performing | Nonperforming |
| Residential real estate | \$ 93 | \$ | \$ | \$ |
| Commercial, industrial and agricultural real estate | 8,023 | | 656 | |
| | \$ 8,116 | \$ | \$ 656 | \$ |

The following table reports the recorded investment in new TDR loans made during the year ended December 31, 2011.

| | Number of Contracts | Recorded Investment | | Current Balance |
|---|------------------------|-------------------------|---------------------------|--------------------|
| | | Pre-TDR Modification | After-TDR Modification | |
| Residential real estate | 2 | \$ 94 | \$ 94 | \$ 93 |
| Commercial, industrial and agricultural real estate | 7 | 9,234 | 7,366 | 7,567 |
| Total | 9 | \$ 9,328 | \$ 7,460 | \$ 7,660 |

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TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 6. Loan Quality (continued)**

The following table reports the recorded investment in new TDR loans made during the year ended December 31, 2010.

| | Number of Contracts | Recorded Investment | | Current Balance |
|---|------------------------|-------------------------|---------------------------|--------------------|
| | | Pre-TDR Modification | After-TDR Modification | |
| Commercial, industrial and agricultural real estate | 2 | \$ 656 | \$ 656 | \$ 456 |

The type of loan concession granted for loans newly classified as a troubled debt restructuring during the periods ended.

| Modification or Concession | Twelve Months Ended December 31, 2011 | | Twelve Months Ended December 31, 2010 | |
|----------------------------|--|------------------------|--|------------------------|
| | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |
| Maturity | 1 | \$ 257 | | \$ |
| Rate | 3 | 2,935 | 2 | 656 |
| Payment | 5 | 4,468 | | |
| | 9 | \$ 7,660 | 2 | \$ 656 |

The Bank holds \$3.2 million of other real estate owned, comprised of seven properties compared to \$618 thousand and 6 properties at December 31, 2010. The largest borrower (\$2.4 million) was added in 2011 and represents a failed residential real estate development comprised of 4 properties that the Bank received deeds in lieu of foreclosure.

The following table provides additional information on other real estate owned:

| Other Real Estate Owned December 31, 2011 | | | | | |
|--|------------------|---------|--|----------|-------------------|
| (Dollars in thousands) | Date Acquired | Balance | Collateral | Location | Last Appraisal |
| Property 1 | 2011 | \$2,383 | unimproved and improved real estate for residential development on four separate tracts totaling 150 acres | PA | Aug-11 |
| Property 2 | 2011 | 536 | townhouses and residential building lots | PA | Jun-11 |
| Property 3 | 2011 | 23 | residential real estate | PA | Sep-11 |
| Property 4 | 2011 | 9 | residential real estate | PA | Oct-11 |
| Property 5 | 2011 | 93 | residential building lots | MD | Apr-11 |
| Property 6 | 2011 | 42 | residential real estate 2 properties | PA | Dec-10 |

| | | | | | | |
|------------|------|---------|----------|----------|----|--------|
| Property 7 | 2009 | 138 | farmland | 36 acres | PA | Feb-11 |
| | | \$3,224 | | | | |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 6. Loan Quality (continued)

At December 31, 2011, the Bank had \$1.0 million of residential properties in the process of foreclosure compared to \$1.4 million at the end of 2010.

Allowance for Loan Losses:

Management performs a monthly evaluation of the adequacy of the allowance for loan losses (ALL). The ALL is determined by segmenting the loan portfolio based on the loan's collateral. The Bank further classifies the portfolio based on the primary purpose of the loan, either consumer or commercial. When calculating the ALL, 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. The Bank begins enhanced monitoring of all loans rated 6 (OAEM) or worse (commercial loans), and obtains a new appraisal or asset valuation for any loan rated 7 (substandard) or worse, including all nonaccrual loans. 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 factors, including, but not limited to the economy, deferred maintenance, industry, type of property/equipment, age of the appraisal, etc. and the knowledge Management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated and deducted from the valuation in order to determine the net realizable value to the Bank. When determining the allowance for loan loss, certain factors involved in the evaluation are inherently subjective and 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. 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 allowance for loan losses at December 31, 2011 is adequate.

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 for impaired loans. However, it is possible that as a result of the credit analysis, a specific reserve is not required for an impaired loan. See the previous impaired loan discussion for a table that reports impaired loans and the specific reserve established for impaired loans.

The general allocation component addresses the reserves established for pools of homogenous loans. The general component includes a quantitative and qualitative analysis. When calculating the general allocation, the Bank segregates its loan portfolio into the following sectors based primarily on the type of supporting collateral: residential real estate, commercial, industrial or agricultural real estate; commercial and industrial (C&I non-real estate), and consumer. The residential real estate sector is further segregated by first lien loans, junior liens and home equity products, and residential real estate construction. The quantitative analysis uses the Bank's eight quarter rolling historical loan loss experience adjusted for factors derived from current 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.

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 6. Loan Quality (continued)**

Real estate appraisals and collateral valuations are an important part of the Bank's process for determining potential loss on collateral dependent loans and thereby have a direct affect on the determination of loan charge-offs and the calculation of the allowance for loan losses. As long as the loan remains a performing loan, no further updates to appraisals are required. If a loan is risk rated 6 or worse, Management determines the need to obtain a new or updated appraisal based on several factors, including general economic conditions and factors specific to the loan. If a loan / relationship migrates to risk rating of 7 or worse, an evaluation for impairment is made based on the current information available at the time of downgrade and a new appraisal or collateral valuation is obtained. We believe this practice complies with the regulatory guidance dated December 12, 2010.

In determining the allowance for loan losses, Management, at its discretion, may determine that additional adjustments to the fair value obtained from an appraisal or collateral valuation are required. Adjustments will be made as necessary based on 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 and deducted from the valuation in order to determine the net realizable value to the Bank. If an appraisal is not available, Management may make its best estimate of the real value of the collateral or use last known market value and apply appropriate discounts. If an adjustment is made to the collateral valuation, this will be documented in the credit file with appropriate support and reported to the Loan Management Committee.

The following table shows the loans that were evaluated for the allowance for loan losses under a specific reserve (individually) and those that were evaluated under a general reserve (collectively), and the amount of the allowance established in each category as of December 31, 2011 and 2010:

| <i>(Dollars in thousands)</i> | Residential Real Estate 1 - 4 | | | Commercial Industrial & Agricultural Real Estate | Commercial Industrial & Agricultural | Consumer | Total |
|--------------------------------|-------------------------------|---|--------------|--|---|----------|----------|
| | Family First Liens | Junior Liens & Lines of Credit | Construction | | | | |
| Allowance at December 31, 2008 | \$54 | \$70 | \$1,201 | \$5,041 | \$697 | \$294 | \$7,357 |
| Charge-offs | | (94) | (724) | (63) | (567) | (681) | (2,129) |
| Recoveries | 25 | | | | 61 | 185 | 271 |
| Provision | 471 | 302 | 2,610 | (803) | 561 | 297 | 3,438 |
| Allowance at December 31, 2009 | \$550 | \$278 | \$3,087 | \$4,175 | \$752 | \$95 | \$8,937 |
| Allowance at December 31, 2009 | \$550 | \$278 | \$3,087 | \$4,175 | \$752 | \$95 | \$8,937 |
| Charge-offs | (107) | (165) | (982) | (1,736) | (232) | (452) | (3,674) |
| Recoveries | 19 | 10 | 53 | 18 | 61 | 142 | 303 |
| Provision | 138 | 229 | 438 | 901 | 997 | 532 | 3,235 |

| | | | | | | | |
|--------------------------------|-----------------|---------------|-----------------|-----------------|-----------------|---------------|-----------------|
| Allowance at December 31, 2010 | \$ 600 | \$ 352 | \$ 2,596 | \$ 3,358 | \$ 1,578 | \$ 317 | \$ 8,801 |
| Allowance at December 31, 2010 | \$ 600 | \$ 352 | \$ 2,596 | \$ 3,358 | \$ 1,578 | \$ 317 | \$ 8,801 |
| Charge-offs | (324) | (202) | (2,352) | (3,817) | (115) | (237) | (7,047) |
| Recoveries | 30 | 10 | 306 | 11 | 88 | 445 | |
| Provision | 743 | 148 | 978 | 5,410 | 177 | 68 | 7,524 |
| Allowance at December 31, 2011 | \$ 1,049 | \$ 308 | \$ 1,222 | \$ 5,257 | \$ 1,651 | \$ 236 | \$ 9,723 |

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| <i>(Dollars in thousands)</i> | Residential Real Estate 1 4 Family | | | Commercial Industrial & Agricultural Real Estate | Commercial Industrial & Agricultural | Consumer | Total |
|--|---------------------------------------|---|--------------|--|---|----------|-----------|
| | First Liens | Junior Liens & Lines of Credit | Construction | | | | |
| <u>December 31, 2011</u> | | | | | | | |
| Loans evaluated for allowance: | | | | | | | |
| Individually | \$3,899 | \$162 | \$43 | \$21,622 | \$2,308 | \$ | \$28,034 |
| Collectively | 137,998 | 47,974 | 21,239 | 337,352 | 180,386 | 13,427 | 738,376 |
| Total | \$141,897 | \$48,136 | \$21,282 | \$358,974 | \$182,694 | \$13,427 | \$766,410 |
| Allowance established for loans evaluated: | | | | | | | |
| Individually | \$495 | \$3 | \$ | \$1,591 | \$870 | \$ | \$2,959 |
| Collectively | 554 | 305 | 1,222 | 3,666 | 781 | 236 | 6,764 |
| Allowance at December 31, 2011 | \$1,049 | \$308 | \$1,222 | \$5,257 | \$1,651 | \$236 | \$9,723 |
| <u>December 31, 2010</u> | | | | | | | |
| Loans evaluated for allowance: | | | | | | | |
| Individually | \$965 | \$408 | \$7,988 | \$21,425 | \$2,398 | \$3 | \$33,187 |
| Collectively | 143,163 | 56,286 | 71,569 | 282,770 | 144,274 | 17,393 | 715,455 |
| Total | \$144,128 | \$56,694 | \$79,557 | \$304,195 | \$146,672 | \$17,396 | \$748,642 |
| Allowance established for loans evaluated: | | | | | | | |
| Individually | \$179 | \$4 | \$1,566 | \$2,170 | \$854 | \$3 | \$4,776 |
| Collectively | 421 | 348 | 1,030 | 1,188 | 724 | 314 | 4,025 |
| Allowance at December 31, 2010 | \$600 | \$352 | \$2,596 | \$3,358 | \$1,578 | \$317 | \$8,801 |

The following table shows the allocation of the allowance for loan losses by loan category as of December 31, 2011 and 2010:

Allocation of the Allowance for Loan Losses

| <i>(Dollars in thousands)</i> | 2011 | | 2010 | |
|------------------------------------|----------|-----|--------|----|
| Residential real estate 1 4 family | | | | |
| First liens | \$ 1,049 | 11% | \$ 600 | 7% |
| Junior liens and lines of credit | 308 | 3% | 352 | 4% |

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| | | | | | |
|---|-----------------|-------------|----------|-----|---|
| Total | 1,357 | 14% | 952 | 11 | % |
| Residential real estate construction | 1,222 | 13% | 2,596 | 29 | % |
| Commercial, industrial and agricultural real estate | 5,257 | 54% | 3,358 | 38 | % |
| Commercial, industrial and agricultural | 1,651 | 17% | 1,578 | 18 | % |
| Consumer | 236 | 2% | 317 | 4 | % |
| | \$ 9,723 | 100% | \$ 8,801 | 100 | % |

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TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 6. Loan Quality (continued)**

The percentage of the loans in each category to total gross loans at year end is as follows:

| | 2011 | 2010 | |
|---|-------------|------|---|
| Residential real estate 1 4 family | | | |
| First liens | 19% | 19 | % |
| Junior liens and lines of credit | 6% | 8 | % |
| Total | 25% | 27 | % |
| Residential real estate construction | 3% | 11 | % |
| Commercial, industrial and agricultural real estate | 47% | 40 | % |
| Commercial, industrial and agricultural | 24% | 20 | % |
| Consumer | 1% | 2 | % |
| | 100% | 100 | % |

The allocation of the allowance for loan losses is based on estimates and is not intended to imply limitations on the usage of the allowance. The entire allowance is available to absorb any losses without regard to the category in which the loan is classified.

In 2011, \$7.5 million was added to the allowance for loan losses (ALL) through the provision for loan loss expense compared to \$3.2 million in the prior year. The increase in provision expense was due to a higher level of loan charge-offs and Management's intention to ensure adequate ALL coverage for future losses inherent in the loan portfolio as of December 31, 2011 due to weakening credit quality. As a result of these actions, the ALL increased by \$922 thousand during 2011.

Charged-off loans usually result from: (1) a borrower being legally relieved of loan repayment responsibility through bankruptcy, (2) insufficient proceeds from the sale of collateral 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 \$6.6 million in 2011, nearly double the 2010 number of \$3.4 million. The largest increase in gross charge-offs was in the residential real estate construction category, and the commercial, industrial and agricultural real estate category. Combined, these two categories accounted for \$6.2 million of the total gross charge-offs and the year over year increase in these categories of \$3.4 million represented more than the entire increase in gross charge-offs in 2010. Driving the increase in these categories were charge-offs of \$4.9 million related to 4 relationships. Three of these credits are on nonaccrual status and accounted for \$3.8 million of the \$4.9 million increase, including the \$1.9 million charge-off on the shared national credit previously discussed. In addition, the Bank recorded a charge-off of \$1.3 million on four related credits that were moved to OREO. The Bank expects to see a continued reduction in consumer loan charge-offs due to ending its indirect lending activity. The majority of consumer loan charge-offs in past years were attributable to indirect loans.

Note 7. Premises and Equipment

Premises and equipment consist of:

| <i>(Dollars in thousands)</i> | Estimated Life | December 31 | |
|--------------------------------------|----------------------------|-----------------|----------|
| | | 2011 | 2010 |
| Land | | \$3,028 | \$3,028 |
| Buildings and leasehold improvements | 15 30 years, or lease term | 22,296 | 22,036 |
| Furniture, fixtures and equipment | 3 10 years | 13,991 | 13,555 |
| Total cost | | 39,315 | 38,619 |
| Less: Accumulated depreciation | | (23,274) | (22,027) |
| Net premises and equipment | | \$16,041 | \$16,592 |

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TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 7. Premises and Equipment (continued)**

The following table shows the amount of depreciation and rental expense for the years ended December 31:

| | 2011 | 2010 | 2009 |
|------------------------|-----------------|----------|----------|
| Depreciation expense | \$ 1,293 | \$ 1,226 | \$ 1,284 |
| Rent expense on leases | \$ 406 | \$ 383 | \$ 385 |

The Corporation leases various premises and equipment for use in banking operations. Some of these leases provide renewal options of varying terms. The rental cost of these optional renewals is not included below. At December 31, 2011, future minimum payments on these leases are as follows:

(Amounts in thousands)

| | |
|-----------------|-----------------|
| 2012 | \$ 445 |
| 2013 | 384 |
| 2014 | 346 |
| 2015 | 364 |
| 2016 | 334 |
| 2017 and beyond | 2,962 |
| | \$ 4,835 |

Note 8. Goodwill and Intangible Assets

The following table summarizes the changes in goodwill:

| | For the years ended December 31 | |
|-------------------------------|------------------------------------|----------|
| <i>(Amounts in thousands)</i> | 2011 | 2010 |
| Beginning balance | \$ 9,016 | \$ 9,159 |
| Goodwill acquired | | |
| Adjustment to goodwill | | (143) |
| Ending balance | \$ 9,016 | \$ 9,016 |

The following table summarizes the other intangible assets at December 31:

| | Core Deposit | | Customer List | |
|--------------------------|-----------------|----------|---------------|--------|
| | 2011 | 2010 | 2011 | 2010 |
| Gross carrying amount | \$ 3,252 | \$ 3,252 | \$ 589 | \$ 589 |
| Accumulated amortization | (1,987) | (1,626) | (296) | (211) |
| Net carrying amount | \$ 1,265 | \$ 1,626 | \$ 293 | \$ 378 |

The following table shows the amortization expense for the years ended December 31:

(Amounts in thousands)

| | 2011 | 2010 | 2009 |
|----------------------|---------------|--------|--------|
| Amortization expense | \$ 446 | \$ 457 | \$ 468 |

Core deposit intangibles are amortized over the estimated life of the acquired core deposits. At December 31, 2011 the remaining life was 3.5 years. The customer list intangible is amortized over the estimated life of the acquired customer list. At December 31, 2011, the remaining life was 6.9 years.

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 8. Goodwill and Intangible Assets (continued)**

The following table shows the expected amortization expense for intangible assets:

| | <i>(Amounts in thousands)</i> |
|-----------|-------------------------------|
| 2012 | \$ 435 |
| 2013 | 424 |
| 2014 | 414 |
| 2015 | 223 |
| 2016 | 31 |
| 2017 2018 | 30 |

Note 9. Mortgage Servicing Rights

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

| <i>(Amounts in thousands)</i> | For the Years Ended December 31 | | |
|------------------------------------|---------------------------------|----------|----------|
| | 2011 | 2010 | 2009 |
| Cost of mortgage servicing rights: | | | |
| Beginning balance | \$933 | \$1,190 | \$1,551 |
| Originations | | 10 | 8 |
| Amortization | (203) | (267) | (369) |
| Ending balance | \$730 | \$933 | \$1,190 |
| Valuation allowance: | | | |
| Beginning balance | \$(330) | \$(476) | \$(688) |
| Valuation charges | (81) | (48) | |
| Valuation reversals | 49 | 194 | 212 |
| Ending balance | \$(362) | \$(330) | \$(476) |
| Mortgage servicing rights cost | \$730 | \$933 | \$1,190 |
| Valuation allowance | (362) | (330) | (476) |
| Carrying value | \$368 | \$603 | \$714 |
| Fair value | \$368 | \$603 | \$714 |
| Fair value assumptions: | | | |
| Weighted average discount rate | 10.00% | 10.00% | 10.00% |
| Weighted average prepayment speed | 21.85% | 15.55% | 18.67% |

The value of mortgage servicing rights is greatly affected by changes in mortgage interest rates and the resulting changes in prepayment speeds. The following chart shows the changes in fair value under different rate scenarios:

| <i>(Amounts in thousands)</i> | 2011 | 2010 | 2009 |
|-------------------------------|------|------|------|
| Changes in fair value: | | | |

| | | | |
|------------|---------------|---------|----------|
| Rates + 1% | \$ 87 | \$ 321 | \$ 226 |
| Rates (1)% | (\$36) | (\$142) | (\$195) |

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Deposits are summarized as follows:

| <i>(Amounts in thousands)</i> | December 31 | |
|--|-------------------|------------|
| | 2011 | 2010 |
| Demand, noninterest-bearing checking | \$ 104,245 | \$ 90,317 |
| Interest-bearing checking | 117,479 | 103,918 |
| Money market | 326,219 | 289,763 |
| Savings | 51,728 | 48,138 |
| Total interest-bearing checking and savings | 495,426 | 441,819 |
| Retail time deposits | 147,479 | 161,399 |
| Brokered time deposits | 40,836 | 40,796 |
| Total time deposits | 188,315 | 202,195 |
| Total deposits | \$ 787,986 | \$ 734,331 |
| Overdrawn deposit accounts reclassified as loans | \$ 232 | \$ 74 |

The following table shows the maturity of outstanding time deposits of \$100,000 or more at December 31, 2011:

| <i>(Amounts in thousands)</i> | Retail Time Deposits | Brokered Time Deposits | Total Time Deposits |
|--------------------------------|----------------------------|------------------------------|---------------------------|
| Maturity distribution: | | | |
| Within three months | \$ 8,395 | \$ 1,224 | \$ 9,619 |
| Over three through six months | 6,634 | 4,278 | 10,912 |
| Over six through twelve months | 7,761 | 1,653 | 9,414 |
| Over twelve months | 14,678 | 669 | 15,347 |
| Total | \$ 37,468 | \$ 7,824 | \$ 45,292 |

At December 31, 2011 the scheduled maturities of time deposits are as follows:

| <i>(Amounts in thousands)</i> | Retail Time Deposits | Brokered Time Deposits | Total Time Deposits |
|-------------------------------|----------------------------|------------------------------|---------------------------|
| 2012 | \$ 92,366 | \$ 7,409 | \$ 99,775 |
| 2013 | 31,570 | 15,250 | 46,820 |
| 2014 | 11,270 | 505 | 11,775 |
| 2015 | 12,206 | 7,000 | 19,206 |
| 2016 | 14 | 4,916 | 4,930 |
| 2017 and beyond | 53 | 5,756 | 5,809 |
| | \$ 147,479 | \$ 40,836 | \$ 188,315 |

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 11. Securities Sold Under Agreements to Repurchase, Short-Term Borrowings and Long-Term Debt**

The Bank's short-term borrowings are comprised of securities sold under agreements to repurchase and a line-of-credit with the Federal Home Loan Bank of Pittsburgh (Open Repo Plus). Securities sold under agreements to repurchase are overnight borrowings between the Bank and its commercial and municipal depositors. These accounts reprice weekly.

Open Repo Plus is a revolving term commitment used on an overnight basis. The term of this commitment may not exceed 364 days and it reprices daily at market rates.

These borrowings are described below:

| <i>(Dollars in thousands)</i> | December 31 | | 2010 | |
|--|-------------|----------------------------------|----------|----------------------------------|
| | 2011 | FHLB Repurchase Agreements | 2010 | FHLB Repurchase Agreements |
| Ending balance | \$53,103 | \$ | \$51,164 | \$ |
| Weighted average rate at year end | 0.25% | | 0.25% | |
| Range of interest rates paid at year end | 0.25% | | 0.25% | |
| Maximum month-end balance during the year | \$71,485 | \$1,800 | \$68,622 | \$1,900 |
| Average balance during the year | \$60,136 | \$192 | \$60,262 | \$185 |
| Weighted average interest rate during the year | 0.25% | 0.74% | 0.25% | 0.66% |

The collateral for securities sold under agreements to repurchase consists of U.S. Government and U.S. Government agency securities with a fair value of \$62.7 million and \$57.1 million, respectively, at December 31, 2011 and 2010.

A summary of long-term debt at the end of the reporting period follows:

| <i>(Amounts in thousands)</i> | December 31 | |
|---------------------------------------|-------------|----------|
| | 2011 | 2010 |
| Loans from the Federal Home Loan Bank | \$48,336 | \$70,885 |

The loans from the FHLB are comprised of term loans payable at maturity and amortizing advances. These loans have fixed interest rates ranging from 3.70% to 5.60% (weighted average rate of 4.18%) and final maturities ranging from January 2012 to November 2039. All borrowings from the FHLB are collateralized by FHLB stock, mortgage-backed securities and first mortgage loans.

The scheduled amortization and maturities of the FHLB borrowings at December 31, 2011 are as follows:

| | <i>(Amounts in thousands)</i> |
|------|-------------------------------|
| 2012 | \$24,500 |
| 2013 | 9,193 |

| | |
|-----------------|-----------|
| 2014 | 2,201 |
| 2015 | 10,209 |
| 2016 | 218 |
| 2017 and beyond | 2,015 |
| | \$ 48,336 |

The Corporation's maximum borrowing capacity with the FHLB at December 31, 2011, was \$79.3 million. The total amount available to borrow at year-end was approximately \$31.0 million.

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The temporary differences which give rise to significant portions of deferred tax assets and liabilities are as follows:

| <i>(Amounts in thousands)</i> | December 31 | |
|--|-----------------|----------|
| | 2011 | 2010 |
| <u>Deferred Tax Assets</u> | | |
| Allowance for loan losses | \$ 3,306 | \$ 3,222 |
| Deferred compensation | 1,084 | 1,156 |
| Purchase accounting | 75 | 92 |
| Deferred loan fees and costs, net | 160 | 160 |
| Intangibles | | 32 |
| Capital loss carryover | 887 | 303 |
| Other than temporary impairment of investments | 478 | 962 |
| Accumulated other comprehensive loss | 2,643 | 2,906 |
| Other | 536 | 88 |
| | 9,169 | 8,921 |
| Valuation allowance | (1,232) | (1,151) |
| Total gross deferred tax assets | 7,937 | 7,770 |
| <u>Deferred Tax Liabilities</u> | | |
| Core deposit intangibles | 430 | 553 |
| Depreciation | 163 | 68 |
| Joint ventures and partnerships | 61 | 64 |
| Pension | 674 | 196 |
| Mortgage servicing rights | 125 | 205 |
| Customer list | 100 | 129 |
| Total gross deferred tax liabilities | 1,553 | 1,215 |
| Net deferred tax asset | \$ 6,384 | \$ 6,555 |

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during periods in which those temporary differences become deductible.

Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based on the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Bank will realize the benefits of these deferred tax assets.

The components of the provision for Federal income taxes attributable to income from operations were as follows:

| <i>(Amounts in thousands)</i> | For the Years Ended December 31 | | |
|--------------------------------|---------------------------------|----------|----------|
| | 2011 | 2010 | 2009 |
| Current tax expense | \$ 502 | \$ 3,177 | \$ 2,753 |
| Deferred tax (benefit) expense | (91) | (240) | (742) |

| | | | |
|----------------------|---------------|----------|----------|
| Income tax provision | \$ 411 | \$ 2,937 | \$ 2,011 |
|----------------------|---------------|----------|----------|

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For the years ended December 31, 2011, 2010, and 2009, the income tax provisions are different from the tax expense which would be computed by applying the Federal statutory rate to pretax operating earnings. A reconciliation between the tax provision at the statutory rate and the tax provision at the effective tax rate is as follows:

| <i>(Amounts in thousands)</i> | For the Years Ended December 31 | | |
|--|---------------------------------|----------|----------|
| | 2011 | 2010 | 2009 |
| Tax provision at statutory rate | \$2,373 | \$ 3,587 | \$ 2,923 |
| Income on tax-exempt loans and securities | (1,167) | (701) | (787) |
| Nondeductible interest expense relating to carrying tax-exempt obligations | 63 | 42 | 56 |
| Dividends received exclusion | (20) | (12) | (36) |
| Income from bank owned life insurance | (226) | (218) | (212) |
| Life insurance proceeds | | | (94) |
| Valuation allowance | 32 | 272 | 188 |
| Stock option compensation | | | 10 |
| Other, net | (644) | (33) | (37) |
| Income tax provision | \$411 | \$ 2,937 | \$ 2,011 |
| Effective income tax rate | 3.9% | 27.8 % | 23.4 % |

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

At December 31, 2011, the Corporation had a capital loss carryover of \$2.6 million. This loss carryover can only be offset with capital gains for federal income tax purposes. The tax benefit of this carryover is \$887 thousand and the Corporation has recorded a valuation allowance of \$887 thousand against the capital loss carryover.

The Corporation recognizes interest accrued related to unrecognized tax benefits and penalties in income tax expense for all periods presented. The Corporation is no longer subject to U.S. Federal examinations by tax authorities for the years before 2008.

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

| <i>(Amounts in thousands)</i> | December 31 | |
|---|-------------|-------------|
| | 2011 | 2010 |
| Net unrealized gains (losses) on securities | \$ 1,427 | \$ (1,026) |
| Tax effect | (485) | 349 |
| Net of tax amount | 942 | (677) |
| Net unrealized losses on derivatives | (1,738) | (1,752) |
| Tax effect | 590 | 596 |
| Net of tax amount | (1,148) | (1,156) |
| Accumulated pension adjustment | (7,462) | (5,771) |
| Tax effect | 2,537 | 1,962 |
| Net of tax amount | (4,925) | (3,809) |
| Total accumulated other comprehensive loss | \$ (5,131) | \$ (5,642) |

Note 14. Financial Derivatives

As part of managing interest rate risk, the Bank has entered into interest rate swap agreements as vehicles to partially hedge cash flows associated with interest expense on variable rate deposit accounts. Under the swap agreements, the Bank receives a variable rate and pays a fixed rate. Such agreements are generally entered into with counterparties that meet established credit standards and most contain collateral provisions protecting the at-risk party. The Bank considers the credit risk inherent in these contracts to be negligible. Interest rate swap agreements derive their value from underlying interest rates. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments, and the value of the derivative are based. The notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the swap, is reflected on the Corporation's balance sheet.

The Corporation is exposed to credit-related losses in the event of nonperformance by the counterparty to these agreements. The Corporation controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect the counterparty to fail its obligations.

The primary focus of the Corporation's asset/liability management program is to monitor the sensitivity of the Corporation's net portfolio value and net income under varying interest rate scenarios to take steps to control its risks. On a quarterly basis, the Corporation simulates the net portfolio value and net interest income expected to be earned over a twelve-month period following the date of simulation. The simulation is based upon projection of market interest rates at varying levels and estimates the impact of such market rates on the levels of interest-earning assets and interest-bearing liabilities during the measurement period. Based upon the outcome of the simulation analysis, the Corporation considers the use of derivatives as a means of reducing the volatility of net portfolio value and projected net income within certain ranges of projected changes in interest rates. The Corporation evaluates the effectiveness of entering into any derivative instrument agreement by measuring the cost of such an agreement in relation to the reduction in net portfolio value and net income volatility within an assumed range of interest rates.

During 2008, the Bank entered into two swap transactions. Each swap has a notional amount of \$10 million with one maturing in 2013 and one in 2015. According to the terms of each transaction, the Bank pays fixed-rate interest payments and receives floating-rate payments. The swaps were entered into to hedge the Corporation's exposure to changes in cash flows attributable to the effect of interest rate changes on variable-rate liabilities. At December 31, 2011, the fair value of the swaps was negative \$1.7 million and was recognized in accumulated other comprehensive loss, net of tax.

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The Board of Directors has given Management authorization to enter into additional 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.

Information regarding the interest rate swaps as of December 31, 2011 follows:

| <i>(Dollars in thousands)</i> Notional Amount | Maturity Date | Interest Rate | | Amount Expected to be Expensed into Earnings within the next 12 Months |
|--|------------------|---------------|--------------|---|
| | | Fixed | Variable | |
| \$10,000 | 5/30/2013 | 3.60% | 0.03% | \$ 358 |
| \$10,000 | 5/30/2015 | 3.87% | 0.03% | \$ 385 |

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

Fair Value of Derivative Instruments in the Consolidated Balance Sheets were as follows as of December 31, 2011:

| Fair Value of Derivative Instruments <i>(Dollars in thousands)</i> | | Balance Sheet | Fair Value |
|---|--------------------------------|--------------------------|-----------------|
| Date | Type | Location | |
| December 31, 2011 | Interest rate contracts | Other liabilities | \$ 1,738 |
| December 31, 2010 | Interest rate contracts | Other liabilities | \$ 1,752 |

The Effect of Derivative Instruments on the Statement of Income for the years ended December 31, 2011, 2010 and 2009 follows:

| Derivatives in ASC Topic 815 Cash Flow Hedging Relationships <i>(Dollars in thousands)</i> | | | | | |
|---|---|---|---|---|---|
| Date / Type | Amount of Gain or (Loss) Recognized in OCI net of tax on Derivative (Effective Portion) | Location of Gain or (Loss) Reclassified from 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) |
|--------------------------|-----------|-----------------------------|-----------|-----------------------------------|---|
| <u>December 31, 2011</u> | | | | | |
| Interest rate contracts | \$ 8 | Interest Expense | \$ (727) | Other income (expense) | \$ |
| <u>December 31, 2010</u> | | | | | |
| Interest rate contracts | \$ (322) | Interest Expense | \$ (718) | Other income (expense) | \$ |
| <u>December 31, 2009</u> | | | | | |
| Interest rate contracts | \$ 801 | Interest Expense | \$ (716) | Other income (expense) | \$ |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 15. Benefit Plans

The Bank has a 401(k) plan covering substantially all employees of F&M Trust who have completed one year and 1,000 hours of service. In 2011, employee contributions to the plan were matched at 100% up to 4% of each employee's deferrals plus 50% of the next 2% of deferrals from participants' eligible compensation. Under this plan, the maximum amount of employee contributions in any given year is defined by Internal Revenue Service regulations. In addition, a 100% discretionary profit sharing contribution of up to 2% of each employee's eligible compensation is possible provided net income targets are achieved. The Personnel Committee of the Corporation's Board of Directors approves the established net income targets annually. The related expense for the 401(k) plan, and the profit sharing plan as approved by the Board of Directors, was approximately \$394 thousand in 2011, \$368 thousand in 2010 and \$366 thousand in 2009.

The Bank has a noncontributory pension plan covering substantially all employees of F&M Trust who meet certain age and service requirements. Benefits are based on years of service and the employee's compensation using a career average formula for all employees. The pension plan was closed to new participants on April 1, 2007. The change to a career average formula in 2008 affected future pension benefits for some employees more than others, primarily long-term employees. In an attempt to minimize the affect of the change on these employees the Bank added the following benefits: (1) an additional annual contribution over 10 years to the 401(k) plan for pension participants that were deemed to have a significant expected shortfall as a result of the change to a career average formula; and (2) contributions to a non-qualified deferred compensation plan for current or potential highly-compensated employees that were deemed to have a significant expected shortfall as a result of the change to a career average formula. The annual contribution to the non-qualified plan ranges from 1% to 9% of the covered employee's salary depending on such factors as the employee's length of service and time to retirement. Any contribution made to the non-qualified plan is in lieu of the additional contribution made to the 401(k) plan identified as change number 1 above. The expense associated with the additional plans described above was \$42 thousand in 2011, \$46 thousand in 2010 and \$51 thousand in 2009. The Bank's funding policy is to contribute annually the amount required to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974. Contributions are intended to provide not only for the benefits attributed to service to date but also for those expected to be earned in the future.

Due to the low interest rate environment, the pension plan returns have been negatively affected and the Bank incurred substantially higher pension expense, \$705 thousand in 2011, \$441 thousand in 2010 and \$567 thousand in 2009.

Pension plan asset classes include cash, fixed income securities and equities. The fixed income portion is comprised of Government Bonds, Corporate Bonds and Taxable Municipal Bonds; the equity portion is comprised of financial institution equities and individual corporate equities across a broad range of sectors. Investments are made on the basis of sound economic principles and in accordance with established guidelines. Target allocations of fund assets measured at fair value are as follows: fixed income, a range of 60% - 90%, equities, a range of 10% to 30% and cash as needed. The allocation as of December 31, 2011 is shown in a table within this note. The Bank has undertaken a restructuring of the portfolio in order to more closely align the duration of the assets with the duration of the pension liability.

On a regular basis, the Pension and Benefits Committee (the Committee) monitors the allocation to each asset class. Due to changes in market conditions, the asset allocation may vary from time to time. The Committee is responsible to direct the rebalancing of Plan assets when allocations are not within the established guidelines and to ensure that such

action is implemented. The Bank has currently begun a process of reallocating pension assets in an attempt to more closely match the structure of pension liabilities. This has and will to continue to result in a smaller allocation of equity investments and a higher allocation of longer duration bonds. Once completed, the new allocation should reduce large fluctuations in projected benefit obligations.

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Specific guidelines for fixed income investments are that no individual bond shall have a rating of less than an A as rated by Standard and Poor and Moodys at the time of purchase. If the rating subsequently falls below an A rating, the

Committee, at its next quarterly meeting, will discuss the merits of retaining that particular security. Allowable securities include obligations of the U.S. Government and its agencies, CDs, commercial paper, corporate obligations and insured municipal bonds.

General guidelines for equities are that a diversified common stock program is used and that diversification patterns can be changed with the ongoing analysis of the outlook for economic and financial conditions. Specific guidelines for equities include a sector cap and an individual stock cap. The guidelines for the sector cap direct that because the Plan sponsor is a bank, a significantly large exposure to the financial sector is permissible; therefore, there is no sector cap for financial equities. All other sectors are limited to 25% of the equity component. The individual stock cap guidelines direct that no one stock may represent more than 5% of the total equity portfolio.

The Committee revisits and determines the expected long-term rate of return on Plan assets annually. The policy of the Committee has been to take a conservative approach to all Plan assumptions. The expected long-term rate of return has remained steady at 7.5%, but is reviewed annually and historical investment returns play a significant role in determining what this rate should be.

The following table sets forth the plan's funded status, based on the December 31, 2011, 2010 and 2009 actuarial valuations.

| <i>(Amounts in thousands)</i> | For the Years Ended December 31 | | |
|--|---------------------------------|------------|------------|
| | 2011 | 2010 | 2009 |
| Change in projected benefit obligation | | | |
| Benefit obligation at beginning of measurement year | \$14,252 | \$13,287 | \$12,149 |
| Service cost | 358 | 365 | 354 |
| Interest cost | 729 | 742 | 738 |
| Actuarial loss | 2,570 | 782 | 748 |
| Benefits paid | (771) | (924) | (702) |
| Benefit obligation at end of measurement year | 17,138 | 14,252 | 13,287 |
| Change in plan assets | | | |
| Fair value of plan assets at beginning of measurement year | 9,056 | 8,985 | 8,059 |
| Actual return on plan assets net of expenses | 1,261 | 369 | 1,385 |
| Employer contribution | 2,112 | 626 | 243 |
| Benefits paid | (771) | (924) | (702) |
| Fair value of plan assets at end of measurement year | 11,658 | 9,056 | 8,985 |
| Funded status of projected benefit obligation at end of measurement year | \$(5,480) | \$(5,196) | \$(4,302) |

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 15. Benefit Plans (continued)**

| | For the Years Ended December 31 | | |
|---|------------------------------------|------------|------------|
| | 2011 | 2010 | 2009 |
| Amounts recognized in accumulated other comprehensive income (loss), net of tax | | | |
| Net actuarial loss | \$(8,059) | \$(6,494) | \$(5,541) |
| Prior service cost obligation | 597 | 723 | 848 |
| | (7,462) | (5,771) | (4,693) |
| Tax effect | 2,537 | 1,962 | 1,596 |
| Net amount recognized in accumulated comprehensive loss | \$(4,925) | \$(3,809) | \$(3,097) |

| | For the Years Ended December 31 | | |
|---|---------------------------------|--------|--------|
| | 2011 | 2010 | 2009 |
| Components of net periodic pension cost | | | |
| Service cost | \$ 358 | \$ 365 | \$ 354 |
| Interest cost | 729 | 742 | 738 |
| Expected return on plan assets | (757) | (838) | (753) |
| Amortization of prior service cost | (126) | (125) | (126) |
| Recognized net actuarial loss | 501 | 297 | 354 |
| Net periodic pension cost | \$ 705 | \$ 441 | \$ 567 |

| | For the Years Ended December 31 | | |
|---|------------------------------------|--------|--------|
| | 2011 | 2010 | 2009 |
| Assumptions used to determine benefit obligations as of measurement date: | | | |
| Discount rate | 4.18% | 5.28 % | 5.79 % |
| Rate of compensation increase | 4.00% | 4.00 % | 4.50 % |
| Assumptions used to determine net periodic benefit cost: | | | |
| Discount rate | 5.28% | 5.79 % | 6.13 % |
| Expected long-term return on plan assets | 7.50% | 8.00 % | 8.00 % |
| Rate of compensation increase | 4.50% | 4.50 % | 4.50 % |
| Asset allocations as of measurement date: | | | |
| Cash and cash equivalents | 3% | 12 % | 3 % |
| Common stocks | 25% | 18 % | 23 % |
| Corporate bonds | 7% | 7 % | 12 % |
| Municipal bonds | 62% | 59 % | 58 % |
| Insurance contracts | 3% | 4 % | 4 % |
| Total | 100% | 100 % | 100 % |

| | | | |
|---|-------------|-------|-------|
| Shares of the Corporation's common stock held in the plan Value of shares (in thousands) | \$36 | \$ 52 | \$ 47 |
| Percent of total plan assets | 0.3% | 0.6 % | 0.5 % |

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| | For the Years Ended December 31 | | |
|---------------------------------|---------------------------------|-------------|-------------|
| | 2011 | 2010 | 2009 |
| Reconciliation of Funded Status | | | |
| Funded Status | \$ (5,480) | \$ (5,196) | \$ (4,302) |
| Unrecognized net actuarial loss | 8,059 | 6,494 | 5,541 |
| Unrecognized prior service cost | (597) | (723) | (848) |
| Net Asset recognized | \$ 1,982 | \$ 575 | \$ 391 |
| Accumulated Benefit Obligation | \$ 16,532 | \$ 13,680 | \$ 12,691 |

The following table sets forth by level, within the fair value hierarchy, the Plan's investments at fair value as of December 31, 2011 and 2010:

For more information on the levels within the fair value hierarchy, please refer to Note 20.

| <i>(Dollars in Thousands)</i> | December 31, 2011 | | | |
|---|-------------------|-----------------|-----------------|---------------|
| | Fair Value | Level 1 | Level 2 | Level 3 |
| Asset Description | | | | |
| Cash and cash equivalents | \$394 | \$ 395 | \$ | \$ |
| Common stocks | 2,870 | 2,870 | | |
| Corporate bonds | 833 | | 833 | |
| Municipal bonds | 7,238 | | 7,238 | |
| Cash value of life insurance | 83 | | | 83 |
| Deposit in immediate participation guarantee contract | 240 | | | 240 |
| Total assets | \$11,658 | \$ 3,265 | \$ 8,071 | \$ 323 |

| <i>(Dollars in Thousands)</i> | December 31, 2010 | | | |
|---|-------------------|----------|----------|---------|
| | Fair Value | Level 1 | Level 2 | Level 3 |
| Asset Description | | | | |
| Cash and cash equivalents | \$1,128 | \$ 1,128 | \$ | \$ |
| Common stocks | 1,655 | 1,655 | | |
| Corporate bonds | 610 | | 610 | |
| Municipal bonds | 5,314 | | 5,314 | |
| Cash value of life insurance | 122 | | | 122 |
| Deposit in immediate participation guarantee contract | 227 | | | 227 |
| Total assets | \$9,056 | \$ 2,783 | \$ 5,924 | \$ 349 |

The following table sets forth a summary of the changes in the fair value of the Plan's level 3 investments for the year ended December 31, 2011:

| | Cash Value of Life Insurance | Deposits in Immediate Participation Guarantee Contract |
|---|---------------------------------------|--|
| Balance January 1, 2011 | \$ 122 | \$ 227 |
| Unrealized gain (loss) relating to investments held at the reporting date | 5 | 4 |
| Purchases, sales, issuances and settlement, net | (44) | 9 |
| Balance December 31, 2011 | \$ 83 | \$ 240 |

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The Bank expects to contribute \$980 thousand to its pension plan in 2012. This amount will meet the minimum funding requirements.

| | | |
|---|------|----------|
| Estimated future benefit payments at December 31, 2011 (in thousands) | | |
| 2012 | | \$ 756 |
| 2013 | | 791 |
| 2014 | | 854 |
| 2015 | | 843 |
| 2016 | | 916 |
| 2017 | 2021 | 4,725 |
| | | \$ 8,885 |

Note 16. Stock Purchase Plans

In 2004, the Corporation adopted the Employee Stock Purchase Plan of 2004 (ESPP), replacing the ESPP of 1994 that expired in 2004. Under the ESPP of 2004, options for 250,000 shares of stock can be issued to eligible employees. The number of shares that can be purchased by each participant is defined by the plan and the Board of Directors sets the option price. However, the option price cannot be less than 90% of the fair market value of a share of the Corporation's common stock on the date the option is granted. The Board of Directors also determines the expiration date of the options; however, no option may have a term that exceeds 1 year from the grant date. ESPP options are exercisable immediately upon grant. Any shares related to unexercised options are available for future grant. As of December 31, 2011 there are 212,863 shares available for future grants. The Board of Directors may amend, suspend or terminate the ESPP at any time.

The grant price of the 2011 ESPP options was set at 95% of the stock's fair value at the time of the award. Therefore, no compensation expense was recognized in 2011 for the ESPP.

In 2002, the Corporation adopted the Incentive Stock Option Plan of 2002 (ISOP). Under the ISOP, options for 250,000 shares of stock can be issued to selected Officers, as defined in the plan. The number of options available to be awarded to each eligible Officer is determined by the Board of Directors, but is limited with respect to the aggregate fair value of the options as defined in the plan. The exercise price of the option shall be equal to the fair value of a share of the Corporation's common stock on the date the option is granted. The options have a life of 10 years and may be exercised only after the optionee has completed 6 months of continuous employment with the Corporation or its Subsidiary immediately following the grant date, or upon a change of control as defined in the plan. As of December 31, 2011 there are 154,877 shares available for future grants. The ISOP has a 10-year plan life with respect to the granting of new awards. However, awards granted prior to expiration of the plan will continue to be exercisable in accordance with the plan. The risk-free interest rate is the U.S. Treasury rate commensurate with the expected average life of the option at the date of grant. The Corporation uses the simplified method for estimating the expected term of the ISO award.

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 16. Stock Purchase Plans (continued)**

The ESPP and ISOP options outstanding at December 31, 2011 are all exercisable. The ESPP options expire on July 02, 2012 and the ISOP options expire 10 years from the grant date. The following table summarizes the stock option activity:

| <i>(Amounts in thousands except share and per share data)</i> | ESPP Options | Weighted Average Price Per Share | Aggregate Intrinsic Value |
|---|-----------------|--|------------------------------|
| Balance Outstanding at December 31, 2008 | 34,520 | \$ 22.08 | |
| Granted | 27,241 | 16.61 | |
| Exercised | (113) | 16.61 | |
| Expired | (35,233) | 21.97 | |
| Balance Outstanding at December 31, 2009 | 26,415 | 16.61 | |
| Granted | 25,973 | 16.81 | |
| Exercised | (1,138) | 16.71 | |
| Expired | (27,069) | 16.62 | |
| Balance Outstanding at December 31, 2010 | 24,181 | 16.81 | |
| Granted | 26,792 | 16.75 | |
| Exercised | (1,776) | 16.80 | |
| Expired | (23,502) | 16.81 | |
| Balance Outstanding at December 31, 2011 | 25,695 | \$ 16.75 | |

| | ISOP Options | Weighted Average Price Per Share |
|--|-----------------|--|
| Balance Outstanding at December 31, 2008 | 76,724 | \$ 24.86 |
| Granted | 14,900 | 16.11 |
| Exercised | | |
| Forfeited | (1,500) | 21.82 |
| Balance Outstanding at December 31, 2009 | 90,124 | 23.46 |
| Granted | | |
| Exercised | (500) | 16.11 |
| Forfeited | (6,750) | 24.47 |
| Balance Outstanding at December 31, 2010 | 82,874 | 23.42 |
| Granted | | |
| Exercised | | |
| Forfeited | | |
| Balance Outstanding at December 31, 2011 | 82,874 | \$ 23.42 |

The following table provides information about the options outstanding at December 31, 2011:

| Stock Option Plan | Options Outstanding and Exercisable | Exercise Price or Price Range | | Weighted Average Exercise Price | Weighted Average Remaining Life (years) |
|------------------------------|--|----------------------------------|---------|---------------------------------------|--|
| Employee Stock Purchase Plan | 25,695 | \$ 16.75 | | \$ 16.75 | 0.5 |
| Incentive Stock Option Plan | 12,900 | \$ 16.11 | \$18.42 | \$ 16.11 | 7.2 |
| Incentive Stock Option Plan | 10,000 | \$ 18.42 | \$20.74 | \$ 20.00 | 0.3 |
| Incentive Stock Option Plan | 4,999 | \$ 20.74 | \$23.05 | \$ 21.42 | 1.1 |
| Incentive Stock Option Plan | 24,825 | \$ 23.05 | \$25.37 | \$ 24.04 | 5.7 |
| Incentive Stock Option Plan | 30,150 | \$ 25.37 | \$27.68 | \$ 27.51 | 3.5 |
| ISOP Total/Average | 82,874 | | | \$ 23.42 | 4.2 |

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The fair value of the ISOP options granted has been estimated using the Black-Scholes method and the following assumptions for the years shown:

| | 2011 | 2010 | 2009 |
|--|------|------|---------|
| Incentive Stock Option Plan | | | |
| Options granted | | | 14,900 |
| Risk-free interest rate | | | 2.07 % |
| Expected volatility of the Corporation's stock | | | 32.62 % |
| Expected dividend yield | | | 5.92 % |
| Expected life (in years) | | | 5.25 |
| Weighted average fair value of options granted (Dollars in thousands) | \$ | \$ | \$ 1.95 |
| Compensation expense included in net income | | | |
| ESPP | \$ | \$ | \$ |
| ISOP | | | 29 |
| Total compensation expense included in net income | \$ | \$ | \$ 29 |

Note 17. Deferred Compensation Agreement

The Corporation has entered into deferred compensation agreements with four directors that provides for the payment of benefits over a ten-year period, beginning at age 65. At inception, the present value of the obligations under these deferred compensation agreements amounted to approximately \$600 thousand, which is being accrued over the estimated remaining service period of these officers and directors. These obligations are partially funded through life insurance covering these individuals. Expense associated with the agreements was \$20 thousand for 2011, \$22 thousand for 2010 and \$22 thousand for 2009.

The Corporation has two deferred compensation agreements it recorded as part of its acquisition of Fulton Bancshares Corporation in 2006 and no expense for these plans was recognized in 2011.

Note 18. Shareholders Equity

The Board of Directors regularly authorizes the repurchase of the Corporation's \$1.00 par value common stock. The repurchased shares will be held as Treasury shares available for issuance in connection with future stock dividends and stock splits, employee benefit plans, executive compensation plans, the Dividend Reinvestment Plan and other appropriate corporate purposes. The term of the repurchase plans is normally 1 year.

The following table provides information regarding approved stock repurchase plans.

(Amounts in thousands, except share information)

| Plan Approved | Expiration Date | Shares Authorized | Shares Repurchased Under Approved Plan | | | |
|--|-----------------|-------------------|--|---------|-------|------|
| | | | 2011 | 2010 | Total | Cost |
| July 8, 2010 | July 8, 2011 | 100,000 | | | | |
| Number of Treasury shares held at year-end | | | 396,174 | 397,950 | | |

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Effective September 30, 2010, the Corporation amended its dividend reinvestment plan for shareholders electing to purchase additional shares of the Corporation's common stock by reinvesting cash dividends paid on their shares or through optional cash payments. Under the amended plan, the Corporation has modified the minimum and maximum amounts that may be invested pursuant to the voluntary cash payment option under the plan, provided for the investment of voluntary cash payments as frequently as weekly, permitted participants to make voluntary cash payments via direct draft (ACH transfer); and modified the formula for determining the purchase price with respect to shares purchased under the plan directly from the Corporation. The Corporation also authorized one million (1,000,000) shares of its currently authorized common stock to be issued under the amended plan. During 2011, 102,200 shares of common stock were purchased through the dividend reinvestment plan at a cost of \$1.7 million.

Note 19. Commitments and Contingencies

In the normal course of business, the Bank is a party to financial instruments that are not reflected in the accompanying financial statements and are commonly referred to as off-balance-sheet instruments. These financial instruments are entered into primarily to meet the financing needs of the Bank's customers and include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk not recognized in the consolidated balance sheet.

The Corporation's exposure to credit loss in the event of nonperformance by other parties to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contract or notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they do for on-balance-sheet instruments.

Unless noted otherwise, the Bank does not require collateral or other security to support financial instruments with credit risk. The Bank had the following outstanding commitments as of December 31:

| (Amounts in thousands) | 2011 | 2010 |
|---|-------------------|------------|
| Financial instruments whose contract amounts represent credit risk: | | |
| Commercial commitments to extend credit | \$ 179,369 | \$ 159,166 |
| Consumer commitments to extend credit (secured) | 37,113 | 34,914 |
| Consumer commitments to extend credit (unsecured) | 5,077 | 4,797 |
| | \$ 221,559 | \$ 198,877 |
| Standby letters of credit | \$ 28,191 | \$ 20,467 |

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

commitments consists of liens on residential real estate.

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Standby letters of credit are instruments issued by the Bank, which guarantee the beneficiary payment by the Bank in the event of default by the Bank's customer in the nonperformance of an obligation or service. Most standby letters of credit are extended for one-year periods. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds collateral supporting those commitments for which collateral is deemed necessary primarily in the form of certificates of deposit and liens on real estate. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of December 31, 2011 and 2010 for guarantees under standby letters of credit issued is not material.

Most of the Bank's business activity is with customers located within its primary market and does not involve any significant concentrations of credit to any one entity or industry.

In the normal course of business, the Corporation has commitments, lawsuits, contingent liabilities and claims. However, the Corporation does not expect that the outcome of these matters will have a material adverse effect on its consolidated financial position or results of operations.

Note 20. Fair Value Measurements and Fair Values of Financial Instruments

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 year-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 year-end.

FASB ASC Topic 820, 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 nonrecurring basis. The Corporation does not report any nonfinancial assets at fair value.

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

| (Dollars in thousands) | December 31, 2011 | | December 31, 2010 | |
|--|-------------------|------------|-------------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 34,144 | \$ 34,144 | \$ 22,106 | \$ 22,106 |
| Investment securities available for sale | 125,301 | 125,301 | 117,616 | 117,616 |
| Restricted stock | 5,022 | 5,022 | 6,159 | 6,159 |

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| | | | | |
|--|------------------|------------------|-----------|-----------|
| Net loans | 756,687 | 765,707 | 739,841 | 750,944 |
| Accrued interest receivable | 3,391 | 3,391 | 3,662 | 3,662 |
| Mortgage servicing rights | 368 | 368 | 603 | 603 |
| Financial liabilities: | | | | |
| Deposits | \$787,986 | \$790,887 | \$734,331 | \$737,274 |
| Securities sold under agreements to repurchase | 53,103 | 53,103 | 51,164 | 51,164 |
| Long-term debt | 48,336 | 51,015 | 70,885 | 74,695 |
| Accrued interest payable | 561 | 561 | 757 | 757 |
| Interest rate swaps | 1,738 | 1,738 | 1,752 | 1,752 |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 20. Fair Value Measurements and Fair Values of Financial Instruments (continued)

The following 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 December 31, 2011 and 2010:

Cash and Cash Equivalents:

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

Investment securities:

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. Other borrowings consist of a line of credit with the FHLB at a variable interest rate and securities sold under agreements to repurchase, for which the carrying value approximates a reasonable estimate of the fair value.

Accrued interest payable:

The carrying amount is a reasonable estimate of fair value.

Derivatives:

The fair value of the interest rate swaps is based on other similar financial instruments and is classified as Level 2.

TABLE OF CONTENTS**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 20. Fair Value Measurements and Fair Values of Financial Instruments (continued)**

FASB ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).

The three levels of the fair value hierarchy under FASB ASC Topic 820 are as follows:

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

Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market. There may be substantial differences in the assumptions used for securities within the same level. For example, prices for U.S. Agency securities have fewer assumptions and are closer to level 1 valuations than the private label mortgage backed securities that require more assumptions and are closer to level 3 valuations.

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

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.

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 December 31, 2011.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2011 and 2010 are as follows:

| (Dollars in Thousands) | Fair Value at December 31, 2011 | | | |
|---|---------------------------------|------------|---------|------------|
| | Level 1 | Level 2 | Level 3 | Total |
| <u>Asset Description</u> | | | | |
| Equity securities | \$ 1,759 | \$ | \$ | \$ 1,759 |
| Obligations of U.S. Government agencies | | 13,229 | | 13,229 |
| Obligations of state and political subdivisions | | 45,081 | | 45,081 |
| Corporate debt securities | | 2,414 | | 2,414 |
| Trust Preferred Securities | | 4,618 | | 4,618 |
| Agency mortgage-backed securities | | 55,285 | | 55,285 |
| Private-label mortgage-backed securities | | 2,867 | | 2,867 |
| Asset-backed securities | | 48 | | 48 |
| Total assets | \$ 1,759 | \$ 123,542 | \$ | \$ 125,301 |

Liability Description

| | | | | |
|---------------------|----|----------|----|----------|
| Interest rate swaps | \$ | \$ 1,738 | \$ | \$ 1,738 |
| Total liabilities | \$ | \$ 1,738 | \$ | \$ 1,738 |

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

The Corporation used the following methods and significant assumptions to estimate the fair values shown above.

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

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

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2011 and 2010 are as follows:

| <i>(Dollars in Thousands)</i> | Fair Value at December 31, 2011 | | | |
|--|---------------------------------|---------|-----------|-----------|
| | Level 1 | Level 2 | Level 3 | Total |
| <u>Asset Description</u> | | | | |
| Impaired loans with specific allowance | \$ | \$ | \$ 13,705 | \$ 13,705 |
| Other real estate owned | | | 3,224 | 3,224 |
| Mortgage servicing rights | | | 368 | 368 |
| Total assets | \$ | \$ | \$ 17,297 | \$ 17,297 |

Fair Value at December 31, 2010

| <i>(Dollars in Thousands)</i> | Level 1 | Level 2 | Level 3 | Total |
|--|------------|---------|-----------|-----------|
| <u>Asset Description</u> | | | | |
| Impaired loans with specific allowance | \$ | \$ | \$ 16,973 | \$ 16,973 |
| Other real estate owned | | | 618 | 618 |
| Mortgage servicing rights | | | 603 | 603 |
| Total assets | \$ | \$ | \$ 18,194 | \$ 18,194 |

The Corporation used the following methods and significant assumptions to estimate the fair values shown above.

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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.

The Corporation did not record any liabilities at fair value for which measurement of the fair value was made on a nonrecurring basis at December 31, 2011.

Note 21. Parent Company (Franklin Financial Services Corporation) Financial Information**Balance Sheets**

| (Amounts in thousands) | December 31 | |
|--|-------------|-----------|
| | 2011 | 2010 |
| Assets: | | |
| Cash and cash equivalents | \$ 419 | \$ 488 |
| Investment securities, available for sale | 619 | 783 |
| Equity investment in subsidiaries | 84,320 | 80,028 |
| Other assets | 1,836 | 1,590 |
| Total assets | \$ 87,194 | \$ 82,889 |
| Liabilities: | | |
| Other liabilities | \$ 12 | \$ 250 |
| Total liabilities | 12 | 250 |
| Shareholders' equity | 87,182 | 82,639 |
| Total liabilities and shareholders' equity | \$ 87,194 | \$ 82,889 |

Statements of Income

| (Amounts in thousands) | Years Ended December 31 | | |
|---|-------------------------|----------|----------|
| | 2011 | 2010 | 2009 |
| Income: | | | |
| Dividends from Bank subsidiary | \$3,231 | \$4,210 | \$4,311 |
| Interest and dividend income | 28 | 26 | 16 |
| OTTI losses on securities | (4) | (201) | (67) |
| Less: Loss recognized in other comprehensive loss (before taxes) | | | |
| Net OTTI losses recognized in earnings | (4) | (201) | (67) |
| Securities gains (losses), net | (37) | 8 | (131) |
| | 3,218 | 4,043 | 4,129 |
| Expenses: | | | |
| Operating expenses | 728 | 772 | 767 |
| Income before income taxes and equity in undistributed income of subsidiaries | 2,490 | 3,271 | 3,362 |
| Income tax benefit | 236 | 272 | 292 |
| Equity in undistributed income of subsidiaries | 3,843 | 4,069 | 2,931 |
| Net income | \$ 6,569 | \$ 7,612 | \$ 6,585 |

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| (Amounts in thousands) | Years Ended December 31 | | |
|---|-------------------------|---------|----------|
| | 2011 | 2010 | 2009 |
| Cash flows from operating activities | | | |
| Net income | \$6,569 | \$7,612 | \$6,585 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Equity in undistributed income of subsidiary | (3,843) | (4,069) | (2,931) |
| Securities losses (gains) | 37 | (8) | 131 |
| OTTI writedown on equity securities | 4 | 201 | 67 |
| (Increase) decrease in other assets | (245) | (204) | (183) |
| (Decrease) increase in other liabilities | (238) | | 239 |
| Stock option compensation | | | 29 |
| Other, net | 103 | 13 | (359) |
| Net cash provided by operating activities | 2,387 | 3,545 | 3,578 |
| Cash flows from investing activities | | | |
| Proceeds from sales of investment securities | 81 | 21 | 4 |
| Net cash provided by investing activities | 81 | 21 | 4 |
| Cash flows from financing activities | | | |
| Dividends paid | (4,273) | (4,194) | (4,145) |
| Common stock issued from treasury stock | | | 2 |
| Common stock issued under stock option plans | 30 | 26 | |
| Treasury shares issued to fund dividend reinvestment plan | | 617 | 777 |
| Common stock issued under dividend reinvestment plan | 1,706 | 316 | |
| Purchase of treasury shares | | | (160) |
| Net cash used in financing activities | (2,537) | (3,235) | (3,526) |
| (Decrease) increase in cash and cash equivalents | (69) | 331 | 56 |
| Cash and cash equivalents as of January 1 | 488 | 157 | 101 |
| Cash and cash equivalents as of December 31 | \$419 | \$488 | \$157 |

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The following is a summary of the quarterly results of consolidated operations of Franklin Financial for the years ended December 31, 2011 and 2010:

| (Amounts in thousands, except per share) | Three months ended | | September 30 | December 31 |
|--|--------------------|-----------|-----------------|-------------|
| | March 31 | June 30 | | |
| <u>2011</u> | | | | |
| Interest income | \$ 10,300 | \$ 10,493 | \$ 10,403 | \$ 10,595 |
| Interest expense | 2,405 | 2,408 | 2,287 | 2,054 |
| Net interest income | 7,895 | 8,085 | 8,116 | 8,541 |
| Provision for loan losses | 900 | 1,767 | 2,775 | 2,082 |
| Other noninterest income | 2,511 | 2,481 | 2,275 | 3,017 |
| Securities gains (losses) | 11 | (55) | 138 | (178) |
| Noninterest expense | 7,022 | 7,433 | 6,996 | 6,883 |
| Income before income taxes | 2,495 | 1,311 | 758 | 2,415 |
| Income tax (benefit) | 646 | (447) | (301) | 512 |
| Net Income | \$ 1,849 | \$ 1,758 | \$ 1,059 | \$ 1,903 |
| Basic earnings per share | \$ 0.47 | \$ 0.45 | \$ 0.27 | \$ 0.47 |
| Diluted earnings per share | \$ 0.47 | \$ 0.45 | \$ 0.27 | \$ 0.47 |
| Dividends declared per share | \$ 0.27 | \$ 0.27 | \$ 0.27 | \$ 0.27 |

| (Amounts in thousands, except per share) | Three months ended | | September 30 | December 31 |
|--|--------------------|-----------|-----------------|-------------|
| | March 31 | June 30 | | |
| <u>2010</u> | | | | |
| Interest income | \$ 10,916 | \$ 10,866 | \$ 10,984 | \$ 10,518 |
| Interest expense | 3,371 | 3,221 | 3,066 | 2,785 |
| Net interest income | 7,545 | 7,645 | 7,918 | 7,733 |
| Provision for loan losses | 625 | 625 | 625 | 1,360 |
| Other noninterest income | 2,401 | 2,422 | 2,282 | 2,645 |
| Securities (losses) gains | (6) | 20 | (374) | (24) |
| Noninterest expense | 6,660 | 6,525 | 6,635 | 6,603 |
| Income before income taxes | 2,655 | 2,937 | 2,566 | 2,391 |
| Income taxes | 681 | 778 | 763 | 715 |
| Net Income | \$ 1,974 | \$ 2,159 | \$ 1,803 | \$ 1,676 |
| Basic earnings per share | \$ 0.51 | \$ 0.56 | \$ 0.46 | \$ 0.43 |
| Diluted earnings per share | \$ 0.51 | \$ 0.56 | \$ 0.46 | \$ 0.43 |
| Dividends declared per share | \$ 0.27 | \$ 0.27 | \$ 0.27 | \$ 0.27 |

Due to rounding, the sum of the quarters may not equal the amount reported for the year.

Note 23. Subsequent Events

Immediately prior to the release of the December 31, 2011 10-K, the Bank obtained an appraisal on a \$5.2 million loan from the lead bank in a loan participation. In accordance with the Bank's loan policy and regulatory guidance, the Bank conducts third-party reviews of appraisals for loans it considers to be significant or complex. Furthermore, in this particular case, the Bank has identified several inconsistencies in the appraisal as compared to an appraisal on the same property a year earlier causing the Bank to believe the appraisal may be incorrect. At this time, this review process has not been completed nor has the valuation been confirmed. However, preliminary estimates indicate that a loss on this loan is possible and could range from \$0 to \$1.1 million, pre-tax, in addition to the \$467 thousand specifically reserved for this loan.

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. 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 December 31, 2011, the Corporation's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in the Corporation's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

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

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

Management Report on Internal Control Over Financial Reporting

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2011, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Based on this assessment, management concluded that, as of December 31, 2011, the Corporation's internal control over financial reporting is effective based on those criteria.

There were no changes during the fourth quarter of 2011 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.

The Corporation's independent registered public accounting firm has audited the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2011. Their report is included herein.

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Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Franklin Financial Services Corporation
Chambersburg, Pennsylvania

We have audited Franklin Financial Services Corporation and its subsidiaries (the Corporation) internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Corporation's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Corporation's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A corporation's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. A corporation's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the corporation; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the corporation are being made only in accordance with authorizations of management and directors of the corporation; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the corporation's assets that could have a material effect on the financial statements.

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.

In our opinion, the Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Franklin Financial Services Corporation and its subsidiaries as of December 31, 2011 and 2010 and the related consolidated statements of income, changes in shareholders' equity and

cash flows for each of the years in the three-year period ended December 31, 2011, and our report dated March 9, 2012 expressed an unqualified opinion.

/s/ ParenteBeard LLC
Harrisburg, Pennsylvania
March 9, 2012

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Item 9B. Other Information

None

Part III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this Item relating to the directors and executive officers of the Corporation is incorporated herein by reference to the information set forth under the heading INFORMATION CONCERNING THE ELECTION OF DIRECTORS Information about Nominees, Continuing Directors and Executive Officers and under the heading ADDITIONAL INFORMATION Executive Officers appearing in the Corporation's proxy statement dated March 27, 2012.

The information required by this item relating to compliance with Section 16(a) of the Exchange Act is incorporated herein by reference to the information set forth under the heading ADDITIONAL INFORMATION Compliance with Section 16(a) of the Exchange Act appearing in the Corporation's proxy statement dated March 27, 2012.

The information required by this item relating to the Corporation's code of ethics is incorporated herein by reference to the information set forth under the heading INFORMATION CONCERNING CORPORATE GOVERNANCE POLICIES, PRACTICES AND PROCEDURES appearing in the Corporation's proxy statement dated March 27, 2012. The Corporation will file on Form 8-K any amendments to, or waivers from, the code of ethics applicable to any of its directors or executive officers.

The information required by this item relating to material changes to the procedures by which the Corporation's shareholders may recommend nominees to the Board of Directors is incorporated herein by reference to the information set forth under the heading INFORMATION CONCERNING THE ELECTION OF DIRECTORS Nominations for Election of Directors appearing in the Corporation's proxy statement dated March 27, 2012.

The information required by this item relating to the Corporation's audit committee and relating to an audit committee financial expert is incorporated herein by reference to the information set forth under the heading COMMITTEES OF THE BOARD OF DIRECTORS Audit Committee appearing, in the Corporation's proxy statement dated March 27, 2012.

Item 11. Executive Compensation

The information required by this item relating to executive compensation is incorporated herein by reference to the information set forth under the heading EXECUTIVE COMPENSATION appearing in the Corporation's proxy statement dated March 27, 2012; provided, however, that the information set forth under the subheading Compensation Committee Report is intended to be furnished and not filed.

The information required by this item relating to the compensation committee interlocks and insider participation is incorporated herein by reference to the information set forth under the heading COMMITTEES OF THE BOARD OF

DIRECTORS Compensation Committee Interlocks and Insider Participation appearing in the Corporation's proxy statement dated March 27, 2012.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this item relating to securities authorized for issuance under executive compensation plans is incorporated herein by reference to the information set forth under the heading EXECUTIVE COMPENSATION Compensation Tables and Additional Compensation Disclosure Equity Compensation Plan Information appearing in the Corporation's proxy statement dated March 27, 2012.

The information required by this item relating to security ownership of certain beneficial owners is incorporated herein by reference to the information set forth under the heading GENERAL INFORMATION Voting of Shares and Principal Holders Thereof appearing in the Corporation's proxy statement dated March 27, 2012.

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The information required by this item relating to security ownership of management is incorporated herein by reference to the information set forth under the heading INFORMATION CONCERNING THE ELECTION OF DIRECTORS Information about Nominees, Continuing Directors and Executive Officers appearing in the Corporation s proxy statement dated March 27, 2012.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this item relating to transactions with related persons is incorporated herein by reference to the information set forth under the heading ADDITIONAL INFORMATION Transactions with Related Persons appearing in the Corporation s proxy statement dated March 27, 2012.

The information required by this item relating to director independence is incorporated herein by reference to the information set forth under the heading INFORMATION CONCERNING THE ELECTION OF DIRECTORS Director Independence and under the heading ADDITIONAL INFORMATION Transactions with Related Persons appearing in the Corporation s proxy statement dated March 27, 2012.

Item 14. Principal Accountant Fees and Services

The information required by this item relating to principal accountant fees and services is incorporated herein by reference to the information set forth under the heading RELATIONSHIP WITH INDEPENDENT PUBLIC ACCOUNTANTS appearing in the Corporation s proxy statement dated March 27, 2012.

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Part IV

Item 15. Exhibits and Financial Statement Schedules

- (a) The following documents are filed as part of this report:
 (1) The following Consolidated Financial Statements of the Corporation:

| | |
|--|-----------|
| <u>Report of Independent Registered Public Accounting Firm</u> | <u>54</u> |
| <u>Consolidated Balance Sheets December 31, 2011 and 2010,</u> | <u>55</u> |
| <u>Consolidated Statements of Income Years ended December 31, 2011, 2010 and 2009,</u> | <u>56</u> |
| <u>Consolidated Statements of Changes in Shareholders Equity Years ended December 31, 2011, 2010 and 2009,</u> | <u>58</u> |
| <u>Consolidated Statements of Cash Flows Years ended December 31, 2011, 2010 and 2009,</u> | <u>59</u> |
| <u>Notes to Consolidated Financial Statements</u> | <u>60</u> |

All financial statement schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and have therefore been omitted.

- (3) The following exhibits are part of this report:

| | |
|------|--|
| 3.1 | Articles of Incorporation of the Corporation |
| 3.2 | Bylaws of the Corporation |
| 4. | Instruments defining the rights of security holders, including indentures, are contained in the Articles of Incorporation (Exhibit 3.1) and the Bylaws (Exhibit 3.2) |
| 10.1 | Deferred Compensation Agreements with Bank Directors* |
| 10.2 | Directors Deferred Compensation Plan* |
| 10.3 | Incentive Stock Option Plan* |
| 10.4 | Management Group Pay for Performance Plan* |
| 10.5 | Directors Pay for Performance Plan* |
| 14. | Code of Ethics posted on the Corporation's website |
| 21 | Subsidiaries of the Corporation |
| 23.1 | Consent of ParenteBeard LLC |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification (Chief Executive Officer) |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification (Chief Financial Officer) |
| 32.1 | Section 1350 Certification (Chief Executive Officer) |
| 32.2 | Section 1350 Certification (Chief Financial Officer) |
| 101 | Interactive Data File (XBRL)** |

* Compensatory plan or arrangement.

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

- (b) The exhibits required to be filed as part of this report are submitted as a separate section of this report.

(c) Financial Statement Schedules: None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and 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

By:

Dated: March 9, 2012

/s/ William E. Snell, Jr.

William E. Snell, Jr.
President and Chief Executive Officer

Pursuant to the requirements of the Securities and Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|----------------------------|---|---------------|
| /s/ G. Warren Elliott | Chairman of the Board and Director | March 9, 2012 |
| G. Warren Elliott | | |
| /s/ William E. Snell, Jr. | President and Chief Executive Officer and Director (Principal Executive Officer) | March 9, 2012 |
| William E. Snell, Jr. | | |
| /s/ Mark R. Hollar | Treasurer and Chief Financial Officer (Principal Financial and Accounting Officer) | March 9, 2012 |
| Mark R. Hollar | | |
| /s/ Charles S. Bender II | Director | March 9, 2012 |
| Charles S. Bender II | | |
| /s/ Martin R. Brown | Director | March 9, 2012 |
| Martin R. Brown | | |
| /s/ Daniel J. Fisher | Director | March 9, 2012 |
| Daniel J. Fisher | | |
| /s/ Donald A. Fry | Director | March 9, 2012 |
| Donald A. Fry | | |
| /s/ Allan E. Jennings, Jr. | Director | March 9, 2012 |
| Allan E. Jennings, Jr. | | |
| /s/ Stanley J. Kerlin | Director | March 9, 2012 |
| Stanley J. Kerlin | | |
| | Director | March 9, 2012 |

/s/ Donald H. Mowery

Donald H. Mowery

/s/ Stephen E. Patterson

Director

March 9, 2012

Stephen E. Patterson

/s/ Martha B. Walker

Director

March 9, 2012

Martha B. Walker

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Exhibit Index for the Year Ended December 31, 2011

| Item | Description |
|------|---|
| 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.) |
| 4. | Instruments defining the rights of securities holders, including indentures, are contained in the Articles of Incorporation (Exhibit 3.1) and Bylaws (Exhibit 3.2) |
| 10.1 | Deferred Compensation Agreements with Bank Directors. (Filed as Exhibit 10.1 to Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.)* |
| 10.2 | Director s Deferred Compensation Plan. (Filed as Exhibit 10.2 to Annual Report on Form 10-K for the year ended December 31, 2007 and incorporated herein by reference.)* |
| 10.3 | Incentive Stock Option Plan (Filed as Exhibit 99.1 to Registration Statement No. 3390348 on Form S-8 and incorporated herein by reference.)* |
| 10.4 | Management Group Pay for Performance Program (Filed as Exhibit 10.4 to Annual Report on Form 10-K for the year ended December 31, 2006 and incorporated herein by reference.)* |
| 10.5 | Directors Pay for Performance Program (Filed as Exhibit 10.5 to Annual Report on Form 10-K for the year ended December 31, 2007 and incorporated herein by reference.)* |
| 14. | Code of Ethics posted on the Corporation s website |
| 21. | Subsidiaries of Corporation filed herewith |
| 23.1 | Consent of ParenteBeard LLC filed herewith |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification (Chief Executive Officer) filed herewith |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification (Chief Financial Officer) filed herewith |
| 32.1 | Section 1350 Certification (Chief Executive Officer) filed herewith |
| 32.2 | Section 1350 Certification (Chief Financial Officer) filed herewith |
| 101 | Interactive Data File (XBRL)** |

* Compensatory plan or arrangement.

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