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

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

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

For the quarterly period ended March 31, 2010,

OR

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

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

Commission file number 0-12126

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

PENNSYLVANIA	25-1440803
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

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

717/264-6116
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer ¨ Accelerated filer x 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 x

There were 3,876,601 outstanding shares of the Registrant’s common stock as of April 30, 2010.

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Part I FINANCIAL INFORMATION

Item 1 Financial Statements

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

	March 31 2010	December 31 2009
Assets		
Cash and due from banks	$ 17,057	$ 14,336
Interest-bearing deposits in other banks	11,384	18,912
Total cash and cash equivalents	28,441	33,248
Investment securities available for sale	132,681	143,288
Restricted stock	6,482	6,482
Loans	750,072	739,563
Allowance for loan losses	(9,349)	(8,937)
Net Loans	740,723	730,626
Premises and equipment, net	15,754	15,741
Bank owned life insurance	19,084	18,919
Goodwill	9,016	9,159
Other intangible assets	2,346	2,461
Other assets	19,740	19,449
Total assets	$ 974,267	$ 979,373
Liabilities		
Deposits		
Demand (non-interest bearing)	$ 89,092	$ 77,675
Savings and interest checking	401,103	388,222
Time	236,485	272,468
Total Deposits	726,680	738,365
Securities sold under agreements to repurchase	59,670	55,855
Long-term debt	94,244	94,688
Other liabilities	13,050	11,699
Total liabilities	893,644	900,607
Shareholders' equity		
Common stock $1 par value per share, 15,000 shares authorized with 4,299 shares issued, and 3,876 shares and 3,863 shares outstanding at March 31, 2010 and December 31, 2009, respectively	4,299	4,299
Capital stock without par value, 5,000 shares authorized with no shares issued or outstanding	-	-
Additional paid-in capital	32,806	32,832
Retained earnings	55,498	54,566
Accumulated other comprehensive loss	(4,417)	(5,138)
Treasury stock, 423 shares and 436 shares at cost at March 31, 2010 and December 31, 2009, respectively	(7,563)	(7,793)

Total shareholders' equity	80,623	78,766
Total liabilities and shareholders' equity	$ 974,267	$ 979,373

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

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

	For the Three Months Ended March 31	
	2010	2009
Interest income		
Loans, including fees	$ 9,551	$ 9,192
Interest and dividends on investments:		
Taxable interest	870	1,089
Tax exempt interest	472	474
Dividend income	16	57
Deposits and obligations of other banks	7	-
Total interest income	10,916	10,812
Interest expense		
Deposits	2,360	2,482
Securities sold under agreements to repurchase	38	45
Short-term borrowings	-	11
Long-term debt	973	1,055
Total interest expense	3,371	3,593
Net interest income	7,545	7,219
Provision for loan losses	625	593
Net interest income after provision for loan losses	6,920	6,626
Noninterest income		
Investment and trust services fees	1,017	894
Loan service charges	197	277
Mortgage banking activities	69	(28)
Deposit service charges and fees	577	580
Other service charges and fees	326	302
Increase in cash surrender value of life insurance	166	164
Other	49	295
OTTI losses on securities	(689)	(209)
Loss recognized in other comprehensive income (before taxes)	(434)	-
Net OTTI losses recognized in earnings	(255)	(209)
Securities gains, net	249	12
Total noninterest income	2,395	2,287
Noninterest Expense		
Salaries and benefits	3,441	3,153
Net occupancy expense	526	480
Furniture and equipment expense	192	217
Advertising	312	315
Legal and professional fees	395	251

Data processing		377		401
Pennsylvania bank shares tax		156		145
Intangible amortization		114		117
FDIC insurance		292		231
Other		855		840
Total noninterest expense		6,660		6,150
Income before federal income taxes		2,655		2,763
Federal income tax expense		681		662
Net income	$	1,974	$	2,101
Per share				
Basic earnings per share	$	0.51	$	0.55
Diluted earnings per share	$	0.51	$	0.55
Cash dividends declared per share	$	0.27	$	0.27

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

Consolidated Statements of Changes in Shareholders' Equity
For the Three Months Ended March 31, 2010 and 2009
(unaudited)

(Dollars in thousands, except per share data)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance at December 31, 2008	$ 4,299	$ 32,883	$ 52,126	$ (7,757)	$ (8,492)	$ 73,059
Comprehensive income:						
Net income	-	-	2,101	-	-	2,101
Unrealized loss on securities, net of reclassification adjustments and taxes	-	-	-	(1,202)	-	(1,202)
Unrealized gain on hedging activities, net of reclassification adjustments and taxes	-	-	-	186	-	186
Total Comprehensive income				-		1,085
Cash dividends declared, $.27 per share	-	-	(1,033)	-	-	(1,033)
Acquisition of 3,000 shares of treasury stock	-	-	-	-	(51)	(51)
Treasury shares issued to dividend reinvestment plan: 12,049 shares	-	(34)	-	-	217	183
Stock option compensation	-	5	-	-	-	5
Balance at March 31, 2009	$ 4,299	$ 32,854	$ 53,194	$ (8,773)	$ (8,326)	$ 73,248
Balance at December 31, 2009	$ 4,299	$ 32,832	$ 54,566	$ (5,138)	$ (7,793)	$ 78,766
Comprehensive income:						
Net income	-	-	1,974	-	-	1,974
Unrealized gain on securities, net of reclassification adjustments and taxes	-	-	-	951	-	951
Unrealized loss on hedging activities, net of reclassification adjustments and taxes	-	-	-	(104)	-	(104)
Pension adjustment, net of tax				(126)		(126)
Total Comprehensive income				-		2,695
Cash dividends declared, $.27 per share	-	-	(1,042)	-	-	(1,042)
Treasury shares issued to dividend reinvestment plan: 12,885 shares	-	(26)	-	-	230	204
Balance at March 31, 2010	$ 4,299	$ 32,806	$ 55,498	$ (4,417)	$ (7,563)	$ 80,623

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

Consolidated Statements of Cash Flows
(unaudited)

	For the Three Months Ended March 31	
	2010	2009
(Amounts in thousands)		
Cash flows from operating activities		
Net income	$ 1,974	$ 2,101
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	336	361
Net amortization (accretion) of loans and investment securities	40	(35)
Stock option compensation expense	-	5
Amortization and net change in mortgage servicing rights valuation	9	111
Amortization of intangibles	114	117
Provision for loan losses	625	593
Net realized gains on sales of securities	(249)	(12)
Other-than-temporary-impairment losses on securities	255	209
Loans originated for sale	(121)	-
Proceeds from sale of loans	137	-
Gain on sales of loans	(16)	-
Gain on sale or disposal of premises and equipment	-	(5)
Net loss on sale or disposal of other real estate/other repossessed assets	18	-
Increase in cash surrender value of life insurance	(166)	(164)
Gain from surrender of life insurance policy	-	(275)
Contribution to pension plan	(321)	-
(Increase) decrease in interest receivable and other assets	(481)	453
Increase in interest payable and other liabilities	1,038	959
Other, net	(171)	(111)
Net cash provided by operating activities	3,021	4,307
Cash flows from investing activities		
Proceeds from sales of investment securities available for sale	4,408	2,964
Proceeds from maturities of investment securities available for sale	9,503	5,120
Purchase of investment securities available for sale	(1,853)	(2,687)
Net increase in loans	(10,806)	(20,754)
Proceeds from sale of other real estate/other repossessed assets	391	-
Capital expenditures	(319)	(609)
Net cash provided by (used in) investing activities	1,324	(15,966)
Cash flows from financing activities		
Net increase in demand deposits, NOW accounts and savings accounts	24,298	3,481
Net (decrease) increase in certificates of deposit	(35,983)	23,583
Net increase (decrease) in short-term borrowings	3,815	(14,434)
Long-term debt payments	(444)	(1,183)
Long-term debt advances	-	260
Dividends paid	(1,042)	(1,033)
Common stock issued to dividend reinvestment plan	204	183

Purchase of treasury shares		-		(51)
Net cash (used in) provided by financing activities		(9,152)		10,806
Decrease in cash and cash equivalents		(4,807)		(853)
Cash and cash equivalents as of January 1		33,248		16,713
Cash and cash equivalents as of March 31	$	28,441	$	15,860
Supplemental Disclosures of Cash Flow Information				
Cash paid during the year for:				
Interest on deposits and other borrowed funds	$	3,311	$	3,323
Income taxes	$	1,002	$	203

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

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

Note 1 - Basis of Presentation

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

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of March 31, 2010, and for all other periods presented have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United State of America (“GAAP”) have been condensed or omitted. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation’s 2009 Annual Report on Form 10-K. The consolidated results of operations for the period ended March 31, 2010 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

The consolidated balance sheet at December 31, 2009 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements.

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

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

	For the Three Months Ended March 31	
(In thousands, except per share data)	2010	2009
Weighted average shares outstanding (basic)	3,868	3,827
Impact of common stock equivalents	-	-
Weighted average shares outstanding (diluted)	3,868	3,827
Anti-dilutive options excluded from the calculation	102	111
Net income	$ 1,974	$ 2,101
Basic earnings per share	$ 0.51	$ 0.55
Diluted earnings per share	$ 0.51	$ 0.55

Note 2 – Recent Accounting Pronouncements

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

Note 3 – Comprehensive Income

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

The components of other comprehensive income (loss) and related tax effects are as follows:

(Amounts in thousands)	For the Three Months Ended March 31 2010	2009
Net Income	$ 1,974	$ 2,101
Securities:		
Unrealized gains (losses) arising during the period	1,435	(2,018)
Reclassification adjustment for losses included in net income	6	197
Net unrealized gains (losses)	1,441	(1,821)
Tax effect	(490)	619
Net of tax amount	951	(1,202)
Derivatives:		
Unrealized (losses) gains arising during the period	(338)	109
Reclassification adjustment for losses included in net income	181	173
Net unrealized (losses) gains	(157)	282
Tax effect	53	(96)
Net of tax amount	(104)	186
Pension:		
Change in plan assets and benefit obligations	(191)	-
Reclassification adjustment for losses included in net income	-	-
Net unrealized losses	(191)	-
Tax effect	65	-
Net of tax amount	(126)	-
Total other comprehensive income (loss)	721	(1,016)
Total Comprehensive Income	$ 2,695	$ 1,085

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

(Amounts in thousands)	March 31 2010	December 31 2009
Net unrealized losses on securities	$ (388)	$ (1,829)
Tax effect	132	622
Net of tax amount	(256)	(1,207)
Net unrealized losses on derivatives	(1,422)	(1,263)
Tax effect	484	429
Net of tax amount	(938)	(834)
Accumulated pension adjustment	(4,883)	(4,692)
Tax effect	1,660	1,595
Net of tax amount	(3,223)	(3,097)
Total accumulated other comprehensive loss	$ (4,417)	$ (5,138)

Note 4 – Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting these commitments. The Bank had $28.1 million and $26.7 million of standby letters of credit as of March 31, 2010 and December 31, 2009, respectively. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of March 31, 2010 and December 31, 2009 for guarantees under standby letters of credit issued was not material.

Note 5 - Investments

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

(Amounts in thousands) March 31, 2010	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Equity securities	$ 5,400	$ 142	$ (963)	$ 4,579
U.S. Treasury securities and obligations of U.S. Government agencies	23,095	470	(125)	23,440
Obligations of state and political subdivisions	41,238	1,427	(38)	42,627
Corporate debt securities	9,609	25	(1,968)	7,666
Mortgage-backed securities				
Agency	48,283	1,476	(8)	49,751
Non-Agency	5,362	-	(797)	4,565
Asset-backed securities	82	-	(29)	53
	$ 133,069	$ 3,540	$ (3,928)	$ 132,681

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

The book value of securities pledged as collateral to secure various funding sources was $122.9 million at March 31, 2010 and $134.6 million at December 31, 2009.

The amortized cost and estimated fair value of debt securities as of March 31, 2010, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

(Amounts in thousands)	Amortized cost	Estimated fair value
Due in one year or less	$ 3,037	$ 3,043
Due after one year through five years	15,060	15,342
Due after five years through ten years	28,473	29,694
Due after ten years	27,454	25,707
	74,024	73,786
Mortgage-backed securities	53,645	54,316
	$ 127,669	$ 128,102

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 March 31, 2010 and December 31, 2009:

	March 31, 2010								
	Less than 12 months			12 months or more			Total		
(Amounts in thousands)	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number
Equity securities	$ 26	$ (12)	2	$ 2,004	$ (951)	23	$ 2,030	$ (963)	25
U.S. Treasury securities and obligations of U.S. Government agencies	45	-	1	12,846	(125)	24	12,891	(125)	25
Obligations of state and political subdivisions	1,339	(20)	4	289	(18)	1	1,628	(38)	5
Corporate debt securities	-	-	-	6,915	(1,968)	10	6,915	(1,968)	10
Mortgage-backed securities									
Agency	4,617	(8)	4	-	-	-	4,617	(8)	4
Non-Agency	-	-	-	4,565	(797)	7	4,565	(797)	7
Asset-backed securities	-	-	-	53	(29)	3	53	(29)	3
Total temporarily impaired securities	$ 6,027	$ (40)	11	$ 26,672	$ (3,888)	68	$ 32,699	$ (3,928)	79

	December 31, 2009								
	Less than 12 months			12 months or more			Total		
	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number

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

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

Note 6 – Pensions

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

	Three Months Ended March 31	
(Amounts in thousands)	2010	2009
Components of net periodic cost:		
Service cost	$ 91	$ 85
Interest cost	185	181
Expected return on plan assets	(209)	(190)
Amortization of prior service cost	-	(31)
Recognized net actuarial loss	43	82
Net periodic cost	$ 110	$ 127

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

Note 7 – Mortgage Servicing Rights

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

	Three Months Ended March 31	
(Amounts in thousands)	2010	2009
Cost of mortgage servicing rights:		
Beginning balance	$ 1,190	$ 1,551
Originations	6	-
Amortization	(69)	(110)
Ending balance	$ 1,127	$ 1,441
Valuation allowance:		
Beginning balance	$ (477)	$ (689)
Valuation charges	-	-
Valuation reversals	60	-
Ending balance	$ (417)	$ (689)
Mortgage servicing rights cost	$ 1,127	$ 1,441
Valuation allowance	(417)	(689)
Carrying value	$ 710	$ 752
Fair value	$ 710	$ 763

Note 8 – Fair Value Measurements

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

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

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

	March 31, 2010		December 31, 2009	
(Amounts in thousands)	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	$ 28,441	$ 28,441	$ 33,248	$ 33,248
Investment securities available for sale	132,681	132,681	143,288	143,288
Restricted stock	6,482	6,482	6,482	6,482
Net loans	740,723	747,867	730,626	742,929
Accrued interest receivable	4,021	4,021	3,904	3,904
Mortgage servicing rights	710	710	714	714
Financial liabilities:				
Deposits	$ 726,680	$ 729,982	$ 738,365	$ 742,953
Securities sold under agreements to repurchase	59,670	59,670	55,855	55,855
Long-term debt	94,244	98,639	94,688	99,013
Accrued interest payable	1,347	1,347	1,288	1,288
Interest rate swaps	1,422	1,422	1,263	1,263

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

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

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

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

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

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

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

Level 1:	Valuation is based on unadjusted, quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
Level 2:	Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
Level 3:	Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Corporation’s assumptions regarding what market participants would assume when pricing a financial instrument.

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

(Dollars in Thousands)	Fair Value at March 31, 2010			
Asset Description	Level 1	Level 2	Level 3	Total
Equity securities	$ 4,579	$ -	$ -	$ 4,579
U.S. Treasury securities and obligations of U.S. Government agencies	-	23,440	-	23,440
Obligations of state and political subdivisions	-	42,627	-	42,627
Corporate debt securities	-	7,666	-	7,666
Mortgage-backed securities				
Agency	-	49,751	-	49,751
Non-Agency	-	4,565	-	4,565
Asset-backed securities	-	53	-	53
Total assets	$ 4,579	$ 128,102	$ -	$ 132,681
Liability Description				
Interest rate swaps	$ -	$ 1,422	$ -	$ 1,422
Total liabilities	$ -	$ 1,422	$ -	$ 1,422

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

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

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

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

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

(Dollars in Thousands)

	Fair Value at March 31, 2010			
Asset Description	Level 1	Level 2	Level 3	Total
Impaired loans	$ -	$ -	$ 9,781	$ 9,781
Other real estate owned	-	-	229	229
Mortgage servicing rights	-	-	710	710
Total assets	$ -	$ -	$ 10,720	$ 10,720

(Dollars in Thousands)

	Fair Value at December 31, 2009			
Asset Description	Level 1	Level 2	Level 3	Total
Impaired loans	$ -	$ -	$ 7,943	$ 7,943
Other real estate owned	-	-	642	642
Mortgage servicing rights	-	-	714	714
Total assets	$ -	$ -	$ 9,299	$ 9,299

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

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

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

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

Note 9 – Financial Derivatives

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

Information regarding the interest rate swap as of March 31, 2010 follows:

(Dollars in thousands)

Notional Amount	Maturity Date	Interest Rate Fixed	Interest Rate Variable	Amount Expected to be Expensed into Earnings within the next 12 Months
$ 10,000	5/30/2013	3.60%	0.11%	$ 349
$ 10,000	5/30/2015	3.87%	0.11%	$ 376

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

Fair Value of Derivative Instruments in the Consolidated Balance Sheets as of March 31, 2010 and December 31, 2009 are as follows:

Fair Value of Derivative Instruments Designated as Hedging Instruments Under ASC Topic 815
(Dollars in thousands)

		Liability Derivatives	
Date	Type	Balance Sheet Location	Fair Value
March 31, 2010	Interest rate contracts	Other liabilities	$ 1,422
December 31, 2009	Interest rate contracts	Other liabilities	$ 1,263

The Effect of Derivative Instruments on the Statement of Income for the Three Months Ended March 31, 2010 and 2009 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships
(Dollars in thousands)

Date / Type	Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion)	Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain or (Loss) Recognized in Income on Derivatives (Ineffective Portion and Amount Excluded from Effectiveness Testing)
March 31, 2010:					
Interest rate contracts	$ (104)	Interest Expense	$ (181)	Other income (expense)	$ -
March 31, 2009:					
Interest rate contracts	$ 186	Interest Expense	$ (173)	Other income (expense)	$ -

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Note 10 – Reclassifications

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

Item 2

Management's Discussion and Analysis of Results of Operations and Financial Condition
For the Three Month Periods Ended March 31, 2010 and 2009

Forward Looking Statements

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

Critical Accounting Policies

Management has identified critical accounting policies for the Corporation to include Allowance for Loan Losses, Mortgage Servicing Rights, Financial Derivatives, Temporary Investment Impairment and Stock-based Compensation. There were no changes to the critical accounting policies disclosed in the 2009 Annual Report on Form 10-K in regards to application or related judgements and estimates used. Please refer to Item 7 of the Corporation's 2009 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Results of Operations

Year-to-Date Summary

The Corporation reported net income for the three months ended March 31, 2010 of $2.0 million. This is a 6% decrease versus net income of $2.1 million for the same period in 2009. Total revenue (interest income and noninterest income) increased $212 thousand year-over-year, as loan volume increased interest income and investment and trust revenue, and security gains helped improve noninterest income. Noninterest expense increased due to increased salary and benefit expense and higher legal fees. The provision for loan losses was $625 thousand for the period, $32 thousand more than in 2009. Diluted earnings per share decreased to $.51 in 2010 from $.55 in 2009. Total assets were $974.3 million at March 31, 2010, a decrease of $5.1 million from year-end 2009. Net loans grew to $740.7 million, while total deposits decreased to $726.7 million.

Other key performance ratios as of, or for the three months ended March 31, 2010 and 2009 (on an annualized basis) are listed below:

	2010	2009
Return on average equity (ROE)	10.00%	11.42%
Return on average assets (ROA)	.82%	.94%
Return on average tangible average equity(1)	12.02%	14.10%
Return on average tangible average assets(1)	.85%	.98%
Net interest margin	3.46%	3.61%
Efficiency ratio	65.17%	62.93%

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

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

A more detailed discussion of the operating results for the three months ended March 31, 2010 and 2009 follows:

Comparison of the three months ended March 31, 2010 to the three months ended March 31, 2009:

Net Interest Income

The most important source of the Corporation's earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal categories of interest-earning assets are loans and securities, while deposits, securities sold under agreements to repurchase (Repos), short-term borrowings and long-term debt are the principal categories of interest-bearing liabilities. Demand deposits enhance net interest income because they are noninterest-bearing deposits. All balance sheet amounts in the discussion of net interest income refer to either year-to-date or quarterly average balances.

Interest income for the first quarter of 2010 increased to $10.9 million from $10.8 million during the first quarter of 2009. Average interest-earning assets increased by $74.1 million from the first quarter of 2009, however the yield on these assets decreased by 40 basis points. The average balance on investment securities decreased $3.5 million quarter over quarter due to pay downs, maturities and sales in the portfolio, net of investment purchases. Total average loans increased $67.6 million (10.0%) quarter over quarter. Average commercial loans increased $91.0 million, but the increase was partially offset by a decrease in the average balance of mortgage and consumer loans. Average mortgage loans decreased $7.7 million, as the majority of new mortgage originations are sold in the secondary market and the portfolio continues to runoff. Average consumer loans decreased $15.8 million, as consumers continue to borrow less during the economic recession.

Interest expense was $3.4 million for the first quarter, a decrease of $222 thousand from the first quarter of 2009 total of $3.6 million. Average interest-bearing liabilities increased to $802.3 million in the first quarter of 2010 from an average balance of $734.2 million during the same period in 2009, an increase of $68.2 million. The average cost of these liabilities decreased from 1.98% to 1.70%. Average interest-bearing deposits increased $97.7 million, due to increases in money management accounts ($44.2 million) and certificates of deposit ($51.3 million), but the cost decreased from 1.83% to 1.48%. Securities sold under agreements to repurchase have decreased $11.7 million on average over the prior year quarter and the average rate has remained constant at .25%. The average balance of long-term debt decreased by $11.4 million as the Bank paid down advances from the Federal Home Loan Bank of Pittsburgh (FHLB).

The changes in the balance sheet and interest rates resulted in an increase in net interest income of $326 thousand to $7.5 million for the first quarter of 2010 compared to $7.2 million for the first quarter of 2009. The Bank's net interest margin decreased from 3.60% to 3.46% in 2010. The decrease in the net interest margin is due to the yield on interest-earning assets (mainly variable rate commercial loans) decreasing 40 basis points, while the yield on interest-bearing liabilities only decreased 28 basis points. An extended period of low market interest rates is likely to continue to reduce the net interest margin because liability rates can no longer be significantly reduced.

The following table shows a comparative analysis of average balances, asset yields and funding costs for the three months ended March 31, 2010 and 2009. These components drive changes in net interest income.

	For the Three Months Ended March 31					
	2010			2009		
(Dollars in thousands)	Average balance	Tax Equivalent Interest	Average yield/rate	Average balance	Tax Equivalent Interest	Average yield/rate
Interest-earning assets						
Federal funds sold and interest-bearing balances	$ 10,636	$ 7	0.25%	$ 626	$ -	0.38%
Investment securities	148,326	1,576	4.25%	151,855	1,835	4.83%
Loans	746,523	9,607	5.18%	678,951	9,255	5.49%
Total interest-earning assets	$ 905,486	11,190	4.97%	$ 831,432	11,090	5.37%
Interest-bearing liabilities						
Interest-bearing deposits	$ 647,079	2,360	1.48%	$ 549,381	2,482	1.83%
Securities sold under agreements to repurchase	60,612	38	0.25%	72,297	45	0.25%
Short-term borrowings	223	-	0.65%	6,684	11	0.68%
Long-term debt	94,416	973	4.18%	105,790	1,055	4.04%
Total interest-bearing liabilities	$ 802,330	3,371	1.70%	$ 734,152	3,593	1.98%
Interest spread			3.27%			3.39%
Tax equivalent Net interest income/Net interest margin		7,819	3.46%		7,497	3.60%
Tax equivalent adjustment		(274)			(278)	
Net interest income		$ 7,545			$ 7,219	

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses.
Dividend income is reported as taxable income but is adjusted for the dividend received deduction. Loan balances include nonaccruing loans, loans held for sale, and are gross of the allowance for loan losses.

Provision for Loan Losses

For the first quarter of 2010, the provision expense was $625 thousand versus $593 thousand for the same period in 2009. For more information concerning loan quality and the allowance for loan losses, refer to the Loan discussion in the Financial Condition section.

Noninterest Income

For the three months ended March 31, 2010, noninterest income increased $108 thousand to $2.4 million, compared to $2.3 million for the first quarter of 2009. Investment and trust service fees increased $123 thousand due to increases in nonrecurring income from estate fees. Loan service charges decreased $80 thousand, as the 2009 first quarter total included a high volume of fees from mortgage refinancing. Mortgage banking fees increased quarter to quarter due to a net impairment recovery on mortgage servicing rights in 2010, compared to net impairment charge in 2009. Deposit service charges and increase in cash surrender value of life insurance remained flat in the first quarter of 2010. Other noninterest income decreased $246 thousand quarter over quarter as 2009 included the income from the surrender of a life insurance policy. Other than temporary impairment charges of $255 thousand were recognized in income on two debt securities in the quarter, compared to $209 thousand on equity securities in 2009. The Corporation took gains of $249 thousand on three debt securities during the quarter ended March 31, 2010 versus gains of $12 thousand for the same period in 2009.

	For the Three Months Ended March 31		Change	
(Dollars in thousands)	2010	2009	Amount	%
Noninterest Income				
Investment and trust services fees	$ 1,017	$ 894	$ 123	13.8
Loan service charges	197	277	(80)	(28.9)
Mortgage banking activities	69	(28)	97	346.4
Deposit service charges and fees	577	580	(3)	(0.5)
Other service charges and fees	326	302	24	7.9
Increase in cash surrender value of life insurance	166	164	2	1.2
Other	49	295	(246)	(83.4)
Net OTTI recognized in earnings	(255)	(209)	(46)	(22.0)
Securities gains, net	249	12	237	1,975.0
Total noninterest income	$ 2,395	$ 2,287	$ 108	4.7

Noninterest Expense

Noninterest expense for the first quarter of 2010 totaled $6.7 million compared to $6.2 million in the first quarter of 2009. The increase in salaries and benefits was due to increased health insurance costs and an accrual for a severance payment. Net occupancy expense increased in 2010 from the cost of snow removal. Advertising expense remained flat, while legal and professional fees increased over the same period in 2009 due to expenses from several ongoing lawsuits stemming from activities at Community Financial, Inc prior to its acquisition by the Corporation in 2008. The Pennsylvania bank shares tax expense and intangible amortization expense remained flat quarter over quarter. FDIC Insurance increased $61 thousand due to increases in the rates paid in the first quarter of 2010 versus the same period in 2009. Other expenses increased primarily due to expense related to the disposal of other real estate owned and repossessed assets.