FULTON FINANCIAL CORP
Form 424B2
April 27, 2007

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**Filed Pursuant to Rule 424(b)(2)**
**Registration No. 333-130718**

**PROSPECTUS SUPPLEMENT TO THE PROSPECTUS DATED APRIL 25, 2007**

**$100,000,000**
**5.75% Subordinated Notes due 2017**

Fulton Financial Corporation, a Pennsylvania corporation, referred to as Fulton Financial, is offering for sale, subject to the terms and conditions described in this prospectus supplement, 5.75% subordinated notes due 2017. Interest on the subordinated notes will be payable semi-annually in arrears at an annual rate of 5.75% on May 1 and November 1 of each year, beginning on November 1, 2007. The subordinated notes will mature on May 1, 2017 and are not redeemable at the option of Fulton Financial or repayable at the option of the holders at any time before that date.

The subordinated notes will be our general unsecured subordinated obligations and will rank equally with all of our other unsecured subordinated obligations from time to time outstanding, provided that the subordinated notes will rank senior to the junior subordinated debentures issued to our capital trust subsidiaries. The subordinated notes will rank junior to all of our existing and future senior indebtedness to the extent and in the manner set forth in the subordinated debt indenture. The subordinated notes will effectively be subordinated to all of the existing and future liabilities and obligations of our subsidiaries, including our deposit liabilities and claims of other creditors of our subsidiary banks.

**Investing in the subordinated notes involves risks. See Risk Factors beginning on page S-9.**

**The subordinated notes are not savings accounts or deposits and are not insured by the Federal Deposit Insurance Corporation or any other government agency. Neither the Securities and Exchange Commission nor any state securities commission or regulator has approved or disapproved of these securities or determined that this prospectus supplement or the accompanying prospectus is accurate or complete. It is illegal for anyone to tell you otherwise.**

| | Per Note | Total |
|---|---|---|
| Public offering price(1) | 99.714% | $ 99,714,000 |
| Underwriting commission to be paid by us | 0.650% | $ 650,000 |
| Proceeds to Fulton Financial Corporation (before expenses) | 99.064% | $ 99,064,000 |

(1) Plus accrued interest from May 1, 2007, if settlement occurs after that date.

The underwriters expect to deliver the subordinated notes in book-entry only form through the facilities of The Depository Trust Company on or about May 1, 2007.

**Keefe, Bruyette & Woods**

**BB&T Capital Markets**

**JPMorgan**

**SunTrust Robinson Humphrey**

The date of this Prospectus Supplement is April 26, 2007.

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## ABOUT THIS PROSPECTUS SUPPLEMENT

This prospectus supplement relates to a registration statement on Form S-3, as amended on April 25, 2007, initially filed by Fulton Financial with the Securities and Exchange Commission, referred to as the SEC, under the Securities Act of 1933, as amended, referred to as the Securities Act, on December 27, 2005. Any statements contained in this prospectus supplement concerning the provisions of any document are not necessarily complete, and, in each instance, reference is made to the copy of such document filed as an exhibit to the registration statement or otherwise filed with the SEC. Each such statement is qualified in its entirety by such reference.

In this prospectus supplement, references to Fulton Financial, us, we, our or similar references mean Fulton Financial Corporation, and not Fulton Financial Corporation together with any of its subsidiaries, unless the context indicates otherwise.

Fulton Financial is offering to sell the subordinated notes, and is seeking offers to buy the subordinated notes, only in jurisdictions where such offers and sales are permitted. If you are in a jurisdiction where offers to sell or solicitations of offers to purchase the subordinated notes offered by this prospectus supplement are unlawful, or if you are a person to whom it is unlawful to conduct these types of activities, then the offer presented in this prospectus supplement and the accompanying prospectus does not extend to you.

If the information set forth in this prospectus supplement differs in any way from the information set forth in the accompanying prospectus, you should rely on the information set forth in this prospectus supplement.

## WHERE YOU CAN FIND MORE INFORMATION

Fulton Financial files reports, proxy statements and other information with the SEC under the Securities Exchange Act of 1934, as amended, referred to as the Exchange Act. You may read and copy this information at prescribed rates at the following location of the SEC:

Public Reference Room
100 F Street, N.E.
Washington, D.C. 20549

You can also obtain additional information about the operation of the SEC s public reference facilities by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet web site that contains reports, proxy statements and other information about issuers like us who file electronically with the SEC. The address of that site is *www.sec.gov.*

The common stock of Fulton Financial is traded on the Global Select Market of The Nasdaq Stock Market, Inc., referred to as NASDAQ, and quoted under the symbol FULT. You can also inspect information about Fulton Financial by visiting the NASDAQ web site (*www.nasdaq.com*). Our Internet web site is *www.fult.com*. Information contained in our web site does not constitute part of this prospectus supplement or the accompanying prospectus.

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## INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

We are incorporating information into this prospectus supplement by reference, which means that we are disclosing important information to you by referring you to documents filed with the SEC. The information incorporated by reference is considered to be a part of this prospectus supplement and the accompanying prospectus, except as discussed below.

The following documents that we have filed with the SEC are incorporated into this prospectus supplement and the accompanying prospectus by reference (other than information that, pursuant to SEC rules, is deemed not to be filed):

*Annual Report on Form 10-K for the year ended December 31, 2006, filed March 1, 2007; and*

*Current Reports on Form 8-K filed January 17, 2007 and March 20, 2007.*

All future filings that we make with the SEC, such as Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and proxy statements, are incorporated by reference into this prospectus supplement and the accompanying prospectus (other than information that, pursuant to SEC rules, is deemed not to be filed) until we complete the offering of the subordinated notes. Any statement contained in a document incorporated by reference in this prospectus supplement will be deemed to be modified or superseded for purposes of this prospectus supplement to the extent that any statement contained in this prospectus supplement or in any subsequently filed document which also is or is deemed to be incorporated by reference in this prospectus supplement modifies or supersedes this statement. Any statement modified or superseded in this way will not be deemed, except as so modified or superseded, to constitute a part of this prospectus supplement or the accompanying prospectus. The information incorporated by reference contains information about us and our financial condition and performance and is an important part of this prospectus supplement.

You can obtain any of the documents incorporated by reference in this prospectus supplement from us, or from the SEC, through the SEC s Internet web site at *www.sec.gov*. Documents incorporated by reference in this prospectus supplement are available without charge, excluding all exhibits unless we have specifically incorporated an exhibit into this document by reference. You may obtain documents incorporated by reference in this document by requesting them by writing or telephoning us at:

Fulton Financial Corporation
One Penn Square, P.O. Box 4887
Lancaster, Pennsylvania 17604
Attention: Corporate Secretary
(717) 291-2411

You should rely only on the information included or incorporated by reference in this prospectus supplement or the accompanying prospectus. We have not authorized anyone to give any information or make any representation about us that is different from, or in addition to, those included or incorporated by reference in this prospectus supplement or the accompanying prospectus. If anyone does give you any additional or different information, you should not rely on it. The information included or incorporated by reference in this prospectus supplement speaks only as of the date of this document unless the information specifically indicates that another date applies.

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## SUMMARY

The following information is a summary of the significant terms of the offering of subordinated notes made by this prospectus supplement. You should carefully read this prospectus supplement to understand fully the terms of the subordinated notes, as well as the tax and other considerations that are important to you in making a decision about whether to purchase the subordinated notes. You should pay special attention to the Risk Factors section beginning on page S-9 of this prospectus supplement to determine whether an investment in the subordinated notes is appropriate for you.

**Fulton Financial Corporation**

Fulton Financial is a Pennsylvania business corporation and a registered financial holding company that maintains its headquarters in Lancaster, Pennsylvania. As a financial holding company, Fulton Financial engages in general commercial and retail banking and trust business, and also in related financial businesses, through its bank and non-bank subsidiaries. Fulton Financial s bank subsidiaries currently operate 263 banking offices in Pennsylvania, Maryland, Delaware, New Jersey and Virginia. As of December 31, 2006, Fulton Financial had, on a consolidated basis, total assets of approximately $14.9 billion, total loans of $10.3 billion, total deposits of $10.2 billion and total shareholders equity of $1.5 billion.

The principal assets of Fulton Financial are its thirteen wholly-owned bank subsidiaries:

- Maryland state-chartered institutions include: Hagerstown Trust Company; The Peoples Bank of Elkton; and The Columbia Bank;
- Nationally chartered associations include: Swineford National Bank; FNB Bank, National Association; and Delaware National Bank;
- New Jersey state-chartered institutions include: The Bank; Skylands Community Bank; and Somerset Valley Bank;
- Pennsylvania state-chartered institutions include: Fulton Bank; Lafayette Ambassador Bank; and Lebanon Valley Farmers Bank; and
- A Virginia state-chartered institution: Resource Bank.

In addition, Fulton Financial has the following wholly-owned non-bank direct subsidiaries:

- Fulton Financial Realty Company, which holds title to or leases certain properties upon which Fulton Financial s branch offices and other facilities are located;
- Fulton Reinsurance Company, LTD, which engages in the business of reinsuring credit life, accident and health insurance that is directly related to extensions of credit by Fulton Financial s bank subsidiaries;
- Central Pennsylvania Financial Corp., which owns certain limited partnership interests in partnerships invested in low and moderate income housing projects;
- FFC Management, Inc., which owns certain investment securities and other passive investments;
- Fulton Financial Advisors, National Association, a limited purpose national banking association with trust powers;
- Fulton Insurance Services Group, Inc., an insurance agency;
- FFC Penn Square, Inc. which owns $44.0 million of trust preferred securities issued by a subsidiary of Fulton Financial s largest bank subsidiary; and

PBI Capital Trust, Premier Capital Trust II, Resource Capital Trust III, SVB Bald Eagle Statutory Trust I, SVB Bald Eagle Statutory Trust II, Columbia Bancorp Statutory Trust, Columbia Bancorp Statutory Trust II, Columbia Bancorp Statutory Trust III and Fulton Capital Trust I, each of which has issued trust preferred securities.

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Our executive offices are located at One Penn Square, Lancaster, Pennsylvania 17602, and the telephone number at those offices is (717) 291-2411.

We have announced our plans to consolidate our affiliated bank subsidiaries in 2007 as follows:

Somerset Valley Bank will merge with and into Skylands Community Bank; and

Fulton Bank will purchase substantially all assets, and assume substantially all liabilities, of Lebanon Valley Farmers Bank, with Lebanon Valley Farmers Bank thereafter winding up its corporate existence.

Additional information about Fulton Financial and its subsidiaries is included in documents incorporated by reference in this prospectus supplement. You should refer to Where You Can Find More Information.

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## The Offering

| | |
|---|---|
| **Issuer** | Fulton Financial Corporation |
| **Subordinated Notes Offered** | $100,000,000 aggregate principal amount of 5.75% subordinated notes due 2017. |
| **Denominations** | $1,000 and integral multiples of $1,000 in excess thereof. |
| **Interest** | Interest on the subordinated notes will be payable semiannually in arrears at an annual rate of 5.75% on May 1 and November 1 of each year, beginning November 1, 2007. The record dates will be the 15th calendar day (whether or not a business day) immediately preceding the relevant interest payment date. The amount of each interest payment with respect to the subordinated notes will include amounts accrued to, but excluding, the date the interest is due. |
| **Ranking** | The subordinated notes will be our unsecured obligations and will:<br>Rank junior to all of our existing and future senior indebtedness;<br>Rank equal in right of payment to all of our existing and future unsecured and subordinated indebtedness;<br>Rank senior to our obligations relating to the junior subordinated debt securities we issue in connection with trust preferred securities of special purpose entities established by us; and<br>Be effectively subordinated to all of the existing and future liabilities and obligations of our subsidiaries, including the deposit liabilities and claims of other creditors of our subsidiary banks.<br>At December 31, 2006, we had $13.0 billion in senior indebtedness outstanding on a consolidated basis, including deposits of $10.2 billion and other obligations of our subsidiaries. |
| **Maturity** | The subordinated notes will mature on May 1, 2017. |
| **Listing of the Subordinated Notes** | We do not intend to seek a listing of the subordinated notes on any national securities exchange or on the NASDAQ Global Select Market. For more information, you should read Underwriting. |
| **Use of Proceeds** | We intend to use the net proceeds from the issuance of the subordinated notes for general corporate purposes, which may include stock repurchases, the redemption of debentures issued in conjunction with certain existing trust preferred securities and a possible reduction of the amount outstanding under our $100 million Revolving Credit Agreement with SunTrust Bank, dated as of July 12, 2004, as amended. SunTrust Bank is an affiliate of SunTrust Capital Markets, Inc., one of the underwriters of the subordinated notes. |

| | |
|---|---|
| **Ratings** | The subordinated notes have been rated A3 by Moody s Investors Service, referred to as Moody s, and A- by Fitch Ratings, referred to as Fitch. A credit rating is not a recommendation to buy, sell or hold the subordinated notes and may be subject to revision or withdrawal at any |

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| | |
|---|---|
| | time by the relevant rating agency. Each rating should be evaluated independently of the other rating assigned to the subordinated notes. |
| **Tax Considerations** | For a discussion of certain U.S. federal income tax considerations, you should read Certain U.S. Federal Income Tax Consequences. |
| **ERISA Considerations** | For a discussion of certain prohibited transactions and fiduciary duty issues pertaining to purchases by or on behalf of an employee benefit plan, you should read ERISA Considerations. |
| **You Will Not Receive Certificates** | The subordinated notes will be represented by a global note that will be deposited with, and registered in the name of, The Depository Trust Company, referred to as DTC, or its nominee. As a result, you will not receive a certificate for the subordinated notes, and your beneficial ownership interests will be recorded through the DTC book-entry system. For more information, you should read Description of Subordinated Notes Form, Denomination, Book-Entry Procedures and Transfers. |
| **Risk Factors** | For a discussion of certain considerations relevant to an investment in the subordinated notes that you should carefully consider, you should read Risk Factors. |

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## Selected Consolidated Financial and Other Data

Set forth below is a summary of our consolidated financial data for each of the years during the five year period ended December 31, 2006, which have been derived in part from our audited consolidated financial statements and related notes. The following data should be read in conjunction with our consolidated financial statements and related notes appearing in our Annual Report on Form 10-K for each of the years ended December 31, 2006, 2005, 2004, 2003 and 2002, and other financial information included or incorporated by reference in this prospectus supplement and the accompanying prospectus.

| | As of or for the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2003** | **2002** |
| | (Dollars in thousands, except for per share data) | | | | |
| SUMMARY OF INCOME | | | | | |
| Interest income | $ 864,507 | $ 625,768 | $ 493,643 | $ 435,531 | $ 469,288 |
| Interest expense | 378,944 | 213,220 | 135,994 | 131,094 | 158,219 |
| Net interest income | 485,563 | 412,548 | 357,649 | 304,437 | 311,069 |
| Provision for loan loss | 3,498 | 3,120 | 4,717 | 9,705 | 11,900 |
| Other income | 149,875 | 144,298 | 138,864 | 134,370 | 114,012 |
| Other expenses | 365,991 | 316,291 | 277,515 | 233,651 | 226,046 |
| Income before income taxes | 265,949 | 237,435 | 214,281 | 195,451 | 187,135 |
| Income taxes | 80,422 | 71,361 | 64,673 | 59,084 | 56,181 |
| Net income | $ 185,527 | $ 166,074 | $ 149,608 | $ 136,367 | $ 130,954 |
| PER SHARE DATA(1) | | | | | |
| Net income (basic) | $ 1.07 | $ 1.01 | $ 0.95 | $ 0.93 | $ 0.88 |
| Net income (diluted) | 1.06 | 1.00 | 0.94 | 0.92 | 0.88 |
| Cash dividends | 0.581 | 0.540 | 0.493 | 0.452 | 0.405 |
| RATIOS | | | | | |
| Return on average assets | 1.30% | 1.41% | 1.45% | 1.55% | 1.66% |
| Return on average equity | 12.84 | 13.24 | 13.98 | 15.23 | 15.61 |
| Return on average equity (tangible)(2) | 23.87 | 20.28 | 18.58 | 17.33 | 17.25 |
| Net interest margin | 3.82 | 3.93 | 3.83 | 3.82 | 4.35 |
| Efficiency ratio | 56.00 | 55.50 | 55.90 | 54.00 | 52.70 |
| Average equity to average assets | 10.10 | 10.60 | 10.30 | 10.20 | 10.60 |
| Dividend payout ratio | 54.80 | 54.00 | 52.50 | 49.20 | 46.00 |
| Total risk-based capital ratio | 11.7 | 12.1 | 11.8 | 12.7 | 13.8 |
| Tier 1 risk-based capital ratio. | 9.8 | 10.0 | 10.6 | 11.5 | 12.6 |
| Tier 1 leverage ratio | 7.6 | 7.7 | 8.8 | 8.7 | 9.4 |

(*Notes on following page*)

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| | As of or for the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| | (Dollars in thousands) | | | | |
| PERIOD-END BALANCES | | | | | |
| Total assets | $14,918,964 | $12,401,555 | $11,160,148 | $9,768,669 | $8,388,915 |
| Investment securities | 2,878,238 | 2,562,145 | 2,449,859 | 2,927,150 | 2,416,291 |
| Loans, net of unearned income | 10,374,323 | 8,424,728 | 7,533,915 | 6,140,200 | 5,295,459 |
| Deposits | 10,232,469 | 8,804,839 | 7,895,524 | 6,751,783 | 6,245,528 |
| Federal Home Loan Bank advances and long-term debt | 1,304,148 | 860,345 | 684,236 | 568,730 | 535,555 |
| Shareholders equity | 1,516,310 | 1,282,971 | 1,244,087 | 948,317 | 864,879 |
| AVERAGE BALANCES | | | | | |
| Total assets | $14,297,681 | $11,781,485 | $10,348,268 | $8,805,554 | $7,902,592 |
| Investment securities | 2,869,862 | 2,498,538 | 2,563,143 | 2,569,168 | 1,949,635 |
| Loans, net of unearned income | 9,892,082 | 7,981,604 | 6,857,386 | 5,564,806 | 5,381,950 |
| Deposits | 9,955,247 | 8,364,435 | 7,285,134 | 6,505,371 | 6,052,667 |
| Federal Home Loan Bank advances and long-term debt | 1,069,868 | 839,694 | 641,154 | 568,706 | 477,609 |
| Shareholders equity | 1,444,793 | 1,254,476 | 1,069,904 | 895,616 | 839,111 |

(1) Adjusted for stock dividends and stock splits.

(2) Net income, as adjusted for intangible amortization (net of tax), divided by average shareholders equity, net of goodwill and intangible assets.

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## RISK FACTORS

*You should carefully review the information contained elsewhere or incorporated by reference in this prospectus supplement and should particularly consider the following factors, which do not necessarily appear in the order of importance. Investors should consider all of these factors to be important.*

### Risks Related to Your Investment in the Subordinated Notes

***If we are in default on our obligations to pay our senior indebtedness, we will not be able to make payments on the subordinated notes.***

Our obligations under the subordinated notes will be unsecured and will rank junior to the following, unless, by their terms, the obligation ranks equal with or junior to, the subordinated notes:

- any of our obligations for money borrowed;
- any of our obligations evidenced by bonds, debentures, notes or other written instruments;
- any of our reimbursement obligations under letters of credit, bankers acceptances or similar facilities;
- any of our obligations issued or assumed as the deferred purchase price of property or services (but excluding trade accounts payable or accrued liabilities arising in the ordinary course of business);
- any of our capital lease obligations;
- any of our obligations under any derivative products, including interest rate, foreign exchange rate and commodity forward contracts, options and swaps; and
- any obligation of the type listed above of another person and any dividends of another person that are guaranteed by us or for which we are responsible or liable for directly or indirectly, as obligor or otherwise.

If we default on payments under any of these obligations that are senior to the subordinated notes, or if any of these senior obligations are accelerated or any judicial proceeding with respect to a default is pending, we will not be able to make payments on the subordinated notes, unless we cure the default. If we liquidate, go bankrupt or dissolve, we would be able to pay under the subordinated notes only after we have paid in full all of our liabilities that are senior to the subordinated notes. At December 31, 2006, we had outstanding $113 million in debt and other obligations (holding company only) that ranked senior to the subordinated notes. The subordinated debt indenture does not limit the amount of senior indebtedness that we may incur. For more information on the subordination of payments under the subordinated notes, see Description of Subordinated Notes Subordination.

In addition, under the terms of our 5.35% subordinated notes due April 1, 2015, which rank *pari passu* to these subordinated notes, if we default on a payment under the 5.35% subordinated notes or we breach our covenants under the related subordinated debt indenture that results in a default or event of default under such subordinated debt indenture, we will not be able to make payments on these subordinated notes (or any other series of subordinated notes to be issued under the subordinated debt indenture) unless we either cure the default or event of default or, if such default is a payment default, make payments on such subordinated notes, these subordinated notes and such future series of subordinated notes on a pro rata basis.

***We are a holding company, and banking laws and regulations could limit our access to funds from our subsidiary banks with the result that we may not have access to sufficient cash to make payments on the subordinated notes.***

As a holding company, our principal source of funds to service our debt, including the subordinated notes, is dividends from our subsidiaries. For 2006, our interest expense on our debt obligations was $28.4 million (holding company only), and operating expenses were $62.9 million (holding company only).

Federal and state banking regulations limit dividends from our bank subsidiaries to us. Dividend limitations vary, depending on the subsidiary bank s charter and whether or not it is a member of the Federal Reserve System. Generally, banks are prohibited from paying dividends when doing so would cause them to fall below regulatory minimum capital levels. Additionally, limits exist on banks paying dividends in excess of net income for specified periods. Under such limitations, the total amount available for payment of dividends by our subsidiary banks was approximately $320 million at December 31, 2006. During 2006, our bank subsidiaries paid dividends of $178.4 million to us. In addition, federal bank regulatory agencies have the authority to prohibit our subsidiary banks from engaging in unsafe or unsound practices in conducting their business. The payment of dividends or other transfers of funds to us, depending on the financial condition of the bank, could be deemed an unsafe or unsound practice.

Dividend payments from any of our subsidiary banks would also be prohibited under the prompt corrective action regulations of federal bank regulators if such subsidiary bank is, or after payment of such dividends would be, undercapitalized under such regulations. In addition, our subsidiary banks are subject to restrictions under federal law that limit their ability to transfer funds or other items of value to us and our non-bank subsidiaries, including affiliates, whether in the form of loans and other extensions of credit, investments and asset purchases, or as other transactions involving the transfer of value. Unless an exemption applies, these transactions by each of our subsidiary banks with us are limited to 10% of such subsidiary bank s capital and surplus and, with respect to all such transactions with affiliates in the aggregate, to 20% of such subsidiary bank s capital and surplus. As of December 31, 2006, a maximum of approximately $410 million was available to us from our bank subsidiaries pursuant to the limitations. Moreover, loans and extensions of credit by our bank subsidiaries to their affiliates, including us, generally are required to be secured in specified amounts. A bank s transactions with its non-bank affiliates also are required generally to be on arm s-length terms.

Accordingly, we can provide no assurance that we will receive dividends or other distributions from our bank subsidiaries and our other subsidiaries in an amount sufficient to pay interest on or principal of the subordinated notes.

***The subordinated notes will be structurally subordinated to all indebtedness of our subsidiaries and creditors of our subsidiaries will have priority as to our subsidiaries assets.***

The subordinated notes are not obligations of, or guaranteed by, any of our subsidiaries and, as a result, our right and the rights of our creditors, including holders of the subordinated notes, to participate in any distribution of assets of any of our subsidiaries upon its liquidation, reorganization or otherwise would be subject to the prior claims of creditors of that subsidiary. In the event of any such distribution of assets of our bank subsidiaries, the claims of depositors and other general or subordinated creditors of such subsidiary would be entitled to priority over the claims of ours or holders of the subordinated notes. Accordingly, the subordinated notes will effectively be subordinated to all of the existing and future liabilities and obligations of our subsidiaries, including our deposit liabilities and claims of other creditors of our subsidiary banks. As of December 31, 2006, our subsidiaries had outstanding $13.0 billion in financial obligations that would effectively rank senior to the subordinated notes in case of liquidation or reorganization, such as deposit liabilities.

***The subordinated notes will be subject to limited rights of acceleration.***

Payment of principal of the subordinated notes may be accelerated only in the case of an event of default under the subordinated debt indenture, which is limited to certain liquidation, insolvency or receivership events with respect to us. Thus, you will have no right to accelerate the payment of principal of the subordinated notes if we fail to pay interest on the subordinated notes or if we fail in the performance of any of our other obligations under the subordinated notes or any of our other obligations.

***The limited covenants relating to the subordinated notes do not protect you.***

The covenants in the subordinated debt indenture governing the subordinated notes are limited. In addition, the subordinated notes and the subordinated debt indenture do not limit our or our subsidiaries ability to issue additional subordinated notes or to incur additional debt, including senior indebtedness. As a result, the terms of the subordinated debt indenture do not protect you in the event of an adverse change in our financial condition or results

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of operations, and you should not consider the terms of the subordinated debt indenture to be a significant factor in evaluating whether we will be able to comply with our obligations under the subordinated notes.

***There may be no active market for the subordinated notes.***

The subordinated notes are a new issue of securities with no established trading market. We do not intend to apply for listing of the subordinated notes on any national securities exchange or for quotation of the subordinated notes on any automated dealer quotation system. The underwriters have advised us that they presently intend to make a market in the subordinated notes. However, they are under no obligation to do so and may discontinue any market making activities at any time without any notice. A liquid or active trading market for the subordinated notes may not develop. If an active trading market for the subordinated notes does not develop, the market price and liquidity of the subordinated notes may be adversely affected. If the subordinated notes are traded, they may trade at a discount from their initial offering price, depending on prevailing interest rates, the market for similar securities, our performance and other factors.

**Risk Factors Relating to Fulton Financial Corporation**

***Changes in interest rates may have an adverse effect on Fulton Financial s profitability.***

Fulton Financial is affected by fiscal and monetary policies of the federal government, including those of the Federal Reserve Board (FRB), which regulates the national money supply in order to manage recessionary and inflationary pressures. Among the techniques available to the FRB are engaging in open market transactions of U.S. Government securities, changing the discount rate and changing reserve requirements against bank deposits. The use of these techniques may also affect interest rates charged on loans and paid on deposits.

Net interest income is the most significant component of Fulton Financial s net income, accounting for approximately 76% of total revenues in 2006. The narrowing of interest rate spreads, the difference between interest rates earned on loans and investments and interest rates paid on deposits and borrowings, could adversely affect Fulton Financial s net income and financial condition. Based on the current interest rate environment and the price sensitivity of customers, loan demand could continue to outpace the growth of core demand and savings accounts, resulting in compression of net interest margin. Furthermore, the U. S. Treasury yield curve, which is a plot of the yields on treasury securities over various maturity terms, was relatively flat, and at times, downward sloping, with minimal differences between long and short-term rates during 2006, resulting in a negative impact to Fulton Financial s net interest income and net interest margin. Finally, regional and local economic conditions as well as fiscal and monetary policies of the federal government, including those of the FRB, may affect prevailing interest rates. Fulton Financial cannot predict or control changes in interest rates.

***Changes in economic conditions and the composition of Fulton Financial s loan portfolio could lead to higher loan charge-offs or an increase in Fulton Financial s provision for loan losses and may reduce Fulton Financial s net income.***

Changes in national and regional economic conditions could impact the loan portfolios of Fulton Financial s subsidiary banks. For example, an increase in unemployment, a decrease in real estate values or increases in interest rates, as well as other factors, could weaken the economies of the communities Fulton Financial serves. Weakness in the market areas served by Fulton Financial s subsidiary banks could depress its earnings and consequently its financial condition because:

- customers may not want or need Fulton Financial s products or services;
- borrowers may not be able to repay their loans;
- the value of the collateral securing Fulton Financial s loans to borrowers may decline; and
- the quality of Fulton Financial s loan portfolio may decline.

Any of the latter three scenarios could require Fulton Financial to charge-off a higher percentage of its loans and/or increase its provision for loan losses, which would reduce its net income.

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The second and third scenarios could also result in potential repurchase liability to Fulton Financial on residential mortgage loans originated and sold into the secondary market. Except for The Columbia Bank, Fulton Financial s bank subsidiaries originate mortgages through mortgage divisions. One subsidiary in particular, Resource Bank, originates a variety of residential products through its Resource Mortgage Division to meet customer demand. These products include conventional residential mortgages that meet published guidelines of Fannie Mae and Freddie Mac for sale into the secondary market, which are generally considered prime loans, and loans that deviate from those guidelines. This latter category of loans includes loans with higher loan to value ratios, loans with no or limited verification of a borrower s income or net worth stated on the loan application, and loans to borrowers with lower credit ratings, referred to as FICO scores. The general market for these alternative loan products across the country has declined as a result of moderating real estate prices, increased payment defaults by borrowers and increased loan foreclosures. In particular, Resource Bank has recently experienced an increase in requests from investors for Resource Bank to repurchase loans sold to those investors due to claimed loan payment defaults in one particular loan product. This resulted in Fulton Financial recording a $5.5 million contingent loss during the first quarter of 2007. This charge reflects losses that may be incurred due to potential repurchases of residential mortgage loans and home equity loans originated and sold in the secondary market. For more information regarding this contingent loss, see Recent Developments. We cannot assure you that additional payment defaults and related repurchase requests with respect to loans originated and sold by Resource Bank will not continue, which may result in additional related charges, which would adversely affect Fulton Financial s net income.

In addition, the amount of Fulton Financial s provision for loan losses and the percentage of loans it is required to charge-off may be impacted by the overall risk composition of the loan portfolio. In recent years, the amount of Fulton Financial s commercial loans (including agricultural loans) and commercial mortgages has increased, comprising a greater percentage of its overall loan portfolio. These loans are inherently more risky than certain other types of loans, such as residential mortgage loans. While Fulton Financial believes that its allowance for loan losses as of December 31, 2006 is sufficient to cover losses inherent in the loan portfolio on that date, Fulton Financial may be required to increase its loan loss provision or charge-off a higher percentage of loans due to changes in the risk characteristics of the loan portfolio, thereby reducing its net income. To the extent any of Fulton Financial s subsidiary banks rely more heavily on loans secured by real estate, a decrease in real estate values could cause higher loan losses and require higher loan loss provisions.

***Fluctuations in the value of Fulton Financial s equity portfolio, or assets under management by Fulton Financial s investment management and trust services, could have an impact on Fulton Financial s results of operations.***

At December 31, 2006, Fulton Financial s investments consisted of $72.3 million of Federal Home Loan Bank and other government agency stock, $79.8 million of stocks of other financial institutions and $13.5 million of mutual funds and other equity investment securities. Fulton Financial s equity portfolio consists primarily of common stocks of publicly traded financial institutions. Fulton Financial realized net gains on sales of financial institutions stocks of $7.0 million in 2006, $5.8 million in 2005 and $14.7 million in 2004. The value of the securities in Fulton Financial s equity portfolio may be affected by a number of factors, including factors that impact the performance of the U.S. securities market in general and, due to the concentration in stocks of financial institutions in Fulton Financial s equity portfolio, specific risks associated with that sector. If the value of one or more equity securities in the portfolio were to decline significantly, the unrealized gains in the portfolio could be reduced or lost in their entirety. In addition to Fulton Financial s equity portfolio, Fulton Financial s investment management and trust services income could be impacted by fluctuations in the securities market. A portion of Fulton Financial s trust revenue is based on the value of the underlying investment portfolios. If the values of those investment portfolios decrease, whether due to factors influencing U.S. securities markets in general, or otherwise, Fulton Financial s revenue could be negatively impacted. In addition, Fulton Financial s ability to sell its brokerage services is dependent, in part, upon consumers level of confidence in the outlook for rising securities prices.

***If Fulton Financial is unable to acquire additional banks on favorable terms or if it fails to successfully integrate or improve the operations of acquired banks, Fulton Financial may be unable to execute its growth strategies.***

Fulton Financial has historically supplemented its internal growth with strategic acquisitions of banks, branches and other financial services companies. There can be no assurance that Fulton Financial will be able to complete future acquisitions on favorable terms or that it will be able to assimilate acquired institutions successfully.

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In addition, Fulton Financial may not be able to achieve anticipated cost savings or operating results associated with acquisitions. Acquired institutions also may have unknown or contingent liabilities or deficiencies in internal controls that could result in material liabilities or negatively impact Fulton Financial s ability to complete the internal control procedures required under federal securities laws, rules and regulations or by certain laws, rules and regulations applicable to the banking industry.

***If the goodwill that Fulton Financial has recorded in connection with its acquisitions becomes impaired, it could have a negative impact on Fulton Financial s profitability.***

Applicable accounting standards require that the purchase method of accounting be used for all business combinations. Under purchase accounting, if the purchase price of an acquired company exceeds the fair value of the company s net assets, the excess is carried on the acquirer s balance sheet as goodwill. At December 31, 2006, Fulton Financial had approximately $626.0 million of goodwill on its balance sheet. Companies must evaluate goodwill for impairment at least annually. Write-downs of the amount of any impairment, if necessary, are to be charged to the results of operations in the period in which the impairment occurs. Based on tests of goodwill impairment conducted to date, Fulton Financial has concluded that there has been no impairment, and no write-downs have been recorded. However, there can be no assurance that the future evaluations of goodwill will not result in findings of impairment and write-downs.

***The competition Fulton Financial faces is increasing and may reduce Fulton Financial s customer base and negatively impact Fulton Financial s results of operations.***

There is significant competition among commercial banks in the market areas served by Fulton Financial s subsidiary banks. In addition, as a result of the deregulation of the financial industry, Fulton Financial s subsidiary banks also compete with other providers of financial services such as savings and loan associations, credit unions, consumer finance companies, securities firms, insurance companies, commercial finance and leasing companies, the mutual funds industry, full service brokerage firms and discount brokerage firms, some of which are subject to less extensive regulations than Fulton Financial is with respect to the products and services they provide. Some of Fulton Financial s competitors, including certain super-regional and national bank holding companies that have made acquisitions in its market area, have greater resources than Fulton Financial and, as such, may have higher lending limits and may offer other services not offered by Fulton Financial.

Fulton Financial also experiences competition from a variety of institutions outside its market areas. Some of these institutions conduct business primarily over the Internet and may be able to realize certain cost savings and offer products and services at more favorable rates and with greater convenience to the customer.

Competition may adversely affect the rates Fulton Financial pays on deposits and charges on loans, thereby potentially adversely affecting Fulton Financial s profitability. Fulton Financial s profitability depends upon its continued ability to successfully compete in the market areas it serves while achieving its objectives.

***The supervision and regulation to which Fulton Financial is subject can be a competitive disadvantage.***

Fulton Financial is a registered financial holding company, and its subsidiary banks are depository institutions whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC). As a result, Fulton Financial and its subsidiaries are subject to regulations and examinations by various regulatory authorities. In general, statutes establish the eligible business activities for Fulton Financial, certain acquisition and merger restrictions, limitations on inter-company transactions such as loans and dividends, capital adequacy requirements, requirements for anti-money laundering programs and other compliance matters, among other regulations. Fulton Financial is extensively regulated under federal and state banking laws and regulations that are intended primarily for the protection of depositors, federal deposit insurance funds and the banking system as a whole, and not for investors such as holders of the subordinated notes. Compliance with these statutes and regulations is important to Fulton Financial s ability to engage in new activities and to consummate additional acquisitions. In addition, Fulton Financial is subject to changes in federal and state tax laws as well as changes in banking and credit regulations, accounting principles and governmental economic and monetary policies. Fulton Financial cannot predict whether any of these changes may adversely and materially affect it. Federal and state banking regulators also possess broad powers to take supervisory actions, as they deem appropriate. These supervisory actions may result in higher capital requirements, higher insurance premiums and limitations on Fulton Financial s activities that could have a material adverse effect on its business and profitability. While these statutes are generally designed to minimize potential

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loss to depositors and the FDIC insurance funds, they do not eliminate risk, and compliance with such statutes increases Fulton Financial s expense, requires management s attention and can be a disadvantage from a competitive standpoint with respect to non-regulated competitors.

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## RECENT DEVELOPMENTS

The summary consolidated financial and other data and other ratios set forth in the following table as of and for the three months ended March 31, 2007 were derived from incomplete and unaudited consolidated financial statements. The summary consolidated financial and other data and other ratios set forth in the following table as of and for the three months ended March 31, 2006 were derived from unaudited consolidated financial statements. In the opinion of management, all adjustments necessary for a fair presentation of the results of unaudited periods have been included and are normal and recurring, except where otherwise indicated. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of the results of operations that may be expected for the entire year.

| | March 31, | |
|---|---|---|
| | **2007** | **2006** |
| | In thousands, except per-share data | |
| **BALANCE SHEET DATA** | | |
| Total assets | $14,670,336 | $14,174,485 |
| Loans, net of unearned income | 10,448,175 | 9,718,710 |
| Investment securities | 2,621,608 | 2,790,622 |
| Deposits | 10,235,580 | 9,953,846 |
| Shareholders equity | 1,521,931 | 1,448,339 |

| | Quarter Ended March 31, | |
|---|---|---|
| | **2007** | **2006** |
| **INCOME SUMMARY** | | |
| Interest income | $ 230,656 | $ 192,652 |
| Interest expense | (108,881) | (77,609) |
| Net interest income | 121,775 | 115,043 |
| Provision for loan losses | (957) | (1,000) |
| Investment securities gains | 1,782 | 2,665 |
| Other income | 37,283 | 33,942 |
| Other expenses | (100,905) | (88,016) |
| Income before income taxes | 58,978 | 62,634 |
| Income taxes | (17,850) | (18,755) |
| Net income | $ 41,128 | $ 43,879 |
| **PER-SHARE DATA:** | | |
| Net income: | | |
| Basic | $ 0.24 | $ 0.26 |
| Diluted | 0.24 | 0.25 |
| Cash dividends | 0.1475 | 0.138 |
| Shareholders equity | 8.79 | 8.32 |
| Shareholders equity (tangible) | 4.97 | 4.49 |
| **SELECTED FINANCIAL RATIOS:** | | |
| Return on average assets | 1.12% | 1.32% |
| Return on average equity | 11.06% | 12.83% |

| | | |
|---|---|---|
| Return on average equity (tangible) | 20.34% | 23.01% |
| Net interest margin | 3.74% | 3.88% |
| Efficiency ratio | 60.98% | 56.83% |
| Nonperforming assets to total assets | 0.40% | 0.35% |

We earned $41.1 million for the first quarter ended March 31, 2007, a 6.3 percent decrease from the same period in 2006. Diluted net income per share for the quarter decreased to 24 cents, a 4.0 percent decrease from the 25 cents reported in the same period in 2006. Total assets at March 31, 2007 were approximately $14.7 billion.

Net interest income for the quarter increased $6.7 million, or 5.9 percent, compared to the first quarter of 2006. Approximately $4.5 million of this increase resulted from a full quarter s contribution by one of our subsidiaries, The Columbia Bank, in 2007 as compared to two months contribution in 2006. The Columbia Bank was acquired on February 1, 2006.

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In comparison to the fourth quarter of 2006, net interest income was essentially unchanged. During the first quarter of 2007, interest recoveries on non-accrual loans totaled $3.7 million. This compares to recoveries of $480,000 in the fourth quarter of 2006 and $490,000 in the first quarter of 2006. Our net interest margin was 3.74 percent for the first quarter of 2007, 3.68 percent for the fourth quarter of 2006 and 3.88 percent for the first quarter of 2006. Interest recoveries and other nonrecurring items added approximately 11 basis points to the net interest margin for the first quarter of 2007, compared to approximately four basis points in the fourth quarter of 2006.

Other income, excluding investment securities gains, increased $3.3 million, or 9.8 percent, in the first quarter of 2007 compared to the same period in 2006. The Columbia Bank contributed $560,000 to the increase in other income. The remaining $2.7 million increase resulted primarily from gains on the sale of real estate and increases in other service charges and fees. Compared to the fourth quarter of 2006, other income, excluding security gains, decreased $1.2 million, or 3.0 percent, primarily due a decrease in gains on sales of fixed assets, as well as decreased service charges on deposit accounts.

Other expenses increased $12.9 million, or 14.6 percent, compared to the first quarter of 2006, to $100.9 million. The Columbia Bank added $3.5 million to the increase in other expenses. The remaining increase of $9.4 million resulted from the $5.5 million contingent loss described below and an increase in salaries and employee benefits. Compared to the fourth quarter of 2006, other expenses increased $6.1 million, or 6.5 percent.

Loans, net of unearned income, increased $729.5 million, or 7.5 percent, to $10.4 billion at March 31, 2007, compared to $9.7 billion at March 31, 2006. The increase was realized mainly in commercial loans, which grew $357.5 million, or 13.1 percent, and commercial mortgages, which increased $237.5 million, or 7.9 percent.

Non-performing assets were 0.40 percent of total assets at March 31, 2007, compared to 0.39 percent at December 31, 2006 and 0.35 percent at March 31, 2006. Annualized net recoveries for the quarter ended March 31, 2007 were less than one basis point as a percentage of average total loans, compared to annualized net charge-offs of 0.06 percent for the quarter ended December 31, 2006 and 0.03 percent for the quarter ended March 31, 2006. The provision for loan losses decreased $43,000, or 4.3 percent, for the first quarter of 2007, as compared to the same period in 2006.

Total deposits increased $281.7 million, or 2.8 percent, to $10.2 billion at March 31, 2007, compared to $10.0 billion at March 31, 2006. Time deposits increased $513.2 million, or 12.9 percent, offset by a $231.5 million, or 3.9 percent, decrease in demand and savings deposits.

On April 17, 2007, Fulton Financial announced that its board of directors approved a plan to repurchase up to one million shares, or approximately 0.6 percent of Fulton Financial s outstanding shares, through December 31, 2007. All Fulton Financial shares authorized to be repurchased under the plan that was declared in March of 2006 and extended in December 2006 have been repurchased. On April 17, 2007, Fulton Financial also announced that its board of directors had authorized an increase in the regular quarterly cash dividend. The regular quarterly cash dividend, which will increase to 15 cents per share, will be payable on July 15, 2007 to shareholders of record as of June 20, 2007.

As noted above, we recorded a $5.5 million contingent loss during the first quarter of 2007 related to losses that may be incurred due to the repurchase of residential mortgage loans and home equity loans that had been originated and sold in the secondary market by Resource Bank, one of our banking subsidiaries. In addition, we recorded a $3.4 million interest income recovery related to a previously charged off commercial mortgage loan. The net effect of these two items was a $0.01 decrease in diluted net income per share for the quarter ended March 31, 2007.

In recent months, Resource Bank has experienced an increase in the rate of requests to repurchase residential mortgage and home equity loans, primarily due to the failure of borrowers to make timely payment on their loans during the first three months after the sale of the loan, commonly referred to as early payment default or EPD. Most of these requests to repurchase such loans are related to one specific product sold to one investor. This product, referred to as the 80/20 Program, involves financing of up to 80 percent of the lesser of the purchase price or appraised value for a first lien mortgage loan and up to an additional 20 percent of the lesser of the purchase price or appraised value for a second lien home equity loan. Investor underwriting requirements for the 80/20 Program do

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not require independent verification of the borrower s income. To be eligible for loans under the 80/20 Program, borrowers were generally required to have a FICO score of 620 or greater. The average FICO score for borrowers in the 80/20 Program exceeded 650.

Resource Bank ceased issuing commitments for loans under the 80/20 Program in February 2007. Resource Bank has issued commitments for loans under the 80/20 Program, which had not closed as of March 31, 2007, of approximately $675,000. Resource Bank has commitments from a secondary market investor to purchase these loans. At March 31, 2007, Resource Bank had received repurchase requests for approximately $34 million of residential mortgage loans that remained unresolved through repurchase, cure or otherwise. Of the total unresolved repurchase requests, approximately 37 percent are secured by properties located in Virginia, 38 percent in Maryland, 5 percent in Florida, and the remainder in fourteen other states and the District of Columbia, none of which constitute more than 5 percent of the total.

The $5.5 million pre-tax charge for the first quarter of 2007 represents Fulton Financial s best estimate of anticipated losses based on current information. However, additional EPDs and other repurchase requests may be received and, as a result, future charges may be incurred.

Fulton s other subsidiary banks also originate and sell residential mortgage loans in the secondary market. Fulton Financial s other subsidiary banks have not experienced any unusual increases in repurchase requests as a result of EPD or otherwise. Other than the loans originated under the 80/20 Program, Resource Bank has not experienced any unusual increases in repurchase requests as a result of EPD or otherwise. In addition, Fulton Financial has not experienced any material change in trends with respect to the asset quality of its mortgage loan portfolio that is held for investment.

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## FORWARD-LOOKING STATEMENTS

This prospectus supplement, including information incorporated into this prospectus supplement by reference, may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as may, could, should, would, believe, anticipate, estimate, expect, intend, plan and s are intended to identify these forward-looking statements. These forward-looking statements involve risk and uncertainty and a variety of factors could cause our actual results and experience to differ materially from the anticipated results or other expectations expressed in these forward-looking statements.

We have made, and may continue to make, certain forward-looking statements with respect to acquisition and growth strategies, market risk, the effect of competition and interest rates on net interest margin and net interest income, investment strategy and income growth, investment securities gains, other-than-temporary impairment of investment securities, deposit and loan growth, asset quality, balances of risk-sensitive assets to risk-sensitive liabilities, employee benefits and other expenses, amortization of intangible assets, goodwill impairment, capital and liquidity strategies and other financial and business matters for future periods. We caution that these forward-looking statements are subject to various assumptions, risks and uncertainties. Because of the possibility that the underlying assumptions may change, actual results could differ materially from these forward-looking statements.

In addition to other factors identified herein, the following could cause actual results to differ materially from such forward-looking statements: pricing pressures on loan and deposit products, actions of bank and non-bank competitors, changes in local and national economic conditions, changes in regulatory requirements, actions of the FRB, creditworthiness of current borrowers, customers acceptance of our products and services, acquisition pricing and our ability to continue making acquisitions and integrating completed acquisitions successfully and within the expected timeframes.

Our forward-looking statements are relevant only as of the date on which such statements are made. By making any forward-looking statements, we assume no duty to update them to reflect new, changing or unanticipated events or circumstances.

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## USE OF PROCEEDS

The net proceeds from the issuance of the subordinated notes, after deducting estimated offering commissions and expenses, are estimated to be approximately $98,664,000. We intend to use such net proceeds for general corporate purposes, which may include stock repurchases, the redemption of debentures issued in conjunction with certain existing trust preferred securities and a possible reduction of the amount outstanding under our $100 million Revolving Credit Agreement with SunTrust Bank, dated as of July 12, 2004, as amended. At December 31, 2006 we had $36.3 million outstanding under that agreement. SunTrust Bank is an affiliate of SunTrust Capital Markets, Inc., one of the underwriters of the subordinated notes. See Underwriting. At various times during 2007, $21.1 million of debentures issued in conjunction with trust preferred securities will be eligible for redemption as indicated in the following table:

| Debentures issued to | Type of Rate | Rate at December 31, 2006 | Outstanding Principal Amount (in thousands) | Maturity | First Call Date | Callable Rate |
|---|---|---|---|---|---|---|
| Premier Capital Trust II | Variable | 8.86% | $ 15,464 | 11/7/2032 | 11/7/2007 | 100% |
| Resource Capital Trust III | Variable | 8.86% | 3,093 | 11/7/2032 | 11/7/2007 | 100 |
| SVB Bald Eagle Statutory Trust II | Variable | 8.92% | 2,578 | 6/26/2032 | 6/26/2007 | 100 |

## CAPITALIZATION

The following table sets forth our consolidated capitalization, as of December 31, 2006, on an actual basis and on an as adjusted basis to give effect to the sale of the subordinated notes offered hereby. The following data is qualified in its entirety by our financial statements and other information contained elsewhere in this prospectus supplement or incorporated by reference. The as adjusted data does not give effect to any redemption of debentures issued in conjunction with certain existing trust preferred securities, any repayment of our $100 million Revolving Credit Agreement with SunTrust Bank or any possible stock repurchases. See Use of Proceeds.

| | December 31, 2006 (In Thousands) | |
|---|---|---|
| | **Actual** | **As Adjusted** |
| Long-term borrowings: | | |
| FHLB Advances[(1)] | $ 998,521 | $ 998,521 |
| Subordinated Notes | 100,000 | 200,000 |
| Junior Subordinated Deferrable Interest Debt Securities[(2)] | 206,705 | 206,705 |
| Other Long-Term Debt | 1,999 | 1,999 |
| Total Long-Term Borrowings[(3)] | 1,307,225 | 1,407,225 |
| Shareholders Equity[(4)] | | |
| Common stock, $2.50 par value, 600 million shares authorized, 173.6 million shares outstanding as of December 31, 2006 | 476,987 | 476,987 |
| Additional paid-in capital | 1,246,823 | 1,246,823 |
| Retained earnings | 92,592 | 92,592 |
| Accumulated other comprehensive (loss) income | (39,091) | (39,091) |
| Treasury stock (17.1 million shares in 2006 and 16.1 million shares in 2005) at cost | (261,001) | (261,001) |
| Total Shareholders Equity | 1,516,310 | 1,516,310 |
| Total Long-Term Borrowings and Shareholders Equity | $ 2,823,535 | $ 2,923,535 |

(1) $190,305 of which mature in 2007.

(2) Includes debentures issued in conjunction with trust preferred securities.

(3) Excludes unamortized issuance costs of ($3,077).

(4) Adjusted for stock dividends and stock splits.

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## CAPITAL RATIOS

The following table sets forth our regulatory capital ratios at December 31 for the years indicated below on an actual basis and giving effect to the sale of the subordinated notes offered hereby on a pro forma basis at December 31, 2006. The pro forma data does not give effect to any redemption of certain debentures issued in conjunction with existing trust preferred securities, any repayment of our $100 million Revolving Credit Agreement with SunTrust Bank or any possible stock repurchases. See Use of Proceeds.

| | 2006 | 2006 Pro Forma(1) | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|---|
| **Capital Ratios:** | | | | | | |
| Total risk-based capital ratio | 11.7% | 12.6% | 12.1% | 11.8% | 12.7% | 13.8% |
| Tier 1 risk-based capital ratio | 9.8% | 9.8% | 10.0% | 10.6% | 11.5% | 12.6% |
| Tier 1 leverage ratio | 7.6% | 7.6% | 7.7% | 8.8% | 8.7% | 9.4% |

(1) Giving effect to the issuance of the subordinated notes being offered by this prospectus supplement and assuming the proceeds are invested in assets with a 50% risk weighting for purposes of computing risk-based capital ratios.

## RATIOS OF EARNINGS TO FIXED CHARGES

The following table sets forth our ratios of earnings to fixed charges for the periods shown.

| | Twelve Months Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Ratio of earnings to fixed charges: | | | | | |
| Including interest on deposits | 1.7x | 2.1x | 2.6x | 2.5x | 2.2x |
| Excluding interest on deposits | 3.0 | 4.3 | 5.6 | 6.3 | 6.7 |

For purposes of computing the ratios, earnings represent income before income taxes plus fixed charges. Fixed charges include all interest expense and the proportion deemed representative of the interest factor of rent expense for capitalized leases. These ratios are presented both including and excluding interest on deposits.

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# FULTON FINANCIAL CORPORATION

## General

Fulton Financial was incorporated under the laws of Pennsylvania on February 8, 1982 and became a bank holding company through the acquisition of all of the outstanding stock of Fulton Bank on June 30, 1982. In 2000, Fulton Financial became a financial holding company as defined in the Gramm-Leach-Bliley Act (GLB Act), which allowed Fulton Financial to expand its financial services activities under its holding company structure. Fulton Financial directly owns 100% of the common stock of thirteen community banks, two financial services companies and fifteen non-bank entities. As of December 31, 2006, Fulton Financial had approximately 4,400 employees.

## Bank and Financial Services Subsidiaries

Fulton Financial s 13 subsidiary banks are located primarily in suburban or semi-rural geographical markets throughout a five state region (Pennsylvania, Maryland, New Jersey, Delaware and Virginia). Pursuant to its super-community banking strategy, Fulton Financial operates the banks autonomously to maximize the advantage of community banking and service to its customers. Where appropriate, operations are centralized through common platforms and back-office functions; however, decision-making generally remains with the local bank management. Fulton Financial is committed to a decentralized operating philosophy; however in some markets, merging one bank into another creates operating and marketing efficiencies by leveraging existing brand awareness over a larger geographic area. During 2006, Fulton Financial merged its Premier Bank subsidiary into its Fulton Bank subsidiary. Additionally, in February 2007 Fulton Financial merged its First Washington State Bank subsidiary into The Bank. Fulton Financial has announced plans for two additional affiliate mergers that will take place during 2007.

The subsidiary banks are located in areas that are home to a wide range of manufacturing, distribution, health care and other service companies. Fulton Financial and its banks are not dependent upon one or a few customers or any one industry and the loss of any single customer or a few customers would not have a material adverse impact on any of the subsidiary banks.

Each of the subsidiary banks offers a full range of consumer and commercial banking services in its local market area. Personal banking services include various checking and savings products, certificates of deposit and individual retirement accounts. The subsidiary banks offer a variety of consumer lending products to creditworthy customers in their market areas. Secured loan products include home equity loans and lines of credit, which are underwritten based on loan-to-value limits specified in the lending policy. Subsidiary banks also offer a variety of fixed and variable-rate products, including construction loans and jumbo loans. Residential mortgages are offered through Fulton Mortgage Company, which operates as a division of each subsidiary bank (except for Resource Bank and The Columbia Bank, which maintain their own mortgage lending operations). Residential mortgages are generally underwritten based on secondary market standards. Consumer loan products also include automobile loans, automobile and equipment leases, credit cards, personal lines of credit and checking account overdraft protection.

Commercial banking services are provided to small and medium sized businesses (generally with sales of less than $100 million) in the subsidiary banks market areas. Loans to one borrower are generally limited to $33 million in total commitments, which is below Fulton Financial s regulatory lending limit. Commercial lending options include commercial, financial, agricultural and real estate loans. Both floating and fixed rate loans are provided, with floating rate loans generally tied to an index such as the Prime Rate or LIBOR (London Interbank Offering Rate). Fulton Financial s commercial lending policy encourages relationship banking and provides strict guidelines related to customer creditworthiness and collateral requirements. In addition, construction lending, equipment leasing, credit cards, letters of credit, cash management services and traditional deposit products are offered to commercial customers.

Through its financial services subsidiaries, Fulton Financial offers investment management, trust, brokerage, insurance and investment advisory services in the market areas serviced by the subsidiary banks. Fulton Financial s subsidiary banks deliver their products and services through traditional branch banking, with a network of full service branch offices. Electronic delivery channels include a network of automated teller machines, telephone banking and online banking through the Internet. The variety of available delivery channels allows

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customers to access their account information and perform certain transactions such as transferring funds and paying bills at virtually any hour of the day.

The following table provides certain information for Fulton Financial s banking and financial services subsidiaries as of December 31, 2006.

| Subsidiary | Main Office Location | Total Assets | Total Deposits | Branches |
|---|---|---|---|---|
| | | (in millions) | | |
| Fulton Bank | Lancaster, PA | $5,003 | $3,341 | 83 |
| Lebanon Valley Farmers Bank | Lebanon, PA | 786 | 602 | 12 |
| Swineford National Bank | Hummels Wharf, PA | 266 | 202 | 7 |
| Lafayette Ambassador Bank | Easton, PA | 1,328 | 990 | 24 |
| FNB Bank, N.A | Danville, PA | 304 | 219 | 8 |
| Hagerstown Trust Company | Hagerstown, MD | 518 | 407 | 12 |
| Delaware National Bank | Georgetown, DE | 411 | 271 | 12 |
| The Bank | Woodbury, NJ | 1,318 | 1,058 | 31 |
| The Peoples Bank of Elkton | Elkton, MD | 111 | 96 | 2 |
| Skylands Community Bank | Hackettstown, NJ | 609 | 467 | 12 |
| Resource Bank | Virginia Beach, VA | 1,448 | 832 | 7 |
| First Washington State Bank(1) | Windsor, NJ | 589 | 428 | 16 |
| Somerset Valley Bank | Somerville, NJ | 575 | 403 | 13 |
| The Columbia Bank | Columbia, MD | 1,678 | 1,035 | 25 |
| Fulton Financial Advisors, N.A. and Fulton Insurance Services Group, Inc. (2) | Lancaster, PA | | | |
| Total | | | | 264 |

(1) First Washington State Bank merged into The Bank in February 2007.

(2) Dearden, Maguire, Weaver and Barrett LLC, an investment management and advisory company, is a wholly-owned subsidiary of Fulton Financial Advisors, N.A.

**Non-Bank Subsidiaries**

Fulton Financial owns 100% of the common stock of five non-bank subsidiaries which are consolidated for financial reporting purposes: (i) Fulton Reinsurance Company, Ltd., which engages in the business of reinsuring credit life and accident and health insurance directly related to extensions of credit by the banking subsidiaries of Fulton Financial; (ii) Fulton Financial Realty Company, which holds title to or leases certain properties upon which Fulton Financial s branch offices and other facilities are located; (iii) Central Pennsylvania Financial Corp., which owns certain limited partnership interests in partnerships invested in low and moderate income housing projects; (iv) FFC Management, Inc., which owns certain investment securities and other passive investments; and (v) FFC Penn Square, Inc. which owns $44.0 million of trust preferred securities issued by a subsidiary of Fulton Financial s largest bank subsidiary.

Fulton Financial owns 100% of the common stock of nine non-bank subsidiaries which are not consolidated for financial reporting purposes: (i) PBI Capital Trust, a Delaware business trust whose sole asset is $10.3 million of junior subordinated deferrable interest debentures from Fulton Financial; (ii) Premier Capital Trust II, a Delaware business trust whose sole asset is $15.5 million of junior subordinated deferrable interest debentures from Fulton Financial; (iii) Resource Capital Trust III, a Delaware business trust whose sole asset is $3.1 million of junior subordinated deferrable interest debentures from Fulton Financial; (iv) SVB Bald Eagle Statutory Trust I, a Connecticut business trust whose sole asset is $4.1 million of junior subordinated deferrable interest debentures from Fulton Financial; (v) SVB Bald Eagle Statutory Trust II, a Connecticut business trust whose sole asset is $2.6 million of junior subordinated deferrable interest debentures from Fulton Financial; (vi) Columbia Bancorp Statutory Trust, a Delaware business trust whose sole asset is $6.2 million of junior subordinated deferrable interest debentures from Fulton Financial; (vii) Columbia Bancorp Statutory Trust II, a Delaware business trust whose sole asset is $4.1 million of junior subordinated deferrable interest debentures from Fulton Financial; (viii) Columbia

Bancorp Statutory Trust III, a Delaware business trust whose sole asset is $6.2 million of junior subordinated deferrable interest debentures from Fulton Financial; and (ix) Fulton Capital Trust I, a Delaware business trust whose sole asset is $154.6 million of junior subordinated deferrable interest debentures from Fulton Financial.

## DESCRIPTION OF SUBORDINATED NOTES

*This summary describes the material provisions of the subordinated notes. It is not complete and is both subject to and qualified by the subordinated debt indenture (as defined below), including the definitions used in the subordinated debt indenture. We have incorporated the definitions used in the subordinated debt indenture in this prospectus supplement. You can request a complete copy of the subordinated debt indenture from Fulton Financial. Wilmington Trust Company will act as trustee under the subordinated debt indenture.*

### General

The subordinated notes are a series of our subordinated notes (as defined in the accompanying prospectus) and will be issued under the indenture, to be dated May 1, 2007, between Fulton Financial and Wilmington Trust Company, as supplemented by the First Supplemental Indenture, to be dated May 1, 2007, between Fulton Financial and Wilmington Trust Company, referred to collectively as the subordinated debt indenture. The subordinated notes will be our general unsecured subordinated obligations and will rank equally with all of our other unsecured subordinated obligations from time to time outstanding, provided that the subordinated notes will rank senior to the junior subordinated debentures issued to our capital trust subsidiaries. The subordinated notes will rank junior to all of our existing and future senior indebtedness to the extent and in the manner set forth in the subordinated debt indenture. The subordinated notes will effectively be subordinated to all of the existing and future liabilities and obligations of our subsidiaries, including the deposit liabilities and claims of other creditors of our subsidiary banks. See Subordination.

The subordinated notes will be issued on May 1, 2007. The subordinated notes will mature on May 1, 2017. The subordinated notes will not be redeemable at the option of Fulton Financial or repayable at the option of the holders at any time before that date. There is no sinking fund for the subordinated notes.

The subordinated notes will initially be limited to an aggregate principal amount of $100,000,000. We may, without the consent of the holders of the subordinated notes, issue an unlimited principal amount of additional subordinated notes having identical terms and conditions as the subordinated notes. Such additional subordinated notes will be consolidated and form a single series with the previously outstanding subordinated notes. We will only be permitted to issue such additional subordinated notes if, at the time of such issuance, we are in compliance with the covenants contained in the subordinated debt indenture.

The subordinated notes have been rated A3 by Moody s and A- by Fitch. If another rating agency were to rate the subordinated notes, such rating agency may assign a rating different from the ratings described above. A security rating is not a recommendation to buy, sell or hold securities and may be subject to revision or withdrawal at any time by the assigning rating organization.

### Interest

The subordinated notes will bear interest at the annual rate of 5.75% of the principal amount of the subordinated notes. Interest will be payable semi-annually in arrears on interest payment dates of May 1 and November 1 of each year to the person in whose name each note is registered at the close of business on the relevant record date, except in the case of defaulted interest. The record dates will be the $15^{th}$ calendar day, whether or not a business day, immediately preceding the relevant interest payment date. Interest payable at maturity of the subordinated notes will be paid to the registered holder to whom the principal is payable. The first interest payment date for the subordinated notes will be November 1, 2007. The period beginning on and including the date the subordinated notes are first issued and ending on but excluding November 1, 2007 and each period beginning on and including an interest payment date and ending on but excluding the next interest payment date is an interest period. The amount of interest payable for any interest period will be computed on the basis of a 360-day year of twelve 30-day months.

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Payments not made on the required date will bear additional interest thereon (without duplication and to the extent permitted by law) at the rate of 5.75% per year, compounded semi-annually, from the last interest payment date for which interest was paid.

If an interest payment date or the maturity date falls on a day that is not a business day, the related payment of principal or interest will be paid on the next business day, with the same force and effect as if made on such date, and no interest on such payments will accrue from and after such interest payment date or maturity date, as the case may be. A business day means any day other than a Saturday or a Sunday, or a day on which banking institutions in The City of New York, Lancaster, Pennsylvania or Wilmington, Delaware are authorized or required by law, executive order or regulation to close.

**Subordination**

Upon any payment or distribution of our assets to creditors upon our liquidation, dissolution, winding up, reorganization, assignment for the benefit of our creditors, marshalling of our assets or any bankruptcy, insolvency, debt restructuring or similar proceedings in connection with any insolvency or bankruptcy proceeding involving us, the allocable amounts in respect of the senior indebtedness must be paid in full before the holders of the subordinated notes will be entitled to receive or retain any payment in respect of the subordinated notes.

In the event and during the continuation of any default by Fulton Financial in the payment of principal, premium, interest or any other payment due on any senior indebtedness, Fulton Financial will make no payment with respect to the principal or interest on the subordinated notes or any other amounts which may be due on the subordinated notes pursuant to the terms of the subordinated notes or the subordinated debt indenture. If the maturity of the subordinated notes is accelerated, Fulton Financial will make no payment with respect to the principal or interest on the subordinated notes or any other amounts which may be due on the subordinated notes pursuant to the terms of the subordinated notes or the subordinated debt indenture until the holders of all senior indebtedness outstanding at the time of such acceleration receive payment, in full, of all allocable amounts due on or in respect of such senior indebtedness (including any amounts due upon acceleration).

Allocable amounts, when used with respect to any senior indebtedness, means all amounts due or to become due on such senior indebtedness less, if applicable, any amount which would have been paid to, and retained by, the holders of such senior indebtedness (whether as a result of the receipt of payments by the holders of such senior indebtedness from us or any other obligor thereon or from any holders of, or trustee in respect of, other indebtedness that is subordinate and junior in right of payment to such senior indebtedness pursuant to any provision of such indebtedness for the payment over of amounts received on account of such indebtedness to the holders of such senior indebtedness or otherwise) but for the fact that such senior indebtedness is subordinate or junior in right of payment to (or subject to a requirement that amounts received on such senior indebtedness be paid over to obligees on) trade accounts payable or accrued liabilities arising in the ordinary course of business.

Senior indebtedness means the following, whether now outstanding or subsequently created, assumed or incurred, whether or not recourse is to all or a portion of our assets and whether or not contingent:

any of our obligations for money borrowed;

any of our obligations evidenced by bonds, debentures, notes or other similar instruments, including obligations incurred in connection with the acquisition of property, assets or businesses;

any of our reimbursement obligations under letters of credit, bankers acceptances, security purchase facilities or similar facilities issued for our account;

any of our obligations issued or assumed as the deferred purchase price of property or services (but excluding trade accounts payable or accrued liabilities arising in the ordinary course of business);

any of our capital lease obligations;

any of our obligations under any derivative products, including interest rate, foreign exchange rate and commodity forward contracts, options and swaps and similar arrangements; and

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any obligation of the type listed above of another person and any dividends of another person, the payment of which, in either case, (x) is guaranteed by us or for which we are responsible or liable for directly or indirectly, as obligor or otherwise or (y) is secured by a lien on any of our property or assets;

but does not include (A) any indebtedness issued to any statutory trust created by Fulton Financial for the purpose of issuing trust securities in connection with such issuance of indebtedness, which shall in all cases be junior to the subordinated notes, including without limitation the debt securities issued to (i) PBI Capital Trust, (ii) Premier Capital Trust II, (iii) Resource Capital Trust III, (iv) SVB Bald Eagle Statutory Trust I, (v) SVB Bald Eagle Statutory Trust II, (vi) Columbia Bancorp Statutory Trust, (vii) Columbia Bancorp Statutory Trust II, (viii) Columbia Bancorp Statutory Trust III and (ix) Fulton Capital Trust I, (B) any guarantees of Fulton Financial in respect of the equity securities or other securities of such trusts, (C) our 5.35% subordinated notes due April 1, 2015 (with respect to which the subordinated notes rank *pari passu*) or (D) any other subordinated debt of Fulton Financial that, by its terms, ranks *pari passu* or junior to the subordinated notes.

As of December 31, 2006, we had $113 million (holding company only) of senior indebtedness outstanding. The subordinated notes and the subordinated debt indenture do not contain any limitation on the amount of senior indebtedness that we or any of our subsidiaries may hereafter incur.

We are a financial holding company and substantially all of our assets are held by our direct and indirect subsidiaries. We rely on dividends and other payments or distributions from our subsidiaries to pay the interest on our debt obligations (such as the subordinated notes), which interest expense was $7.0 million in the fourth quarter of 2006, and our non-consolidated operating expenses, which were $16.3 million in the fourth quarter of 2006. Federal and state bank regulations impose certain restrictions on the ability of our bank subsidiaries to pay dividends directly or indirectly to us, to make any extensions of credit to us or certain of our affiliates and from investing in our stock or securities. These regulations also prevent us from borrowing from our bank subsidiaries unless the loans are secured by collateral. See Risk Factors. We are a holding company and may not have access to sufficient cash to make payments on the subordinated notes; in addition, banking laws and regulations could limit our access to funds from our subsidiary banks.

Because we are a holding company, our right and the rights of our creditors, including holders of the subordinated notes, to participate in any distribution of assets of any of our subsidiaries upon their liquidation, reorganization or otherwise would be subject to the prior claims of creditors of that subsidiary (except to the extent that we are a creditor with a recognized claim). In the event of any such distribution of assets of our bank subsidiaries due in part to their status as insured depository institutions, the claims of depositors and other general or subordinated creditors of such bank subsidiaries would be entitled to priority over claims of shareholders of such bank subsidiary, including us as its parent holding company and any creditor of ours, such as holders of the subordinated notes. As of December 31, 2006, our subsidiaries had $13.0 billion in long-term debt and other obligations that ranked effectively senior to the subordinated notes.

**Events of Default; Limited Rights of Acceleration**

The only events of default with respect to the subordinated notes under the subordinated debt indenture are certain events related to our bankruptcy or insolvency, whether voluntary or involuntary. If an event of default with respect to the subordinated notes occurs and is continuing, the principal amount of all of the subordinated notes shall become and be immediately due and payable without any declaration or other action on the part of the trustee or any holder of the subordinated notes.

There is no right of acceleration of the payment of principal of the subordinated notes upon a default in the payment of interest on the subordinated notes or in the performance of any of our covenants or agreements contained in the subordinated notes, in the subordinated debt indenture or any of our other obligations or liabilities. However, upon a default in the payment of principal of or interest on the subordinated notes, holders of subordinated notes will have a right to institute suit directly against us for the collection of such overdue payment.

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The following are  defaults  with respect to the subordinated notes:

- default in the payment of principal of the subordinated notes when due, whether at maturity, by acceleration of maturity or otherwise; and
- default in the payment of interest on the subordinated notes when due, which continues for 30 days.

If a  default  or an  event of default  occurs and is continuing under the subordinated debt indenture, the trustee or the holders of not less than 25% in aggregate principal amount of the subordinated notes outstanding may seek to enforce its rights and the rights of the holders of the subordinated notes by appropriate judicial proceedings, which may include demanding payment of any amounts then due and payable on the subordinated notes. The trustee and the holders of subordinated notes may not accelerate the maturity of the subordinated notes upon the occurrence of a default. They may only accelerate the maturity of the subordinated notes upon the occurrence of an event of default described above.

**Certain Covenants; Limitations On Dividends**

If there occurs a default or event of default under the subordinated debt indenture, or if any event, act or condition is, or with the giving of notice or the lapse of time, or both, would be, a default or an event of default under the subordinated debt indenture, and we have not taken reasonable steps to cure the default, event of default, event, act or condition, then we will not:

- declare or pay any dividends or distributions on, or redeem, purchase, acquire or make a liquidation payment with respect to, any of our capital stock;

- make any payment of principal of, or interest, on, or repay, repurchase or redeem any of our debt securities that rank equal with or junior to the subordinated notes, other than such payments, repayments, repurchases or redemptions of our debt securities that rank equal with the subordinated notes that are made on a pro rata basis with payments, repayments, repurchases or redemptions on the subordinated notes; or

- make any guarantee payments with respect to any guarantee by us of the debt securities of any of our subsidiaries if such guarantee ranks equal with or junior to the subordinated notes, other than such payments on guarantees that rank equal with the subordinated notes that are made on a pro rata basis with payments on the subordinated notes,

except that we may:

- pay dividends or distributions in shares of, or options, warrants or rights to subscribe for or purchase shares of, our common stock;

- declare a dividend in connection with the implementation of a stockholder s rights plan, or the issuance of stock under any such plan in the future, or the redemption or repurchase of any such rights pursuant thereto;

- redeem, purchase, acquire or make a liquidation payment with respect to our capital stock as a result of a reclassification of our capital stock or the exchange or conversion of one class or series of our capital stock for another class or series of our capital stock;

- purchase fractional interests in shares of our capital stock pursuant to the conversion or exchange provisions of such capital stock or the security being converted or exchanged; and

- purchase our common stock related to the issuance of common stock or rights under any of our benefit or compensation plans for our directors, officers or employees or any of our dividend reinvestment plans.

### Modification

From time to time, we, together with the trustee, may, without the consent of the holders of subordinated notes, amend the subordinated debt indenture for one or more of the following purposes:

- to provide for the assumption by a successor corporation of our obligations under the subordinated debt indenture;
- to add to our covenants and the default provisions for the benefit of the holders of subordinated notes;
- to cure ambiguities, defects or inconsistencies; provided, that any such amendment does not materially adversely affect the interests of the holders of subordinated notes;
- to appoint a successor trustee with respect to the subordinated notes;
- to qualify and maintain the qualification of the subordinated debt indenture under the Trust Indenture Act;
- to establish the form or terms of each series of subordinated notes; or
- to make any other change that does not adversely affect the interests of any holders of subordinated notes in any material respect.

The subordinated debt indenture permits us and the trustee, with the consent of the holders of a majority in aggregate principal amount of each series of subordinated notes affected thereby, to modify the subordinated debt indenture in a manner affecting the rights of the holders of the subordinated notes of such series; provided, that no modification may, without the consent of the holders of each outstanding note affected:

- change the maturity date, provide for the redemption of the subordinated notes prior to the maturity date or reduce the principal amount of the subordinated notes;
- reduce the rate or extend the time of payment of interest;
- make the principal of or interest on the subordinated notes payable in any coin or currency other than that provided in the subordinated notes;
- impair or affect the right of any holder of the subordinated notes to institute suit for the payment thereof; or
- reduce the percentage of the principal amount of the subordinated notes, the holders of which are required to consent to any such modification.

### Consolidation, Merger and Sale of Assets

We will not consolidate with or merge into any other corporation or sell, convey, transfer or lease substantially all of our properties and assets to any person, unless:

- if we are the surviving person or if we consolidate with or merge into another person or sell, convey, transfer or lease substantially all of our properties and assets to any person, the successor is organized under the laws of the United States of America or any State or the District of Columbia, and the successor, if not Fulton Financial, expressly assumes our obligations relating to the subordinated notes;
- immediately after giving effect to the transaction, no default or event of default, and no event which, after notice or lapse of time or both, would become a default or event of default shall have occurred and be continuing; and

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other conditions described in the subordinated debt indenture are met.

The general provisions of the subordinated debt indenture do not protect you against transactions, such as a highly leveraged transaction, that may adversely affect you.

**Satisfaction And Discharge**

The subordinated debt indenture provides that when, among other things, all subordinated notes not previously delivered to the trustee for cancellation:

have become due and payable, or

will become due and payable at their stated maturity within one year, and we deposit or cause to be deposited with the trustee, in trust, for the purpose and in an amount sufficient to pay and discharge the entire indebtedness on the subordinated notes not previously delivered to the trustee for cancellation, for the principal, and interest to May 1, 2017,

then the subordinated debt indenture will cease to be of further effect, and we will be deemed to have satisfied and discharged the subordinated debt indenture with respect to the subordinated notes. However, we will continue to be obligated to pay all other sums due under the subordinated debt indenture and to provide the officers certificates and opinions of counsel described in the subordinated debt indenture.

**Defeasance**

We may at any time terminate all of our obligations under the subordinated notes, except for certain obligations, including those respecting the defeasance trust. Our obligations will be deemed to have been discharged on the 91st day after the following applicable conditions have been satisfied:

we have irrevocably deposited in trust with the trustee or the defeasance agent, if any, money or U.S. government obligations for the payment of principal and interest on the subordinated notes to maturity;

if the subordinated notes are then listed on any national securities exchange, we have delivered to the trustee or defeasance agent an opinion of counsel that our defeasance will not cause the subordinated notes to be delisted from such exchange;

no default or event of default (or any event which after notice or the lapse of time or both would become a default or an event of default) with respect to the subordinated notes shall have occurred and be continuing; and

we have delivered to the trustee and the defeasance agent, if any, an opinion of counsel to the effect that holders of the subordinated notes will not recognize income, gain or loss for United States federal income tax purposes as a result of such defeasance and will be subject to United States federal income tax on the same amount and in the same manner and at the same times as would have been the case if such defeasance had not occurred.

**Form, Denomination, Book-Entry Procedures and Transfers**

The subordinated notes initially will be represented by one or more subordinated notes in registered, global form, referred to collectively as the global subordinated notes. The global subordinated notes will be deposited upon issuance with the trustee as custodian for DTC and registered in the name of DTC or its nominee.

Except as set forth in this prospectus supplement, the global subordinated notes may be transferred, in whole and not in part, only to another nominee of DTC or to a successor of DTC or its nominee. Transfer of beneficial interests in the global subordinated notes will be subject to the applicable rules and procedures of DTC and its direct and indirect participants, which may change from time to time.

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### Exchange of Book-Entry Subordinated Notes for Certificated Subordinated Notes

A global subordinated note can be exchanged for subordinated notes in certificated form only if:

- DTC notifies the Trustee or us that it is unwilling or unable to continue as depositary for the global subordinated note and the Trustee fails to appoint a successor depositary within 90 days of receipt of DTC s notice, or DTC has ceased to be a clearing agency registered under the Exchange Act and the Trustee fails to appoint a successor depositary within 90 days of becoming aware of this condition;

- we determine, in our discretion, that the global subordinated notes will be exchangeable for subordinated notes in certificated form; or

- an event of default shall have occurred and be continuing.

Any such subordinated notes in certificated form will be issued in minimum denominations of $1,000 and multiples of $1,000 in excess thereof and may be transferred or exchanged only in such minimum denominations.

### Payment And Paying Agents

We will pay principal and interest on your subordinated notes at the office of the trustee in Wilmington, Delaware or in The City of New York, or at the office of any paying agent that we may designate.

We will pay any interest on the subordinated notes to the registered owner of the subordinated notes at the close of business on the record date for the interest, except in the case of defaulted interest. Interest payable at maturity of the subordinated notes will be paid to the registered holder to whom principal is payable. We may at any time designate additional paying agents or rescind the designation of any paying agent.

Any moneys deposited with the trustee or any paying agent, or then held by us in trust, for the payment of the principal of and interest on any subordinated note that remains unclaimed for two years after the principal or interest has become due and payable will, at our request, be repaid to us. After repayment to us, you are entitled to seek payment only from us as a general unsecured creditor.

### Governing Law

The subordinated debt indenture and the subordinated notes will be governed by and construed in accordance with the laws of the State of New York.

### The Trustee

Wilmington Trust Company will be the trustee under the subordinated debt indenture. Wilmington Trust Company is also the trustee under the existing subordinated debt indenture dated as of March 28, 2005 between Fulton Financial and Wilmington Trust Company.

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## CERTAIN U.S. FEDERAL INCOME TAX CONSEQUENCES

The following discussion is a summary of the material U.S. federal income tax consequences relevant to the ownership and disposition of the subordinated notes by holders who acquire the subordinated notes upon issuance. This discussion does not purport to be a complete analysis of all potential tax considerations relating to the subordinated notes. This discussion does not address all of the U.S. federal income tax consequences that may be relevant to a holder in light of such holder s particular circumstances. The discussion also does not address the U.S. federal income tax consequences of holders subject to special treatment under U.S. federal income tax laws, such as certain controlled foreign corporations, passive foreign investment companies, banks, thrifts, regulated investment companies, real estate investment trusts, U.S. expatriates, insurance companies, dealers in securities or currencies, traders in securities, tax-exempt organizations, partnerships and pass-through entities, persons that hold the subordinated notes as part of a straddle, a hedge against currency risk, a conversion transaction, or an integrated or other risk reduction transaction, or persons that have a functional currency other than the U.S. dollar. Moreover, neither the effect of any applicable state, local or foreign tax laws nor the possible application of federal estate and gift taxation or the alternative minimum tax is discussed. In addition, this discussion is limited to initial holders who purchased subordinated notes for cash at original issue and at their issue price within the meaning of Section 1273 of the Internal Revenue Code of 1986, as amended (the Code ) (*i.e.*, the first price at which a substantial amount of subordinated notes are sold for cash). This discussion deals only with subordinated notes that are held as capital assets within the meaning of Section 1221 of the Code.

If a partnership or other entity treated for tax purposes as a partnership holds subordinated notes, the tax treatment of a partner thereof generally will depend on the status of the partner and the activities of the partnership. Such partner should consult its tax advisor as to the tax consequences of the partnership of owning and disposing of the subordinated notes.

We have not sought and will not seek any rulings from the Internal Revenue Service ( IRS ) with respect to the matters discussed below. This discussion is based upon the Code, existing and proposed regulations thereunder, IRS rulings and pronouncements and judicial decisions now in effect, all of which are subject to change, possibly on a retroactive basis. The discussion herein does not foreclose the possibility of a contrary decision by the IRS or a court of competent jurisdiction, or of a contrary position by the IRS or Treasury Department in regulations or rulings issued in the future.

**Holders of subordinated notes should consult their own tax advisors regarding the application of U.S. federal tax laws, as well as the tax laws of any state, local, or foreign jurisdiction, to holding and disposing of the subordinated notes in light of their particular circumstances.**

### United States Holders

As used herein, United States Holder means a beneficial owner of the subordinated notes who or that is:

- an individual that is a citizen or resident of the United States;

- a corporation or other entity taxable as a corporation for United States federal income tax purposes created or organized in or under the laws of the United States or any state thereof (including the District of Columbia);

- an estate, the income of which is subject to U.S. federal income tax regardless of its source; or

- a trust, if a U.S. court can exercise primary supervision over the administration of the trust and one or more United States persons has the authority to control all substantial trust decisions, or, if the trust was in existence on August 20, 1996, was treated as a United States person prior to such date and has elected to continue to be treated as a United States person.

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*Interest*

Payments of stated interest on the subordinated notes generally will be taxable to a United States Holder as ordinary income at the time that such payments are received or accrued, in accordance with such United States Holder s method of accounting for U.S. federal income tax purposes.

***Sale or Other Taxable Disposition of the Subordinated Notes***

In general, a United States Holder will recognize gain or loss on the sale, exchange (other than in a tax-free transaction), retirement or other taxable disposition of a subordinated note in an amount equal to the difference between the amount realized upon the disposition (less a portion allocable to any accrued and unpaid interest, which will be taxable as ordinary income if not previously included in such United States Holder s income) and the United States Holder s adjusted tax basis in the subordinated note. This gain or loss generally will be a capital gain or loss, and will be a long-term capital gain or loss if the United States Holder s holding period for the subordinated note is more than one year. Otherwise, such gain or loss will be a short-term capital gain or loss. The deductibility of any capital loss is subject to limitation.

***Backup Withholding and Information Reporting***

In general, information reporting requirements will apply to payments of interest and principal on the subordinated notes to United States Holders and the receipt of proceeds upon the sale or other disposition of subordinated notes by United States Holders. A United States Holder may be subject to a backup withholding tax. Certain holders (including, among others, corporations and certain tax-exempt organizations) are generally not subject to backup withholding. A United States Holder will be subject to this backup withholding tax if such holder is not otherwise exempt and such holder:

- fails to furnish its taxpayer identification number ( TIN ), which, for an individual, is ordinarily his or her social security number;
- furnishes an incorrect TIN;
- is notified by the IRS that it has failed to properly report payments of interest or dividends; or
- fails to certify, under penalties of perjury, that it has furnished a correct TIN and that the IRS has not notified the United States Holder that it is subject to backup withholding.

United States Holders should consult their tax advisor regarding their qualification for an exemption from backup withholding and the procedures for obtaining such an exemption, if applicable. The backup withholding tax is not an additional tax and taxpayers may use amounts withheld as a credit against their U.S. federal income tax liability or may claim a refund as long as they timely provide certain information to the IRS.

We will furnish annually to the IRS, and to record holders of the subordinated notes to whom we are required to furnish such information, information relating to the amount of interest paid and the amount of tax withheld, if any, with respect to payments on the subordinated notes.

**Non-United States Holders**

The following summary is a general description of certain U.S. federal income tax consequences to a non-United States Holder (which, for purposes of this discussion, means a beneficial owner of a subordinated note that is an individual, corporation or other entity taxable as a corporation for U.S. federal income tax purposes, estate or trust and not a United States Holder as defined above).

***Interest Payments***

United States tax law generally imposes a withholding tax of 30% in respect of interest payments to non-United States Holders if such interest is not effectively connected with the non-United States Holder s conduct of a U.S. trade or business. Subject to the discussions of Backup Withholding and Information Reporting below, interest paid to a non-United States Holder will not be subject to U.S. federal withholding tax of 30% (or, if applicable, a lower treaty rate), provided that:

- such holder does not directly or indirectly, actually or constructively, own 10% or more of the total combined voting power of all of our classes of stock;
- such holder is not a controlled foreign corporation that is directly or indirectly related to us through stock ownership;
- such holder is not a bank that received such note on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business; and
- either (1) the non-United States Holder certifies in a statement provided to us or our paying agent, under penalties of perjury, that it is not a United States person within the meaning of the Code and provides its name and address (generally on IRS Form W-8BEN), or (2) a securities clearing organization, bank or other financial institution that holds customers securities in the ordinary course of its trade or business and holds the subordinated notes on behalf of the non-United States Holder certifies to us or our paying agent under penalties of perjury that it has received from the non-United States Holder a statement, under penalties of perjury, that such holder is not a United States person and provides us or our paying agent with a copy of such statement or (3) the non-United States Holder holds its subordinated notes through a qualified intermediary and certain conditions are satisfied.

Even if the above conditions are not met, a non-United States Holder may be entitled to a reduction in, or exemption from, withholding tax on interest under a tax treaty between the United States and the non-United States Holder s country of residence. To claim a reduction or exemption under a tax treaty, a non-United States Holder must generally complete IRS Form W-8BEN and claim the reduction or exemption on the form.

The certification requirements described above may require a non-United States Holder that provides an IRS form, or that claims the benefit of an income tax treaty, to also provide its U.S. taxpayer identification number.

Prospective investors should consult their tax advisors regarding the certification requirements for non-United States Holders.

***Sale or Other Taxable Disposition of Subordinated Notes***

Subject to the discussion of United States Trade or Business below, a non-United States Holder generally will not be subject to U.S. federal income tax or withholding tax on gain recognized on the sale, exchange, retirement or other disposition of a subordinated note. However, a non-United States Holder may be subject to tax on such gain if such holder is an individual who was present in the United States for 183 days or more in the taxable year of the disposition and certain other conditions are met.

***United States Trade or Business***

If interest or gain from a disposition of the subordinated notes is effectively connected with a non-United States Holder s conduct of a U.S. trade or business (and, if an income tax treaty applies and the non-United States Holder maintains a U.S. permanent establishment to which the interest or gain is generally attributable), the non-United States Holder may be subject to U.S. federal income tax on the interest or gain on a net basis in the same manner as if it were a United States Holder. If interest income received with respect to the subordinated notes is taxable on a net basis, the 30% withholding tax described above will not apply (assuming an appropriate certification is provided). A foreign corporation that is a holder of a subordinated note also may be subject to a branch profits tax equal to 30% of its effectively connected earnings and profits for the taxable year, subject to certain adjustments, unless it qualifies for a lower rate under an applicable income tax treaty.

***Backup Withholding and Information Reporting***

Generally, we must report to the IRS and to each non-United States Holder the amount of interest paid to such non-United States Holder and the amount of tax, if any, withheld with respect to those payments. Copies of the information returns reporting such interest payments and any withholding may also be made available to the tax

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authorities in the country in which the non-United States Holder resides under the provisions of an applicable income tax treaty. Backup withholding generally will not apply to payments of principal and interest made by us or our paying agent on a subordinated note to a non-United States Holder if the non-United States Holder has provided the required certification that it is not a United States person (provided that neither we nor our agents have actual knowledge or reason to know that the holder is a United States person).

Information reporting and, depending on the circumstances, backup withholding may apply to the proceeds of a sale of subordinated notes made within the United States or conducted through certain United States-related financial intermediaries, unless the non-United States Holder certifies under penalties of perjury that it is not a United States person (and the payor does not have actual knowledge or reason to know that the non-United States Holder is a United States person), or the non-United States Holder otherwise establishes an exemption.

Non-United States Holders should consult their own tax advisors regarding application of withholding and backup withholding in their particular circumstance and the availability of and procedure for obtaining an exemption from withholding and backup withholding under current Treasury Regulations. In this regard, the current Treasury Regulations provide that a certification may not be relied on if we or our agent (or other payor) knows or has reasons to know that the certification is false. Any amounts withheld under the backup withholding rules from a payment to a non-United States Holder will be allowed as a credit against the holder s U.S. federal income tax liability or may be claimed as a refund, provided the required information is furnished timely to the IRS.

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## ERISA CONSIDERATIONS

The following is a general summary based upon provisions of The Employee Retirement Income Security Act of 1974, as amended ( ERISA ), and Section 4975 of the Code and related regulations and administrative interpretations as of the date hereof. This summary does not purport to be complete, and no assurance can be given that future legislation, court decisions, administrative regulations, rules or administrative pronouncements will not significantly modify the requirements summarized herein. Any such changes may be retroactive and may thereby apply to transactions entered into prior to the date of the enactment or release of any such change.

EACH PROSPECTIVE PURCHASER THAT MAY BE SUBJECT TO ERISA OR TO SECTION 4975 OF THE CODE IS URGED TO CONSULT WITH ITS OWN COUNSEL ABOUT THE POTENTIAL CONSEQUENCES OF AN INVESTMENT IN THE SUBORDINATED NOTES UNDER SUCH LAWS.

ERISA imposes certain requirements on employee benefit plans (as defined in Section 3(3) of ERISA) subject to ERISA, including entities such as collective investment funds whose underlying assets include the assets of such plans (collectively, ERISA Plans ), and on those persons who are fiduciaries with respect to ERISA Plans. Investments by ERISA Plans are subject to ERISA s general fiduciary requirements, including the requirement of investment prudence and diversification and the requirement that an ERISA Plan s investments be made in accordance with the documents governing the ERISA Plan. The prudence of a particular investment must be determined by the responsible fiduciary of an ERISA Plan by taking into account the ERISA Plan s particular circumstances and all of the facts and circumstances of an investment in a note including, but not limited to, the matters discussed above under Risk Factors and the fact that in the future there may be no market in which such ERISA Plan will be able to sell or otherwise dispose of any subordinated note it may purchase.

Section 406 of ERISA and Section 4975 of the Code prohibit ERISA Plans, as well as individual retirement accounts and Keogh plans subject to Section 4975 of the Code ( Plans ), from engaging in certain transactions involving plan assets with persons who are parties in interest under ERISA or disqualified persons under the Code ( Parties in Interest ) with respect to certain Plans. As a result of our business we, or our affiliates, may be a Party in Interest with respect to certain Plans. Where we are a Party in Interest with respect to a Plan, the purchase and holding of the subordinated notes by or on behalf of the Plan may be a prohibited transaction under Section 406(a)(l) of ERISA and Section 4975(c)(l) of the Code, unless exemptive relief were available under an applicable administrative exemption (as described below) or there was some other basis on which the transaction was not prohibited.

Accordingly, the subordinated notes may not be purchased or held by any Plan, any entity whose underlying assets include plan assets by reason of any Plan s investment in the entity (a Plan Asset Entity ) or any person investing plan assets of any Plan, unless such purchaser or holder is eligible for the exemptive relief available under Prohibited Transaction Class Exemption ( PTCE ) 96-23, 95-60, 91-38, 90-1 or 84-14 issued by the U.S. Department of Labor or there is some other basis on which the purchase and holding of the subordinated notes by the Plan Asset Entity is not prohibited. Any purchaser or holder of the subordinated notes or any interest therein will be deemed to have represented by its purchase and holding thereof that either (a) it is not a Plan or a Plan Asset Entity and is not purchasing the subordinated notes on behalf of or with plan assets of any Plan or (b) its purchase and holding of the subordinated notes is eligible for the exemptive relief available under PTCE 96-23, 95-60, 91-38, 90-1 or 84-14 or such purchase and holding is otherwise not prohibited.

Employee benefit plans that are governmental plans (as defined in Section 3(32) of ERISA), certain church plans (as defined in Section 3(33) of ERISA) and foreign plans (as described in Section 4(b)(4) of ERISA) are not subject to these prohibited transaction rules of ERISA or Section 4975 of the Code, but may be subject to similar rules under other applicable laws or documents.

Due to the complexity of the applicable rules, it is particularly important that any Plan fiduciaries or other persons proposing to cause a Plan to purchase subordinated notes should consult with their legal counsel regarding the relevant provisions of ERISA and the Code and the availability of exemptive relief under PTCE 96-23, 95-60, 91-38, 90-1 or 84-14.

The sale of any subordinated notes to a Plan is in no respect a representation by any party or entity that such an investment meets all relevant legal requirements with respect to investments by Plans generally or any particular Plan, or that such an investment is appropriate for Plans generally or any particular Plan.

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## UNDERWRITING

Subject to the terms and conditions of the purchase agreement among us and the underwriters named below, for which Keefe, Bruyette & Woods, Inc. is acting as representative, the underwriters have severally agreed to purchase and we have agreed to sell to them, the principal amount of subordinated notes listed below opposite their names.

| Underwriters | Principal Amount of Subordinated Notes |
|---|---|
| Keefe, Bruyette & Woods, Inc. | $ 50,000,000 |
| BB&T Capital Markets, a division of Scott & Stringfellow, Inc. | 16,667,000 |
| J.P. Morgan Securities Inc. | 16,667,000 |
| SunTrust Capital Markets, Inc. | 16,666,000 |
| Total | $ 100,000,000 |

The purchase agreement provides that the obligations of the underwriters are subject to approval of certain legal matters by their counsel and to certain other customary conditions. The obligations of the underwriters may also be terminated upon the occurrence of the events specified in the purchase agreement. The purchase agreement provides that the underwriters are obligated to purchase all of the subordinated notes in this offering if any are purchased.

The underwriters propose to offer the subordinated notes initially directly to the public at the public offering price set forth on the cover page of this prospectus supplement. The underwriters may offer the subordinated notes to securities dealers at the public offering price less a concession not in excess of 0.40% per subordinated note. The underwriters may allow, and the dealers may reallow, a discount not in excess of 0.25% per subordinated note to other brokers and dealers. If all of the subordinated notes are not sold at the initial public offering price, the underwriters may change the offering price and other selling terms.

The information below shows per subordinated note the underwriting commissions to be paid by Fulton Financial in connection with this offering (expressed as a percentage of the principal amount of the subordinated notes).

| | |
|---|---|
| Per subordinated note | 0.650% |

The expenses of the offering, not including the underwriting commission, are estimated to be $400,000 and are payable by us.

We have agreed to indemnify the underwriters against certain liabilities, including liabilities under the Securities Act.

In connection with the offering of the subordinated notes, the underwriters may purchase and sell subordinated notes in the open market. These transactions may include short sales, stabilizing transactions and purchases to cover positions created by short sales. Short sales involve the sale by the underwriters of a greater principal amount of subordinated notes than they are required to purchase in the offering of the subordinated notes. Stabilizing transactions consist of certain bids or purchases made for the purpose of preventing or retarding a decline in the market price of the subordinated notes while the offering of the subordinated notes is in progress.

The underwriters also may impose a penalty bid. This occurs when a particular underwriter repays to the underwriters a portion of the underwriting discount received by it because the representative has repurchased subordinated notes sold by or for the account of such underwriter in stabilizing or short covering transactions.

These activities by the underwriters may stabilize, maintain or otherwise affect the market prices of the subordinated notes. As a result, the prices of the subordinated notes may be higher than the prices that otherwise might exist in the open market. If these activities are commenced, they may be discontinued by the underwriters at any time. These transactions may be effected in the over-the-counter market or otherwise.

We may use a portion of the net proceeds from this offering to reduce the amount outstanding under our $100 million Revolving Credit Agreement with SunTrust Bank, dated as of July 12, 2004, as amended. As a result, SunTrust Bank may receive more than 10% of the net proceeds of this offering. SunTrust Bank is an affiliate of SunTrust Capital Markets, Inc., one of the underwriters. Accordingly, this offering is being made in compliance with the requirements of Rule 2710(h) of the Conduct Rules of the National Association of Securities Dealers, Inc.

Certain of the underwriters and their affiliates have performed and may perform in the future, from time to time, investment banking and other services (in addition to those described in the previous paragraph) for us in the ordinary course of business and have received and may receive customary fees from us for their services.

## LEGAL MATTERS

Certain legal matters will be passed upon for Fulton Financial by Thacher Proffitt & Wood llp and Barley Snyder LLC. Certain legal matters will be passed upon for the underwriters by Sidley Austin LLP .

## EXPERTS

The consolidated financial statements of Fulton Financial as of December 31, 2006 and 2005, and for each of the years in the three-year period ended December 31, 2006, and management s assessment of the effectiveness of internal control over financial reporting as of December 31, 2006, have been incorporated by reference herein in reliance upon the reports of KPMG LLP, independent registered public accounting firm, incorporated by reference herein, and upon the authority of said firm as experts in accounting and auditing.

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**PROSPECTUS**

**Fulton Financial Corporation**
**Common Stock**
**Preferred Stock**
**Subordinated Notes**
**Junior Subordinated Debt Securities**
**Guarantees**
**Fulton Capital Trust I**
**Fulton Capital Trust II**
**Fulton Capital Trust III**
**Fulton Capital Trust IV**
**Capital Securities**

We will provide the specific terms of the securities in supplements to this prospectus. You should read this prospectus and the applicable prospectus supplement carefully before you invest in the securities described in the applicable prospectus supplement. This prospectus may not be used to consummate sales of securities unless accompanied by a prospectus supplement and a pricing supplement, if any.

We may sell the securities to or through underwriters, and also to other purchasers or through agents. The names of the underwriters will be stated in the prospectus supplements and other offering material. We may also sell securities directly to investors.

Our common stock trades on the Global Select Market of The Nasdaq Stock Market, Inc. referred to as NASDAQ, under the trading symbol FULT. Any common stock that we sell pursuant to any supplement to this prospectus will be listed for quotation on the Global Select Market of NASDAQ upon official notice of issuance.

*These securities are unsecured and are not savings accounts or deposits of any of our bank or non-bank subsidiaries, and are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. These securities involve investment risks, including possible loss of principal.*

*This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.*

*Neither the Securities and Exchange Commission, referred to as the SEC, nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy of this prospectus. Any representation to the contrary is a criminal offense.*

The date of this prospectus is April 25, 2007.

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|---|---|
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| Incorporation of Certain Documents by Reference | 2 |
| Description of Subordinated Notes | 2 |
| Experts | 5 |

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## WHERE YOU CAN FIND MORE INFORMATION

Fulton Financial Corporation, referred to as Fulton Financial, files reports, proxy statements and other information with the SEC under the Securities Exchange Act of 1934, as amended, referred to as the Exchange Act. You may read and copy this information at prescribed rates at the following location of the SEC:

Public Reference Room
100 F Street, N.E.
Washington, D.C. 20549

You can also obtain additional information about the operation of the SEC s public reference facilities by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet web site that contains reports, proxy statements and other information about issuers like us who file electronically with the SEC. The address of that site is *www.sec.gov*.

The common stock of Fulton Financial is traded on the NASDAQ under the symbol FULT. You can also inspect information about Fulton Financial by visiting the NASDAQ web site (*www.nasdaq.com*). Our Internet web site is *www.fult.com*. Information contained in our web site does not constitute part of this prospectus.

*We have not included separate financial statements of any of the co-registrant statutory trusts in this prospectus and we will not prepare separate financial statements of any of these trusts in the future. We do not consider that such financial statements would be material to holders of the capital securities of a particular trust because Fulton Financial will fully, irrevocably and unconditionally guarantee, on a subordinated basis, payments on those capital securities to the extent described in this prospectus and the applicable prospectus supplement and each of the trusts is a newly-formed special purpose entity, has no operating history or independent operations, is not engaged in and does not propose to engage in any activity other than holding as its assets our debt securities, issuing, in the future, its capital securities to investors and common securities to Fulton Financial and engaging in incidental activities. Fulton Financial does not expect that any of these trusts will file reports, proxy statements and other information under the Exchange Act with the SEC.*

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## INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

We are incorporating information into this prospectus by reference, which means that we are disclosing important information to you by referring you to documents filed with the SEC. The information incorporated by reference is considered to be a part of this prospectus, except as discussed below.

The following documents that we have filed with the SEC are incorporated into this prospectus by reference (other than information that pursuant to SEC rules is deemed not to be filed):

*Annual Report on Form 10-K for the year ended December 31, 2006, filed March 1, 2007; and*

*Current Reports on Form 8-K filed January 17, 2007 and March 20, 2007.*

All future filings that we make with the SEC, such as Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and proxy statements, are incorporated by reference into this prospectus and any supplements to this prospectus (other than information that pursuant to SEC rules is deemed not to be filed). Any statement contained in a document incorporated by reference in this prospectus will be deemed to be modified or superseded for purposes of this prospectus to the extent that any statement contained in this prospectus or in any subsequently filed document which also is or is deemed to be incorporated by reference in this prospectus modifies or supersedes this statement. Any statement modified or superseded in this way will not be deemed, except as so modified or superseded, to constitute a part of this prospectus or any supplement to this prospectus. The information incorporated by reference contains information about us and our financial condition and performance and is an important part of this prospectus.

You can obtain any of the documents incorporated by reference in this prospectus from us, or from the SEC, through the SEC s Internet web site at the address specified above. Documents incorporated by reference in this prospectus are available without charge, excluding all exhibits unless we have specifically incorporated an exhibit into this document by reference. You may obtain documents incorporated by reference in this document by requesting them by writing or telephoning us at:

Fulton Financial Corporation
One Penn Square, P.O. Box 4887
Lancaster, PA 17604
Attention: Corporate Secretary
(717) 291-2411

You should rely only on the information included or incorporated by reference in this prospectus. We have not authorized anyone to give any information or make any representation about us that is different from, or in addition to, those included or incorporated by reference in this prospectus. If anyone does give you any additional or different information, you should not rely on it. The information included or incorporated by reference in this prospectus speaks only as of the date of this document unless the information specifically indicates that another date applies.

## DESCRIPTION OF SUBORDINATED NOTES

The subordinated notes will be general unsecured subordinated obligations of Fulton Financial. The indenture to be executed between Fulton Financial and Wilmington Trust Company, as Trustee, referred to as the indenture, does not limit the amount of subordinated notes that we may issue from time to time in one or more series. The indenture provides that subordinated notes may be issued up to the principal amount authorized by us from time to time. Unless otherwise specified in the prospectus supplement for a particular series of subordinated notes, we may reopen a previous issue of a series of subordinated notes and issue additional subordinated notes of that series.

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We will specify in the prospectus supplement relating to a particular series of subordinated notes being offered the terms relating to the offering. The terms may include:

- the form of the subordinated notes of the series;
- the title of the subordinated notes of the series (which shall distinguish the subordinated notes of the series from all other subordinated notes);
- any limit upon the aggregate principal amount of the subordinated notes of the series which may be authenticated and delivered under the indenture (except for subordinated notes authenticated and delivered upon registration of transfer of, or in exchange for, or in lieu of, other subordinated notes of the same series pursuant to article two of the indenture);
- the date or dates on which such subordinated notes may be issued;
- the date or dates on which the subordinated notes will mature;
- the date or dates, which may be serial, on which the principal of, and premium, if any, on the subordinated notes of such series shall be payable;
- the rate or rates, or the method of determination thereof, at which the subordinated notes of such series shall bear interest, if any, the date or dates from which such interest shall accrue and the interest payment dates on which such interest shall be payable;
- the place or places where the principal of, and premium, if any, and interest, if any, on subordinated notes of the series shall be payable;
- if other than denominations of 1,000 and any integral multiple thereof, in dollars or the foreign currency or currency unit in which the subordinated notes of such series are denominated, the denominations in which subordinated notes of such series shall be issuable;
- if other than the principal amount thereof, the portion of the principal amount of subordinated notes of such series which shall be payable upon declaration of acceleration of the maturity date thereof or provable in bankruptcy;
- whether payment of the principal of, premium, if any, and interest, if any, on the subordinated notes of such series shall be with or without deduction for taxes, assessments or governmental charges, and with or without reimbursement of taxes, assessments or governmental charges paid by noteholders;
- any events of default with respect to the subordinated notes of such series;
- in case the subordinated notes of such series do not bear interest, the applicable dates for providing notice to noteholders;
- a description of any provisions providing for redemption, exchange or conversion of the subordinated notes of the series at Fulton Financial s option, a noteholder s option or otherwise, and the terms and provisions of such redemption, exchange or conversion;
- the currency or currencies, or currency unit or currency units, whether in dollars or a foreign currency or currency unit, in which the principal of, and premium, if any, and interest, if any, on the subordinated notes of

such series or any other amounts payable with respect thereto will be payable, and whether such principal, premium, if any, and interest, if any, payable otherwise than in dollars may, at the option of the noteholders of any subordinated notes of such series, also be payable in dollars;

the provisions for the satisfaction and discharge of the indebtedness represented by the subordinated notes of such series;

whether the subordinated notes of such series are issuable as a global note and, in such case, the identity of the depositary for such series;

if the amount of payment of principal of (and premium, if any) or interest on the subordinated notes of such series may be determined with reference to an index, formula or other method based on a coin, currency or currency unit other than that in which the subordinated notes are stated to be payable or otherwise, the manner in which such amounts shall be determined;

any other terms of such series (which terms shall not be inconsistent with the provisions of the indenture); and

any trustees, paying agents, or registrars with respect to the subordinated notes of such series.

We intend for any subordinated notes offered to qualify (subject to applicable limitations) as Tier 2 capital under Federal Reserve Board interpretations.

If any of the subordinated notes are sold for, or if the principal of or any interest on any series of subordinated notes is payable in, foreign currencies or foreign currency units, the relevant restrictions, elections, tax consequences, specific terms and other information will be set forth in the applicable prospectus supplement.

Each series of subordinated notes will be issued in fully registered form unless the prospectus supplement provides otherwise.

The principal of, and premium and interest on, subordinated notes will be payable at the place of payment designated for such securities and stated in the prospectus supplement. Fulton Financial also has the right to make interest payments by check mailed to the holder at the holder s registered address. The principal of, and premium, if any, and interest on any subordinated notes in other forms will be payable in the manner and at the place or places as may be designated by Fulton Financial and specified in the prospectus supplement.

You may exchange or transfer the subordinated notes at the corporate trust office of the trustee for the series of subordinated notes or at any other office or agency maintained by us for those purposes. We will not require payment of a service charge for any transfer or exchange of the subordinated notes, but Fulton Financial may require payment of a sum sufficient to cover any applicable tax or other governmental charge.

Unless the prospectus supplement provides otherwise, each series of the subordinated notes will be issued only in denominations of $1,000 or any integral multiple thereof and payable in dollars. Under the indenture, however, subordinated notes may be issued in any denomination and payable in a foreign currency or currency unit.

We may issue subordinated notes with original issue discount. Original issue discount subordinated notes bear no interest or bear interest at below-market rates and will be sold below their stated principal amount. The prospectus supplement will describe any special federal income tax consequences and other special considerations applicable to any securities issued with original issue discount.

The subordinated notes will rank equally with all other unsecured subordinated indebtedness of Fulton Financial, provided that the subordinated notes will rank senior to the junior subordinated debentures Fulton Financial issues to its capital trust subsidiaries. The subordinated notes will be subordinated in right of payment to all senior indebtedness (as defined in the applicable prospectus supplement) of Fulton Financial. The subordinated notes will rank senior to our obligations relating to the junior subordinated notes issued in connection with trust preferred securities of our special purpose entity subsidiaries. The subordinated notes will effectively be subordinated to all of the existing and future liabilities and obligations of our subsidiaries, including the deposit liabilities and claims of other creditors of our subsidiary banks.

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Upon any payment or distribution of our assets to creditors upon our liquidation, dissolution, winding up, reorganization, assignment for the benefit of our creditors, marshaling of our assets or any bankruptcy, insolvency, debt restructuring or similar proceedings in connection with any insolvency or bankruptcy proceeding involving us, the allocable amounts (as defined in the applicable prospectus supplement) in respect of the senior indebtedness must be paid in full before the holders of the subordinated notes will be entitled to receive or retain any payment in respect of the subordinated notes.

In addition, Fulton Financial may not make any payment on the subordinated notes of a series in the event:

Fulton Financial has failed to make full payment of the principal of, or premium, if any, interest or any other payment due on any senior indebtedness of Fulton Financial, or

the maturity of the subordinated notes of such series has been accelerated, until the holders of all senior indebtedness of Fulton Financial outstanding at the time of such acceleration receive payment, in full, of all allocable amounts due on or in respect of such senior indebtedness (including any amounts due upon acceleration).

## EXPERTS

The consolidated financial statements of Fulton Financial as of December 31, 2006 and 2005, and for each of the years in the three-year period ended December 31, 2006, and management s assessment of the effectiveness of internal control over financial reporting as of December 31, 2006, have been incorporated by reference herein in reliance upon the reports of KPMG LLP, independent registered public accounting firm, incorporated by reference herein, and upon the authority of said firm as experts in accounting and auditing.

**You should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with any additional or different information. This prospectus supplement and the accompanying prospectus do not constitute an offer to sell, or the solicitation of an offer to buy, any of the securities offered hereby to any person in any jurisdiction in which such offer or solicitation would be unlawful. The affairs of Fulton Financial may change after the date of this prospectus supplement.**

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**$100,000,000**

**Fulton Financial Corporation**

**5.75% Subordinated Notes**

**due 2017**

**PROSPECTUS**
**SUPPLEMENT**

**Keefe, Bruyette & Woods**
**BB&T Capital Markets**
**JPMorgan**
**SunTrust Robinson Humphrey**

April 26, 2007

pace: nowrap; vertical-align: text-bottom; text-align:
left"> 48,138 Time 46,872 33,662 31,019 89,001 1,641 202,195 Securities sold under agreements to repurchase 51,164 51,164 Short-tem borrowings Long-term debt 6,515 1,388 14,964 48,016 2 70,885 Interest rate swaps (pay side) 20,000 20,000 Total interest-bearing liabilities **$546,370 $35,050 $45,983 $157,017 $1,643 $786,063** Interest rate gap **$(111,315) $941 $8,647 $75,008 $143,651 $116,932** Cumulative interest rate gap **$(111,315) $(110,374) $(101,727) $(26,719) $116,932**

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.

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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: | **$ 34,251** | **$ 34,135** | **$ 35,327** |
| Percentage change | **0.3%** | | **3.5%** |
| Change in net interest income, year two: | **$ 34,273** | **$ 34,444** | **$ 36,895** |
| Percent change | **-0.5%** | | **7.1%** |

| | -100 bps | Unchanged | +100 bps | +200 bps |
|---|---|---|---|---|
| Economic value of portfolio equity (EVE): | **$ 87,285** | **$ 95,609** | **$ 94,141** | **$ 95,426** |
| Percentage change | **-8.7%** | | **-1.5%** | **-0.2%** |

# 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 Company ) as of December 31, 2010 and 2009, 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, 2010. These consolidated financial statements are the responsibility of the Company 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, 2010 and 2009, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2010, 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 Company s internal control over financial reporting as of December 31, 2010, 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 11, 2011 expressed an unqualified opinion.

/s/ ParenteBeard LLC

Harrisburg, Pennsylvania
March 11, 2011

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# FRANKLIN FINANCIAL SERVICES CORPORATION

## Consolidated Balance Sheets

| | December 31 | |
|---|---|---|
| (Amounts in thousands, except share and per share data) | 2010 | 2009 |
| Assets | | |
| Cash and due from banks | **$11,528** | $14,336 |
| Interest-bearing deposits in other banks | **10,578** | 18,912 |
| Total cash and cash equivalents | **22,106** | 33,248 |
| Investment securities available for sale, at fair value | **117,616** | 143,288 |
| Restricted stock | **6,159** | 6,482 |
| Loans | **748,642** | 739,563 |
| Allowance for loan losses | **(8,801)** | (8,937) |
| Net Loans | **739,841** | 730,626 |
| Premises and equipment, net | **16,592** | 15,741 |
| Bank owned life insurance | **19,591** | 18,919 |
| Goodwill | **9,016** | 9,159 |
| Other intangible assets | **2,004** | 2,461 |
| Other assets | **18,964** | 19,449 |
| Total assets | **$951,889** | $979,373 |
| Liabilities | | |
| Deposits | | |
| Demand (noninterest-bearing) | **$90,317** | $77,675 |
| Savings and interest checking | **441,819** | 388,222 |
| Time | **202,195** | 272,468 |
| Total Deposits | **734,331** | 738,365 |
| Securities sold under agreements to repurchase | **51,164** | 55,855 |
| Long-term debt | **70,885** | 94,688 |
| Other liabilities | **12,870** | 11,699 |
| Total liabilities | **869,250** | 900,607 |
| Shareholders equity | | |
| Common stock, $1 par value per share,15,000,000 shares authorized with 4,317,058 shares issued and 3,919,108 shares outstanding at December 31, 2010 and 4,298,904 shares issued and 3,863,066 shares outstanding at December 31, 2009 | **4,317** | 4,299 |
| Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding | | |
| Additional paid-in capital | **33,096** | 32,832 |
| Retained earnings | **57,984** | 54,566 |
| Accumulated other comprehensive loss | **(5,642)** | (5,138) |
| Treasury stock, 397,950 and 435,838 shares at cost at December 31, 2010 and 2009, respectively | **(7,116)** | (7,793) |
| Total shareholders equity | **82,639** | 78,766 |

| | | |
|---|---|---|
| Total liabilities and shareholders equity | **$951,889** | $979,373 |

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

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# FRANKLIN FINANCIAL SERVICES CORPORATION

## Consolidated Statements of Income

| (Amounts in thousands, except per share data) | Years ended December 31 2010 | 2009 | 2008 |
|---|---|---|---|
| Interest income | | | |
| Loans, including fees | **$ 38,537** | $ 37,829 | $ 38,654 |
| Interest and dividends on investments: | | | |
| Taxable interest | **3,037** | 3,969 | 5,117 |
| Tax exempt interest | **1,625** | 1,779 | 2,060 |
| Dividend income | **52** | 150 | 282 |
| Federal funds sold | | 12 | 37 |
| Deposits and obligations of other banks | **33** | 18 | 6 |
| Total interest income | **43,284** | 43,757 | 46,156 |
| Interest expense | | | |
| Deposits | **8,445** | 10,320 | 11,026 |
| Securities sold under agreements to repurchase | **151** | 168 | 1,412 |
| Short-term borrowings | **1** | 14 | 200 |
| Long-term debt | **3,846** | 4,172 | 3,399 |
| Total interest expense | **12,443** | 14,674 | 16,037 |
| Net interest income | **30,841** | 29,083 | 30,119 |
| Provision for loan losses | **3,235** | 3,438 | 1,193 |
| Net interest income after provision for loan losses | **27,606** | 25,645 | 28,926 |
| Noninterest income | | | |
| Investment and trust services fees | **3,844** | 3,519 | 3,500 |
| Loan service charges | **1,132** | 1,151 | 897 |
| Mortgage banking activities | **146** | 145 | (335) |
| Deposit service charges and fees | **2,390** | 2,575 | 2,569 |
| Other service charges and fees | **1,390** | 1,292 | 1,210 |
| Increase in cash surrender value of life insurance | **672** | 643 | 660 |
| Equity method investment | | | (143) |
| Exchange of equity method investment | | | (1,205) |
| Other | **178** | 499 | 109 |
| OTTI losses on securities | **(1,373)** | (422) | (888) |
| Less: Loss recognized in other comprehensive loss (before taxes) | **(314)** | | |
| Net OTTI losses recognized in earnings | **(1,059)** | (422) | (888) |
| Securities gains (losses), net | **673** | (522) | 164 |
| Total noninterest income | **9,366** | 8,880 | 6,538 |
| Noninterest expense | | | |
| Salaries and employee benefits | **13,592** | 12,713 | 12,086 |
| Net occupancy expense | **1,962** | 1,898 | 1,792 |
| Furniture and equipment expense | **781** | 850 | 843 |
| Advertising | **1,342** | 1,226 | 1,663 |

| | | | |
|---|---|---|---|
| Legal and professional fees | **1,505** | 1,697 | 1,146 |
| Data processing | **1,617** | 1,538 | 1,430 |
| Pennsylvania bank shares tax | **610** | 573 | 367 |
| Intangible amortization | **457** | 468 | 370 |
| FDIC insurance | **1,178** | 1,397 | 105 |
| Other | **3,379** | 3,569 | 3,387 |
| Total noninterest expense | **26,423** | 25,929 | 23,189 |
| Income before federal income taxes | **10,549** | 8,596 | 12,275 |
| Federal income tax expense | **2,937** | 2,011 | 3,680 |
| Net income | **$ 7,612** | $ 6,585 | $ 8,595 |
| Per share | | | |
| Basic earnings per share | **$ 1.96** | $ 1.71 | $ 2.24 |
| Diluted earnings per share | **$ 1.96** | $ 1.71 | $ 2.24 |
| Cash dividends declared | **$ 1.08** | $ 1.08 | $ 1.07 |

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

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# Consolidated Statements of Changes in Shareholders Equity
# For years ended December 31, 2010, 2009, and 2008:

| (Dollars in thousands, except per share data) | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total |
|---|---|---|---|---|---|---|
| Balance at December 31, 2007 | $4,299 | $32,620 | $47,946 | $664 | $(7,887) | $77,642 |
| Comprehensive income: | | | | | | |
| Net income | | | 8,595 | | | 8,595 |
| Unrealized loss on securities, net of reclassification adjustments and taxes | | | | (3,706) | | (3,706) |
| Unrealized loss on hedging activities, net of reclassification adjustments and taxes | | | | (1,602) | | (1,602) |
| Pension adjustment, net of tax | | | | (3,113) | | (3,113) |
| Total Comprehensive income | | | | | | 174 |
| Cash dividends declared, $1.07 per share | | | (4,096) | | | (4,096) |
| Cumulative adjustment for change in accounting principle | | | (319) | | | (319) |
| Acquisition of 53,783 shares of treasury stock | | | | | (1,205) | (1,205) |
| Common stock issued from treasury stock, 1,000 shares | | 4 | | | 18 | 22 |
| Common stock issued under stock option plans, 329 shares | | 1 | | | 6 | 7 |
| Treasury shares issued to fund dividend reinvestment plan, 32,474 shares | | 146 | | | 576 | 722 |
| Stock option compensation | | 112 | | | | 112 |
| Balance at December 31, 2008 | 4,299 | 32,883 | 52,126 | (7,757) | (8,492) | 73,059 |
| Comprehensive income: | | | | | | |
| Net income | | | 6,585 | | | 6,585 |
| Unrealized gain on securities, net of reclassification adjustments and taxes | | | | 1,744 | | 1,744 |
| | | | | 801 | | 801 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Unrealized gain on hedging activities, net of reclassification adjustments and taxes | | | | | | |
| Pension adjustment, net of tax | | | | 74 | | 74 |
| Total Comprehensive income | | | | | | 9,204 |
| Cash dividends declared, $1.08 per share | | | (4,145 ) | | | (4,145 ) |
| Acquisition of 9,819 shares of treasury stock | | | | | (160 ) | (160 ) |
| Treasury shares issued to fund dividend reinvestment plan, 47,874 shares | | (80 ) | | | 857 | 777 |
| Common stock issued under stock option plans, 113 shares | | | | | 2 | 2 |
| Stock option compensation | | 29 | | | | 29 |
| Balance at December 31, 2009 | 4,299 | 32,832 | 54,566 | (5,138 ) | (7,793 ) | 78,766 |
| Comprehensive income: | | | | | | |
| Net income | | | **7,612** | | | **7,612** |
| Unrealized gain on securities, net of reclassification adjustments and taxes | | | | **530** | | **530** |
| Unrealized loss on hedging activities, net of reclassification adjustments and taxes | | | | **(322)** | | **(322)** |
| Pension adjustment, net of tax | | | | **(712)** | | **(712)** |
| Total Comprehensive income | | | | | | **7,108** |
| Cash dividends declared, $1.08 per share | | | **(4,194)** | | | **(4,194)** |
| Treasury shares issued to fund dividend reinvestment plan, 36,250 shares | | **(31)** | | | **648** | **617** |
| Common stock issued under stock option plans, 1,098 shares | | **(3)** | | | **29** | **26** |
| Common stock issued under dividend reinvestment plan, 18,154 shares | **18** | **298** | | | | **316** |
| Balance at December 31, 2010 | **$4,317** | **$33,096** | **$57,984** | **$(5,642)** | **$(7,116)** | **$82,639** |

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

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# Consolidated Statements of Cash Flows

| | Years ended December 31 | | |
|---|---|---|---|
| (Amounts in thousands) | 2010 | 2009 | 2008 |
| Cash flows from operating activities | | | |
| Net income | **$7,612** | $6,585 | $8,595 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | **1,344** | 1,419 | 1,321 |
| Net amortization (accretion) of loans and investment securities | **410** | 170 | (189) |
| Stock option compensation expense | | 29 | 112 |
| Amortization and net change in mortgage servicing rights valuation | **121** | 157 | 786 |
| Amortization of intangibles | **457** | 468 | 370 |
| Provision for loan losses | **3,235** | 3,438 | 1,193 |
| Net realized (gains) losses on sales and calls of securities | **(673)** | 522 | (164) |
| Impairment write down on securities | **1,059** | 422 | 888 |
| Loans originated for sale | **(920)** | (647) | (4,415) |
| Proceeds from sale of loans | **952** | 659 | 4,985 |
| Gain on sales of loans | **(32)** | (12) | (94) |
| Net (gain) loss on sale or disposal of premises and equipment | **(61)** | 120 | |
| Net loss (gain) on sale or disposal of other real estate/other repossessed assets | **15** | (30) | 40 |
| Increase in cash surrender value of life insurance | **(672)** | (643) | (660) |
| Gain from surrender of life insurance policy | | (278) | |
| Loss on equity method investments | | | 143 |
| Loss on exchange of equity method investment | | | 1,205 |
| Contribution to pension plan | **(626)** | (243) | (333) |
| Decrease (increase) in interest receivable and other assets | **963** | (3,483) | (1,135) |
| (Decrease) increase in interest payable and other liabilities | **(515)** | 399 | (1,888) |
| Deferred tax (benefit) expense | **(240)** | (742) | 246 |
| Other, net | **(71)** | 306 | 41 |
| Net cash provided by operating activities | **12,358** | 8,616 | 11,047 |
| Cash flows from investing activities | | | |
| Proceeds from sales and calls of investment securities available for sale | **25,322** | 10,217 | 10,044 |
| Proceeds from maturities and pay downs of investment securities available for sale | **29,713** | 38,916 | 46,047 |
| Net decrease (increase) in restricted stock | **323** | | (2,566) |
| Purchase of investment securities available for sale | **(28,123)** | (43,014) | (42,454) |
| Net increase in loans | **(13,415)** | (66,377) | (106,243) |
| Exchange of equity method investment | | | 638 |
| Proceeds from sale of other real estate/other repossessed assets | **448** | 82 | 431 |

| | | | |
|---|---|---|---|
| Proceeds from sale or disposal of premises and equipment | **117** | | |
| Cash and cash equivalents acquired from acquisition | | | 33 |
| Cash paid in acquisition | | | (1,130) |
| Proceeds from surrender of life insurance policy | | 878 | |
| Capital expenditures | **(2,122)** | (1,521) | (2,571) |
| Net cash provided by (used) in investing activities | **12,263** | (60,819) | (97,771) |
| Cash flows from financing activities | | | |
| Net increase (decrease) in demand deposits, NOW accounts and savings accounts | **66,239** | 43,525 | (23,791) |
| Net (decrease) increase in time deposits | **(70,273)** | 67,499 | 44,855 |
| Net (decrease) increase in short-term borrowings and repurchase agreements | **(4,691)** | (27,307) | 15,005 |
| Long-term debt advances | | 379 | 57,057 |
| Long-term debt payments | **(23,803)** | (11,832) | (10,630) |
| Dividends paid | **(4,194)** | (4,145) | (4,096) |
| Common stock issued under stock option plans | **26** | | 7 |
| Common stock issued from treasury shares | | 2 | 22 |
| Common stock issued under dividend reinvestment plan | **316** | | |
| Common stock issued to dividend reinvestment plan | **617** | 777 | 722 |
| Purchase of treasury shares | | (160) | (1,205) |
| Net cash (used in) provided by financing activities | **(35,763)** | 68,738 | 77,946 |
| (Decrease) increase in cash and cash equivalents | **(11,142)** | 16,535 | (8,778) |
| Cash and cash equivalents as of January 1 | **33,248** | 16,713 | 25,491 |
| Cash and cash equivalents as of December 31 | **$22,106** | $33,248 | $16,713 |
| Supplemental Disclosures of Cash Flow Information | | | |
| Cash paid during the year for: | | | |
| Interest on deposits and other borrowed funds | **$12,974** | $14,866 | $16,058 |
| Income taxes | **$4,012** | $2,119 | $4,060 |
| Noncash Activities | | | |
| Loans transferred to Other Real Estate | **$438** | $643 | $ |

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

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# 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.

**New Accounting Guidance** In June 2009, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Codification ( ASC ) 105 Generally Accepted Accounting Principles. The ASC is the official source of authoritative United States Generally Accepted Accounting Principles ( GAAP ) superseding existing FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force, and related literature. Rules and interpretive releases of the Securities and Exchange Commission ( SEC ) under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to GAAP in financial statements and accounting policies. ASC 105 became effective during the third quarter of 2009 and did not have a significant impact on the Corporation s financial statements.

**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.

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 1. Summary of Significant Accounting Policies (continued)

**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, 2010 and 2009, 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 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 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 Corporationdoes 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** The Bank held $6.2 million of restricted stock at the end of 2010. 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. This stock is carried at a cost of $100 per share. 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). 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. However, during the fourth quarter of 2010, FHLB repurchased $323 thousand of its capital stock as part of a one-time special repurchase. 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

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 1. Summary of Significant Accounting Policies (continued)

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, 2010.

**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 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.

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 judgement 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.

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 1. Summary of Significant Accounting Policies (continued)

**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. The Bank had $167 thousand in loans held for sale at December 31, 2010.

**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 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 $79.9 million, $101.2 million and $138.5 million at December 31, 2010, 2009 and 2008, 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.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 1. Summary of Significant Accounting Policies (continued)

The Corporation s allowance for possible loan losses consists of three elements: (1) specific valuation allowances established for probable losses on specific loans; (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 of current conditions; and (3) unallocated general valuation allowances determined based on 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, 2010 and subsequently reviewed by Management as of December 31, 2010. Goodwill was determined not to be 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 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

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 1. Summary of Significant Accounting Policies (continued)

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. Adoption of ASC Topic 740, Income Taxes did not have a significant impact on the Corporation s financial statements.

**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, 2010 were $490.4 million. 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. Such financial instruments are recorded on the balance sheet when they are funded.

**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 2010, $29 thousand in 2009 and $112 thousand in 2008. 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. The 2008 expense is related to options granted in February 2008 under the Corporation s Incentive Stock Option Plan of 2002 and was fully expensed in 2008.

**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

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 1. Summary of Significant Accounting Policies (continued)

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:

| *(In thousands, except per share data)* | 2010 | 2009 | 2008 |
|---|---|---|---|
| Weighted average shares outstanding (basic) | **3,887** | 3,840 | 3,829 |
| Impact of common stock equivalents | **1** | | 1 |
| Weighted average shares outstanding (diluted) | **3,888** | 3,840 | 3,830 |
| Anti-dilutive options excluded from calculation | **74** | 76 | 75 |
| Net income | **$ 7,612** | $ 6,585 | $ 8,595 |
| Basic earnings per share | **$ 1.96** | $ 1.71 | $ 2.24 |
| Diluted earnings per share | **$ 1.96** | $ 1.71 | $ 2.24 |

**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 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:

Receivables and the Allowances for Credit Losses. In July 2010, the FASB issued Accounting Standards Update No. (ASU) 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowances for Credit Losses*. This Update requires expanded disclosures to help financial statement users understand the nature of credit risks inherent in a creditor s portfolio of financing receivables; how that risk is analyzed and assessed in arriving at the allowance for credit losses; and the changes, and reasons for those changes, in both the receivables and the allowance for credit losses. The disclosures should be prepared on a disaggregated basis and provide a roll-forward schedule of the allowance for credit losses and detailed information on financing receivables including, among other things, recorded balances, nonaccrual status, impairments, credit quality indicators, details for troubled debt restructurings and an aging

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 1. Summary of Significant Accounting Policies (continued)

of past due financing receivables. Disclosures required as of the end of a reporting period are effective for interim and annual reporting periods ending after December 15, 2010. Disclosures required for activity occurring during a reporting period are effective for interim and annual reporting periods beginning after December 15, 2010. This Update did not have a material affect on the Corporation s financial position or consolidated financial statements.

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

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

Troubled Debt Restructuring. The amendments in ASU 2011-01, *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings* temporarily delay the effective date of the disclosures about troubled debt restructurings in Update 2010-20 for public entities. Under the existing effective date in Update 2010-20, public entity creditors would have provided disclosures about troubled debt restructurings for periods beginning on or after December 15, 2010. The delay is intended to allow the Board time to complete its deliberations on what constitutes a troubled debt restructuring. The effective date of the new disclosure about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring will then be coordinated. Currently, that guidance is anticipated to be effective for interim and annual periods ending after June 15, 2011. The deferral in this amendment is effective upon issuance and is not expected to have a material affect on the Corporation s financial position or consolidated financial statements.

Proforma Disclosures for Business Combinations. The objective of this ASU 2010-29, *Business Combinations,* is to address diversity in practice about the interpretation of the pro forma revenue and earnings disclosure requirements for business combinations. Paragraph 805-10-50-2(h) requires a public entity to disclose pro forma information for business combinations that occurred in the current reporting period. The disclosures include pro forma revenue and earnings for the combined entity for the current reporting period as

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 1. Summary of Significant Accounting Policies (continued)

though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, the pro forma revenue and earnings of the combined entity for the comparable prior reporting period should be reported as though the acquisition date for all business combinations that occurred during the current year had been as of the beginning of the comparable prior annual reporting period. The amendments in this Update specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments in this Update also expand the supplemental pro forma disclosures under Topic 805 to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma earnings. The amendments in this Update are effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010 and is not expected to have a material affect on the Corporation s financial position or consolidated financial statements.

## 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 $57.6 million at December 31, 2010. 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, 2010, that the Corporation and the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2010 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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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 2. Regulatory Matters (continued)

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, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | Minimum to be Adequately Capitalized | | Minimum to be Well Capitalized | |
| *(Dollars in thousands)* | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Risk-based Capital Ratio | | | | | | |
| 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%** |
| Tier 1 Risk-based Capital Ratio | | | | | | |
| 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%** |
| Tier 1 Leverage Ratio | | | | | | |
| 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%** |

| | As of December 31, 2009 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | Minimum to be Adequately Capitalized | | Minimum to be Well Capitalized | |
| *(Dollars in thousands)* | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Risk-based Capital Ratio | | | | | | |
| Corporation | $ 81,009 | 10.89 % | $ 59,521 | 8.00 % | N/A | N/A |
| Bank | 77,369 | 10.45 % | 59,214 | 8.00 % | $ 74,018 | 10.00 % |
| Tier 1 Risk-based Capital Ratio | | | | | | |
| Corporation | $ 72,072 | 9.69 % | $ 29,760 | 4.00 % | N/A | N/A |
| Bank | 68,432 | 9.25 % | 29,607 | 4.00 % | $ 44,411 | 6.00 % |
| Tier 1 Leverage Ratio | | | | | | |
| Corporation | $ 72,072 | 7.50 % | $ 38,454 | 4.00 % | N/A | N/A |
| Bank | 68,432 | 7.13 % | 38,365 | 4.00 % | $ 47,956 | 5.00 % |

## Note 3. Restricted Cash Balances

The Corporation s subsidiary 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 $949 thousand and $851 thousand at December 31, 2010 and 2009, 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, 2010 and 2009, 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 invests 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 trust

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 4. Investments (continued)

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.

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

**(Amounts in thousands)**

| 2010 | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|---|---|---|---|---|
| Equity securities | **$ 4,126** | **$ 50** | **$ (538)** | **$ 3,638** |
| Obligations of U.S. Government agencies | **14,780** | **61** | **(56)** | **14,785** |
| Obligations of state and political subdivisions | **39,477** | **894** | **(419)** | **39,952** |
| Corporate debt securities | **8,522** | **64** | **(1,724)** | **6,862** |
| Mortgage-backed securities | | | | |
| Agency | **47,239** | **1,104** | **(46)** | **48,297** |
| Non Agency | **4,424** | **20** | **(415)** | **4,029** |
| Asset-backed securities | **74** | | **(21)** | **53** |
| | **$ 118,642** | **$ 2,193** | **$ (3,219)** | **$ 117,616** |

**(Amounts in thousands)**

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

At December 31, 2010 and 2009, the amortized cost of investment securities pledged to secure public funds, trust balances, repurchase agreements, deposit and other obligations totaled $108.7 million and $134.6 million, respectively.

The amortized cost and estimated fair value of debt securities at December 31, 2010, by contractual maturity are shown below.

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 4. Investments (continued)

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 | **$ 1,516** | **$ 1,533** |
| Due after one year through five years | **14,306** | **14,642** |
| Due after five years through ten years | **18,656** | **19,091** |
| Due after ten years | **28,375** | **26,386** |
| | **62,853** | **61,652** |
| Mortgage-backed securities | **51,663** | **52,326** |
| | **$ 114,516** | **$ 113,978** |

The composition of the net realized securities gains (losses) for the years ended December 31, 2010, 2009 and 2008 is as follows:

| *(Amounts in thousands)* | 2010 | 2009 | 2008 |
|---|---|---|---|
| Gross gains realized | **$846** | $66 | $ 894 |
| Gross losses realized | **(173)** | (588) | (730) |
| Net gains (losses) realized | **$673** | $(522) | $ 164 |
| Tax provision (benefits) applicable to net securities gains (losses) | **$229** | $(177) | $ 56 |

### Impairment:

At December 31, 2010, the investment portfolio contained 85 temporarily impaired securities with a fair value of $44.1 million and $3.2 million in unrealized losses. The unrealized loss position is improved from year-end 2009 when there were 99 temporarily impaired securities with an unrealized loss of $5.4 million. However, we have seen a large increase in the number and fair value of municipal securities with an unrealized loss, albeit small, since 2009. The investment category with the largest unrealized losses continues to be the corporate bond portfolio (9 securities and $1.7 million unrealized loss) and this represents 54% of the total unrealized loss. However, the unrealized loss in this sector is less than it was at the end of 2009.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. Accordingly, the impairments identified on debt and equity securities, and subjected to the assessment at December 31, 2010, were deemed to be temporary and required no further adjustment to the financial statements, unless otherwise noted.

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## Note 4. Investments (continued)

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, 2010 and 2009:

| | December 31, 2010 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less than 12 months | | | 12 months or more | | | Total | | |
| *(Amounts in thousands)* | Fair Value | Unrealized Losses | Count | Fair Value | Unrealized Losses | Count | Fair Value | Unrealized Losses | Count |
| Equity securities | **$1** | **$ (1)** | **1** | **$3,261** | **$(537)** | **20** | **$3,262** | **$(538)** | **21** |
| Obligations of U.S. Government agencies | **3,476** | **(17)** | **2** | **6,433** | **(39)** | **14** | **9,909** | **(56)** | **16** |
| Obligations of state and political subdivisions | **11,861** | **(405)** | **24** | **292** | **(14)** | **1** | **12,153** | **(419)** | **25** |
| Corporate debt securities | | | | **6,164** | **(1,724)** | **9** | **6,164** | **(1,724)** | **9** |
| Mortgage-backed securities | | | | | | | | | |
| Agency | **9,859** | **(46)** | **6** | | | | **9,859** | **(46)** | **6** |
| Non Agency | | | | **2,676** | **(415)** | **5** | **2,676** | **(415)** | **5** |
| Asset-backed securities | | | | **53** | **(21)** | **3** | **53** | **(21)** | **3** |
| Total temporarily impaired securities | **$25,197** | **$ (469)** | **33** | **$18,879** | **$(2,750)** | **52** | **$44,076** | **$(3,219)** | **85** |

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 4. Investments (continued)

The unrealized loss in the equity portfolio was $538 thousand on 21 issues at year-end, and improvement over the unrealized loss of $1.5 million at year-end 2009. This was caused in by an improvement in the price of bank stocks during 2010 and the write down of the carrying cost of 4 stocks. In 2010, other-than-temporary impairment charges of $724 thousand were recorded in the equity portfolio. The largest single charge was $406 thousand on First Chester County Corporation, as previously discussed.

The unrealized loss in the corporate bond portfolio of $1.7 million is concentrated in trust-preferred securities. Due to the problems in the financial markets the past three years, most trust preferred securities realized a significant decline in value, but market prices have improved since the end of 2009 and the value of the Bank s trust preferred portfolio has improved by $800 thousand during 2010. 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, 2010, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded.

The following table provides additional detail about the Bank s trust preferred securities at December 31, 2010.

Trust Preferred Securities

**(Dollars in thousands)**

The largest unrealized loss in the MBS portfolio is in the non-agency PLMBS sector with an unrealized loss of $395 thousand on 7 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 during 2010. Management determined $335 thousand was credit related and therefore, recorded an impairment charge of $335 thousand against earnings in 2010. 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.

(Dollars in thousands)

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 4. Investments (continued)

The following table provides additional detail about the Bank s PLMBS at December 31, 2010.

Private Label Mortgage Backed Securities

**(Dollars in thousands)**

The following table represents the cumulative credit losses on securities recognized in earnings as of December 31, 2010.

| | Twelve Months Ended December 31, 2010 |
|---|---|
| Balance of cumulative credit losses on securities, January 1, 2010 | $ |
| Additions for credit losses recorded which were not previously recognized as components of earnings | 335 |
| Balance of cumulative credit losses on securities, December 31, 2010 | $ 335 |

## Note 5. Loans

Consumer loans are comprised of direct, indirect (primarily automobile) 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 to 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 included loans to government municipalities. Commercial lending is concentrated the Bank s primary market but also includes purchased loan participations.

# FRANKLIN FINANCIAL SERVICES CORPORATION

# 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:

| *(Amounts in thousands)* | December 31, 2010 | December 31, 2009 |
|---|---|---|
| Residential Real Estate 1 4 Family | | |
| First liens | **$ 144,128** | $ 142,330 |
| Junior liens and lines of credit | **56,694** | 61,460 |
| Total | **200,822** | 203,790 |
| Residential real estate construction | **79,557** | 84,649 |
| Commercial, industrial and agricultural real estate | **304,195** | 283,839 |
| Commercial, industrial and agricultural | **146,672** | 144,035 |
| Consumer | **17,396** | 23,250 |
| | **748,642** | 739,563 |
| Less: Allowance for loan losses | **(8,801)** | (8,937) |
| Net Loans | **$ 739,841** | $ 730,626 |
| Included in the loan balances are the following: | | |
| Net unamortized deferred loan costs | **$ 567** | $ 589 |
| Unamortized discount on purchased loans | **$ (220)** | $ (286) |
| Loans pledged as collateral for borrowings and commitments from: | | |
| FHLB | **$ 648,272** | $ 578,823 |
| Federal Reserve Bank | **53,682** | 122,723 |
| | **$ 701,954** | $ 701,546 |

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

| *(Amounts in thousands)* | 2010 | 2009 |
|---|---|---|
| Balance at beginning of year | **$ 7,798** | $ 10,087 |
| New loans made | **2,613** | 289 |
| Repayments | **(2,339)** | (2,578) |
| Balance at end of year | **$ 8,072** | $ 7,798 |

## Note 6. Loan Quality

Management performs a monthly evaluation of the adequacy of the allowance for loan losses (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. It is Management s general practice to obtain a new appraisal or asset valuation for any loan that it has rated as substandard or higher, including nonaccrual. Management, at its discretion, may determine that additional adjustments to the appraisal or valuation are required. Valuation adjustments will be made as necessary based on other factors, including, but not limited to the economy, deferred maintenance, industry, type of property/equipment etc. and the knowledge Management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated when determining the realizable value to the Bank.

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

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 6. Loan Quality (continued)

For the purposes of calculating the ALL, the Bank segregates its loan portfolio into the following segments based on 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 segment is further segregated by first lien loans, junior liens and home equity products, and residential real estate construction. The residential real estate construction sector contains loans to individuals to construct their own homes as well as loans to contractors and developers to construct homes for resale or develop residential purpose real estate. Included in the residential real estate sectors are loans made for a commercial purpose, but secured by residential real estate. These loans are normally made to small businesses where the residential real estate may be taken as collateral in addition to other business assets in order to provide adequate collateral for the risk.

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. Loans measured for ALL under the specific allocation method normally tend to be impaired commercial, industrial or agricultural in nature, or involve real estate development.

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

The total allowance reflects the Bank s estimate of loan losses inherent in the loan portfolio and considers the ALL of \$8.8 million adequate to cover losses inherent in the portfolio as of December 31, 2010.

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 6. Loan Quality (continued)

The following table presents, by loan segment, the ALL and changes to ALL for the years ended December 31, 2010, 2009 and 2008.

| (Dollars in thousands) | Residential Real Estate 1 4 Family First Liens | Junior Liens & Lines of Credit | Construction | Commercial Industrial & Agricultural Real Estate | Commercial Industrial & Agricultural | Consumer | Total |
|---|---|---|---|---|---|---|---|
| Allowance at December 31, 2007 | | | | | | | $7,361 |
| Charge-offs | | | | | | | (1,433) |
| Recoveries | | | | | | | 236 |
| Provision | | | | | | | 1,193 |
| Allowance at December 31, 2008 | | | | | | | $7,357 |
| 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** |

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 6. Loan Quality (continued)

The following table presents, by loan segment, loans that were evaluated for the ALL under the specific reserve (individually) and those that were evaluated under the general reserve (collectively) as of December 31, 2010 and 2009.

| (Dollars in thousands) | Residential Real Estate 1 4 Family First Liens | Junior Liens & Lines of Credit | Construction | Commercial Industrial & Agricultural Real Estate | Commercial Industrial & Agricultural | Consumer | Total |
|---|---|---|---|---|---|---|---|
| December 31, 2009 | | | | | | | |
| Loans evaluated for allowance: | | | | | | | |
| Individually | $430 | $258 | $7,997 | $8,202 | $1,223 | $13 | $18,123 |
| Collectively | 141,900 | 61,202 | 76,652 | 275,637 | 142,812 | 23,237 | 721,440 |
| Total | $142,330 | $61,460 | $84,649 | $283,839 | $144,035 | $23,250 | $739,563 |
| Allowance established for loans evaluated: | | | | | | | |
| Individually | $ | $ | $2,063 | $2,431 | $383 | $13 | $4,890 |
| Collectively | 550 | 278 | 1,024 | 1,744 | 369 | 82 | 4,047 |
| Allowance at December 31, 2009 | $550 | $278 | $3,087 | $4,175 | $752 | $95 | $8,937 |
| December 31, 2010 | | | | | | | |
| 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 |

In 2008, $349 thousand of gross interest would have been recorded if nonaccrual loans had been current and in accordance with their original terms. Of that amount, $211 thousand was recorded as interest income and $138 thousand was not recognized. Interest income recognized on impaired loans, primarily on a cash basis, was $728 thousand. Total impaired loan balance at December 31, 2008 was $11.3 million, with $8.9 million in impaired loans with an allowance for loan loss totaling $1.3 million. The average recorded investment in impaired loans was $7.6 million.

# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 6. Loan Quality (continued)

The following table shows additional information about those loans considered to be impaired at December 31:

| | December 31 | | | For the Year Ended December 31 | |
|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| (Dollars in thousands) | | | | | |
| 2010 | | | | | |
| Impaired loans with no specific allowance | | | | | |
| Residential Real Estate 1 4 Family | | | | | |
| First liens | $ | $ | $ | $ | $ |
| Junior liens and lines of credit | 122 | 122 | | 122 | |
| Total | 122 | 122 | | 122 | |
| Residential real estate construction | 3,958 | 3,958 | | 3,412 | |
| Commercial, industrial and agricultural real estate | 7,307 | 7,378 | | 7,939 | 248 |
| Commercial, industrial and agricultural | 51 | 52 | | 52 | |
| Consumer | | | | | |
| Total | $11,438 | $11,510 | $ | $11,525 | $ 248 |
| Impaired loans with specific allowance | | | | | |
| Residential Real Estate 1 4 Family | | | | | |
| First liens | $965 | $971 | $ 179 | $991 | $ 41 |
| Junior liens and lines of credit | 286 | 286 | 4 | 301 | 2 |
| Total | 1,251 | 1,257 | 183 | 1,292 | 43 |
| Residential real estate construction | 4,030 | 4,030 | 1,566 | 4,477 | 37 |
| Commercial, industrial and agricultural real estate | 14,118 | 14,312 | 2,170 | 14,279 | 483 |
| Commercial, industrial and agricultural | 2,347 | 2,386 | 854 | 2,444 | 95 |
| Consumer | 3 | 3 | 3 | 4 | |
| Total | $21,749 | $21,988 | $ 4,776 | $22,496 | $ 658 |
| (Dollars in thousands) | | | | | |
| 2009 | | | | | |
| Impaired loans with no specific allowance | | | | | |
| Residential Real Estate 1 4 Family | | | | | |
| First liens | $10 | $10 | $ | $11 | $ 1 |
| Junior liens and lines of credit | 30 | 30 | | 30 | 1 |
| Total | 40 | 40 | | 41 | 2 |
| Residential real estate construction | 3,957 | 3,957 | | 2,484 | 128 |
| Commercial, industrial and agricultural real estate | 1,022 | 1,022 | | 1,031 | 49 |

| | | | | | |
|---|---|---|---|---|---|
| Commercial, industrial and agricultural | 188 | 188 | | 238 | 12 |
| Consumer | | | | | |
| Total | $5,207 | $5,207 | $ | $3,794 | $ 191 |
| Impaired loans with specific allowance | | | | | |
| Residential Real Estate 1 4 Family | | | | | |
| First liens | $420 | $420 | $ | $450 | $ 24 |
| Junior liens and lines of credit | 228 | 2,099 | | 2,066 | 90 |
| Total | 648 | 2,519 | | 2,516 | 114 |
| Residential real estate construction | 4,040 | 4,040 | 2,063 | 4,684 | |
| Commercial, industrial and agricultural real estate | 7,180 | 5,389 | 2,431 | 5,112 | 66 |
| Commercial, industrial and agricultural | 952 | 1,037 | 383 | 1,129 | 29 |
| Consumer | 13 | 13 | 13 | 14 | |
| Total | $12,833 | $12,998 | $ 4,890 | $13,455 | $ 209 |

As part of it process to calculate the ALL, the Bank reviews several credit quality factors including payment status (performing, nonperforming and aging) and internal credit rating.

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 6. Loan Quality (continued)

The following table presents a summary of nonperforminging assets as of December 31 for the following years:

| (Dollars in thousands) | 2010 Balance | % of Loan Segment | 2009 Balance | % of Loan Segment | 2008 Balance | % of Loan Segment |
|---|---|---|---|---|---|---|
| Nonaccrual loans | | | | | | |
| Residential Real Estate 1 4 Family | | | | | | |
| First liens | **$691** | **0.48%** | $345 | 0.24 % | $333 | 0.22 % |
| Junior liens and lines of credit | **122** | **0.22%** | | | | |
| Total | **813** | **0.40%** | 345 | 0.17 % | 333 | 0.15 % |
| Residential real estate construction | **6,500** | **8.17%** | 4,040 | 4.77 % | 1,286 | 1.77 % |
| Commercial, industrial and agricultural real estate | **13,003** | **4.27%** | 5,654 | 1.99 % | | |
| Commercial, industrial and agricultural | **1,668** | **1.14%** | 124 | 0.09 % | 1,252 | 0.95 % |
| Consumer | | | 30 | 0.02 % | | |
| Total nonaccrual loans | **$21,984** | | $10,193 | | $2,871 | |
| Loans past due 90 days or more and not included above | | | | | | |
| Residential Real Estate 1 4 Family | | | | | | |
| First liens | **$1,093** | | $3,060 | | $411 | |
| Junior liens and lines of credit | **833** | | 494 | | 133 | |
| Total | **1,926** | | 3,554 | | 544 | |
| Residential real estate construction | **911** | | 1,426 | | 429 | |
| Commercial, industrial and agricultural real estate | **2,343** | | 1,926 | | | |
| Commercial, industrial and agricultural | **244** | | 960 | | 33 | |
| Consumer | **125** | | 195 | | 123 | |
| Total loans past due 90 days or more and still accruing | **5,549** | | 8,061 | | 1,129 | |
| Total nonaccrual and loans past due 90 days or more | **27,533** | | 18,254 | | 4,000 | |
| Repossessed assets | | | 18 | | | |
| Foreclosed real estate | **618** | | 642 | | | |
| Total nonperforming assets | **$28,151** | | $18,914 | | $4,000 | |
| Restructured Loans (TDRs) | | | | | | |

| | | | |
|---|---|---|---|
| Performing | **$656** | $ | $ |
| Total TDRs | **$656** | $ | $ |
| Nonperforming loans to total gross loans | **3.68%** | 2.47 % | 0.59 % |
| Nonperforming assets to total assets | **2.96%** | 1.93 % | 0.44 % |
| Allowance for loan losses to nonperforming loans | **31.97%** | 48.96 % | 183.93% |

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 6. Loan Quality (continued)

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

**(Dollars in thousands)**

| | Current | Loans Past Due 30 59 Days | 60 89 Days | 90 Days+ | Total | Non-Accrual | Total Loans |
|---|---|---|---|---|---|---|---|
| December 31, 2010 | | | | | | | |
| Residential Real Estate 1 4 Family | | | | | | | |
| First liens | $140,711 | $979 | $654 | $1,093 | $2,726 | $691 | $144,128 |
| Junior liens and lines of credit | 55,723 | 16 | | 833 | 849 | 122 | 56,694 |
| Total | 196,434 | 995 | 654 | 1,926 | 3,575 | 813 | 200,822 |
| Residential real estate construction | 72,146 | | | 911 | 911 | 6,500 | 79,557 |
| Commercial, industrial and agricultural real estate | 285,050 | 3,786 | 13 | 2,343 | 6,142 | 13,003 | 304,195 |
| Commercial, industrial and agricultural | 142,829 | 1,786 | 145 | 244 | 2,175 | 1,668 | 146,672 |
| Consumer | 17,077 | 164 | 30 | 125 | 319 | | 17,396 |
| Total | $713,536 | $6,731 | $842 | $5,549 | $13,122 | $21,984 | $748,642 |
| December 31, 2009 | | | | | | | |
| Residential Real Estate 1 4 Family | | | | | | | |
| First liens | $136,189 | $1,308 | $1,428 | $3,060 | $5,796 | $345 | $142,330 |
| Junior liens and lines of credit | 60,966 | | | 494 | 494 | | 61,460 |
| Total | 197,155 | 1,308 | 1,428 | 3,554 | 6,290 | 345 | 203,790 |
| Residential real estate construction | 77,708 | 1,475 | | 1,426 | 2,901 | 4,040 | 84,649 |
| Commercial, industrial and agricultural real estate | 274,386 | 1,523 | 350 | 1,926 | 3,799 | 5,654 | 283,839 |
| Commercial, industrial and agricultural | 142,322 | 500 | 129 | 960 | 1,589 | 124 | 144,035 |
| Consumer | 22,286 | 529 | 210 | 195 | 934 | 30 | 23,250 |
| Total | $713,857 | $5,335 | $2,117 | $8,061 | $15,513 | $10,193 | $739,563 |

In addition to monitoring the performance status of the loan portfolio, the Bank also utilizes a risk rating scale (1 9) to evaluate loan asset quality. This methodology is primarily used for loans that are reviewed individually (usually commercial loans) for ALL as described above and are not part of a homogeneous loan pool. Loans that are rated 1 4 are classified as pass credits. Loans rated a 5 are pass credits but have been identified as credits that warrant additional attention and monitoring. Loans that are risk rated 6 (OAEM) or higher are placed on the on the Bank s watch list. Loans on the watch list are adversely criticized/classified because the borrowers are experiencing weakening cash flow and may be paying loans with alternative

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(Dollars in thousands)

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 6. Loan Quality (continued)

sources of cash, for example, savings or the sale of unrelated assets. 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. Potential problem loans are loans on the watch list that represent borrowers that may or may not be able to comply with current loan terms, but excludes loans that are 90 days or more past due and nonaccrual loans. Management emphasizes early identification and monitoring of these loans to proactively minimize any risk of loss.

In the normal course of loan portfolio management, the account officer assigned to a particular relationship is responsible for assigning the appropriate risk rating based on the Bank s 9 point risk rating scale. In the event a credit relationship is downgraded to a risk rating of 6 (OAEM) or higher, the relationship is reviewed no less than quarterly at the Bank s Loan Management Committee. The following table reports on the internal credit rating for those loans in the portfolio that are assigned an individual credit rating (primarily commercial loans):

**(Dollars in thousands)**

| | Pass | Special Mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| December 31, 2010 | | | | | |
| Residential Real Estate 1 4 Family | | | | | |
| First liens | $40,051 | $1,821 | $ 3,299 | $ | $45,171 |
| Junior liens and lines of credit | 10,565 | 68 | 391 | | 11,024 |
| Total | 50,616 | 1,889 | 3,690 | | 56,195 |
| Residential real estate construction | 59,097 | 6,671 | 11,892 | | 77,660 |
| Commercial, industrial and agricultural real estate | 273,279 | 8,481 | 22,435 | | 304,195 |
| Commercial, industrial and agricultural | 132,981 | 6,383 | 7,308 | | 146,672 |
| Total | $515,973 | $23,424 | $ 45,325 | $ | $584,722 |
| December 31, 2009 | | | | | |
| Residential Real Estate 1 4 Family | | | | | |
| First liens | $29,013 | $1,777 | $ 315 | $ | $31,105 |
| Junior liens and lines of credit | 9,133 | 176 | 248 | | 9,557 |
| Total | 38,146 | 1,953 | 563 | | 40,662 |
| Residential real estate construction | 74,733 | | 8,151 | | 82,884 |
| Commercial, industrial and agricultural real estate | 268,617 | 1,233 | 13,989 | | 283,839 |
| Commercial, industrial and agricultural | 134,004 | 8,603 | 1,428 | | 144,035 |
| Total | $515,500 | $11,789 | $ 24,131 | $ | $551,420 |

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

**(Dollars in thousands)**

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

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 6. Loan Quality (continued)

*(Dollars in thousands)*

| | December 31, 2009 | | | | |
|---|---|---|---|---|---|
| | Consumer | | Residential Real Estate | | |
| | Lines of Credit | Installment | Home Equity | Mortgages | Total |
| Performing | $ 2,963 | $ 20,062 | $ 19,280 | $ 143,142 | $ 185,447 |
| Non-performing (Nonaccrual) | 36 | 189 | 33 | 2,438 | 2,696 |
| Total | $ 2,999 | $ 20,251 | $ 19,313 | $ 145,580 | $ 188,143 |

## Note 7. Premises and Equipment

Premises and equipment consist of:

| | | December 31 | |
|---|---|---|---|
| (Dollars in thousands) | Estimated Life | 2010 | 2009 |
| Land | | **$ 3,028** | $ 2,590 |
| Buildings and leasehold improvements | 15 30 years, or lease term | **22,036** | 21,215 |
| Furniture, fixtures and equipment | 3 10 years | **13,555** | 12,883 |
| Total cost | | **38,619** | 36,688 |
| Less: Accumulated depreciation | | **(22,027)** | (20,947) |
| Net premises and equipment | | **$ 16,592** | $ 15,741 |

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

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| Depreciation expense | **$ 1,226** | $ 1,284 | $ 1,198 |
| Rent expense on leases | **$ 383** | $ 385 | $ 336 |

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, 2010, future minimum payments on these leases are as follows:

| (Amounts in thousands) | |
|---|---|
| 2011 | $ 348 |
| 2012 | 208 |
| 2013 | 198 |

| | |
|---|---|
| 2014 | 172 |
| 2015 | 165 |
| 2016 and beyond | 1,744 |
| | $ 2,835 |

# Note 8. Goodwill and Intangible Assets

The following table summarizes the changes in goodwill:

| | For the years ended December 31 | |
|---|---|---|
| (Amounts in thousands) | 2010 | 2009 |
| Beginning balance | **$ 9,159** | $ 9,152 |
| Goodwill acquired | | |
| Adjustment to goodwill | **(143)** | 7 |
| Ending balance | **$ 9,016** | $ 9,159 |

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 8. Goodwill and Intangible Assets (continued)

The adjustment to goodwill in 2010 was an adjustment on a previously recorded deferred tax asset. The adjustment to goodwill in 2009 was a final purchase accounting adjustment to goodwill acquired in 2008.

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

| | Core Deposit | | Customer List | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Gross carrying amount | $ 3,252 | $ 3,252 | $ 589 | $ 589 |
| Accumulated amortization | (1,626 ) | (1,265 ) | (211 ) | (115 ) |
| Net carrying amount | $ 1,626 | $ 1,987 | $ 378 | $ 474 |

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

| (Amounts in thousands) | 2010 | 2009 | 2008 |
|---|---|---|---|
| Amortization expense | **$ 457** | $ 468 | $ 370 |

Core deposit intangibles are amortized over the estimated life of the acquired core deposits. At December 31, 2010 the remaining life was 4.5 years. The customer list intangible is amortized over the estimated life of the acquired customer list. At December 31, 2010, the remaining life was 7.9 years.

The following table shows the expected amortization expense for intangible assets over the next five years:

| | *(Amounts in thousands)* |
|---|---|
| 2011 | $ 446 |
| 2012 | 435 |
| 2013 | 424 |
| 2014 | 414 |
| 2015 | 285 |

## Note 9. Mortgage Servicing Rights

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

**(Amounts in thousands)**

For the Years Ended December 31

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| Cost of mortgage servicing rights: | | | |
| Beginning balance | **$ 1,190** | $ 1,551 | $ 1,778 |
| Originations | **10** | 8 | 59 |
| Amortization | **(267)** | (369 ) | (286 ) |
| Ending balance | **$ 933** | $ 1,190 | $ 1,551 |
| Valuation allowance: | | | |
| Beginning balance | **$ (476)** | $ (688 ) | $ (188 ) |
| Valuation charges | **(48)** | | (722 ) |
| Valuation reversals | **194** | 212 | 222 |
| Ending balance | **$ (330)** | $ (476 ) | $ (688 ) |
| Mortgage servicing rights cost | **$ 933** | $ 1,190 | $ 1,551 |
| Valuation allowance | **(330)** | (476 ) | (688 ) |
| Carrying value | **$ 603** | $ 714 | $ 863 |
| Fair value | **$ 603** | $ 714 | $ 863 |
| Fair value assumptions: | | | |
| Weighted average discount rate | **10.00%** | 10.00 % | 10.00 % |
| Weighted average prepayment speed | **15.55%** | 18.67 % | 23.60 % |

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(Amounts in thousands) 117

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 9. Mortgage Servicing Rights (continued)

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:

| (Amounts in thousands) | 2010 | 2009 | 2008 |
|---|---|---|---|
| Changes in fair value: | | | |
| Rates + 1% | **$ 321** | $ 226 | $ 382 |
| Rates (1)% | **($142)** | ($195 ) | ($252 ) |

## Note 10. Deposits

Deposits are summarized as follows:

| | December 31 | |
|---|---|---|
| (Amounts in thousands) | 2010 | 2009 |
| Demand, noninterest-bearing checking | **$ 90,317** | $ 77,675 |
| Interest-bearing checking | **103,918** | 97,636 |
| Money market accounts | **289,763** | 243,600 |
| Passbook and statement savings | **48,138** | 46,986 |
| Total interest-bearing checking and savings | **441,819** | 388,222 |
| Retail time deposits | **161,399** | 207,338 |
| Brokered time deposits | **40,796** | 65,130 |
| Total time deposits | **202,195** | 272,468 |
| Total deposits | **$ 734,331** | $ 738,365 |
| Overdrawn deposit accounts reclassified as loans | **$ 74** | $ 183 |

The following table shows the maturity of outstanding time deposits of $100,000 or more at December 31, 2010:

| (Amounts in thousands) | Retail Time Deposits | Brokered Time Deposits | Total Time Deposits |
|---|---|---|---|
| Maturity distribution: | | | |
| Within three months | $ 11,072 | $ 9,758 | $ 20,830 |
| Over three through six months | 7,694 | 4,241 | 11,935 |
| Over six through twelve months | 6,528 | 1,865 | 8,393 |
| Over twelve months | 17,028 | 219 | 17,247 |
| Total | $ 42,322 | $ 16,083 | $ 58,405 |

At December 31, 2010 the scheduled maturities of time deposits are as follows:

| (Amounts in thousands) | Retail Time Deposits | Brokered Time Deposits | Total Time Deposits |
|---|---|---|---|
| 2011 | $ 94,375 | $ 17,029 | $ 111,404 |
| 2012 | 37,191 | 251 | 37,442 |
| 2013 | 18,393 | 15,000 | 33,393 |
| 2014 | 5,577 | | 5,577 |
| 2015 | 5,811 | 7,000 | 12,811 |
| 2016 and beyond | 52 | 1,516 | 1,568 |
| | $ 161,399 | $ 40,796 | $ 202,195 |

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 11. Securities Sold Under Agreements to Repurchase, Short-Term Borrowings and Long-Term Debt

The Corporation 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:

| (Dollars in thousands) | December 31 2010 Sweep Repurchase | FHLB Open Repo | 2009 Sweep Repurchase | FHLB Open Repo |
|---|---|---|---|---|
| Ending balance | **$ 51,164** | **$** | $ 55,855 | $ |
| 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 | **$ 68,622** | **$ 1,900** | $ 74,331 | $ 9,900 |
| Average balance during the year | **$ 60,262** | **$ 185** | $ 67,032 | $ 2,142 |
| Weighted average interest rate during the year | **0.25%** | **0.66%** | 0.25 % | 0.66 % |

The securities that serve as collateral for securities sold under agreements to repurchase consist primarily of U.S. Government and U.S. Agency securities with a fair value of $57.1 million and $64.1 million, respectively, at December 31, 2010 and 2009.

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

| (Amounts in thousands) | December 31 2010 | 2009 |
|---|---|---|
| Loans from the Federal Home Loan Bank | **$ 70,885** | $ 94,688 |

The loans from the FHLB are comprised of term loans payable at maturity and amortizing advances. These loans have fixed interest rates ranging from 3.07% to 5.83% (weighted average rate of 4.16%) and final maturities ranging from January 2011 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, 2010 are as follows:

| | *(Amounts in thousands)* |
|---|---|
| 2011 | $ 23,209 |
| 2012 | 25,128 |
| 2013 | 10,146 |
| 2014 | 2,008 |
| 2015 | 10,008 |
| 2016 and beyond | 386 |
| | $ 70,885 |

The Corporation s maximum borrowing capacity with the FHLB at December 31, 2010, was $237.5 million. The total amount available to borrow at year-end was approximately $166.6 million.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 12. Federal Income Taxes

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

| | December 31 | |
|---|---|---|
| (Amounts in thousands) | 2010 | 2009 |
| Deferred Tax Assets | | |
| Allowance for loan losses | **$ 3,222** | $ 3,269 |
| Deferred compensation | **1,156** | 1,082 |
| Purchase accounting | **92** | 113 |
| Deferred loan fees and costs, net | **160** | 160 |
| Intangibles | **32** | 74 |
| Capital loss carryover | **303** | 45 |
| Other than temporary impairment of investments | **962** | 854 |
| Accumulated other comprehensive loss | **2,906** | 2,648 |
| Other | **88** | 91 |
| | **8,921** | 8,336 |
| Valuation allowance | **(1,151)** | (899) |
| Total gross deferred tax assets | **7,770** | 7,437 |
| Deferred Tax Liabilities | | |
| Core deposit intangibles | **553** | 676 |
| Time deposit purchase accounting | | 7 |
| Depreciation | **68** | 93 |
| Joint ventures and partnerships | **64** | 67 |
| Pension | **196** | 133 |
| Mortgage servicing rights | **205** | 243 |
| Customer list | **129** | 161 |
| Total gross deferred tax liabilities | **1,215** | 1,380 |
| Net deferred tax asset | **$ 6,555** | $ 6,057 |

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

| | For the Years Ended December 31 | | |
|---|---|---|---|
| (Amounts in thousands) | 2010 | 2009 | 2008 |
| Current tax expense | **$ 3,177** | $ 2,753 | $ 3,434 |
| Deferred tax (benefit) expense | **(240)** | (742) | 246 |
| Income tax provision | **$ 2,937** | $ 2,011 | $ 3,680 |

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 12. Federal Income Taxes (continued)

For the years ended December 31, 2010, 2009, and 2008, 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:

| | For the Years Ended December 31 | | |
|---|---|---|---|
| (Amounts in thousands) | 2010 | 2009 | 2008 |
| Tax provision at statutory rate | **$3,587** | $2,923 | $4,173 |
| Income on tax-exempt loans and securities | **(701)** | (787) | (908) |
| Nondeductible interest expense relating to carrying tax-exempt obligations | **42** | 56 | 77 |
| Dividends received exclusion | **(12)** | (36) | (33) |
| Income from bank owned life insurance | **(218)** | (212) | (216) |
| Life insurance proceeds | | (94) | |
| Valuation allowance | **272** | 188 | 711 |
| Stock option compensation | | 10 | 38 |
| Other, net | **(33)** | (37) | (129) |
| Tax credit | | | (33) |
| Income tax provision | **$2,937** | $2,011 | $3,680 |
| Effective income tax rate | **27.8%** | 23.4% | 30.0% |

At December 31, 2010, the Corporation had a capital loss carryover of $892 thousand. This loss carryover can only be offset with capital gains for federal income tax purposes. The tax benefit of this carryover is $303 thousand and the Corporation has recorded a valuation allowance of $303 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 2007.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 13. 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, derivatives and the change in plan assets and benefit obligations on the Bank s pension plan, net of tax, that are recognized as separate components of shareholders equity.

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

| | For the Years Ended December 31 | | |
|---|---|---|---|
| (Amounts in thousands) | 2010 | 2009 | 2008 |
| Net Income | **$7,612** | $6,585 | $8,595 |
| Securities: | | | |
| Unrealized gains (losses) arising during the period | **417** | 1,698 | (6,339) |
| Reclassification adjustment for losses included in net income | **386** | 944 | 724 |
| Net unrealized gains (losses) | **803** | 2,642 | (5,615) |
| Tax effect | **(273)** | (898) | 1,909 |
| Net of tax amount | **530** | 1,744 | (3,706) |
| Derivatives: | | | |
| Unrealized (losses) gains arising during the period | **(1,206)** | 497 | (2,817) |
| Reclassification adjustment for losses included in net income | **718** | 716 | 390 |
| Net unrealized (losses) gains | **(489)** | 1,213 | (2,427) |
| Tax effect | **167** | (412) | 825 |
| Net of tax amount | **(322)** | 801 | (1,602) |
| Pension: | | | |
| Change in plan assets and benefit obligations | **(1,078)** | 113 | (4,717) |
| Reclassification adjustment for losses included in net income | | | |
| Net unrealized (losses) gains | **(1,078)** | 113 | (4,717) |
| Tax effect | **366** | (38) | 1,604 |
| Net of tax amount | **(712)** | 74 | (3,113) |
| Total other comprehensive (loss) income | **(504)** | 2,618 | (8,421) |
| Total Comprehensive Income | **$7,108** | $9,203 | $174 |

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

| | December 31 | |
|---|---|---|
| (Amounts in thousands) | 2010 | 2009 |
| Net unrealized losses on securities | **$ (1,026)** | $ (1,829) |
| Tax effect | **349** | 622 |

| | | |
|---|---|---|
| Net of tax amount | **(677)** | (1,207 ) |
| Net unrealized losses on derivatives | **(1,752)** | (1,263 ) |
| Tax effect | **596** | 429 |
| Net of tax amount | **(1,156)** | (834 ) |
| Accumulated pension adjustment | **(5,771)** | (4,692 ) |
| Tax effect | **1,962** | 1,595 |
| Net of tax amount | **(3,809)** | (3,097 ) |
| Total accumulated other comprehensive loss | **$ (5,642)** | $ (5,138 ) |

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 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, 2010, the fair value of the swaps was negative $1.8 million and was recognized in accumulated other comprehensive loss, net of tax.

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, 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%** | **0.18%** | **$ 342** |
| $ 10,000 | **5/30/2015** | **3.87%** | **0.18%** | **$ 369** |

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

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 14. Financial Derivatives (continued)

Derivatives with a positive fair value are reflected as other assets in the balance sheet while those with a negative fair value are reflected as other liabilities. The swaps added $718 thousand to interest expense in 2010 compared to $716 thousand in 2009 and $390 thousand in 2008. As short-term interest rates decrease, the net expense of the swap increases and as short-term rates increase the net expense of the swaps decrease. The 2011 swap interest expense is expected to be comparable to 2010 because lower short-term interest rates are not expected to change significantly in 2011.

Fair Value of Derivative Instruments in the Consolidated Balance Sheets were as follows as of December 31, 2010:

Fair Value of Derivative Instruments

| (Dollars in thousands) Date | Type | Balance Sheet Location | Fair Value |
|---|---|---|---|
| December 31, 2010 | **Interest rate contracts** | **Other liabilities** | **$ 1,752** |
| December 31, 2009 | Interest rate contracts | Other liabilities | $ 1,263 |

The Effect of Derivative Instruments on the Statement of Income for the Year Ended December 31, 2010 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships

| (Dollars in thousands) **Date / Type** | Amount of Gain or (Loss) Recognized in OCI, net of tax, on Derivative (Effective Portion) | Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | Amount of Gain or (Loss) Recognized in Income on Derivatives (Ineffective Portion and Amount Excluded from Effectiveness Testing) |
|---|---|---|---|---|---|
| December 31, 2010 | | | | | |
| Interest rate contracts | **$ (322)** | **Interest Expense** | **$ (718)** | **Other income (expense)** | **$** |
| December 31, 2009 | | | | | |
| Interest rate contracts | $ 801 | Interest Expense | $ (716 ) | Other income (expense) | $ |

# 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 2010, 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. 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. Under this plan, the maximum amount of employee contributions in any given year is defined by Internal Revenue Service regulations. The related expense for the 401(k) plan, and the profit sharing plan as approved by the Board of Directors, was approximately $368 thousand in 2010, $366 thousand in 2009 and $365 thousand in 2008. The cost of a deferred compensation benefit (life insurance) was $14 thousand in 2010, $9 thousand in 2009 and $15 thousand in 2008. This benefit is provided to selected employees via the life insurance policies owned by the Bank.

# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 15. Benefit Plans (continued)

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 $46 thousand in 2010, $51 thousand in 2009 and $57 thousand in 2008. 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, $441 thousand in 2010 and $567 thousand in 2009 compared to a pension expense credit of $21 thousand in 2008. The Bank expects its 2011 pension expense to be higher than the 2010 expense. The 2010 measurement date of the Plan was December 31, 2010.

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. At December 31, 2010, fixed income investments accounted for 75% of total Plan assets, equities accounted for 18% and cash accounted for 12%. 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.

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.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 15. Benefit Plans (continued)

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 8%, 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, 2010, 2009 and 2008 actuarial valuations.

| | For the Years Ended December 31 | | |
|---|---|---|---|
| (Amounts in thousands) | 2010 | 2009 | 2008 |
| Change in projected benefit obligation | | | |
| Benefit obligation at beginning of measurement year | **$13,287** | $12,149 | $11,626 |
| Service cost | **365** | 354 | 448 |
| Interest cost | **742** | 738 | 847 |
| Actuarial loss | **782** | 748 | 29 |
| Benefits paid | **(924)** | (702) | (801) |
| Benefit obligation at end of measurement year | **14,252** | 13,287 | 12,149 |
| Change in plan assets | | | |
| Fair value of plan assets at beginning of measurement year | **8,985** | 8,059 | 11,899 |
| Actual return on plan assets net of expenses | **369** | 1,385 | (3,372) |
| Employer contribution | **626** | 243 | 333 |
| Benefits paid | **(924)** | (702) | (801) |
| Fair value of plan assets at end of measurement year | **9,056** | 8,985 | 8,059 |
| Funded status of projected benefit obligation at end of measurement year | **$(5,196)** | $(4,302) | $(4,090) |

| | For the Years Ended December 31 | | |
|---|---|---|---|
| Amounts recognized in accumulated other comprehensive income (loss), net of tax | 2010 | 2009 | 2008 |

| | | | |
|---|---|---|---|
| Net actuarial loss | **$ (6,494)** | $ (5,541 ) | $ (5,778 ) |
| Prior service cost obligation | **723** | 848 | 974 |
| | **(5,771)** | (4,693 ) | (4,804 ) |
| Tax effect | **1,962** | 1,596 | 1,633 |
| Net amount recognized in accumulated comprehensive loss | **$ (3,809)** | $ (3,097 ) | $ (3,171 ) |

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 15. Benefit Plans (continued)

| | For the Years Ended December 31 | | |
|---|---|---|---|
| Components of net periodic pension cost | 2010 | 2009 | 2008 |
| Service cost | **$ 365** | $ 354 | $ 448 |
| Interest cost | **742** | 738 | 847 |
| Expected return on plan assets | **(838)** | (753) | (1,161) |
| Amortization of prior service cost | **(125)** | (126) | (157) |
| Recognized net actuarial loss | **297** | 354 | 2 |
| Net periodic pension (benefit) cost | **$ 441** | $ 567 | $ (21) |

| | For the Years Ended December 31 | | |
|---|---|---|---|
| | 2010 | 2009 | 2008 |
| Assumptions used to determine benefit obligations as of measurement date: | | | |
| Discount rate | **5.28%** | 5.79% | 6.13% |
| Rate of compensation increase | **4.00%** | 4.50% | 4.50% |
| Assumptions used to determine net periodic benefit cost: | | | |
| Discount rate | **5.79%** | 6.13% | 6.00% |
| Expected long-term return on plan assets | **8.00%** | 8.00% | 8.00% |
| Rate of compensation increase | **4.50%** | 4.50% | 4.50% |
| Asset allocations as of measurement date: | | | |
| Cash and cash equivalents | **12%** | 3% | 9% |
| Common stocks | **18%** | 23% | 47% |
| Corporate bonds | **7%** | 12% | 26% |
| Municipal bonds | **59%** | 58% | 13% |
| Other | **4%** | 4% | 5% |
| Total | **100%** | 100% | 100% |
| Shares of the Corporation s common stock held in the plan | | | |
| Value of shares | **$52** | $47 | $52 |
| Percent of total plan assets | **0.6%** | 0.5% | 0.6% |

| | For the Years Ended December 31 | | |
|---|---|---|---|
| Reconciliation of Funded Status | 2010 | 2009 | 2008 |
| Funded Status | **$ (5,196)** | $ (4,302) | $ (4,090) |
| Unrecognized net actuarial loss | **6,494** | 5,541 | 5,778 |
| Unrecognized prior service cost | **(723)** | (848) | (974) |

| | | | |
|---|---|---|---|
| Net Asset recognized | **$ 575** | $ 391 | $ 714 |
| Accumulated Benefit Obligation | **$ 13,680** | $ 12,691 | $ 11,692 |

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 15. Benefit Plans (continued)

The following table sets forth by level, within the fair value hierarchy, the Plan s investments at fair value as of December 31, 2010 and 2009:

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

**(Dollars in Thousands)**

| Asset Description | Fair Value at December 31, 2010 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Cash and money market funds | **$ 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 particiaption guarantee participation contract | **227** | | | **227** |
| Total assets | **$ 9,056** | **$ 2,783** | **$ 5,924** | **$ 349** |

**(Dollars in Thousands)**

| Asset Description | Fair Value at December 31, 2009 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Cash and money market funds | **$ 206** | **$ 206** | **$** | **$** |
| Common stocks | **2,005** | **2,005** | | |
| Corporate bonds | **1,079** | | **1,079** | |
| Cash value of life insurance | **142** | | | **142** |
| Deposit in immediate particiaption guarantee participation contract | **215** | | | **215** |
| Municipal bonds | **5,338** | | **5,338** | |
| Total assets | **$ 8,985** | **$ 2,211** | **$ 6,417** | **$ 357** |

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, 2010:

| | Cash Value of Life Insurance | Deposits in Immediate Participation Guarantee Contract |
|---|---|---|
| Balance January 1, 2010 | **$ 142** | **$ 215** |
| Unrealized gain (loss) relating to investments held at the reporting date | **5** | **(8)** |
| Purchases, sales, issuances and settlement, net | **(25)** | **20** |
| Balance December 31, 2010 | **$ 122** | **$ 227** |

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 15. Benefit Plans (continued)

## Contributions

The Bank expects to contribute $935 thousand to its pension plan in 2011. This amount will meet the minimum funding requirements.

## Estimated future benefit payments at December 31, 2010 (in thousands)

| | |
|---|---|
| 2011 | $ 726 |
| 2012 | 743 |
| 2013 | 771 |
| 2014 | 830 |
| 2015 | 817 |
| 2016 2020 | 4,503 |
| | $ 8,390 |

## 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, 2010 there are 216,153 shares available for future grants. The Board of Directors may amend, suspend or terminate the ESPP at any time.

The grant price of the 2010 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 2010 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, 2010 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.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 16. Stock Purchase Plans (continued)

The ESPP and ISOP options outstanding at December 31, 2010 are all exercisable. The ESPP options expire on June 30, 2011 and the ISOP options expire 10 years from the grant date. The following table summarizes the stock option activity:

**(Amounts in thousands except share and per share data)**

| | ESPP Options | Weighted Average Price Per Share | Aggregate Intrinsic Value |
|---|---|---|---|
| Balance Outstanding at December 31, 2007 | 24,515 | $ 25.92 | |
| Granted | 35,980 | 22.08 | |
| Exercised | (329 ) | 22.08 | |
| Expired | (25,646 ) | 25.75 | |
| 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** | **$ 35** |

| | ISOP Options | Weighted Average Price Per Share |
|---|---|---|
| Balance Outstanding at December 31, 2007 | 62,436 | $ 25.22 |
| Granted | 24,225 | 23.77 |
| Exercised | | |
| Forfeited | (9,937 ) | 24.48 |
| 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** |

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 16. Stock Purchase Plans (continued)

The following table provides information about the options outstanding at December 31, 2010:

| 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 | 24,181 | $ 16.81 | | $ 16.81 | 0.5 |
| Incentive Stock Option Plan | 12,900 | $ 16.11 | $18.42 | $ 16.11 | 8.2 |
| Incentive Stock Option Plan | 10,000 | $ 18.42 | $20.74 | $ 20.00 | 1.3 |
| Incentive Stock Option Plan | 4,999 | $ 20.74 | $23.05 | $ 21.42 | 2.1 |
| Incentive Stock Option Plan | 24,825 | $ 23.05 | $25.37 | $ 24.04 | 6.7 |
| Incentive Stock Option Plan | 30,150 | $ 25.37 | $27.68 | $ 27.51 | 4.5 |
| ISOP Total/Average | 82,874 | | | $ 23.42 | 5.2 |

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

| | 2010 | 2009 | 2008 |
|---|---|---|---|
| Incentive Stock Option Plan | | | |
| Options granted | | 14,900 | 24,225 |
| Risk-free interest rate | | 2.07 % | 2.71 % |
| Expected volatility of the Corporation s stock | | 32.62 % | 29.65 % |
| Expected dividend yield | | 5.92 % | 4.17 % |
| Expected life (in years) | | 5.25 | 5.25 |
| Weighted average fair value of options granted | **$** | $ 1.95 | $ 4.61 |
| (Dollars in thousands) | | | |
| Compensation expense included in net income | | | |
| ESPP | **$** | $ | $ |
| ISOP | | 29 | 112 |
| Total compensation expense included in net income | **$** | $ 29 | $ 112 |

## 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 $22 thousand for 2010, $22 thousand for 2009 and $31 thousand for 2008.

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 2010.

## 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.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 18. Shareholders Equity (continued)

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

**(Amounts in thousands, except share information)**

| Plan Approved | Expiration Date | Shares Authorized | Shares Repurchased Under Approved Plan 2010 | 2009 | Total | Cost |
|---|---|---|---|---|---|---|
| July 8, 2010 | July 8, 2011 | 100,000 | | | | |
| July 9, 2009 | July 9, 2010 | 100,000 | | 4,179 | 4,179 | $ 67 |
| Number of Treasury shares held at year-end | | | 397,950 | 435,838 | | |

## 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)* | 2010 | 2009 |
|---|---|---|
| Financial instruments whose contract amounts represent credit risk: | | |
| Commercial commitments to extend credit | **$ 159,166** | $ 151,520 |
| Consumer commitments to extend credit (secured) | **34,914** | 36,117 |

| | | |
|---|---|---|
| Consumer commitments to extend credit (unsecured) | **4,797** | 4,747 |
| | **$ 198,877** | $ 192,384 |
| Standby letters of credit | **$ 20,467** | $ 26,718 |

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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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 19. Commitments and Contingencies (continued)

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, 2010 and 2009 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 maybe 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 estimated fair value of the Corporation s financial instruments are as follows:

| | December 31, 2010 | | December 31, 2009 | |
|---|---|---|---|---|
| *(Dollars in thousands)* | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | | | | |

| | | | | |
|---|---|---|---|---|
| Cash and cash equivalents | **$22,106** | **$22,106** | $33,248 | $ 33,248 |
| Investment securities available for sale | **117,616** | **117,616** | 143,288 | 143,288 |
| Restricted stock | **6,159** | **6,159** | 6,482 | 6,482 |
| Net loans | **739,841** | **750,944** | 730,626 | 742,929 |
| Accrued interest receivable | **3,662** | **3,662** | 3,904 | 3,904 |
| Mortgage servicing rights | **603** | **603** | 714 | 714 |
| Financial liabilities: | | | | |
| Deposits | **$734,331** | **$737,274** | $738,365 | $ 742,953 |
| Securities sold under agreements to repurchase | **51,164** | **51,164** | 55,855 | 55,855 |
| Long-term debt | **70,885** | **74,695** | 94,688 | 99,013 |
| Accrued interest payable | **757** | **757** | 1,288 | 1,288 |
| Interest rate swaps | **1,752** | **1,752** | 1,263 | 1,263 |

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# 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, 2010 and 2009:

## 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.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

## Derivatives:

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

## Off balance sheet financial instruments:

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

FASB ASC Topic 820 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.

*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, 2010.

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, 2010 and 2009 are as follows:

**(Dollars in Thousands)**

| | Fair Value at December 31, 2010 | | | |
|---|---|---|---|---|
| Asset Description | Level 1 | Level 2 | Level 3 | Total |
| Equity securities | **$ 3,638** | **$** | **$** | **$ 3,638** |
| Obligations of U.S. Government agencies | | **14,785** | | **14,785** |
| Obligations of state and political subdivisions | | **39,952** | | **39,952** |
| Corporate debt securities | | **6,862** | | **6,862** |
| Mortgage-backed securities | | | | |
| Agency | | **48,297** | | **48,297** |
| Non-Agency | | **4,029** | | **4,029** |
| Asset-backed securities | | **53** | | **53** |
| Total assets | **$ 3,638** | **$ 113,978** | **$** | **$ 117,616** |
| Liability Description | | | | |
| Interest rate swaps | **$** | **$ 1,752** | **$** | **$ 1,752** |
| Total liabilities | **$** | **$ 1,752** | **$** | **$ 1,752** |

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

**(Dollars in Thousands)**

| | Fair Value at December 31, 2009 | | | |
|---|---|---|---|---|
| Asset Description | Level 1 | Level 2 | Level 3 | Total |
| Equity securities | $ 3,975 | $ | $ | $ 3,975 |
| 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 |

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, 2010 and 2009 are as follows:

**(Dollars in Thousands)**

| | Fair Value at December 31, 2010 | | | |
|---|---|---|---|---|
| Asset Description | Level 1 | Level 2 | Level 3 | Total |
| Impaired loans | **$** | **$** | **$ 16,973** | **$ 16,973** |

| | | | | |
|---|---|---|---|---|
| Other real estate owned | | | **618** | **618** |
| Mortgage servicing rights | | | **603** | **603** |
| Total assets | **$** | **$** | **$ 18,194** | **$ 18,194** |

**(Dollars in Thousands)**

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

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

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, 2010.

The following table presents a reconciliation of impaired loans, foreclosed real estate and mortgage servicing rights measured at fair value on a nonrecurring basis, using significant unobservable inputs (Level 3) as of December 31, 2010:

| (Dollars in Thousands) | Impaired Loans | Foreclosed Real Estate | Mortgage Servicing Rights |
|---|---|---|---|
| Balance January 1, 2010 | $ 7,943 | $ 643 | $ 714 |
| Charged off | (2,011 ) | | |
| Settled or otherwise removed | (3,667 ) | (463 ) | |
| Additions | 15,510 | 438 | 10 |
| Payments / amortization | (916 ) | | (267 ) |
| (Increase) decrease in valuation allowance | 114 | | 146 |
| Balance December 31, 2010 | $ 16,973 | $ 618 | $ 603 |

## Note 21. Parent Company (Franklin Financial Services Corporation) Financial Information

# Balance Sheets

| (Amounts in thousands) | December 31 2010 | 2009 |
|---|---|---|
| Assets: | | |
| Cash and cash equivalents | **$ 488** | $ 157 |
| Investment securities, available for sale | **783** | 680 |
| Equity investment in subsidiaries | **80,028** | 76,752 |
| Other assets | **1,590** | 1,427 |
| Total assets | **$ 82,889** | $ 79,016 |
| Liabilities: | | |
| Other liabilities | **$ 250** | $ 250 |
| Total liabilities | **250** | 250 |
| Shareholders equity | **82,639** | 78,766 |
| Total liabilities and shareholders equity | **$ 82,889** | $ 79,016 |

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 21. Parent Company (Franklin Financial Services Corporation) Financial Information (continued)

## Statements of Income

| | Years Ended December 31 | | |
|---|---|---|---|
| (Amounts in thousands) | 2010 | 2009 | 2008 |
| Income: | | | |
| Dividends from Bank subsidiary | **$4,210** | $ 4,311 | $ 5,559 |
| Interest and dividend income | **26** | 16 | 65 |
| OTTI losses on securities | **(201)** | (67 ) | (888 ) |
| Less: Loss recognized in other comprehensive loss (before taxes) | | | |
| Net OTTI losses recognized in earnings | **(201)** | (67 ) | (888 ) |
| Securities gains (losses), net | **8** | (131 ) | 264 |
| Equity method investment | | | (143 ) |
| Exchange of equity method investment | | | (1,205 ) |
| Other income | | | 60 |
| | **4,043** | 4,129 | 3,712 |
| Expenses: | | | |
| Operating expenses | **772** | 767 | 1,794 |
| Income before income taxes and equity in undistributed income of subsidiaries | **3,271** | 3,362 | 1,918 |
| Income tax benefit | **272** | 292 | 321 |
| Equity in undistributed income of subsidiaries | **4,069** | 2,931 | 6,356 |
| Net income | **$7,612** | $ 6,585 | $ 8,595 |

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 21. Parent Company (Franklin Financial Services Corporation) Financial Information (continued)

## Statements of Cash Flows

| | Years Ended December 31 | | |
|---|---|---|---|
| (Amounts in thousands) | 2010 | 2009 | 2008 |
| Cash flows from operating activities | | | |
| Net income | **$7,612** | $ 6,585 | $ 8,595 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Equity in undistributed income of subsidiary | **(4,069)** | (2,931 ) | (6,356 ) |
| Securities (gains) losses | **(8)** | 131 | (264 ) |
| Impairment writedown on equity securities | **201** | 67 | 888 |
| (Increase) decrease in other assets | **(204)** | (183 ) | 560 |
| Increase (decrease) in other liabilities | | 239 | (123 ) |
| Loss on equity method investments | | | 143 |
| Stock option compensation | | 29 | 112 |
| Writedown on equity method investment | | | 1,205 |
| Other, net | **13** | (359 ) | (70 ) |
| Net cash provided by operating activities | **3,545** | 3,578 | 4,690 |
| Cash flows from investing activities | | | |
| Proceeds from sales of investment securities | **21** | 4 | 1,280 |
| Purchase of investment securities | | | (870 ) |
| Proceeds from acquisition of equity method investment | | | 638 |
| Investment in subsidiary | | | (1,888 ) |
| Net cash provided by (used in) investing activities | **21** | 4 | (840 ) |
| Cash flows from financing activities | | | |
| Dividends paid | **(4,194)** | (4,145 ) | (4,096 ) |
| Common stock issued from treasury stock | | | 22 |
| Common stock issued under stock option plans | **26** | 2 | 7 |
| Treasury shares issued to fund dividend reinvestment plan | **617** | 777 | 722 |
| Common stock issued under dividend reinvestment plan | **316** | | |
| Purchase of treasury shares | | (160 ) | (1,205 ) |
| Net cash used in financing activities | **(3,235)** | (3,526 ) | (4,550 ) |
| Increase (decrease) in cash and cash equivalents | **331** | 56 | (700 ) |
| Cash and cash equivalents as of January 1 | **157** | 101 | 801 |
| Cash and cash equivalents as of December 31 | **$488** | $ 157 | $ 101 |

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# FRANKLIN FINANCIAL SERVICES CORPORATION

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Note 22. Quarterly Results of Operations (unaudited)

The following is a summary of the quarterly results of consolidated operations of Franklin Financial for the years ended December 31, 2010 and 2009:

**(Amounts in thousands, except per share)**

| | Three months ended | | | |
|---|---|---|---|---|
| 2010 | March 31 | June 30 | September 30 | December 31 |
| 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** |

**(Amounts in thousands, except per share)**

| | Three months ended | | | |
|---|---|---|---|---|
| 2009 | March 31 | June 30 | September 30 | December 31 |
| Interest income | $ 10,812 | $ 10,989 | $ 10,984 | $ 10,971 |
| Interest expense | 3,593 | 3,630 | 3,741 | 3,709 |
| Net interest income | 7,219 | 7,359 | 7,243 | 7,262 |
| Provision for loan losses | 593 | 426 | 1,644 | 775 |
| Other noninterest income | 2,484 | 2,539 | 2,249 | 2,553 |
| Securities (losses) | (197) | (170) | (267) | (310) |
| Noninterest expense | 6,150 | 6,966 | 6,465 | 6,348 |
| Income before income taxes | 2,763 | 2,336 | 1,116 | 2,382 |
| Income taxes | 662 | 697 | 33 | 619 |
| Net Income | $ 2,101 | $ 1,639 | $ 1,083 | $ 1,763 |
| Basic earnings per share | $ 0.55 | $ 0.43 | $ 0.28 | $ 0.46 |

| | | | | |
|---|---|---|---|---|
| Diluted earnings per share | $ 0.55 | $ 0.43 | $ 0.28 | $ 0.46 |
| 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.

Net income for the fourth quarter of 2010 fell from the third quarter primarily as a result of a higher provision for loan loss expense. The provision for loan losses was $1.4 million in the fourth quarter, $735 thousand more than the previous quarter. Net interest income was $185 thousand less in the fourth quarter compared to the third quarter. Losses on securities decreased during the fourth quarter as the third quarter included losses from the sale of an equity security and write-downs on two equity securities. In the fourth quarter, gains from sales of securities almost offset the writedowns on two debt securities and one equity security. Noninterest expense remained flat quarter to quarter at $6.6 million.

(Amounts in thousands, except per share) 160

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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, 2010, the Corporation s disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in the Corporation s reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms.

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

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

# 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, 2010, 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, 2010, the Corporation s internal control over financial reporting is effective based on those criteria.

There were no changes during the fourth quarter of 2010 in the Corporation s internal control over financial reporting which materially affected, or which are reasonably likely to affect, the Corporation s internal control over financial reporting.

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, 2010. 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 Company ) internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company 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 Company 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 of internal control over financial reporting 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 company 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 company 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 company; (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 company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company 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 Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, 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, 2010 and 2009 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, 2010, and our report dated March 11, 2011 expressed an unqualified opinion.

/s/ ParenteBeard LLC

Harrisburg, Pennsylvania
March 11, 2011

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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 29, 2011.

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 29, 2011.

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 29, 2011. 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 29, 2011.

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 29, 2011.

## 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 29, 2011; 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 29, 2011.

## 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 29, 2011.

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 29, 2011.

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 29, 2011.

## 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 29, 2011.

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 29, 2011.

## 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 29, 2011.

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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:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets December 31, 2010 and 2009,
Consolidated Statements of Income Years ended December 31, 2010, 2009 and 2008,
Consolidated Statements of Changes in Shareholders Equity Years ended December 31, 2010, 2009 and 2008,
Consolidated Statements of Cash Flows Years ended December 31, 2010, 2009 and 2008,
Notes to Consolidated Financial Statements

(2) 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) |

(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:

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

Dated: March 10, 2011

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/ Charles M. Sioberg<br>Charles M. Sioberg | Chairman of the Board and Director | March 10, 2011 |
| /s/ William E. Snell, Jr.<br>William E. Snell, Jr. | President and Chief Executive Officer and Director (Principal Executive Officer) | March 10, 2011 |
| /s/ Mark R. Hollar<br>Mark R. Hollar | Treasurer and Chief Financial Officer (Principal Financial and Accounting Officer) | March 10, 2011 |
| /s/ Charles S. Bender II<br>Charles S. Bender II | Director | March 10, 2011 |
| /s/ Martin R. Brown<br>Martin R. Brown | Director | March 10, 2011 |
| /s/ G. Warren Elliott<br>G. Warren Elliott | Director | March 10, 2011 |
| /s/ Daniel J. Fisher<br>Daniel J. Fisher | Director | March 10, 2011 |
| /s/ Donald A. Fry<br>Donald A. Fry | Director | March 10, 2011 |
| /s/ Allan E. Jennings, Jr.<br>Allan E. Jennings, Jr. | Director | March 10, 2011 |
| /s/ Stanley J. Kerlin<br>Stanley J. Kerlin | Director | March 10, 2011 |
| /s/ Donald H. Mowery<br>Donald H. Mowery | Director | March 10, 2011 |
| /s/ Stephen E. Patterson<br>Stephen E. Patterson | Director | March 10, 2011 |
| /s/ Martha B. Walker<br>Martha B. Walker | Director | March 10, 2011 |

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# Exhibit Index for the Year Ended December 31, 2010

| 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 |

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