FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-Q
August 08, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from to

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

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

20 SOUTH MAIN STREET (P.O. BOX 6010), CHAMBERSBURG, PA 17201-0819

(Address of principal executive offices)

717/264-6116

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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

Large accelerated filer o **Accelerated filer x** **Non-accelerated filer o**

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

There were 3,353,525 outstanding shares of the Registrant s common stock as of June 30, 2006.

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Part I FINANCIAL INFORMATION

Item 1 Financial Statements

Consolidated Balance Sheets

(Amounts in thousands, except per share data)

	June 30 2006 (unaudited)	December 31 2005
Assets		
Cash and due from banks	$ 15,763	$ 19,706
Fed funds sold	5,200	4,000
Interest bearing deposits in other banks	110	1,032
Total cash and cash equivalents	21,073	24,738
Investment securities available for sale	169,257	164,060
Restricted stock	2,869	3,184
Loans held for sale	4,102	1,328
Loans	432,785	397,190
Allowance for loan losses	(5,568)	(5,402)
Net Loans	427,217	391,788
Premises and equipment, net	9,478	8,897
Bank owned life insurance	12,044	11,814
Other assets	16,246	15,548
Total Assets	$ 662,286	$ 621,357
Liabilities		
Deposits		
Demand (non-interest bearing)	$ 77,709	$ 77,354
Savings and Interest checking	287,950	254,722
Time	123,984	124,723
Total Deposits	489,643	456,799
Securities sold under agreements to repurchase	71,016	52,069
Short term borrowings	600	4,000
Long term debt	39,898	48,546
Other liabilities	4,136	4,273
Total Liabilities	605,293	565,687
Shareholders equity		
Common stock $1 par value per share, 15,000 shares authorized with 3,806 shares issued and 3,353 shares and 3,352 shares outstanding at June 30, 2006 and December 31, 2005, respectively	3,806	3,806
Capital stock without par value, 5,000 shares authorized with no shares issued or outstanding		

Additional paid in capital		20,016		19,907
Retained earnings		40,362		38,638
Accumulated other comprehensive income		316		801
Treasury stock, 453 shares and 454 shares at cost at June 30, 2006 and December 31, 2005, respectively		(7,507)		(7,482)
Total shareholders equity		56,993		55,670
Total Liabilities and Shareholders Equity	$	662,286	$	621,357

The accompanying notes are an integral part of these financial statements

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Consolidated Statements of Income

(Amounts in thousands, except per share data)

(unaudited)

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2006	2005	2006	2005
Interest Income				
Loans	$ 7,138	$ 5,616	$ 13,747	$ 10,663
Interest and dividends on investments:				
Taxable interest	1,287	1,032	2,484	1,998
Tax exempt interest	513	442	978	885
Dividend income	77	65	145	133
Federal funds sold	143	52	195	94
Deposits and obligations of other banks	12	5	20	7
Total interest income	9,170	7,212	17,569	13,780
Interest Expense				
Deposits	3,059	1,739	5,717	3,285
Securities sold under agreements to repurchase	777	322	1,319	537
Short term borrowings	1	9	27	53
Long term debt	540	710	1,148	1,423
Total interest expense	4,377	2,780	8,211	5,298
Net interest income	4,793	4,432	9,358	8,482
Provision for loan losses	60	80	240	186
Net interest income after provision for loan losses	4,733	4,352	9,118	8,296
Noninterest Income				
Investment and trust services fees	818	726	1,615	1,412
Service charges and fees	954	802	1,793	1,531
Mortgage banking activities	163	12	218	180
Increase in cash surrender value of life insurance	115	114	230	237
Equity method investments	62	(88)	(14)	(508)
Securities gains, net		64	95	219
Total noninterest income	2,112	1,630	3,937	3,071
Noninterest Expense				
Salaries and benefits	2,169	2,075	4,454	4,459
Net occupancy expense	297	292	605	587
Furniture and equipment expense	167	179	344	368
Advertising	308	303	543	455
Legal & professional fees	225	235	479	432
Data processing	264	276	609	492
Pennsylvania bank shares tax	124	120	247	241
Other	**745**	732	**1,485**	1,403
Total noninterest expense	4,299	4,212	8,766	8,437
Income before Federal income taxes	2,546	1,770	4,289	2,930
Federal income tax expense	668	317	922	87
Net income	$ 1,878	$ 1,453	$ 3,367	$ 2,843
Per share data				
Basic earnings per share	$ 0.56	$ 0.43	$ 1.00	$ 0.84
Diluted earnings per share	$ 0.56	$ 0.43	$ 1.00	$ 0.84

Cash dividends declared	$	0.25	$	0.24	$	0.49	$	0.47

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

Consolidated Statements of Changes in Shareholders Equity

for the six months ended June 30, 2006 and 2005

(unaudited)

(Dollars in thousands, except per share data)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total
Balance at December 31, 2004	$ 3,806	$ 19,864	$ 35,723	$ 2,175	$ (6,925)	$ 54,643
Comprehensive income:						
Net income			2,843			2,843
Unrealized loss on securities, net of reclassification adjustments				(673)		(673)
Unrealized loss on hedging actvities, net of reclassification adjustments				(32)		(32)
Total Comprehensive income						2,138
Cash dividends declared, $.47 per share			(1,584)			(1,584)
Acquisition of 5,000 shares of treasury stock					(134)	(134)
Common stock issued under stock option plans		23			69	92
Balance at June 30, 2005	$ 3,806	$ 19,887	$ 36,982	$ 1,470	$ (6,990)	$ 55,155
Balance at December 31, 2005	$ 3,806	$ 19,907	$ 38,638	$ 801	$ (7,482)	$ 55,670
Comprehensive income:						
Net income			3,367			3,367
Unrealized loss on securities, net of reclassification adjustments				(559)		(559)
Unrealized gain on hedging actvities, net of reclassification adjustments				74		74
Total Comprehensive income						2,882
Cash dividends declared, $.49 per share			(1,643)			(1,643)
Acquisition of 6,592 shares of treasury stock					(166)	(166)
Common stock issued under stock option plans		70			141	211
Stock option compensation		39				39
Balance at June 30, 2006	$ 3,806	$ 20,016	$ 40,362	$ 316	$ (7,507)	$ 56,993

Consolidated Statements of Cash Flows

(unaudited)

(Amounts in thousands)	For the Six Months Ended June 30 2006	2005
Cash flows from operating activities		
Net income	**$ 3,367**	$ 2,843
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**537**	574
Net amortization of investment securities	**3**	214
Stock option compensation expense	**39**	
Amortization and write down of mortgage servicing rights	**50**	130
Provision for loan losses	**240**	186
Securities gains, net	**(95)**	(219)
Loans originated for sale	**(13,053)**	(28,642)
Proceeds from sale of loans	**10,383**	34,638
Gain on sales of loans	**(104)**	(167)
Loss on sale or disposal of premises and equipment	**5**	57
Increase in cash surrender value of life insurance	**(230)**	(237)
Increase in interest receivable and other assets	**(670)**	(61)
Increase (decrease) in interest payable and other liabilities	**198**	(68)
Other, net	**27**	50
Net cash provided by operating activities	**697**	9,298
Cash flows from investing activities		
Proceeds from sales of investment securities available for sale	**537**	643
Proceeds from maturities of investment securities available for sale	**20,131**	22,080
Net decrease in restricted stock	**315**	528
Purchase of investment securities available for sale	**(26,620)**	(25,145)
Net increase in loans	**(35,840)**	(29,380)
Investment in joint venture		(186)
Proceeds from sale of premises and equipment		103
Capital expenditures	**(1,030)**	(113)
Net cash used in investing activities	**(42,507)**	(31,470)
Cash flows from financing activities		
Net increase in demand deposits, NOW accounts and savings accounts	**33,583**	19,328
Net (decrease) increase in certificates of deposit	**(739)**	1,404
Net increase in short term borrowings	**15,547**	3,654
Long term debt advances		5,000
Long term debt payments	**(8,648)**	(3,253)
Dividends paid	**(1,643)**	(1,584)
Common stock issued under stock option plans	**211**	92
Purchase of treasury shares	**(166)**	(134)
Net cash provided by financing activities	**38,145**	24,507
(Decrease) increase in cash and cash equivalents	**(3,665)**	2,335
Cash and cash equivalents as of January 1	**24,738**	10,209
Cash and cash equivalents as of June 30	**$ 21,073**	$ 12,544

The accompanying notes are an integral part of these statements.

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FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Franklin Financial Services Corporation (the Corporation), and its wholly-owned subsidiaries, Farmers and Merchants Trust Company of Chambersburg (the Bank), Franklin Financial Properties Corp., and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank that has one wholly-owned subsidiary, Franklin Realty Services Corporation. Franklin Realty Services Corporation is an inactive real-estate brokerage company. Franklin Financial Properties Corp. holds real estate assets that are leased by the Bank. Franklin Future Fund Inc. is a non-bank investment company. All significant intercompany transactions and account balances have been eliminated.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations, and cash flows at June 30, 2006, and for all periods presented have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. It is suggested that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation s 2005 Annual Report on Form 10-K. The results of operations for the period ended June 30, 2006 are not necessarily indicative of the operating results for the full year.

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

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

	For the three months ended June 30		**For the six months ended June 30**	
(Amounts in thousands)	**2006**	**2005**	**2006**	**2005**
Weighted average shares outstanding (basic)	3,350	3,367	3,351	3,369
Impact of common stock equivalents	6	7	7	9
Weighted average shares outstanding (diluted)	3,356	3,374	3,358	3,378

Note 2 Comprehensive Income

The components of other comprehensive income (loss) are as follows:

(Amounts in thousands)	Three months ended June 30 2006	Three months ended June 30 2005	Six months ended June 30 2006	Six months ended June 30 2005
Investment Securities:				
Unrealized holding (losses) gains arising during the period	**$ (773)**	$ 361	$ (751)	$ (1,083)
Reclassification adjustments for gains included in net income		(64)	(95)	(219)
Cash-flow Hedges:				
Unrealized holding gains (losses) arising during the period	**33**	(83)	84	63
Reclassification adjustments for losses included in net income	**8**	81	29	171
Other comprehensive (loss) income	**(732)**	295	(733)	(1,068)
Tax Effect	**249**	(100)	248	363
Other comprehensive (loss) income, net of tax	**$ (483)**	$ 195	$ (485)	$ (705)

Note 3 Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank, generally, holds collateral and/or personal guarantees supporting these commitments. The Bank had $14.8 million standby letters of credit as of June 30, 2006 and $9.7 million as of December 31, 2005. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees.

Note 4 Stock Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123(R), Share-Based Payment. Statement No. 123(R) revised Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. Statement No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements (with limited exceptions). The amount of compensation cost is measured on the grant-date fair value of the equity or liability instruments issued. Compensation cost is recognized over the period that an employee provides services in exchange for the award.

The Corporation implemented Statement No. 123(R) in the first quarter of 2006. For the second quarter of 2006, $25 thousand was recognized as compensation expense and $39 thousand has been recognized as compensation expense year-to-date. This expense is related to options granted in February 2006 under the Corporation s Incentive Stock Option Plan of 2002. The total value of this award is $50 thousand. The remaining balance of $11 thousand will be accrued ratably over the remaining service period.

Prior to the implementation of FASB Statement No. 123(R), stock options were accounted for under Accounting Principal Bulletin (APB) No. 25. Under APB 25, no compensation expense was recognized related to these options. Had compensation expense for the plans been recognized in accordance with Statement No. 123(R) in 2005, the Corporation s net income and per share amounts would have been reduced to the following pro-forma amounts.

(Amounts in thousands, except per share)		**Three Months Ended June 30, 2005**	**Six Months Ended June 30, 2005**
Net Income:	As reported	**$ 1,453**	$ 2,843
	Compensation not expensed	**(40)**	(67)
	Proforma	**$ 1,413**	$ 2,776
Basic earnings per share:	As reported	**$ 0.43**	$ 0.84
	Proforma	**0.42**	0.82
Diluted earnings per share:	As reported	**$ 0.43**	$ 0.84
	Proforma	**0.42**	0.82

Note 5 Pensions

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

(Amounts in thousands)	Three months ended June 30 2006	Three months ended June 30 2005	Six months ended June 30 2006	Six months ended June 30 2005
Components of net periodic benefit cost:				
Service cost	**$ 91**	$ 107	**$ 183**	$ 214
Interest cost	**172**	175	**345**	350
Expected return on plan assets	**(219)**	(218)	**(440)**	(436)
Amortization of prior service cost	**22**	24	**44**	170
Net periodic benefit cost	**$ 66**	$ 88	**$ 132**	$ 298

Note 6 Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that companies recognize in their financial statements the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on our financial statements.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets An Amendment of FASB Statement No. 140 (SFAS 156). SFAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. The statement permits, but does not require, the subsequent measurement of servicing assets and servicing liabilities at fair value. SFAS 156 is effective as of the beginning of an entity s first fiscal year that begins after September 15, 2006, which for the Company will be as of the beginning of fiscal 2007. The Company does not believe that the adoption of SFAS 156 will have a significant effect on its financial statements.

Note 7 Reclassification

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

Note 8 Acquisition

On January 23, 2006, Franklin Financial Services Corporation (the Corporation) entered into an Agreement and Plan of Merger (the Merger Agreement) with Fulton Bancshares Corporation (Fulton) pursuant to which Fulton will merge with and into the Corporation (the Merger) with the Corporation being the surviving corporation in the Merger. In connection with the Merger, Fulton will also cause its wholly-owned subsidiary, Fulton County National Bank and Trust Company (FCNB), to merge with and into the Corporation s wholly-owned subsidiary, Farmers and Merchants Trust Company of Chambersburg (F&M Trust), (the Bank Merger) with F&M Trust being the surviving bank in the Bank Merger. Additionally, pursuant to the terms of the Merger Agreement, two (2) persons designated by Fulton s board of directors shall be appointed to the Corporation s board.

On July 1, 2006, Franklin Financial Services Corporation(OTCBB: FRAF) (Franklin Financial) completed its acquisition of Fulton Bancshares Corporation (Fulton Bancshares) pursuant to the previously announced Agreement and Plan of Merger, dated as of January 23, 2006, between Franklin Financial and Fulton Bancshares (the Merger Agreement).

The total estimated purchase price of the transaction is valued at approximately $23.9 million.

PART I, Item 2

Management s Discussion and Analysis of Results of Operations and Financial Condition

For the Three and Six Month Periods Ended June 30, 2006 and 2005

Forward Looking Statements

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

Critical Accounting Policies

Management has identified critical accounting policies for the Corporation to include Allowance for Loan Losses, Mortgage Servicing Rights, Financial Derivatives, Temporary Investment Impairment and Stock-based Compensation. The Corporation implemented Financial Accounting Standards Board (FASB) Statement No. 123(R), Share-Based Payment in the first quarter of 2006. There were no other changes to the critical accounting policies disclosed in the 2005 Annual Report on Form 10-K in regards to application or related judgements and estimates used. Please refer to Item 7 on pages 14 - 17 of the Corporation s 2005 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Acquisition

On January 23, 2006, Franklin Financial Services Corporation (the Corporation) entered into an Agreement and Plan of Merger (the Merger Agreement) with Fulton Bancshares Corporation (Fulton) pursuant to which Fulton will merge with and into the Corporation (the Merger) with the Corporation being the surviving corporation in the Merger. In connection with the Merger, Fulton will also cause its wholly-owned subsidiary, Fulton County National Bank and Trust Company (FCNB), to merge with and into the Corporation s wholly-owned subsidiary, Farmers and Merchants Trust Company of Chambersburg (F&M Trust), (the Bank Merger) with F&M Trust being the surviving bank in the Bank Merger. Additionally, pursuant to the terms of the Merger Agreement, two (2) persons designated by Fulton s board of directors shall be appointed to the Corporation s board.

On July 1, 2006, Franklin Financial Services Corporation(OTCBB: FRAF) (Franklin Financial) completed its acquisition of Fulton Bancshares Corporation (Fulton Bancshares) pursuant to the previously announced Agreement and Plan of Merger, dated as of January 23, 2006, between Franklin Financial and Fulton Bancshares (the Merger Agreement).

In accordance with the terms of the Merger Agreement, the shareholders of Fulton Bancshares are entitled to receive, for each share of Fulton Bancshares common stock they own, (a) $48.00 cash; or (b)

1.864 shares of Franklin Common Stock. As a result of the transaction, Franklin Financial will issue approximately 492,790 shares of its common stock to former shareholders of Fulton Bancshares.

The total estimated purchase price of the transaction is valued at approximately $23.9 million.

In connection with the transaction, The Fulton County National Bank and Trust Company, a subsidiary of Fulton Bancshares, has merged with and into Farmers and Merchants Trust Company of Chambersburg (F&M Trust), a subsidiary of Franklin Financial.

Also in accordance with the Merger Agreement, Martin R. Brown and Stanley J. Kerlin, Esquire, formerly directors of Fulton Bancshares, have been appointed to serve as Directors for Franklin Financial and F&M Trust. Mr. Brown will serve as a Class B director of Franklin Financial with a term of office through Franklin Financial s 2007 annual meeting of shareholders and Mr. Kerlin will serve as a Class A director of Franklin Financial with a term of office through Franklin Financial s 2008 annual meeting of shareholders. Except for the Merger Agreement, there was no arrangement or understanding between Messrs. Brown and Kerlin and any other person pursuant to which they were selected as a director.

Results of Operations

Summary

The Corporation reported net income for the second quarter of $1.9 million and $3.4 million for the six months ended June 30, 2006. For the quarter, net income increased 29.2% versus net income of $1.5 million during the second quarter of 2005. Year-to-date net income increased 18.4% from $2.8 million in 2005. Diluted earnings per share also increased from $.43 for the second quarter of 2005 to $.56 in 2006. Year-to-date diluted earnings per share were $1.00 in 2006 compared to $.84 in 2005.

Total assets increased $41 million from year-end 2005 with most of the growth occurring in the commercial loan portfolio. At June 30, 2006, total assets were $662.3 million. The increase in assets was funded primarily by deposit growth during the period.

Other key performance ratios as of, or for the six months ended June 30 are listed below:

	2006	**2005**
Return on average equity (ROE)	11.86%	10.33%
Return on average assets (ROA)	1.06%	.98%

A more detailed discussion of the operating results for the three and six months ended June 30, 2006 follows:

Net Interest Income

Comparison of the three months ended June 30, 2006 to the three months ended June 30, 2005:

Net interest income increased $361 thousand (8.1%) during the period to $4.8 million compared to $4.4 million in the prior year period. Interest income increased by $2.0 million, of which approximately $1.5 million came from interest on loans. Of the total increase, approximately $1.0 million was the result of changes in interest rates and approximately $1.0 million was due to growth in interest earning assets, primarily commercial loans. On average, commercial loans were $40 million higher during the second quarter of 2006 as compared to the same period in 2005.

Interest expense increased $1.6 million quarter-over-quarter with the majority of the increase coming from increased interest expense on deposits. The increase in interest expense was primarily the result of rising interest rates on the Money Management product and Securities Purchased Under Agreements to Repurchase (Repos). While both of these accounts showed nice growth as measured by average outstanding balances, the interest rate on these products is indexed to short-term rates and as the Federal Reserve continued to raise short-term rates, the cost of these accounts increased.

Comparison of the six months ended June 30, 2006 to the six months ended June 30, 2005:

For the first six months of 2006, net interest income was $9.4 million. This is an increase of $876 thousand (10.3%) as compared to net interest income of $8.5 million reported in 2005. Interest income increased by $3.8 million with over $3.0 million of this increase attributable to an increase in loan interest. The total increase was nearly equally attributable to volume and rate factors. Average loans outstanding increased $50.2 million on a year-to-date basis as compared to 2005. Commercial loans contributed most of the loan growth during 2006 and also benefited by the continued increase in short-term interest rates.

Interest expense was $8.2 million for the first six months of 2006. This is $2.9 million greater than interest expense of $5.3 million in 2005. Interest expense on deposits contributed the largest dollar increase from 2005, most of which is the result of a $53 million increase in average outstanding balances on the Money Management product. Interest expense on Repos also increased due to higher interest rates and to a lesser extent, an increase in average outstanding balances. The interest expense on long-term debt decreased year-over-year due to the prepayment of Federal Home Loan Bank debt in December 2005 and again in April 2006.

The Federal Reserve continued to increase short-term interest rates during 2005 and the first half of 2006. The Federal funds rate increased from 3.25% on June 30, 2005 to 5.25% on June 30, 2006. The prime rate also increased from 6.25% to 8.25%. The rate increases helped increase the yield on earning assets from 5.44% in 2005 to 6.28% in 2006. However, the cost of interest-bearing liabilities also increased from 2.38% to 3.31%. The interest spread decreased from 3.06% to 2.97%, from 2005 to 2006, and the net interest margin fell from 3.44% to 3.41%.

Provision for Loan Losses

The Corporation charged $60 thousand against earnings for loan losses during the second quarter of 2006 versus $80 thousand for the same period in 2005. For the first six months of 2006, the provision for loan losses was $240 thousand compared to $186 thousand for the same period in 2005.

For more information concerning loan quality and the allowance for loan losses, refer to the Asset Quality discussion.

Noninterest Income

Comparison of the three months ended June 30, 2006 to the three months ended June 30, 2005:

Noninterest income for the second quarter was $2.1 million. This is $546 thousand more than reported in the second quarter of 2005, when noninterest income was $1.6 million, excluding securities gains. There were no securities gains recorded in the second quarter of 2006 and $64 thousand recorded in the second quarter of 2005.

All categories of noninterest income, except securities gains, showed an increase for the quarter when compared to 2005. Investment and Trust Service fees increased as trust assets under management have increased $59 million from a year ago and commissions earned by the Bank s Personal Investment Centers increased 44%. Other fee income increased $152 thousand during the quarter. Contributing to this increase was an increase in loan fees of $112 thousand. Much of the increase in loan fees is attributable to commercial loan fees and debt protection fees. Due to strong growth in commercial lending activity, the Bank has recognized more commercial loan fees. The consumer debt protection product was introduced in 2005 and provides debt protection in the event of death, disability or involuntary unemployment. Fee income from debit card activity increased $20 thousand quarter-over-quarter. Fees and service charges on deposit accounts were relatively flat at $480 thousand when compared to the second quarter of 2005. Mortgage banking fees increased $151 thousand during the quarter due to a $178 thousand shift from an impairment charge of $95 thousand in the second quarter of 2005 to income of $83 thousand in the second quarter of 2006 from the partial reversal of previously recorded impairment charges. Income from investments accounted for on the equity method of accounting swung from a loss of $88 thousand in 2005 to income of $62 thousand. The Bank s remaining equity method investment in American Home Bank is expected to be profitable in 2006 and therefore, add to noninterest income in 2006 as experienced in the second quarter of 2006.

Comparison of the six months ended June 30, 2006 to the six months ended June 30, 2005:

Year-to-date, noninterest income, excluding securities gains, increased $990 thousand to $3.8 million from $2.9 million in 2005. Fee income from Investment and Trust Services increased $203 thousand versus the prior year. This increase came from an increase in trust assets under management and commissions from the sale of investment products by the Bank s Personal Investment Centers. Service charges and fee income increased 14.4% over the prior year. The same factors that contributed to the increase in other fee income for the second quarter are primarily responsible for the increase in other fee income on a year-to-date basis. However, while total deposit fees were flat quarter-over-quarter, total deposit fees were up $53 thousand year-over-year due primarily to increases in retail deposit fees. Mortgage banking fees are up $39 thousand from 2005. During 2006, the Bank reversed previously recorded impairment charges of $71 thousand as compared to an impairment charge of $22 thousand in 2005. However, this positive swing of $93 thousand was somewhat offset by a decrease in gains from the sale of mortgages. Income from equity method investments showed the biggest improvement moving from a loss of $508 thousand in 2005 to a loss of only $14 thousand in 2006. The 2005 loss was due primarily to losses on the Bank s investment in a joint-venture mortgage banking company. This company discontinued operation in the first quarter of 2005. The Bank s remaining equity method investment in American Home Bank is expected to be profitable in 2006 and therefore, add to noninterest income in 2006 as experienced in the second quarter of 2006.

Securities gains were $95 thousand in 2006 versus $219 thousand in 2005.

Noninterest Expense

Comparison of the three months ended June 30, 2006 to the three months ended June 30, 2005:

For the second quarter of 2006, noninterest expense was $4.3 million. This is $87 thousand more than the second quarter of 2005 total of $4.2 million. Salaries and benefits increased $94 thousand quarter-over-quarter. Increases in salary expense and health insurance premiums contributed to the increase from 2005. Also during the second quarter of 2006, stock option compensation expense of $25 thousand was recorded and no expense was recorded in 2005. All other noninterest expense categories were generally flat quarter-over quarter.

Comparison of the six months ended June 30, 2006 to the six months ended June 30, 2005:

Noninterest expense for the first six months of 2006 was $8.8 million as compared to $8.4 million for the same period in 2005. Total salaries and benefits declined slightly year-over-year. During the period, salary expense increased $116 thousand and the Corporation expensed $39 thousand in stock option compensation. However, these increases were offset by a decline in health and pension costs, and incentive compensation expense. Included in the health insurance and pension costs for 2005 was a one-time charge totaling $130 thousand for a severance agreement that was not present in 2006. Advertising costs increased due primarily to the timing of media placement as compared to the prior year and increases due to promotion of the Bank s 100th anniversary in 2006. Data processing expense increased $117 thousand from 2005. Nearly half of this increase was caused by a $60 thousand credit received in 2005 (but not in 2006) by the Bank from its core system processor as an incentive to renew a contract. Included in noninterest expense is a prepayment penalty of $17 thousand for the prepayment of debt with the Federal Home Loan Bank of Pittsburgh during the second quarter of 2006.

Federal income tax expense was $668 thousand for the second quarter of 2006 and $922 thousand year-to-date 2006. This expense resulted in an effective tax rate for the second quarter of 2006 of 26.2% and 21.5% on a year-to-date basis. Federal income tax expense for the first six months of 2006 was $835 thousand more than the expense of $87 thousand recorded for the same period in 2005. For both the second quarter and six months of 2006, pre-tax income was more than 40% higher than in the same periods of 2005. During the first quarter of 2005, the Corporation reversed income tax expense when it became apparent that an accrual for additional taxes was no longer warranted. The reversal was primarily responsible for the lower than normal tax expense in 2005. All taxable income for the Corporation is taxed at a rate of 34%.

Financial Condition

Total assets reached $662.3 million as of June 30, 2006 as compared to $621.4 million at December 31, 2005. Total cash and cash equivalents decreased slightly while investment securities increase slightly during the period. Net loans increased $35.4 million (9%) to $427.2 million at June 30, 2006 from $391.8 million at the prior year-end. Commercial loan growth continues to be strong and these loans have increased nearly $34 million, or 14.9% during the period. Consumer lending activity has also been good during the period with most categories of consumer loans registering an increase from December 31, 2005. Most of the growth in consumer lending has occurred in the home equity loan portfolio and is the result of competitive pricing and periodic home equity loan specials offered by the Bank. Mortgage loans outstanding continue to decline as the Bank retains fewer of its originated mortgages and outstanding balances continue to pay down.

As of June 30, 2006, total deposits were $489.6 million. This balance represents an increase of $32.8 million from $456.8 million at December 31, 2005. After falling slightly during the first quarter as compared to the prior year-end balance, demand deposits have rebounded during the second quarter and are virtually unchanged at $77.7 million from December 31, 2005. During the year, the Bank has continued to have rapid growth in its Money Management product. This product has grown $37.4 million (approximately 30%) to $162.8 million as of June 30, 2006. This growth has been primarily in the form of new accounts opened during the period The product is indexed to short-term interest rates and has become very popular as short-term market interest rates have increased. The Bank is pleased with the growth in the Money Management product, especially the new account relationships, however it continues to monitor the effect of this rapid growth on its balance sheet. Securities sold under agreements to repurchase (Repos) increased nearly $19 million reaching $71 million as of June 30, 2006. After remaining fairly flat for much of the year, the Repo balances increased quickly during the second half of the second quarter of 2006. This spike occurred in the account of one commercial relationship. The Bank is monitoring this account and has had discussion with the account holder with regard to the its plans for the excess funds in the account. With the increase in deposits and Repos, the short-term borrowing position of the Bank has been reduced since year-end. Likewise, long-term debt has decreased by $8.6 million due primarily to a scheduled debt maturity of $5.0 million in the first quarter and the prepayment of $2.1 million during the second quarter of 2006. The prepayment of long-term debt was undertaken to eliminate high interest rate debt.

Total shareholders equity recorded a net increase of $1.3 million to $57 million at June 30, 2006 from $55.7 million at December 31, 2005. Cash dividends declared in the second quarter were $838 thousand and $1.6 million year-to-date. The Corporation repurchased 6,592 shares of its common stock for approximately $166 thousand during the year.

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. At June 30, 2006, the Corporation was well capitalized as defined by the banking regulatory agencies. Regulatory capital ratios for the Corporation and the Bank are shown below:

		Regulatory Ratios	
	June 30, 2006	**Minimum**	**Well Capitalized Minimum**
Total Risk Based Capital Ratio			
Franklin Financial Services Corporation	13.31%	8.0%	n/a
Farmers & Merchants Trust Company	11.16%	8.0%	10.0%
Tier 1 Capital Ratio			
Franklin Financial Services Corporation	12.04%	4.0%	n/a
Farmers & Merchants Trust Company	9.93%	4.0%	6.0%
Leverage Ratio			
Franklin Financial Services Corporation	8.81%	4.0%	n/a
Farmers & Merchants Trust Company	7.21%	4.0%	5.0%

Asset Quality

The Bank saw a slight increase in nonperforming loans from year-end 2005. This increase was due to an increase in the balance of loans past due 90 days or more as of June 30, 2006. Likewise, the nonperforming ratios increased slightly from year-end 2005. The Corporation held no foreclosed real estate on June 30, 2006. The following table presents a summary of nonperforming assets:

(Dollars in thousands)		June 30 2006		December 31 2005
Nonaccrual loans	$	186	$	206
Loans past due 90 days or more and not include above		826		583
Total nonperforming loans		1,012		789
Foreclosed real estate				
Total nonperforming assets	$	1,012	$	789
Nonperforming loans to total loans		0.23%		0.20%
Nonperforming assets to total assets		0.15%		0.13%
Allowance for loan losses to nonperforming loans		550.20%		648.66%

Net charge-offs during the second quarter of 2006 were $12 thousand compared to a net recovery of $238 thousand in the second quarter of 2005. During the second quarter of 2005, the Bank recovered $266 thousand from a previously charged-off commercial credit that contributed to the net recovery position in 2005.

For the first six months of 2006, the provision for loan losses was $240 thousand compared to $186 thousand for the same period in 2005. Net charge-offs increased in 2006 due primarily to the large recovery recorded in 2005, but not again in 2006. Gross charge-offs have remained constant year over year. The annualized ratio of net charge-offs to average loans was .04% for the first six months of 2006 compared to a net recovery ratio of (.03%) in 2005.

The allowance for loan losses was $5.6 million at June 30, 2006, as compared to $5.4 million at December 31, 2005. The allowance for loan losses as a percentage of total loans was 1.29% at June 30, 2006, versus 1.36% at year-end 2005. The decrease in the allowance coverage ratio is due to strong loan growth in 2006. The allowance provided coverage for nonperforming loans at a ratio of approximately 550% at June 30, 2006, slightly less than the coverage ratio at December 31, 2005.

The Corporation monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy assessment monthly to the Board of Directors. This assessment is used to determine the provision for loan loss. The following table presents an analysis of the allowance for loan losses.

Allowance for Loan Losses

	Three Months Ended June 30				Six Months Ended June 30				Twelve Months Ended December 31	
(amounts in thousands)		2006		2005		2006		2005		2005
Balance at beginning of period	$	5,520	$	4,937	$	5,402	$	4,886	$	4,886
Charge-offs		(65)		(58)		(143)		(141)		(285)
Recoveries		53		296						