

FRANKLIN FINANCIAL SERVICES CORP /PA/

Form 10-Q

November 10, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2014

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

PENNSYLVANIA

(State or other jurisdiction of incorporation or organization)

25-1440803

(I.R.S. Employer Identification No.)

20 South Main Street, Chambersburg PA17201-0819

(Address of principal executive offices) (Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

Not Applicable

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

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

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

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

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

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

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

There were 4,202,690 outstanding shares of the Registrant’s common stock as of October 31, 2014.

---

INDEX

Part I - FINANCIAL INFORMATION

<u>Item 1</u>	<u>Financial Statements</u>	
	<u>Consolidated Balance Sheets as of September 30, 2014 and December 31, 2013 (unaudited)</u>	1
	<u>Consolidated Statements of Income for the Three and Nine Months ended September 30, 2014 and 2013 (unaudited)</u>	2
	<u>Consolidated Statements of Comprehensive Income for the Three and Nine Months ended September 30, 2014 and 2013 (unaudited)</u>	3
	<u>Consolidated Statements of Changes in Shareholders' Equity for the Nine Months ended September 30, 2014 and 2013 (unaudited)</u>	3
	<u>Consolidated Statements of Cash Flows for the Nine Months ended September 30, 2014 and 2013 (unaudited)</u>	4
	<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
<u>Item 2</u>	<u>Management's Discussion and Analysis of Results of Operations and Financial Condition</u>	28
<u>Item 3</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	52
<u>Item 4</u>	<u>Controls and Procedures</u>	52

Part II - OTHER INFORMATION

<u>Item 1</u>	<u>Legal Proceedings</u>	53
<u>Item 1A</u>	<u>Risk Factors</u>	53
<u>Item 2</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	53
<u>Item 3</u>	<u>Defaults Upon Senior Securities</u>	53
<u>Item 4</u>	<u>Mine Safety Disclosures</u>	53
<u>Item 5</u>	<u>Other Information</u>	53
<u>Item 6</u>	<u>Exhibits</u>	53
	<u>SIGNATURE PAGE</u>	54
	<u>EXHIBITS</u>	

## Part I FINANCIAL INFORMATION

## Item 1 Financial Statements

## Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)	(unaudited) September 30 2014	December 31 2013
<b>Assets</b>		
Cash and due from banks	\$ 15,302	\$ 13,542
Interest-bearing deposits in other banks	40,905	27,203
Total cash and cash equivalents	56,207	40,745
Investment securities available for sale, at fair value	176,111	159,674
Restricted stock	1,938	1,906
Loans held for sale	1,333	349
Loans	730,645	723,413
Allowance for loan losses	(8,935)	(9,702)
Net Loans	721,710	713,711
Premises and equipment, net	15,386	16,145
Bank owned life insurance	21,956	21,530
Goodwill	9,016	9,016
Other intangible assets	387	698
Other real estate owned	3,737	4,708
Deferred tax asset, net	4,617	5,445
Other assets	10,400	10,660
Total assets	\$ 1,022,798	\$ 984,587
<b>Liabilities</b>		
<b>Deposits</b>		
Noninterest-bearing checking	\$ 138,346	\$ 121,565
Money management, savings and interest checking	657,731	610,245
Time	102,788	113,914
Total Deposits	898,865	845,724
Securities sold under agreements to repurchase	1,556	23,834
Long-term debt	12,000	12,403
Other liabilities	8,290	7,238
Total liabilities	920,711	889,199
<b>Shareholders' equity</b>		
Common stock, \$1 par value per share, 15,000,000 shares authorized with 4,589,842 shares issued and 4,201,413 shares outstanding at September 30, 2014 and 4,560,700 shares issued and 4,168,673 shares outstanding at December 31, 2013	4,590	4,561

Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding	-	-
Additional paid-in capital	37,141	36,636
Retained earnings	70,320	65,897
Accumulated other comprehensive loss	(3,018)	(4,696)
Treasury stock, 388,429 shares at September 30, 2014 and 392,027 shares at December 31, 2013, at cost	(6,946)	(7,010)
Total shareholders' equity	102,087	95,388
Total liabilities and shareholders' equity	\$ 1,022,798	\$ 984,587

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

## Consolidated Statements of Income

(Dollars in thousands, except per share data) (unaudited)	For the Three Months Ended		For the Nine Months Ended	
	September 30 2014	2013	September 30 2014	2013
Interest income				
Loans, including fees	\$ 7,706	\$ 8,019	\$ 22,865	\$ 24,351
Interest and dividends on investments:				
Taxable interest	665	476	1,967	1,194
Tax exempt interest	386	378	1,120	1,135
Dividend income	24	19	80	59
Deposits and obligations of other banks	49	49	133	180
Total interest income	8,830	8,941	26,165	26,919
Interest expense				
Deposits	679	811	2,076	3,076
Securities sold under agreements to repurchase	2	10	11	40
Long-term debt	118	124	360	367
Total interest expense	799	945	2,447	3,483
Net interest income	8,031	7,996	23,718	23,436
Provision for loan losses	-	350	464	1,955
Net interest income after provision for loan losses	8,031	7,646	23,254	21,481
Noninterest income				
Investment and trust services fees	1,120	1,140	3,311	3,288
Loan service charges	265	232	682	674
Mortgage banking activities	15	18	47	36
Deposit service charges and fees	563	472	1,553	1,359
Other service charges and fees	317	232	901	687
Debit card income	339	315	982	917
Increase in cash surrender value of life insurance	139	150	426	455
Other real estate owned (losses) gains, net	-	(119)	(184)	(260)
Other	30	89	92	179
OTTI losses recognized in earnings	(20)	(25)	(20)	(75)
Securities gains, net	-	-	221	30
Total noninterest income	2,768	2,504	8,011	7,290
Noninterest expense				
Salaries and employee benefits	4,191	3,977	12,548	12,208
Net occupancy expense	555	566	1,817	1,702
Furniture and equipment expense	241	239	732	730
Advertising	312	386	898	1,039
Legal and professional fees	361	233	979	871
Data processing	471	472	1,355	1,317
Pennsylvania bank shares tax	173	204	520	612
Intangible amortization	104	106	311	319
FDIC insurance	236	245	690	760

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

ATM/debit card processing	188	174	545	520
Other	916	780	2,656	2,513
Total noninterest expense	7,748	7,382	23,051	22,591
Income before federal income tax expense	3,051	2,768	8,214	6,180
Federal income tax expense	641	583	1,659	1,089
Net income	\$ 2,410	\$ 2,185	\$ 6,555	\$ 5,091

Per share

Basic earnings per share	\$ 0.57	\$ 0.53	\$ 1.57	\$ 1.23
Diluted earnings per share	\$ 0.57	\$ 0.53	\$ 1.56	\$ 1.23
Cash dividends declared	\$ 0.17	\$ 0.17	\$ 0.51	\$ 0.51

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

## Consolidated Statements of Comprehensive Income

(Dollars in thousands) (unaudited)	For the Three Months Ended September 30		For the Nine Months Ended September 30	
	2014	2013	2014	2013
Net Income	\$ 2,410	\$ 2,185	\$ 6,555	\$ 5,091
Securities:				
Unrealized gains (losses) arising during the period	275	(1,772)	2,469	(3,362)
Reclassification adjustment for losses (gains) included in net income	20	25	(201)	45
Net unrealized gains (losses)	295	(1,747)	2,268	(3,317)
Tax effect	(100)	594	(771)	1,128
Net of tax amount	195	(1,153)	1,497	(2,189)
Derivatives:				
Unrealized gains (losses) arising during the period	2	(20)	(10)	24
Reclassification adjustment for losses included in net income (1)	96	97	285	429
Net unrealized gains	98	77	275	453
Tax effect	(34)	(26)	(94)	(154)
Net of tax amount	64	51	181	299
Total other comprehensive income (loss)	259	(1,102)	1,678	(1,890)
Total Comprehensive Income	\$ 2,669	\$ 1,083	\$ 8,233	\$ 3,201
			Tax expense	Tax expense
Reclassification adjustment / Statement line item			(benefit)	(benefit)
(1) Derivatives / interest expense on deposits	\$ (33)	\$ (33)	\$ (97)	\$ (146)

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

## Consolidated Statements of Changes in Shareholders' Equity

For the Nine months September 30, 2014 and 2013:



	Common	Additional Paid-in	Retained	Accumulated Other Comprehensive	Treasury	Total
(Dollars in thousands, except per share data) (unaudited)	Stock	Capital	Earnings	Loss	Stock	Total
Balance at December 31, 2012	\$ 4,503	\$ 35,788	\$ 62,475	\$ (4,050)	\$ (7,082)	\$ 91,634
Net income	-	-	5,091	-	-	5,091
Other comprehensive loss	-	-	-	(1,890)	-	(1,890)
Cash dividends declared, \$.51 per share	-	-	(2,103)	-	-	(2,103)
Treasury shares issued under stock option plans, 4,007 shares	-	(20)	-	-	72	52
Common stock issued under dividend reinvestment plan, 36,616 shares	37	545	-	-	-	582
Balance at September 30, 2013	\$ 4,540	\$ 36,313	\$ 65,463	\$ (5,940)	\$ (7,010)	\$ 93,366
Balance at December 31, 2013	\$ 4,561	\$ 36,636	\$ 65,897	\$ (4,696)	\$ (7,010)	\$ 95,388
Net income	-	-	6,555	-	-	6,555
Other comprehensive income	-	-	-	1,678	-	1,678
Cash dividends declared, \$.51 per share	-	-	(2,132)	-	-	(2,132)
Treasury shares issued under stock option plans, 3,598 shares	-	(9)	-	-	64	55
Common stock issued under dividend reinvestment plan, 29,142 shares	29	514	-	-	-	543
Balance at September 30, 2014	\$ 4,590	\$ 37,141	\$ 70,320	\$ (3,018)	\$ (6,946)	\$ 102,087

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

## Consolidated Statements of Cash Flows

	Nine Months Ended September 30	
	2014	2013
(Dollars in thousands) (unaudited)		
Cash flows from operating activities		
Net income	\$ 6,555	\$ 5,091
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,078	1,118
Net amortization of loans and investment securities	1,372	1,525
Amortization and net change in mortgage servicing rights valuation	12	39
Amortization of intangibles	311	319
Provision for loan losses	464	1,955
Net realized gains on sales of securities	(221)	(30)
Impairment writedown on securities recognized in earnings	20	75
Loans originated for sale	(5,809)	(7,859)
Proceeds from sale of loans	4,825	7,480
Writedown of other real estate owned	200	256
Net (gain) loss on sale or disposal of other real estate/other repossessed assets	(16)	4
Increase in cash surrender value of life insurance	(426)	(455)
Decrease in other assets	236	2,107
Increase in other liabilities	1,259	1,108
Net cash provided by operating activities	9,860	12,733
Cash flows from investing activities		
Proceeds from sales and calls of investment securities available for sale	1,582	5,819
Proceeds from maturities and paydowns of securities available for sale	19,998	25,161
Purchase of investment securities available for sale	(36,956)	(65,315)
Net (increase) decrease in restricted stock	(32)	1,665
Net (increase) decrease in loans	(8,509)	32,092
Capital expenditures	(275)	(439)
Proceeds from sale of other real estate/other repossessed assets	868	518
Net cash used in investing activities	(23,324)	(499)

Cash flows from financing activities		
Net increase in demand deposits, NOW, and savings accounts	64,267	40,351
Net decrease in time deposits	(11,126)	(48,973)
Net decrease in repurchase agreements	(22,278)	(18,339)
Long-term debt payments	(403)	(5)
Dividends paid	(2,132)	(2,103)
Treasury stock issued under stock option plans	55	52
Common stock issued under dividend reinvestment plan	543	582
Net cash provided by (used in) financing activities	28,926	(28,435)
Increase (decrease) in cash and cash equivalents	15,462	(16,201)
Cash and cash equivalents as of January 1	40,745	77,834
Cash and cash equivalents as of September 30	\$ 56,207	\$ 61,633
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest on deposits and other borrowed funds	\$ 2,434	\$ 3,483
Income taxes	\$ 706	\$ 300
Noncash Activities		
Loans transferred to Other Real Estate	\$ 82	\$ 390

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

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

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

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of September 30, 2014, and for all other periods presented have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation's 2013 Annual Report on Form 10-K. The consolidated results of operations for the period ended September 30, 2014 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

The consolidated balance sheet at December 31, 2013 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements.

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

Earnings per share are 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 September 30		For the Nine Months Ended September 30	
(Dollars and shares in thousands, except per share data)	2014	2013	2014	2013
Weighted average shares outstanding (basic)	4,196	4,142	4,184	4,127

Impact of common stock equivalents	4	2	5	5
Weighted average shares outstanding (diluted)	4,200	4,144	4,189	4,132
Anti-dilutive options excluded from calculation	34	56	45	57
Net income	\$ 2,410	\$ 2,185	\$ 6,555	\$ 5,091
Basic earnings per share	\$ 0.57	\$ 0.53	\$ 1.57	\$ 1.23
Diluted earnings per share	\$ 0.57	\$ 0.53	\$ 1.56	\$ 1.23

## Note 2. Recent Accounting Pronouncements

Receivables (Topic 310): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure. ASU 2014-04 "Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure" clarifies that a creditor is considered to have physical possession of residential real estate that is collateral for a residential mortgage loan when it obtains legal title to the collateral or a deed in lieu of foreclosure or similar legal agreement is completed. Consequently, it should reclassify the loan to other real estate owned at that time. ASU 2014-04 applies to all creditors who obtain physical possession resulting from an in substance repossession or foreclosure of residential real estate property collateralizing a consumer mortgage loan in satisfaction of a receivable. The ASU does not apply to commercial real estate loans, as the foreclosure process and applicable laws for those assets are significantly different from residential real estate. The ASU is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Corporation does not believe ASU 2014-04 will have a material effect on its financial statements.

Revenue from Contracts with Customers (Topic 606). The amendments in this Update (ASU 2014-09) establish a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The ASU is effective for public entities for annual periods beginning after December 15, 2016, including interim periods therein. Three basic transition methods are available – full retrospective, retrospective with certain practical expedients, and a cumulative effect approach. Under the third alternative, an entity would apply the new revenue standard only to contracts that are incomplete under legacy U.S. GAAP at the date of initial application (e.g. January 1, 2017) and recognize the cumulative effect of the new standard as an adjustment to the opening balance of retained earnings. That is, prior years would not be restated and additional disclosures would be required to enable users of the financial statements to understand the impact of adopting the new standard in the current year compared to prior years that are presented under legacy U.S. GAAP. Early adoption is prohibited under U.S. GAAP. The Corporation does not believe ASU 2014-09 will have a material effect on its financial statements.

### Note 3. Accumulated Other Comprehensive Loss

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

	September 30 2014	December 31 2013
(Dollars in thousands)		
Net unrealized gains (losses) on securities	\$ 1,527	\$ (741)
Tax effect	(519)	252
Net of tax amount	1,008	(489)
Net unrealized losses on derivatives	(286)	(561)
Tax effect	97	191
Net of tax amount	(189)	(370)
Accumulated pension adjustment	(5,814)	(5,814)
Tax effect	1,977	1,977
Net of tax amount	(3,837)	(3,837)
Total accumulated other comprehensive loss	\$ (3,018)	\$ (4,696)

Note 4. Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting these commitments. The Bank had \$24.3 million and \$20.2 million of standby letters of credit as of September 30, 2014 and December 31, 2013, respectively. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of September 30, 2014 and December 31, 2013 for guarantees under standby letters of credit issued was not material.

6

---

## Note 5. Investments

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2014 and December 31, 2013 is as follows:

(Dollars in thousands)	Amortized	Gross	Gross	Fair
	cost	unrealized	unrealized	value
September 30, 2014		gains	losses	
Equity securities	\$ 274	\$ 336	\$ -	\$ 610
U.S. Government agency securities	16,064	112	(85)	16,091
Municipal securities	64,850	1,790	(466)	66,174
Trust preferred securities	5,935	-	(588)	5,347
Agency mortgage-backed securities	85,665	836	(459)	86,042
Private-label mortgage-backed securities	1,750	53	-	1,803
Asset-backed securities	46	-	(2)	44
	\$ 174,584	\$ 3,127	\$ (1,600)	\$ 176,111

(Dollars in thousands)	Amortized	Gross	Gross	Fair
	cost	unrealized	unrealized	value
December 31, 2013		gains	losses	
Equity securities	\$ 1,472	\$ 499	\$ (1)	\$ 1,970
U.S. Government agency securities	11,771	94	(114)	11,751
Municipal securities	56,861	1,400	(1,404)	56,857
Corporate debt securities	1,002	-	(1)	1,001
Trust preferred securities	5,922	-	(871)	5,051
Agency mortgage-backed securities	81,352	726	(1,051)	81,027
Private-label mortgage-backed securities	1,984	16	(31)	1,969
Asset-backed securities	51	-	(3)	48
	\$ 160,415	\$ 2,735	\$ (3,476)	\$ 159,674

At September 30, 2014 and December 31, 2013, the fair value of investment securities pledged to secure public funds, trust balances, repurchase agreements, deposit and other obligations totaled \$84.6 million and \$107.6 million, respectively.



The amortized cost and estimated fair value of debt securities at September 30, 2014, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

(Dollars in thousands)	Amortized	
	cost	Fair value
Due in one year or less	\$ 2,113	\$ 2,148
Due after one year through five years	12,207	12,597
Due after five years through ten years	30,499	30,828
Due after ten years	42,076	42,083
	86,895	87,656
Mortgage-backed securities	87,415	87,845
	\$ 174,310	\$ 175,501

7

---

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

The following table provides additional detail about trust preferred securities as of September 30, 2014:

Trust Preferred Securities

(Dollars in thousands)

Deal Name	Maturity	Single Issuer or Pooled	Class	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Lowest Credit Rating Assigned
BankAmerica Cap III	1/15/2027	Single	Preferred Stock	\$ 962	\$ 843	\$ (119)	BB
Wachovia Cap Trust II	1/15/2027	Single	Preferred Stock	276	263	(13)	BBB
Huntington Cap Trust	2/1/2027	Single	Preferred Stock	938	846	(92)	BB+
Corestates Captl Tr II	2/15/2027	Single	Preferred Stock	934	879	(55)	BBB+
Huntington Cap Trust II	6/15/2028	Single	Preferred Stock	889	823	(66)	BB+
Chase Cap VI JPM	8/1/2028	Single	Preferred Stock	962	879	(83)	BBB-
Fleet Cap Tr V	12/18/2028	Single	Preferred Stock	974	814	(160)	BB
				\$ 5,935	\$ 5,347	\$ (588)	

The following table provides additional detail about private label mortgage-backed securities as of September 30, 2014:

Private Label Mortgage Backed Securities

(Dollars in thousands)

Description	Origination Date	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
RALI 2004-QS4 A7	3/1/2004	\$ 105	\$ 108	\$ 3	ALT A	BBB+	12.31	\$ -
MALT 2004-6 7A1	6/1/2004	417	426	9	ALT A	CCC	14.00	-
RALI 2005-QS2 A1	2/1/2005	289	302	13	ALT A	CC	5.85	10
	4/1/2006	562	573	11	ALT A	D	-	293

RALI 2006-QS4

A2								
GSR 2006-5F 2A1	5/1/2006	87	93	6	Prime	D	-	15
RALI 2006-QS8								
A1	7/28/2006	290	301	11	ALT A	D	-	217
		\$ 1,750	\$ 1,803	\$ 53				\$ 535

8

---

## Impairment:

The investment portfolio contained 94 securities with \$72.6 million of temporarily impaired fair value and \$1.6 million in unrealized losses at September 30, 2014. The total unrealized loss position has improved by \$1.9 million since year-end 2013.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities and subject to assessment at September 30, 2014, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of September 30, 2014 and December 31, 2013:

(Dollars in thousands)	September 30, 2014			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government agency securities	\$ 993	\$ (2)	1	\$ 7,321	\$ (83)	14	\$ 8,314	\$ (85)	15
Municipal securities	6,752	(72)	11	11,557	(394)	17	18,309	(466)	28
Trust preferred securities	-	-	-	5,347	(588)	7	5,347	(588)	7
Agency mortgage-backed securities	28,538	(161)	28	12,091	(298)	15	40,629	(459)	43
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	\$ 36,283	\$ (235)	40	\$ 36,321	\$ (1,365)	54	\$ 72,604	\$ (1,600)	94

	December 31, 2013								
	Less than 12 months			12 months or more			Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
Equity securities	\$ 22	\$ (1)	1	\$ -	\$ -	-	\$ 22	\$ (1)	1
U.S. Government agency securities	3,971	(85)	7	3,807	(29)	7	7,778	(114)	14
Municipal securities	16,770	(1,022)	24	3,160	(382)	4	19,930	(1,404)	28
Corporate debt securities	-	-	-	1,001	(1)	1	1,001	(1)	1
Trust preferred securities	-	-	-	5,051	(871)	7	5,051	(871)	7
Agency mortgage-backed securities	40,395	(999)	38	2,213	(52)	4	42,608	(1,051)	42
Private-label mortgage-backed securities	-	-	-	911	(31)	2	911	(31)	2
Asset-backed securities	-	-	-	48	(3)	3	48	(3)	3
Total temporarily impaired securities	\$ 61,158	\$ (2,107)	70	\$ 16,191	\$ (1,369)	28	\$ 77,349	\$ (3,476)	98

The municipal bond portfolio has an unrealized loss of \$466 thousand at quarter end. However, the unrealized loss has declined significantly from \$730 thousand at the end of the second quarter and \$1.4 million at the prior-year end. The unrealized loss in this portfolio is deemed to be non-credit related and no other-than-temporary impairment charges have been recorded.

The trust preferred portfolio contains seven securities with a fair value of \$5.3 million and an unrealized loss of \$588 thousand. The trust-preferred securities held by the Bank are single entity issues, not pooled trust preferred securities. Therefore, the impairment review of these securities is based only on the issuer and the security cannot be impaired by the performance of other issuers as if it was a pooled trust-preferred bond. All of the Bank's trust preferred securities are

single issue, variable rate notes with long maturities (2027 – 2028). None of these bonds have suspended or missed a dividend payment. At September 30, 2014, 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 PLMBS sector shows a gross unrealized gain \$53 thousand. Even though there is no unrealized loss, due to the nature of these bonds, they are evaluated closely. 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 PLMBS 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 a \$20 thousand impairment charge was required at quarter end. It is primarily a result of the OTTI charge that these bonds are showing an unrealized gain at quarter end. The Bank has recorded \$535 thousand of cumulative impairment charges on this portfolio. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. The Bank is currently participating in a class-action lawsuit against one PLMBS servicer that centers on defective warranties and representations made as part of the underwriting process.

The Bank held \$1.9 million of restricted stock at September 30, 2014. Except for \$30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of \$100 per share.

FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. Management intends to remain a member of the FHLB and believes that it will be able to fully recover the cost basis of this investment. In October 2014, the FHLB repurchased approximately \$1 million of its stock from the Bank.

## Note 6. Loans

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

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

(Dollars in thousands)	September 30, 2014	December 31, 2013	Change	
			Amount	%
Residential Real Estate 1-4 Family				
Consumer first liens	\$ 104,823	\$ 103,573	\$ 1,250	1.2
Consumer junior liens and lines of credit	37,454	34,636	2,818	8.1
Total consumer	142,277	138,209	4,068	2.9
Commercial first lien	58,320	58,466	(146)	(0.2)
Commercial junior liens and lines of credit	5,664	5,939	(275)	(4.6)
Total commercial	63,984	64,405	(421)	(0.7)
Total residential real estate 1-4 family	206,261	202,614	3,647	1.8
Residential real estate - construction				
Consumer	1,286	3,960	(2,674)	(67.5)
Commercial	8,854	8,559	295	3.4
Total residential real estate construction	10,140	12,519	(2,379)	(19.0)
Commercial real estate	323,570	329,373	(5,803)	(1.8)
Commercial	184,049	170,327	13,722	8.1
Total commercial	507,619	499,700	7,919	1.6
Consumer	6,625	8,580	(1,955)	(22.8)
	730,645	723,413	7,232	1.0
Less: Allowance for loan losses	(8,935)	(9,702)	767	(7.9)
Net Loans	\$ 721,710	\$ 713,711	\$ 7,999	1.1
Included in the loan balances are the following:				
Net unamortized deferred loan costs	\$ 511	\$ 372		
Unamortized discount on purchased loans	\$ (25)	\$ (92)		

Loans pledged as collateral for borrowings and commitments from:

FHLB	\$ 602,666	\$ 607,524
Federal Reserve Bank	57,143	45,809
	\$ 659,809	\$ 653,333



## Note 7. Loan Quality

The following table presents, by class, the activity in the Allowance for Loan Losses (ALL) for the periods ended:

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial			Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Consumer	
Allowance at June 30, 2014	\$ 1,079	\$ 266	\$ 261	\$ 5,412	\$ 2,366	\$ 135	\$ 9,519
Charge-offs	-	-	-	-	(611)	(67)	(678)
Recoveries	2	-	-	49	23	20	94
Provision	48	56	(27)	33	(149)	39	-
Allowance at September 30, 2014	\$ 1,129	\$ 322	\$ 234	\$ 5,494	\$ 1,629	\$ 127	\$ 8,935
Allowance at December 31, 2013	\$ 1,108	\$ 278	\$ 291	\$ 5,571	\$ 2,306	\$ 148	\$ 9,702
Charge-offs	(257)	-	(27)	(348)	(623)	(147)	(1,402)
Recoveries	5	-	-	49	56	61	171
Provision	273	44	(30)	222	(110)	65	464
Allowance at September 30, 2014	\$ 1,129	\$ 322	\$ 234	\$ 5,494	\$ 1,629	\$ 127	\$ 8,935
Allowance at June 30, 2013	\$ 1,365	\$ 278	\$ 701	\$ 6,730	\$ 2,202	\$ 162	\$ 11,438
Charge-offs	-	-	-	(369)	(35)	(29)	(433)
Recoveries	1	-	-	2	5	13	21
Provision	125	(15)	(448)	598	79	11	350
Allowance at September 30, 2013	\$ 1,491	\$ 263	\$ 253	\$ 6,961	\$ 2,251	\$ 157	\$ 11,376
Allowance at December 31, 2012	\$ 913	\$ 306	\$ 899	\$ 6,450	\$ 1,620	\$ 191	\$ 10,379
Charge-offs	(39)	(45)	-	(536)	(362)	(113)	(1,095)
Recoveries	10	-	-	5	80	42	137
Provision	607	2	(646)	1,042	913	37	1,955
Allowance at September 30, 2013	\$ 1,491	\$ 263	\$ 253	\$ 6,961	\$ 2,251	\$ 157	\$ 11,376



The following table presents, by class, loans that were evaluated for the ALL under the specific reserve (individually) and those that were evaluated under the general reserve (collectively) and the amount of the ALL established in each class as of September 30, 2014 and December 31, 2013:

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial		Consumer	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial		
September 30, 2014							
Loans evaluated for allowance:							
Individually	\$ 1,193	\$ 51	\$ 1,155	\$ 20,338	\$ 1,343	\$ -	\$ 24,080
Collectively	161,950	43,067	8,985	303,232	182,706	6,625	706,565
Total	\$ 163,143	\$ 43,118	\$ 10,140	\$ 323,570	\$ 184,049	\$ 6,625	\$ 730,645
Allowance established for loans evaluated:							
Individually	\$ -	\$ -	\$ -	\$ 71	\$ 28	\$ -	\$ 99
Collectively	1,129	322	234	5,423	1,601	127	8,836
Allowance at September 30, 2014	\$ 1,129	\$ 322	\$ 234	\$ 5,494	\$ 1,629	\$ 127	\$ 8,935
December 31, 2013							
Loans evaluated for allowance:							
Individually	\$ 2,354	\$ 50	\$ 537	\$ 25,107	\$ 1,996	\$ -	\$ 30,044
Collectively	159,685	40,525	11,982	304,266	168,331	8,580	693,369
Total	\$ 162,039	\$ 40,575	\$ 12,519	\$ 329,373	\$ 170,327	\$ 8,580	\$ 723,413
Allowance established for loans evaluated:							
Individually	\$ 9	\$ -	\$ -	\$ 89	\$ 1,002	\$ -	\$ 1,100
Collectively	1,099	278	291	5,482	1,304	148	8,602
Allowance at December 31, 2013	\$ 1,108	\$ 278	\$ 291	\$ 5,571	\$ 2,306	\$ 148	\$ 9,702

The following table shows additional information about those loans considered to be impaired at September 30, 2014 and December 31, 2013:

(Dollars in thousands)	Impaired Loans				
	With No Allowance		With Allowance		Related Allowance
	Recorded Investment	Principal Balance	Recorded Investment	Principal Balance	
Unpaid					
September 30, 2014					
Residential Real Estate 1-4 Family					
First liens	\$ 2,002	\$ 2,107	\$ -	\$ -	\$ -
Junior liens and lines of credit	129	155	-	-	-
Total	2,131	2,262	-	-	-
Residential real estate - construction	1,155	1,184	-	-	-
Commercial real estate	19,848	24,125	896	1,013	71
Commercial	79	81	1,318	2,010	28
Total	\$ 23,213	\$ 27,652	\$ 2,214	\$ 3,023	\$ 99

December 31, 2013					
Residential Real Estate 1-4 Family					
First liens	\$ 3,030	\$ 3,500	\$ 9	\$ 39	\$ 9
Junior liens and lines of credit	108	127	-	-	-
Total	3,138	3,627	9	39	9
Residential real estate - construction	537	556	-	-	-
Commercial real estate	24,188	30,334	966	1,043	89
Commercial	88	89	1,970	2,043	1,002
Total	\$ 27,951	\$ 34,606	\$ 2,945	\$ 3,125	\$ 1,100

The following table shows the average of impaired loans and related interest income for the three and nine months ended September 30, 2014 and 2013:

(Dollars in thousands)	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	\$ 2,026	\$ 11	\$ 2,666	\$ 35
Junior liens and lines of credit	131	-	127	-
Total	2,157	11	2,793	35
Residential real estate - construction	1,155	-	739	-
Commercial real estate	20,488	83	23,395	257
Commercial	1,930	-	2,032	1
Total	\$ 25,730	\$ 94	\$ 28,959	\$ 293

(Dollars in thousands)	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	\$ 3,365	\$ 4	\$ 3,477	\$ 12
Junior liens and lines of credit	417	-	613	5
Total	3,782	4	4,090	17
Residential real estate - construction	544	-	550	-
Commercial real estate	31,730	118	30,508	252
Commercial	2,112	-	3,015	-
Total	\$ 38,168	\$ 122	\$ 38,163	\$ 269

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

(Dollars in thousands)	Loans Past Due and Still Accruing					Non-Accrual	Total Loans
	Current	30-59 Days	60-89 Days	90 Days+	Total		
September 30, 2014							
Residential Real Estate 1-4 Family							
First liens	\$ 160,593	\$ 298	\$ 849	\$ 163	\$ 1,310	\$ 1,240	\$ 163,143
Junior liens and lines of credit	42,756	180	53	11	244	118	43,118
Total	203,349	478	902	174	1,554	1,358	206,261
Residential real estate - construction							
Commercial real estate	8,985	-	-	-	-	1,155	10,140
Commercial	306,896	121	2,050	152	2,323	14,351	323,570
Commercial	182,232	87	20	23	130	1,687	184,049
Consumer	6,553	51	5	16	72	-	6,625
Total	\$ 708,015	\$ 737	\$ 2,977	\$ 365	\$ 4,079	\$ 18,551	\$ 730,645

December 31, 2013

Residential Real Estate 1-4 Family							
First liens	\$ 156,916	\$ 1,725	\$ 497	\$ 302	\$ 2,524	\$ 2,599	\$ 162,039
Junior liens and lines of credit	40,204	204	19	41	264	107	40,575
Total	197,120	1,929	516	343	2,788	2,706	202,614
Residential real estate - construction							
Commercial real estate	11,458	523	-	-	523	538	12,519
Commercial	309,531	634	-	207	841	19,001	329,373
Commercial	167,747	78	60	44	182	2,398	170,327
Consumer	8,430	117	23	10	150	-	8,580
Total	\$ 694,286	\$ 3,281	\$ 599	\$ 604	\$ 4,484	\$ 24,643	\$ 723,413

The following table reports the internal credit rating for the loan portfolio. Consumer purpose loans (mortgage, home equity and installment) are assigned a rating of either pass or substandard. Substandard consumer loans are comprised of loans 90 days or more past due and still accruing and nonaccrual loans. Commercial loans may be assigned any rating in accordance with the Bank's internal risk rating system.

(Dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
September 30, 2014					
Residential Real Estate 1-4 Family					
First liens	\$ 156,650	\$ 1,959	\$ 4,534	\$ -	\$ 163,143
Junior liens and lines of credit	42,721	29	368	-	43,118
Total	199,371	1,988	4,902	-	206,261
Residential real estate - construction	8,714	271	1,155	-	10,140
Commercial real estate	281,094	14,611	27,865	-	323,570
Commercial	168,928	5,634	9,487	-	184,049
Consumer	6,609	-	16	-	6,625
Total	\$ 664,716	\$ 22,504	\$ 43,425	\$ -	\$ 730,645

December 31, 2013					
Residential Real Estate 1-4 Family					
First liens	\$ 150,762	\$ 3,653	\$ 7,624	\$ -	\$ 162,039
Junior liens and lines of credit	40,102	66	407	-	40,575
Total	190,864	3,719	8,031	-	202,614
Residential real estate - construction	10,955	-	1,564	-	12,519
Commercial real estate	281,857	11,861	35,655	-	329,373
Commercial	154,888	3,393	12,046	-	170,327
Consumer	8,570	-	10	-	8,580
Total	\$ 647,134	\$ 18,973	\$ 57,306	\$ -	\$ 723,413

The following table presents information on the Bank's Troubled Debt Restructuring (TDR) loans:

(Dollars in thousands)	Troubled Debt Restructurings			Troubled Debt Restructurings That Have Defaulted on Modified Terms YTD		
	Number of Contracts	Recorded Investment	Performing*	Nonperforming*	Number of Contracts	Recorded Investment
September 30, 2014						
Residential real estate - construction	1	\$ 524	\$ -	\$ 524	-	\$ -
Residential real estate	5	598	598	-	-	-
Commercial real estate	12	15,398	14,459	939	-	-
Total	18	\$ 16,520	\$ 15,057	\$ 1,463	-	\$ -
December 31, 2013						
Residential real estate - construction	1	\$ 537	\$ -	\$ 537	-	\$ -
Residential real estate	5	625	625	-	-	-
Commercial real estate	12	15,877	14,318	1,559	-	-
Total	18	\$ 17,039	\$ 14,943	\$ 2,096	-	\$ -

\*The performing status is determined by the loan's compliance with the modified terms.

There were no new TDR loans made during 2014.

The following table reports new TDR loans made during 2013, concession granted and the recorded investment as of September 30, 2013:

Nine Months Ended September 30, 2013	New During Period			Recorded Investment	Concession multiple
	Number of Contracts	Pre-TDR Modification	After-TDR Modification		
Residential real estate	1	\$ 75	\$ 75	\$ 73	multiple
Commercial real estate	2	10,458	10,745	10,659	multiple
	3	\$ 10,533	\$ 10,820	\$ 10,732	



## Note 8. Pension

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

(Dollars in thousands)	Three Months		Nine Months	
	Ended		Ended	
	September 30		September 30	
	2014	2013	2014	2013
Components of net periodic cost:				
Service cost	\$ 83	\$ 114	\$ 253	\$ 342
Interest cost	194	179	585	537
Expected return on plan assets	(291)	(312)	(872)	(936)
Recognized net actuarial loss	81	159	243	477
Net period cost	\$ 67	\$ 140	\$ 209	\$ 420

The Bank expects its pension expense to decrease to approximately \$275 thousand in 2014 compared to \$560 thousand in 2013.

## Note 9. Fair Value Measurements and Fair Values of Financial Instruments

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

FASB ASC Topic 820, "Financial Instruments", requires disclosure of the fair value of financial assets and liabilities, including those financial assets and liabilities that are not measured and reported at fair value on a recurring and nonrecurring basis. The Corporation does not report any nonfinancial assets at fair value. FASB ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC Topic 820 are as follows:

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

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

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

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at September 30, 2014 and December 31, 2013.

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.

Loans held for sale: The fair value of loans held for sale is determined by the price set between the Bank and the purchaser prior to origination. These loans are usually sold at par.

Net loans: The fair value of fixed-rate loans is estimated for each major type of loan (e.g. real estate, commercial, industrial and agricultural and consumer) by discounting the future cash flows associated with such loans using rates currently offered for loans with similar terms to borrowers of comparable credit quality. The model considers scheduled principal maturities, repricing characteristics, prepayment assumptions and interest cash flows. The discount rates used are estimated based upon consideration of a number of factors including the treasury yield curve, expense and service charge factors. For variable rate loans that reprice frequently and have no significant change in credit quality, carrying values approximate the fair value.

Accrued Interest Receivable: The carrying amount is a reasonable estimate of fair value.

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

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

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

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

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

(Dollars in thousands)	September 30, 2014				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial assets:</b>					
Cash and cash equivalents	\$ 56,207	\$ 56,207	\$ 56,207	\$ -	\$ -
Investment securities available for sale	176,111	176,111	610	175,501	-
Restricted stock	1,938	1,938	-	1,938	-
Loans held for sale	1,333	1,333	-	1,333	-
Net loans	721,710	726,221	-	-	726,221
Accrued interest receivable	2,853	2,853	-	2,853	-
Mortgage servicing rights	172	172	-	-	172
<b>Financial liabilities:</b>					
Deposits	\$ 898,865	\$ 899,010	\$ -	\$ 899,010	\$ -
Securities sold under agreements to repurchase	1,556	1,556	-	1,556	-
Long-term debt	12,000	12,237	-	12,237	-
Accrued interest payable	242	242	-	242	-
Interest rate swaps	286	286	-	286	-
<b>December 31, 2013</b>					
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial assets:</b>					
Cash and cash equivalents	\$ 40,745	\$ 40,745	\$ 40,745	\$ -	\$ -
Investment securities available for sale	159,674	159,674	1,970	157,704	-
Restricted stock	1,906	1,906	-	1,906	-
Loans held for sale	349	349	-	349	-
Net loans	713,711	722,119	-	-	722,119
Accrued interest receivable	3,087	3,087	-	3,087	-
Mortgage servicing rights	184	184	-	-	184
<b>Financial liabilities:</b>					
Deposits	\$ 845,724	\$ 846,289	\$ -	\$ 846,289	\$ -
Securities sold under agreements to repurchase	23,834	23,834	-	23,834	-
Long-term debt	12,403	12,999	-	12,999	-
Accrued interest payable	229	229	-	229	-
Interest rate swaps	561	561	-	561	-



## Recurring Fair Value Measurements

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2014 and December 31, 2013 are as follows:

(Dollars in Thousands)	Fair Value at September 30, 2014			
	Level 1	Level 2	Level 3	Total
Asset Description				
Equity securities	\$ 610	\$ -	\$ -	\$ 610
Obligations of U.S. Government agencies	-	16,091	-	16,091
Obligations of state and political subdivisions	-	66,174	-	66,174
Trust Preferred Securities	-	5,347	-	5,347
Agency mortgage-backed securities	-	86,042	-	86,042
Private-label mortgage-backed securities	-	1,803	-	1,803
Asset-backed securities	-	44	-	44
Total assets	\$ 610	\$ 175,501	\$ -	\$ 176,111
Liability Description				
Interest rate swaps	\$ -	\$ 286	\$ -	\$ 286
Total liabilities	\$ -	\$ 286	\$ -	\$ 286

(Dollars in Thousands)	Fair Value at December 31, 2013			
	Level 1	Level 2	Level 3	Total
Asset Description				
Equity securities	\$ 1,970	\$ -	\$ -	\$ 1,970
Obligations of U.S. Government agencies	-	11,751	-	11,751
Obligations of state and political subdivisions	-	56,857	-	56,857
Corporate debt securities	-	1,001	-	1,001
Trust Preferred Securities	-	5,051	-	5,051
Agency mortgage-backed securities	-	81,027	-	81,027
Private-label mortgage-backed securities	-	1,969	-	1,969
Asset-backed securities	-	48	-	48
Total assets	\$ 1,970	\$ 157,704	\$ -	\$ 159,674
Liability Description				
Interest rate swaps	\$ -	\$ 561	\$ -	\$ 561
Total liabilities	\$ -	\$ 561	\$ -	\$ 561

The Corporation used the following methods and significant assumptions to estimate the fair values for financial assets measured at fair value on a recurring basis.

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

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

## Nonrecurring Fair Value Measurements

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2014 and December 31, 2013 are as follows:

(Dollars in Thousands)

Asset Description	Fair Value at September 30, 2014			
	Level 1	Level 2	Level 3	Total
	Impaired loans (1)	\$ -	\$ -	\$ 3,083
Other real estate owned (1)	-	-	538	538
Mortgage servicing rights	-	-	172	172
Total assets	\$ -	\$ -	\$ 3,793	\$ 3,793

Asset Description	Fair Value at December 31, 2013			
	Level 1	Level 2	Level 3	Total
	Impaired loans (1)	\$ -	\$ -	\$ 8,588
Other real estate owned (1)	-	-	498	498
Mortgage servicing rights	-	-	184	184
Total assets	\$ -	\$ -	\$ 9,270	\$ 9,270

(1) Includes assets directly charged-down to fair value during the year-to-date period.

The Corporation used the following methods and significant assumptions to estimate the fair values for financial assets measured at fair value on a nonrecurring basis.

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

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



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 September 30, 2014. 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 September 30, 2014.

23

---

The following table presents additional quantitative information about Level 3 assets measured at fair value on a nonrecurring basis:

Quantitative Information about Level 3 Fair Value Measurements				
at September 30, 2014				
(Dollars in Thousands)	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Asset Description			Appraisal Adjustments	
Impaired loans (1)	\$ 3,083	Appraisal	(2)	0% - 100% (22.93%)
			Cost to sell	0% - 10% (5.52%)
Other real estate owned (1)	538	Appraisal	Appraisal Adjustments	
			(2)	
			Cost to sell	8% (8%)
Mortgage servicing rights	172	Discounted Cash Flow		
		(3)		
at December 31, 2013				
Impaired loans (1)	\$ 8,588	Appraisal	Appraisal Adjustments	
			(2)	0% - 60% (5%)
			Cost to sell	5% - 13.5% (7%)
Other real estate owned (1)	498	Appraisal	Appraisal Adjustments	
			(2)	
			Cost to sell	8% (8%)
Mortgage servicing rights	184	Discounted Cash Flow		
		(3)		

(1) Includes assets directly charged-down to fair value during the year-to-date period.

(2) Qualitative adjustments are discounts specific to each asset and are made as needed.

(3) Valuation and inputs are determined by a third-party pricing service without adjustment.

#### Note 10. Financial Derivatives

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 September 30, 2014 follows:

(Dollars in thousands)				Amount Expected to be Expensed into Earnings within the next 12 Months
Notional Amount	Maturity Date	Interest Rate Fixed Variable		
\$ 10,000	5/30/2015	3.87%	0.02%	\$ 257

Fair Value of Derivative Instruments in the Consolidated Balance Sheets were as follows as of September 30, 2014 and December 31, 2013:

Fair Value of Derivative Instruments (Dollars in thousands)		Balance Sheet	
Date	Type	Location	Fair Value
September 30, 2014	Interest rate contracts	Other liabilities	\$ 286
December 31, 2013	Interest rate contracts	Other liabilities	\$ 561

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

The Effect of Derivative Instruments on the Statement of Income for the Three and Nine Months Ended September 30, 2014 and 2013 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships

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) 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)
(Dollars in thousands)					
Interest rate contracts					
Three months ended:					
September 30, 2014	\$ 64	Interest Expense	\$ (96)	Other income (expense)	\$ -
September 30, 2013	\$ 51	Interest Expense	\$ (97)	Other income (expense)	\$ -
Nine months ended:					
September 30, 2014	\$ 181	Interest Expense	\$ (285)	Other income (expense)	\$ -
September 30, 2013	\$ 299	Interest Expense	\$ (429)	Other income (expense)	\$ -

Interest Rate Swap Agreements (“Swap Agreements”)

The Bank has entered into interest rate swap agreements as part of its asset/liability management program. The swap agreements are free-standing derivatives and are recorded at fair value in the Corporation’s consolidated statements of condition. The Bank is party to master netting arrangements with its financial institution counterparties; however, the Bank does not offset assets and liabilities under these arrangements for financial statement presentation purposes. The master netting arrangements provide for a single net settlement of all swap agreements, as well as collateral, in the event of default on, or termination of, any one contract. Collateral, in the form of marketable securities, is posted by the counterparty with net liability positions in accordance with contract thresholds.

Securities Sold Under Agreements to Repurchase (“Repurchase Agreements”)

The Bank enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Bank may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Bank to repurchase the agreements. As a result, these repurchase agreements are accounted for as collateralized financing arrangements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Corporation's consolidated statements of condition, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. In other words, there is no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Bank does not enter into reverse repurchase agreements, there is no such offsetting to be done with repurchase agreements.

25

---

The following table presents the liabilities subject to an enforceable master netting arrangement or repurchase agreements as of September 30, 2014 and December 31, 2013. As of these dates, all of the Bank's swap agreement with an institutional counterparty was in a liability position. Therefore, there were no assets to be recognized in the consolidated statements of condition. The Bank has no swap agreements with our commercial banking customers.

	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Statements of Condition	Net Amounts of Liabilities Presented in the Statements of Condition	Gross Amounts Not Offset in the Statements of Condition		
				Financial Instruments	Cash Collateral Pledged	Net Amount
(Dollars in thousands) Interest Rate Swap Agreements						
September 30, 2014	\$ 286	\$ -	\$ 286	\$ 286	\$ -	\$ -
December 31, 2013	\$ 561	\$ -	\$ 561	\$ 561	\$ -	\$ -

#### 1Note 11. Reclassification

Certain prior period amounts may have been reclassified to conform to the current year presentation. Such reclassifications did not affect the Corporation's financial position or results of operations.

#### Note 12. Subsequent Events

On October 27, 2014, the Bank announced the consolidation of several community banking offices. On January 21, 2015, the Bank will consolidate the Warfordsburg and Penns Village offices with the McConnellsburg Office in

Fulton County and the St. Thomas office with the West Side Office in Franklin County.

On October 30, 2014, S&T Bancorp Inc. agreed to acquire Integrity Bancshares Inc. (Integrity). The Bank owns shares of Integrity and expects to recognize a pre-tax gain of approximately \$628,000, based on the terms of the agreement, upon completion of this transaction in the first quarter of 2015.

These subsequent events did not have an effect on the Corporation's third quarter financial statements.

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

For the Three and Nine Months Ended September 30, 2014 and 2013

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. There were no changes to the critical accounting policies disclosed in the 2013 Annual Report on Form 10-K in regards to application or related judgments and estimates used. Please refer to Item 7 of the Corporation's 2013 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Results of Operations

Year-to-Date Summary

At September 30, 2014, total assets were \$1.023 billion, an increase of \$38.2 million from December 31, 2013. Net loans increased to \$721.7 million and total deposits increased to \$898.9 million. The Corporation reported net income for the first nine months of 2014 of \$6.6 million. This is a 28.8% increase versus net income of \$5.1 million for the same period in 2013. Total revenue (interest income and noninterest income) decreased \$33 thousand year-over-year. Interest income decreased \$754 thousand, while interest expense decreased by \$1.0 million, resulting in a \$282 thousand increase in net interest income. The provision for loan losses was \$464 thousand for the period, \$1.5 million less than in 2013. Noninterest income increased \$721 thousand, while noninterest expense increased \$460 thousand. Income tax expense increased from \$1.1 million in 2013 to \$1.7 million in 2014. The effective tax rate increased from 17.6% in 2013 to 20.2% in 2014 due to tax exempt income comprising a less significant amount of income before federal income taxes. Diluted earnings per share increased to \$1.56 in 2014 from \$1.23 in 2013.





Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

Key performance ratios as of, or for the nine months ended September 30, 2014 and 2013 are listed below:

	September 30,	
	2014	2013
Performance measurements		
Return on average assets*	0.86%	0.66%
Return on average equity*	8.90%	7.37%
Return on average tangible assets (1)*	0.89%	0.69%
Return on average tangible equity (1)*	10.15%	8.58%
Efficiency ratio (1)	69.86%	70.70%
Net interest margin*	3.56%	3.40%
Current dividend yield*	3.24%	4.26%
Dividend payout ratio	32.52%	41.31%
Shareholders' Value (per common share)		
Diluted earnings per share	\$ 1.56	\$ 1.23
Basic earnings per share	1.57	1.23
Regular cash dividends paid	0.51	0.51
Book value	24.30	22.51
Tangible book value (1)	22.06	20.14
Market value	21.00	15.95
Market value/book value ratio	86.42%	70.86%
Price/earnings multiple*	10.10	9.73
Safety and Soundness		
Risk-based capital ratio (Total)	15.04%	13.92%
Leverage ratio (Tier 1)	9.51%	8.90%
Common equity ratio	9.98%	9.31%
Tangible common equity ratio (1)	9.15%	8.41%
Nonperforming loans/gross loans	2.59%	4.00%
Nonperforming assets/total assets	2.21%	3.35%
Allowance for loan losses as a % of loans	1.22%	1.58%
Net charge-offs/average loans*	0.22%	0.17%
Trust assets under management (fair value)	\$ 594,046	\$ 560,940

\* Annualized

(1) See GAAP versus Non-GAAP disclosures that follow

28

---

GAAP versus Non-GAAP Disclosure – The Corporation supplements its traditional GAAP measurements with Non-GAAP measurements. The Non-GAAP measurements include Return on Average Tangible Assets, Return on Average Tangible Equity, Tangible Book Value and Tangible Common Equity ratio. As a result of merger transactions, intangible assets (primarily goodwill, core deposit intangibles and customer list) were created. The Non-GAAP disclosures are intended to eliminate the effects of the intangible assets and allow for better comparisons to periods when such assets did not exist. However, not all companies use the same calculation methods for the same non-GAAP measurements and therefore may not be comparable. The following table shows the adjustments made between the GAAP and NON-GAAP measurements:

GAAP Measurement	Calculation
Return on Average Assets	Net Income / Average Assets
Return on Average Equity	Net Income / Average Equity
Book Value	Total Shareholders' Equity / Shares Outstanding
Common Equity Ratio	Total Shareholders' Equity / Total Assets
Non- GAAP Measurement	Calculation
Return on Average Tangible Assets	Net Income plus Intangible Amortization (net of tax) / Average Assets less Average Intangible Assets
Return on Average Tangible Equity	Net Income plus Intangible Amortization (net of tax) / Average Equity less Average Intangible Assets
Tangible Book Value	Total Shareholders' Equity less Intangible Assets / Shares outstanding
Tangible Common Equity Ratio	Total Shareholders' Equity less Intangible Assets / Total Assets less Intangible Assets
Efficiency Ratio	Noninterest expense / tax equivalent net interest income plus noninterest income less net securities gains or losses

Comparison of the three months ended September 30, 2014 to the three months ended September 30, 2013:

#### Net Interest Income

The most important source of the Corporation's earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal categories of interest-earning assets are loans and securities, while deposits, securities sold under agreements to repurchase (Repos), short-term borrowings and long-term debt are the principal categories of interest-bearing liabilities. Demand deposits enhance net interest income because they are noninterest-bearing deposits. For the purpose of this discussion, balance sheet items refer to the average balance for the year and net interest income is adjusted to a fully taxable-equivalent basis. This tax-equivalent adjustment facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Corporation's 34% Federal statutory rate.

Tax equivalent net interest income for the third quarter of 2014 increased \$156 thousand quarter over quarter. Average interest-earning assets increased \$4.9 million from 2013, but the yield on these assets decreased by 2 basis points. The average balance of investment securities increased \$16.9 million while average loans increased \$7.4 million quarter over quarter. Average commercial loans increased \$4.5 million and average mortgage loans increased \$3.0 million. The average balance of consumer loans, including home equity loans, decreased slightly, by \$181 thousand.

Interest expense was \$799 thousand for the third quarter, a decrease of \$146 thousand from the 2013 total of \$945 thousand. Average interest-bearing liabilities decreased \$21.9 million to \$779.1 million for 2014 from an average balance of \$801.0 million in 2013. The average cost of these liabilities decreased from .47% in 2013 to .41% in 2014. Average interest-bearing deposits decreased \$162 thousand and the cost of these deposits decreased from .42% to .35%. Securities sold under agreements to repurchase (Repos) decreased \$21.3 million on average over the prior year quarter while the average rate remained constant at .15% in both years. The average balance of long-term debt decreased \$405 thousand, due to prepayments and amortizations.

The changes in the balance sheet and interest rates resulted in an increase in tax equivalent net interest income of \$156 thousand to \$8.5 million in 2014 compared to \$8.4 million in 2013. The increase in net interest income was due to a \$245 thousand increase from higher volume offset by an \$89 thousand decrease due to changes in rates.

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

The following table presents average balances, tax-equivalent (T/E) interest income, and yields earned or rates paid on the assets or liabilities. All nontaxable interest income has been adjusted to a tax-equivalent basis using a tax rate of 34%.

(Dollars in thousands)	For the Three Months Ended September 30,					
	2014			2013		
	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
<b>Interest-earning assets:</b>						
Interest-bearing obligations of other banks and federal funds sold	\$ 40,881	\$ 49	0.48%	\$ 60,244	\$ 49	0.32%
<b>Investment securities:</b>						
Taxable	129,489	689	2.11%	118,863	495	1.65%
Nontaxable	49,160	579	4.71%	42,909	557	5.19%
<b>Loans:</b>						
Commercial, industrial and agricultural	582,296	6,266	4.21%	577,760	6,399	4.31%
Residential mortgage	82,850	856	4.10%	79,827	840	4.17%
Home equity loans and lines	60,243	773	5.09%	58,617	839	5.68%
Consumer	7,658	128	6.63%	9,465	151	6.33%
Loans	733,047	8,023	4.30%	725,669	8,229	4.45%
Total interest-earning assets	952,577	9,340	3.89%	947,685	9,330	3.91%
Other assets	71,324			71,030		
Total assets	\$ 1,023,901			\$ 1,018,715		
<b>Interest-bearing liabilities:</b>						
<b>Deposits:</b>						
Interest-bearing checking	\$ 212,061	62	0.12%	\$ 187,111	48	0.10%
Money Management	382,623	418	0.43%	382,620	422	0.44%
Savings	63,559	12	0.08%	61,584	12	0.07%
Time	104,533	187	0.71%	131,623	329	0.99%
Total interest-bearing deposits	762,776	679	0.35%	762,938	811	0.42%
<b>Securities sold under agreements to repurchase</b>						
	4,370	2	0.15%	25,702	10	0.15%
Long- term debt	12,000	118	3.95%	12,405	124	3.99%
Total interest-bearing liabilities	779,146	799	0.41%	801,045	945	0.47%
Noninterest-bearing deposits	135,574			118,077		
Other liabilities	8,542			7,365		
Shareholders' equity	100,639			92,228		
Total liabilities and shareholders' equity	\$ 1,023,901			\$ 1,018,715		
T/E net interest income/Net interest margin		8,541	3.56%		8,385	3.51%
Tax equivalent adjustment		(510)			(389)	
Net interest income		\$ 8,031			\$ 7,996	



## Provision for Loan Losses

For the third quarter of 2014, the Bank recorded net charge-offs of \$584 thousand compared to \$412 thousand in 2013. Provision expense for the third quarter was \$0 and as a result, the allowance for loan losses (ALL) decreased \$584 thousand during the quarter. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

## Noninterest Income

For the third quarter of 2014, noninterest income increased \$264 thousand from the same period in 2013. Investment and trust service fees decreased due to lower nonrecurring estate fees. Loan service charges increased due to higher commercial letter of credit fees. Mortgage banking fees decreased, as 2014 had lower reversals of previously recorded impairment charges compared to the prior year. Deposit service charges increased due to higher account analysis fees and higher retail and commercial overdraft fees. Other service charges and fees increased primarily due to increases in ATM fees, while debit card income also increased. The net losses in other real estate owned decreased from prior year due to less write downs in 2014. Other than temporary impairment charges were recorded on one bond in 2014 compared to OTTI losses on two bonds in 2013.

The following table presents a comparison of noninterest income for the three months ended September 30, 2014 and 2013:

(Dollars in thousands)	For the Three Months Ended		Change	
	September 30 2014	2013	Amount	%
Noninterest Income				
Investment and trust services fees	\$ 1,120	\$ 1,140	\$ (20)	(1.8)
Loan service charges	265	232	33	14.2
Mortgage banking activities	15	18	(3)	(16.7)
Deposit service charges and fees	563	472	91	19.3
Other service charges and fees	317	232	85	36.6
Debit card income	339	315	24	7.6
Increase in cash surrender value of life insurance	139	150	(11)	(7.3)
Other real estate owned	-	(119)	119	100.0
Other	30	89	(59)	(66.3)
OTTI losses recognized in income	(20)	(25)	5	(20.0)
Total noninterest income	\$ 2,768	\$ 2,504	\$ 264	10.5

## Noninterest Expense

Noninterest expense for the third quarter of 2014 increased \$366 thousand compared to the same period in 2013. The increase in salaries and benefits was primarily due to annual salary adjustments (\$148 thousand) and incentive program expense (\$128 thousand), but these increases were partially offset by a \$73 thousand decrease in pension



expense and a \$31 decrease in health insurance expense. Advertising expenses decreased over prior year, due to the timing of various marketing campaigns. Legal and professional fees increased due to the implementation of new corporate initiatives. Bank shares tax expense decreased year over year due to a change by the state of Pennsylvania in the method of calculating the shares tax. Other expenses increased due to prepayment penalties on several FHLB term loans, as well as development costs for a potential community office site.

31

---

The following table presents a comparison of noninterest expense for the three months ended September 30, 2014 and 2013:

(Dollars in thousands)	For the Three Months Ended		Change	
	September 30 2014	September 30 2013	Amount	%
Noninterest Expense	\$ 4,191	\$ 3,977	\$ 214	5.4
Salaries and benefits	555	566	(11)	(1.9)
Net occupancy expense	241	239	2	0.8
Furniture and equipment expense	312	386	(74)	(19.2)
Advertising	361	233	128	54.9
Legal and professional fees	471	472	(1)	(0.2)
Data processing	173	204	(31)	(15.2)
Pennsylvania bank shares tax	104	106	(2)	(1.9)
Intangible amortization	236	245	(9)	(3.7)
FDIC insurance	188	174	14	8.0
ATM/debit card processing	916	780	136	17.4
Other	\$ 7,748	\$ 7,382	\$ 366	5.0
Total noninterest expense				

#### Provision for Income Taxes

For the third quarter of 2014 the Corporation recorded a Federal income tax expense of \$641 thousand compared to \$583 thousand for the same quarter in 2013. While pretax income was higher in 2014 due primarily to less provision expense, 2014 also had a higher ratio of tax exempt income to pre-tax income. As a result, the effective tax rate remained virtually unchanged at 21.0% for the third quarter of 2014 compared to 21.1% for 2013. All taxable income for the Corporation is taxed at a rate of 34%.

Comparison of the nine months ended September 30, 2014 to the nine months ended September 30, 2013:

#### Net Interest Income

Tax equivalent net interest income for the first nine months of 2014 increased \$570 thousand year over year. Average interest-earning assets decreased \$21.5 million from 2013, but the yield on these assets increased by 3 basis points. The average balance of investment securities increased \$22.5 million while average loans decreased \$7.7 million (1.0%) year over year. Average mortgage loans increased \$6.0 million, but the increase was offset by a decrease in the average balance of commercial loans and consumer loans. Average commercial loans decreased \$11.3 million, as commercial loans continue to run-off. Average consumer loans, including home equity loans, decreased \$2.4 million, as consumers continue to borrow less.

Interest expense was \$2.4 million for the first nine months of 2014, a decrease of \$1.1 million from the 2013 total of \$3.5 million. Average interest-bearing liabilities decreased \$39.3 million to \$783.8 million for 2014 from an average balance of \$823.1 million in 2013. The average cost of these liabilities decreased from .57% in 2013 to .42% in

2014. Average interest-bearing deposits decreased \$13.5 million and the cost of these deposits decreased from .53% to .36%. Securities sold under agreements to repurchase (Repos) decreased \$25.6 million on average over the prior year quarter while the average rate remained constant at .15% in both years. The average balance of long-term debt decreased \$183 thousand, due to prepayments and amortizations.

The changes in the balance sheet and interest rates resulted in an increase in tax equivalent net interest income of \$570 thousand to \$25.2 million in 2014 compared to \$24.6 million in 2013. This increase was due to a \$367 thousand increase from higher volume and a \$203 thousand increase due to changes in rates.

The Bank's net interest margin increased from 3.40% in 2013 to 3.56% in 2014. The increase in the net interest margin is the result of an increase in the rate on interest-earning assets of 3 basis points, compared to a decrease in the yield on interest-bearing liabilities of 15 basis points.

The following table presents average balances, tax-equivalent (T/E) interest income, and yields earned or rates paid on the assets or liabilities. All nontaxable interest income has been adjusted to a tax-equivalent basis using a tax rate of 34%.

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

For the Nine Months Ended September 30,  
2014 2013

(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
<b>Interest-earning assets:</b>						
Interest-bearing obligations of other banks and federal funds sold	\$ 45,303	\$ 133	0.39%	\$ 81,561	\$ 180	0.29%
<b>Investment securities:</b>						
Taxable	125,110	2,047	2.19%	105,842	1,253	1.58%
Nontaxable	45,577	1,680	4.92%	42,362	1,671	5.26%
<b>Loans:</b>						
Commercial, industrial and agricultural	579,503	18,445	4.20%	590,762	19,390	4.31%
Residential mortgage	82,845	2,569	4.15%	76,849	2,511	4.37%
Home equity loans and lines	59,460	2,332	5.24%	59,771	2,607	5.83%
Consumer	7,935	428	7.21%	10,048	488	6.49%
Loans	729,743	23,774	4.31%	737,430	24,996	4.48%
Total interest-earning assets	945,733	27,634	3.91%	967,195	28,100	3.88%
Other assets	71,386			72,473		
Total assets	\$ 1,017,119			\$ 1,039,668		
<b>Interest-bearing liabilities:</b>						
<b>Deposits:</b>						
Interest-bearing checking	\$ 202,394	170	0.11%	\$ 168,381	110	0.09%
Money Management	388,386	1,267	0.44%	391,649	1,470	0.50%
Savings	62,741	36	0.08%	60,183	42	0.09%
Time	108,232	603	0.74%	155,022	1,454	1.25%
Total interest-bearing deposits	761,753	2,076	0.36%	775,235	3,076	0.53%
<b>Securities sold under agreements to repurchase</b>						
Long- term debt	9,792	11	0.15%	35,414	40	0.15%
Total interest-bearing liabilities	12,228	360	3.93%	12,411	367	3.95%
Noninterest-bearing deposits	783,773	2,447	0.42%	823,060	3,483	0.57%
Other liabilities	127,109			116,483		
Shareholders' equity	7,900			7,750		
Total liabilities and shareholders' equity	98,337			92,375		
Total liabilities and shareholders' equity	\$ 1,017,119			\$ 1,039,668		
T/E net interest income/Net interest margin		25,187	3.56%		24,617	3.40%
Tax equivalent adjustment		(1,469)			(1,181)	
Net interest income		\$ 23,718			\$ 23,436	

## Provision for Loan Losses

For 2014, the Bank recorded net charge-offs of \$1.2 million compared to \$958 thousand in 2013. The charge-offs were not completely offset by the provision expense of \$464 thousand for the year and as a result, the allowance for loan losses (ALL) decreased \$767 thousand over year-end 2013. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

## Noninterest Income

For the first nine months of 2014, noninterest income increased \$721 thousand from the same period in 2013. Investment and trust service fees increased due to higher recurring asset management fees. Loan service charges remained flat, while mortgage banking fees increased slightly, as 2014 had lower amortization costs compared to 2013. Deposit service charges increased due to higher account analysis fees and higher retail and commercial overdraft fees. Other service charges and fees increased primarily due to increases in ATM fees, while debit card income also increased. Net losses on other real estate owned decreased from prior year due to smaller write-downs in 2014 compared to 2013. Other than temporary impairment charges were recorded on one bond in 2014 compared to OTTI losses on two bonds in 2013. Security gains were higher in 2014 compared to prior year as the Corporation liquidated the majority of its equity portfolio.

The following table presents a comparison of noninterest income for the nine months ended September 30, 2014 and 2013:

(Dollars in thousands)	For the Nine Months Ended		Change	
	September 30 2014	2013	Amount	%
Noninterest Income				
Investment and trust services fees	\$ 3,311	\$ 3,288	\$ 23	0.7
Loan service charges	682	674	8	1.2
Mortgage banking activities	47	36	11	30.6
Deposit service charges and fees	1,553	1,359	194	14.3
Other service charges and fees	901	687	214	31.1
Debit card income	982	917	65	7.1
Increase in cash surrender value of life insurance	426	455	(29)	(6.4)
Other real estate owned	(184)	(260)	76	(29.2)
Other	92	179	(87)	(48.6)
OTTI losses recognized in income	(20)	(75)	55	(73.3)
Securities gain (losses), net	221	30	191	636.7
Total noninterest income	\$ 8,011	\$ 7,290	\$ 721	9.9

## Noninterest Expense

Noninterest expense for the first nine months of 2014 increased \$460 thousand compared to the same period in 2013. The increase in salaries and benefits was primarily due to annual salary adjustments (\$376 thousand) and incentive program expense (\$262 thousand), but these increases were partially offset by a \$191 thousand decrease in health insurance and a \$211 thousand decrease in pension expense. Health insurance expense declined due to lower claims expense during the year from the Bank's participation in a self-insured health insurance plan. Net occupancy expense increased due to higher costs for snow removal and utilities in 2014 compared to 2013. Advertising expenses decreased over prior year, due to the timing of various marketing campaigns. Legal and professional fees increased due to the implementation of new corporate initiatives that began in the third quarter of 2014. Bank shares tax expense decreased year over year due to a change in the calculation. FDIC expense decreased as the Corporation's balance sheet was smaller in 2014 compared to 2013. Other expenses increased due to prepayment penalties on several FHLB term loans, as well as development costs for a potential community office site.

The following table presents a comparison of noninterest expense for the nine months ended September 30, 2014 and 2013:

(Dollars in thousands)	For the Nine Months Ended		Change	
	September 30 2014	September 30 2013	Amount	%
Noninterest Expense	\$ 12,548	\$ 12,208	\$ 340	2.8
Salaries and benefits	1,817	1,702	115	6.8
Net occupancy expense	732	730	2	0.3
Furniture and equipment expense	898	1,039	(141)	(13.6)
Advertising	979	871	108	12.4
Legal and professional fees	1,355	1,317	38	2.9
Pennsylvania bank shares tax	520	612	(92)	(15.0)
Intangible amortization	311	319	(8)	(2.5)
FDIC insurance	690	760	(70)	(9.2)
ATM/debit card processing	545	520	25	4.8
Other	2,656	2,513	143	5.7
Total noninterest expense	\$ 23,051	\$ 22,591	\$ 460	2.0

#### Provision for Income Taxes

For the first nine months of 2014 the Corporation recorded a Federal income tax expense of \$1.7 million compared to \$1.1 million for the same period in 2013. While pretax income was higher in 2014 due primarily to less provision expense, 2013 benefited from a higher ratio of tax exempt income to pre-tax income. As a result, the effective tax rate increased year over year to 20.2% for the first nine months of 2014 compared to 17.6% for 2013. All taxable income for the Corporation is taxed at a rate of 34%.

#### Financial Condition

##### Summary:

At September 30, 2014, assets totaled \$1.023 billion, an increase of \$38.2 million from the 2013 year-end balance of \$984.6 million. Investment securities increased \$16.4 million, while net loans increased \$8.0 million. Deposits were up \$53.1 million for the first nine months of 2014 due to increases in every deposit category except time deposits. Shareholders' equity increased \$6.7 million during the first nine months as retained earnings increased approximately \$4.4 million, other comprehensive loss improved \$1.7 million and the Corporation's Dividend Reinvestment Plan (DRIP) added an additional \$543 thousand in new capital.

##### Cash and Cash Equivalents:

Cash and cash equivalents totaled \$56.2 million at September 30, 2014, an increase of \$15.5 million from the prior year-end balance of \$40.7 million. The increase is due to inflows of deposits as well as slow loan growth

opportunities. Interest-bearing deposits are held primarily at the Federal Reserve.

Investment Securities:

The investment portfolio has grown approximately 9% on a cost basis, since year-end 2013. However, the composition of the portfolio is essentially unchanged. Municipal securities and U.S. Agency mortgage-backed securities continue to comprise the greatest portion of the portfolio at approximately 38% and 49% of the portfolio fair value, respectively. The Bank invested \$37.0 million during the first nine months of 2014 with the purchases spread between U.S. Agency securities, U.S. Agency mortgage-backed securities and municipal securities.

The investment portfolio had a net unrealized gain of \$1.5 million at September 30, compared to an unrealized loss of \$741 thousand at year-end 2013. The trust preferred securities sector continues to hold the largest net unrealized loss.

The portfolio averaged \$170.7 million with a yield of 2.91% for the first nine months of 2014. This compares to an average of \$148.2 million and a yield of 2.63% for the same period in 2013. The improvement in the yield is primarily the result of a slow-down in prepayments on mortgage-backed securities.

During 2014, the equity portfolio was reduced significantly as the Corporation took advantage of price increases and sold selected holdings with gains. The Bank currently holds only 2 equity securities, both in Pennsylvania community banks. The municipal bond portfolio is well diversified geographically (issuers from within 28 states) and is comprised



primarily of general obligation bonds (70%). Most municipal bonds have credit enhancements in the form of private bond insurance or other credit support. The largest geographic municipal bond exposure is to nineteen issuers in the state of Texas with a fair value of \$9.7 million and eleven issuers in the state of Pennsylvania with a fair value of \$7.1 million. The municipal bond portfolio contains \$64.7 million of bonds rated A, or higher and \$1.4 million that are not rated by Moody's rating agency. No municipal bonds are rated below investment grade.

The holdings of trust preferred investments and private-label mortgage-backed securities are unchanged since year-end and are detailed in separate tables.

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2014 and December 31, 2013 is as follows:

(Dollars in thousands)	Amortized	Gross	Gross	Fair
September 30, 2014	cost	unrealized	unrealized	value
Equity securities	\$ 274	\$ 336	\$ -	\$ 610
U.S. Government agency securities	16,064	112	(85)	16,091
Municipal securities	64,850	1,790	(466)	66,174
Trust preferred securities	5,935	-	(588)	5,347
Agency mortgage-backed securities	85,665	836	(459)	86,042
Private-label mortgage-backed securities	1,750	53	-	1,803
Asset-backed securities	46	-	(2)	44
	\$ 174,584	\$ 3,127	\$ (1,600)	\$ 176,111

(Dollars in thousands)	Amortized	Gross	Gross	Fair
December 31, 2013	cost	unrealized	unrealized	value
Equity securities	\$ 1,472	\$ 499	\$ (1)	\$ 1,970
U.S. Government agency securities	11,771	94	(114)	11,751
Municipal securities	56,861	1,400	(1,404)	56,857
Corporate debt securities	1,002	-	(1)	1,001
Trust preferred securities	5,922	-	(871)	5,051
Agency mortgage-backed securities	81,352	726	(1,051)	81,027
Private-label mortgage-backed securities	1,984	16	(31)	1,969
Asset-backed securities	51	-	(3)	48
	\$ 160,415	\$ 2,735	\$ (3,476)	\$ 159,674



Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

The following table provides additional detail about the Bank's trust preferred securities as of September 30, 2014:

(Dollars in thousands)

Deal Name	Maturity	Single Issuer or Pooled	Class	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Lowest Credit Rating Assigned
BankAmerica Cap III	1/15/2027	Single	Preferred Stock	\$ 962	\$ 843	\$ (119)	BB
Wachovia Cap Trust II	1/15/2027	Single	Preferred Stock	276	263	(13)	BBB
Huntington Cap Trust	2/1/2027	Single	Preferred Stock	938	846	(92)	BB+
Corestates Captl Tr II	2/15/2027	Single	Preferred Stock	934	879	(55)	BBB+
Huntington Cap Trust II	6/15/2028	Single	Preferred Stock	889	823	(66)	BB+
Chase Cap VI JPM	8/1/2028	Single	Preferred Stock	962	879	(83)	BBB-
Fleet Cap Tr V	12/18/2028	Single	Preferred Stock	974	814	(160)	BB
				\$ 5,935	\$ 5,347	\$ (588)	

The following table provides additional detail about private label mortgage-backed securities as of September 30, 2014:

(Dollars in thousands)

Description	Origination Date	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
RALI 2004-QS4 A7	3/1/2004	\$ 105	\$ 108	\$ 3	ALT A	BBB+	12.31	\$ -
MALT 2004-6 7A1	6/1/2004	417	426	9	ALT A	CCC	14.00	-
RALI 2005-QS2 A1	2/1/2005	289	302	13	ALT A	CC	5.85	10
RALI 2006-QS4 A2	4/1/2006	562	573	11	ALT A	D	-	293
GSR 2006-5F 2A1	5/1/2006	87	93	6	Prime	D	-	15

## RALI 2006-QS8

A1	7/28/2006	290	301	11	ALT A	D	-	217
		\$ 1,750	\$ 1,803	\$ 53				\$ 535

The investment portfolio contained 94 securities with \$72.6 million of temporarily impaired fair value and \$1.6 million in unrealized losses at September 30, 2014. The total unrealized loss position has improved by \$1.9 million since year-end 2013.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities and subject to assessment at September 30, 2014, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

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 September 30, 2014 and December 31, 2013:

(Dollars in thousands)	September 30, 2014			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government agency securities	\$ 993	\$ (2)	1	\$ 7,321	\$ (83)	14	\$ 8,314	\$ (85)	15
Municipal securities	6,752	(72)	11	11,557	(394)	17	18,309	(466)	28
Trust preferred securities	-	-	-	5,347	(588)	7	5,347	(588)	7
Agency mortgage-backed securities	28,538	(161)	28	12,091	(298)	15	40,629	(459)	43
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	\$ 36,283	\$ (235)	40	\$ 36,321	\$ (1,365)	54	\$ 72,604	\$ (1,600)	94

(Dollars in thousands)	December 31, 2013			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
Equity securities	\$ 22	\$ (1)	1	\$ -	\$ -	-	\$ 22	\$ (1)	1
U.S. Government agency securities	3,971	(85)	7	3,807	(29)	7	7,778	(114)	14
Municipal securities	16,770	(1,022)	24	3,160	(382)	4	19,930	(1,404)	28
Corporate debt securities	-	-	-	1,001	(1)	1	1,001	(1)	1
Trust preferred securities	-	-	-	5,051	(871)	7	5,051	(871)	7
Agency mortgage-backed securities	40,395	(999)	38	2,213	(52)	4	42,608	(1,051)	42
Private-label mortgage-backed securities	-	-	-	911	(31)	2	911	(31)	2
Asset-backed securities	-	-	-	48	(3)	3	48	(3)	3
	\$ 61,158	\$ (2,107)	70	\$ 16,191	\$ (1,369)	28	\$ 77,349	\$ (3,476)	98

Total temporarily  
impaired securities

The municipal bond portfolio has an unrealized loss of \$466 thousand at quarter end. However, the unrealized loss has declined significantly from \$730 thousand at the end of the second quarter and \$1.4 million at the prior-year end. The unrealized loss in this portfolio is deemed to be non-credit related and no other-than-temporary impairment charges have been recorded.

The trust preferred portfolio contains seven securities with a fair value of \$5.3 million and an unrealized loss of \$588 thousand. The trust-preferred securities held by the Bank are single entity issues, not pooled trust preferred securities. Therefore, the impairment review of these securities is based only on the issuer and the security cannot be impaired by the performance of other issuers as if it was a pooled trust-preferred bond. All of the Bank's trust preferred securities are single issue, variable rate notes with long maturities (2027 – 2028). None of these bonds have suspended or missed a dividend payment. At September 30, 2014, 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 PLMBS sector shows a gross unrealized gain \$53 thousand. Even though there is no unrealized loss, due to the nature of these bonds, they are evaluated closely. 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 PLMBS 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 a \$20 thousand impairment charge was required at quarter end. It is primarily a result of the OTTI charge that these bonds are showing an unrealized gain at quarter end. The Bank has recorded \$535 thousand of cumulative impairment charges on this portfolio. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. The Bank is currently participating in a class-action lawsuit against one PLMBS servicer that centers on defective warranties and representations made as part of the underwriting process.

The following table represents the cumulative credit losses on securities recognized in earnings as of September 30, 2014 and 2013.

(Dollars in thousands)	Nine Months Ended	
	2014	2013
Balance of cumulative credit-related OTTI at January 1	\$ 515	\$ 490
Additions for credit-related OTTI not previously recognized	20	25
Additional increases for credit-related OTTI previously recognized when there is no intent to sell and no requirement to sell before recovery of amortized cost basis	-	-
Decreases for previously recognized credit-related OTTI because there was an intent to sell	-	-
Reduction for increases in cash flows expected to be collected	-	-
Balance of credit-related OTTI at September 30	\$ 535	\$ 515

The Bank held \$1.9 million of restricted stock at September 30, 2014. Except for \$30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of \$100 per share.

FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. Management intends to remain a member of the FHLB and believes that it will be able to fully recover the cost basis of this investment. In October 2014, the FHLB repurchased approximately \$1 million of its stock from the Bank.

#### Loans:

**Residential real estate:** This category is comprised of consumer purpose loans secured by residential real estate and to a lesser extent, commercial purpose loans secured by residential real estate. The consumer purpose category represents traditional residential mortgage loans and home equity products (primarily junior liens and lines of credit). Commercial purpose loans in this category represent loans made for various business needs, but are secured with residential real estate. In addition to the real estate collateral, it is possible that additional security is provided by personal guarantees or UCC filings. These loans are underwritten as commercial loans and are not originated to be sold.

Total residential real estate loans increased \$3.6 million over 2013, primarily in the consumer junior liens and consumer first lien loan categories. For the first nine months of 2014, the Bank originated \$15.4 million in mortgages, including approximately \$5.8 million for a fee through a third party brokerage agreement. The Bank does not originate or hold any loans that would be considered sub-prime or Alt-A, and does not generally originate mortgages outside of its primary market area. Home equity lending, reflected in consumer junior liens and lines of credit, has increased with the Bank's home equity campaign in the second and third quarters of 2014.

**Residential real estate construction:** The largest component of this category represents loans to residential real estate developers (\$8.9 million), while loans for individuals to construct personal residences totaled \$1.3 million at September 30, 2014. The Bank's exposure to residential construction loans is concentrated primarily in south central Pennsylvania.

Real estate construction loans, including residential real estate and land development loans, frequently provide an interest reserve in order to assist the developer during the development stage when minimal cash flow is generated. All real estate construction loans are underwritten in the same manner, regardless of the use of an interest reserve. Real estate construction loans are monitored on a regular basis by either an independent third party inspector or the assigned loan officer depending on loan amount or complexity of the project. This monitoring process includes at a minimum, the submission of invoices and AIA documents of costs incurred by the borrower, on-site inspections, and a signature by the assigned loan officer for disbursement of funds. The Bank has no residential real estate construction loans with an interest reserve.

Commercial loans and commercial real estate: Loans in this category include commercial, industrial, farm, agricultural, land development and municipal government loans. Collateral for these loans may include commercial real estate, farm real estate, equipment or other business assets. Total commercial real estate loans decreased to \$323.6 million from \$329.4 million at the end of 2013. At September 30, 2014, the Bank had \$9.4 million in land development real estate construction loans funded with an interest reserve and capitalized \$25 thousand of interest from these reserves on active projects. The largest sectors (by collateral) in the commercial real estate category are: land development (\$52.2 million), office buildings (\$38.4 million), hotels and motels (\$37.1 million), farm land (\$34.1 million), and auto dealerships (\$18.1 million). Commercial loans increased by 8.1% compared to year end, an increase of \$13.7 million. The largest sectors



(by industry) in the commercial loan category are: construction (\$55.2 million), retail trade (\$53.2 million), food services (\$42.7 million), and manufacturing (\$37.8 million). The Bank is very active in its market in pursuing commercial lending opportunities, but supplements in-market growth with purchased loan participations. The Bank purchases commercial loan participations in an effort to increase its commercial lending and diversify its loan mix, both geographically and by industry sector. Purchased loans are originated primarily within the south central Pennsylvania market and are purchased from only a few select counter parties. These loans usually represent an opportunity to participate in larger credits that are not available in market, with the benefit of lower origination and servicing costs. For the first nine months of 2014, the Bank purchased \$12.1 million of loan participations and commitments. At September 30, 2014, the Bank held \$133.1 million in purchased loan participations in its portfolio.

Consumer loans decreased \$2.0 million due primarily to regular payments and maturities. The Bank believes consumer portfolio will continue to run-down, as consumers are unwilling to increase their debt and nearly all consumer auto financing has shifted to dealer financing.

The following table presents a summary of loans outstanding, by primary collateral as of:

(Dollars in thousands)	September 30, 2014	December 31, 2013	Change	
			Amount	%
Residential Real Estate 1-4 Family				
Consumer first liens	\$ 104,823	\$ 103,573	\$ 1,250	1.2
Consumer junior liens and lines of credit	37,454	34,636	2,818	8.1
Total consumer	142,277	138,209	4,068	2.9
Commercial first lien	58,320	58,466	(146)	(0.2)
Commercial junior liens and lines of credit	5,664	5,939	(275)	(4.6)
Total commercial	63,984	64,405	(421)	(0.7)
Total residential real estate 1-4 family	206,261	202,614	3,647	1.8
Residential real estate - construction				
Consumer	1,286	3,960	(2,674)	(67.5)
Commercial	8,854	8,559	295	3.4
Total residential real estate construction	10,140	12,519	(2,379)	(19.0)
Commercial real estate	323,570	329,373	(5,803)	(1.8)
Commercial	184,049	170,327	13,722	8.1
Total commercial	507,619	499,700	7,919	1.6
Consumer	6,625	8,580	(1,955)	(22.8)
	730,645	723,413	7,232	1.0
Less: Allowance for loan losses	(8,935)	(9,702)	767	(7.9)
Net Loans	\$ 721,710	\$ 713,711	\$ 7,999	1.1
Included in the loan balances are the following:				
Net unamortized deferred loan costs	\$ 511	\$ 372		

Unamortized discount on purchased loans	\$ (25)	\$ (92)
Loans pledged as collateral for borrowings and commitments from:		
FHLB	\$ 602,666	\$ 607,524
Federal Reserve Bank	57,143	45,809
	\$ 659,809	\$ 653,333

40

---

## Loan Quality:

Management utilizes a risk rating scale ranging from 1 (Prime) to 9 (Loss) to evaluate loan quality. This risk rating scale is used primarily for commercial purpose loans. Consumer purpose loans are identified as either a pass or substandard rating. Substandard consumer loans are loans that are 90 days or more past due and still accruing. Loans rated 1 – 4 are considered pass credits. Loans that are rated 5 are pass credits, but have been identified as credits that are likely to warrant additional attention and monitoring. Loans rated 6 (Special Mention) or worse begin to receive enhanced monitoring and reporting by the Bank. Loans rated 7 (Substandard) or 8 (Doubtful) exhibit the greatest financial weakness and present the greatest possible risk of loss to the Bank. Nonaccrual loans are rated no better than 7. The following factors represent some of the factors used in determining the risk rating of a borrower: cash flow, debt coverage, liquidity, management, and collateral. Risk ratings, for pass credits, are generally reviewed annually for term debt and at renewal for revolving or renewing debt. The Bank monitors loan quality by reviewing four measurements: (1) loans rated 6 or worse (collectively “watch list”), (2) delinquent loans, (3) other real estate owned (OREO), and (4) net-charge-offs. Management compares trends in these measurements with the Bank’s internally established targets, as well as its national peer group.

Watch list loans exhibit financial weaknesses that increase the potential risk of default or loss to the Bank. However, inclusion on the watch list, does not by itself, mean a loss is certain. The watch list includes both performing and nonperforming loans. Watch list loans totaled \$65.9 million at quarter-end compared to \$76.3 million at the prior year-end. The watch list is comprised of \$22.5 million rated 6 and \$43.4 million rated 7. The Bank has no loans rated 8-doubtful or 9-loss. The credit composition of the portfolio, by primary collateral is shown in Note 7 of the accompanying financial statement. Included in the substandard loan total is \$18.6 million of nonaccrual loans. The Bank’s Loan Management Committee reviews these loans and risk ratings on a quarterly basis in order to proactively identify and manage problem loans. In addition, a committee meets monthly to discuss possible workout strategies for OREO and all credits rated 7 or worse. Management also tracks other commercial loan risk measurements including high loan to value loans, concentrations, participations and policy exceptions and reports these to the Credit Risk Oversight Committee of the Board of Directors. The Bank also uses a third-party consultant to assist with internal loan review with a goal of reviewing 60% of commercial loans each year. The FDIC defines certain supervisory loan-to-value lending limits. The Bank’s internal loan-to-value limits are all equal to, or have a lower loan-to-value limit, than the supervisory limits. At September 30, 2014, the Bank had loans of \$22.8 million that exceeded the supervisory limit.

Delinquent loans are a result of borrowers’ cash flow and/or alternative sources of cash being insufficient to repay loans. The Bank’s likelihood of collateral liquidation to repay the loans becomes more probable the further behind a borrower falls, particularly when loans reach 90 days or more past due. Management monitors the performance status of loans by the use of an aging report. The aging report can provide an early indicator of loans that may become severely delinquent and possibly result in a loss to the Bank. See Note 7 in the accompanying financial statements for a note that presents the aging of payments in the loan portfolio.

Nonaccruing loans generally represent Management’s determination that the borrower will be unable to repay the loan in accordance with its contractual terms and that collateral liquidation may or may not fully repay both interest and principal. It is the Bank’s policy to evaluate the probable collectability of principal and interest due under terms of loan contracts for all loans 90-days or more, nonaccrual loans, or impaired loans. Further, it is the Bank’s policy to discontinue accruing interest on loans that are not adequately secured and in the process of collection. Upon determination of nonaccrual status, the Bank subtracts any current year accrued and unpaid interest from its income, and any prior year accrued and unpaid interest from the allowance for loan losses. Management continually monitors the status of nonperforming loans, the value of any collateral and potential of risk of loss. Nonaccrual loans are rated no better than 7 (Substandard).



Loan quality, as measured by the balance of nonperforming loans, is virtually unchanged from year-end. However, the performance ratios related to nonperforming loans have improved since December 31, 2013. The following table presents a summary of nonperforming assets:

(Dollars in thousands)	September 30, 2014	December 31, 2013
Nonaccrual loans		
Residential Real Estate 1-4 Family		
First liens	\$ 1,240	\$ 2,599
Junior liens and lines of credit	118	107
Total	1,358	2,706
Residential real estate - construction		
Commercial real estate	1,155	538
Commercial	14,351	19,001
Total nonaccrual loans	1,687	2,398
Loans past due 90 days or more and not included above		
Residential Real Estate 1-4 Family		
First liens	163	302
Junior liens and lines of credit	11	41
Total	174	343
Commercial real estate		
Commercial	152	207
Consumer	23	44
Total loans past due 90 days or more and still accruing	16	10
Total nonperforming loans	365	604
Other real estate owned	18,916	25,247
Total nonperforming assets	\$ 3,737	\$ 4,708
	\$ 22,653	\$ 29,955
Nonaccrual loans to total gross loans		
	2.54%	3.41%
Nonperforming loans to total gross loans		
	2.59%	3.49%
Nonperforming assets to total assets		
	2.21%	3.04%
Allowance for loan losses to nonperforming loans		
	47.24%	38.43%

The following table identifies the most significant loans in nonaccrual status. These six nonaccrual loans account for 87% of the total nonaccrual balance. The table also indicates those significant nonaccrual loans that are classified as troubled debt restructurings (TDR). A TDR loan is maintained on nonaccrual status until a satisfactory repayment history is established. It is possible that other nonaccrual loans could be removed from nonaccrual status in 2014. However, it is also possible that other loans may become delinquent and nonperforming loans could remain at a high level due to lengthy workout periods on these loans. All loans on the watch list that are not on nonaccrual or past due 90 days more are considered potential problem loans. Potential problem loans at September 30, 2014 totaled \$47.4 million compared to \$51.6 million at year-end 2013.



The following table provides information on the most significant nonaccrual loans as of September 30, 2014.

(Dollars in thousands)	Balance	ALL Reserve	Nonaccrual Date	TDR Status	Collateral	Location	Last Appraisal(1)
Credit 1 - Commercial real estate	\$ 3,040	\$ -	Dec-10	N	1st lien on 92 acres undeveloped commercial real estate	PA	Dec-13 \$ 3,304
Credit 2 - Residential real estate and commercial real estate	875	-	Aug-11	N	1st lien on commercial and residential properties and 70 acres of farmland	PA	Aug-14 \$ 1,235
Credit 3 - Residential real estate	2,008	-	Mar-12	Y	1st and 2nd liens on commercial real estate, residential real estate and business assets	PA	Oct-13 \$ 4,320
Credit 4 - Commercial real estate	7,521	-	Sep-12	Y	1st lien residential real estate development - 379 acres and other commercial and residential properties	PA	Apr-14 \$ 7,332
Credit 5 - Commercial / commercial real estate	1,899	19	Mar-13	N	Liens on land, commercial and residential real estate and business assets	PA	Sep-14 \$ 2,965
Credit 6 - Commercial real estate	770	-	Mar-14	N	1st lien on commercial real estate	PA	Jun-13 \$ 1,550
	\$ 16,113	\$ 19					

(1) Appraisal value, as reported, does not reflect the pay-off of any senior liens or the cost to liquidate the collateral, but does reflect only the Bank's share of the collateral if it is a participated loan.

Credit 1 has been charged down by \$3.5 million since being placed on nonaccrual due to declining appraisal values. This credit is part of a participated loan and the lead bank has begun foreclosure action. Credit 2 is in the process of foreclosure and the real estate is listed for sale. Credit 3 is a TDR that is not performing in accordance with

the modified terms. Credit 4 is a TDR and is performing in accordance with its modified terms. The Bank holds real estate collateral, but the loan is not considered collateral dependent for repayment. Credit 5 reflects a \$549 thousand charge-off in the wnd quarter of 2014 and the borrower and guarantor have filed bankruptcy. Credit 6 is a new nonaccrual loan in 2014 and is performing under a forbearance agreement with the Bank. During the third quarter of 2014, a significant nonaccrual credit of \$883 thousand was paid-off with third party financing.

In addition to monitoring nonaccrual loans, the Bank also closely monitors impaired loans and troubled debt restructurings (TDR). A loan is considered to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect all interest and principal payments due according to the originally contracted terms of the loan agreement. Nonaccrual loans and TDR loans are always considered impaired. For impaired loans with balances less than \$250 thousand and consumer purpose loans, a specific reserve analysis is not performed and these loans are added to the general allocation pool. In accordance with financial accounting standards, TDR loans are always considered impaired until they are paid off. However, an impaired TDR loan can be a performing loan. Impaired loans totaled \$25.4 million at quarter-end compared to \$30.9 million at year-end 2013. Included in the impaired loan total is \$16.5 million of TDR loans. Note 7 of the accompanying financial statements provides additional information on the composition of the impaired loans, including the allowance for loan loss that has been established for impaired loans.

A loan is considered a troubled debt restructuring (TDR) if the creditor (the Bank), for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. These concessions may include lowering the rate, extending the maturity, reamortization of the payment, or a combination of multiple concessions. The Bank reviews all loans rated 6 or worse when it is providing a loan restructure, modification or new credit facility to determine if the action is a TDR. If a TDR loan is placed on nonaccrual status, it remains on nonaccrual status for at least six months to ensure performance. All TDR loans except one, Credit 3 in the table of significant nonaccrual loans, are in compliance with their modified terms. See Note 7 in the accompanying financial statements for a note that identifies TDR loans in the portfolio.

The Bank holds \$3.7 million of other real estate owned (OREO), comprised of five properties compared to \$4.7 million and eight properties at December 31, 2013. The most significant OREO holdings are listed in the table below.



Property 1 was written down by \$181 thousand in 2014 and a parcel was sold in July 2014. The appraised value for Property 2 reflects an “as is” valuation. A second appraisal that reflects the commercial and industrial development potential of the property, which is the most likely use for the property, was \$6.9 million. The Bank has reported the lower of the two valuations.

During 2014, the Bank has incurred a net loss of \$184 thousand on OREO and an expense of \$46 thousand to hold and maintain OREO.

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

September 30, 2014

(Dollars in thousands)

	Date Acquired	Balance	Collateral	Location	Last Appraisal
Property 1 (2 properties)	2011	\$ 538	unimproved real estate for residential development	PA	Jan-14 \$ 970
Property 2	2012	2,758	1st, 2nd, and 3rd liens residential development land - four tracts with 200 acres	PA	Apr-14 \$ 2,950
		\$ 3,296			

At September 30, 2014, the Bank had \$717 thousand of residential properties in the process of foreclosure compared to \$1.1 million at the end of 2013.

Allowance for Loan Losses:

Management performs a monthly evaluation of the adequacy of the allowance for loan losses (ALL). The ALL is determined by segmenting the loan portfolio based on the loan’s collateral. The Bank further classifies the portfolio based on the primary purpose of the loan, either consumer or commercial. When calculating the ALL, consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, historical charge-offs, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. The Bank begins enhanced monitoring of all loans rated 6 (OAE) or worse, and obtains a new appraisal or asset valuation for any loan rated 7 (substandard) or worse. Management, at its discretion, may determine that additional adjustments to the appraisal or valuation are required. Valuation adjustments will be made as necessary based on factors, including, but not limited to: the economy, deferred maintenance, industry, type of property/equipment, age of the appraisal, etc. and the knowledge Management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated and deducted from the valuation in order to determine the net realizable value to the Bank. When determining the allowance for loan losses, certain factors involved in the evaluation are inherently subjective and require material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans. Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy quarterly to the Credit Risk Oversight Committee of the Board of Directors. Management believes that the allowance for loan losses at September 30, 2014 is adequate.

The analysis for determining the ALL is consistent with guidance set forth in generally accepted accounting principles (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. Collateral values discounted for market conditions and selling costs are used to establish specific allocations for impaired loans. It is possible that as a result of the credit analysis, a specific reserve is not required for an impaired loan. For impaired loans with balances less than \$250 thousand and consumer purpose loans, a specific reserve analysis is not performed and these loans are added to the general allocation pool. The specific allowance decreased significantly from \$1.0 million at June 30, 2014 to \$99 thousand at September 30, 2014. At June 30, \$948 thousand of the specific allowance was established for Credit 6 in the table of significant nonaccrual loans. As a result of a \$549 thousand charge-off and improved collateral values on this credit during third quarter, the specific allowance on this credit was reduced to \$19 thousand. Note 7 in the accompanying financial statements provides additional information about the ALL established for impaired loans.

The general allocation component addresses the reserves established for pools of homogenous loans. The general component includes a quantitative and qualitative analysis. When calculating the general allocation, the Bank segregates

its loan portfolio into the following sectors based primarily on the type of supporting collateral: residential real estate, commercial, industrial or agricultural real estate; commercial and industrial (C&I non-real estate), and consumer. The residential real estate sector is further segregated by first lien loans, junior liens and home equity products, and residential real estate construction. The quantitative analysis uses the Bank's eight quarter rolling historical loan loss experience adjusted for factors derived from current economic and market conditions that have been determined to have an effect on the probability and magnitude of a loss. The historical loss experience factor was 1.21% of gross loans at September 30, 2014 compared to .99% at December 31, 2013. The qualitative analysis utilizes a risk matrix that incorporates qualitative and environmental factors such as: loan volume, management, loan review process, credit concentrations, competition, and legal and regulatory issues. These factors are each risk rated from minimal to high risk and in total can add up to a maximum qualitative factor of 37.5 basis points. At quarter-end, this factor was 20.5 basis points unchanged from year-end 2013. These factors are determined on the basis of Management's observation, judgment and experience.

Real estate appraisals and collateral valuations are an important part of the Bank's process for determining potential loss on collateral dependent loans and thereby have a direct effect on the determination of loan reserves, charge-offs and the calculation of the allowance for loan losses. As long as the loan remains a performing loan, no further updates to appraisals are required. If a loan or relationship migrates to risk rating of 7 or worse, an evaluation for impairment status is made based on the current information available at the time of downgrade and a new appraisal or collateral valuation is obtained.

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

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

The following table shows the loans that were evaluated for the allowance for loan losses under a specific reserve (individually) and those that were evaluated under a general reserve (collectively), and the amount of the allowance established in each loan class as of September 30, 2014:

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial		Consumer	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial		
September 30, 2014							
Loans evaluated for allowance:							
Individually	\$ 1,193	\$ 51	\$ 1,155	\$ 20,338	\$ 1,343	\$ -	\$ 24,080
Collectively	161,950	43,067	8,985	303,232	182,706	6,625	706,565
Total	\$ 163,143	\$ 43,118	\$ 10,140	\$ 323,570	\$ 184,049	\$ 6,625	\$ 730,645
Allowance established for loans evaluated:							
Individually	\$ -	\$ -	\$ -	\$ 71	\$ 28	\$ -	\$ 99
Collectively	1,129	322	234	5,423	1,601	127	8,836
Allowance at September 30, 2014	\$ 1,129	\$ 322	\$ 234	\$ 5,494	\$ 1,629	\$ 127	\$ 8,935
December 31, 2013							
Loans evaluated for allowance:							
Individually	\$ 2,354	\$ 50	\$ 537	\$ 25,107	\$ 1,996	\$ -	\$ 30,044
Collectively	159,685	40,525	11,982	304,266	168,331	8,580	693,369
Total	\$ 162,039	\$ 40,575	\$ 12,519	\$ 329,373	\$ 170,327	\$ 8,580	\$ 723,413
Allowance established for loans evaluated:							
Individually	\$ 9	\$ -	\$ -	\$ 89	\$ 1,002	\$ -	\$ 1,100
Collectively	1,099	278	291	5,482	1,304	148	8,602
Allowance at December 31, 2013	\$ 1,108	\$ 278	\$ 291	\$ 5,571	\$ 2,306	\$ 148	\$ 9,702

During the third quarter of 2014, the Bank recorded \$0 provision expense and therefore, nothing was added to the allowance for loan losses (ALL) through the provision for loan loss expense. This compares to a provision expense of \$350 thousand for the same period in 2013.

Charged-off loans usually result from: (1) a borrower being legally relieved of loan repayment responsibility through bankruptcy, (2) insufficient collateral sale proceeds to repay a loan; or (3) the borrower and/or guarantor does not own other assets that, if sold, would generate sufficient sale proceeds to repay a loan.

The Bank recorded net loan charge-offs of \$584 thousand for the third quarter of 2014 and \$1.2 million year-to-date. In 2013, net charge-offs were \$412 thousand and \$958 thousand for the third quarter and year-to-date period, respectively. The largest charge-off in 2014 was \$549 thousand on Credit 5 in the significant nonaccrual table.

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

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial			Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Consumer	
Allowance at June 30, 2014	\$ 1,079	\$ 266	\$ 261	\$ 5,412	\$ 2,366	\$ 135	\$ 9,519
Charge-offs	-	-	-	-	(611)	(67)	(678)
Recoveries	2	-	-	49	23	20	94
Provision	48	56	(27)	33	(149)	39	-
Allowance at September 30, 2014	\$ 1,129	\$ 322	\$ 234	\$ 5,494	\$ 1,629	\$ 127	\$ 8,935
Allowance at December 31, 2013	\$ 1,108	\$ 278	\$ 291	\$ 5,571	\$ 2,306	\$ 148	\$ 9,702
Charge-offs	(257)	-	(27)	(348)	(623)	(147)	(1,402)
Recoveries	5	-	-	49	56	61	171
Provision	273	44	(30)	222	(110)	65	464
Allowance at September 30, 2014	\$ 1,129	\$ 322	\$ 234	\$ 5,494	\$ 1,629	\$ 127	\$ 8,935

Net loans charged-off as a percentage of average gross loans	September 30, 2014	December 31, 2013	September 30, 2013
	0.22%	0.49%	0.17%

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

Net loans charged-off as a percentage of the provision for loan losses	265.30%	123.18%	49.00%
Allowance as a percentage of loans	1.22%	1.34%	1.58%
Net charge-offs	\$ 1,231	\$ 3,597	\$ 958

47

---

## Deposits:

Total deposits increased \$53.0 million during the first nine months of 2014 to \$898.9 million. Non-interest bearing deposits increased \$16.8 million, while savings and interest-bearing checking increased \$47.5 million and time deposits decreased \$11.1 million. The increase in non-interest bearing checking accounts occurred primarily in municipal checking accounts (\$5.6 million), retail checking accounts (\$5.4 million) and small business checking accounts (\$4.6 million). Interest bearing checking increased by \$33.5 million, primarily from commercial deposits. The Bank's Money Management product increased \$17.2 million due primarily to an increase in commercial deposits. Retail time deposits decreased since year-end, as customers moved funds to more liquid accounts. As of September 30, 2014, the Bank had \$5.6 million in CDARS reciprocal time deposits included in brokered time deposits.

(Dollars in thousands)	September 30, 2014	December 31, 2013	Change	
			Amount	%
Noninterest-bearing checking	\$ 138,346	\$ 121,565	\$ 16,781	13.8
Interest-bearing checking	207,526	180,450	27,076	15.0
Money management	387,560	370,401	17,159	4.6
Savings	62,645	59,394	3,251	5.5
Total interest-bearing checking and savings	657,731	610,245	47,486	7.8
Retail time deposits	97,167	108,283	(11,116)	(10.3)
Brokered time deposits	5,621	5,631	(10)	(0.2)
Total time deposits	102,788	113,914	(11,126)	(9.8)
Total deposits	\$ 898,865	\$ 845,724	\$ 53,141	6.3
Overdrawn deposit accounts reclassified as loans	\$ 108	\$ 106		

## Borrowings:

The balance of securities sold under agreements to repurchase, which are accounted for as collateralized financings, decreased \$22.3 million from year-end to \$1.6 million. The Bank is transitioning customers from this product to a deposit sweep product, which provides full FDIC coverage. This will free-up collateral that was required to cover these balances and will increase the Bank's liquidity. The long-term debt from the FHLB decreased due to the Bank prepaying several small term loans and also to scheduled amortization.

## Shareholders' Equity:

Total shareholders' equity increased \$6.7 million to \$102.1 million at September 30, 2014, compared to \$95.4 million at the end of 2013. The increase in retained earnings from the Corporation's net income of \$6.6 million was partially offset by the cash dividend of \$2.1 million. The Corporation's dividend payout ratio is 32.5% for the first nine months of 2014 compared to 41.3% in 2013.

As part of its quarterly dividend decision, the Corporation considers current and future income projections, dividend yield, payout ratio, and current and future capital ratios. In July 2014, the Board of Directors declared a \$.17 per share regular quarterly dividend for the third quarter of 2014. This compares to a regular quarterly cash dividend of \$.17 paid in the second quarter of 2013. On October 23, 2014 the Board of Directors declared a \$.17 per share regular quarterly dividend for the fourth quarter of 2014, which will be paid on November 26, 2014.



In addition, the Corporation considers how dividend decisions may affect the Dividend Reinvestment Plan (DRIP), which has raised \$543 thousand in new capital this year with 29,142 new shares purchased. The Corporation continually explores other sources of capital as part of its capital management plan for the Corporation and the Bank. The Corporation did not repurchase any shares of the Corporation's common stock during the first nine months of 2014.

48

---

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. At September 30, 2014, the Corporation was well capitalized as defined by the banking regulatory agencies. Regulatory capital ratios for the Corporation and the Bank are shown below:

(Dollars in thousands)	September 30, 2014	December 31, 2013	Regulatory Ratios	
			Minimum	Well Capitalized Minimum
<b>Total Risk-based Capital Ratio</b>				
Franklin Financial Services Corporation	15.04%	14.24%	8.00%	N/A
Farmers & Merchants Trust Company	14.75%	13.78%	8.00%	10.00%
<b>Tier 1 Risk-based Capital Ratio</b>				
Franklin Financial Services Corporation	13.77%	12.97%	4.00%	N/A
Farmers & Merchants Trust Company	13.48%	12.52%	4.00%	6.00%
<b>Tier 1 Leverage Ratio</b>				
Franklin Financial Services Corporation	9.51%	9.14%	4.00%	N/A
Farmers & Merchants Trust Company	9.24%	8.81%	4.00%	5.00%

Economy

The Corporation's primary market area includes Franklin, Fulton, Cumberland and Huntingdon County, PA. This area is diverse in demographic and economic makeup. County populations range from a low of approximately 15,000 in Fulton County to over 220,000 in Cumberland County. Unemployment in the Bank's market area has remained virtually unchanged over the past year and ranges from a low of 5.1% in Cumberland County to high of 7.1% in Fulton County. The market area has a diverse economic base and local industries include, warehousing, truck & rail shipping centers, light and heavy manufacturers, health-care, higher education institutions, farming and agriculture, and a varied service sector. The Corporation's primary market area is located in south central Pennsylvania and provides easy access to the major metropolitan markets on the east coast via trucking and rail transportation. Because of this, warehousing and distribution companies continue to find the area attractive. The local economy is not overly dependent on any one industry or business and Management believes that the Bank's primary market area continues to be well suited for growth as the recession eases.

The following provides selected economic data for the Bank's primary market:

Economic Data

	September 30, 2014	December 31, 2013
Unemployment Rate (seasonally adjusted)		
Market area range (1)	5.1% - 7.1%	5.9% - 9.2%

Pennsylvania	5.8%	7.3%
United States	6.1%	6.7%
Housing Price Index - year over year change		
PA, nonmetropolitan statistical area	-1.4%	1.3%
United States	5.8%	4.6%
Franklin County Building Permits - year over year change		
Residential, estimated	11.5%	18.2%
Multifamily, estimated	-16.5%	-68.5%

(1) Franklin, Cumberland, Fulton and Huntingdon Counties

Unlike many companies, the assets and liabilities of the Corporation are financial in nature. As such, interest rates and changes in interest rates may have a more significant effect on the Corporation's financial results than on other types of industries. Because of this, the Corporation watches the actions of the Federal Reserve Open Market Committee (FOMC) as it makes decisions about interest rate changes. The FOMC continues to hold short-term rates at historic lows. The FOMC continued its tapering of bond purchases that it began at the end of 2013 and it is expected that the quantitative

easing program will end in 2014. It continues to monitor employment and inflation data as it considers the timing of an increase in the Fed Funds rate. Many analysts believe that the FOMC will begin to increase rates in 2015.

## Liquidity

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

Historically, the Corporation has satisfied its liquidity needs from earnings, repayment of loans and amortizing investment securities, maturing investment securities, loan sales, deposit growth and its ability to access existing lines of credit. All investment securities are classified as available for sale; therefore, securities that are not pledged as collateral for borrowings are an additional source of readily available liquidity, either by selling the security or, more preferably, to provide collateral for additional borrowing. At September 30, 2014, the Bank had approximately \$85 million (fair value) in its investment portfolio pledged as collateral for deposits and Repos. Another source of available liquidity for the Bank is a line of credit with the FHLB. At September 30, 2014, the Bank had approximately \$35 million available on this line of credit and \$16 million of unsecured lines of credit at correspondent banks. At September 30, 2014, the Bank had an excess borrowing capacity of \$224.5 million, which includes the amount available on the line of credit. The Bank has established credit at the Federal Reserve Discount Window and as of quarter-end had the ability to borrow approximately \$29 million.

## Off Balance Sheet Commitments

The Corporation's financial statements do not reflect various commitments that are made in the normal course of business, which may involve some liquidity risk. These commitments consist mainly of unfunded loans and letters of credit made under the same standards as on-balance sheet instruments. Because these instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant liquidity risk to the Corporation. Unused commitments and standby letters of credit totaled \$272.0 million and \$239.6 million, respectively, at September 30, 2014 and December 31, 2013.

The Corporation has entered into various contractual obligations to make future payments. These obligations include time deposits, long-term debt, operating leases, deferred compensation and pension payments. These amounts have not changed materially from those reported in the Corporation's 2013 Annual Report on Form 10-K.



Item 3. Quantitative and Qualitative Disclosures about Market Risk

There were no material changes in the Corporation's exposure to market risk during the nine months ended September 30, 2014. For more information on market risk refer to the Corporation's 2013 Annual Report on Form 10-K.

Item 4. Controls and Procedures

Evaluation of Controls and Procedures

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2014, 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.

Part II – OTHER INFORMATION

Item 1. Legal Proceedings

The nature of the Corporation's business generates a certain amount of litigation involving matters arising in the ordinary course of business. However, in management's opinion, there are no proceedings pending to which the Corporation is a party or to which our property is subject, which, if determined adversely to the Corporation, would be material in relation to our shareholders' equity or financial condition. In addition, no material proceedings are pending or are known to be threatened or contemplated against us by governmental authorities or other parties.

Item 1A. Risk Factors

There were no material changes in the Corporation's risk factors during the nine months ended September 30, 2014. For more information, refer to the Corporation's 2013 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults by the Company on its Senior Securities

None

Item 4. Mine Safety Disclosures

Not Applicable

Item 5. Other Information

None

Item 6. Exhibits

Exhibits

3.1 Articles of Incorporation of the Corporation. (Filed as Exhibit 3.1 to Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference.)

3.2 Bylaws of the Corporation. (Filed as Exhibit 99 to Current Report on Form 8-K filed on December 20, 2004 and incorporated herein by reference.)

31.1 Rule 13a – 14(a)/15d-14(a) Certifications – Principal Executive Officer

31.2 Rule 13a – 14(a)/15d-14(a) Certifications – Principal Financial Officer

32.1 Section 1350 Certifications – Principal Executive Officer

32.2 Section 1350 Certifications – Principal Financial Officer

101 Interactive Data File (XBRL)

52

---



FRANKLIN FINANCIAL SERVICES CORPORATION

and SUBSIDIARIES

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Franklin Financial Services Corporation

November 10, 2014 /s/ William E. Snell, Jr  
William E. Snell, Jr.  
President and Chief Executive Officer  
(Principal Executive)

November 10, 2014 /s/ Mark R. Hollar  
Mark R. Hollar  
Treasurer and Chief Financial Officer  
(Principal Financial Officer)