

FRANKLIN FINANCIAL SERVICES CORP /PA/

Form 10-Q

August 07, 2015

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 June 30, 2015

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

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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 4,252,508 outstanding shares of the Registrant’s common stock as of July 31, 2015.

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## Part I FINANCIAL INFORMATION

## Item 1 Financial Statements

## Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)	(unaudited)	
	June 30 2015	December 31 2014
<b>Assets</b>		
Cash and due from banks	\$ 17,649	\$ 14,258
Interest-bearing deposits in other banks	46,754	34,335
Total cash and cash equivalents	64,403	48,593
Investment securities available for sale, at fair value	176,424	171,751
Restricted stock	439	438
Loans held for sale	1,755	389
Loans	733,212	726,531
Allowance for loan losses	(9,450)	(9,111)
Net Loans	723,762	717,420
Premises and equipment, net	14,531	15,046
Bank owned life insurance	22,377	22,098
Goodwill	9,016	9,016
Other intangible assets	-	181
Other real estate owned	4,018	3,666
Deferred tax asset, net	4,690	4,328
Other assets	7,124	8,522
Total assets	\$ 1,028,539	\$ 1,001,448
<b>Liabilities</b>		
<b>Deposits</b>		
Noninterest-bearing checking	\$ 143,564	\$ 136,910
Money management, savings and interest checking	680,424	645,672
Time	92,071	98,599
Total Deposits	916,059	881,181
Repurchase Agreements	-	9,079
Other liabilities	5,302	7,667
Total liabilities	921,361	897,927
<b>Shareholders' equity</b>		
Common stock, \$1 par value per share, 15,000,000 shares authorized with 4,625,071 shares issued and 4,241,355 shares outstanding at June 30, 2015 and 4,606,564 shares issued and 4,218,330 shares outstanding at December 31, 2014	4,625	4,607
Capital stock without par value, 5,000,000 shares authorized with no		

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shares issued and outstanding	-	-
Additional paid-in capital	37,926	37,504
Retained earnings	75,288	71,452
Accumulated other comprehensive loss	(3,800)	(3,100)
Treasury stock, 383,716 shares at June 30, 2015 and 388,234 shares at December 31, 2014, at cost	(6,861)	(6,942)
Total shareholders' equity	107,178	103,521
Total liabilities and shareholders' equity	\$ 1,028,539	\$ 1,001,448

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

## Consolidated Statements of Income

(Dollars in thousands, except per share data) (unaudited)	For the Three Months Ended		For the Six Months Ended	
	June 30 2015	2014	June 30 2015	2014
Interest income				
Loans, including fees	\$ 7,477	\$ 7,648	\$ 14,853	\$ 15,159
Interest and dividends on investments:				
Taxable interest	613	661	1,248	1,302
Tax exempt interest	408	376	817	734
Dividend income	8	31	60	56
Deposits and obligations of other banks	72	45	127	84
Total interest income	8,578	8,761	17,105	17,335
Interest expense				
Deposits	619	694	1,260	1,396
Securities sold under agreements to repurchase	-	2	-	9
Long-term debt	-	121	-	242
Total interest expense	619	817	1,260	1,647
Net interest income	7,959	7,944	15,845	15,688
Provision for loan losses	310	266	635	464
Net interest income after provision for loan losses	7,649	7,678	15,210	15,224
Noninterest income				
Investment and trust services fees	1,388	1,101	2,651	2,192
Loan service charges	297	250	471	418
Mortgage banking activities	17	19	25	32
Deposit service charges and fees	586	525	1,077	990
Other service charges and fees	311	317	607	584
Debit card income	356	337	675	643
Increase in cash surrender value of life insurance	140	144	279	286
Other real estate owned (losses) gains, net	-	(62)	32	(185)
Other	13	10	237	62
OTTI losses recognized in earnings	-	-	(20)	-
Gain on conversion	-	-	728	-
Securities gains, net	8	221	8	221
Total noninterest income	3,116	2,862	6,770	5,243
Noninterest expense				
Salaries and employee benefits	4,203	4,107	8,286	8,357
Net occupancy expense	556	586	1,172	1,262
Furniture and equipment expense	239	237	470	491
Advertising	283	270	471	586
Legal and professional fees	203	353	499	618
Data processing	556	493	1,023	884
Pennsylvania bank shares tax	206	173	402	347
Intangible amortization	90	104	181	207

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FDIC insurance	160	222	308	454
ATM/debit card processing	186	178	373	357
Other	977	892	1,965	1,741
Total noninterest expense	7,659	7,615	15,150	15,304
Income before federal income taxes	3,106	2,925	6,830	5,163
Federal income tax expense	632	606	1,472	1,018
Net income	\$ 2,474	\$ 2,319	\$ 5,358	\$ 4,145

Per share

Basic earnings per share	\$ 0.58	\$ 0.55	\$ 1.27	\$ 0.99
Diluted earnings per share	\$ 0.58	\$ 0.55	\$ 1.26	\$ 0.99
Cash dividends declared	\$ 0.19	\$ 0.17	\$ 0.36	\$ 0.34

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

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## Consolidated Statements of Comprehensive Income

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(Dollars in thousands) (unaudited)	2015	2014	2015	2014
Net Income	\$ 2,474	\$ 2,319	\$ 5,358	\$ 4,145
Securities:				
Unrealized (losses) gains arising during the period	(1,239)	774	(536)	2,194
Reclassification adjustment for gains included in net income (1)	(8)	(221)	(716)	(221)
Net unrealized (losses) gains	(1,247)	553	(1,252)	1,973
Tax effect	424	(188)	426	(671)
Net of tax amount	(823)	365	(826)	1,302
Derivatives:				
Unrealized gains (losses) arising during the period	32	(4)	31	(12)
Reclassification adjustment for losses included in net income (2)	64	94	160	189
Net unrealized gains	96	90	191	177
Tax effect	(32)	(30)	(65)	(60)
Net of tax amount	64	60	126	117
Total other comprehensive (loss) income	(759)	425	(700)	1,419
Total Comprehensive Income	\$ 1,715	\$ 2,744	\$ 4,658	\$ 5,564
Reclassification adjustment / Statement line item	Tax expense (benefit)		Tax expense (benefit)	
(1) Securities / gain on conversion & securities (gains) losses, net	\$ 3	\$ 75	\$ 243	\$ 75
(2) Derivatives / interest expense on deposits	(22)	(32)	(54)	(64)

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



## Consolidated Statements of Changes in Shareholders' Equity

For the Six months June 30, 2015 and 2014:

	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, 2013	\$ 4,561	\$ 36,636	\$ 65,897	\$ (4,696)	\$ (7,010)	\$ 95,388
Net income	-	-	4,145	-	-	4,145
Other comprehensive income	-	-	-	1,419	-	1,419
Cash dividends declared, \$.34 per share	-	-	(1,419)	-	-	(1,419)
Treasury shares issued under stock option plans, 3,476 shares	-	(10)	-	-	62	52
Common stock issued under dividend reinvestment plan, 20,642 shares	20	354	-	-	-	374
Balance at June 30, 2014	\$ 4,581	\$ 36,980	\$ 68,623	\$ (3,277)	\$ (6,948)	\$ 99,959
Balance at December 31, 2014	\$ 4,607	\$ 37,504	\$ 71,452	\$ (3,100)	\$ (6,942)	\$ 103,521
Net income	-	-	5,358	-	-	5,358
Other comprehensive loss	-	-	-	(700)	-	(700)
Cash dividends declared, \$.36 per share	-	-	(1,522)	-	-	(1,522)
Treasury shares issued under stock option plans, 4,518 shares	-	5	-	-	81	86
Common stock issued under dividend reinvestment plan, 18,507 shares	18	417	-	-	-	435
Balance at June 30, 2015	\$ 4,625	\$ 37,926	\$ 75,288	\$ (3,800)	\$ (6,861)	\$ 107,178

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



## Consolidated Statements of Cash Flows

	Six Months Ended June 30	
	2015	2014
(Dollars in thousands)		
(unaudited)		
Cash flows from operating activities		
Net income	\$ 5,358	\$ 4,145
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	675	732
Net amortization of loans and investment securities	796	893
Amortization and net change in mortgage servicing rights valuation	9	8
Amortization of intangibles	181	207
Provision for loan losses	635	464
Net realized gains on sales of securities	(8)	(221)
Impairment writedown on securities recognized in earnings	20	-
Gain on conversion	(728)	-
Loans originated for sale	(3,812)	(3,554)
Proceeds from sale of loans	2,446	3,303
Writedown on premises and equipment	60	-
Writedown of other real estate owned	-	200
Net gain on sale or disposal of other real estate/other repossessed assets	(32)	(15)
Increase in cash surrender value of life insurance	(279)	(286)
	1,380	(118)

Decrease (increase) in other assets		
(Decrease) increase in other liabilities	(2,195)	613
Net cash provided by operating activities	4,506	6,371
Cash flows from investing activities		
Proceeds from sales and calls of investment securities available for sale	1,381	1,582
Proceeds from maturities and paydowns of securities available for sale	14,132	12,313
Purchase of investment securities available for sale	(21,689)	(28,362)
Net increase in restricted stock	(1)	(32)
Net increase in loans	(7,256)	(10,012)
Capital expenditures	(190)	(321)
Proceeds from sale of other real estate/other repossessed assets	129	493
Net cash used in investing activities	(13,494)	(24,339)
Cash flows from financing activities		
Net increase in demand deposits, NOW, and savings accounts	41,406	63,087
Net decrease in time deposits	(6,528)	(8,107)
Net decrease in repurchase agreements	(9,079)	(21,570)
Long-term debt payments	-	(403)
Dividends paid	(1,522)	(1,419)
Treasury stock issued under stock option plans	86	52
Common stock issued under dividend reinvestment plan	435	374
Net cash provided by financing activities	24,798	32,014
Increase in cash and cash equivalents	15,810	14,046

Cash and cash equivalents as of January 1	48,593		40,745
Cash and cash equivalents as of June 30	\$ 64,403	\$	54,791

Supplemental Disclosures  
of Cash Flow Information

Cash paid during the year  
for:

Interest on deposits and other borrowed funds	\$ 1,304	\$	1,670
Income taxes	\$ 1,513	\$	236

Noncash Activities

Loans transferred to Other Real Estate	\$ 449	\$	82
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The accompanying notes  
are an integral part of  
these 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 Properties Corp. holds real estate assets that are leased by the Bank. Franklin Future Fund Inc. is a non-bank investment company. The activities of non-bank entities are not significant to the consolidated totals. All significant intercompany transactions and account balances have been eliminated.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of June 30, 2015, 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 2014 Annual Report on Form 10-K. The consolidated results of operations for the period ended June 30, 2015 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, 2014 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 June 30		For the Six Months Ended June 30	
	2015	2014	2015	2014
(Dollars and shares in thousands, except per share data)				
Weighted average shares outstanding (basic)	4,234	4,184	4,228	4,178
Impact of common stock equivalents	11	7	8	6
Weighted average shares outstanding (diluted)	4,245	4,191	4,236	4,184
Anti-dilutive options excluded from calculation	13	34	28	37
Net income	\$ 2,474	\$ 2,319	\$ 5,358	\$ 4,145
Basic earnings per share	\$ 0.58	\$ 0.55	\$ 1.27	\$ 0.99
Diluted earnings per share	\$ 0.58	\$ 0.55	\$ 1.26	\$ 0.99

## Note 2. Recent Accounting Pronouncements

Customer's Accounting for Fees Paid in a Cloud Computing Arrangement . ASU 2015-05 "Customer's Accounting for Fees Paid in a Cloud Computing Arrangement, revises the scope of Subtopic 350-40 to include internal-use software accessed through a hosting arrangement (e.g., cloud computing, software as a service, etc.) only if both of the following criteria are met: (1) the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty (there is no significant penalty if the customer has the ability to take delivery of the software without incurring significant cost and the ability to use the software separately without significant loss of utility or value); and (2) it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. If both of the criteria are present in a hosting arrangement, then the arrangement contains a software license and the customer should account for that element in accordance with Subtopic 350-40 (i.e., expense fees as incurred). The ASU is effective for public business entities for fiscal years beginning after

December 15, 2015, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2015, and interim periods within fiscal year beginning after December 15, 2016. Early adoption is permitted. An entity can elect to adopt the amendments either (1) prospectively to all arrangements entered into or materially modified after the effective date, or (2) retrospectively. The Corporation does not believe ASU 350-40 will have a material effect on its financial statements.

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. ASU 2014-04 did not have a material effect on the Corporation’s 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:

	December
June 30	31



	2015	2014
(Dollars in thousands)		
Net unrealized gains on securities	\$ 1,100	\$ 2,352
Tax effect	(374)	(800)
Net of tax amount	726	1,552
Net unrealized losses on derivatives	-	(191)
Tax effect	-	65
Net of tax amount	-	(126)
Accumulated pension adjustment	(6,858)	(6,858)
Tax effect	2,332	2,332
Net of tax amount	(4,526)	(4,526)
Total accumulated other comprehensive loss	\$ (3,800)	\$ (3,100)

## 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 \$26.0 million and \$22.7 million of standby letters of credit as of June 30, 2015 and December 31, 2014, 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 June 30, 2015 and December 31, 2014 for guarantees under standby letters of credit issued was not material.

## Note 5. Investments

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2015 and December 31, 2014 are as follows:

(Dollars in thousands)	Amortized	Gross	Gross	Fair
	cost	unrealized	unrealized	value
June 30, 2015		gains	losses	
Equity securities	\$ 164	\$ 78	\$ -	\$ 242
U.S. Government agency securities	16,245	168	(29)	16,384
Municipal securities	71,277	1,459	(604)	72,132
Trust preferred securities	5,949	-	(621)	5,328
Agency mortgage-backed securities	80,145	917	(323)	80,739
Private-label mortgage-backed securities	1,502	58	-	1,560
Asset-backed securities	42	-	(3)	39
	\$ 175,324	\$ 2,680	\$ (1,580)	\$ 176,424

(Dollars in thousands)	Amortized	Gross	Gross	Fair
	cost	unrealized	unrealized	value
December 31, 2014		gains	losses	
Equity securities	\$ 274	\$ 779	\$ -	\$ 1,053

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U.S. Government and Agency securities	15,854	173	(64)	15,963
Municipal securities	66,832	1,826	(292)	68,366
Trust preferred securities	5,940	-	(803)	5,137
Agency mortgage-backed securities	78,779	932	(217)	79,494
Private-label mortgage-backed securities	1,675	35	(15)	1,695
Asset-backed securities	45	-	(2)	43
	\$ 169,399	\$ 3,745	\$ (1,393)	\$ 171,751

At June 30, 2015 and December 31, 2014, the fair value of investment securities pledged to secure public funds, trust balances, repurchase agreements, deposit and other obligations totaled \$69.3 million and \$91.6 million, respectively.

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The amortized cost and estimated fair value of debt securities at June 30, 2015, 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	\$ 4,570	\$ 4,609
Due after one year through five years	10,483	10,680
Due after five years through ten years	32,927	33,512
Due after ten years	45,533	45,082
	93,513	93,883
Mortgage-backed securities	81,647	82,299
	\$ 175,160	\$ 176,182

The following table provides additional detail about trust preferred securities as of June 30, 2015:

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	\$ 964	\$ 906	\$ (58)	BB
Wachovia Cap Trust II	1/15/2027	Single	Preferred Stock	277	261	(16)	BBB
Huntington Cap Trust	2/1/2027	Single	Preferred Stock	941	816	(125)	BB
Corestates Captl Tr II	2/15/2027	Single	Preferred Stock	937	871	(66)	BBB+
Huntington Cap Trust II	6/15/2028	Single	Preferred Stock	892	790	(102)	BB
Chase Cap VI JPM	8/1/2028	Single	Preferred Stock	963	850	(113)	BBB-
Fleet Cap Tr V	12/18/2028	Single	Preferred Stock	975	834	(141)	BB
				\$ 5,949	\$ 5,328	\$ (621)	

The following table provides additional detail about private label mortgage-backed securities as of June 30, 2015:

Private Label Mortgage Backed Securities

(Dollars in thousands)	Origination	Amortized	Fair	Gross	Collateral	Lowest Credit	Credit	Cumulative
Description	Date	Cost	Value	Unrealized Gain (Loss)	Type	Rating Assigned	Support %	OTTI Charges
RALI 2004-QS4 A7	3/1/2004	\$ 43	\$ 43	\$ -	ALT A	BBB+	11.84	\$ -
MALT 2004-6 7A1	6/1/2004	385	393	8	ALT A	CCC	14.11	-
RALI 2005-QS2 A1	2/1/2005	236	251	15	ALT A	CC	5.20	10
RALI 2006-QS4 A2	4/1/2006	502	523	21	ALT A	D	-	313
GSR 2006-5F 2A1	5/1/2006	72	80	8	Prime	D	-	15
RALI 2006-QS8 A1	7/28/2006	264	270	6	ALT A	D	-	217
		\$ 1,502	\$ 1,560	\$ 58				\$ 555

Impairment:

The investment portfolio contained 91 securities with \$59.9 million of temporarily impaired fair value and \$1.6 million in unrealized losses at June 30, 2015. The total unrealized loss position has increased slightly from \$1.4 million at year-end 2014.

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 June 30, 2015, 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 June 30, 2015 and December 31, 2014:

(Dollars in thousands)	June 30, 2015								
	Less than 12 months			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	\$ 1,498	\$ (7)	3	\$ 4,617	\$ (22)	10	\$ 6,115	\$ (29)	13
Municipal securities	20,359	(386)	33	4,775	(218)	7	25,134	(604)	40
Trust preferred securities	-	-	-	5,328	(621)	7	5,328	(621)	7
Agency mortgage-backed securities	18,002	(179)	22	5,346	(144)	8	23,348	(323)	30
Asset-backed securities	-	-	-	4	(3)	1	4	(3)	1
Total temporarily impaired securities	\$ 39,859	\$ (572)	58	\$ 20,070	\$ (1,008)	33	\$ 59,929	\$ (1,580)	91

(Dollars in thousands)	December 31, 2014								
	Less than 12 months			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	4	-	1	7,207	(64)	14	7,211	(64)	15
Municipal securities	5,651	(33)	9	9,441	(259)	14	15,092	(292)	23
	-	-	-	5,137	(803)	7	5,137	(803)	7

Trust preferred securities									
Agency mortgage-backed securities	9,304	(60)	13	8,199	(157)	10	17,503	(217)	23
Private-label mortgage-backed securities	-	-	-	540	(15)	1	540	(15)	1
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	\$ 14,959	\$ (93)	23	\$ 30,529	\$ (1,300)	47	\$ 45,488	\$ (1,393)	70

The municipal bond portfolio has an unrealized loss of \$604 thousand at June 30, 2015 compared to \$292 thousand at year-end 2014. This number of securities in this portfolio with an unrealized loss increased from 23 to 40 and the 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 7 securities with a fair value of \$5.3 million and an unrealized loss of \$621 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 June 30, 2015, 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 net unrealized gain \$58 thousand with all bonds showing an unrealized gain. 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 the end of the first

quarter; however, no additional impairment charge was required at June 30, 2015. It is primarily a result of the cumulative OTTI charges that these bonds are showing an unrealized gain at quarter end. The Bank has recorded \$555 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 June 30, 2015 and 2014.

(Dollars in thousands)	Six Months Ended	
	2015	2014
Balance of cumulative credit-related OTTI at January 1	\$ 535	\$ 515
Additions for credit-related OTTI not previously recognized	20	-
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 June 30	\$ 555	\$ 515

The Bank held \$439 thousand of restricted stock at June 30, 2015. 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.



## 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)	June 30, 2015	December 31, 2014	Change	
			Amount	%
Residential Real Estate 1-4 Family				
Consumer first liens	\$ 103,852	\$ 105,014	\$ (1,162)	(1.1)
Consumer junior liens and lines of credit	39,915	38,132	1,783	4.7
Total consumer	143,767	143,146	621	0.4
Commercial first lien	60,438	56,300	4,138	7.3
Commercial junior liens and lines of credit	5,637	5,663	(26)	(0.5)
Total commercial	66,075	61,963	4,112	6.6
Total residential real estate 1-4 family	209,842	205,109	4,733	2.3
Residential real estate - construction				
Consumer	1,736	1,627	109	6.7
Commercial	6,676	8,088	(1,412)	(17.5)
Total residential real estate construction	8,412	9,715	(1,303)	(13.4)
Commercial real estate	317,329	326,482	(9,153)	(2.8)
Commercial	192,224	179,071	13,153	7.3
Total commercial	509,553	505,553	4,000	0.8
Consumer	5,405	6,154	(749)	(12.2)
	733,212	726,531	6,681	0.9
Less: Allowance for loan losses	(9,450)	(9,111)	(339)	(3.7)
Net Loans	\$ 723,762	\$ 717,420	\$ 6,342	0.9
Included in the loan balances are the following:				
Net unamortized deferred loan costs	\$ 169	\$ (76)		

Loans pledged as collateral for borrowings and commitments from:

FHLB	\$ 612,011	\$ 602,633
Federal Reserve Bank	54,844	56,367
	\$ 666,855	\$ 659,000

## 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 March 31, 2015	\$ 1,260	\$ 334	\$ 263	\$ 5,600	\$ 1,628	\$ 125	\$ 9,210
Charge-offs	(43)	-	(21)	-	(17)	(26)	(107)
Recoveries	1	-	-	14	8	14	37
Provision	75	25	(22)	72	152	8	310
Allowance at June 30, 2015	\$ 1,293	\$ 359	\$ 220	\$ 5,686	\$ 1,771	\$ 121	\$ 9,450
Allowance at December 31, 2014	\$ 1,225	\$ 334	\$ 226	\$ 5,417	\$ 1,773	\$ 136	\$ 9,111
Charge-offs	(43)	-	(21)	-	(218)	(78)	(360)
Recoveries	3	-	-	14	14	33	64
Provision	108	25	15	255	202	30	635
Allowance at June 30, 2015	\$ 1,293	\$ 359	\$ 220	\$ 5,686	\$ 1,771	\$ 121	\$ 9,450
Allowance at March 31, 2014	\$ 1,133	\$ 276	\$ 374	\$ 5,509	\$ 2,309	\$ 144	\$ 9,745
Charge-offs	(241)	-	-	(234)	(11)	(37)	(523)
Recoveries	-	-	-	-	13	18	31
Provision	187	(10)	(113)	137	55	10	266
Allowance at June 30, 2014	\$ 1,079	\$ 266	\$ 261	\$ 5,412	\$ 2,366	\$ 135	\$ 9,519
Allowance at December 31, 2013	\$ 1,108	\$ 278	\$ 291	\$ 5,571	\$ 2,306	\$ 148	\$ 9,702
Charge-offs	(257)	-	(27)	(348)	(12)	(80)	(724)
Recoveries	3	-	-	-	33	41	77
Provision	225	(12)	(3)	189	39	26	464
Allowance at June 30, 2014	\$ 1,079	\$ 266	\$ 261	\$ 5,412	\$ 2,366	\$ 135	\$ 9,519

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 June 30, 2015 and December 31, 2014:

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial		Consumer	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial		
June 30, 2015							
Loans evaluated for allowance:							
Individually	\$ 1,083	\$ 51	\$ 513	\$ 21,512	\$ 237	\$ -	\$ 23,396
Collectively	163,207	45,501	7,899	295,817	191,987	5,405	709,816
Total	\$ 164,290	\$ 45,552	\$ 8,412	\$ 317,329	\$ 192,224	\$ 5,405	\$ 733,212
Allowance established for loans evaluated:							
Individually	\$ -	\$ -	\$ -	\$ 2	\$ 8	\$ -	\$ 10
Collectively	1,293	359	220	5,684	1,763	121	9,440
Allowance at June 30, 2015	\$ 1,293	\$ 359	\$ 220	\$ 5,686	\$ 1,771	\$ 121	\$ 9,450
December 31, 2014							
Loans evaluated for allowance:							
Individually	\$ 1,171	\$ 51	\$ 931	\$ 22,307	\$ 1,298	\$ -	\$ 25,758
Collectively	160,143	43,744	8,784	304,175	177,773	6,154	700,773
Total	\$ 161,314	\$ 43,795	\$ 9,715	\$ 326,482	\$ 179,071	\$ 6,154	\$ 726,531
Allowance established for loans evaluated:							
Individually	\$ -	\$ -	\$ -	\$ 60	\$ 171	\$ -	\$ 231
Collectively	1,225	334	226	5,357	1,602	136	8,880
Allowance at December 31, 2014	\$ 1,225	\$ 334	\$ 226	\$ 5,417	\$ 1,773	\$ 136	\$ 9,111

The following table shows additional information about those loans considered to be impaired at June 30, 2015 and December 31, 2014:

(Dollars in thousands)	Impaired Loans				
	With No Allowance		With Allowance		Related
	Unpaid		Unpaid		
Recorded Investment	Principal Balance	Recorded Investment	Principal Balance		
June 30, 2015					
Residential Real Estate 1-4 Family					
First liens	\$ 1,601	\$ 1,778	\$ -	\$ -	\$ -
Junior liens and lines of credit	117	144	-	-	-
Total	1,718	1,922	-	-	-
Residential real estate - construction	513	551	-	-	-
Commercial real estate	21,317	25,297	195	278	2
Commercial	337	397	9	10	8
Total	\$ 23,885	\$ 28,167	\$ 204	\$ 288	\$ 10

December 31, 2014					
Residential Real Estate 1-4 Family					
First liens	\$ 1,804	\$ 2,002	\$ -	\$ -	\$ -
Junior liens and lines of credit	169	195	-	-	-
Total	1,973	2,197	-	-	-
Residential real estate - construction	931	977	-	-	-
Commercial real estate	21,487	25,744	862	1,001	60
Commercial	78	80	1,274	1,990	171
Total	\$ 24,469	\$ 28,998	\$ 2,136	\$ 2,991	\$ 231

The following table shows the average of impaired loans and related interest income for the three and six months ended June 30, 2015 and 2014:

(Dollars in thousands)	Three Months Ended June 30, 2015		Six Months Ended June 30, 2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	\$ 1,618	\$ 9	\$ 1,723	\$ 16
Junior liens and lines of credit	117	-	131	-
Total	1,735	9	1,854	16
Residential real estate - construction	516	-	723	-
Commercial real estate	21,756	174	21,971	327
Commercial	361	-	1,012	-
Total	\$ 24,368	\$ 183	\$ 25,560	\$ 343

(Dollars in thousands)	Three Months Ended June 30, 2014		Six Months Ended June 30, 2014	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	\$ 2,289	\$ 15	\$ 2,753	\$ 25
Junior liens and lines of credit	120	-	123	-
Total	2,409	15	2,876	25
Residential real estate - construction	527	-	530	-
Commercial real estate	22,399	81	24,032	174
Commercial	2,056	-	2,074	1
Total	\$ 27,391	\$ 96	\$ 29,512	\$ 200

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

(Dollars in thousands)	Loans Past Due and Still Accruing						Total Loans
	Current	30-59 Days	60-89 Days	90 Days+	Total	Non-Accrual	
June 30, 2015							
Residential Real Estate 1-4 Family							
First liens	\$ 162,515	\$ 58	\$ 625	\$ 153	\$ 836	\$ 939	\$ 164,290
Junior liens and lines of credit	45,171	167	97	-	264	117	45,552
Total	207,686	225	722	153	1,100	1,056	209,842
Residential real estate - construction							
Commercial real estate	7,106	793	-	-	793	513	8,412
Commercial	309,525	367	-	-	367	7,437	317,329
Consumer	191,849	29	-	-	29	346	192,224
Total	5,369	15	11	10	36	-	5,405
Total	\$ 721,535	\$ 1,429	\$ 733	\$ 163	\$ 2,325	\$ 9,352	\$ 733,212

December 31, 2014

Residential Real Estate 1-4 Family							
First liens	\$ 158,197	\$ 1,531	\$ 297	\$ 165	\$ 1,993	\$ 1,124	\$ 161,314
Junior liens and lines of credit	43,424	174	28	-	202	169	43,795
Total	201,621	1,705	325	165	2,195	1,293	205,109
Residential real estate - construction							
Commercial real estate	8,784	-	-	-	-	931	9,715
Commercial	317,576	336	-	140	476	8,430	326,482
Consumer	177,407	12	15	-	27	1,637	179,071
Total	6,056	59	22	17	98	-	6,154
Total	\$ 711,444	\$ 2,112	\$ 362	\$ 322	\$ 2,796	\$ 12,291	\$ 726,531

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
June 30, 2015					
Residential Real Estate 1-4 Family					
First liens	\$ 158,575	\$ 2,240	\$ 3,475	\$ -	\$ 164,290
Junior liens and lines of credit	45,273	29	250	-	45,552
Total	203,848	2,269	3,725	-	209,842
Residential real estate - construction	7,899	-	513	-	8,412
Commercial real estate	294,338	10,732	12,259	-	317,329
Commercial	183,559	7,256	1,409	-	192,224
Consumer	5,395	-	10	-	5,405
Total	\$ 695,039	\$ 20,257	\$ 17,916	\$ -	\$ 733,212

December 31, 2014					
Residential Real Estate 1-4 Family					
First liens	\$ 155,676	\$ 1,919	\$ 3,719	\$ -	\$ 161,314
Junior liens and lines of credit	43,559	29	207	-	43,795
Total	199,235	1,948	3,926	-	205,109
Residential real estate - construction	8,784	-	931	-	9,715
Commercial real estate	301,149	10,578	14,755	-	326,482
Commercial	170,774	5,413	2,884	-	179,071
Consumer	6,137	-	17	-	6,154
Total	\$ 686,079	\$ 17,939	\$ 22,513	\$ -	\$ 726,531



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
June 30, 2015						
Residential real estate - construction	1	\$ 513	\$ 513	\$ -	-	\$ -
Residential real estate	4	661	661	-	-	-
Commercial real estate	12	15,493	1,493	-	-	-
Total	17	\$ 16,667	\$ 2,667	\$ 0	-	\$ -
December 31, 2014						
Residential real estate - construction	1	\$ 521	\$ -	\$ 521	-	\$ -
Residential real estate	5	699	673	26	-	-
Commercial real estate	12	15,748	14,283	1,465	-	-
Total	18	\$ 16,968	\$ 14,956	\$ 2,012	-	\$ -

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

There were no new TDR loans made in the first six months of 2015 or 2014.

#### Note 8. Pension

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

(Dollars in thousands)	Three Months Ended June 30		Six Months Ended June 30	
	2015	2014	2015	2014
Components of net periodic cost:				
Service cost	\$ 92	\$ 83	\$ 192	\$ 169
Interest cost	172	194	350	391
Expected return on plan assets	(296)	(291)	(592)	(581)
Recognized net actuarial loss	123	81	254	163

Net period cost	\$ 91	\$ 67	\$ 204	\$ 142
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The Bank expects its pension expense to increase to approximately \$387 thousand in 2015 compared to \$276 thousand in 2014.

In October, 2014, the Society of Actuaries released new mortality tables for pension plans. The new tables are expected to raise the assumed life of plan participants due to refinements in age and gender distribution of participants. This change is expected to result in higher pension contribution requirements, lower balance sheet funded status, pricier lump-sum payouts, and higher PBGC variable rate premiums. The Bank has not adopted the new mortality tables. If the tables had been adopted at year-end 2014, it is estimated that the new tables would reduce the funded status by \$1.6 million and increase the 2015 pension expense by \$272 thousand over the current 2015 estimate. The Bank is still in the process of reviewing the effect of the new tables and is also watching the IRS for its decision on adoption of the new table. Therefore an adoption date for the new tables has not been determined.

#### 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 period-

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 June 30, 2015 and December 31, 2014.

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)	June 30, 2015		Level 1	Level 2	Level 3
	Carrying Amount	Fair Value			
Financial assets:					
Cash and cash equivalents	\$ 64,403	\$ 64,403	\$ 64,403	\$ -	\$ -
Investment securities available for sale	176,424	176,424	242	176,182	-
Restricted stock	439	439	-	439	-
Loans held for sale	1,755	1,755	-	1,755	-
Net loans	723,762	730,507	-	-	730,507
Accrued interest receivable	3,068	3,068	-	3,068	-
Mortgage servicing rights	133	133	-	-	133
Financial liabilities:					
Deposits	\$ 916,059	\$ 916,110	\$ -	\$ 916,110	\$ -
Accrued interest payable	125	125	-	125	-
(Dollars in thousands)	December 31, 2014		Level 1	Level 2	Level 3
	Carrying Amount	Fair Value			
Financial assets:					
Cash and cash equivalents	\$ 48,593	\$ 48,593	\$ 48,593	\$ -	\$ -
Investment securities available for sale	171,751	171,751	1,053	170,698	-
Restricted stock	438	438	-	438	-
Loans held for sale	389	389	-	389	-
Net loans	717,420	721,680	-	-	721,680
Accrued interest receivable	3,038	3,038	-	3,038	-
Mortgage servicing rights	143	143	-	-	143

Financial liabilities:

Deposits	\$ 881,181	\$ 881,289	\$ -	\$ 881,289	\$ -
Securities sold under agreements to repurchase	9,079	9,079	-	9,079	-
Accrued interest payable	169	169	-	169	-
Interest rate swaps	191	191	-	191	-

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## 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 June 30, 2015 and December 31, 2014 are as follows:

(Dollars in Thousands)	Fair Value at June 30, 2015			
	Level 1	Level 2	Level 3	Total
Asset Description				
Equity securities	\$ 242	\$ -	\$ -	\$ 242
U.S. Government and Agency securities	-	16,384	-	16,384
Municipal securities	-	72,132	-	72,132
Trust Preferred Securities	-	5,328	-	5,328
Agency mortgage-backed securities	-	80,739	-	80,739
Private-label mortgage-backed securities	-	1,560	-	1,560
Asset-backed securities	-	39	-	39
Total assets	\$ 242	\$ 176,182	\$ -	\$ 176,424

(Dollars in Thousands)	Fair Value at December 31, 2014			
	Level 1	Level 2	Level 3	Total
Asset Description				
Equity securities	\$ 1,053	\$ -	\$ -	\$ 1,053
U.S. Government and Agency securities	-	15,963	-	15,963
Municipal securities	-	68,366	-	68,366
Trust Preferred Securities	-	5,137	-	5,137
Agency mortgage-backed securities	-	79,494	-	79,494
Private-label mortgage-backed securities	-	1,695	-	1,695
Asset-backed securities	-	43	-	43
Total assets	\$ 1,053	\$ 170,698	\$ -	\$ 171,751

Liability Description				
Interest rate swaps	\$ -	\$ 191	\$ -	\$ 191
Total liabilities	\$ -	\$ 191	\$ -	\$ 191

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 June 30, 2015 and December 31, 2014 are as follows:

(Dollars in Thousands)

Asset Description	Fair Value at June 30, 2015			Total
	Level 1	Level 2	Level 3	
Impaired loans (1)	\$ -	\$ -	\$ 636	\$ 636
Premises held-for-sale (1)	-	-	358	358
Other real estate owned (1)	-	-	449	449
Mortgage servicing rights	-	-	133	133
Total assets	\$ -	\$ -	\$ 1,576	\$ 1,576

Asset Description	Fair Value at December 31, 2014			Total
	Level 1	Level 2	Level 3	
Impaired loans (1)	\$ -	\$ -	\$ 3,469	\$ 3,469
Other real estate owned (1)	-	-	760	760
Mortgage servicing rights	-	-	143	143
Total assets	\$ -	\$ -	\$ 4,372	\$ 4,372

(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 June 30, 2015. 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 June 30, 2015.

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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 June 30, 2015				
(Dollars in Thousands)				
Asset Description	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans (1)	\$ 636	Appraisal	Appraisal Adjustments (2)	0% - 10% (4.39%)
			Cost to sell	0% - 8% (4.49%)
Premises held-for-sale (1)	358	Appraisal	Appraisal Adjustments (2)	
Other real estate owned (1)	449	Appraisal	Appraisal Adjustments (2)	
			Cost to sell	8% (8%)
Mortgage servicing rights	133	Discounted Cash Flow (3)		
at December 31, 2014				
Impaired loans (1)	\$ 3,469	Appraisal	Appraisal Adjustments (2)	0% - 100% (26%)
			Cost to sell	0% - 10% (5%)
Other real estate owned (1)	760	Appraisal	Appraisal Adjustments (2)	
			Cost to sell	8% (8%)
Mortgage servicing rights	143	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.

Fair Value of Derivative Instruments in the Consolidated Balance Sheets were as follows as of June 30, 2015 and December 31, 2014:

Fair Value of Derivative Instruments (Dollars in thousands)		Balance Sheet	Fair Value
Date	Type	Location	
June 30, 2015	Interest rate contracts	Other liabilities	\$ -
December 31, 2014	Interest rate contracts	Other liabilities	\$ 191

The Effect of Derivative Instruments on the Statement of Income for the Three and Six Months Ended June 30, 2015 and 2014 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships

(Dollars in thousands)				Location of Gain or (Loss) Recognized in	Amount of Gain or (Loss) Recognized in	Location of Gain or (Loss) Recognized in	Amount of Gain or (Loss) Recognized in
Date / Type	Amount of Gain or (Loss) Recognized in OCI net of tax on Derivative (Effective Portion)	Location of Gain or (Loss) Recognized in OCI net of tax on Derivative (Effective Portion)	Amount of Gain or (Loss) Recognized in OCI net of tax on Derivative (Effective Portion)	Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain or (Loss) Recognized in OCI net of tax on Derivative (Effective Portion)	Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain or (Loss) Recognized in Derivatives (Ineffective Portion and Amount Excluded from Effectiveness Testing)
Interest rate contracts							
Three months ended:							
June 30, 2015	\$ 64	Interest Expense	\$ (64)	Interest Expense	\$ (64)	Other income (expense)	\$ -
June 30, 2014	\$ 60	Interest Expense	\$ (94)	Interest Expense	\$ (94)	Other income (expense)	\$ -
Six months ended:							
June 30, 2015	\$ 126	Interest Expense	\$ (160)	Interest Expense	\$ (160)	Other income (expense)	\$ -
June 30, 2014	\$ 117	Interest Expense	\$ (189)	Interest Expense	\$ (189)	Other income (expense)	\$ -

Interest Rate Swap Agreements (“Swap Agreements”)

As of June 30, 2015, the Bank had no swap agreements outstanding. The Bank had entered into interest rate swap agreements as part of its asset/liability management program. The swap agreements were free-standing derivatives and were recorded at fair value in the Corporation’s consolidated statements of condition. The Bank was party to master netting arrangements with its financial institution counterparties; however, the Bank did not offset assets and liabilities under these arrangements for financial statement presentation purposes. The master netting arrangements provided 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, was posted by the counterparty with net liability positions in accordance with contract thresholds.

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

As of June 30, 2015, the Bank had no repurchase agreements outstanding. The Bank entered into agreements under which it sold securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Bank may have transferred legal control over the assets but still retained effective control through an agreement that both entitled and obligated the Bank to repurchase the agreements. As a result, these repurchase agreements were 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 was reflected as a liability in the Corporation's consolidated statements of condition, while the securities underlying the repurchase agreements remained in the respective investment securities asset accounts. In other words, there was no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Bank did not enter into reverse repurchase agreements, there was no such offsetting to be done with repurchase agreements.

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The following table presents the liabilities subject to an enforceable master netting arrangement or repurchase agreements as of June 30, 2015 and December 31, 2014. 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						
June 30, 2015	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
December 31, 2014	191	-	191	191	-	-

Note 11. Capital Ratios

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. In July 2013, Federal Banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for U.S. Banks, generally referred to as "Basel III." Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those in place at the end of 2014. The capital ratios to be considered "well capitalized" under Basel III are: common equity tier 1 of 6.5%, Tier 1 leverage of 5%, Tier 1 risk-based capital of 8%, and Total Risk-Based capital of 10%. The common equity tier 1 ratio is a new capital ratio under Basel III. Common equity consists of common stock, additional paid-in capital and retained earnings. The Tier 1 risk-based capital ratio of 8% has been increased from 6%. The new rule also includes a provision for banks to make a one-time irrevocable choice to exclude accumulated other comprehensive income (AOCI) from its common equity Tier 1 capital. The Bank elected to exclude AOCI from the capital calculation with its March 31, 2015 regulatory filing. In addition, a capital conservation buffer will be required to be maintained above the minimum capital ratios to avoid any capital distribution restrictions. The capital conservation buffer will be phased in from 0% in 2015 to 2.5% in 2019. The Basel III capital rules took effect for the Corporation and the Bank on January 1, 2015. At June 30, 2015, the Corporation and the Bank were both well capitalized as defined by the

banking regulatory agencies.

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The following table summarizes regulatory capital information as of June 30, 2015 and December 31, 2014 on a consolidated basis and for the Bank, as defined. Regulatory capital ratios for June 30, 2015 were calculated in accordance with the Basel III rules, whereas the December 31, 2015 regulatory ratios were calculated in accordance with Basel I rules. The minimum regulatory ratios shown below define capital levels under Basel III rules.

(Dollars in thousands)	June 30, 2015	December 31, 2014	Regulatory Ratios	
			Adequately Capitalized Minimum	Well Capitalized Minimum
<b>Common Equity Tier 1 Risk-based Capital Ratio (1)</b>				
Franklin Financial Services Corporation	14.48%	N/A	4.50%	N/A
Farmers & Merchants Trust Company	14.39%	N/A	4.50%	6.50%
<b>Tier 1 Risk-based Capital Ratio (2)</b>				
Franklin Financial Services Corporation	14.48%	14.19%	6.00%	N/A
Farmers & Merchants Trust Company	14.39%	13.96%	6.00%	8.00%
<b>Total Risk-based Capital Ratio (3)</b>				
Franklin Financial Services Corporation	15.73%	15.49%	8.00%	N/A
Farmers & Merchants Trust Company	15.64%	15.26%	8.00%	10.00%
<b>Tier 1 Leverage Ratio (4)</b>				
Franklin Financial Services Corporation	10.17%	9.69%	4.00%	N/A
Farmers & Merchants Trust Company	9.96%	9.55%	4.00%	5.00%

(1) Common equity Tier 1 capital/ total risk-weighted assets (2) Tier 1 capital / total risk-weighted assets  
(3) Total risk-based capital / total risk-weighted assets, (4) Tier 1 capital / average quarterly assets

1Note 12. 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.



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

For the Three and Six Months Ended June 30, 2015 and 2014

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 2014 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 2014 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Results of Operations

Year-to-Date Summary

At June 30, 2015, total assets were \$1.029 billion, an increase of \$27.1 million from December 31, 2014. Net loans increased to \$723.8 million and total deposits increased to \$916.1 million. The Corporation reported net income for the first six months of 2015 of \$5.4 million. This is a 29.3% increase versus net income of \$4.1 million for the same period in 2014. Net income for 2015 was enhanced by two nonrecurring events that increased noninterest income by \$899 thousand. These events included a gain of \$171 thousand from the liquidation of an off-shore insurance company in which the Bank held an ownership interest and a \$728 thousand gain on the conversion of equity securities held by the Bank as the result of an acquisition. Without these events, net income for the first six months would have been \$4.8 million, a 15% increase over the prior year. Total revenue (interest income and noninterest income) increased \$1.3 million year-over-year boosted by these nonrecurring items. Interest income decreased \$230 thousand, while interest expense decreased by \$387 thousand, resulting in a \$157 thousand increase in net interest

income. The provision for loan losses was \$635 thousand for the period, \$171 thousand more than in 2014. Noninterest income increased \$1.5 million, while noninterest expense decreased \$154 thousand. Income tax expense increased from \$1.0 million in 2014 to \$1.5 million in 2015. The effective tax rate increased from 19.7% in 2014 to 21.6% in 2015 due to a lower ratio of tax exempt income to income before federal income taxes. Diluted earnings per share increased to \$1.26 in 2015 from \$0.99 in 2014.

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Key performance ratios as of, or for the six months ended June 30, 2015 and 2014 and twelve months ended December 31, 2014 are listed below:

	June 30, 2015	December 31, 2014	June 30, 2014
<b>Performance measurements</b>			
Return on average assets*	1.07%	0.83%	0.82%
Return on average equity*	10.28%	8.44%	8.60%
Return on average tangible assets (1)*	1.09%	0.87%	0.85%
Return on average tangible equity (1)*	11.40%	9.72%	9.77%
Efficiency ratio (1)	66.11%	70.83%	70.63%
Net interest margin*	3.60%	3.56%	3.56%
Current dividend yield*	3.10%	3.09%	3.42%
Dividend payout ratio	28.41%	33.88%	34.23%
<b>Shareholders' Value (per common share)</b>			
Diluted earnings per share	\$ 1.26	\$ 2.00	\$ 0.99
Basic earnings per share	1.27	2.01	0.99
Regular cash dividends paid	0.36	0.68	0.34
Book value	25.27	24.54	23.85
Tangible book value (1)	23.14	22.36	21.57
Market value	24.55	22.00	19.90
Market value/book value ratio	97.15%	89.65%	83.44%
Price/earnings multiple*	9.74	11.00	10.05
<b>Safety and Soundness</b>			
Risk-based capital ratio (Total)	15.73%	15.49%	14.53%
Leverage ratio (Tier 1)	10.17%	9.69%	9.26%
Common equity ratio (Tier 1)	14.48%	-	-
Tangible common equity ratio (1)	9.63%	9.51%	8.93%
Nonperforming loans/gross loans	1.30%	1.74%	2.87%
Nonperforming assets/total assets	1.32%	1.63%	2.46%
Allowance for loan losses as a % of loans	1.29%	1.25%	1.30%
Net charge-offs/average loans*	0.08%	0.19%	0.18%
Trust assets under management (fair value)	\$ 598,085	\$ 605,796	\$ 582,647

\* Annualized

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



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
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 June 30, 2015 to the three months ended June 30, 2014:

#### 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 second quarter of 2015 increased \$32 thousand quarter over quarter. Average interest-earning assets increased \$5.8 million from 2014, but the yield on these assets decreased to 3.80% from 3.90% in 2014. The average balance of investment securities increased \$5.4 million while average loans decreased \$2.8 million quarter over quarter. Average commercial loans decreased \$3.9 million and average mortgage loans decreased \$2.5 million. These decreases were partially offset with an increase in the average balance of consumer loans, including home equity loans, which increased by \$3.6 million.

Interest expense was \$619 thousand for the second quarter, a decrease of \$198 thousand from the 2014 total of \$817 thousand. Average interest-bearing liabilities decreased \$18.7 million to \$770.1 million for 2015 from an average balance of \$788.8 million in 2014. The average cost of these liabilities decreased from 0.42% in 2014 to 0.32% in

2015. Average interest-bearing deposits increased \$404 thousand and the cost of these deposits decreased from 0.36% to 0.32%. The securities sold under agreements to repurchase (Repo) accounts were closed out in 2014 and transferred to other products. All long-term debt was paid off in 2014.

The changes in the balance sheet and interest rates resulted in an increase in tax equivalent net interest income of \$32 thousand to \$8.5 million in 2015 compared to \$8.4 million in 2014. The increase in net interest income was due to a \$100 thousand increase from higher volume offset by a \$68 thousand decrease due to changes in rates.



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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 June 30,					
	2015			2014		
	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	\$ 52,114	\$ 72	0.55%	\$ 48,903	\$ 45	0.37%
<b>Investment securities:</b>						
Taxable	121,383	621	2.05%	125,219	692	2.22%
Tax Exempt	55,611	613	4.41%	46,397	563	4.86%
Investments	176,994	1,234	2.80%	171,616	1,255	2.93%
<b>Loans:</b>						
Commercial, industrial and agricultural	578,985	6,134	4.22%	582,877	6,184	4.20%
Residential mortgage	80,474	829	4.14%	82,954	854	4.13%
Home equity loans and lines	63,650	745	4.69%	58,750	772	5.27%
Consumer	6,490	79	4.88%	7,786	149	7.68%
Loans	729,599	7,787	4.25%	732,367	7,959	4.31%
Total interest-earning assets	958,707	9,093	3.80%	952,886	9,259	3.90%
Other assets	66,770			71,627		
Total assets	\$ 1,025,477			\$ 1,024,513		
<b>Interest-bearing liabilities:</b>						
<b>Deposits:</b>						
Interest-bearing checking	\$ 227,943	67	0.12%	\$ 206,850	60	0.12%
Money Management	382,738	387	0.41%	391,283	424	0.43%
Savings	65,738	12	0.07%	63,704	12	0.08%
Time	93,687	153	0.66%	107,865	198	0.74%
Total interest-bearing deposits	770,106	619	0.32%	769,702	694	0.36%
<b>Securities sold under agreements to repurchase</b>						
	-	-	-	6,855	2	0.15%
Other borrowings	-	-	-	12,286	121	3.93%
Total interest-bearing liabilities	770,106	619	0.32%	788,843	817	0.42%
Noninterest-bearing deposits	142,621			129,464		
Other liabilities	6,751			7,871		
Shareholders' equity	105,999			98,335		
Total liabilities and shareholders' equity	\$ 1,025,477			\$ 1,024,513		
T/E net interest income/Net interest margin		8,474	3.55%		8,442	3.55%
Tax equivalent adjustment		(515)			(498)	

Net interest income	\$ 7,959	\$ 7,944
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## Provision for Loan Losses

For the second quarter of 2015, the Bank recorded net charge-offs of \$70 thousand compared to \$492 thousand in 2014. Provision expense for the second quarter was \$310 thousand and as a result, the allowance for loan losses (ALL) increased \$240 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 second quarter of 2015, noninterest income increased \$254 thousand from the same period in 2014. Investment and trust service fees increased due to higher recurring trust fees and an increase in estate fees. Loan service charges increased primarily due to a large commercial loan prepayment penalty. Deposit service charges increased due to higher fees from the Bank's overdraft program. The other real estate owned expense in 2014 was a writedown compared to none in 2015. The securities gains in both years were in the equity portfolio.

The following table presents a comparison of noninterest income for the three months ended June 30, 2015 and 2014.

(Dollars in thousands)	For the Three Months Ended		Change	
	June 30 2015	2014	Amount	%
Noninterest Income				
Investment and trust services fees	\$ 1,388	\$ 1,101	\$ 287	26.1
Loan service charges	297	250	47	18.8
Mortgage banking activities	17	19	(2)	(10.5)
Deposit service charges and fees	586	525	61	11.6
Other service charges and fees	311	317	(6)	(1.9)
Debit card income	356	337	19	5.6
Increase in cash surrender value of life insurance	140	144	(4)	(2.8)
Other real estate owned	-	(62)	62	N/A
Other	13	10	3	30.0
Securities gain (losses), net	8	221	(213)	(96.4)
Total noninterest income	\$ 3,116	\$ 2,862	\$ 254	8.9

## Noninterest Expense

Noninterest expense for the second quarter of 2015 increased \$44 thousand compared to the same period in 2014. The increase in salaries and benefits was primarily due to a \$47 thousand increase in salaries, primarily for merit increases, as well as a \$24 thousand increase in pension expense and a \$23 increase in health insurance expense. Net occupancy expenses decreased compared to prior year due to less utility and snow removal expense in 2015. Legal and professional fees decreased as 2014 had higher consulting expenses for the implementation of strategic initiatives. The increase in data processing was due to higher charges for mobile banking, remote deposit capture, and Franklin Businesslink due to growth in volume, as well as the migration to a new mortgage origination system. The shares tax

increase was due to the growth in the Bank's balance sheet and shareholders' equity. FDIC insurance expense decreased over prior year due to a reduction in the assessment rate used to calculate the premium. Other expenses increased due to several one-time expenses the Bank took related to branch assets taken out of service.

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The following table presents a comparison of noninterest expense for the three months ended June 30, 2015 and 2014:

(Dollars in thousands)	For the Three Months Ended		Change	
	June 30 2015	2014	Amount	%
Noninterest Expense	\$ 4,203	\$ 4,107	\$ 96	2.3
Salaries and benefits	556	586	(30)	(5.1)
Net occupancy expense	239	237	2	0.8
Furniture and equipment expense	283	270	13	4.8
Advertising	203	353	(150)	(42.5)
Legal and professional fees	556	493	63	12.8
Data processing	206	173	33	19.1
Pennsylvania bank shares tax	90	104	(14)	(13.5)
Intangible amortization	160	222	(62)	(27.9)
FDIC insurance	186	178	8	4.5
ATM/debit card processing	977	892	85	9.5
Other	\$ 7,659	\$ 7,615	\$ 44	0.6
Total noninterest expense				

#### Provision for Income Taxes

For the second quarter of 2015, the Corporation recorded a Federal income tax expense of \$632 thousand compared to \$606 thousand for the same quarter in 2014. The effective tax rate was 20.3% for the second quarter of 2015 compared to 20.7% for the same period in 2014. All taxable income for the Corporation is taxed at a rate of 34%.

Comparison of the six months ended June 30, 2015 to the six months ended June 30, 2014:

#### Net Interest Income

Tax equivalent net interest income for the first half of 2015 increased \$214 thousand from the prior year. Average interest-earning assets increased \$2.5 million from 2014 and the yield on these assets decreased from 3.92% in 2014 to 3.87% in 2015. The average balance of investment securities increased \$9.4 million while average loans decreased \$2.0 million year over year. Average commercial loans decreased \$3.2 million and average mortgage loans decreased \$1.9 million. These decreases were partially offset by an increase of \$3.1 million in the average balance of consumer loans, including home equity loans.

Interest expense was \$1.3 million for the first six months, a decrease of \$387 thousand from the 2014 total of \$1.6 million. Average interest-bearing liabilities decreased \$26.7 million to \$759.5 million for 2015 from an average balance of \$786.1 million in 2014. The average cost of these liabilities decreased from 0.42% in 2014 to 0.33% in 2015. Average interest-bearing deposits decreased \$1.8 million and the cost of these deposits decreased from 0.37%

to 0.33%. The securities sold under agreements to repurchase (Repo) accounts were being closed out in 2014 and transferred to other products. The final Repo account closed in January 2015. Other borrowings reflect a short-term borrowing in 2015, as all long-term debt was paid off in 2014.

The changes in the balance sheet and interest rates resulted in an increase in tax equivalent net interest income of \$214 thousand to \$16.9 million in 2015 compared to \$16.6 million in 2014. The increase in tax equivalent net interest income was due to a \$268 thousand increase from higher volume offset by a \$54 thousand decrease due to changes in rates.

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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 Six Months Ended June 30,					
	2015			2014		
	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	\$ 42,577	\$ 127	0.60%	\$ 47,550	\$ 84	0.36%
<b>Investment securities:</b>						
Taxable	120,988	1,308	2.18%	122,885	1,358	2.23%
Tax Exempt	55,083	1,225	4.45%	43,755	1,101	5.32%
Investments	176,071	2,533	2.90%	166,640	2,459	2.98%
<b>Loans:</b>						
Commercial, industrial and agricultural	574,924	12,147	4.22%	578,084	12,179	4.19%
Residential mortgage	80,902	1,653	4.10%	82,841	1,713	4.17%
Home equity loans and lines	63,778	1,496	4.73%	59,061	1,558	5.32%
Consumer	6,478	165	5.14%	8,077	301	7.52%
Loans	726,082	15,461	4.25%	728,063	15,751	4.31%
Total interest-earning assets	944,730	18,121	3.87%	942,253	18,294	3.92%
Other assets	66,786			71,420		
Total assets	\$ 1,011,516			\$ 1,013,673		
<b>Interest-bearing liabilities:</b>						
<b>Deposits:</b>						
Interest-bearing checking	\$ 216,313	120	0.11%	\$ 197,481	109	0.11%
Money Management	383,423	803	0.42%	391,317	845	0.44%
Savings	64,487	24	0.08%	62,325	24	0.08%
Time	95,180	313	0.66%	110,112	418	0.77%
Total interest-bearing deposits	759,403	1,260	0.33%	761,235	1,396	0.37%
<b>Securities sold under agreements to repurchase</b>						
	50	-	0.15%	12,548	9	0.15%
Other borrowings	12	-	0.30%	12,343	242	3.92%
Total interest-bearing liabilities	759,465	1,260	0.33%	786,126	1,647	0.42%
Noninterest-bearing deposits	139,399			122,807		
Other liabilities	7,481			7,573		
Shareholders' equity	105,171			97,167		
Total liabilities and shareholders' equity	\$ 1,011,516			\$ 1,013,673		
T/E net interest income/Net interest margin		16,861	3.60%		16,647	3.56%
Tax equivalent adjustment		(1,016)			(959)	

Net interest income	\$ 15,845	\$ 15,688
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All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.



## Provision for Loan Losses

For the first half of 2015, the Bank recorded net charge-offs of \$296 thousand compared to \$674 thousand in 2014. Provision expense for the first six months was \$635 thousand and as a result, the allowance for loan losses (ALL) increased \$339 thousand. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

## Noninterest Income

For the first six months of 2015, noninterest income increased \$1.5 million from the same period in 2014. Investment and trust service fees increased due to higher recurring trust fees, estate fees and insurance commissions. Loan service charges increased primarily from a large commercial loan prepayment penalty. Mortgage banking fees remained flat, while deposit service charges increased due to the Bank's overdraft program. Other service charges and fees increased primarily due to ATM and merchant card fees. The net gain in other real estate owned was from the gain on a sale, compared to write downs in 2014. Other income increased from an investment the Corporation owned in an offshore insurance company that liquidated and paid out the investors. Other than temporary impairment charges were recorded on one bond in 2015. The gain on conversion occurred in the equity portfolio and was the result of the Bank receiving shares of S&T Bancorp following its acquisition of Integrity Bancshares.

The following table presents a comparison of noninterest income for the six months ended June 30, 2015 and 2014.

(Dollars in thousands)	For the Six Months Ended		Change	
	June 30 2015	2014	Amount	%
Noninterest Income				
Investment and trust services fees	\$ 2,651	\$ 2,192	\$ 459	20.9
Loan service charges	471	418	53	12.7
Mortgage banking activities	25	32	(7)	(21.9)
Deposit service charges and fees	1,077	990	87	8.8
Other service charges and fees	607	584	23	3.9
Debit card income	675	643	32	5.0
Increase in cash surrender value of life insurance	279	286	(7)	(2.4)
Other real estate owned	32	(185)	217	(117.3)
Other	237	62	175	282.3
OTTI losses recognized in income	(20)	-	(20)	N/A
Gain on conversion	728	-	728	N/A
Securities gain (losses), net	8	221	(213)	(96.4)
Total noninterest income	\$ 6,770	\$ 5,243	\$ 1,527	29.1

## Noninterest Expense

Noninterest expense for the first six months of 2015 decreased \$154 thousand compared to the same period in 2014. The decrease in salaries and benefits was primarily due to a decrease in incentive pay expense, as the 2014 expense included a final adjustment for the 2013 payout, and lower commissions expense, but these decreases were partially offset by increases in pension expense and health insurance expenses. Net occupancy expenses decreased compared to prior year due to less utility and snow removal expense in 2015. Advertising expenses decreased over prior year, due to the timing of various marketing campaigns. Legal and professional fees decreased due to a change in internal audit firms. The increase in data processing expenses was from higher volumes in mobile banking, remote deposit capture, and Franklin Businesslink volumes, as well as the migration to a new mortgage origination system. FDIC insurance expense decreased over prior year due to a reduction in the assessment rate used to calculate the premium. Other expenses increased due to one-time expenses the Bank took to fulfill the funding requirement of a deferred director's benefit plan established thirty years ago, as well as expenses related to branch assets taken out of service.

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The following table presents a comparison of noninterest expense for the six months ended June 30, 2015 and 2014:

(Dollars in thousands)	For the Six Months Ended		Change	
	June 30 2015	2014	Amount	%
Noninterest Expense	\$ 8,286	\$ 8,357	\$ (71)	(0.8)
Salaries and benefits	1,172	1,262	(90)	(7.1)
Net occupancy expense	470	491	(21)	(4.3)
Furniture and equipment expense	471	586	(115)	(19.6)
Advertising	499	618	(119)	(19.3)
Legal and professional fees	1,023	884	139	15.7
Data processing	402	347	55	15.9
Pennsylvania bank shares tax	181	207	(26)	(12.6)
Intangible amortization	308	454	(146)	(32.2)
FDIC insurance	373	357	16	4.5
ATM/debit card processing	1,965	1,741	224	12.9
Other	\$ 15,150	\$ 15,304	\$ (154)	(1.0)
Total noninterest expense				

#### Provision for Income Taxes

For the first half of 2015, the Corporation recorded a Federal income tax expense of \$1.5 million compared to \$1.0 million for the same period in 2014. The increase was due to a lower ratio of tax exempt income to income before federal income taxes. As a result, the effective tax rate increased to 21.5% for the first six months of 2015 compared to 19.7% for 2014. All taxable income for the Corporation is taxed at a rate of 34%.

#### Financial Condition

##### Summary:

At June 30, 2015, assets totaled \$1.029 billion, an increase of \$27.1 million from the 2014 year-end balance of \$1.001 billion. Investment securities increased \$4.7 million, while net loans increased \$6.3 million. Deposits were up \$34.9 million for the first six months of 2015 due to increases in every deposit category except time deposits and money management accounts. Shareholders' equity increased \$3.7 million during the first six months as retained earnings increased approximately \$3.8 million, other comprehensive loss decreased \$700 thousand and the Corporation's Dividend Reinvestment Plan (DRIP) added an additional \$435 thousand in new capital.

##### Cash and Cash Equivalents:

Cash and cash equivalents totaled \$64.4 million at June 30, 2015, an increase of \$15.8 million from the prior year-end balance of \$48.6 million. Interest-bearing deposits are held primarily at the Federal Reserve and in short-term bank

owned certificates of deposit.

#### Investment Securities:

The investment portfolio has grown approximately \$6 million on a cost basis, since year-end 2014. The composition of the portfolio is essentially unchanged with municipal securities and U.S. Agency mortgage-backed securities comprising the greatest portion of the portfolio at approximately 41% and 45% of the portfolio fair value, respectively. The Bank invested \$21.7 million during the first six months of 2015 with the purchases spread between, U.S. Agency mortgage-backed securities and municipal securities.

The investment portfolio had a net unrealized gain of \$1.1 million at June 30, 2015 compared to \$2.4 million at the prior year-end. The decline in the unrealized gain is primarily the result of a \$700 thousand reduction in the unrealized gain in equity securities as Bank should equity securities and recorded the gain from this portfolio. The municipal portfolio also saw its unrealized gains decline during the year, primarily the result of changes in the yield curve. The portfolio averaged \$176.1 million with a yield of 2.90% for the first half of 2015. This compares to an average of \$166.6 million and a yield of 2.98% for the same period in 2014.

The Bank holds only one equity security, a Pennsylvania community bank. The municipal bond portfolio is well diversified geographically (issuers from within 29 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 20 issuers in the state of Texas with a fair value of \$10.9 million and 15 issuers in the state of Pennsylvania with a fair value of \$9.0 million. The average rating of the municipal portfolio from Moody's is Aa2. It contains \$70.2 million of bonds rated A3 or higher and \$1.9 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 June 30, 2015 and December 31, 2014 is as follows:

(Dollars in thousands)      Gross    Gross