FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-Q
August 08, 2016
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, 2016

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

For the transition period from__________ to___________

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

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

20 South Main Street, Chambersburg	PA 17201-0819
(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

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 4,302,395 outstanding shares of the Registrant's common stock as of July 31, 2016.

INDEX

Part I FINANCIAL INFORMATION

Item 1 Financial Statements

Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)(unaudited)	June 30 2016	December 31 2015
Assets		
Cash and due from banks	$ 15,668	$ 20,664
Interest-bearing deposits in other banks	25,381	18,502
Total cash and cash equivalents	41,049	39,166
Investment securities available for sale, at fair value	163,557	159,473
Restricted stock	436	782
Loans held for sale	487	461
Loans	826,656	782,016
Allowance for loan losses	(10,318)	(10,086)
Net Loans	816,338	771,930
Premises and equipment, net	14,414	14,759
Bank owned life insurance	22,196	22,364
Goodwill	9,016	9,016
Other real estate owned	6,194	6,451
Deferred tax asset, net	3,947	4,758
Other assets	6,412	6,135
Total assets	$ 1,084,046	$ 1,035,295
Liabilities		
Deposits		
Noninterest-bearing checking	$ 162,515	$ 152,095
Money management, savings and interest checking	722,413	680,686
Time	80,626	85,731
Total Deposits	965,554	918,512
Other liabilities	2,544	5,407
Total liabilities	968,098	923,919
Shareholders' equity		
Common stock, $1 par value per share,15,000,000 shares authorized with 4,685,049 shares issued and 4,301,648 shares outstanding at June 30, 2016 and 4,659,319 shares issued and 4,275,879 shares outstanding at December 31, 2015	4,685	4,659
Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding	-	-
Additional paid-in capital	39,454	38,778
Retained earnings	81,090	78,517
Accumulated other comprehensive loss	(2,356)	(3,722)

Treasury stock, 383,401 shares at June 30, 2016 and 383,440 shares at December 31, 2015, at cost	(6,925)	(6,856)
Total shareholders' equity	115,948	111,376
Total liabilities and shareholders' equity	$ 1,084,046	$ 1,035,295

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

1

Consolidated Statements of Income

(Dollars in thousands, except per share data) (unaudited)	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2016	2015	2016	2015
Interest income				
Loans, including fees:	$ 7,964	$ 7,477	$ 16,053	$ 14,853
Interest and dividends on investments:				
Taxable interest	584	613	1,160	1,248
Tax exempt interest	357	408	723	817
Dividend income	4	8	10	60
Deposits and obligations of other banks	79	72	141	127
Total interest income	8,988	8,578	18,087	17,105
Interest expense				
Deposits	548	619	1,091	1,260
Short-term borrowings	-	-	2	-
Total interest expense	548	619	1,093	1,260
Net interest income	8,440	7,959	16,994	15,845
Provision for loan losses	1,875	310	2,175	635
Net interest income after provision for loan losses	6,565	7,649	14,819	15,210
Noninterest income				
Investment and trust services fees	1,218	1,388	2,472	2,651
Loan service charges	189	314	415	496
Deposit service charges and fees	602	586	1,180	1,077
Other service charges and fees	313	311	616	607
Debit card income	375	356	722	675
Increase in cash surrender value of life insurance	132	140	267	279
Net (loss) gain on sale of other real estate owned	(2)	-	(10)	32
OTTI losses on debt securities	-	-	(20)	(20)
Gain on conversion of investment security	-	-	-	728
Securities gains, net	2	8	3	8
Other	27	13	164	237
Total noninterest income	2,856	3,116	5,809	6,770
Noninterest expense				
Salaries and employee benefits	4,346	4,203	8,716	8,286
Occupancy, net	553	556	1,152	1,172
Furniture and equipment	218	239	434	470
Advertising	262	283	543	471
Legal and professional	394	203	691	499
Data processing	504	556	1,001	1,023
Pennsylvania bank shares tax	260	206	496	402
Intangible amortization	-	90	-	181
FDIC insurance	169	160	326	308
ATM/debit card processing	200	186	428	373

Foreclosed real estate	13	7	76	19
Telecommunications	90	118	209	235
Other	721	852	1,453	1,711
Total noninterest expense	7,730	7,659	15,525	15,150
Income before federal income tax expense	1,691	3,106	5,103	6,830
Federal income tax expense	130	632	815	1,472
Net income	$ 1,561	$ 2,474	$ 4,288	$ 5,358
Per share				
Basic earnings per share	$ 0.36	$ 0.58	$ 1.00	$ 1.27
Diluted earnings per share	$ 0.36	$ 0.58	$ 1.00	$ 1.26
Cash dividends declared	$ 0.21	$ 0.19	$ 0.40	$ 0.36

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

Consolidated Statements of Comprehensive Income

(Dollars in thousands) (unaudited)	For the Three Months Ended June 30 2016	2015	For the Six Months Ended June 30 2016	2015
Net Income	$ 1,561	$ 2,474	$ 4,288	$ 5,358
Securities:				
Unrealized gains arising during the period	1,006	(1,239)	2,051	(536)
Reclassification adjustment for (gains) losses included in net income (1)	(2)	(8)	17	(716)
Net unrealized gains (losses)	1,004	(1,247)	2,068	(1,252)
Tax effect	(340)	424	(702)	426
Net of tax amount	664	(823)	1,366	(826)
Derivatives:				
Unrealized gains arising during the period	-	32	-	31
Reclassification adjustment for losses included in net income (2)	-	64	-	160
Net unrealized gains	-	96	-	191
Tax effect	-	(32)	-	(65)
Net of tax amount	-	64	-	126
Total other comprehensive income (loss)	664	(759)	1,366	(700)
Total Comprehensive Income	$ 2,225	$ 1,715	$ 5,654	$ 4,658

Reclassification adjustment / Statement line item	Tax expense (benefit)			
(1) Securities / gain on conversion & securities (gains) losses, net	$ 1	$ 3	$ (6)	$ 243
(2) Derivatives / interest expense on deposits	-	(22)	-	(54)

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

3

Consolidated Statements of Changes in Shareholders' Equity

For the Six Months Ended June 30, 2016 and 2015:

(Dollars in thousands, except per share data) (unaudited)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
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 employer 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
Balance at December 31, 2015	$ 4,659	$ 38,778	$ 78,517	$ (3,722)	$ (6,856)	$ 111,376
Net income	-	-	4,288	-	-	4,288
Other comprehensive income	-	-	-	1,366	-	1,366
Cash dividends declared, $.40 per share	-	-	(1,715)	-	-	(1,715)
Acquisition of 15,521 shares of treasury stock	-	-	-	-	(350)	(350)
Treasury shares issued under employer stock purchase plan, 188 shares	-	1	-	-	278	279
Treasury shares issued under dividend reinvestment plan, 15,372 shares	-	82	-	-	3	85
Common stock issued under dividend reinvestment plan, 25,230 shares	25	527	-	-	-	552
Common stock issued under incentive stock option plan, 500 shares	1	8	-	-	-	9
Stock option compensation expense	-	58	-	-	-	58
Balance at June 30, 2016	$ 4,685	$ 39,454	$ 81,090	$ (2,356)	$ (6,925)	$ 115,948

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

Consolidated Statements of Cash Flows

	Six Months Ended June 30	
	2016	2015
(Dollars in thousands) (unaudited)		
Cash flows from operating activities		
Net income	$ 4,288	$ 5,358
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	666	675
Net amortization of loans and investment securities	794	796
Amortization and net change in mortgage servicing rights valuation	27	9
Amortization of intangibles	-	181
Provision for loan losses	2,175	635
Gain on sales of securities	(3)	(8)
Impairment write-down on securities recognized in earnings	20	20
Gain on conversion of investment security	-	(728)
Loans originated for sale	(4,963)	(3,812)
Proceeds from sale of loans	4,937	2,446
Write-down of other real estate owned	46	-
Write-down on premises and equipment	-	60
Net loss (gain) on sale or disposal of other real estate/other repossessed assets	10	(32)
Increase in cash surrender value of life insurance	(267)	(279)
Stock option compensation	58	-
(Increase) decrease in other assets	(504)	1,380
(Decrease) in other liabilities	(2,588)	(2,195)
Net cash provided by operating activities	4,696	4,506
Cash flows from investing activities		
Proceeds from sales and calls of investment securities available for sale	1,765	1,381
Proceeds from maturities and pay-downs of securities available for sale	11,929	14,132
Purchase of investment securities available for sale	(16,605)	(21,689)
Net decrease (increase) in restricted stock	346	(1)
Net increase in loans	(46,522)	(7,256)
Capital expenditures	(288)	(190)
Proceeds from surrender of life insurance policy	436	-
Proceeds from sale of other real estate	224	129
Net cash used in investing activities	(48,715)	(13,494)
Cash flows from financing activities		
Net increase in demand deposits, interest-bearing checking, and savings accounts	52,147	41,406
Net decrease in time deposits	(5,105)	(6,528)
Net decrease in repurchase agreements	-	(9,079)
Dividends paid	(1,715)	(1,522)
Common stock issued under stock option plans	288	86
Common stock issued under dividend reinvestment plan	637	435
Purchase of treasury stock	(350)	-

Net cash provided by financing activities	45,902	24,798
Increase in cash and cash equivalents	1,883	15,810
Cash and cash equivalents as of January 1	39,166	48,593
Cash and cash equivalents as of June 30	$ 41,049	$ 64,403
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest on deposits and other borrowed funds	$ 1,097	$ 1,304
Income taxes	$ 2,100	$ 1,513
Noncash Activities		
Loans transferred to Other Real Estate	$ 23	$ 449

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

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Franklin Financial Services Corporation (the Corporation), and its wholly-owned subsidiaries, Farmers and Merchants Trust Company of Chambersburg (the Bank) and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank that has one wholly-owned subsidiary, Franklin Financial Properties Corp. Franklin Financial 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, 2016, 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 2015 Annual Report on Form 10-K. The consolidated results of operations for the three and six month periods ended June 30, 2016 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, 2015 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	
(Dollars and shares in thousands, except per share data)	2016	2015	2016	2015
Weighted average shares outstanding (basic)	4,294	4,234	4,289	4,228
Impact of common stock equivalents	4	11	3	8
Weighted average shares outstanding (diluted)	4,298	4,245	4,292	4,236

Anti-dilutive options excluded from calculation	43	13	44	28
Net income	$ 1,561	$ 2,474	$ 4,288	$ 5,358
Basic earnings per share	$ 0.36	$ 0.58	$ 1.00	$ 1.27
Diluted earnings per share	$ 0.36	$ 0.58	$ 1.00	$ 1.26

Note 2. Recent Accounting Pronouncements

Financial Instruments – Credit Losses (Topic 326). In June 2016, the FASB issued ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” ASU 2016-13 requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss (CECL) model). Under this model, entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments, but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument. The ASU replaces the current accounting model for purchased credit impaired loans and debt securities. The allowance for credit losses for purchased financial assets with a more-than insignificant amount of credit deterioration since origination (“PCD assets”), should be determined in a similar manner to other financial assets measured on an amortized cost basis. However, upon initial recognition, the allowance for credit losses is added to the purchase price (“gross up approach”) to determine the initial amortized cost basis. The subsequent account for PCD financial assets is the same expected loss model described above. The ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of the fiscal year beginning after December 15, 2018, including interim periods within those fiscal years. The Corporation is currently evaluating the impact of the pending adoption of the new standard on its consolidated 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.

Financial Instruments – Overall (Topic 825-10). In January 2016, the FASB issued ASU 2016-01, "Financial Instruments – Overall (Topic 825-10): "Recognition and Measurement of Financial Assets and Financial Liabilities." ASU 2016-01 amends the guidance on the classification and measurement of financial instruments. Some of the amendments in ASU 2016-01 include the following: 1) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; 2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and 4) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others. For public business entities, the amendments of ASU 2016-01 are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Corporation does not believe ASU 2016-01 will have a material effect on its financial statements.

Leases (Topic 842). In February 2016, the FASB issued Accounting Standards Update ("ASU") No. 2016-02, Leases. From the lessee's perspective, the new standard established a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for a lessees. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as financing. If the lessor doesn't convey risks and rewards or control, an operating lease results.

The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. A modified retrospective transition approach is required for lessors for sales-type, direct financing, and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Corporation is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

Note 3. Accumulated Other Comprehensive Loss

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

(Dollars in thousands)	June 30 2016	December 31, 2015
Net unrealized gains on securities	$ 3,206	$ 1,138
Tax effect	(1,089)	(387)
Net of tax amount	2,117	751
Accumulated pension adjustment	(6,777)	(6,777)
Tax effect	2,304	2,304
Net of tax amount	(4,473)	(4,473)
Total accumulated other comprehensive loss	$ (2,356)	$ (3,722)

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 $29.4 million and $25.9 million of standby letters of credit as of June 30, 2016 and December 31, 2015, 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, 2016 and December 31, 2015 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, 2016 and December 31, 2015 are as follows:

(Dollars in thousands) June 30, 2016	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 164	$ 76	$ -	$ 240
U.S. Government and Agency securities	13,104	339	(17)	13,426
Municipal securities	68,430	2,354	(43)	70,741
Trust preferred securities	5,968	-	(798)	5,170
Agency mortgage-backed securities	71,448	1,310	(35)	72,723
Private-label mortgage-backed securities	1,201	27	(5)	1,223
Asset-backed securities	36	-	(2)	34
	$ 160,351	$ 4,106	$ (900)	$ 163,557

(Dollars in thousands) December 31, 2015	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 164	$ 69	$ -	$ 233
U.S. Government and Agency securities	13,705	164	(33)	13,836
Municipal securities	67,851	1,555	(218)	69,188
Trust preferred securities	5,958	-	(669)	5,289
Agency mortgage-backed securities	69,284	621	(386)	69,519
Private-label mortgage-backed securities	1,335	39	(2)	1,372
Asset-backed securities	38	-	(2)	36
	$ 158,335	$ 2,448	$ (1,310)	$ 159,473

At June 30, 2016 and December 31, 2015, the fair value of investment securities pledged to secure public funds, trust balances, deposit and other obligations totaled $69.4 million and $79.6 million, respectively.

The amortized cost and estimated fair value of debt securities at June 30, 2016, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

(Dollars in thousands)	Amortized cost	Fair value
Due in one year or less	$ 2,618	$ 2,641
Due after one year through five years	11,175	11,516
Due after five years through ten years	28,597	29,698
Due after ten years	45,148	45,516
	87,538	89,371
Mortgage-backed securities	72,649	73,946
	$ 160,187	$ 163,317

The composition of the net realized securities gains for the three and six months ended are as follows:

(Dollars in thousands)	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2016	2015	2016	2015
Gross gains realized	$ 2	$ -	$ 3	$ 8
Gross losses realized	-	-	-	-
Conversion gain	-	-	-	728
Net gains realized	$ 2	$ -	$ 3	$ 736

The following table provides additional detail about trust preferred securities as of June 30, 2016:

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	$ 966	$ 832	$ (134)	BB+
Wachovia Cap Trust II	1/15/2027	Single	Preferred Stock	279	254	(25)	BBB
Huntington Cap Trust	2/1/2027	Single	Preferred Stock	944	795	(149)	BB
Corestates Captl Tr II	2/15/2027	Single	Preferred Stock	941	848	(93)	BBB+
Huntington Cap Trust II	6/15/2028	Single	Preferred Stock	897	767	(130)	BB
Chase Cap VI JPM	8/1/2028	Single	Preferred Stock	965	832	(133)	BBB-
Fleet Cap Tr V	12/18/2028	Single	Preferred Stock	976	842	(134)	BB+
				$ 5,968	$ 5,170	$ (798)	

The following table provides additional detail about private label mortgage-backed securities as of June 30, 2016:

Private Label Mortgage Backed Securities

(Dollars in thousands) Description	Origination Date	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
MALT 2004-6 7A1	6/1/2004	$ 322	$ 319	$ (3)	ALT A	CCC	15.07	$ -
RALI 2005-QS2 A1	2/1/2005	176	187	11	ALT A	CC	4.83	10
RALI 2006-QS4 A2	4/1/2006	425	423	(2)	ALT A	D	-	323
GSR 2006-5F 2A1	5/1/2006	53	60	7	Prime	D	-	15
RALI 2006-QS8 A1	7/28/2006	225	234	9	ALT A	D	-	227
		$ 1,201	$ 1,223	$ 22				$ 575

Impairment:

The investment portfolio contained thirty-seven securities with $21.0 million of temporarily impaired fair value and $900 thousand in unrealized losses at June 30, 2016. The total unrealized loss position has improved from a $1.3 million unrealized loss at year-end 2015.

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, 2016, 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, 2016 and December 31, 2015:

	June 30, 2016								
	Less than 12 months			12 months or more			Total		
	Fair	Unrealized		Fair	Unrealized		Fair	Unrealized	
(Dollars in thousands)	Value	Losses	Count	Value	Losses	Count	Value	Losses	Count
U.S. Government and Agency securities	$ -	$ -	-	$ 3,612	$ (17)	10	$ 3,612	$ (17)	10
Municipal securities	-	-	-	2,328	(43)	3	2,328	(43)	3
Trust preferred securities	-	-	-	5,170	(798)	7	5,170	(798)	7
Agency mortgage-backed securities	3,218	(2)	3	5,929	(33)	11	9,147	(35)	14
Private-label mortgage-backed securities	319	(3)	1	423	(2)	1	742	(5)	2
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	$ 3,537	$ (5)	4	$ 17,467	$ (895)	33	$ 21,004	$ (900)	37

	December 31, 2015								
	Less than 12 months			12 months or more			Total		
	Fair	Unrealized		Fair	Unrealized		Fair	Unrealized	
(Dollars in thousands)	Value	Losses	Count	Value	Losses	Count	Value	Losses	Count
U.S. Government and Agency securities	$ 479	$ (1)	3	$ 4,364	$ (32)	10	$ 4,843	$ (33)	13
Municipal securities	5,806	(35)	8	4,785	(183)	7	10,591	(218)	15
Trust preferred securities	-	-	-	5,289	(669)	7	5,289	(669)	7
Agency mortgage-backed securities	18,977	(215)	29	7,394	(171)	13	26,371	(386)	42
	-	-	-	246	(2)	1	246	(2)	1

Private-label mortgage-backed securities									
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	$ 25,262	$ (251)	40	$ 22,083	$ (1,059)	39	$ 47,345	$ (1,310)	79

The unrealized loss in the municipal bond portfolio decreased to $43 thousand from $218 thousand at December 31, 2015 as market prices improved during the quarter. There are three securities in this portfolio with an unrealized loss 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 seven securities with a fair value of $5.2 million and an unrealized loss of $798 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, 2016, 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.

There are two PLMBS bonds showing a small unrealized loss of $5 thousand. However, the PLMBS sector as a whole is showing an unrealized gain of $22 thousand at quarter end. This is primarily a result of the cumulative OTTI charges recorded on this portfolio. 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. The Bank recorded a $20 thousand impairment charge during the first quarter of 2016 and has recorded

$575 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 following table represents the cumulative credit losses on debt securities recognized in earnings as of June 30:

(Dollars in thousands)	Six Months Ended	
	2016	2015
Balance of cumulative credit-related OTTI at January 1	$ 555	$ 535
Additions for credit-related OTTI not previously recognized	20	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	$ 575	$ 555

The Bank held $436 thousand of restricted stock at June 30, 2016. 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. The level of FHLB stock held is determined by FHLB and is comprised of a minimum membership amount plus a variable activity amount. 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.

12

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

(Dollars in thousands)	June 30, 2016	December 31, 2015	Change Amount	%
Residential Real Estate 1-4 Family				
Consumer first liens	$ 101,113	$ 103,698	$ (2,585)	(2.5)
Commercial first lien	62,424	57,780	4,644	8.0
Total first liens	163,537	161,478	2,059	1.3
Consumer junior liens and lines of credit	46,106	44,996	1,110	2.5
Commercial junior liens and lines of credit	5,908	5,917	(9)	(0.2)
Total junior liens and lines of credit	52,014	50,913	1,101	2.2
Total residential real estate 1-4 family	215,551	212,391	3,160	1.5
Residential real estate - construction				
Consumer	1,067	545	522	95.8
Commercial	7,253	7,343	(90)	(1.2)
Total residential real estate construction	8,320	7,888	432	5.5
Commercial real estate	371,786	340,695	31,091	9.1
Commercial	226,307	215,942	10,365	4.8
Total commercial	598,093	556,637	41,456	7.4
Consumer	4,692	5,100	(408)	(8.0)
	826,656	782,016	44,640	5.7
Less: Allowance for loan losses	(10,318)	(10,086)	(232)	2.3
Net Loans	$ 816,338	$ 771,930	$ 44,408	5.8
Included in the loan balances are the following:				
Net unamortized deferred loan fees	$ 225	$ 436		
Loans pledged as collateral for borrowings and commitments from:				
FHLB	$ 583,567	$ 643,449		
Federal Reserve Bank	42,060	45,111		
	$ 625,627	$ 688,560		

Note 7. Loan Quality

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

	Residential Real Estate 1-4 Family							
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Commercial Real Estate	Commercial	Consumer	Unallocated	Total
ALL at March 31, 2016	$ 997	$ 316	$ 199	$ 6,181	$ 1,510	$ 99	$ 1,040	$ 10,342
Charge-offs	(46)	-	-	(1,951)	(3)	(42)	-	(2,042)
Recoveries	1	-	-	14	106	22	-	143
Provision	71	3	6	1,696	(17)	18	98	1,875
ALL at June 30, 2016	$ 1,023	$ 319	$ 205	$ 5,940	$ 1,596	$ 97	$ 1,138	$ 10,318
ALL at December 31, 2015	$ 989	$ 308	$ 194	$ 5,649	$ 1,519	$ 102	$ 1,325	$ 10,086
Charge-offs	(49)	-	-	(1,954)	(66)	(84)	-	(2,153)
Recoveries	33	-	-	14	121	42	-	210
Provision	50	11	11	2,231	22	37	(187)	2,175
ALL at June 30, 2016	$ 1,023	$ 319	$ 205	$ 5,940	$ 1,596	$ 97	$ 1,138	$ 10,318
ALL at March 31, 2015	$ 1,016	$ 268	$ 249	$ 5,137	$ 1,353	$ 116	$ 1,071	$ 9,210
Charge-offs	(43)	-	(21)	-	(17)	(26)	-	(107)
Recoveries	1	-	-	14	8	14	-	37
Provision	40	13	(22)	28	96	8	147	310
ALL at June 30, 2015	$ 1,014	$ 281	$ 206	$ 5,179	$ 1,440	$ 112	$ 1,218	$ 9,450
ALL at December 31, 2014	$ 994	$ 271	$ 214	$ 4,978	$ 1,515	$ 127	$ 1,012	$ 9,111
Charge-offs	(43)	-	(21)	-	(218)	(78)	-	(360)
Recoveries	3	-	-	14	14	33	-	64
Provision	60	10	13	187	129	30	206	635
ALL at June 30, 2015	$ 1,014	$ 281	$ 206	$ 5,179	$ 1,440	$ 112	$ 1,218	$ 9,450

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, 2016 and December 31, 2015:

	Residential Real Estate 1-4 Family							
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Commercial Real Estate	Commercial	Consumer	Unallocated	Total
June 30, 2016								
Loans evaluated for ALL:								
Individually	$ 396	$ 52	$ 491	$ 17,082	$ -	$ -	$ -	$ 18,021
Collectively	163,141	51,962	7,829	354,704	226,307	4,692	-	808,635
Total	$ 163,537	$ 52,014	$ 8,320	$ 371,786	$ 226,307	$ 4,692	$ -	$ 826,656
ALL established for loans evaluated:								
Individually	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Collectively	1,023	319	205	5,940	1,596	97	1,138	10,318
ALL at June 30, 2016	$ 1,023	$ 319	$ 205	$ 5,940	$ 1,596	$ 97	$ 1,138	$ 10,318
December 31, 2015								
Loans evaluated for ALL:								
Individually	$ 930	$ 51	$ 502	$ 14,309	$ 230	$ -	$ -	$ 16,022
Collectively	160,548	50,862	7,386	326,386	215,712	5,100	-	765,994
Total	$ 161,478	$ 50,913	$ 7,888	$ 340,695	$ 215,942	$ 5,100	$ -	$ 782,016
ALL established for loans evaluated:								
Individually	$ -	$ -	$ -	$ -	$ 9	$ -	$ -	$ 9
Collectively	989	308	194	5,649	1,510	102	1,325	10,077
ALL at December 31, 2015	$ 989	$ 308	$ 194	$ 5,649	$ 1,519	$ 102	$ 1,325	$ 10,086

The following table shows additional information about those loans considered to be impaired at June 30, 2016 and December 31, 2015:

	Impaired Loans				
	With No Allowance		With Allowance		
(Dollars in thousands)		Unpaid		Unpaid	
	Recorded	Principal	Recorded	Principal	Related
June 30, 2016	Investment	Balance	Investment	Balance	Allowance
Residential Real Estate 1-4 Family					
First liens	$ 921	$ 996	$ -	$ -	$ -
Junior liens and lines of credit	63	75	-	-	-
Total	984	1,071	-	-	-
Residential real estate - construction	491	540	-	-	-
Commercial real estate	17,357	19,910	-	-	-
Commercial	25	37	-	-	-
Total	$ 18,857	$ 21,558	$ -	$ -	$ -
December 31, 2015					
Residential Real Estate 1-4 Family					
First liens	$ 1,523	$ 1,725	$ -	$ -	$ -
Junior liens and lines of credit	105	133	-	-	-
Total	1,628	1,858	-	-	-
Residential real estate - construction	502	546	-	-	-
Commercial real estate	14,431	15,007		-	-
Commercial	267	330	9	10	9
Total	$ 16,828	$ 17,741	$ 9	$ 10	$ 9

The following table shows the average of impaired loans and related interest income for the three and six months ended June 30, 2016 and 2015:

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2016	
(Dollars in thousands)	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	$ 926	$ 6	$ 998	$ 12
Junior liens and lines of credit	63	-	67	-
Total	989	6	1,065	12
Residential real estate - construction	494	-	498	-
Commercial real estate	19,345	117	19,555	239
Commercial	34	-	39	-
Total	$ 20,862	$ 123	$ 21,157	$ 251

	Three Months Ended June 30, 2015		Six Months Ended June 30, 2015	
(Dollars in thousands)	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

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

(Dollars in thousands)		Loans Past Due and Still Accruing					Total
		30-59	60-89	90			
	Current	Days	Days	Days+	Total	Non-Accrual	Loans
June 30, 2016							
Residential Real Estate 1-4 Family							
First liens	$ 162,601	$ 102	$ 393	$ 14	$ 509	$ 427	$ 163,537
Junior liens and lines of credit	51,764	154	-	33	187	63	52,014
Total	214,365	256	393	47	696	490	215,551
Residential real estate - construction	7,652	117	-	60	177	491	8,320
Commercial real estate	362,157	2,415	96	306	2,817	6,812	371,786
Commercial	225,802	381	53	46	480	25	226,307
Consumer	4,674	18	-	-	18	-	4,692
Total	$ 814,650	$ 3,187	$ 542	$ 459	$ 4,188	$ 7,818	$ 826,656

December 31, 2015							
Residential Real Estate 1-4 Family							
First liens	$ 159,998	$ 44	$ 416	$ 214	$ 674	$ 806	$ 161,478
Junior liens and lines of credit	50,541	217	50	-	267	105	50,913
Total	210,539	261	466	214	941	911	212,391
Residential real estate - construction	7,209	177	-	-	177	502	7,888
Commercial real estate	330,953	5,713	196	152	6,061	3,681	340,695
Commercial	215,449	210	5	2	217	276	215,942
Consumer	5,041	55	4	-	59	-	5,100
Total	$ 769,191	$ 6,416	$ 671	$ 368	$ 7,455	$ 5,370	$ 782,016

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 purpose loans may be assigned any rating in accordance with the Bank's internal risk rating system.

(Dollars in thousands)	Pass (1-5)	Special Mention (6)	Substandard (7)	Doubtful (8)	Total
June 30, 2016					
Residential Real Estate 1-4 Family					
First liens	$ 160,151	$ 2,003	$ 1,383	$ -	$ 163,537
Junior liens and lines of credit	51,796	28	190	-	52,014
Total	211,947	2,031	1,573	-	215,551
Residential real estate - construction	7,488	-	832	-	8,320
Commercial real estate	352,191	1,758	17,837	-	371,786
Commercial	223,082	1,161	2,064	-	226,307
Consumer	4,692	-	-	-	4,692
Total	$ 799,400	$ 4,950	$ 22,306	$ -	$ 826,656

December 31, 2015					
Residential Real Estate 1-4 Family					
First liens	$ 157,514	$ 2,122	$ 1,842	$ -	$ 161,478
Junior liens and lines of credit	50,685	28	200	-	50,913
Total	208,199	2,150	2,042	-	212,391
Residential real estate - construction	7,386	-	502	-	7,888
Commercial real estate	319,985	6,175	14,535	-	340,695
Commercial	213,492	1,978	472	-	215,942
Consumer	5,100	-	-	-	5,100
Total	$ 754,162	$ 10,303	$ 17,551	$ -	$ 782,016

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 in the Last Twelve Months	
	Number of Contracts	Recorded Investment	Performing*	Nonperforming*	Number of Contracts	Recorded Investment
June 30, 2016						
Residential real estate - construction	1	$ 491	$ 491	$ -	-	$ -
Residential real estate	4	645	494	151	-	-
Commercial real estate	11	12,351	12,351	-	-	-
Total	16	$ 13,487	$ 13,336	$ 151	-	$ -
December 31, 2015						
Residential real estate - construction	1	$ 502	$ 502	$ -	-	$ -
Residential real estate	4	654	503	151	-	-
Commercial real estate	10	12,125	12,125	-	-	-
Total	15	$ 13,281	$ 13,130	$ 151	-	$ -

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

The following table reports new TDR loans during 2016, concession granted and the recorded investment as of June 30, 2016:

	New During Period				
Six Months Ended June 30, 2016	Number of Contracts	Pre-TDR Modification	After-TDR Modification	Recorded Investment	Concession
Commercial real estate	1	$ 525	$ 525	$ 515	multiple

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

Note 8. OREO

Changes in other real estate owned during the three months ended June 30, 2016 and 2015 were as follows:

	June 30	
(Dollars in thousands)	2016	2015
Balance at January 1	$ 6,451	$ 3,666
Additions	23	449
Proceeds from dispositions	(224)	(129)
(Loss) gain on sales, net	(10)	32
Valuation adjustment	(46)	-
Balance at June 30	$ 6,194	$ 4,018

Note 9. Pension

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

	Three Months Ended June 30		Six Months Ended June 30	
(Dollars in thousands)	2016	2015	2016	2015
Components of net periodic cost:				
Service cost	$ 83	$ 92	$ 164	$ 192
Interest cost	180	172	360	350
Expected return on plan assets	(290)	(296)	(583)	(592)
Recognized net actuarial loss	120	123	231	254
Net period cost	$ 93	$ 91	$ 172	$ 204

The Bank expects its pension expense to increase to approximately $809 thousand in 2016 compared to $387 thousand in 2015, due to a pension settlement expense of approximately $450,000 that will be recorded during the second half of 2016. No pension contributions were made or are expected to be made in 2016.

Note 10. 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 maybe different than the amounts reported at each year-end.

FASB ASC Topic 820, “Financial Instruments”, requires disclosure of the fair value of financial assets and liabilities, including those financial assets and liabilities that are not measured and reported at fair value on a recurring and nonrecurring basis. The Corporation does not report any nonfinancial assets at fair value. 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, 2016 and December 31, 2015.

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 (including impaired 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.

Deposits and Short-term borrowings: 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 is estimated by discounting the future cash flows using rates approximating those currently offered for certificates of deposit with similar remaining maturities. For short-term borrowings, the carrying value approximates a reasonable estimate of the fair value.

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

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:

	June 30, 2016				
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	$ 41,049	$ 41,049	$ 41,049	$ -	$ -
Investment securities available for sale	163,557	163,557	240	163,317	-
Restricted stock	436	436	-	436	-
Loans held for sale	487	487	-	487	-
Net loans	816,338	824,266	-	-	824,266
Accrued interest receivable	3,151	3,151	-	3,151	-
Financial liabilities:					
Deposits	$ 965,554	$ 965,439	$ -	$ 965,439	$ -
Accrued interest payable	120	120	-	120	-

	December 31, 2015				
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	$ 39,166	$ 39,166	$ 39,166	$ -	$ -
Investment securities available for sale	159,473	159,473	233	159,240	-
Restricted stock	782	782	-	782	-
Loans held for sale	461	461	-	461	-
Net loans	771,930	779,742	-	-	779,742
Accrued interest receivable	3,164	3,164	-	3,164	-
Financial liabilities:					
Deposits	$ 918,512	$ 918,401	$ -	$ 918,401	$ -
Accrued interest payable	124	124	-	124	-

Recurring Fair Value Measurements

For financial assets and liabilities measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2016 and December 31, 2015 are as follows:

(Dollars in Thousands	Fair Value at June 30, 2016			
Asset Description	Level 1	Level 2	Level 3	Total
Equity securities	$ 240	$ -	$ -	$ 240
U.S. Government and Agency securities	-	13,426	-	13,426
Municipal securities	-	70,741	-	70,741
Trust Preferred Securities	-	5,170	-	5,170
Agency mortgage-backed securities	-	72,723	-	72,723
Private-label mortgage-backed securities	-	1,223	-	1,223
Asset-backed securities	-	34	-	34
Total assets	$ 240	$ 163,317	$ -	$ 163,557

(Dollars in Thousands)	Fair Value at December 31, 2015			
Asset Description	Level 1	Level 2	Level 3	Total
Equity securities	$ 233	$ -	$ -	$ 233
U.S. Government and Agency securities	-	13,836	-	13,836
Municipal securities	-	69,188	-	69,188
Trust Preferred Securities	-	5,289	-	5,289
Agency mortgage-backed securities	-	69,519	-	69,519
Private-label mortgage-backed securities	-	1,372	-	1,372
Asset-backed securities	-	36	-	36
Total assets	$ 233	$ 159,240	$ -	$ 159,473

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.

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, 2016 and December 31, 2015 are as follows:

(Dollars in Thousands)	Fair Value at June 30, 2016			
	Level	Level		
Asset Description	1	2	Level 3	Total
Impaired loans (1)	$ -	$ -	$ 3,363	$ 3,363
Other real estate owned (1)	-	-	225	225
Total assets	$ -	$ -	$ 3,588	$ 3,588

(Dollars in Thousands)	Fair Value at December 31, 2015			
	Level	Level		
Asset Description	1	2	Level 3	Total
Premises held-for-sale (1)	$ -	$ -	$ 225	$ 225
Other real estate owned (1)	-	-	6,128	6,128
Total assets	$ -	$ -	$ 6,353	$ 6,353

(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.

Premises held-for-sale: The fair value of premises held for sale, upon initial recognition, is estimated using Level 3 inputs within the fair value hierarchy.

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.

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, 2016. 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, 2016.

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

(Dollars in Thousands)	Quantitative Information about Level 3 Fair Value Measurements at June 30, 2016			
Asset Description	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans (1)	$ 3,363	Appraisal	Appraisal Adjustments (2)	100% (100%)
			Cost to sell	8% (8%)
Other real estate owned (1)	225	Appraisal	Cost to sell	8% (8%)
	at December 31, 2015			
Premises held-for-sale (1)	$ 225	Appraisal	-	-
Other real estate owned (1)	6,128	Appraisal	Cost to sell	8% (8%)

(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.

Note 11. Financial Derivatives

The Board of Directors has given Management authorization to enter into derivative activity including interest rate swaps, caps and floors, forward-rate agreements, options and futures contracts in order to hedge interest rate risk. The Bank is exposed to credit risk equal to the positive fair value of a derivative instrument, if any, as a positive fair value indicates that the counterparty to the agreement is financially liable to the Bank. To limit this risk, counterparties must have an investment grade long-term debt rating and individual counterparty credit exposure is limited by Board approved parameters. The final swap transaction matured in 2015.

The Effect of Derivative Instruments on the Statement of Income for the Three and Six Months Ended June 30, 2016 and 2015 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships

(Dollars in thousands)

Date / Type	Amount of Gain or (Loss) Recognized in OCI net of tax on Derivative (Effective Portion)	Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain or (Loss) Recognized in Income on Derivatives (Ineffective Portion and Amount Excluded from Effectiveness Testing)
Interest rate contracts					
Three months ended:					
June 30, 2016	$ -	Interest Expense	$ -	Other income (expense)	$ -
June 30, 2015	$ 64	Interest Expense	$ (64)	Other income (expense)	$ -
Six months ended:					
June 30, 2016	$ -	Interest Expense	$ -	Other income (expense)	$ -
June 30, 2015	$ 126	Interest Expense	$ (160)	Other income (expense)	$ -

Interest Rate Swap Agreements (“Swap Agreements”)

As of June 30, 2016, 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.

Note 12. 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 bank holding companies and U.S banks, generally referred to as “Basel III.” The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered “well capitalized” under Basel III are: (1) Common Equity Tier 1(CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3)Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The CET1 ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.625%, increasing each year until fully implemented in 2019 at 2.5% above the minimum capital ratios required to avoid any capital distribution restrictions. The capital conservation buffer will be applicable to all of the capital ratios except for the Tier1 Leverage ratio. When fully implemented, the capital conservation buffer will have the effect of increasing the minimum capital ratios by 2.5%. As of June 30, 2016, the Bank was "well capitalized' under the Basel III requirements and believes it would be "well capitalized" on a fully-phased in basis had such a requirement been in effect.

The following table summarizes regulatory capital information as of June 30, 2016 and December 31, 2015 (restated) for the Corporation and the Bank. The adequately capitalized minimum ratios, except for the Tier 1 Leverage Ratio, include the 0.625% Capital Conservation buffer effective for 2016.

			Regulatory Ratios	
			Adequately Capitalized	Well Capitalized
(Dollars in thousands)	June 30, 2016	December 31, 2015	Minimum	Minimum
Common Equity Tier 1 Risk-based Capital Ratio (1)				
Franklin Financial Services Corporation	14.64%	14.77%	5.125%	N/A
Farmers & Merchants Trust Company	14.59%	14.76%	5.125%	6.50%
Tier 1 Risk-based Capital Ratio (2)				
Franklin Financial Services Corporation	14.64%	14.77%	6.625%	N/A
Farmers & Merchants Trust Company	14.59%	14.76%	6.625%	8.00%
Total Risk-based Capital Ratio (3)				
Franklin Financial Services Corporation	15.90%	16.03%	8.625%	N/A
Farmers & Merchants Trust Company	15.85%	16.02%	8.625%	10.00%
Tier 1 Leverage Ratio (4)				
Franklin Financial Services Corporation	10.20%	10.38%	4.000%	N/A
Farmers & Merchants Trust Company	10.17%	10.37%	4.000%	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

31Note 13. 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, 2016 and 2015

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 risk 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. These policies are particularly sensitive, requiring significant judgements, estimates and assumptions to be made by Management. There were no changes to the critical accounting policies disclosed in the 2015 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 2015 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, 2016, total assets were $1.084 billion, an increase of $48.8 million from December 31, 2015. Net loans increased to $816.3 million and total deposits increased to $965.6 million. The Corporation reported net income for the first six months of 2016 of $4.3 million. This is a 20.0% decrease versus net income of $5.4 million for the same period in 2015. Net income for 2016 was negatively affected by a provision for loan loss expense that was $1.5 million more than 2015, while 2015 was enhanced by two nonrecurring events that increased noninterest income by $899 thousand. Despite the nonrecurring events in 2015, total revenue (interest income and noninterest income) for the first half of 2016 increased slightly, by $21 thousand year-over-year. Interest income increased $982 thousand, while interest expense decreased by $167 thousand, resulting in a $1.1 million increase in net interest income. The provision for loan losses was $2.2 million for the first six months of 2016, $1.5 million more than in 2015. Noninterest income decreased $961 thousand, while noninterest expense increased $375 thousand. Income tax expense decreased from $1.5 million in 2015 to $815 thousand in 2016. The effective tax rate decreased from 21.6% in 2015 to 16.0% in 2016. Diluted earnings per share decreased to $1.00 in 2016 from $1.26 in 2015.

28

Key performance ratios as of, or for the six months ended June 30, 2016 and 2015 and the year ended December 31, 2015 are listed below:

(Dollars in thousands, except per share)	June 30 2016	December 31, 2015	June 30 2015
Balance Sheet Highlights			
Total assets	$ 1,084,046	$ 1,035,295	$ 1,028,539
Investment securities	163,557	159,473	176,424
Loans, net	816,338	771,930	723,762
Deposits	965,554	918,512	916,059
Shareholders' equity	115,948	111,376	107,178
Summary of Operations			
Interest income	$ 18,087	$ 34,615	$ 17,105
Interest expense	1,093	2,371	1,260
Net interest income	16,994	32,244	15,845
Provision for loan losses	2,175	1,285	635
Net interest income after provision for loan losses	14,819	30,959	15,210
Noninterest income	5,809	12,652	6,770
Noninterest expense	15,525	31,136	15,150
Income before income taxes	5,103	12,475	6,830
Income tax	815	2,271	1,472
Net income	$ 4,288	$ 10,204	$ 5,358
Performance Measurements			
Return on average assets*	0.80%	1.00%	1.07%
Return on average equity*	7.56%	9.52%	10.28%
Return on average tangible assets (1)*	0.81%	1.02%	1.09%
Return on average tangible equity (1)*	8.21%	10.52%	11.40%
Efficiency ratio (1)	65.04%	67.39%	66.11%
Net interest margin*	3.63%	3.59%	3.60%
Current dividend yield*	3.54%	3.23%	3.10%
Dividend payout ratio	40.00%	30.76%	28.41%
Shareholders' Value (per common share)			
Diluted earnings per share	$ 1.00	$ 2.40	$ 1.26
Basic earnings per share	1.00	2.40	1.27
Regular cash dividends paid	0.40	0.74	0.36
Book value	26.95	26.05	25.27
Tangible book value (1)	24.86	23.94	23.15
Market value	23.73	23.50	24.55
Market value/book value ratio	88.05%	90.21%	97.15%
Price/earnings multiple*	11.87	9.79	9.74

Safety and Soundness			
Risk-based capital ratio (Total)	15.90%	16.03%	15.73%
Leverage ratio (Tier 1)	10.20%	10.38%	10.17%
Common equity ratio (Tier 1)	14.64%	14.77%	14.48%
Nonperforming loans/gross loans	1.00%	0.73%	1.30%
Nonperforming assets/total assets	1.33%	1.18%	1.32%
Allowance for loan losses as a % of loans	1.25%	1.29%	1.29%
Net charge-offs/average loans*	0.48%	0.04%	0.08%
Trust assets under management (fair value)	$ 606,334	$ 586,664	$ 598,085

*Annualized

(1) See the section titled "GAAP versus Non-GAAP Presentation" that follows.

29

GAAP versus non-GAAP Presentations – The Corporation supplements its traditional GAAP measurements with certain non-GAAP measurements to evaluate its performance and to eliminate the effect of intangible assets. By eliminating intangible assets, the Corporation believes it presents a measurement that is comparable to companies that have no intangible assets or to companies that have eliminated intangible assets in similar calculations. However, not all companies may use the same calculation method for each measurement. The non-GAAP measurements are not intended to be used as a substitute for the related GAAP measurements. The following table shows the calculation of the non-GAAP measurements.

(Dollars in thousands, except per share)	Six months ended June 30, 2016	December 31, 2015	Six months ended June 30, 2015
Return on Average Tangible Assets (non-GAAP)			
Net income	$ 4,288	$ 10,204	$ 5,358
Plus intangible amortization (net of tax)	-	119	119
Net income (non-GAAP)	4,288	10,323	5,477
Average assets	1,066,183	1,021,275	1,011,516
Less average intangible assets	(9,016)	(9,066)	(9,116)
Average assets (non-GAAP)	1,057,167	1,012,209	1,002,400
Return on average tangible assets (non-GAAP)	0.81%	1.02%	1.09%
Return on Tangible Equity (non-GAAP)			
Net income	$ 4,288	$ 10,204	$ 5,358
Plus intangible amortization (net of tax)	-	119	119
Net income (non-GAAP)	4,288	10,323	5,477
Average shareholders' equity	113,452	107,175	105,171
Less average intangible assets	(9,016)	(9,066)	(9,116)
Average shareholders' equity (non-GAAP)	104,436	98,109	96,055
Return on average tangible equity (non-GAAP)	8.21%	10.52%	11.40%
Tangible Book Value (per share) (non-GAAP)			
Shareholders' equity	$ 115,948	$ 111,376	$ 107,178
Less intangible assets	(9,016)	(9,016)	(9,016)
Shareholders' equity (non-GAAP)	106,932	102,360	98,162
Shares outstanding (in thousands)	4,302	4,276	4,241
Tangible book value (non-GAAP)	24.86	23.94	23.15
Efficiency Ratio			
Noninterest expense	$ 15,525	$ 31,136	$ 15,150
Net interest income plus noninterest income	22,803	44,896	22,615
Plus tax equivalent adjustment to net interest income	1,051	2,023	1,016
Less net securities gains (losses), and OTTI	(17)	716	716

Net interest income plus noninterest income	23,871	46,203	22,915
Efficiency ratio	65.04%	67.39%	66.11%

30

Comparison of the three months ended June 30, 2016 to the three months ended June 30, 2015:

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, 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 2016 increased $489 thousand quarter over quarter. Average interest-earning assets increased $53.7 million from 2015, while the yield on these assets decreased to 3.78% in 2016 from 3.80% in 2015. The average balance of investment securities decreased $17.1 million while average loans increased $84.5 million quarter over quarter. Average commercial loans increased $81.2 million and average consumer and home equity loans increased $7.0 million. These increases were partially offset by a decrease of $3.6 million in the average balance of mortgage loans.

Interest expense was $548 thousand for the second quarter, a decrease of $71 thousand from the 2015 total of $619 thousand. Average interest-bearing deposits increased $29.5 million to $799.6 million for the second quarter of 2016 from an average balance of $770.1 million in the same period in 2015. The average cost of these deposits decreased from 0.32% in 2015 to 0.28% in 2016.

Tax equivalent net interest income increased $489 thousand to $9.0 million in the second quarter of 2016 compared to $8.5 million in the same period in 2015. Changes in the balance sheet contributed $732 thousand to this increase, but this was reduced by $243 thousand due to lower rates.

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%.

	For the Three Months Ended June 30,					
	2016			2015		
(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
Interest-earning assets:						
Interest-bearing obligations of other banks and federal funds sold	$ 38,400	$ 79	0.83%	$ 52,114	$ 72	0.55%
Investment securities:						
Taxable	108,168	588	2.19%	121,383	621	2.05%
Tax Exempt	51,679	535	4.14%	55,611	613	4.41%
Investments	159,847	1,123	2.83%	176,994	1,234	2.80%
Loans:						
Commercial, industrial and agricultural	660,177	6,725	4.03%	578,985	6,134	4.22%
Residential mortgage	76,832	768	4.00%	80,474	829	4.14%
Home equity loans and lines	71,413	756	4.26%	63,650	745	4.69%
Consumer	5,715	60	4.22%	6,490	79	4.88%
Loans	814,137	8,309	4.05%	729,599	7,787	4.25%
Total interest-earning assets	1,012,384	$ 9,511	3.78%	958,707	$ 9,093	3.80%
Other assets	67,771			66,770		
Total assets	$ 1,080,155			$ 1,025,477		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing checking	$ 253,299	$ 81	0.13%	$ 227,943	67	0.12%
Money Management	390,985	333	0.34%	382,738	387	0.41%
Savings	73,323	14	0.08%	65,738	12	0.07%
Time	81,957	120	0.59%	93,687	153	0.66%
Total interest-bearing deposits	799,564	548	0.28%	770,106	619	0.32%
Other borrowings	6	-	0.58%	-	-	-
Total interest-bearing liabilities	799,570	548	0.28%	770,106	619	0.32%
Noninterest-bearing deposits	161,209			142,621		
Other liabilities	5,003			6,751		
Shareholders' equity	114,373			105,999		
Total liabilities and shareholders' equity	$ 1,080,155			$ 1,025,477		
T/E net interest income/Net interest margin		8,963	3.56%		8,474	3.55%
Tax equivalent adjustment		(523)			(515)	
Net interest income		$ 8,440			$ 7,959	

32

Provision for Loan Losses

The increase in the provision expense was due to a higher level of charge-offs and growth in the loan portfolio compared to $310 thousand in 2015. Provision expense for the second quarter was $1.9 million. 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 2016, noninterest income decreased $260 thousand from the same period in 2015. Investment and trust service fees decreased due to a decline in estate fees and investment commissions from 2015 to 2016. Loan service charges decreased due to a large prepayment penalty in the second quarter of 2015. Deposit service charges increased due to increased enrollment and use of the Bank's overdraft program. The change in debit card income was due to increased usage by customers in the second quarter of 2016, compared to the same period in 2015.

The following table presents a comparison of noninterest income for the three months ended June 30, 2016 and 2015.

	For the Three Months Ended June 30		Change	
(Dollars in thousands)	2016	2015	Amount	%
Noninterest Income				
Investment and trust services fees	$ 1,218	$ 1,388	$ (170)	(12.2)
Loan service charges	189	314	(125)	(39.8)
Deposit service charges and fees	602	586	16	2.7
Other service charges and fees	313	311	2	0.6
Debit card income	375	356	19	5.3
Increase in cash surrender value of life insurance	132	140	(8)	(5.7)
Net (loss) gain on sale of other real estate owned	(2)	-	(2)	N/A
Securities gains, net	2	8	(6)	(75.0)
Other	27	13	14	107.7
Total noninterest income	$ 2,856	$ 3,116	$ (260)	(8.3)

Noninterest Expense

Noninterest expense for the second quarter of 2016 increased $71 thousand compared to the same period in 2015. The increase in salaries and benefits was primarily due to a $150 thousand increase in salary expense due to merit increases. Legal and professional fees increased due to fees associated with a lawsuit brought against the Corporation in 2015. This lawsuit was more thoroughly described on a Form 8-K that was filed on July 29, 2016. It is expected that the Corporation will incur additional legal expenses until this lawsuit is resolved. The shares tax increase was due to growth in the Bank's balance sheet and shareholders' equity that resulted in a higher premium. Intangible amortization expense decreased as the core deposit intangible was fully amortized as of June 2015. Data processing expenses decreased due to timing of invoices due to a change in vendors. Other expenses decreased due to several one-time expenses the Bank took in the second quarter of 2015 related to branch assets taken out of service.

The following table presents a comparison of noninterest expense for the three months ended June 30, 2016 and 2015:

	For the Three Months Ended			
(Dollars in thousands)	June 30		Change	
Noninterest Expense	2016	2015	Amount	%
Salaries and benefits	$ 4,346	$ 4,203	$ 143	3.4
Net occupancy expense	553	556	(3)	(0.5)
Furniture and equipment expense	218	239	(21)	(8.8)
Advertising	262	283	(21)	(7.4)
Legal and professional fees	394	203	191	94.1
Data processing	504	556	(52)	(9.4)
Pennsylvania bank shares tax	260	206	54	26.2
Intangible amortization	-	90	(90)	(100.0)
FDIC insurance	169	160	9	5.6
ATM/debit card processing	200	186	14	7.5
Foreclosed real estate	13	7	6	85.7
Telecommunications	90	118	(28)	(23.7)
Other	721	852	(131)	(15.4)
Total noninterest expense	$ 7,730	$ 7,659	$ 71	0.9

Provision for Income Taxes

For the second quarter of 2016, the Corporation recorded a Federal income tax expense of $130 thousand compared to $632 thousand for the same quarter in 2015. The effective tax rate was 7.7% for the second quarter of 2016 compared to 20.3% for the same period in 2015. The decrease was due to a reduction in pretax income, due to increased provision expense and nonrecurring items in 2015. The variances from the federal statutory rate are generally due to tax-exempt income from investments, loans and bank-owned life insurance. All taxable income for the Corporation is taxed at a rate of 34%.

Comparison of the six months ended June 30, 2016 to the six months ended June 30, 2015:

Net Interest Income

Tax equivalent net interest income for the first half of 2016 increased $1.2 million year over year. Average interest-earning assets increased $54.5 million from 2015, while the yield on these assets decreased slightly to 3.85% in 2016 from 3.87% in 2015. The average balance of investment securities decreased $17.5 million while average loans increased $80.0 million year over year. Average commercial loans increased $76.6 million and average consumer and home equity loans increased $6.5 million. These increases were partially offset by a decrease of $3.2 million in the average balance of mortgage loans.

Interest expense was $1.1 million for the first half of 2016, a decrease of $167 thousand from the 2015 total of $1.3 million. Average interest-bearing deposits increased $31.8 million to $791.2 million for 2016 from an average balance of $759.4 million in 2015. The average cost of these deposits decreased from 0.33% in 2015 to 0.28% in 2016.

Tax equivalent net interest income increased $1.2 million to $18.0 million in 2016 compared to $16.9 million in 2015. Changes in the balance sheet contributed $1.4 million to this increase, but this was reduced by $210 thousand due to lower rates.

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%.

	For the Six Months Ended June 30,					
	2016			2015		
(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
Interest-earning assets:						
Interest-bearing obligations of other banks and federal funds sold	$ 34,639	$ 141	0.82%	$ 42,577	$ 127	0.60%
Investment securities:						
Taxable	106,962	1,170	2.20%	120,988	1,308	2.18%
Tax Exempt	51,571	1,085	4.21%	55,083	1,225	4.45%
Investments	158,533	2,255	2.86%	176,071	2,533	2.90%
Loans:						
Commercial, industrial and agricultural	651,542	13,548	4.11%	574,924	12,147	4.22%
Residential mortgage	77,727	1,555	4.00%	80,902	1,653	4.10%
Home equity loans and lines	71,166	1,511	4.27%	63,778	1,496	4.73%
Consumer	5,635	128	4.57%	6,478	165	5.14%
Loans	806,070	16,742	4.12%	726,082	15,461	4.25%
Total interest-earning assets	999,242	$ 19,138	3.85%	944,730	$ 18,121	3.87%
Other assets	66,941			66,786		
Total assets	$ 1,066,183			$ 1,011,516		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing checking	$ 245,539	$ 153	0.13%	$ 216,313	120	0.11%
Money Management	390,626	666	0.34%	383,423	803	0.42%
Savings	71,637	27	0.08%	64,487	24	0.08%
Time	83,415	245	0.59%	95,180	313	0.66%
Total interest-bearing deposits	791,217	1,091	0.28%	759,403	1,260	0.33%
Securities sold under agreements to repurchase	-	-	-	50	-	0.15%

Other borrowings	791	2	0.60%	12	-	0.30%
Total interest-bearing liabilities	792,008	1,093	0.28%	759,465	1,260	0.33%
Noninterest-bearing deposits	155,456			139,399		
Other liabilities	5,267			7,481		
Shareholders' equity	113,452			105,171		
Total liabilities and shareholders' equity	$ 1,066,183			$ 1,011,516		
T/E net interest income/Net interest margin		18,045	3.63%		16,861	3.60%
Tax equivalent adjustment		(1,051)			(1,016)	
Net interest income		$ 16,994			$ 15,845	

35

Provision for Loan Losses

The increase in the provision expense was due to a higher level of charge-offs and growth in the loan portfolio compared to $635 thousand in 2015. Provision expense for the first six months of 2016 was $2.2 million. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

Noninterest Income

For the first half of 2016, noninterest income decreased $961 thousand from the same period in 2015. Investment and trust service fees decreased due to a decline in estate fees and insurance commissions from 2015 to 2016. Loan service charges decreased due less loan prepayment fees in 2016, compared to 2015. Deposit service charges increased due to increased enrollment and use of the Bank’s overdraft program. The change in debit card income was due to increased usage by customers in 2016. During 2016, two properties held as other real estate owned were sold at a loss compared to one property sold at a gain in 2015. The Corporation recorded a nonrecurring gain on the conversion of an investment security in 2015. Other income in 2015 included a $171 thousand gain from an investment the Corporation owned in an offshore insurance company that liquidated and paid out the investors.

The following table presents a comparison of noninterest income for the six months ended June 30, 2016 and 2015.

(Dollars in thousands)	For the Six Months Ended June 30 2016	2015	Change Amount	%
Noninterest Income				
Investment and trust services fees	$ 2,472	$ 2,651	$ (179)	(6.8)
Loan service charges	415	496	(81)	(16.3)
Deposit service charges and fees	1,180	1,077	103	9.6
Other service charges and fees	616	607	9	1.5
Debit card income	722	675	47	7.0
Increase in cash surrender value of life insurance	267	279	(12)	(4.3)
Net (loss) gain on sale of other real estate owned	(10)	32	(42)	(131.3)
OTTI losses on debt securities	(20)	(20)	-	-
Gain on conversion of investment security	-	728	(728)	(100.0)
Securities gains, net	3	8	(5)	(62.5)
Other	164	237	(73)	(30.8)
Total noninterest income	$ 5,809	$ 6,770	$ (961)	(14.2)

Noninterest Expense

Noninterest expense for the first half of 2016 increased $375 thousand compared to the same period in 2015. The increase in salaries and benefits was primarily due to a $288 thousand increase in salary expense due to merit increases and $58 thousand for stock option expense, compared to none in 2015. Net occupancy expense decreased compared to prior year due to less expenses for snow removal in 2016. Advertising expense increased due to customer acquisition promotions. Legal and professional fees increased due to fees associated with a lawsuit brought against the Corporation in 2015. This lawsuit was more thoroughly described on a Form 8-K that was filed on July 29, 2016. It is expected that the Corporation will incur additional legal expenses until this lawsuit is resolved. The shares tax increase was due to growth in the Bank's balance sheet and shareholders' equity that resulted in a higher premium. Intangible amortization expense decreased as the core deposit intangible was fully amortized as of June 2015. ATM/Debit card processing increased due to the purchase of EMV debit card inventory. Foreclosed real estate expense increased in 2016, due to a $46 thousand write-down on one property. Other expense decreased due to a one-time expense taken in 2015 to fund a deferred director's compensation plan and several one-time expenses the Bank took in 2015 related to branch assets taken out of service.

The following table presents a comparison of noninterest expense for the six months ended June 30, 2016 and 2015:

(Dollars in thousands) Noninterest Expense	For the Six Months Ended June 30 2016	 2015	Change Amount	 %
Salaries and benefits	$ 8,716	$ 8,286	$ 430	5.2
Net occupancy expense	1,152	1,172	(20)	(1.7)
Furniture and equipment expense	434	470	(36)	(7.7)
Advertising	543	471	72	15.3
Legal and professional fees	691	499	192	38.5
Data processing	1,001	1,023	(22)	(2.2)
Pennsylvania bank shares tax	496	402	94	23.4
Intangible amortization	-	181	(181)	(100.0)
FDIC insurance	326	308	18	5.8
ATM/debit card processing	428	373	55	14.7
Foreclosed real estate	76	19	57	300.0
Telecommunications	209	235	(26)	(11.1)
Other	1,453	1,711	(258)	(15.1)
Total noninterest expense	$ 15,525	$ 15,150	$ 375	2.5

Provision for Income Taxes

For the first half of 2016, the Corporation recorded a Federal income tax expense of $815 thousand compared to $1.5 million for the same period in 2015. The effective tax rate was 16.0% for the first half of 2016 compared to 21.6% for the same period in 2015. The decrease was due to a reduction in pretax income, due to increased provision expense and nonrecurring items in 2015. The variances from the federal statutory rate are generally due to tax-exempt income from investments, loans and bank-owned life insurance. All taxable income for the Corporation is taxed at a rate of 34%.

Financial Condition

Summary:

At June 30, 2016, assets totaled $1.084 billion, an increase of $48.8 million from the 2015 year-end balance of $1.035 billion. Investment securities increased $4.1 million, while net loans increased $44.4 million (5.6%). Deposits increased $47.0 million (5.1%) for the first six months of 2016 due to increases in every deposit category except time deposits. Shareholders' equity increased $4.6 million during the first six months as retained earnings increased $2.6 million, accumulated other comprehensive loss decreased $1.4 million and the Corporation's Dividend Reinvestment Plan (DRIP) added an additional $637 thousand in new capital.

Cash and Cash Equivalents:

Cash and cash equivalents totaled $41.0 million at June 30, 2016, an increase of approximately $2 million from the prior year-end balance of $39.2 million. Interest-bearing deposits are held primarily at the Federal Reserve ($4.6 million) and in short-term bank owned certificates of deposit ($20.6 million).

Investment Securities:

The investment portfolio has increased $2.0 million on a cost basis, since year-end 2015. The composition of the portfolio has remained consistent with municipal securities and U.S. Agency mortgage-backed securities comprising the greatest portion of the portfolio at approximately 43% and 44% of the portfolio fair value, respectively. The Bank invested $16.6 million during the first half of 2016 with the purchases spread between, U.S. Agency mortgage-backed securities and municipal securities. The average life of the portfolio was 3.81 years.

The investment portfolio had a net unrealized gain of $3.2 million at June 30, 2016 compared to $1.1 million at the prior year-end. The increase in the unrealized gain is due primarily to the decline in intermediate and long term interest rates. The portfolio averaged $158.5 million with a yield of 2.86% for the first half of 2016. This compares to an average of $176.1 million and a yield of 2.90% for the same period in 2015.

The Bank holds only one equity security, a Pennsylvania community bank. The municipal bond portfolio is well diversified geographically (issuers from within 30 states) and is comprised primarily of general obligation bonds (74%). Many municipal bonds have credit enhancements in the form of private bond insurance or other credit support. The largest geographic municipal bond exposure is to 16 issuers in the state of Pennsylvania with a fair value of $9.0 million and 15 issuers in the state of Texas with a fair value of $9.2 million. The average rating of the municipal portfolio from Moody's is Aa2. It contains $67.8 million of bonds rated A3 or higher and one bond of $600 thousand that is 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 (PLMBS) 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, 2016 and December 31, 2015 is as follows:

(Dollars in thousands)		Gross	Gross	
	Amortized	unrealized	unrealized	Fair
June 30, 2016	cost	gains	losses	value
Equity securities				