

FRANKLIN FINANCIAL SERVICES CORP /PA/  
Form 10-Q  
November 09, 2012

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, DC 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2012,

OR

**☐ 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<br>incorporation or organization) | (I.R.S. Employer<br>Identification No.) |

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

(Address of principal executive offices)

717/264-6116

(Registrant's telephone number, including area code)

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 4,094,469 outstanding shares of the Registrant's common stock as of October 31, 2012.

## INDEX

|                                                                                                                              |    |
|------------------------------------------------------------------------------------------------------------------------------|----|
| <u>Part I - FINANCIAL INFORMATION</u>                                                                                        | 3  |
| Item 1 - Financial Statements                                                                                                | 3  |
| Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011 (unaudited)                                       | 3  |
| Consolidated Statements of Income for the Three and Nine Months ended September 30, 2012 and 2011 (unaudited)                | 4  |
| Consolidated Statements of Comprehensive Income for the Three and Nine Months ended September 30, 2012 and 2011 (unaudited)  | 5  |
| Consolidated Statements of Changes in Shareholders' Equity for the Nine Months ended September 30, 2012 and 2011 (unaudited) | 6  |
| Consolidated Statements of Cash Flows for the Nine Months ended September 30, 2012 and 2011 (unaudited)                      | 7  |
| Notes to Consolidated Financial Statements (unaudited)                                                                       | 8  |
| Item 2 - Management's Discussion and Analysis of Results of Operations and Financial Condition                               | 33 |
| Item 3 – Quantitative and Qualitative Disclosures about Market Risk                                                          | 61 |
| Item 4 – Controls and Procedures                                                                                             | 61 |
| Part II - OTHER INFORMATION                                                                                                  | 61 |
| Item 1 – Legal Proceedings                                                                                                   | 61 |
| Item 1A – Risk Factors                                                                                                       | 61 |
| Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds                                                         | 61 |
| Item 3 – Defaults Upon Senior Securities                                                                                     | 62 |
| Item 4 – Mine Safety Disclosures                                                                                             | 62 |
| Item 5 – Other Information                                                                                                   | 62 |
| Item 6 – Exhibits                                                                                                            | 62 |
| SIGNATURE PAGE                                                                                                               | 63 |
| EXHIBITS                                                                                                                     |    |



**Part I FINANCIAL INFORMATION****Item 1 Financial Statements****Consolidated Balance Sheets****(Dollars in thousands, except per share data)****(unaudited)**

|                                                         | September 30<br>2012 | December 31<br>2011 |
|---------------------------------------------------------|----------------------|---------------------|
| <b>Assets</b>                                           |                      |                     |
| Cash and due from banks                                 | \$ 16,278            | \$ 16,932           |
| Interest-bearing deposits in other banks                | 87,939               | 17,212              |
| Total cash and cash equivalents                         | 104,217              | 34,144              |
| Investment securities available for sale, at fair value | 134,321              | 125,301             |
| Restricted stock                                        | 4,104                | 5,022               |
| Loans held for sale                                     | 991                  | -                   |
| Loans                                                   | 752,596              | 766,410             |
| Allowance for loan losses                               | (10,113 )            | (9,723 )            |
| Net loans                                               | 742,483              | 756,687             |
| Premises and equipment, net                             | 16,180               | 16,041              |
| Bank owned life insurance                               | 20,766               | 20,273              |
| Goodwill                                                | 9,016                | 9,016               |
| Other intangible assets                                 | 1,231                | 1,558               |
| Other real estate owned                                 | 6,165                | 3,224               |
| Deferred tax assets                                     | 6,103                | 6,384               |
| Other assets                                            | 11,696               | 12,598              |
| Total assets                                            | \$ 1,057,273         | \$ 990,248          |
| <b>Liabilities</b>                                      |                      |                     |
| <b>Deposits</b>                                         |                      |                     |
| Demand (non-interest bearing)                           | \$ 118,180           | \$ 104,245          |
| Savings and interest checking                           | 548,009              | 495,426             |
| Time                                                    | 191,637              | 188,315             |
| Total deposits                                          | 857,826              | 787,986             |
| Securities sold under agreements to repurchase          | 56,151               | 53,103              |
| Long-term debt                                          | 37,922               | 48,336              |
| Other liabilities                                       | 13,670               | 13,641              |
| Total liabilities                                       | 965,569              | 903,066             |

**Shareholders' equity**

|                                                                                                                                                                                                                                          |              |   |            |   |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|---|------------|---|
| Common stock \$1 par value per share, 15,000,000 shares authorized with 4,488,910 shares issued and 4,092,828 shares outstanding at September 30, 2012 and 4,419,258 shares issued and 4,023,084 shares outstanding at December 31, 2011 | 4,489        |   | 4,419      |   |
| Capital stock without par value, 5,000,000 shares authorized with no shares issued or outstanding                                                                                                                                        | -            |   | -          |   |
| Additional paid-in capital                                                                                                                                                                                                               | 35,599       |   | 34,698     |   |
| Retained earnings                                                                                                                                                                                                                        | 62,827       |   | 60,280     |   |
| Accumulated other comprehensive loss                                                                                                                                                                                                     | (4,128       | ) | (5,131     | ) |
| Treasury stock, 396,082 shares at cost at September 30, 2012 and 396,174 shares at cost at December 31, 2011, respectively                                                                                                               | (7,083       | ) | (7,084     | ) |
| Total shareholders' equity                                                                                                                                                                                                               | 91,704       |   | 87,182     |   |
| Total liabilities and shareholders' equity                                                                                                                                                                                               | \$ 1,057,273 |   | \$ 990,248 |   |

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

**Consolidated Statements of Income****(Dollars in thousands, except per share data)****(unaudited)**

|                                                              | For the Three Months<br>Ended<br>September 30 |          | For the Nine Months<br>Ended<br>September 30 |           |
|--------------------------------------------------------------|-----------------------------------------------|----------|----------------------------------------------|-----------|
|                                                              | 2012                                          | 2011     | 2012                                         | 2011      |
| Interest income                                              |                                               |          |                                              |           |
| Loans, including fees                                        | \$ 8,826                                      | \$ 9,413 | \$ 27,035                                    | \$ 28,241 |
| Interest and dividends on investments:                       |                                               |          |                                              |           |
| Taxable interest                                             | 448                                           | 603      | 1,332                                        | 1,821     |
| Tax exempt interest                                          | 380                                           | 353      | 1,112                                        | 1,027     |
| Dividend income                                              | 18                                            | 17       | 53                                           | 67        |
| Deposits and obligations of other banks                      | 56                                            | 17       | 148                                          | 43        |
| Total interest income                                        | 9,728                                         | 10,403   | 29,680                                       | 31,199    |
| Interest expense                                             |                                               |          |                                              |           |
| Deposits                                                     | 1,262                                         | 1,725    | 4,020                                        | 5,153     |
| Securities sold under agreements to repurchase               | 20                                            | 40       | 59                                           | 113       |
| Short-term borrowings                                        | -                                             | -        | -                                            | 1         |
| Long-term debt                                               | 410                                           | 522      | 1,390                                        | 1,837     |
| Total interest expense                                       | 1,692                                         | 2,287    | 5,469                                        | 7,104     |
| Net interest income                                          | 8,036                                         | 8,116    | 24,211                                       | 24,095    |
| Provision for loan losses                                    | 825                                           | 2,775    | 3,600                                        | 5,442     |
| Net interest income after provision for loan losses          | 7,211                                         | 5,341    | 20,611                                       | 18,653    |
| Noninterest income                                           |                                               |          |                                              |           |
| Investment and trust services fees                           | 957                                           | 953      | 2,984                                        | 2,943     |
| Loan service charges                                         | 328                                           | 197      | 869                                          | 909       |
| Mortgage banking activities                                  | (27 )                                         | (53 )    | (8 )                                         | (88 )     |
| Deposit service charges and fees                             | 479                                           | 518      | 1,432                                        | 1,652     |
| Other service charges and fees                               | 209                                           | 164      | 657                                          | 414       |
| Debit card income                                            | 288                                           | 258      | 859                                          | 753       |
| Increase in cash surrender value of life insurance           | 159                                           | 168      | 493                                          | 508       |
| Other                                                        | (157 )                                        | 70       | (15 )                                        | 176       |
| OTTI losses on securities                                    | (162 )                                        | -        | (162 )                                       | (271 )    |
| Loss recognized in other comprehensive income (before taxes) | (112 )                                        | -        | (112 )                                       | (216 )    |
| Net OTTI losses recognized in earnings                       | (50 )                                         | -        | (50 )                                        | (55 )     |
| Securities gains, net                                        | 23                                            | 138      | 44                                           | 150       |

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|                                      |          |          |          |          |
|--------------------------------------|----------|----------|----------|----------|
| Total noninterest income             | 2,209    | 2,413    | 7,265    | 7,362    |
| Noninterest Expense                  |          |          |          |          |
| Salaries and benefits                | 4,141    | 3,796    | 12,097   | 11,392   |
| Net occupancy expense                | 499      | 495      | 1,510    | 1,523    |
| Furniture and equipment expense      | 226      | 194      | 653      | 631      |
| Advertising                          | 315      | 356      | 1,024    | 1,000    |
| Legal and professional fees          | 252      | 287      | 791      | 801      |
| Data processing                      | 382      | 339      | 1,234    | 1,208    |
| Pennsylvania bank shares tax         | 187      | 173      | 560      | 510      |
| Intangible amortization              | 109      | 112      | 327      | 335      |
| FDIC insurance                       | 274      | 256      | 803      | 822      |
| Other                                | 970      | 988      | 2,963    | 3,228    |
| Total noninterest expense            | 7,355    | 6,996    | 21,962   | 21,450   |
| Income before federal income taxes   | 2,065    | 758      | 5,914    | 4,565    |
| Federal income tax expense (benefit) | 318      | (301)    | ) 893    | (102)    |
| Net income                           | \$ 1,747 | \$ 1,059 | \$ 5,021 | \$ 4,667 |
| Per share                            |          |          |          |          |
| Basic earnings per share             | \$ 0.43  | \$ 0.27  | \$ 1.24  | \$ 1.18  |
| Diluted earnings per share           | \$ 0.43  | \$ 0.27  | \$ 1.24  | \$ 1.18  |
| Cash dividends declared per share    | \$ 0.17  | \$ 0.27  | \$ 0.61  | \$ 0.81  |

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

# Consolidated Statements of Comprehensive Income

(Dollars in thousands)

(unaudited)

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

|                                                                       | For the Three<br>Months Ended<br>September 30 |          | For the Nine<br>Months Ended<br>September 30 |          |
|-----------------------------------------------------------------------|-----------------------------------------------|----------|----------------------------------------------|----------|
|                                                                       | 2012                                          | 2011     | 2012                                         | 2011     |
| Net Income                                                            | \$ 1,747                                      | \$ 1,059 | \$ 5,021                                     | \$ 4,667 |
| Securities:                                                           |                                               |          |                                              |          |
| Unrealized gains arising during the period                            | 558                                           | 1,000    | 1,058                                        | 1,683    |
| Reclassification adjustment for losses (gains) included in net income | 27                                            | (138 )   | 6                                            | (95 )    |
| Net unrealized gains                                                  | 585                                           | 862      | 1,064                                        | 1,588    |
| Tax effect                                                            | (199 )                                        | (293 )   | (362 )                                       | (540 )   |
| Net of tax amount                                                     | 386                                           | 569      | 702                                          | 1,048    |
| Derivatives:                                                          |                                               |          |                                              |          |
| Unrealized losses arising during the period                           | (33 )                                         | (525 )   | (97 )                                        | (639 )   |
| Reclassification adjustment for losses included in net income         | 192                                           | 186      | 551                                          | 541      |
| Net unrealized gains (losses)                                         | 159                                           | (339 )   | 454                                          | (98 )    |
| Tax effect                                                            | (53 )                                         | 115      | (153 )                                       | 32       |
| Net of tax amount                                                     | 106                                           | (224 )   | 301                                          | (66 )    |
| Total other comprehensive income                                      | 492                                           | 345      | 1,003                                        | 982      |
| Total Comprehensive Income                                            | \$ 2,239                                      | \$ 1,404 | \$ 6,024                                     | \$ 5,649 |

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

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**Consolidated Statements of Changes in Shareholders' Equity****For the Nine Months Ended September 30, 2012 and 2011****(Dollars in thousands, except per share data)****(unaudited)**

|                                                                                         | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Treasury<br>Stock | Total     |
|-----------------------------------------------------------------------------------------|-----------------|----------------------------------|----------------------|-----------------------------------------------|-------------------|-----------|
| Balance at December 31, 2010                                                            | \$ 4,317        | \$ 33,096                        | \$ 57,984            | \$ (5,642 )                                   | \$ (7,116 )       | \$ 82,639 |
| Net income                                                                              | -               | -                                | 4,667                | -                                             | -                 | 4,667     |
| Unrealized gain on securities, net of<br>reclassification adjustments and taxes         | -               | -                                | -                    | 1,048                                         | -                 | 1,048     |
| Unrealized gain on hedging activities, net of<br>reclassification adjustments and taxes | -               | -                                | -                    | (66 )                                         | -                 | (66 )     |
| Cash dividends declared, \$.81 per share                                                | -               | -                                | (3,193 )             | -                                             | -                 | (3,193 )  |
| Treasury shares issued under stock option<br>plans, 1,776 shares                        | -               | (2 )                             | -                    | -                                             | 32                | 30        |
| Common stock issued under dividend<br>reinvestment plan, 77,963 shares                  | 78              | 1,273                            | -                    | -                                             | -                 | 1,351     |
| Balance at September 30, 2011                                                           | \$ 4,395        | \$ 34,367                        | \$ 59,458            | \$ (4,660 )                                   | \$ (7,084 )       | \$ 86,476 |
| Balance at December 31, 2011                                                            | \$ 4,419        | \$ 34,698                        | \$ 60,280            | \$ (5,131 )                                   | \$ (7,084 )       | \$ 87,182 |
| Net income                                                                              | -               | -                                | 5,021                | -                                             | -                 | 5,021     |
| Unrealized gain on securities, net of<br>reclassification adjustments and taxes         | -               | -                                | -                    | 702                                           | -                 | 702       |
| Unrealized gain on hedging activities, net of<br>reclassification adjustments and taxes | -               | -                                | -                    | 301                                           | -                 | 301       |
| Cash dividends declared, \$.61 per share                                                | -               | -                                | (2,474 )             | -                                             | -                 | (2,474 )  |
| Common stock issued under stock option<br>plans, 92 shares                              | -               | -                                | -                    | -                                             | 1                 | 1         |
| Common stock issued under dividend<br>reinvestment plan, 69,652 shares                  | 70              | 901                              | -                    | -                                             | -                 | 971       |
| Balance at September 30, 2012                                                           | \$ 4,489        | \$ 35,599                        | \$ 62,827            | \$ (4,128 )                                   | \$ (7,083 )       | \$ 91,704 |

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



**Consolidated Statements of Cash Flows****(Dollars in thousands)****(unaudited)**

|                                                                                   | For the Nine Months Ended September 30 |          |
|-----------------------------------------------------------------------------------|----------------------------------------|----------|
|                                                                                   | 2012                                   | 2011     |
| Cash flows from operating activities                                              |                                        |          |
| Net income                                                                        | \$ 5,021                               | \$ 4,667 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                        |          |
| Depreciation and amortization                                                     | 1,053                                  | 1,056    |
| Net amortization of loans and investment securities                               | 1,060                                  | 606      |
| Amortization and net change in mortgage servicing rights valuation                | 116                                    | 214      |
| Amortization of intangibles                                                       | 327                                    | 335      |
| Provision for loan losses                                                         | 3,600                                  | 5,442    |
| Net realized gains on sales of securities                                         | (44)                                   | (150)    |
| OTTI losses on securities                                                         | 50                                     | 55       |
| Loans originated for sale                                                         | (10,241)                               | -        |
| Proceeds from sale of loans                                                       | 9,250                                  | -        |
| Net loss (gain) on sale or disposal of other real estate/other repossessed assets | 169                                    | (26)     |
| Increase in cash surrender value of life insurance                                | (493)                                  | (508)    |
| Contribution to pension plan                                                      | (783)                                  | (1,942)  |
| Decrease in interest receivable and other assets                                  | 2,549                                  | 1,723    |
| Decrease in interest payable and other liabilities                                | (1,160)                                | (2,194)  |
| Other, net                                                                        | 184                                    | (338)    |
| Net cash provided by operating activities                                         | 10,658                                 | 8,940    |
| Cash flows from investing activities                                              |                                        |          |
| Proceeds from sales of investment securities available for sale                   | 516                                    | 4,966    |
| Proceeds from maturities and paydowns of investment securities available for sale | 27,330                                 | 16,537   |
| Purchase of investment securities available for sale                              | (36,598)                               | (34,221) |
| Net decrease in restricted stock                                                  | 918                                    | 874      |
| Net decrease (increase) in loans                                                  | 6,601                                  | (26,771) |
| Proceeds from sale of other real estate/other repossessed assets                  | 788                                    | 296      |
| Capital expenditures                                                              | (1,112)                                | (588)    |
| Net cash used in investing activities                                             | (1,557)                                | (38,907) |
| Cash flows from financing activities                                              |                                        |          |
|                                                                                   | 66,518                                 | 52,255   |

|                                                                                 |            |   |           |   |
|---------------------------------------------------------------------------------|------------|---|-----------|---|
| Net increase in demand deposits, interest-bearing checking and savings accounts |            |   |           |   |
| Net increase in time deposits                                                   | 3,322      |   | 2,760     |   |
| Net increase in short-term borrowings                                           | 3,048      |   | 12,052    |   |
| Long-term debt payments                                                         | (10,414    | ) | (21,993   | ) |
| Dividends paid                                                                  | (2,474     | ) | (3,193    | ) |
| Common stock issued under dividend reinvestment plan                            | 971        |   | 1,351     |   |
| Common stock issued under stock option plans                                    | 1          |   | 30        |   |
| Net cash provided by financing activities                                       | 60,972     |   | 43,262    |   |
| Increase in cash and cash equivalents                                           | 70,073     |   | 13,295    |   |
| Cash and cash equivalents at beginning of period                                | 34,144     |   | 22,106    |   |
| Cash and cash equivalents at end of period                                      | \$ 104,217 |   | \$ 35,401 |   |

Supplemental Disclosures of Cash Flow Information

Cash paid during the year for:

|                                               |          |          |
|-----------------------------------------------|----------|----------|
| Interest on deposits and other borrowed funds | \$ 5,453 | \$ 7,056 |
| Income taxes                                  | \$ 0     | \$ 2,425 |
| Noncash Activities                            |          |          |
| Loans transferred to Other Real Estate        | \$ 3,909 | \$ 3,518 |

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

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Franklin Financial Services Corporation (the Corporation), and its wholly-owned subsidiaries, Farmers and Merchants Trust Company of Chambersburg (the Bank) and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank that has one wholly-owned subsidiary, Franklin Financial Properties Corp. During the first quarter of 2012, Franklin Realty Services Corporation (an inactive real-estate brokerage company and subsidiary of the Bank as of December 31, 2011) merged with Franklin Financial Properties Corp. (a subsidiary of the Corporation at December 31, 2011) with Franklin Financial Properties Corp. becoming the surviving entity and subsidiary of the Bank. Franklin Financial Property Corp. holds real estate assets that are leased by the Bank. Franklin Future Fund Inc. is a non-bank investment company. The activities of non-bank entities are not significant to the consolidated totals. All significant intercompany transactions and account balances have been eliminated.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of September 30, 2012, 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 2011 Annual Report on Form 10-K. The consolidated results of operations for the period ended September 30, 2012 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, 2011 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<br>September 30 |          | For the Nine Months Ended<br>September 30 |          |
|-----------------------------------------------------|--------------------------------------------|----------|-------------------------------------------|----------|
| (In thousands, except per share data)               | 2012                                       | 2011     | 2012                                      | 2011     |
| Weighted average shares outstanding (basic)         | 4,083                                      | 3,971    | 4,063                                     | 3,946    |
| Impact of common stock equivalents                  | 3                                          | -        | 1                                         | 3        |
| Weighted average shares outstanding (diluted)       | 4,086                                      | 3,971    | 4,064                                     | 3,949    |
| Anti-dilutive options excluded from the calculation | 72                                         | 97       | 93                                        | 70       |
| Net income                                          | \$ 1,747                                   | \$ 1,059 | \$ 5,021                                  | \$ 4,667 |
| Basic earnings per share                            | \$ 0.43                                    | \$ 0.27  | \$ 1.24                                   | \$ 1.18  |
| Diluted earnings per share                          | \$ 0.43                                    | \$ 0.27  | \$ 1.24                                   | \$ 1.18  |

## Note 2 – Recent Accounting Pronouncements

**Testing Indefinite-Lived Intangible Assets for Impairment.** In July, 2012, the FASB issued ASU 2012-02, “Testing Indefinite-Lived Intangible Assets for Impairment.” Similar to ASU 2011-08, “Intangibles – Goodwill and Other (Topic 250) – Testing Goodwill for Impairment”, ASU 2012-20 addresses the growing cost and complexity of performing an analysis to evaluate indefinite-lived intangible assets (other than goodwill) for impairment. Rather than requiring a purely quantitative impairment test, the ASU provides entities with the option to first examine qualitative factors, such as economic conditions and cash flow trends, to make this determination. Entities are required by the guidance to consider both positive and negative impacts of such factors before determining whether it is more-likely-than-not (i.e. greater than 50% probability) that the indefinite-lived asset is impaired. It should be noted that the qualitative portion of the analysis is optional for all issuers. This ASU is effective for impairment tests performed during fiscal years beginning after September 15, 2012, and may be early adopted if the entity’s financial statements for the most recent fiscal or interim period have not yet been issued. The Corporation is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

**Testing Goodwill for Impairment.** In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-08, Testing Goodwill for Impairment. The purpose of this ASU is to simplify how entities test goodwill for impairment by adding a new first step to the pre-existing goodwill impairment test under Accounting Standards Codification (ASC) Topic 350, Intangibles – Goodwill and other. This amendment gives the entity the option to first assess a variety of qualitative factors such as economic conditions, cash flows, and competition to determine whether it was more likely than not that the fair value of goodwill has fallen below its carrying value. If the entity determines that it is not likely that the fair value has fallen below its carrying value, then the entity will not have to complete the original two-step test under Topic 350. The amendments in this ASU are effective for impairment tests performed for fiscal years beginning after December 15, 2011.

The Corporation tests goodwill for impairment annually as of August 31. Due to the financial performance of the Corporation, its stock price as compared to book value, and the overall economic forecast, the Corporation did not make an assessment of impairment using the qualitative factors provided for in ASU 2011-08. The impairment test for August 31, 2012 was performed by an independent third-party using the two-step process under Topic 350. Step-one of the test used multiple valuation approaches that Management reviewed to reach its determination that goodwill was

not impaired as of August 31, 2012. Therefore, a step-two valuation was not required. If goodwill is determined to be impaired, an impairment write-down is charged to results of operations in the period in which the impairment is determined.

**Note 3 – Accumulated Other Comprehensive Loss**

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

| (Dollars in thousands)                     | September 30,<br>2012 | December 31,<br>2011 |
|--------------------------------------------|-----------------------|----------------------|
| Net unrealized gains on securities         | \$ 2,491              | \$ 1,427             |
| Tax effect                                 | (847 )                | (485 )               |
| Net of tax amount                          | 1,644                 | 942                  |
| Net unrealized losses on derivatives       | (1,284 )              | (1,738 )             |
| Tax effect                                 | 437                   | 590                  |
| Net of tax amount                          | (847 )                | (1,148 )             |
| Accumulated pension adjustment             | (7,462 )              | (7,462 )             |
| Tax effect                                 | 2,537                 | 2,537                |
| Net of tax amount                          | (4,925 )              | (4,925 )             |
| Total accumulated other comprehensive loss | \$ (4,128 )           | \$ (5,131 )          |

**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 \$28.1 million and \$28.2 million of standby letters of credit as of September 30, 2012 and December 31, 2011, respectively. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of September 30, 2012 and December 31, 2011 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 September 30, 2012 and December 31, 2011 are:

| (Dollars in thousands)                   | Amortized  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|------------------------------------------|------------|------------------------------|-------------------------------|---------------|
| September 30, 2012                       | Cost       |                              |                               |               |
| Equity securities                        | \$ 2,104   | \$ 92                        | \$ (228)                      | ) \$ 1,968    |
| U.S. Government agency securities        | 12,974     | 136                          | (14)                          | ) 13,096      |
| Municipal securities                     | 58,183     | 3,210                        | (122)                         | ) 61,271      |
| Corporate debt securities                | 1,006      | -                            | (21)                          | ) 985         |
| Trust preferred securities               | 5,901      | -                            | (1,200)                       | ) 4,701       |
| Agency mortgage-backed securities        | 48,892     | 992                          | (141)                         | ) 49,743      |
| Private-label mortgage-backed securities | 2,710      | -                            | (201)                         | ) 2,509       |
| Asset-backed securities                  | 60         | -                            | (12)                          | ) 48          |
|                                          | \$ 131,830 | \$ 4,430                     | \$ (1,939)                    | ) \$ 134,321  |

| (Dollars in thousands)                   | Amortized  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|------------------------------------------|------------|------------------------------|-------------------------------|---------------|
| December 31, 2011                        | Cost       |                              |                               |               |
| Equity securities                        | \$ 2,105   | \$ 11                        | \$ (357)                      | ) \$ 1,759    |
| U.S. Government agency securities        | 13,159     | 75                           | (5)                           | ) 13,229      |
| Municipal securities                     | 42,490     | 2,598                        | (7)                           | ) 45,081      |
| Corporate debt securities                | 2,484      | 49                           | (119)                         | ) 2,414       |
| Trust preferred securities               | 5,890      | -                            | (1,272)                       | ) 4,618       |
| Agency mortgage-backed securities        | 54,314     | 1,159                        | (188)                         | ) 55,285      |
| Private-label mortgage-backed securities | 3,366      | 1                            | (500)                         | ) 2,867       |
| Asset-backed securities                  | 66         | -                            | (18)                          | ) 48          |
|                                          | \$ 123,874 | \$ 3,893                     | \$ (2,466)                    | ) \$ 125,301  |

The amortized cost of securities pledged as collateral to secure various funding sources was \$117.4 million at September 30, 2012 and \$112.1 million at December 31, 2011.

The amortized cost and fair value of debt securities as of September 30, 2012, 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<br>Cost | Fair<br>Value |
|----------------------------------------|-------------------|---------------|
| Due in one year or less                | \$ 4,672          | \$ 4,687      |
| Due after one year through five years  | 13,829            | 14,678        |
| Due after five years through ten years | 21,003            | 22,111        |
| Due after ten years                    | 38,620            | 38,625        |
|                                        | 78,124            | 80,101        |
| Mortgage-backed securities             | 51,602            | 52,252        |
|                                        | \$ 129,726        | \$ 132,353    |

At September 30, 2012, the investment portfolio contained 68 securities with \$35.9 million of temporarily impaired fair value and \$1.9 million in unrealized losses. The unrealized loss position is less than at year-end 2011, but there are more securities with an unrealized loss and the temporarily impaired fair value is higher due to an increase in the fair value of municipal bonds with an unrealized loss. The trust preferred sector continues to show the largest unrealized loss at \$1.2 million on seven securities, virtually unchanged from the prior-year end.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for “other-than-temporary” impairment. In the case of debt securities, investments considered for “other-than-temporary” impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. Accordingly, the impairments identified on debt and equity securities and subjected to the assessment at September 30, 2012 were deemed to be temporary and required no further adjustment to the financial statements, unless otherwise noted.

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of September 30, 2012 and December 31, 2011:

| (Dollars in thousands)                   | September 30, 2012  |                   |        |                   |                   |        |            |                   |        |
|------------------------------------------|---------------------|-------------------|--------|-------------------|-------------------|--------|------------|-------------------|--------|
|                                          | Less than 12 months |                   |        | 12 months or more |                   |        | Total      |                   |        |
|                                          | Fair Value          | Unrealized Losses | Number | Fair Value        | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Equity securities                        | \$242               | \$ (3 )           | 3      | \$1,247           | \$ (225 )         | 13     | \$1,489    | \$ (228 )         | 16     |
| U.S. Government agency securities        | 5,297               | (12 )             | 5      | 1,235             | (2 )              | 4      | 6,532      | (14 )             | 9      |
| Municipal securities                     | 7,550               | (122 )            | 8      | -                 | -                 | -      | 7,550      | (122 )            | 8      |
| Corporate debt securities                | -                   | -                 | -      | 985               | (21 )             | 1      | 985        | (21 )             | 1      |
| Trust preferred securities               | -                   | -                 | -      | 4,701             | (1,200 )          | 7      | 4,701      | (1,200 )          | 7      |
| Agency mortgage-backed securities        | 5,430               | (75 )             | 7      | 6,616             | (66 )             | 11     | 12,046     | (141 )            | 18     |
| Private-label mortgage-backed securities | -                   | -                 | -      | 2,509             | (201 )            | 6      | 2,509      | (201 )            | 6      |
| Asset-backed securities                  | -                   | -                 | -      | 49                | (12 )             | 3      | 49         | (12 )             | 3      |
| Total temporarily impaired securities    | \$18,519            | \$ (212 )         | 23     | \$17,342          | \$ (1,727 )       | 45     | \$35,861   | \$ (1,939 )       | 68     |

December 31, 2011

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| (Dollars in thousands)                   | Less than 12 months |                   |        | 12 months or more |                   |        | Total      |                   |        |
|------------------------------------------|---------------------|-------------------|--------|-------------------|-------------------|--------|------------|-------------------|--------|
|                                          | Fair Value          | Unrealized Losses | Number | Fair Value        | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Equity securities                        | \$394               | \$ (111 )         | 3      | \$864             | \$ (246 )         | 13     | \$1,258    | \$ (357 )         | 16     |
| U.S. Government agency securities        | 6,068               | (3 )              | 5      | 1,321             | (2 )              | 5      | 7,389      | (5 )              | 10     |
| Municipal securities                     | 579                 | (7 )              | 1      | -                 | -                 | -      | 579        | (7 )              | 1      |
| Corporate debt securities                | -                   | -                 | -      | 1,889             | (119 )            | 2      | 1,889      | (119 )            | 2      |
| Trust preferred securities               | -                   | -                 | -      | 4,618             | (1,272 )          | 7      | 4,618      | (1,272 )          | 7      |
| Agency mortgage-backed securities        | 12,452              | (156 )            | 12     | 1,174             | (32 )             | 1      | 13,626     | (188 )            | 13     |
| Private-label mortgage-backed securities | 1,057               | (36 )             | 2      | 1,636             | (464 )            | 4      | 2,693      | (500 )            | 6      |
| Asset-backed securities                  | -                   | -                 | -      | 48                | (18 )             | 3      | 48         | (18 )             | 3      |
| Total temporarily impaired securities    | \$20,550            | \$ (313 )         | 23     | \$11,550          | \$ (2,153 )       | 35     | \$32,100   | \$ (2,466 )       | 58     |

The trust preferred portfolio contains the largest unrealized loss in the portfolio. At September 30, 2012 this sector contained seven securities with a fair value of \$4.7 million and an unrealized loss of \$1.2 million. These values are virtually unchanged from the prior year-end. 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) from companies that received money (and in some cases paid back) from the Troubled Asset Relief Program (TARP), continue to pay dividends and have raised capital. None of these bonds have suspended or missed a dividend payment. At September 30, 2012, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded.

The following table provides additional detail about trust preferred securities as of September 30, 2012:

Trust Preferred Securities  
(Dollars in thousands)

| Deal Name               | Single Issuer or Pooled | Class           | Amortized Cost | Fair Value | Gross Unrealized Gain (Loss) | Lowest Credit Rating Assigned | Number of Banks | Deferrals and Defaults % of Original Collateral | Expected Deferral/ Defaults as a Percentage of Remaining Performing Collateral |
|-------------------------|-------------------------|-----------------|----------------|------------|------------------------------|-------------------------------|-----------------|-------------------------------------------------|--------------------------------------------------------------------------------|
| Huntington Cap Trust    | Single                  | Preferred Stock | \$932          | \$745      | \$(187)                      | B                             | 1               | None                                            | None                                                                           |
| Huntington Cap Trust II | Single                  | Preferred Stock | 879            | 707        | (172)                        | B                             | 1               | None                                            | None                                                                           |
| BankAmerica Cap III     | Single                  | Preferred Stock | 958            | 721        | (237)                        | BB                            | 1               | None                                            | None                                                                           |
| Wachovia Cap Trust II   | Single                  | Preferred Stock | 274            | 225        | (49)                         | Baa2                          | 1               | None                                            | None                                                                           |
| Corestates Cap Tr II    | Single                  | Preferred Stock | 928            | 806        | (122)                        | Baa1                          | 1               | None                                            | None                                                                           |
| Chase Cap VI JPM        | Single                  | Preferred Stock | 958            | 763        | (195)                        | BBB                           | 1               | None                                            | None                                                                           |
| Fleet Cap Tr V          | Single                  | Preferred Stock | 972            | 734        | (238)                        | BB                            | 1               | None                                            | None                                                                           |
|                         |                         |                 | \$5,901        | \$4,701    | \$(1,200)                    |                               |                 |                                                 |                                                                                |

The Private Label Mortgage-Backed Securities (PLMBS) sector shows an unrealized loss of \$201 thousand, an improvement over the \$500 thousand unrealized loss at December 31, 2011. These bonds were all rated AAA at time of purchase, but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days

or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. As a result of the analysis on PLMBS it was determined that an other-than-temporary impairment charge was required on two bonds for a total of \$50 thousand during the quarter ended September 30, 2012. The Bank has recorded \$440 thousand of cumulative other-than-temporary impairment charges on this portfolio. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. The Bank is currently participating in a class-action lawsuit against one PLMBS servicer that centers on defective warranties and representations made as part of the underwriting process. See the PLMBS table for additional information.

The following table provides additional detail about private label mortgage-backed securities as of September 30, 2012:

Private Label Mortgage Backed Securities  
(Dollars in thousands)

| Decsription      | Orgination<br>Date | Amortized<br>Cost | Fair<br>Value | Gross<br>Unrealized<br>Gain<br>(Loss) | Collateral<br>Type | Lowest Credit<br>Rating Assigned | Credit<br>Support<br>% | Cummulative<br>OTTI<br>Charges |
|------------------|--------------------|-------------------|---------------|---------------------------------------|--------------------|----------------------------------|------------------------|--------------------------------|
| RALI 2004-QS4 A7 | 3/1/2004           | \$ 358            | \$356         | \$ (2 )                               | ALT A              | AA                               | 12.31                  | \$ -                           |
| MALT 2004-6 7A1  | 6/1/2004           | 559               | 536           | (23 )                                 | ALT A              | B                                | 11.92                  | -                              |
| RALI 2005-QS2 A1 | 2/1/2005           | 475               | 475           | -                                     | ALT A              | CC                               | 7.06                   | -                              |
| RALI 2006-QS4 A2 | 4/1/2006           | 752               | 638           | (114 )                                | ALT A              | D                                | -                      | 253                            |
| GSR 2006-5F 2A1  | 5/1/2006           | 168               | 154           | (14 )                                 | Prime              | C                                | 0.79                   | -                              |
| RALI 2006-QS8 A1 | 7/28/2006          | 398               | 350           | (48 )                                 | ALT A              | D                                | -                      | 187                            |
|                  |                    | \$ 2,710          | \$2,509       | \$ (201 )                             |                    |                                  |                        | \$ 440                         |

The following table represents the cumulative credit losses on securities recognized in earnings as of September 30, 2012.

| (Dollars in thousands)                                                                              | Nine Months<br>Ended<br>September 30,<br>2012 |
|-----------------------------------------------------------------------------------------------------|-----------------------------------------------|
| Balance of cumulative credit losses on securities, January 1, 2012                                  | \$ 390                                        |
| Additions for credit losses recorded which were not previously recognized as components of earnings | 50                                            |
| Balance of cumulative credit losses on securities, September 30, 2012                               | \$ 440                                        |

The Bank held \$4.1 million of restricted stock at September 30, 2012. Except for \$30 thousand, this investment represents stock in Federal Home Loan Bank (FHLB) of 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. In December 2008, FHLB announced it would suspend its regular cash dividend and the regular repurchase of excess capital stock from its members as part of its capital restoration plan. However, FHLB has made stock repurchases of \$918 thousand during the year. In addition, FHLB paid a small dividend in 2012. Despite these actions, it does not appear as if FHLB has resumed its past practice of redeeming excess capital stock on a regular basis or paying a regular dividend. 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**

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

| (Dollars in thousands)                              | September 30, 2012 | December 31, 2011 | Change<br>Amount | %      |
|-----------------------------------------------------|--------------------|-------------------|------------------|--------|
| Residential Real Estate 1-4 Family                  |                    |                   |                  |        |
| Consumer first liens                                | \$ 88,525          | \$ 86,767         | \$1,758          | 2.0    |
| Consumer junior liens and lines of credit           | 36,124             | 40,290            | (4,166 )         | (10.3) |
| Total consumer                                      | 124,649            | 127,057           | (2,408 )         | (1.9 ) |
| Commercial first lien                               | 59,705             | 55,130            | 4,575            | 8.3    |
| Commercial junior liens and lines of credit         | 7,061              | 7,846             | (785 )           | (10.0) |
| Total                                               | 66,766             | 62,976            | 3,790            | 6.0    |
| Total residential real estate 1-4 family            | 191,415            | 190,033           | 1,382            | 0.7    |
| Residential real estate - construction              |                    |                   |                  |        |
| Consumer purpose                                    | 2,086              | 1,381             | 705              | 51.0   |
| Commercial purpose                                  | 13,707             | 19,901            | (6,194 )         | (31.1) |
| Total residential real estate construction          | 15,793             | 21,282            | (5,489 )         | (25.8) |
| Commercial, industrial and agricultural real estate | 366,341            | 358,974           | 7,367            | 2.1    |
| Commercial, industrial and agricultural             | 167,310            | 182,694           | (15,384 )        | (8.4 ) |
| Consumer                                            | 11,737             | 13,427            | (1,690 )         | (12.6) |
|                                                     | 752,596            | 766,410           | (13,814)         | (1.8 ) |
| Less: Allowance for loan losses                     | (10,113 )          | (9,723 )          | (390 )           | 4.0    |
| Net Loans                                           | \$ 742,483         | \$ 756,687        | \$(14,204)       | (1.9 ) |

Included in the loan balances are the following:

|                                         |         |         |
|-----------------------------------------|---------|---------|
| Net unamortized deferred loan costs     | \$280   | \$426   |
| Unamortized discount on purchased loans | \$(133) | \$(167) |

Loans pledged as collateral for borrowings and commitments from:

|                      |           |           |
|----------------------|-----------|-----------|
| FHLB                 | \$600,504 | \$679,272 |
| Federal Reserve Bank | 102,781   | 27,435    |
|                      | \$703,285 | \$706,707 |

**Note 7 – Loan Quality**

The following table presents, by loan segment, the Allowance for Loan Losses (ALL) for the periods ended:

| (Dollars in thousands)    | Residential Real Estate 1-4 Family |                                         |              | Commercial<br>Industrial<br>&<br>Agricultural |              | Commercial<br>Industrial<br>&<br>Consumer |  | Total    |
|---------------------------|------------------------------------|-----------------------------------------|--------------|-----------------------------------------------|--------------|-------------------------------------------|--|----------|
|                           | First<br>Liens                     | Junior Liens<br>&<br>Lines of<br>Credit | Construction | Real Estate                                   | Agricultural |                                           |  |          |
| ALL at June 30, 2012      | \$ 777                             | \$ 321                                  | \$ 925       | \$ 5,839                                      | \$ 1,564     | \$ 201                                    |  | \$9,627  |
| Charge-offs               | (71 )                              | -                                       | -            | (159 )                                        | (73 )        | (61 )                                     |  | (364 )   |
| Recoveries                | -                                  | -                                       | -            | 2                                             | 10           | 13                                        |  | 25       |
| Provision                 | 157                                | (3 )                                    | (8 )         | 269                                           | 359          | 51                                        |  | 825      |
| ALL at September 30, 2012 | \$ 863                             | \$ 318                                  | \$ 917       | \$ 5,951                                      | \$ 1,860     | \$ 204                                    |  | \$10,113 |
| ALL at December 31, 2011  | \$ 1,049                           | \$ 308                                  | \$ 1,222     | \$ 5,257                                      | \$ 1,651     | \$ 236                                    |  | \$9,723  |
| Charge-offs               | (251 )                             | (65 )                                   | -            | (2,413 )                                      | (418 )       | (183 )                                    |  | (3,330 ) |
| Recoveries                | -                                  | 25                                      | -            | 11                                            | 17           | 67                                        |  | 120      |
| Provision                 | 65                                 | 50                                      | (305 )       | 3,096                                         | 610          | 84                                        |  | 3,600    |
| ALL at September 30, 2012 | \$ 863                             | \$ 318                                  | \$ 917       | \$ 5,951                                      | \$ 1,860     | \$ 204                                    |  | \$10,113 |
| ALL at June 30, 2011      | \$ 529                             | \$ 313                                  | \$ 2,392     | \$ 4,644                                      | \$ 1,861     | \$ 411                                    |  | \$10,150 |
| Charge-offs               | (144 )                             | (9 )                                    | (1,543 )     | (2,065 )                                      | (19 )        | (44 )                                     |  | (3,824 ) |
| Recoveries                | 2                                  | 5                                       | -            | 61                                            | 7            | 19                                        |  | 94       |
| Provision                 | 767                                | 22                                      | -            | 1,700                                         | 286          | -                                         |  | 2,775    |
| ALL at September 30, 2011 | \$ 1,154                           | \$ 331                                  | \$ 849       | \$ 4,340                                      | \$ 2,135     | \$ 386                                    |  | \$9,195  |
| ALL at December 31, 2010  | \$ 600                             | \$ 352                                  | \$ 2,596     | \$ 3,358                                      | \$ 1,578     | \$ 317                                    |  | \$8,801  |
| Charge-offs               | (296 )                             | (186 )                                  | (2,280 )     | (2,487 )                                      | (60 )        | (158 )                                    |  | (5,467 ) |
| Recoveries                | 30                                 | 10                                      | -            | 301                                           | 11           | 67                                        |  | 419      |
| Provision                 | 820                                | 155                                     | 533          | 3,168                                         | 606          | 160                                       |  | 5,442    |
| ALL at September 30, 2011 | \$ 1,154                           | \$ 331                                  | \$ 849       | \$ 4,340                                      | \$ 2,135     | \$ 386                                    |  | \$9,195  |
| ALL at December 31, 2010  | \$ 600                             | \$ 352                                  | \$ 2,596     | \$ 3,358                                      | \$ 1,578     | \$ 317                                    |  | \$8,801  |
| Charge-offs               | (324 )                             | (202 )                                  | (2,352 )     | (3,817 )                                      | (115 )       | (237 )                                    |  | (7,047 ) |
| Recoveries                | 30                                 | 10                                      | -            | 306                                           | 11           | 88                                        |  | 445      |
| Provision                 | 743                                | 148                                     | 978          | 5,410                                         | 177          | 68                                        |  | 7,524    |

|                          |          |        |          |          |          |        |         |
|--------------------------|----------|--------|----------|----------|----------|--------|---------|
| ALL at December 31, 2011 | \$ 1,049 | \$ 308 | \$ 1,222 | \$ 5,257 | \$ 1,651 | \$ 236 | \$9,723 |
|--------------------------|----------|--------|----------|----------|----------|--------|---------|

The following table presents, by loan segment, loans that were evaluated for the ALL under the specific reserve (individually) and those that were evaluated under the general reserve (collectively) as of September 30, 2012 and December 31, 2011.

| (Dollars in thousands)               | Residential Real Estate 1-4 Family | Commercial Industrial & Agricultural Real Estate | Commercial Industrial & Agricultural Consumer | Total      |
|--------------------------------------|------------------------------------|--------------------------------------------------|-----------------------------------------------|------------|
|                                      | First Liens                        | Junior Liens & Lines of Credit                   | Construction                                  |            |
| September 30, 2012                   |                                    |                                                  |                                               |            |
| Loans evaluated for allowance:       |                                    |                                                  |                                               |            |
| Individually                         | \$ 3,789                           | \$ 740                                           | \$ 571                                        | \$ 27,729  |
| Collectively                         | 144,441                            | 42,445                                           | 15,222                                        | 338,612    |
| Total                                | \$ 148,230                         | \$ 43,185                                        | \$ 15,793                                     | \$ 366,341 |
| ALL established for loans evaluated: |                                    |                                                  |                                               |            |
| Individually                         | \$ -                               | \$ -                                             | \$ -                                          | \$ 400     |
| Collectively                         | 863                                | 318                                              | 917                                           | 5,551      |
| ALL at September 30, 2012            | \$ 863                             | \$ 318                                           | \$ 917                                        | \$ 5,951   |
| December 31, 2011                    |                                    |                                                  |                                               |            |
| Loans evaluated for allowance:       |                                    |                                                  |                                               |            |
| Individually                         | \$ 3,899                           | \$ 162                                           | \$ 43                                         | \$ 21,622  |
| Collectively                         | 137,998                            | 47,974                                           | 21,239                                        | 337,352    |
| Total                                | \$ 141,897                         | \$ 48,136                                        | \$ 21,282                                     | \$ 358,974 |
| ALL established for loans evaluated: |                                    |                                                  |                                               |            |
| Individually                         | \$ 495                             | \$ 3                                             | \$ -                                          | \$ 1,591   |
| Collectively                         | 554                                | 305                                              | 1,222                                         | 3,666      |
| ALL at December 31, 2011             | \$ 1,049                           | \$ 308                                           | \$ 1,222                                      | \$ 5,257   |

The following table shows additional information about those loans considered to be impaired at September 30, 2012 and December 31, 2011:

Impaired Loans

With Allowance

| (Dollars in thousands)                              | With No Allowance   |                   | Unpaid              |                   | Related Allowance |
|-----------------------------------------------------|---------------------|-------------------|---------------------|-------------------|-------------------|
|                                                     | Recorded Investment | Principal Balance | Recorded Investment | Principal Balance |                   |
| September 30, 2012                                  |                     |                   |                     |                   |                   |
| Residential Real Estate                             |                     |                   |                     |                   |                   |
| First liens                                         | \$3,729             | \$4,068           | \$60                | \$64              | \$ -              |
| Junior liens and lines of credit                    | 686                 | 691               | 54                  | 58                | -                 |
| Total                                               | 4,415               | 4,759             | 114                 | 122               | -                 |
| Residential real estate - construction              | 571                 | 581               | -                   | -                 | -                 |
| Commercial, industrial and agricultural real estate | 24,807              | 28,607            | 2,922               | 3,485             | 400               |
| Commercial, industrial and agricultural             | 2,516               | 2,596             | 1,570               | 1,680             | 845               |
| Consumer                                            | -                   | -                 | -                   | -                 | -                 |
| Total                                               | \$32,309            | \$36,543          | \$4,606             | \$5,287           | \$1,245           |
| December 31, 2011                                   |                     |                   |                     |                   |                   |
| Residential Real Estate                             |                     |                   |                     |                   |                   |
| First liens                                         | \$176               | \$177             | \$3,723             | \$3,867           | \$495             |
| Junior liens and lines of credit                    | 28                  | 30                | 134                 | 134               | 3                 |
| Total                                               | 204                 | 207               | 3,857               | 4,001             | 498               |
| Residential real estate - construction              | -                   | -                 | 43                  | 43                | -                 |
| Commercial, industrial and agricultural real estate | 11,072              | 12,092            | 10,550              | 12,050            | 1,591             |
| Commercial, industrial and agricultural             | 94                  | 109               | 2,214               | 2,352             | 870               |
| Consumer                                            | -                   | -                 | -                   | -                 | -                 |
| Total                                               | \$11,370            | \$12,408          | \$16,664            | \$18,446          | \$2,959           |

The following table shows the average of impaired loans and related interest income for the three and nine months ended September 30, 2012 and 2011:

| (Dollars in thousands)                              | Three Months Ended<br>September 30, 2012 |                                  | Nine Months Ended<br>September 30, 2012 |                                  |
|-----------------------------------------------------|------------------------------------------|----------------------------------|-----------------------------------------|----------------------------------|
|                                                     | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized |
| Residential Real Estate 1-4 Family                  |                                          |                                  |                                         |                                  |
| First liens                                         | \$ 3,791                                 | \$ 4                             | \$ 4,225                                | \$ 55                            |
| Junior liens and lines of credit                    | 740                                      | -                                | 760                                     | 1                                |
| Total                                               | 4,531                                    | 4                                | 4,985                                   | 56                               |
| Residential real estate - construction              | 571                                      | -                                | 424                                     | -                                |
| Commercial, industrial and agricultural real estate | 27,741                                   | 35                               | 25,445                                  | 125                              |
| Commercial, industrial and agricultural             | 4,099                                    | 31                               | 4,211                                   | 104                              |
| Consumer                                            | -                                        | -                                | -                                       | -                                |
| Total                                               | \$ 36,942                                | \$ 70                            | \$ 35,065                               | \$ 285                           |

|                                                     | Three Months Ended<br>September 30, 2011 |                                  | Nine Months Ended<br>September 30, 2011 |                                  |
|-----------------------------------------------------|------------------------------------------|----------------------------------|-----------------------------------------|----------------------------------|
|                                                     | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized |
| Residential Real Estate 1-4 Family                  |                                          |                                  |                                         |                                  |
| First liens                                         | \$ 3,123                                 | \$ 190                           | \$ 2,400                                | \$ 193                           |
| Junior liens and lines of credit                    | 398                                      | -                                | 366                                     | -                                |
| Total                                               | 3,521                                    | 190                              | 2,766                                   | 193                              |
| Residential real estate - construction              | 6,352                                    | (63 )                            | 7,329                                   | -                                |
| Commercial, industrial and agricultural real estate | 20,604                                   | 292                              | 19,810                                  | 443                              |
| Commercial, industrial and agricultural             | 3,228                                    | 32                               | 2,965                                   | 47                               |
| Consumer                                            | -                                        | -                                | 1                                       | -                                |
| Total                                               | \$ 33,705                                | \$ 451                           | \$ 32,871                               | \$ 683                           |

The following table presents a summary of nonperforming assets as of September 30, 2012 and December 31, 2011:

| (Dollars in thousands)                                  | September 30, 2012 |                   | December 31, 2011 |                   |
|---------------------------------------------------------|--------------------|-------------------|-------------------|-------------------|
|                                                         | Balance            | % of Loan Segment | Balance           | % of Loan Segment |
| Nonaccrual loans                                        |                    |                   |                   |                   |
| Residential Real Estate                                 |                    |                   |                   |                   |
| First liens                                             | \$ 3,912           | 2.6 %             | \$ 1,749          | 1.2 %             |
| Junior liens and lines of credit                        | 787                | 1.8 %             | 282               | 0.6 %             |
| Total                                                   | 4,699              | 2.5 %             | 2,031             | 1.1 %             |
| Residential real estate - construction                  | 571                | 3.6 %             | -                 | -                 |
| Commercial, industrial and agricultural real estate     | 24,990             | 6.8 %             | 14,278            | 4.0 %             |
| Commercial, industrial and agricultural                 | 1,344              | 0.8 %             | 1,447             | 0.8 %             |
| Consumer                                                | -                  | -                 | -                 | -                 |
| Total nonaccrual loans                                  | \$ 31,604          |                   | \$ 17,756         |                   |
| Loans past due 90 days or more and still accruing       |                    |                   |                   |                   |
| Residential Real Estate                                 |                    |                   |                   |                   |
| First liens                                             | \$ 549             |                   | \$ 2,516          |                   |
| Junior liens and lines of credit                        | 91                 |                   | 301               |                   |
| Total                                                   | 640                |                   | 2,817             |                   |
| Residential real estate - construction                  | 110                |                   | 121               |                   |
| Commercial, industrial and agricultural real estate     | 3,320              |                   | 1,627             |                   |
| Commercial, industrial and agricultural                 | 303                |                   | 100               |                   |
| Consumer                                                | 29                 |                   | 107               |                   |
| Total loans past due 90 days or more and still accruing | 4,402              |                   | 4,772             |                   |
| Total nonaccrual and loans past due 90 days or more     | 36,006             |                   | 22,528            |                   |
| Reposessed assets                                       | 3                  |                   | 6                 |                   |
| Other real estate owned                                 | 6,165              |                   | 3,224             |                   |
| Total nonperforming assets                              | \$ 42,174          |                   | \$ 25,758         |                   |

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

| (Dollars in thousands)                              | Current    | Loans Past Due and |               | Still Accruing |           | Non-Accrual Loans | Total      |
|-----------------------------------------------------|------------|--------------------|---------------|----------------|-----------|-------------------|------------|
|                                                     |            | 30-59<br>Days      | 60-89<br>Days | 90<br>Days+    | Total     |                   |            |
| September 30, 2012                                  |            |                    |               |                |           |                   |            |
| Residential Real Estate                             |            |                    |               |                |           |                   |            |
| First liens                                         | \$ 142,363 | \$ 713             | \$ 693        | \$ 549         | \$ 1,955  | \$ 3,912          | \$ 148,230 |
| Junior liens and lines of credit                    | 41,421     | 797                | 89            | 91             | 977       | 787               | 43,185     |
| Total                                               | 183,784    | 1,510              | 782           | 640            | 2,932     | 4,699             | 191,415    |
| Residential real estate - construction              | 15,112     | -                  | -             | 110            | 110       | 571               | 15,793     |
| Commercial, industrial and agricultural real estate | 336,398    | 1,109              | 524           | 3,320          | 4,953     | 24,990            | 366,341    |
| Commercial, industrial and agricultural             | 165,454    | 139                | 70            | 303            | 512       | 1,344             | 167,310    |
| Consumer                                            | 11,448     | 204                | 56            | 29             | 289       | -                 | 11,737     |
| Total                                               | \$ 712,196 | \$ 2,962           | \$ 1,432      | \$ 4,402       | \$ 8,796  | \$ 31,604         | \$ 752,596 |
| December 31, 2011                                   |            |                    |               |                |           |                   |            |
| Residential Real Estate                             |            |                    |               |                |           |                   |            |
| First liens                                         | \$ 134,105 | \$ 2,574           | \$ 953        | \$ 2,516       | \$ 6,043  | \$ 1,749          | \$ 141,897 |
| Junior liens and lines of credit                    | 46,311     | 1,121              | 121           | 301            | 1,543     | 282               | 48,136     |
| Total                                               | 180,416    | 3,695              | 1,074         | 2,817          | 7,586     | 2,031             | 190,033    |
| Residential real estate - construction              | 21,161     | -                  | -             | 121            | 121       | -                 | 21,282     |
| Commercial, industrial and agricultural real estate | 337,462    | 2,961              | 2,646         | 1,627          | 7,234     | 14,278            | 358,974    |
| Commercial, industrial and agricultural             | 179,907    | 113                | 1,127         | 100            | 1,340     | 1,447             | 182,694    |
| Consumer                                            | 12,917     | 287                | 116           | 107            | 510       | -                 | 13,427     |
| Total                                               | \$ 731,863 | \$ 7,056           | \$ 4,963      | \$ 4,772       | \$ 16,791 | \$ 17,756         | \$ 766,410 |

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

| (Dollars in thousands)           | Pass       | Special<br>Mention | Substandard | Doubtful | Total      |
|----------------------------------|------------|--------------------|-------------|----------|------------|
| September 30, 2012               |            |                    |             |          |            |
| Residential Real Estate          |            |                    |             |          |            |
| First liens                      | \$ 137,939 | \$ 1,576           | \$ 8,715    | \$ -     | \$ 148,230 |
| Junior liens and lines of credit | 41,916     | 133                | 1,136       | -        | 43,185     |
| Total                            | 179,855    | 1,709              | 9,851       | -        | 191,415    |

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|                                                     |           |          |           |          |           |
|-----------------------------------------------------|-----------|----------|-----------|----------|-----------|
| Residential real estate - construction              | 13,616    | 742      | 1,435     | -        | 15,793    |
| Commercial, industrial and agricultural real estate | 295,750   | 27,228   | 43,363    | -        | 366,341   |
| Commercial, industrial and agricultural             | 147,047   | 6,336    | 11,177    | 2,750    | 167,310   |
| Consumer                                            | 11,708    | -        | 29        | -        | 11,737    |
| Total                                               | \$647,976 | \$36,015 | \$ 65,855 | \$ 2,750 | \$752,596 |

December 31, 2011

Residential Real Estate

|                                                     |           |          |           |      |           |
|-----------------------------------------------------|-----------|----------|-----------|------|-----------|
| First liens                                         | \$130,680 | \$3,733  | \$ 7,484  | \$ - | \$141,897 |
| Junior liens and lines of credit                    | 47,329    | 377      | 430       | -    | 48,136    |
| Total                                               | 178,009   | 4,110    | 7,914     | -    | 190,033   |
| Residential real estate - construction              | 19,253    | 941      | 1,088     | -    | 21,282    |
| Commercial, industrial and agricultural real estate | 291,967   | 41,675   | 25,332    | -    | 358,974   |
| Commercial, industrial and agricultural             | 168,207   | 7,649    | 6,838     | -    | 182,694   |
| Consumer                                            | 13,320    | -        | 107       | -    | 13,427    |
| Total                                               | \$670,756 | \$54,375 | \$ 41,279 | \$ - | \$766,410 |

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

| (Dollars in thousands)                              | Total Troubled Debt Restructurings |                     | Troubled Debt Restructurings That Have Defaulted on Modified Terms YTD |                     |
|-----------------------------------------------------|------------------------------------|---------------------|------------------------------------------------------------------------|---------------------|
|                                                     | Number of Contracts                | Recorded Investment | Number of Contracts                                                    | Recorded Investment |
| September 30, 2012                                  |                                    |                     |                                                                        |                     |
| Real estate construction                            | 3                                  | \$ 1,510            | -                                                                      | \$ -                |
| Residential real estate                             | 4                                  | 476                 | -                                                                      | -                   |
| Commercial, industrial and agricultural             | 2                                  | 1,818               | -                                                                      | -                   |
| Commercial, industrial and agricultural real estate | 10                                 | 5,856               | -                                                                      | -                   |
| Total                                               | 19                                 | \$ 9,660            | -                                                                      | \$ -                |
| December 31, 2011                                   |                                    |                     |                                                                        |                     |
| Residential real estate                             | 2                                  | \$ 93               | -                                                                      | \$ -                |
| Commercial, industrial and agricultural real estate | 9                                  | 8,023               | -                                                                      | -                   |
| Total                                               | 11                                 | \$ 8,116            | -                                                                      | \$ -                |

The following table reports the performing status of TDR loans. The performing status is determined by the loans compliance with the modified terms.

| (Dollars in thousands)                              | September 30, 2012 |               | December 31, 2011 |               |
|-----------------------------------------------------|--------------------|---------------|-------------------|---------------|
|                                                     | Performing         | Nonperforming | Performing        | Nonperforming |
| Real estate construction                            | \$ 1,510           | \$ -          | \$ -              | \$ -          |
| Residential real estate                             | 476                | -             | 93                | -             |
| Commercial, industrial and agricultural             | 1,818              | -             | -                 | -             |
| Commercial, industrial and agricultural real estate | 5,856              | -             | 8,023             | -             |
| Total                                               | \$ 9,660           | \$ -          | \$ 8,116          | \$ -          |

The following table reports new TDR loans during 2012 and the recorded investment as of September 30, 2012.

|                                                     | Number of<br>Contracts | Pre-TDR<br>Modification | After-TDR<br>Modification | Recorded<br>Investment |
|-----------------------------------------------------|------------------------|-------------------------|---------------------------|------------------------|
| Three Months Ended September 30, 2012               |                        |                         |                           |                        |
| Residential real estate                             | 1                      | \$ 221                  | \$ 240                    | \$ 240                 |
| Nine Months Ended September 30, 2012                |                        |                         |                           |                        |
| Real estate construction                            | 3                      | \$ 2,073                | \$ 1,897                  | \$ 1,510               |
| Residential real estate                             | 2                      | 371                     | 390                       | 386                    |
| Commercial, industrial and agricultural             | 2                      | 2,223                   | 2,223                     | 1,818                  |
| Commercial, industrial and agricultural real estate | 2                      | 700                     | 1,090                     | 1,064                  |
| Total                                               | 9                      | \$ 5,367                | \$ 5,600                  | \$ 4,778               |

The following table reports the type of loan concession granted for new TDR loans during 2012 and the recorded investment as of September 30, 2012.

|                                       | Number of<br>Contracts | Pre-TDR<br>Modification | After-TDR<br>Modification | Recorded<br>Investment |
|---------------------------------------|------------------------|-------------------------|---------------------------|------------------------|
| Three Months Ended September 30, 2012 |                        |                         |                           |                        |
| Multiple                              | 1                      | \$ 221                  | \$ 240                    | \$ 240                 |
| Nine Months Ended September 30, 2012  |                        |                         |                           |                        |
| Maturity                              | 2                      | \$ 2,223                | \$ 2,223                  | \$ 1,818               |
| Multiple                              | 7                      | 3,144                   | 3,377                     | 2,960                  |
|                                       | 9                      | \$ 5,367                | \$ 5,600                  | \$ 4,778               |

The following table reports new TDR loans during 2011 and the recorded investment as of September 30, 2011.

|                                                     | Number of<br>Contracts | Pre-TDR<br>Modification | After-TDR<br>Modification | Recorded<br>Investment |
|-----------------------------------------------------|------------------------|-------------------------|---------------------------|------------------------|
| Three Months Ended September 30, 2011               |                        |                         |                           |                        |
| Commercial, industrial and agricultural real estate | 1                      | \$ 4,531                | \$ 2,663                  | \$ 2,490               |
| Residential real estate                             | 1                      | 30                      | 30                        | 29                     |
|                                                     | 2                      | \$ 4,561                | \$ 2,693                  | \$ 2,519               |
| Nine Months Ended September 30, 2011                |                        |                         |                           |                        |
| Residential real real estate                        | 2                      | \$ 94                   | \$ 94                     | \$ 90                  |
| Commercial, industrial and agricultural             | 1                      | 2,856                   | 2,856                     | -                      |
| Commercial, industrial and agricultural real estate | 6                      | 6,378                   | 4,510                     | 4,517                  |
|                                                     | 9                      | \$ 9,328                | \$ 7,460                  | \$ 4,607               |

The type of loan concession granted for new TDR loans during 2011 and the recorded investment as of September 30, 2011.

|                                       | Number of<br>Contracts | Pre-TDR<br>Modification | After-TDR<br>Modification | Recorded<br>Investment |
|---------------------------------------|------------------------|-------------------------|---------------------------|------------------------|
| Three Months Ended September 30, 2011 |                        |                         |                           |                        |
| Payment                               | 1                      | \$ 4,531                | \$ 2,663                  | \$ 2,490               |
| Rate                                  | 1                      | 30                      | 30                        | 29                     |
|                                       | 2                      | \$ 4,561                | \$ 2,693                  | \$ 2,519               |
| Nine Months Ended September 30, 2011  |                        |                         |                           |                        |
| Maturity                              | 1                      | \$ 263                  | \$ 263                    | \$ 249                 |
| Rate                                  | 3                      | 2,950                   | 2,950                     | 90                     |
| Payment                               | 5                      | 6,115                   | 4,247                     | 4,268                  |
|                                       | 9                      | \$ 9,328                | \$ 7,460                  | \$ 4,607               |

**Note 8 – Pensions**

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

|                                            | Three months ended<br>September 30 |        | Nine months ended<br>September 30 |        |
|--------------------------------------------|------------------------------------|--------|-----------------------------------|--------|
| (Dollars in thousands)                     | 2012                               | 2011   | 2012                              | 2011   |
| Components of net periodic (benefit) cost: |                                    |        |                                   |        |
| Service cost                               | \$ 115                             | \$ 87  | \$ 345                            | \$ 274 |
| Interest cost                              | 179                                | 183    | 537                               | 545    |
| Expected return on plan assets             | (197 )                             | (189 ) | (591 )                            | (565 ) |
| Recognized net actuarial loss              | 171                                | 95     | 514                               | 275    |
| Net periodic cost                          | \$ 268                             | \$ 176 | \$ 805                            | \$ 529 |

The Bank expects its pension expense to increase to approximately \$1.1 million in 2012 compared to \$705 thousand in 2011. The Bank has contributed \$783 thousand to its pension plan in 2012 and does not expect to contribute any additional amount due to the pension changes discussed below. This contribution will meet the minimum funding requirements.

In June 2012, Congress approved the “Moving Ahead for Progress in the 21<sup>st</sup> Century (MAP-21) Act” as part of a highway expenditures bill that included pension funding relief. The relief is in the form of interest rate stabilization by allowing the use of a 25-year average rate (within a defined range of a minimum and maximum percentage) to calculate pension funding compared to a 2-year average rate currently used. This change is expected to reduce pension contributions, but will have no effect on the Corporation’s financial statements for accounting purposes. The change is effective in 2013 with the option of early implementation in 2012. The Bank has decided to implement MAP-21 in 2012 and will therefore, see a reduction in its pension contribution for 2012 as compared to 2011.

## Note 9 – Mortgage Servicing Rights

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

|                                    | Nine Months Ended<br>September 30 |           |
|------------------------------------|-----------------------------------|-----------|
| (Dollars in thousands)             | 2012                              | 2011      |
| Cost of mortgage servicing rights: |                                   |           |
| Beginning balance                  | \$ 730                            | \$ 933    |
| Originations                       | -                                 | -         |
| Amortization                       | (203 )                            | (145 )    |
| Ending balance                     | \$ 527                            | \$ 788    |
| Valuation allowance:               |                                   |           |
| Beginning balance                  | \$ (362 )                         | \$ (330 ) |
| Valuation charges                  | (17 )                             | (81 )     |
| Valuation reversals                | 104                               | 12        |
| Ending balance                     | \$ (275 )                         | \$ (399 ) |
| Mortgage servicing rights cost     | \$ 527                            | \$ 788    |
| Valuation allowance                | (275 )                            | (399 )    |
| Carrying value                     | \$ 252                            | \$ 389    |
| Fair value                         | \$ 252                            | \$ 389    |

## Note 10 – Fair Value Measurements

Fair value is defined as the exchange price that would be received to sell an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. Fair value estimates are based on quoted market prices, if available, quoted market prices of similar assets or liabilities, or the present value of expected future cash flows, and other valuation techniques. There are certain assumptions made in the valuation process and 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.

## Fair Value Hierarchy

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements and Disclosures*, established 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 assets or liabilities.

*Level 2:* Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

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

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

The following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at September 30, 2012 and December 31, 2011:

Cash and cash equivalents: For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

Investment securities available for sale: The fair value of securities available-for-sale which are measured on a recurring basis are determined primarily by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other similar securities. These securities are classified within Level 1 or 2 of the fair value hierarchy as appropriate. 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.

Restricted stock: The carrying value of restricted stock approximates its fair value based on redemption provisions for the restricted stock.

Net loans (excluding held for sale): 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.

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.

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

Mortgage servicing rights: The fair value of mortgage servicing rights is based on observable market prices when available or the present value of expected future cash flows when not available. Assumptions used to calculate the present value include loan default rates, costs to service, and prepayment speeds. These inputs are provided by a third-party pricing service without adjustment. Mortgage servicing rights are carried at the lower of cost or fair value.

Deposits: 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.

Securities sold under agreement to repurchase: These variable rate liabilities are priced on a short-term market interest rate. Therefore, the carrying value is a reasonable estimate of the fair value.

Long-term debt: The fair value of long-term debt is estimated by discounting the future cash flows using rates approximating those currently offered for borrowings with similar remaining maturities.

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

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

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

| (Dollars in thousands)                         | September 30, 2012 |            |                         |           |         |
|------------------------------------------------|--------------------|------------|-------------------------|-----------|---------|
|                                                | Carrying Amount    | Fair Value | Fair Value Measurements |           |         |
|                                                |                    |            | Level 1                 | Level 2   | Level 3 |
| <b>Financial assets:</b>                       |                    |            |                         |           |         |
| Cash and cash equivalents                      | \$104,217          | \$104,217  | \$104,217               | \$-       | \$-     |
| Investment securities available for sale       | 134,321            | 134,321    | 1,968                   | 132,353   | -       |
| Restricted stock                               | 4,104              | 4,104      | -                       | 4,104     | -       |
| Loans held for sale                            | 991                | 991        | -                       | 991       | -       |
| Net loans                                      | 742,483            | 759,691    | -                       | -         | 759,691 |
| Accrued interest receivable                    | 3,638              | 3,638      | 3,638                   | -         | -       |
| Mortgage servicing rights                      | 252                | 252        | -                       | -         | 252     |
| <b>Financial liabilities:</b>                  |                    |            |                         |           |         |
| Deposits                                       | \$857,826          | \$860,007  | \$666,189               | \$193,818 | \$-     |
| Securities sold under agreements to repurchase | 56,151             | 56,151     | 56,151                  | -         | -       |
| Long-term debt                                 | 37,922             | 39,682     | -                       | 39,682    | -       |
| Accrued interest payable                       | 577                | 577        | 577                     | -         | -       |
| Interest rate swaps                            | 1,284              | 1,284      | -                       | 1,284     | -       |
| <b>December 31, 2011</b>                       |                    |            |                         |           |         |
| (Dollars in thousands)                         | Carrying Amount    |            | Fair Value              |           |         |
|                                                |                    |            |                         |           |         |
| <b>Financial assets:</b>                       |                    |            |                         |           |         |
| Cash and cash equivalents                      | \$34,144           | \$34,144   |                         |           |         |
| Investment securities available for sale       | 125,301            | 125,301    |                         |           |         |
| Restricted stock                               | 5,022              | 5,022      |                         |           |         |
| Net loans                                      | 756,687            | 765,707    |                         |           |         |
| Accrued interest receivable                    | 3,391              | 3,391      |                         |           |         |
| Mortgage servicing rights                      | 368                | 368        |                         |           |         |
| <b>Financial liabilities:</b>                  |                    |            |                         |           |         |
| Deposits                                       | \$787,986          | \$790,887  |                         |           |         |
| Securities sold under agreements to repurchase | 53,103             | 53,103     |                         |           |         |
| Long-term debt                                 | 48,336             | 51,015     |                         |           |         |
| Accrued interest payable                       | 561                | 561        |                         |           |         |
| Interest rate swaps                            | 1,738              | 1,738      |                         |           |         |

**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 are as follows:

| (Dollars in Thousands)                   |         | Fair Value at September 30, 2012 |         |           |  |
|------------------------------------------|---------|----------------------------------|---------|-----------|--|
| Asset Description                        | Level 1 | Level 2                          | Level 3 | Total     |  |
| Equity securities                        | \$1,968 | \$-                              | \$ -    | \$1,968   |  |
| U.S. Government agency securities        | -       | 13,096                           | -       | 13,096    |  |
| Municipal securities                     | -       | 61,271                           | -       | 61,271    |  |
| Corporate debt securities                | -       | 985                              | -       | 985       |  |
| Trust Preferred Securities               | -       | 4,701                            | -       | 4,701     |  |
| Agency mortgage-backed securities        | -       | 49,743                           | -       | 49,743    |  |
| Private-label mortgage-backed securities | -       | 2,509                            | -       | 2,509     |  |
| Asset-backed securities                  | -       | 48                               | -       | 48        |  |
| Total assets                             | \$1,968 | \$132,353                        | \$ -    | \$134,321 |  |
| Liability Description                    |         |                                  |         |           |  |
| Interest rate swaps                      | \$-     | \$1,284                          | \$ -    | \$1,284   |  |
| Total liabilities                        | \$-     | \$1,284                          | \$ -    | \$1,284   |  |

| (Dollars in Thousands)                   |         | Fair Value at December 31, 2011 |         |           |  |
|------------------------------------------|---------|---------------------------------|---------|-----------|--|
| Asset Description                        | Level 1 | Level 2                         | Level 3 | Total     |  |
| Equity securities                        | \$1,759 | \$-                             | \$ -    | \$1,759   |  |
| U.S. Government agency securities        | -       | 13,229                          | -       | 13,229    |  |
| Municipal securities                     | -       | 45,081                          | -       | 45,081    |  |
| Corporate debt securities                | -       | 2,414                           | -       | 2,414     |  |
| Trust Preferred Securities               | -       | 4,618                           | -       | 4,618     |  |
| Agency mortgage-backed securities        | -       | 55,285                          | -       | 55,285    |  |
| Private-label mortgage-backed securities | -       | 2,867                           | -       | 2,867     |  |
| Asset-backed securities                  | -       | 48                              | -       | 48        |  |
| Total assets                             | \$1,759 | \$123,542                       | \$ -    | \$125,301 |  |
| Liability Description                    |         |                                 |         |           |  |
| Interest rate swaps                      | \$-     | \$1,738                         | \$ -    | \$1,738   |  |
| Total liabilities                        | \$-     | \$1,738                         | \$ -    | \$1,738   |  |

For financial assets and liabilities measured at fair value on a recurring basis, there were no transfers of assets or liabilities between Level 1 and Level 2 during the period ending September 30, 2012.

The methods and significant assumptions used to estimate the fair value for assets and liabilities measured on a recurring basis are the same as previously presented for the same asset or liability.

**Nonrecurring Fair Value Measurements**

For financial assets and liabilities measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

| (Dollars in Thousands)      | Fair Value at September 30, 2012 |         |           |           |
|-----------------------------|----------------------------------|---------|-----------|-----------|
| Asset Description           | Level 1                          | Level 2 | Level 3   | Total     |
| Impaired loans (1)          | \$ -                             | \$ -    | \$ 10,404 | \$ 10,404 |
| Other real estate owned (1) | -                                | -       | 6,165     | 6,165     |
| Mortgage servicing rights   | -                                | -       | 252       | 252       |
| Total assets                | \$ -                             | \$ -    | \$ 16,821 | \$ 16,821 |

| (Dollars in Thousands)      | Fair Value at December 31, 2011 |         |           |           |
|-----------------------------|---------------------------------|---------|-----------|-----------|
| Asset Description           | Level 1                         | Level 2 | Level 3   | Total     |
| Impaired loans (1)          | \$ -                            | \$ -    | \$ 13,705 | \$ 13,705 |
| Other real estate owned (1) | -                               | -       | 3,224     | 3,224     |
| Mortgage servicing rights   | -                               | -       | 368       | 368       |
| Total assets                | \$ -                            | \$ -    | \$ 17,297 | \$ 17,297 |

(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 value of assets and liabilities measured on a nonrecurring basis:

**Impaired loans:** Impaired loans are carried at the lower of cost or the fair value of the collateral for collateral-dependent loans. Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. The use of independent appraisals, costs to sell, and management's best judgment are significant inputs in arriving at the fair value measure of the underlying collateral and impaired loans are therefore classified within the Level 3 of the fair value hierarchy. Appraisals may be adjusted for qualitative factors such as economic conditions, and liquidation expenses. Appraisal adjustments reflect discounts that are specific to each credit.

**Other real estate owned:** Other real estate owned is carried at the lower of the investment in the asset or the fair value less estimated costs to sell. The fair value of other real estate owned is generally determined through independent

appraisals of the underlying collateral, which generally included various Level 3 inputs. Appraisals may be adjusted for qualitative factors such as economic conditions or other factors Management believes are relevant to a specific asset.

Mortgage servicing rights: The fair value of mortgage servicing rights is estimated using a valuation model that calculates the present value of estimated future net servicing income. The model incorporates Level 3 assumptions such as cost to service, discount rate, prepayment speeds, default rates and losses. These inputs are provided by a third-party pricing service without adjustment. Mortgage servicing rights are carried at the lower of cost or fair value.

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 September 30, 2012 |                                           |                                 | Range |
|---------------------------|------------|--------------------------------------------------------------------------------------|-------------------------------------------|---------------------------------|-------|
| Asset Description         | Fair Value | Valuation Technique                                                                  | Unobservable Input                        | Weighted Average                |       |
| Impaired loans (1)        | \$10,404   | Appraisal                                                                            | Appraisal Adjustments (2)<br>Cost to sell | 0% - 70% (27%)<br>5% - 25% (7%) |       |
| Other real estate owned   | 6,165      | Appraisal                                                                            | Appraisal Adjustments (2)<br>Cost to sell | 8% (8%)                         |       |
| Mortgage servicing rights | 252        | Discounted Cash Flow (3)                                                             |                                           |                                 |       |

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

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

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

## Note 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. Management anticipates continuing to use derivatives, as permitted by its Board-approved policy, to manage interest rate risk. In 2008, the Bank entered into two interest rate swap transactions in order to hedge the Corporation's exposure to changes in cash flows attributable to the effect of interest rate changes on variable rate liabilities.

Information regarding the interest rate swaps as of September 30, 2012 follows:

|                        |                                     |
|------------------------|-------------------------------------|
| (Dollars in thousands) | Amount Expected to be Expensed into |
|------------------------|-------------------------------------|

| Notional<br>Amount | Maturity<br>Date | Interest Rate |          | Earnings within the<br>next 12 Months |
|--------------------|------------------|---------------|----------|---------------------------------------|
|                    |                  | Fixed         | Variable |                                       |
| \$ 10,000          | 5/30/2013        | 3.60 %        | 0.11     | % \$349                               |
| \$ 10,000          | 5/30/2015        | 3.87 %        | 0.11     | % \$376                               |

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

Derivatives with a positive fair value are reflected as other assets in the consolidated balance sheet while those with a negative fair value are reflected as other liabilities. As short-term interest rates decrease, the net expense of the swap increases. As short-term rates increase, the net expense of the swap decreases.

Fair Value of Derivative Instruments in the Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011 are as follows:

| Fair Value of Derivative Instruments<br>(Dollars in thousands) |                         | Balance Sheet     |            |
|----------------------------------------------------------------|-------------------------|-------------------|------------|
| Date                                                           | Type                    | Location          | Fair Value |
| September 30, 2012                                             | Interest rate contracts | Other liabilities | \$1,284    |
| December 31, 2011                                              | Interest rate contracts | Other liabilities | \$1,738    |

The Effect of Derivative Instruments on the Statement of Income for the Three and Nine Months Ended September 30, 2012 and 2011 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships  
(Dollars in thousands)

| Type / Date | Amount of Gain or (Loss) Recognized in OCI net of tax on Derivative (Effective Portion) | Location of Gain or (Loss)                                        | Amount of Gain or (Loss)                                          | Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion) | Amount of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion) |
|-------------|-----------------------------------------------------------------------------------------|-------------------------------------------------------------------|-------------------------------------------------------------------|-------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------|
|             |                                                                                         | Reclassified from Accumulated OCI into Income (Effective Portion) | Reclassified from Accumulated OCI into Income (Effective Portion) |                                                                                     |                                                                                   |

Interest Rate Contracts

Three months ended:

|                    |          |                    |         |                        |      |
|--------------------|----------|--------------------|---------|------------------------|------|
| September 30, 2012 | \$ 106   | Interest Expense   | \$(192) | Other income (expense) | \$ - |
| September 30, 2011 | \$ (224) | ) Interest Expense | \$(186) | Other income (expense) | \$ - |

Nine months ended:

|                    |         |                    |         |                        |      |
|--------------------|---------|--------------------|---------|------------------------|------|
| September 30, 2012 | \$ 301  | Interest Expense   | \$(551) | Other income (expense) | \$ - |
| September 30, 2011 | \$ (66) | ) Interest Expense | \$(541) | Other income (expense) | \$ - |

**Note 12 – Reclassifications**

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

## Item 2

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

For the Three and Nine Month Periods Ended September 30, 2012 and 2011

#### Forward Looking Statements

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

#### Critical Accounting Policies

Management has identified critical accounting policies for the Corporation to include Allowance for Loan Losses, Mortgage Servicing Rights, Financial Derivatives, Temporary Investment Impairment and Stock-based Compensation. There were no changes to the critical accounting policies disclosed in the 2011 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 2011 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

#### Results of Operations

##### *Year-to-Date Summary*

At September 30, 2012, total assets were \$1.057 billion, an increase of \$67.0 million from December 31, 2011. Net loans decreased to \$742.5 million and total deposits increased to \$857.8 million. The Corporation reported net income for the first nine months of 2012 of \$5.0 million. This is a 7.6% increase versus net income of \$4.7 million for the

same period in 2011. Total revenue (interest income and noninterest income) decreased \$1.6 million year-over-year. Interest income decreased \$1.5 million, but was offset by a decrease of \$1.6 million in interest expense, resulting in a \$116 thousand increase in net interest income. Noninterest income decreased 1.3% due to a decrease in deposit fees. Noninterest expense increased 2.4% due to increases in salary and benefits expense. The provision for loan losses was \$3.6 million for the period, \$1.8 million less than in 2011. Diluted earnings per share increased to \$1.24 in 2012 from \$1.18 in 2011.

Key performance ratios as of, or for the nine months ended September 30, 2012 and 2011 are listed below:

|                                              | September 30 |   |           |   |
|----------------------------------------------|--------------|---|-----------|---|
|                                              | 2012         |   | 2011      |   |
| Performance measurements                     |              |   |           |   |
| Return on average assets*                    | 0.65         | % | 0.63      | % |
| Return on average equity*                    | 7.56         | % | 7.39      | % |
| Return on average tangible assets (1)*       | 0.68         | % | 0.66      | % |
| Return on average tangible equity (1)*       | 8.91         | % | 8.84      | % |
| Efficiency ratio (2)                         | 67.09        | % | 65.97     | % |
| Net interest margin*                         | 3.51         | % | 3.67      | % |
| Current dividend yield*                      | 4.73         | % | 7.06      | % |
| Shareholders' Value (per common share)       |              |   |           |   |
| Diluted earnings per share                   | \$1.24       |   | \$1.18    |   |
| Regular cash dividends paid                  | \$0.61       |   | \$0.81    |   |
| Book value                                   | \$22.41      |   | \$21.63   |   |
| Tangible book value (3)                      | \$19.90      |   | \$19.46   |   |
| Market value                                 | \$14.37      |   | \$15.30   |   |
| Market value/book value ratio                | 64.12        | % | 70.74     | % |
| Price/earnings multiple*                     | 8.71         |   | 9.75      |   |
| Safety and Soundness                         |              |   |           |   |
| Leverage ratio (Tier 1)                      | 8.20         | % | 8.07      | % |
| Total risk-based capital ratio               | 12.66        | % | 11.76     | % |
| Equity ratio                                 | 8.67         | % | 8.67      | % |
| Tangible equity ratio (4)                    | 7.78         | % | 7.70      | % |
| Nonperforming loans/gross loans              | 4.78         | % | 3.41      | % |
| Nonperforming assets/total assets            | 3.99         | % | 2.96      | % |
| Allowance for loan losses as a % of loans    | 1.34         | % | 1.20      | % |
| Net charge-offs/average loans*               | 0.56         | % | 0.88      | % |
| Trust assets under management (market value) | \$511,059    |   | \$485,800 |   |

\* Annualized

(1) Excludes goodwill, intangibles and intangible amortization expense, net of tax

(2) Noninterest expense / tax equivalent net interest income plus noninterest income less net securities gains

(3) Total shareholders' equity less goodwill and intangibles / shares outstanding

(4) Total shareholders' equity less goodwill and intangibles / total assets less goodwill and intangibles

**GAAP versus Non-GAAP Presentations.** The Corporation supplements its traditional GAAP measurements with Non-GAAP measurements. The Non-GAAP measurements include Return on Average Tangible Assets and Return on Average Tangible Equity. As a result of merger transactions, intangible assets (primarily goodwill and core deposit intangibles) were created. The Non-GAAP disclosures are intended to eliminate the effects of the intangible assets and allow for better comparisons to periods when such assets did not exist. The following table shows the adjustments made between the GAAP and NON-GAAP measurements:

|                                   |                                                                                                                                                        |
|-----------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------|
| GAAP Measurement                  | Calculation                                                                                                                                            |
| Return on Average Assets          | Net Income / Average Assets                                                                                                                            |
| Return on Average Equity          | Net Income / Average Equity                                                                                                                            |
| Non- GAAP Measurement             | Calculation                                                                                                                                            |
| Return on Average Tangible Assets | Net Income plus Intangible Amortization / Average Assets less Average Intangible Assets                                                                |
| Return on Average Tangible Equity | Net Income plus Intangible Amortization / Average Equity less Average Intangible Assets                                                                |
| Efficiency Ratio                  | Noninterest Expense / Tax Equivalent Net Interest Income plus Noninterest Income (excluding Security Gains/Losses and Other Than Temporary Impairment) |

***Comparison of the three months ended September 30, 2012 to the three months ended September 30, 2011:***

**Net Interest Income**

The most important source of the Corporation's earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal categories of interest-earning assets are loans and securities, while deposits, securities sold under agreements to repurchase (Repos), short-term borrowings and long-term debt are the principal categories of interest-bearing liabilities. Demand deposits enhance net interest income because they are noninterest-bearing deposits. For the purpose of this discussion, balance sheet items refer to the average balance for the period 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 interest income for the third quarter of 2012 decreased \$620 thousand quarter-over-quarter. Average interest-earning assets increased \$49.5 million from 2011, but the yield on these assets decreased by 48 basis points to 4.10%. The average balance of investment securities increased \$4.4 million while average loans decreased \$9.8 million quarter-over-quarter. Average loan yield decreased 22 basis points to 4.74.

Interest expense was \$1.7 million for the third quarter, a decrease of \$595 thousand from the 2011 total of \$2.3 million. Average interest-bearing liabilities increased \$44.4 million to \$841.1 million for 2012 from an average balance of \$796.7 million in 2011. The average cost of these liabilities decreased from 1.14% in 2011 to .80% in 2012. Average interest-bearing deposits increased \$66.9 million, due to increases in interest checking and savings

accounts (\$16.8 million), and money management deposits (\$62.5 million). The cost of interest-bearing deposits decreased from 1.00% to .67%. Securities sold under agreements to repurchase (Repos) decreased \$12.0 million on average over the prior year quarter while the average rate decreased from .25% in 2011 to .15% in 2012. The average balance of long-term debt decreased by \$10.6 million due to scheduled amortization and maturities, as well as a prepayment of \$8.0 million on two Federal Home Loan Bank of Pittsburgh (FHLB) advances that occurred in the third quarter of 2012.

The changes in the balance sheet and interest rates resulted in a slight decrease in tax equivalent net interest income of \$25 thousand to \$8.5 million in 2012. The Bank's net interest margin decreased from 3.61% in 2011 to 3.42% in 2012. The decrease in the net interest margin is the result of a decrease in the rate on interest-earning assets of 48 basis points, while the yield on interest-bearing liabilities only decreased 34 basis points. Net interest income decreased \$80 thousand during the quarter, with \$81 thousand of the decrease from rate, offset by an increase of \$1 thousand due to volume.

With interest rates forecast to remain at current levels until 2015, the Bank does not expect any increase in the asset yield for several years. As a result, it is likely that the cost of interest-bearing deposits will continue to be reduced in an effort to maintain the net interest margin.

The following table shows a comparative analysis of average balances, asset yields and funding costs for the three months ended September 30, 2012 and 2011. These components drive changes in net interest income.

| (Dollars in thousands)                                             | For the Three Months Ended September 30 |                      |                       |  |                            |                      |                       |
|--------------------------------------------------------------------|-----------------------------------------|----------------------|-----------------------|--|----------------------------|----------------------|-----------------------|
|                                                                    | 2012<br>Average<br>balance              | Income or<br>expense | Average<br>yield/rate |  | 2011<br>Average<br>balance | Income or<br>expense | Average<br>yield/rate |
| Interest-earning assets:                                           |                                         |                      |                       |  |                            |                      |                       |
| Interest-bearing obligations of other banks and federal funds sold | \$82,008                                | \$ 56                | 0.27 %                |  | \$27,159                   | \$ 17                | 0.25 %                |
| Investment securities:                                             |                                         |                      |                       |  |                            |                      |                       |
| Taxable                                                            | 101,011                                 | 466                  | 1.83 %                |  | 101,111                    | 620                  | 2.43 %                |
| Nontaxable                                                         | 40,576                                  | 559                  | 5.47 %                |  | 36,096                     | 521                  | 5.73 %                |
| Loans                                                              | 761,235                                 | 9,104                | 4.74 %                |  | 770,995                    | 9,647                | 4.96 %                |
| Total interest-earning assets                                      | 984,830                                 | 10,185               | 4.10 %                |  | 935,361                    | 10,805               | 4.58 %                |
| Other assets                                                       | 73,137                                  |                      |                       |  | 71,622                     |                      |                       |
| Total assets                                                       | \$1,057,967                             |                      |                       |  | \$1,006,983                |                      |                       |
| Interest-bearing liabilities:                                      |                                         |                      |                       |  |                            |                      |                       |
| Deposits:                                                          |                                         |                      |                       |  |                            |                      |                       |
| Interest-bearing checking                                          | \$123,866                               | 21                   | 0.07 %                |  | \$110,904                  | 27                   | 0.10 %                |
| Money Management                                                   | 376,522                                 | 621                  | 0.65 %                |  | 314,062                    | 839                  | 1.06 %                |
| Savings                                                            | 56,117                                  | 16                   | 0.11 %                |  | 52,269                     | 19                   | 0.14 %                |
| Time                                                               | 194,391                                 | 604                  | 1.23 %                |  | 206,736                    | 840                  | 1.61 %                |
| Total interest-bearing deposits                                    | 750,896                                 | 1,262                | 0.67 %                |  | 683,971                    | 1,725                | 1.00 %                |
| Securities sold under agreements to repurchase                     | 51,681                                  | 20                   | 0.15 %                |  | 63,642                     | 40                   | 0.25 %                |
| Long- term debt                                                    | 38,501                                  | 410                  | 4.22 %                |  | 49,052                     | 522                  | 4.22 %                |
| Total interest-bearing liabilities                                 | 841,078                                 | 1,692                | 0.80 %                |  | 796,665                    | 2,287                | 1.14 %                |
| Noninterest-bearing deposits                                       | 112,718                                 |                      |                       |  | 113,149                    |                      |                       |
| Other liabilities                                                  | 13,705                                  |                      |                       |  | 10,701                     |                      |                       |
| Shareholders' equity                                               | 90,466                                  |                      |                       |  | 86,468                     |                      |                       |
| Total liabilities and shareholders' equity                         | \$1,057,967                             |                      |                       |  | \$1,006,983                |                      |                       |
| Tax equivalent net interest income/Net interest margin             |                                         | 8,493                | 3.42 %                |  |                            | 8,518                | 3.61 %                |
| Tax equivalent adjustment                                          |                                         | (457 )               |                       |  |                            | (402 )               |                       |
| Net interest income                                                |                                         | \$ 8,036             |                       |  |                            | \$ 8,116             |                       |

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses. Loan balances include nonaccruing loans and are gross of the allowance for loan losses.

## Provision for Loan Losses

For the third quarter of 2012, the provision expense was \$825 thousand versus \$2.8 million in 2011. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

## Noninterest Income

For the third quarter of 2012, noninterest income decreased from the same period in 2011. Investment and trust service fees were unchanged, while loan service charges increased \$131 thousand due to the volume of mortgage refinancing. Mortgage banking fees increased \$26 thousand, as the 2012 impairment charge was \$24 thousand less than the prior year's impairment charge. Deposit service charges decreased \$39 thousand due to lower retail overdraft fees and less retail checking service charge fees. Other service charges and fees increased \$45 thousand primarily due to an increase in ATM fees, while debit card income increased \$30 thousand due to increased volume. Other income was negative for the quarter, due to a loss of \$217 thousand on the sale of an OREO property. Securities gains of \$23 thousand were recorded during 2012 from bonds called prior to maturity, compared to \$138 thousand from sales of equity securities in the same period in 2011. An other-than-temporary impairment charge of \$50 thousand on two bonds was recorded in 2012, compared to none in 2011.

The following table presents a comparison of noninterest income for the three months ended September 30, 2012 and 2011:

| (Dollars in thousands)                                             | For the Three Months Ended |          | Change  |         |
|--------------------------------------------------------------------|----------------------------|----------|---------|---------|
|                                                                    | September 30<br>2012       | 2011     | Amount  | %       |
| Noninterest Income                                                 |                            |          |         |         |
| Investment and trust services fees                                 | \$ 957                     | \$ 953   | \$4     | 0.4     |
| Loan service charges                                               | 328                        | 197      | 131     | 66.5    |
| Mortgage banking activities                                        | (27 )                      | (53 )    | 26      | 49.1    |
| Deposit service charges and fees                                   | 479                        | 518      | (39 )   | (7.5 )  |
| Other service charges and fees                                     | 209                        | 164      | 45      | 27.4    |
| Debit card income                                                  | 288                        | 258      | 30      | 11.6    |
| Increase in cash surrender value of life insurance                 | 159                        | 168      | (9 )    | (5.4 )  |
| Other                                                              | (157 )                     | 70       | (227)   | (324.3) |
| OTTI losses on securities                                          | (162 )                     | -        | (162)   | N/A     |
| Less: Loss recognized in other comprehensive income (before taxes) | (112 )                     | -        | (112)   | N/A     |
| Net OTTI losses recognized in earnings                             | (50 )                      | -        | (50 )   | N/A     |
| Securities gains (losses), net                                     | 23                         | 138      | (115)   | (83.3 ) |
| Total noninterest income                                           | \$ 2,209                   | \$ 2,413 | \$(204) | (8.5 )  |

## **Noninterest Expense**

Noninterest expense for the third quarter of 2012 was \$7.4 million compared to \$7.0 million in 2011. The increase in salaries and benefits was primarily due to annual salary adjustments (\$152 thousand) and pension expense (\$92 thousand), but these increases were partially offset by a \$23 thousand decrease in health insurance expense, due to lower claims expense during the quarter from the Bank's participation in a self-insured health insurance plan. Occupancy expense remained flat quarter-over-quarter, while advertising expense decreased \$41 thousand, due to less usage of TV, radio and print advertising. Legal and professional expenses decreased \$35 thousand as expenses for consulting and legal matters are less in 2012 compared to prior year. Data processing fees increased \$43 thousand due to higher cost for software expenses. Other expenses decreased \$18 thousand due to nonrecurring expenses in relation to the core system upgrade that were paid in the third quarter of 2011.

The following table presents a comparison of noninterest expense for the three months ended September 30, 2012 and 2011:

| (Dollars in thousands)          | For the Three Months Ended |          | Change |        |
|---------------------------------|----------------------------|----------|--------|--------|
|                                 | September 30<br>2012       | 2011     | Amount | %      |
| Noninterest Expense             |                            |          |        |        |
| Salaries and benefits           | \$ 4,141                   | \$ 3,796 | \$345  | 9.1    |
| Net occupancy expense           | 499                        | 495      | 4      | 0.8    |
| Furniture and equipment expense | 226                        | 194      | 32     | 16.5   |
| Advertising                     | 315                        | 356      | (41 )  | (11.5) |
| Legal and professional fees     | 252                        | 287      | (35 )  | (12.2) |
| Data processing                 | 382                        | 339      | 43     | 12.7   |
| Pennsylvania bank shares tax    | 187                        | 173      | 14     | 8.1    |
| Intangible amortization         | 109                        | 112      | (3 )   | (2.7 ) |
| FDIC insurance                  | 274                        | 256      | 18     | 7.0    |
| Other                           | 970                        | 988      | (18 )  | (1.8 ) |
| Total noninterest expense       | \$ 7,355                   | \$ 6,996 | \$359  | 5.1    |

## Income Taxes

For the third quarter of 2012 the Corporation recorded a Federal income tax expense of \$318 thousand compared to a tax benefit of \$301 thousand for the same quarter in 2011. The tax benefit in 2011 was due to a lower level of pre-tax income, due primarily to a higher provision for loan loss expense resulting in a higher proportion of tax free income to pre-tax income and less tax expense.

## *Comparison of the nine months ended September 30, 2012 to the nine months ended September 30, 2011:*

## Net Interest Income

Tax equivalent interest income for the first nine months of 2012 decreased by \$1.4 million compared to 2011. Average interest-earning assets increased \$48.0 million from 2011, but the yield on these assets decreased by 44 basis points. The average balance of investment securities increased \$1.2 million from 2011. Average loans decreased \$1.8 million year over year and the yield decreased 20 basis points to 4.85%.

Interest expense was \$5.5 million for the first nine months of 2012, a decrease of \$1.6 million from \$7.1 million in 2011. Average interest-bearing liabilities increased \$42.6 million to \$829.7 million for 2012 from an average balance of \$787.2 million in 2011. The average cost of these liabilities decreased from 1.21% in 2011 to 0.88% in 2012. Average interest-bearing deposits increased \$65.5 million, due to increases in interest checking and savings accounts (\$14.1 million) and money management deposits (\$58.2 million), but these increases were partially offset by decreases in time deposits (\$6.7 million). The cost of interest-bearing deposits decreased from 1.03% to .73%. Securities sold under agreements to repurchase have decreased \$8.5 million on average over the prior year and the average rate has decreased to .15% from .25% a year earlier. The average balance of long-term debt decreased by \$14.2 million due to scheduled amortization and maturities, as well as a prepayment of \$8.0 million on two Federal Home Loan Bank of Pittsburgh (FHLB) advances that occurred in the third quarter of 2012.

The changes in the balance sheet and interest rates resulted in an increase in tax equivalent net interest income of \$217 thousand to \$25.5 million in 2012 compared to \$25.2 million in 2011. The Bank's net interest margin decreased to 3.51% in 2012 from 3.67% in 2011. The decrease in the net interest margin is the result of a decrease in the rate on interest-earning assets of 44 basis points, while the yield on interest-bearing liabilities only decreased 33 basis points. Net interest income increased \$116 thousand during the year, with a \$289 thousand increase from volume, which was offset by \$173 thousand decrease from rates.

With interest rates forecast to remain at current levels until 2015, the Bank does not expect any increase in the asset yield for several years. As a result, it is likely that the cost of interest-bearing deposits will continue to be reduced in an effort to maintain the net interest margin.

The following table shows a comparative analysis of average balances, asset yields and funding costs for the nine months ended September 30, 2012 and 2011. These components drive changes in net interest income.

| (Dollars in thousands)                                             | For the Nine Months Ended September 30 |                         |                       |   |                    |                         |                       |   |
|--------------------------------------------------------------------|----------------------------------------|-------------------------|-----------------------|---|--------------------|-------------------------|-----------------------|---|
|                                                                    | 2012                                   |                         |                       |   | 2011               |                         |                       |   |
|                                                                    | Average<br>Balance                     | Income<br>or<br>expense | Average<br>yield/rate |   | Average<br>balance | Income<br>or<br>expense | Average<br>yield/rate |   |
| Interest-earning assets:                                           |                                        |                         |                       |   |                    |                         |                       |   |
| Interest-bearing obligations of other banks and federal funds sold | \$71,409                               | \$ 148                  | 0.28                  | % | \$22,843           | \$ 43                   | 0.25                  | % |
| Investment securities:                                             |                                        |                         |                       |   |                    |                         |                       |   |
| Taxable                                                            | 93,750                                 | 1,385                   | 1.97                  | % | 97,560             | 1,888                   | 2.59                  | % |
| Nontaxable                                                         | 39,557                                 | 1,636                   | 5.51                  | % | 34,518             | 1,514                   | 5.86                  | % |
| Loans                                                              | 762,907                                | 27,763                  | 4.85                  | % | 764,697            | 28,905                  | 5.05                  | % |
| Total interest-earning assets                                      | 967,623                                | 30,932                  | 4.26                  | % | 919,618            | 32,350                  | 4.70                  | % |
| Other assets                                                       | 72,906                                 |                         |                       |   | 70,942             |                         |                       |   |
| Total assets                                                       | \$1,040,529                            |                         |                       |   | \$990,560          |                         |                       |   |
| Interest-bearing liabilities:                                      |                                        |                         |                       |   |                    |                         |                       |   |
| Deposits:                                                          |                                        |                         |                       |   |                    |                         |                       |   |
| Interest-bearing checking                                          | \$120,125                              | 65                      | 0.07                  | % | \$109,873          | 78                      | 0.09                  | % |
| Money Management                                                   | 362,705                                | 1,875                   | 0.69                  | % | 304,546            | 2,478                   | 1.09                  | % |
| Savings                                                            | 54,899                                 | 47                      | 0.11                  | % | 51,063             | 50                      | 0.13                  | % |
| Time                                                               | 196,121                                | 2,033                   | 1.38                  | % | 202,835            | 2,547                   | 1.68                  | % |
| Total interest-bearing deposits                                    | 733,850                                | 4,020                   | 0.73                  | % | 668,317            | 5,153                   | 1.03                  | % |
| Securities sold under agreements to repurchase                     | 51,990                                 | 59                      | 0.15                  | % | 60,507             | 113                     | 0.25                  | % |
| Short- term borrowings                                             | -                                      | -                       | -                     |   | 238                | 1                       | 0.73                  | % |
| Long- term debt                                                    | 43,901                                 | 1,390                   | 4.22                  | % | 58,114             | 1,837                   | 4.23                  | % |
| Total interest-bearing liabilities                                 | 829,741                                | 5,469                   | 0.88                  | % | 787,176            | 7,104                   | 1.21                  | % |
| Noninterest-bearing deposits                                       | 108,802                                |                         |                       |   | 105,477            |                         |                       |   |
| Other liabilities                                                  | 13,161                                 |                         |                       |   | 12,758             |                         |                       |   |
| Shareholders' equity                                               | 88,825                                 |                         |                       |   | 85,149             |                         |                       |   |
| Total liabilities and shareholders' equity                         | \$1,040,529                            |                         |                       |   | \$990,560          |                         |                       |   |
| Tax equivalent net interest income/Net interest margin             |                                        | 25,463                  | 3.51                  | % |                    | 25,246                  | 3.67                  | % |
| Tax equivalent adjustment                                          |                                        | (1,252 )                |                       |   |                    | (1,151 )                |                       |   |
| Net interest income                                                |                                        | \$ 24,211               |                       |   |                    | \$ 24,095               |                       |   |

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses. Loan balances include nonaccruing loans and are gross of the allowance for loan losses.



## Provision for Loan Losses

For the first nine months of 2012, the provision expense was \$3.6 million versus \$5.4 million in 2011. For more information concerning loan quality and the allowance for loan losses, refer to the Loan discussion in the Financial Condition section.

## Noninterest Income

For the first nine months of 2012, noninterest income decreased slightly to \$7.3 million compared to \$7.4 million in the same period in 2011. Investment and trust service fees increased \$41 thousand due to higher income from estate fees. Loan service charges decreased \$40 thousand, as 2011 contained a large prepayment penalty on a commercial loan. This loan was match funded with an FHLB advance and the fee to prepay the FHLB advance is recorded in other expense for 2011. Mortgage banking fees increased year-over-year as 2012 had a net reversal of previously recorded impairment charges of \$87 thousand compared to a net impairment charge of \$69 thousand in 2011. Deposit service charges decreased \$220 thousand in 2012 due to a decrease in retail overdraft fees and retail checking service charges. The reduction in overdraft fees and checking service charges is the result of changes the Bank made in response to regulatory guidance on best practices. Other service charges and fees increased primarily due to ATM fees, while debit card income was up \$106 thousand due to increased volume. Other income decreased \$191 thousand mainly due to a loss of \$217 thousand on the sale of an OREO property. Other-than-temporary impairment charges of \$50 thousand were taken in 2012 compared to \$55 thousand on two bonds in 2011. The Corporation also had realized gains of \$44 thousand in 2012 from bonds called prior to maturity, compared to \$150 thousand on the sale of equity securities in 2011.

The following table presents a comparison of noninterest income for the nine months ended September 30, 2012 and 2011:

| (Dollars in thousands)                             | For the Nine<br>Months Ended<br>September 30 |         | Change |         |
|----------------------------------------------------|----------------------------------------------|---------|--------|---------|
|                                                    | 2012                                         | 2011    | Amount | %       |
| Noninterest Income                                 |                                              |         |        |         |
| Investment and trust services fees                 | \$2,984                                      | \$2,943 | \$41   | 1.4     |
| Loan service charges                               | 869                                          | 909     | (40 )  | (4.4 )  |
| Mortgage banking activities                        | (8 )                                         | (88 )   | 80     | 90.9    |
| Deposit service charges and fees                   | 1,432                                        | 1,652   | (220)  | (13.3 ) |
| Other service charges and fees                     | 657                                          | 414     | 243    | 58.7    |
| Debit card income                                  | 859                                          | 753     | 106    | 14.1    |
| Increase in cash surrender value of life insurance | 493                                          | 508     | (15 )  | (3.0 )  |
| Other                                              | (15 )                                        | 176     | (191)  | (108.5) |

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|                                                                    |         |         |         |         |
|--------------------------------------------------------------------|---------|---------|---------|---------|
| OTTI losses on securities                                          | (162 )  | (271 )  | 109     | (40.2 ) |
| Less: Loss recognized in other comprehensive income (before taxes) | (112 )  | (216 )  | 104     | (48.1 ) |
| Net OTTI losses recognized in earnings                             | (50 )   | (55 )   | 5       | (9.1 )  |
| Securities gains (losses), net                                     | 44      | 150     | (106)   | (70.7 ) |
| Total noninterest income                                           | \$7,265 | \$7,362 | \$(97 ) | (1.3 )  |

## Noninterest Expense

Noninterest expense for the first nine months of 2012 totaled \$22.0 million compared to \$21.5 million in the same period in 2011. The increase in salaries and benefits was primarily due to annual salary adjustments and filling open positions (\$651 thousand), as well as an increase in pension expense (\$276 thousand), but these increases were partially offset by a \$301 thousand decrease in health insurance expense, due to lower claims expense during the year from the Bank's participation in a self-insured health insurance plan. Advertising expense increased \$24 thousand due to a marketing campaign to take advantage of the disruptions in our local market from mergers, branch closings and other competitive opportunities. FDIC insurance decreased \$19 thousand, as the FDIC assessment decreased due to a new calculation method implemented by the FDIC in the third quarter of 2011. Other expenses decreased \$265 thousand due to prepayment penalties on three FHLB advances in 2011 totaling \$344 thousand.

The following table presents a comparison of noninterest expense for the nine months ended September 30, 2012 and 2011:

| (Dollars in thousands)          | For the Nine Months Ended |           | Change |       |
|---------------------------------|---------------------------|-----------|--------|-------|
|                                 | September 30<br>2012      | 2011      | Amount | %     |
| Noninterest Expense             |                           |           |        |       |
| Salaries and benefits           | \$ 12,097                 | \$ 11,392 | \$ 705 | 6.2   |
| Net occupancy expense           | 1,510                     | 1,523     | (13 )  | (0.9) |
| Furniture and equipment expense | 653                       | 631       | 22     | 3.5   |
| Advertising                     | 1,024                     | 1,000     | 24     | 2.4   |
| Legal and professional fees     | 791                       | 801       | (10 )  | (1.2) |
| Data processing                 | 1,234                     | 1,208     | 26     | 2.2   |
| Pennsylvania bank shares tax    | 560                       | 510       | 50     | 9.8   |
| Intangible amortization         | 327                       | 335       | (8 )   | (2.4) |
| FDIC insurance                  | 803                       | 822       | (19 )  | (2.3) |
| Other                           | 2,963                     | 3,228     | (265 ) | (8.2) |
| Total noninterest expense       | \$ 21,962                 | \$ 21,450 | \$ 512 | 2.4   |

## Income taxes

Federal income tax expense was \$893 thousand in 2012 compared to a tax benefit of \$102 thousand in 2011. During 2011, an internal review discovered that tax-exempt commercial loans booked in the fourth quarter of 2008, during 2009 and 2010 and in the first quarter of 2011 were not properly coded as tax-exempt in the Bank's core processing system. This resulted in the income from these loans being recorded as taxable income and the benefit of the tax-exempt status was not reflected in the Corporation's income tax calculation. After a thorough review of the affected loans to determine the unrecorded tax benefit, and consultation with the Corporation's internal and external audit firms,

the Corporation deemed the adjustment to be immaterial to the consolidated financial statements for the current and prior years and therefore, no prior period adjustment was required. The Corporation recorded the past income tax benefits during the second quarter of 2011. The adjustment to income tax expense for the second quarter of 2011 was a credit of approximately \$660 thousand attributable to the years 2008, 2009 and 2010 and approximately \$95 thousand attributable to the first quarter of 2011. Without the adjustments for past periods, the effective tax rate for 2011 would have been 12.2%. The effective tax rate for 2012 was 15.1%. All taxable income for the Corporation is taxed at a rate of 34%.

## Financial Condition

### *Summary:*

At September 30, 2012, assets totaled \$1.057 million, an increase of \$67.0 million from the 2011 year-end balance of \$990.2 million. Investment securities increased \$9.0 million, while net loans decreased \$14.2 million. Deposits were up \$69.8 million in 2012 due primarily to increases in noninterest-bearing and money management deposits. Shareholders' equity increased \$4.5 million during the first nine months as retained earnings increased approximately \$2.5 million, accumulated other comprehensive loss improved \$1.0 million and the Corporation's Dividend Reinvestment Plan (DRIP) added an additional \$971 thousand in new capital.

### *Cash and Cash Equivalents*

Cash and cash equivalents totaled \$104.2 million at September 30, an increase of \$70.1 million from the prior year-end balance of \$34.1 million. The increase is due to large inflows of deposits as well as slow loan growth opportunities. The funds are invested in interest-bearing deposit accounts, primarily at the Federal Reserve.

### *Investment Securities:*

The investment portfolio totaled \$134.3 million at September 30, up 7.2% from the prior year-end balance of \$125.3 million. The portfolio continues to be comprised primarily of municipal securities (46% of the portfolio) and mortgage-backed securities (39% of the portfolio). The majority of the municipal securities portfolio (70.3%) is in held in tax-exempt bonds and the majority of the mortgage-backed securities portfolio (95%) is held in U.S. Agency bonds. The Bank purchased \$10.5 million of securities during the third quarter with the purchases concentrated in U.S. Agency mortgage-backed securities and municipal securities (both tax-free and taxable). The investment portfolio had a net unrealized gain of \$2.5 million at the end of the quarter. The municipal bond sector shows the largest net unrealized gain, while the trust-preferred sector has the largest net unrealized loss. The portfolio averaged \$133.3 million for the year with a yield of 3.02% compared to an average of \$133.1 million and a yield of 3.43% for the same period in 2011. The Bank expects the yield on the portfolio to continue to decline as higher yielding bonds pay-down or mature and reinvestment yields remain low.

The equity portfolio is comprised of bank stocks and the Bank and the Corporation each maintain separate equity investment portfolios. The municipal bond portfolio is well diversified geographically (issuers from within 27 states) and is comprised primarily of general obligation bonds (68%). Most municipal bonds have credit enhancements in the

form of private bond insurance or other credit support. The largest geographic municipal bond exposure is to nineteen issuers in the state of Texas with a fair value of \$9.7 million and eleven issuers in the state of Pennsylvania with a fair value of \$7.0 million. The municipal bond portfolio contains \$57.5 million of bonds rated A, \$1.4 million rated lower than A (but above noninvestment grade), and \$2.4 million that are not rated by a nationally recognized rating agency. No municipal bonds are rated below investment grade. The Bank holds seven Build America Bonds on which the issuer receives a federal interest subsidy for the interest payable on the bond. There has been recent discussion that without Congressional action, the federal spending cuts mandated to take effect in 2013 will result in the end of this federal direct pay interest subsidy. If implemented, these cuts could trigger a call provision on the bonds at prices that may result in a loss to the Bank.

The Bank has a corporate bond portfolio with a fair value of \$985 thousand on one financial service company with a rating of A3. The trust preferred investments are comprised of seven single issuer trust preferred securities with an amortized cost of \$5.9 million and a fair value of \$4.7 million. The majority of the mortgage-backed security portfolio is comprised of U.S. Government Agency products. However, the Bank has seven private-label mortgage backed securities (PLMBS) with an amortized cost of \$2.7 million and a fair value of \$2.5 million.

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2012 and December 31, 2011 are:

| (Dollars in thousands)                   | Amortized  | Gross      | Gross      | Fair         |
|------------------------------------------|------------|------------|------------|--------------|
|                                          | Cost       | Unrealized | Unrealized | Value        |
|                                          |            | Gains      | Losses     |              |
| September 30, 2012                       |            |            |            |              |
| Equity securities                        | \$ 2,104   | \$ 92      | \$ (228)   | ) \$ 1,968   |
| U.S. Government agency securities        | 12,974     | 136        | (14)       | ) 13,096     |
| Municipal securities                     | 58,183     | 3,210      | (122)      | ) 61,271     |
| Corporate debt securities                | 1,006      | -          | (21)       | ) 985        |
| Trust preferred securities               | 5,901      | -          | (1,200)    | ) 4,701      |
| Agency mortgage-backed securities        | 48,892     | 992        | (141)      | ) 49,743     |
| Private-label mortgage-backed securities | 2,710      | -          | (201)      | ) 2,509      |
| Asset-backed securities                  | 60         | -          | (12)       | ) 48         |
|                                          | \$ 131,830 | \$ 4,430   | \$ (1,939) | ) \$ 134,321 |

| (Dollars in thousands)                   | Amortized  | Gross      | Gross      | Fair         |
|------------------------------------------|------------|------------|------------|--------------|
|                                          | Cost       | Unrealized | Unrealized | Value        |
|                                          |            | Gains      | Losses     |              |
| December 31, 2011                        |            |            |            |              |
| Equity securities                        | \$ 2,105   | \$ 11      | \$ (357)   | ) \$ 1,759   |
| U.S. Government agency securities        | 13,159     | 75         | (5)        | ) 13,229     |
| Municipal securities                     | 42,490     | 2,598      | (7)        | ) 45,081     |
| Corporate debt securities                | 2,484      | 49         | (119)      | ) 2,414      |
| Trust preferred securities               | 5,890      | -          | (1,272)    | ) 4,618      |
| Agency mortgage-backed securities        | 54,314     | 1,159      | (188)      | ) 55,285     |
| Private-label mortgage-backed securities | 3,366      | 1          | (500)      | ) 2,867      |
| Asset-backed securities                  | 66         | -          | (18)       | ) 48         |
|                                          | \$ 123,874 | \$ 3,893   | \$ (2,466) | ) \$ 125,301 |

The following table provides additional detail about the Bank's trust preferred securities as of September 30, 2012:

#### Trust Preferred Securities

(Dollars in thousands)

| Deal Name | Class |
|-----------|-------|
|-----------|-------|

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|                            | Single<br>Issuer or<br>Pooled |                    | Amortized<br>Cost | Fair<br>Value | Gross<br>Unrealized<br>Gain<br>(Loss) | Lowest<br>Credit<br>Rating<br>Assigned | Number<br>of<br>Banks | Deferrals<br>and Defaults<br>as % of<br>Original<br>Collateral | Expected Deferral/<br>Defaults as a<br>Percentage of<br>Remaining Performing<br>Collateral |
|----------------------------|-------------------------------|--------------------|-------------------|---------------|---------------------------------------|----------------------------------------|-----------------------|----------------------------------------------------------------|--------------------------------------------------------------------------------------------|
| Huntington Cap Trust       | Single                        | Preferred<br>Stock | \$932             | \$745         | \$(187 )                              | B                                      | 1                     | None                                                           | None                                                                                       |
| Huntington Cap Trust<br>II | Single                        | Preferred<br>Stock | 879               | 707           | (172 )                                | B                                      | 1                     | None                                                           | None                                                                                       |
| BankAmerica Cap III        | Single                        | Preferred<br>Stock | 958               | 721           | (237 )                                | BB                                     | 1                     | None                                                           | None                                                                                       |
| Wachovia Cap Trust<br>II   | Single                        | Preferred<br>Stock | 274               | 225           | (49 )                                 | Baa2                                   | 1                     | None                                                           | None                                                                                       |
| Corestates Captl Tr II     | Single                        | Preferred<br>Stock | 928               | 806           | (122 )                                | Baa1                                   | 1                     | None                                                           | None                                                                                       |
| Chase Cap VI JPM           | Single                        | Preferred<br>Stock | 958               | 763           | (195 )                                | BBB                                    | 1                     | None                                                           | None                                                                                       |
| Fleet Cap Tr V             | Single                        | Preferred<br>Stock | 972               | 734           | (238 )                                | BB                                     | 1                     | None                                                           | None                                                                                       |
|                            |                               |                    | \$5,901           | \$4,701       | \$(1,200)                             |                                        |                       |                                                                |                                                                                            |

The following table provides additional detail about private label mortgage-backed securities as of September 30, 2012:

Private Label Mortgage Backed Securities

(Dollars in thousands)

| Decsription      | Orgination<br>Date | Amortized<br>Cost | Fair<br>Value | Gross<br>Unrealized<br>Gain<br>(Loss) | Collateral<br>Type | Lowest Credit<br>Rating Assigned | Credit<br>Support<br>% | Cummulative<br>OTTI<br>Charges |
|------------------|--------------------|-------------------|---------------|---------------------------------------|--------------------|----------------------------------|------------------------|--------------------------------|
| RALI 2004-QS4 A7 | 3/1/2004           | \$ 358            | \$356         | \$ (2 )                               | ALT A              | AA                               | 12.31                  | \$ -                           |
| MALT 2004-6 7A1  | 6/1/2004           | 559               | 536           | (23 )                                 | ALT A              | B                                | 11.92                  | -                              |
| RALI 2005-QS2 A1 | 2/1/2005           | 475               | 475           | -                                     | ALT A              | CC                               | 7.06                   | -                              |
| RALI 2006-QS4 A2 | 4/1/2006           | 752               | 638           | (114 )                                | ALT A              | D                                | -                      | 253                            |
| GSR 2006-5F 2A1  | 5/1/2006           | 168               | 154           | (14 )                                 | Prime              | C                                | 0.79                   | -                              |
| RALI 2006-QS8 A1 | 7/28/2006          | 398               | 350           | (48 )                                 | ALT A              | D                                | -                      | 187                            |
|                  |                    | \$ 2,710          | \$2,509       | \$ (201 )                             |                    |                                  |                        | \$ 440                         |

The investment portfolio contained 68 securities with \$35.9 million of temporarily impaired fair value and \$1.9 million in unrealized losses. The unrealized loss position is less than at year-end 2011, but there are more securities with an unrealized loss and the temporarily impaired fair value is higher due to an increase in the fair value of municipal bonds with an unrealized loss. The trust preferred sector continues to show the largest unrealized loss at \$1.2 million on seven securities, virtually unchanged from the prior-year end.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for “other-than-temporary” impairment. In the case of debt securities, investments considered for “other-than-temporary” impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. Accordingly, the impairments identified on debt and equity securities and subjected to the assessment at September 30, 2012 were deemed to be temporary and required no further adjustment to the financial statements, unless otherwise noted.

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of September 30, 2012 and December 31, 2011:

|                                          | September 30, 2012  |                   |        |                   |                   |        |            |                   |        |
|------------------------------------------|---------------------|-------------------|--------|-------------------|-------------------|--------|------------|-------------------|--------|
|                                          | Less than 12 months |                   |        | 12 months or more |                   |        | Total      |                   |        |
| (Dollars in thousands)                   | Fair Value          | Unrealized Losses | Number | Fair Value        | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Equity securities                        | \$242               | \$ (3 )           | 3      | \$1,247           | \$ (225 )         | 13     | \$1,489    | \$ (228 )         | 16     |
| U.S. Government agency securities        | 5,297               | (12 )             | 5      | 1,235             | (2 )              | 4      | 6,532      | (14 )             | 9      |
| Municipal securities                     | 7,550               | (122 )            | 8      | -                 | -                 | -      | 7,550      | (122 )            | 8      |
| Corporate debt securities                | -                   | -                 | -      | 985               | (21 )             | 1      | 985        | (21 )             | 1      |
| Trust preferred securities               | -                   | -                 | -      | 4,701             | (1,200 )          | 7      | 4,701      | (1,200 )          | 7      |
| Agency mortgage-backed securities        | 5,430               | (75 )             | 7      | 6,616             | (66 )             | 11     | 12,046     | (141 )            | 18     |
| Private-label mortgage-backed securities | -                   | -                 | -      | 2,509             | (201 )            | 6      | 2,509      | (201 )            | 6      |
| Asset-backed securities                  | -                   | -                 | -      | 49                | (12 )             | 3      | 49         | (12 )             | 3      |
| Total temporarily impaired securities    | \$18,519            | \$ (212 )         | 23     | \$17,342          | \$ (1,727 )       | 45     | \$35,861   | \$ (1,939 )       | 68     |
|                                          |                     |                   |        |                   |                   |        |            |                   |        |
|                                          | December 31, 2011   |                   |        |                   |                   |        |            |                   |        |
|                                          | Less than 12 months |                   |        | 12 months or more |                   |        | Total      |                   |        |
| (Dollars in thousands)                   | Fair Value          | Unrealized Losses | Number | Fair Value        | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Equity securities                        | \$394               | \$ (111 )         | 3      | \$864             | \$ (246 )         | 13     | \$1,258    | \$ (357 )         | 16     |
| U.S. Government agency securities        | 6,068               | (3 )              | 5      | 1,321             | (2 )              | 5      | 7,389      | (5 )              | 10     |
| Municipal securities                     | 579                 | (7 )              | 1      | -                 | -                 | -      | 579        | (7 )              | 1      |
| Corporate debt securities                | -                   | -                 | -      | 1,889             | (119 )            | 2      | 1,889      | (119 )            | 2      |
| Trust preferred securities               | -                   | -                 | -      | 4,618             | (1,272 )          | 7      | 4,618      | (1,272 )          | 7      |
| Agency mortgage-backed securities        | 12,452              | (156 )            | 12     | 1,174             | (32 )             | 1      | 13,626     | (188 )            | 13     |
| Private-label mortgage-backed securities | 1,057               | (36 )             | 2      | 1,636             | (464 )            | 4      | 2,693      | (500 )            | 6      |
| Asset-backed securities                  | -                   | -                 | -      | 48                | (18 )             | 3      | 48         | (18 )             | 3      |
| Total temporarily impaired securities    | \$20,550            | \$ (313 )         | 23     | \$11,550          | \$ (2,153 )       | 35     | \$32,100   | \$ (2,466 )       | 58     |

The trust preferred portfolio contains the largest unrealized loss in the portfolio. At September 30, 2012 this sector contained seven securities with a fair value of \$4.7 million and an unrealized loss of \$1.2 million. These values are

virtually unchanged from the prior year-end. 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) from companies that received money (and in some cases paid back) from the Troubled Asset Relief Program (TARP), continue to pay dividends and have raised capital. None of these bonds have suspended or missed a dividend payment. At September 30, 2012, 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. See the Trust Preferred Securities table for additional information.

The PLMBS sector shows an unrealized loss of \$201 thousand, an improvement over the \$500 thousand unrealized loss at December 31, 2011. These bonds were all rated AAA at time of purchase, but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. As a result of the analysis on PLMBS it was determined that an impairment charge was required on two bonds for a total of \$50 thousand at September 30, 2012. The Bank has recorded \$440 thousand of cumulative impairment charges on this portfolio. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. The Bank is currently participating in a class-action lawsuit against one PLMBS servicer that centers on defective warranties and representations made as part of the underwriting process. See the PLMBS table above for additional information.

The following table represents the cumulative credit losses on securities recognized in earnings as of September 30, 2012.

| (Dollars in thousands)                                                                              | Nine Months<br>Ended<br>September 30,<br>2012 |
|-----------------------------------------------------------------------------------------------------|-----------------------------------------------|
| Balance of cumulative credit losses on securities, January 1, 2012                                  | \$ 390                                        |
| Additions for credit losses recorded which were not previously recognized as components of earnings | 50                                            |
| Balance of cumulative credit losses on securities, September 30, 2012                               | \$ 440                                        |

The Bank held \$4.1 million of restricted stock at September 30, 2012. 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. In December 2008, FHLB announced it would suspend its regular cash dividend and the regular repurchase of excess capital stock from its members as part of its capital restoration plan. However, FHLB has made stock repurchases of \$918 thousand during the year. In addition, FHLB paid a small dividend in 2012. Despite these actions, it does not appear as if FHLB has resumed its past practice of redeeming excess capital stock on a regular basis or paying a regular dividend. 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.

*Loans:*

Residential real estate: This category is comprised of consumer purpose loans secured by residential real estate and to a lesser extent, commercial purpose loans secured by residential real estate. Total residential real estate loans remained relatively flat in 2012 compared to 2011. The consumer purpose category represents traditional residential mortgage loans and home equity products. Consumer first liens increased \$1.8 million, while consumer junior liens and lines of credit decreased by \$4.2 million. The majority of the mortgages generated by the Bank are not held in the Bank's portfolio, but sold in the secondary markets. They are originated for a fee as part of a third party brokerage agreement. In 2012, the Bank originated approximately \$14.4 million in mortgages for a fee through this brokerage agreement. During 2012, the Bank plans to hold specifically identified mortgages it originates; however, if the volume of new mortgages booked is not sufficient to offset the amortization in the portfolio, the balance will decline again in 2012. Home equity lending has been slowed by the recent recession. Many consumers have seen equity in their homes disappear or have been reluctant to borrow due to uncertainty in the economy. Despite low rates, the Bank expects that home equity lending will not improve significantly until the overall economy improves. Commercial purpose loans in this category, which grew \$1.4 million from prior year-end, represent loans made for various business needs, but are secured with residential real estate. In addition to the real estate collateral, it is possible that additional security is provided by personal guarantees or UCC filings. These loans are underwritten as commercial loans.

Residential real estate construction: The largest component of this category represents loans to residential real estate developers. This category declined significantly during 2012, decreasing by 25.8%. The majority of this decrease is offset by the increase in the commercial real estate portfolio as loans were reclassified to more accurately reflect the collateral or purpose of the loan. Real estate construction loans, especially land development loans, may provide an interest reserve in order to assist the developer during the development stage when minimal cash flow is generated. All real estate construction loans are underwritten in the same manner, regardless of the use of an interest reserve. At September 30, 2012, the Bank had \$16.0 million in real estate loans funded with an interest reserve and has capitalized \$2.5 million of interest from these reserves on active projects. Real estate construction loans are monitored on a regular basis by either an independent third party inspector or the assigned loan officer depending on loan amount or complexity of the project. This monitoring process includes at a minimum, the submission of invoices and American Institute of Architects documents of costs incurred by the borrower, on-site inspections, and a signature by the assigned loan officer for disbursement of funds. Year-to-date, the Bank has recognized \$286 thousand of interest income that was funded by interest reserve accounts.

Commercial loans and commercial real estate: Loans in this category include commercial, industrial, farm, agricultural, and municipal government loans. Collateral for these loans may include, commercial real estate, farm real estate, equipment or other business assets. Total commercial loans decreased to \$533.7 million from \$541.7 million at the end of 2011. Commercial real estate loans increased 2.1% from year-end 2011, with a portion of this increase being offset by the decrease in the residential real estate construction portfolio as loans were reclassified to more accurately reflect the collateral or purpose of the loan and by one credit of \$3.7 million that was transferred to OREO at the end of the third quarter. The largest sectors (by collateral) in the commercial real estate category are: development land (\$75.5 million), hotels and motels (\$45.5 million), farm land (\$38.7 million), office buildings (\$32.8 million) and shopping centers (\$23.9 million). Commercial loans decreased 8.4% due primarily to one municipal credit of \$7.3 million that paid off in the first quarter of 2012. The largest sectors (by industry) in the commercial loan category are: manufacturing (\$22.1 million), retail trade (\$17.7 million) and construction (\$16.0 million). The Bank is very active in its market in pursuing commercial lending opportunities, but supplements in-market growth with purchased loan participations. The Bank purchases commercial loan participations in an effort to increase its commercial lending and diversify its loan mix, both geographically and by industry sector. Purchased loans are originated primarily within the south central Pennsylvania market and are purchased from only a few select counter parties. These loans usually represent an opportunity to participate in larger credits that are not available in market, with the benefit of lower origination and servicing costs. In 2012, the Bank purchased \$14.5 million of loan participations and commitments. At September 30, 2012, the Bank held \$137.0 million in purchased loan participations in its portfolio compared to \$152.9 million at year-end 2011. The Bank expects that commercial lending will continue to be the primary area of loan growth in the future via in-market and loan participation activity.

At September 30, 2012, the Bank had \$28.0 million in loans with loan to value ratios that exceeded supervisory loan to value limits. These loans totaled approximately 31% of risk-based capital. The largest sectors of these loans are \$20.9 million for land development and \$4.8 million for commercial real estate. In most circumstances, the Bank's internal loan-to-value limits are equal to or lower than the supervisory limits. Management tracks these exceptions and reports these exposures to the Credit Risk Oversight Committee of the Board of Directors.

Consumer loans decreased \$1.7 million due primarily to regular payments and maturities. The consumer portfolio will continue to run-down, as consumers are unwilling to increase their debt.

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

| (Dollars in thousands)                                           | September 30,<br>2012 | December 31,<br>2011 | Change     |        |
|------------------------------------------------------------------|-----------------------|----------------------|------------|--------|
|                                                                  |                       |                      | Amount     | %      |
| Residential Real Estate 1-4 Family                               |                       |                      |            |        |
| Consumer first liens                                             | \$ 88,525             | \$ 86,767            | \$1,758    | 2.0    |
| Consumer junior liens and lines of credit                        | 36,124                | 40,290               | (4,166 )   | (10.3) |
| Total consumer                                                   | 124,649               | 127,057              | (2,408 )   | (1.9 ) |
| Commercial first lien                                            | 59,705                | 55,130               | 4,575      | 8.3    |
| Commercial junior liens and lines of credit                      | 7,061                 | 7,846                | (785 )     | (10.0) |
| Total                                                            | 66,766                | 62,976               | 3,790      | 6.0    |
| Total residential real estate 1-4 family                         | 191,415               | 190,033              | 1,382      | 0.7    |
| Residential real estate - construction                           |                       |                      |            |        |
| Consumer purpose                                                 | 2,086                 | 1,381                | 705        | 51.0   |
| Commercial purpose                                               | 13,707                | 19,901               | (6,194 )   | (31.1) |
| Total residential real estate construction                       | 15,793                | 21,282               | (5,489 )   | (25.8) |
| Commercial, industrial and agricultural real estate              | 366,341               | 358,974              | 7,367      | 2.1    |
| Commercial, industrial and agricultural                          | 167,310               | 182,694              | (15,384)   | (8.4 ) |
| Consumer                                                         | 11,737                | 13,427               | (1,690 )   | (12.6) |
|                                                                  | 752,596               | 766,410              | (13,814)   | (1.8 ) |
| Less: Allowance for loan losses                                  | (10,113 )             | (9,723 )             | (390 )     | 4.0    |
| Net Loans                                                        | \$ 742,483            | \$ 756,687           | \$(14,204) | (1.9 ) |
| Included in the loan balances are the following:                 |                       |                      |            |        |
| Net unamortized deferred loan costs                              | \$ 280                | \$ 426               |            |        |
| Unamortized discount on purchased loans                          | \$ (133 )             | \$ (167 )            |            |        |
| Loans pledged as collateral for borrowings and commitments from: |                       |                      |            |        |
| FHLB                                                             | \$ 600,504            | \$ 679,272           |            |        |
| Federal Reserve Bank                                             | 102,781               | 27,435               |            |        |
|                                                                  | \$ 703,285            | \$ 706,707           |            |        |

*Loan Quality:*

Management utilizes a risk rating scale ranging from 1 (Prime) to 9 (Loss) to evaluate loan quality. This risk rating scale is used primarily for commercial purpose loans. Consumer purpose loans are identified as either a pass or substandard rating. Substandard consumer loans are loans that are 90 days or more past due and still accruing or on nonaccrual. Loans rated 1 – 4 are considered pass credits. Loans that are rated 5 are pass credits, but have been

identified as credits that are likely to warrant additional attention and monitoring. Loans rated 6 (OAEM) or worse begin to receive enhanced monitoring and reporting by the Bank. The following factors represent some of the factors used in determining the risk rating of a borrower: cash flow, debt coverage, liquidity, management, and collateral. Risk ratings are generally reviewed annually for term debt and at renewal for revolving or renewing debt. The Bank monitors loan quality by continually reviewing four measurements: (1) potential problem loans, (2) delinquent loans (nonaccrual loans and loans past due 90 days or more), (3) other real estate owned (OREO), and (4) net-charge-offs. Management compares trends in these measurements with the Bank's internally established targets, as well as its national peer group.

The potential problem loan list includes loans rated 6 (OAEM), 7 (Substandard), and 8 (Doubtful), but excludes nonaccrual loans and loans that are 90 days or more past due and still accruing. The potential problem loan list is the Bank's broadest review of loan quality. Loans on this list are adversely classified because the borrowers are, or may be experiencing a weakening financial condition that may result in a payment default. If these trends continue, the Bank has an increasing likelihood that it will need to liquidate collateral for repayment. At September 30, 2012, the Bank had \$68.6 million on the potential problem loan list compared to \$80.2 million at June 30, 2012 and \$71.0 million at year-end 2011. The reduction in potential problem loans from June 30, 2012 is due to an increase of \$6.6 million in nonperforming loans (which are excluded from potential problem loans), a \$2.9 million increase in OREO, and the payoff of a \$2.6 million substandard loan in the second quarter. The Bank has one loan for \$2.8 million rated 8 (Doubtful). This loan represents one loan of an \$8.1 million relationship that is on nonaccrual status and is secured by land for a residential real estate development. The land value does not provide sufficient collateral for the entire \$8.1 million relationship and the doubtful loan represents the potential collateral shortage. The Bank is currently in the process of obtaining a new appraisal on the property and is trying to obtain additional collateral from the borrower. If the borrower is unable or unwilling to provide additional collateral by year-end, it is possible that the Bank will record a loss on this loan. However, the amount of the loss, if any, is unknown at this time and will be dependent on the amount of the collateral and the new appraisal. The Bank has no loans rated 9 (Loss). The Bank's Loan Management Committee reviews the potential problem loan list and risk ratings on a monthly basis in order to proactively identify and manage problem loans. See Note 7 in the accompanying financial statements for a note that reports on the internal credit rating for the loan portfolio.

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

Nonaccruing loans generally represent Management's determination that the borrower will be unable to repay the loan in accordance with its contractual terms and that collateral liquidation is not likely to fully repay both interest and principal. It is the Bank's policy to evaluate the probable collectability of principal and interest due under terms of loan contracts for all loans 90-days or more past due or restructured loans. Further, it is the Bank's policy to discontinue accruing interest on loans that are not adequately secured and in the process of collection. Upon determination of nonaccrual status, the Bank subtracts any current year accrued and unpaid interest from its income, and any prior year accrued and unpaid interest from the allowance for loan losses.

The following table presents a summary of nonperforming assets:

| (Dollars in thousands)                                  | September 30, 2012 |                   | December 31, 2011 |                   |
|---------------------------------------------------------|--------------------|-------------------|-------------------|-------------------|
|                                                         | Balance            | % of Loan Segment | Balance           | % of Loan Segment |
| Nonaccrual loans                                        |                    |                   |                   |                   |
| Residential Real Estate                                 |                    |                   |                   |                   |
| First liens                                             | \$ 3,912           | 2.6               | % \$ 1,749        | 1.2               |
| Junior liens and lines of credit                        | 787                | 1.8               | % 282             | 0.6               |
| Total                                                   | 4,699              | 2.5               | % 2,031           | 1.1               |
| Residential real estate - construction                  | 571                | 3.6               | % -               | -                 |
| Commercial, industrial and agricultural real estate     | 24,990             | 6.8               | % 14,278          | 4.0               |
| Commercial, industrial and agricultural                 | 1,344              | 0.8               | % 1,447           | 0.8               |
| Consumer                                                | -                  | -                 | -                 | -                 |
| Total nonaccrual loans                                  | \$ 31,604          |                   | \$ 17,756         |                   |
| Loans past due 90 days or more and still accruing       |                    |                   |                   |                   |
| Residential Real Estate                                 |                    |                   |                   |                   |
| First liens                                             | \$ 549             |                   | \$ 2,516          |                   |
| Junior liens and lines of credit                        | 91                 |                   | 301               |                   |
| Total                                                   | 640                |                   | 2,817             |                   |
| Residential real estate - construction                  | 110                |                   | 121               |                   |
| Commercial, industrial and agricultural real estate     | 3,320              |                   | 1,627             |                   |
| Commercial, industrial and agricultural                 | 303                |                   | 100               |                   |
| Consumer                                                | 29                 |                   | 107               |                   |
| Total loans past due 90 days or more and still accruing | 4,402              |                   | 4,772             |                   |
| Total nonaccrual and loans past due 90 days or more     | 36,006             |                   | 22,528            |                   |
| Reposessed assets                                       | 3                  |                   | 6                 |                   |
| Other real estate owned                                 | 6,165              |                   | 3,224             |                   |
| Total nonperforming assets                              | \$ 42,174          |                   | \$ 25,758         |                   |
| Nonaccrual loans to total gross loans                   | 4.20               | %                 | 2.32              | %                 |
| Nonperforming loans to total gross loans                | 4.78               | %                 | 2.94              | %                 |
| Nonperforming assets to total assets                    | 3.99               | %                 | 2.60              | %                 |
| Allowance for loan losses to nonperforming loans        | 28.09              | %                 | 43.16             | %                 |

Loan quality, as measured by the balance of nonperforming loans (nonaccrual and loans past due 90-days or more) has increased since the prior year-end. Nonperforming loans have increased by \$13.5 million during the year to \$36.0 million. Nonaccrual loans increased \$13.8 million during the year to \$31.6 million at September 30, 2012 and loans 90 days or more past due and still accruing declined slightly. Seventy-six percent of the total nonaccrual balance (\$31.6 million) is comprised of the eight credits (\$24.1 million) shown in the following table of significant nonaccrual

accounts. Management is diligent in its workout efforts on its nonperforming loans. However, the outcome of these workout efforts is always uncertain and it is possible that other loans may become delinquent and nonperforming loans could remain at a high level due to lengthy workout periods on these loans. OREO, depending on the type of property, can also result in an extended holding period prior to disposal.

The following table provides additional information on the most significant nonaccrual accounts:

September 30, 2012  
(Dollars in thousands)

|                                                    | Balance | ALL<br>Reserve | Nonaccrual<br>Date | Collateral                                                                          | Location | Last<br>Appraisal(1) |
|----------------------------------------------------|---------|----------------|--------------------|-------------------------------------------------------------------------------------|----------|----------------------|
| Credit 1<br>Agricultural                           | \$2,541 | -              | Dec-10             | 1st, 2nd and 3rd lien on 600+ acres of farm real estate, and equipment inventory    | PA       | Apr-12<br>\$ 4,344   |
| Credit 2<br>Commercial real estate                 | 3,588   | -              | Dec-10             | 1st lien on 92 acres undeveloped commercial real estate                             | PA       | Jan-12<br>\$ 3,899   |
| Credit 3<br>Commercial and residential real estate | 1,001   | -              | Aug-11             | 1st lien on commercial and residential properties, and 70 acres                     | PA       | Oct-11<br>\$ 1,280   |
| Credit 4<br>Commercial real estate                 | 2,490   | -              | Sep-11             | 1st liens on commercial real estate - performance theaters and business assets      | MO & PA  | Feb-12<br>\$ 4,997   |
| Credit 5<br>Residential real estate development    | 2,721   | -              | Mar-12             | 1st and 2nd commercial real estate, residential real estate and business assets     | PA       | Sep-12<br>\$ 5,244   |
| Credit 6<br>Residential real estate development    | 2,069   | -              | Jun-12             | 1st lien Residential development land -75 acres<br>2nd lien residential real estate | WV<br>PA | Mar-12<br>\$ 2,550   |
| Credit 7<br>Residential real estate development    | 1,655   | -              | Apr-12             | 1st and 2nd liens, residential real estate                                          | PA       | May-12<br>\$ 2,001   |
| Credit 8<br>Residential real estate development    | 8,050   | -              | Sep-12             | 1st lien residential real estate development - 379 acres                            | PA       | Dec-11<br>\$ 5,300   |

\$24,115 \$ -

(1) Appraisal value, as reported, does not reflect the pay-off of any senior liens or any adjustment to reflect the cost to liquidate the collateral.

Nonaccrual Credit 1 provided additional real estate collateral during the second quarter strengthening the Bank's collateral position. A charge-off of \$1.6 million was recorded against Credit 2 during the first quarter. This property has experienced significant declines in appraised values since origination. An appraisal on this property in 2011 resulted in a 53% reduction in value from the original appraisal and a subsequent appraisal in 2012 resulted in an additional reduction in value of 31% from 2011. The Bank is working with Credit 3 to have the borrower sell or auction the property. Credit 4 is a TDR that is in compliance with the modified terms and is on nonaccrual until a satisfactory repayment history is established. This credit is part of a shared national credit. Credit 5 is a TDR that is in compliance with the modified terms and is on nonaccrual until a satisfactory repayment history is established. Credit 6 was written down by \$240 thousand in the second quarter reflecting the new appraisal value. Credit 8 was added to nonaccrual on September 30, 2012 and the Bank is working with the borrower to obtain additional collateral to strengthen its position and has ordered a new appraisal. If the borrower is unable or unwilling to provide additional collateral, it is likely that a write-down on this credit would occur prior to year-end. This credit includes the loan for \$2.7 million that is rated doubtful and was discussed previously.

The Bank also closely monitors impaired loans and troubled debt restructurings (TDR). A loan is considered to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect all interest and principal payments due according to the originally contracted terms of the loan agreement. The Bank reviews all loans rated 7 or lower and all nonaccrual loans for impairment. All TDR loans are considered impaired loans. Impaired loans totaled \$36.9 million at September 30, 2012, up from \$28.0 million at December 31, 2011. However, impaired loans with an established allowance for loan loss declined to \$4.6 million at September 30, 2012 due primarily to the Bank securing additional collateral for specific credits and charge-offs. The increase in impaired loans occurred in the commercial real estate category primarily from the addition of three large residential real estate development relationships during the year. These new impaired loans were discussed as Credit 5, 6 and 8 in the previous nonaccrual loan discussion. Because nonaccrual loans are considered impaired, the largest nonaccrual loans shown above (\$24.1 million) also comprise the majority of the impaired loan balance of \$36.9 million. See Note 7 in the accompanying financial statements for a note that reports on impaired loans.

A loan is considered a troubled debt restructuring (TDR) if the creditor (the Bank), for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. At September 30, 2012, the Bank had TDR loans totaling \$9.7 million compared to \$8.1 million at year-end 2011. The Bank reviews all loans rated 5 or lower when it is providing a loan restructure, modification or new credit facility to determine if the action is a TDR. In addition, the Bank reviews all consumer loan modifications and/or policy exceptions for TDR status. If a TDR loan is placed on nonaccrual status, it remains on nonaccrual status for at least six months to ensure performance. All TDR loans are in compliance with their modified terms. The Bank recorded nine contracts (three relationships) for \$5.6 million as TDR loans during the year. One new TDR relationship was Credit 5 in the nonaccrual discussion. Another new 2012 TDR relationship (2 contracts) was a \$2.2 million commercial loan to a company in an agricultural feed business that has a current balance of \$1.8 million. On October 3, 2012 this company filed for bankruptcy and announced on October 10, 2012 that a buyer for the company has been identified. Based on the facts at this time, the Bank does not expect to incur a loss on this credit. During the second quarter, a TDR loan with a balance of \$2.8 million paid-off with outside financing. See Note 7 in the accompanying financial statements for a note that identifies TDR loans in the portfolio.

The Bank holds \$6.2 million of other real estate owned (OREO), comprised of various types of real estate. The following table provides additional information on significant other real estate owned.

Significant Other Real Estate Owned  
September 30, 2012

| (Dollars in thousands) | Date<br>Acquired | Balance | Collateral<br>unimproved and improved real estate for residential<br>development on four separate tracts totaling 150<br>acres | Location | Last<br>Appraisal |
|------------------------|------------------|---------|--------------------------------------------------------------------------------------------------------------------------------|----------|-------------------|
| Property 1             | 2011             | 2,383   |                                                                                                                                | PA       | Aug-11            |
| Property 2             | 2012             | 3,668   | 1st, 2nd, and 3rd liens residential development<br>land - four tracts with 294 acres                                           | PA       | Aug-12            |
|                        |                  | \$6,051 |                                                                                                                                |          |                   |

Property 1 is comprised of several tracts of land intended for residential real estate development. These properties were obtained as the result of accepting a deed-in-lieu of foreclosure from the developer. Property 2 was added during the third quarter of 2012 and was also acquired by accepting a deed-in-lieu of foreclosure from the developer. At September 30, 2012 and December 31, 2011, the Bank had \$949 thousand of residential properties in the process of foreclosure.

*Allowance for Loan Losses:*

Management performs a monthly evaluation of the adequacy of the allowance for loan losses (ALL). The ALL is determined by segmenting the loan portfolio based on the loan's collateral. The Bank further classifies the portfolio based on the primary purpose of the loan, either consumer or commercial. When calculating the ALL, consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, borrowers' actual or perceived financial and managerial strengths, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. The Bank begins enhanced monitoring of all commercial loans rated 6 (OAEM) or worse, and obtains a new appraisal or asset valuation for any loan rated 7 (Substandard) or worse, including all nonaccrual loans. Management, at its discretion, may determine that additional adjustments to the appraisal or valuation are required. Valuation adjustments will be made as necessary based on factors, including, but not limited to the economy, deferred maintenance, industry, type of property/equipment, age of the appraisal, etc. and the knowledge Management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated and deducted from the valuation in order to determine the net realizable value to the Bank. When determining the allowance for loan loss, certain factors involved in the evaluation are inherently subjective and require material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans. Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy quarterly to the Credit Risk Oversight Committee of the Board of Directors. Management believes that the allowance for loan losses at September 30, 2012 is adequate.

The analysis for determining the ALL is consistent with guidance set forth in generally accepted accounting principles (GAAP) and the Interagency Policy Statement on the Allowance for Loan and Lease Losses. The analysis has two

components, specific and general allocations. The specific component addresses specific reserves established for impaired loans. A loan is considered to be impaired when, based on current information and events, it is probable that the Bank will be unable to collect all interest and principal payments due according to the originally contracted terms of the loan agreement. Expected cash flow or collateral values discounted for market conditions and selling costs are used to establish specific allocations for impaired loans. However, it is possible that as a result of the credit analysis, a specific reserve is not required for an impaired loan. See the previous impaired loan discussion for a table that reports impaired loans and the specific reserve established for impaired loans.

The general allocation component addresses the reserves established for pools of homogenous loans. The general component includes a quantitative and qualitative analysis. When calculating the general allocation, the Bank segregates its loan portfolio into the following sectors based primarily on the type of supporting collateral: residential real estate, commercial, industrial or agricultural real estate; commercial and industrial (C&I non-real estate), and consumer. The residential real estate sector is further segregated by first lien loans, junior liens and home equity products, and residential real estate construction. The quantitative analysis uses the Bank's eight quarter rolling historical loan loss experience adjusted for factors derived from current economic and market conditions that have been determined to have an affect on the probability and magnitude of a loss. The qualitative analysis utilizes a risk matrix that incorporates qualitative and environmental factors such as: loan volume, management, nonperforming loans, loan review process, credit concentrations, competition, and legal and regulatory issues. Input for these factors is determined on the basis of Management's observation, judgment and experience. As a result of this input, additional loss percentages are assigned to each pool of loans.

Real estate appraisals and collateral valuations are an important part of the Bank's process for determining potential loss on collateral dependent loans and thereby have a direct affect on the determination of loan charge-offs and the calculation of the allowance for loan losses. As long as the loan remains a performing loan, no further updates to appraisals are required. If a loan is risk rated 6 or worse, Management determines the need to obtain a new or updated appraisal based on several factors, including general economic conditions and factors specific to the loan. If a loan or relationship migrates to risk rating of 7 or worse, an evaluation for impairment is made based on the current information available at the time of downgrade and a new appraisal or collateral valuation is obtained. We believe this practice complies with the regulatory guidance dated December 12, 2010.

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

The following table shows the loans that were evaluated for the allowance for loan losses under a specific reserve (individually) and those that were evaluated under a general reserve (collectively), and the amount of the allowance established in each category as of September 30, 2012:

|                                    |                                               |            |
|------------------------------------|-----------------------------------------------|------------|
| Residential Real Estate 1-4 Family | Commercial<br>Industrial<br>&<br>Agricultural | Commercial |
|------------------------------------|-----------------------------------------------|------------|

| (Dollars in thousands)               | First<br>Liens | Junior<br>Liens &<br>Lines of<br>Credit | Construction | Real<br>Estate | Industrial<br>&<br>Agricultural | Consumer  | Total      |
|--------------------------------------|----------------|-----------------------------------------|--------------|----------------|---------------------------------|-----------|------------|
| September 30, 2012                   |                |                                         |              |                |                                 |           |            |
| Loans evaluated for allowance:       |                |                                         |              |                |                                 |           |            |
| Individually                         | \$ 3,789       | \$ 740                                  | \$ 571       | \$ 27,729      | \$ 4,086                        | \$ -      | \$ 36,915  |
| Collectively                         | 144,441        | 42,445                                  | 15,222       | 338,612        | 163,224                         | 11,737    | 715,681    |
| Total                                | \$ 148,230     | \$ 43,185                               | \$ 15,793    | \$ 366,341     | \$ 167,310                      | \$ 11,737 | \$ 752,596 |
| ALL established for loans evaluated: |                |                                         |              |                |                                 |           |            |
| Individually                         | \$ -           | \$ -                                    | \$ -         | \$ 400         | \$ 845                          | \$ -      | \$ 1,245   |
| Collectively                         | 863            | 318                                     | 917          | 5,551          | 1,015                           | 204       | 8,868      |
| ALL at September 30, 2012            | \$ 863         | \$ 318                                  | \$ 917       | \$ 5,951       | \$ 1,860                        | \$ 204    | \$ 10,113  |

During the first nine months, \$3.6 million was added to the allowance for loan losses (ALL) through the provision for loan loss expense. This compares to a provision expense of \$5.4 million for the same period in 2011. The provision expense occurred primarily within the general allocation component of the ALL. In the first quarter of 2012, a charge-off of \$1.6 million on one nonperforming commercial real estate loan was recorded. The charge-off was necessary after receiving a 2012 appraisal that was 31% less than a 2011 appraisal. The 2011 appraisal was 53% less than the original appraisal and to date, the Bank has charged-off \$2.9 million on this loan due to the lower appraisals. For the nine months of 2012, the addition to the ALL exceeded net-charge offs by \$390 thousand and the ALL increased from \$9.7 million at the prior year-end to \$10.1 million at September 30, 2012. The ALL as a percentage of loans was 1.34% at September 30, 2012.

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

The Bank recorded net loan charge-offs of \$3.2 million for year-to-date compared to \$5.0 million for the same period in 2011. The commercial real estate portfolio recorded the largest net charge-off of \$2.4 million, fueled by the \$1.6 million charge-off discussed previously. See Note 7 in the accompanying financial statements for additional information on the allowance for loan loss.

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

| (Dollars in thousands)    | Residential Real Estate 1-4 Family |                                         |              | Commercial<br>Industrial<br>&<br>Agricultural |          | Commercial<br>Industrial<br>&<br>Agricultural |          | Total    |
|---------------------------|------------------------------------|-----------------------------------------|--------------|-----------------------------------------------|----------|-----------------------------------------------|----------|----------|
|                           | First<br>Liens                     | Junior Liens<br>&<br>Lines of<br>Credit | Construction | Real Estate                                   |          |                                               | Consumer |          |
| ALL at June 30, 2012      | \$ 777                             | \$ 321                                  | \$ 925       | \$ 5,839                                      | \$ 1,564 | \$ 201                                        |          | \$9,627  |
| Charge-offs               | (71 )                              | -                                       | -            | (159 )                                        | (73 )    | (61 )                                         | (364 )   |          |
| Recoveries                | -                                  | -                                       | -            | 2                                             | 10       | 13                                            | 25       |          |
| Provision                 | 157                                | (3 )                                    | (8 )         | 269                                           | 359      | 51                                            | 825      |          |
| ALL at September 30, 2012 | \$ 863                             | \$ 318                                  | \$ 917       | \$ 5,951                                      | \$ 1,860 | \$ 204                                        |          | \$10,113 |

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|                           |          |        |          |          |          |        |          |
|---------------------------|----------|--------|----------|----------|----------|--------|----------|
| ALL at December 31, 2011  | \$ 1,049 | \$ 308 | \$ 1,222 | \$ 5,257 | \$ 1,651 | \$ 236 | \$9,723  |
| Charge-offs               | (251 )   | (65 )  | -        | (2,413 ) | (418 )   | (183 ) | (3,330 ) |
| Recoveries                | -        | 25     | -        | 11       | 17       | 67     | 120      |
| Provision                 | 65       | 50     | (305 )   | 3,096    | 610      | 84     | 3,600    |
| ALL at September 30, 2012 | \$ 863   | \$ 318 | \$ 917   | \$ 5,951 | \$ 1,860 | \$ 204 | \$10,113 |

|                          |          |        |          |          |          |        |          |
|--------------------------|----------|--------|----------|----------|----------|--------|----------|
| ALL at December 31, 2010 | \$ 600   | \$ 352 | \$ 2,596 | \$ 3,358 | \$ 1,578 | \$ 317 | \$8,801  |
| Charge-offs              | (324 )   | (202 ) | (2,352 ) | (3,817 ) | (115 )   | (237 ) | (7,047 ) |
| Recoveries               | 30       | 10     | -        | 306      | 11       | 88     | 445      |
| Provision                | 743      | 148    | 978      | 5,410    | 177      | 68     | 7,524    |
| ALL at December 31, 2011 | \$ 1,049 | \$ 308 | \$ 1,222 | \$ 5,257 | \$ 1,651 | \$ 236 | \$9,723  |

|                                                                        | September 30,<br>2012 |   | December 31,<br>2011 |   | September 30,<br>2011 |   |
|------------------------------------------------------------------------|-----------------------|---|----------------------|---|-----------------------|---|
| Net loans charged-off as a percentage of average gross loans           | 0.56                  | % | 0.86                 | % | 0.88                  | % |
| Net loans charged-off as a percentage of the provision for loan losses | 89.17                 | % | 87.75                | % | 92.76                 | % |
| Allowance as a percentage of loans                                     | 1.34                  | % | 1.27                 | % | 1.20                  | % |
| Net charge-offs                                                        | \$ 3,210              |   | \$ 6,602             |   | \$ 5,048              |   |

*Deposits:*

Total deposits increased \$69.8 million during the first nine months of 2012 to \$857.8 million. Non-interest bearing deposits increased \$13.9 million, while interest-bearing checking and savings deposits increased \$52.6 million and time deposits increased \$3.3 million. The increase in non-interest bearing checking accounts came primarily from state & municipal checking accounts (\$7.2 million). The Bank's Money Management product increased \$39.8 million due primarily to an increase in retail accounts and an increase in the balance of ICS reciprocal money market deposits. ICS is used primarily by commercial and municipal accounts for liquidity and FDIC coverage. Retail time deposits decreased since year-end, as customers moved funds to more liquid accounts. However, brokered CDs increased \$9.7 million, which includes new brokered CDs of \$32.2 million that includes \$23 million to pre-fund FHLB term loans that are maturing in 2012 and to replace higher rate brokered CDs of \$9.2 million that were called for early redemption by the Bank. As of September 30, 2012, the Bank had \$3.4 million in CDARS reciprocal deposits included in brokered time deposits.

The following table presents a summary of deposits outstanding at:

| (Dollars in thousands)                                   | September 30, 2012 | December 31, 2011 | Change<br>Amount | %      |
|----------------------------------------------------------|--------------------|-------------------|------------------|--------|
| Demand, noninterest-bearing checking                     | \$ 118,180         | \$ 104,245        | \$13,935         | 13.4   |
| Interest-bearing checking                                | 126,013            | 117,479           | 8,534            | 7.3    |
| Money market accounts                                    | 366,041            | 326,219           | 39,822           | 12.2   |
| Savings accounts                                         | 55,955             | 51,728            | 4,227            | 8.2    |
| Total interest-bearing checking and savings              | 548,009            | 495,426           | 52,583           | 10.6   |
| Retail time deposits                                     | 141,061            | 147,479           | (6,418 )         | (4.4 ) |
| Brokered time deposits                                   | 50,576             | 40,836            | 9,740            | 23.9   |
| Total time deposits                                      | 191,637            | 188,315           | 3,322            | 1.8    |
| Total deposits                                           | \$ 857,826         | \$ 787,986        | \$69,840         | 8.9    |
| Overdrawn deposit accounts reclassified as loan balances | \$ 155             | \$ 232            |                  |        |

*Borrowings:*

The balance of securities sold under agreements to repurchase, which are accounted for as collateralized financings, increased \$3.0 million from year-end and the long-term debt from the FHLB decreased \$10.4 million due to scheduled amortization and maturities, as well as the prepayment of two FHLB term loans totaling \$8 million. The Corporation paid \$74 thousand in prepayment penalties on these prepayments. The prepayment penalties are expected to be recovered by the end of 2012. Subsequent to the end of the third quarter, the Bank also prepaid one FHLB term loan

totaling \$15 million and paid \$93 thousand in prepayment penalties. These penalties are also expected to be recovered by the end of 2012.

*Shareholders' Equity:*

Total shareholders' equity increased \$4.5 million to \$91.7 million at September 30, 2012, compared to \$87.2 million at the end of 2011. The increase in retained earnings from the Corporation's net income of \$5.0 million was partially offset by the cash dividend of \$2.5 million. The Corporation's dividend payout ratio is 49.3% for the first nine months of 2012 compared to 68.4% in 2011.

As part of its quarterly dividend decision, the Corporation considers current and future income projections, dividend yield, payout ratio, and current and future capital ratios. On July 26, 2012, the Board of Directors declared a \$.17 per share regular quarterly dividend for the third quarter of 2012. This compares to a regular quarterly cash dividend of \$.17 paid in the second quarter of 2012 and a \$.27 per share dividend paid in the same period in 2011. On October 25, 2012 the Board of Directors declared a \$.17 per share regular quarterly dividend for the fourth quarter of 2012, which will be paid on November 28, 2012.

In addition, the Corporation considers how dividend decisions may affect the Dividend Reinvestment Plan (DRIP), which has raised \$971 thousand in new capital this year with 69,652 new shares purchased. The Corporation continually explores other sources of capital as part of its capital management plan for the Corporation and the Bank. The Corporation did not repurchase any shares of the Corporation's common stock during the first nine months of 2012. During the first quarter of 2012, the Corporation and the Bank completed a merger of subsidiaries (see Note 1) that resulted in \$1.4 million of new capital to the Bank.

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. At September 30, 2012, the Corporation was well capitalized as defined by the banking regulatory agencies. Regulatory capital ratios for the Corporation and the Bank are shown below:

|                                         | September 30, 2012 |   | December 31, 2011 |   | Regulatory Ratios |         |       |   |
|-----------------------------------------|--------------------|---|-------------------|---|-------------------|---------|-------|---|
|                                         |                    |   |                   |   | Well Capitalized  |         |       |   |
|                                         |                    |   |                   |   | Minimum           | Minimum |       |   |
| Total Risk Based Capital Ratio (1)      |                    |   |                   |   |                   |         |       |   |
| Franklin Financial Services Corporation | 12.66              | % | 12.14             | % | 8.00              | %       | n/a   |   |
| Farmers & Merchants Trust Company       | 12.29              | % | 11.51             | % | 8.00              | %       | 10.00 | % |
| Tier 1 Capital Ratio (2)                |                    |   |                   |   |                   |         |       |   |
| Franklin Financial Services Corporation | 11.41              | % | 10.89             | % | 4.00              | %       | n/a   |   |
| Farmers & Merchants Trust Company       | 11.04              | % | 10.26             | % | 4.00              | %       | 6.00  | % |
| Leverage Ratio (3)                      |                    |   |                   |   |                   |         |       |   |
| Franklin Financial Services Corporation | 8.20               | % | 8.40              | % | 4.00              | %       | n/a   |   |
| Farmers & Merchants Trust Company       | 7.91               | % | 7.89              | % | 4.00              | %       | 5.00  | % |

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

Economy

The Corporation's primary market area includes Franklin, Fulton, Cumberland and Huntingdon County, PA. This area is diverse in demographic and economic makeup. County populations range from a low of approximately 15,000 in Fulton County to over 238,000 in Cumberland County. At September 30, 2012, the unemployment rate for Pennsylvania was 7.5% and the national rate was 7.8%, while the unemployment rate in the Corporation's market area ranged from 6.8% in Franklin County to 8.6% in Fulton County. The unemployment rates for the Bank's market area have remained high during the last three years along with state and national rates. Housing prices have improved slightly over prior year, while mortgage delinquencies are consistent from the end of 2011.

The following table presents economic data for the Bank's primary market area:

#### Economic Data

|                                                          | September 30, 2012 |   | December 31, 2011 |   |
|----------------------------------------------------------|--------------------|---|-------------------|---|
| Unemployment Rate (seasonally adjusted)                  |                    |   |                   |   |
| Market area range (1)                                    | 6.7 - 9.5          | % | 6.7% - 10         | % |
| Pennsylvania                                             | 7.9                | % | 7.9               | % |
| United States                                            | 8.3                | % | 9.0               | % |
| Housing Price Index - year over year change              |                    |   |                   |   |
| PA, nonmetropolitan statistical area                     | -0.7               | % | -3.3              | % |
| United States                                            | -0.6               | % | -4.5              | % |
| Franklin County Building Permits - year over year change |                    |   |                   |   |
| Residential, estimated                                   | -62.2              | % | -34.3             | % |
| Multifamily, estimated                                   | -49.2              | % | -73.4             | % |

(1) Franklin, Cumberland, Fulton and Huntingdon Counties

Unlike many companies, the assets and liabilities of the Corporation are financial in nature. As such, interest rates and changes in interest rates may have a more significant effect on the Corporation's financial results than on other types of industries. Because of this, the Corporation watches the actions of the Federal Reserve Open Market Committee (FOMC) as it makes decisions about interest rate changes. The Fed continues to hold the fed funds target rate steady at .25% and has indicated that it could maintain this level until 2015. This decision, coupled with other Fed actions, seems to indicate that the yield curve will continue to create an environment that is not conducive to bank earnings.

#### Regulatory Issues

Notice of Proposed Rulemaking. In June 2012, U.S. bank regulators issued a joint notice of proposed rule making that included proposals for revisions to capital requirements and risk weighted asset calculations. Included in the proposed capital rules are: 1) revised definitions of regulatory capital, 2) higher minimum capital ratios, 3) a new common equity Tier 1 capital ratio, and 4) a new capital conservation buffer that would limit capital distributions if the buffer ratio is not maintained. The proposed changes to risk based capital primarily center on higher risk weighting for numerous asset classes. If approved, the rules will go into effective on January 1, 2013. However, some components of the rules are phased-in with full compliance not required until January 1, 2019. The Corporation is closely reviewing the proposed rules and the potential effect on its capital and risk weighted assets, but the overall effect has not been determined at this time.

FDIC Insurance. The Transaction Account Guarantee (TAG) program that provides unlimited FDIC insurance on certain non-interest bearing depository accounts is set to expire on December 31, 2012. The Bank is reviewing accounts that could be affected by the loss of full FDIC coverage and the potential implications on the Bank. At this time, it is uncertain if TAG will be extended or not.

Pension Funding. In June 2012, Congress approved the Moving Ahead for Progress in the 21<sup>st</sup> Century (MAP-21) Act as part of a highway expenditures bill that included pension funding relief. The relief is in the form of interest rate stabilization by allowing the use of a 25- year average rate (within a defined range of a minimum and maximum percentage) to calculate pension funding compared to a 2-year average rate currently used. This change is expected to reduce pension contributions, but will have no affect on the Corporation's financial statements for accounting purposes. The change is effective in 2013 with the option of early implementation in 2012. The Bank has decided to implement MAP-21 in 2012 and will therefore, see a reduction in its pension contribution for 2012.

## Liquidity

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

Historically, the Corporation has satisfied its liquidity needs from earnings, repayment of loans and amortizing investment securities, maturing investment securities, loan sales, deposit growth and its ability to access existing lines of credit. All investments are classified as available for sale; therefore, securities that are not pledged as collateral for borrowings are an additional source of readily available liquidity, either by selling the security or, more preferably, to provide collateral for additional borrowing. However, at September 30, 2012, the Bank had approximately \$122 million (fair value) or 94% of its investment portfolio (debt securities) pledged as collateral. The primary source of liquidity for the Bank is a line of credit with the FHLB. At September 30, 2012, the Bank had approximately \$47 million available on this line of credit. The Bank continues to operate in a collateral delivery status with the FHLB as reported in its December 31, 2011 Annual Report on Form 10-K.

The Bank also has \$16 million in unsecured lines of credit at two correspondent banks and approximately \$56 million in funding available at the Federal Reserve Discount Window. The Bank also has the ability to access other funding sources via wholesale borrowings, brokered CDs and CD listing services. The Bank's ability to access brokered CDs could be negatively affected if its capital level was to fall below "well capitalized."

## Off Balance Sheet Commitments and Contractual Obligations

The Corporation's financial statements do not reflect various commitments that are made in the normal course of business, which may involve some liquidity risk. These commitments consist mainly of unfunded loans and letters of credit made under the same standards as on-balance sheet instruments. Because these instruments have fixed maturity dates, and because many of them will expire without being drawn upon, they do not generally present any significant

liquidity risk to the Corporation. Unused commitments and standby letters of credit totaled \$237.8 million and \$249.8 million, respectively, at September 30, 2012 and December 31, 2011.

The Corporation has entered into various contractual obligations to make future payments. These obligations include time deposits, long-term debt, operating leases, deferred compensation and pension payments. These amounts have not changed materially from those reported in the Corporation's 2011 Annual Report on Form 10-K.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There were no material changes in the Corporation's exposure to market risk during the three months ended September 30, 2012. For more information on market risk refer to the Corporation's 2011 Annual Report on Form 10-K.

Item 4. Controls and Procedures

Evaluation of Controls and Procedures

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2012, the Corporation's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in the Corporation's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

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

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

Part II – OTHER INFORMATION

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There were no material changes in the Corporation's risk factors during the three months ended September 30, 2012. For more information, refer to the Corporation's 2011 Annual Report on Form 10-K.

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

None

61

**Item 3. Defaults by the Company on its Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not Applicable

**Item 5. Other Information**

None

**Item 6. Exhibits**

Exhibits

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

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

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

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

32.1 Section 1350 Certifications – Principal Executive Officer

32.2 Section 1350 Certifications – Principal Financial Officer

101 Interactive Data File (XBRL)\*\*

\*\* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability under these sections.

FRANKLIN FINANCIAL SERVICES CORPORATION

and SUBSIDIARIES

SIGNATURES

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

Franklin Financial Services Corporation

November 9, 2012

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

November 9, 2012

/s/ Mark R. Hollar  
Mark R. Hollar  
Treasurer and Chief Financial Officer  
(Principal Financial Officer)