

FRANKLIN FINANCIAL SERVICES CORP /PA/

Form 10-Q

August 11, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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

For the transition period from _____ to _____

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

PENNSYLVANIA

(State or other jurisdiction of incorporation or organization)

25-1440803

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

20 South Main Street, Chambersburg PA17201-0819

(Address of principal executive offices) (Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

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

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

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

There were 4,193,398 outstanding shares of the Registrant’s common stock as of July 31, 2014.

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Part I FINANCIAL INFORMATION

Item 1 Financial Statements

Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)	(unaudited)	
	June 30 2014	December 31 2013
Assets		
Cash and due from banks	\$ 17,515	\$ 13,542
Interest-bearing deposits in other banks	37,276	27,203
Total cash and cash equivalents	54,791	40,745
Investment securities available for sale, at fair value	175,419	159,674
Restricted stock	1,938	1,906
Loans held for sale	600	349
Loans	732,719	723,413
Allowance for loan losses	(9,519)	(9,702)
Net Loans	723,200	713,711
Premises and equipment, net	15,762	16,145
Bank owned life insurance	21,816	21,530
Goodwill	9,016	9,016
Other intangible assets	491	698
Other real estate owned	4,112	4,708
Deferred tax asset, net	4,717	5,445
Other assets	10,689	10,660
Total assets	\$ 1,022,551	\$ 984,587
Liabilities		
Deposits		
Noninterest-bearing checking	\$ 129,270	\$ 121,565
Money management, savings and interest checking	665,627	610,245
Time	105,807	113,914
Total Deposits	900,704	845,724
Securities sold under agreements to repurchase	2,264	23,834
Long-term debt	12,000	12,403
Other liabilities	7,624	7,238
Total liabilities	922,592	889,199
Shareholders' equity		
Common stock, \$1 par value per share, 15,000,000 shares authorized with 4,581,342 shares issued and 4,192,791 shares outstanding at June 30, 2014 and 4,560,700 shares issued and 4,168,673 shares outstanding at December 31, 2013	4,581	4,561

Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding	-	-
Additional paid-in capital	36,980	36,636
Retained earnings	68,623	65,897
Accumulated other comprehensive loss	(3,277)	(4,696)
Treasury stock, 388,551 shares at June 30, 2014 and 392,027 shares at December 31, 2013, at cost	(6,948)	(7,010)
Total shareholders' equity	99,959	95,388
Total liabilities and shareholders' equity	\$ 1,022,551	\$ 984,587

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		For the Six Months	
	Months Ended		Ended	
	June 30	June 30	June 30	2013
	2014	2013	2014	2013
Interest income				
Loans, including fees	\$ 7,648	\$ 8,035	\$ 15,159	\$ 16,332
Interest and dividends on investments:				
Taxable interest	661	365	1,302	718
Tax exempt interest	376	381	734	757
Dividend income	31	22	56	40
Deposits and obligations of other banks	45	73	84	131
Total interest income	8,761	8,876	17,335	17,978
Interest expense				
Deposits	694	1,162	1,396	2,265
Securities sold under agreements to repurchase	2	12	9	30
Long-term debt	121	122	242	243
Total interest expense	817	1,296	1,647	2,538
Net interest income	7,944	7,580	15,688	15,440
Provision for loan losses	266	803	464	1,605
Net interest income after provision for loan losses	7,678	6,777	15,224	13,835
Noninterest income				
Investment and trust services fees	1,101	1,130	2,192	2,148
Loan service charges	250	192	418	442
Mortgage banking activities	19	40	32	18
Deposit service charges and fees	525	452	990	888
Other service charges and fees	317	233	584	455
Debit card income	337	316	643	602
Increase in cash surrender value of life insurance	144	153	286	305
Other real estate owned (losses) gains, net	(62)	(141)	(185)	(141)
Other	10	47	62	89
OTTI losses recognized in earnings	-	(50)	-	(50)
Securities gains, net	221	29	221	29
Total noninterest income	2,862	2,401	5,243	4,785
Noninterest expense				
Salaries and employee benefits	4,107	4,018	8,357	8,232
Net occupancy expense	586	568	1,262	1,136
Furniture and equipment expense	237	244	491	491
Advertising	270	317	586	652
Legal and professional fees	353	359	618	639
Data processing	493	451	884	845
Pennsylvania bank shares tax	173	204	347	409
Intangible amortization	104	106	207	213
FDIC insurance	222	270	454	515

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ATM/debit card processing	178	165	357	346
Other	892	923	1,741	1,730
Total noninterest expense	7,615	7,625	15,304	15,208
Income before federal income taxes	2,925	1,553	5,163	3,412
Federal income tax expense	606	198	1,018	506
Net income	\$ 2,319	\$ 1,355	\$ 4,145	\$ 2,906
Per share				
Basic earnings per share	\$ 0.55	\$ 0.33	\$ 0.99	\$ 0.71
Diluted earnings per share	\$ 0.55	\$ 0.33	\$ 0.99	\$ 0.70
Cash dividends declared	\$ 0.17	\$ 0.17	\$ 0.34	\$ 0.34

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

Consolidated Statements of Comprehensive Income

(Dollars in thousands) (unaudited)	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2014	2013	2014	2013
Net Income	\$ 2,319	\$ 1,355	\$ 4,145	\$ 2,906
Securities:				
Unrealized gains (losses) arising during the period	774	(1,768)	2,194	(1,591)
Reclassification adjustment for (gains) losses included in net income	(221)	21	(221)	21
Net unrealized (losses) gains	553	(1,747)	1,973	(1,570)
Tax effect	(188)	594	(671)	534
Net of tax amount	365	(1,153)	1,302	(1,036)
Derivatives:				
Unrealized (losses) gains arising during the period	(4)	42	(12)	44
Reclassification adjustment for losses included in net income (1)	94	152	189	332
Net unrealized gains	90	194	177	376
Tax effect	(30)	(66)	(60)	(128)
Net of tax amount	60	128	117	248
Total other comprehensive income (loss)	425	(1,025)	1,419	(788)
Total Comprehensive Income	\$ 2,744	\$ 330	\$ 5,564	\$ 2,118
			Tax expense	Tax expense
Reclassification adjustment / Statement line item			(benefit)	(benefit)
(1) Derivatives / interest expense on deposits	\$ (32)	\$ (52)	\$ (64)	\$ (113)

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

Consolidated Statements of Changes in Shareholders' Equity

For the Six months June 30, 2014 and 2013:

	Common	Additional Paid-in	Retained	Accumulated Other	Treasury	
(Dollars in thousands, except per share data) (unaudited)	Stock	Capital	Earnings	Loss	Stock	Total
Balance at December 31, 2012	\$ 4,503	\$ 35,788	\$ 62,475	\$ (4,050)	\$ (7,082)	\$ 91,634
Net income	-	-	2,906	-	-	2,906
Other comprehensive loss	-	-	-	(788)	-	(788)
Cash dividends declared, \$.34 per share	-	-	(1,399)	-	-	(1,399)
Treasury shares issued under stock option plans, 3,701 shares	-	(20)	-	-	67	47
Common stock issued under dividend reinvestment plan, 22,920 shares	23	338	-	-	-	361
Balance at June 30, 2013	\$ 4,526	\$ 36,106	\$ 63,982	\$ (4,838)	\$ (7,015)	\$ 92,761
Balance at December 31, 2013	\$ 4,561	\$ 36,636	\$ 65,897	\$ (4,696)	\$ (7,010)	\$ 95,388
Net income	-	-	4,145	-	-	4,145
Other comprehensive income	-	-	-	1,419	-	1,419
Cash dividends declared, \$.34 per share	-	-	(1,419)	-	-	(1,419)
Treasury shares issued under stock option plans, 3,476 shares	-	(10)	-	-	62	52
Common stock issued under dividend reinvestment plan, 20,642 shares	20	354	-	-	-	374
Balance at June 30, 2014	\$ 4,581	\$ 36,980	\$ 68,623	\$ (3,277)	\$ (6,948)	\$ 99,959

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

Consolidated Statements of Cash Flows

	Six Months Ended June 30	
	2014	2013
(Dollars in thousands)		
(unaudited)		
Cash flows from operating activities		
Net income	\$ 4,145	\$ 2,906
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	732	754
Net amortization of loans and investment securities	893	910
Amortization and net change in mortgage servicing rights valuation	8	33
Amortization of intangibles	207	213
Provision for loan losses	464	1,605
Net realized gains on sales of securities	(221)	(29)
Impairment writedown on securities recognized in earnings	-	50
Loans originated for sale	(3,554)	(5,270)
Proceeds from sale of loans	3,303	5,099
Writedown of other real estate owned	200	135
Net (gain) loss on sale or disposal of other real estate/other repossessed assets	(15)	6
Increase in cash surrender value of life insurance	(286)	(305)
(Increase) decrease in other assets	(118)	1,077
Increase (decrease) in other liabilities	526	(265)
Other, net	87	705
	6,371	7,624

Net cash provided by operating activities		
Cash flows from investing activities		
Proceeds from sales and calls of investment securities available for sale	1,582	5,147
Proceeds from maturities and paydowns of securities available for sale	12,313	18,376
Purchase of investment securities available for sale	(28,362)	(42,743)
Net (increase) decrease in restricted stock	(32)	1,436
Net (increase) decrease in loans	(10,012)	23,614
Capital expenditures	(321)	(275)
Proceeds from sale of other real estate/other repossessed assets	493	15
Net cash (used in) provided by investing activities	(24,339)	5,570
Cash flows from financing activities		
Net increase in demand deposits, NOW, and savings accounts	63,087	50,532
Net decrease in time deposits	(8,107)	(43,175)
Net decrease in repurchase agreements	(21,570)	(3,275)
Long-term debt payments	(403)	(4)
Dividends paid	(1,419)	(1,399)
Treasury stock issued under stock option plans	52	47
Common stock issued under dividend reinvestment plan	374	361
Net cash provided by financing activities	32,014	3,087
Increase in cash and cash equivalents	14,046	16,281
Cash and cash equivalents as of January 1	40,745	77,834

Cash and cash equivalents as of June 30	\$	54,791	\$	94,115
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Supplemental Disclosures
of Cash Flow Information
Cash paid during the year
for:

Interest on deposits and other borrowed funds	\$	1,670	\$	2,607
Income taxes	\$	236	\$	300

Noncash Activities

Loans transferred to Other Real Estate	\$	82	\$	293
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The accompanying notes
are an integral part of
these financial statements.

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Franklin Financial Services Corporation (the Corporation), and its wholly-owned subsidiaries, Farmers and Merchants Trust Company of Chambersburg (the Bank) and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank that has one wholly-owned subsidiary, Franklin Financial Properties Corp. Franklin Financial 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 June 30, 2014, and for all other periods presented have been made.

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

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

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

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

	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2014	2013	2014	2013
(Dollars and shares in thousands, except per share data)				
Weighted average shares outstanding (basic)	4,184	4,126	4,178	4,119
Impact of common stock equivalents	7	7	6	7
Weighted average shares outstanding (diluted)	4,191	4,133	4,184	4,126

Anti-dilutive options excluded from calculation	34	46	37	57
Net income	\$ 2,319	\$ 1,355	\$ 4,145	\$ 2,906
Basic earnings per share	\$ 0.55	\$ 0.33	\$ 0.99	\$ 0.71
Diluted earnings per share	\$ 0.55	\$ 0.33	\$ 0.99	\$ 0.70

Note 2. Recent Accounting Pronouncements

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

Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11 “Presentation of an Unrecognized Tax Benefit

When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists,” require an entity with an unrecognized tax benefit that is ‘not available’ or not intended to be used at the reporting date to present the unrecognized tax benefit as a liability that should not be combined with deferred tax assets. Otherwise, the unrecognized tax benefit should be presented as a reduction to the related deferred tax asset. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments in ASU 2013-11 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Corporation adopted this ASU 2013-11 at March 31, 2014.

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

Note 3. Accumulated Other Comprehensive Loss

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

	June 30 2014	December 31 2013
(Dollars in thousands)		
Net unrealized gains (losses) on securities	\$ 1,232	\$ (741)
Tax effect	(419)	252
Net of tax amount	813	(489)
Net unrealized losses on derivatives	(384)	(561)
Tax effect	131	191
Net of tax amount	(253)	(370)

Accumulated pension adjustment	(5,814)	(5,814)
Tax effect	1,977	1,977
Net of tax amount	(3,837)	(3,837)
Total accumulated other comprehensive loss	\$ (3,277)	\$ (4,696)

Note 4. Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting these commitments. The Bank had \$22.5 million and \$20.2 million of standby letters of credit as of June 30, 2014 and

December 31, 2013, respectively. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of June 30, 2014 and December 31, 2013 for guarantees under standby letters of credit issued was not material.

Note 5. Investments

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

(Dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
June 30, 2014				
Equity securities	\$ 110	\$ 284	\$ -	\$ 394
U.S. Government agency securities	15,376	99	(80)	15,395
Municipal securities	64,018	1,762	(730)	65,050
Corporate debt securities	1,000	-	-	1,000
Trust preferred securities	5,931	-	(625)	5,306
Agency mortgage-backed securities	85,859	905	(412)	86,352
Private-label mortgage-backed securities	1,845	45	(14)	1,876
Asset-backed securities	48	-	(2)	46
	\$ 174,187	\$ 3,095	\$ (1,863)	\$ 175,419

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

\$ 160,415 \$ 2,735 \$ (3,476) \$ 159,674

At June 30, 2014 and December 31, 2013, the fair value of investment securities pledged to secure public funds, trust balances, repurchase agreements, deposit and other obligations totaled \$83.9 million and \$107.6 million, respectively.

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

(Dollars in thousands)	Amortized	
	cost	Fair value
Due in one year or less	\$ 2,741	\$ 2,780
Due after one year through five years	11,474	11,911
Due after five years through ten years	27,749	28,064
Due after ten years	44,409	44,042
	86,373	86,797
Mortgage-backed securities	87,704	88,228
	\$ 174,077	\$ 175,025

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

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 Currently Performing	Deferrals and Defaults as % of Original Collateral	Expected Deferral/ Defaults as a Percentage of Remaining Performing Collateral
Huntington Cap Trust	Single	Preferred Stock	\$ 937	\$ 844	\$ (93)	BB+	1	None	None
Huntington Cap Trust II	Single	Preferred Stock	887	821	(66)	BB+	1	None	None
BankAmerica Cap III	Single	Preferred Stock	962	836	(126)	BB+	1	None	None
Wachovia Cap Trust II	Single	Preferred Stock	276	257	(19)	BBB+	1	None	None
Corestates Captl Tr II	Single	Preferred Stock	934	871	(63)	BBB+	1	None	None
Chase Cap VI JPM	Single	Preferred Stock	961	865	(96)	BBB	1	None	None

Fleet Cap Tr		Preferred							
V	Single	Stock	974	812	(162)	BB+	1	None	None
			\$ 5,931	\$ 5,306	\$ (625)				

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

Private Label Mortgage Backed Securities

(Dollars in thousands)

Description	Origination Date	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
RALI 2004-QS4 A7	3/1/2004	\$ 129	\$ 134	\$ 5	ALT A	BBB+	12.53	\$ -
MALT 2004-6 7A1	6/1/2004	424	444	20	ALT A	CCC	14.38	-
RALI 2005-QS2 A1	2/1/2005	308	321	13	ALT A	CC	5.78	10
RALI 2006-QS4 A2	4/1/2006	575	567	(8)	ALT A	D	-	293
GSR 2006-5F 2A1	5/1/2006	91	98	7	Prime	D	-	15
RALI 2006-QS8 A1	7/28/2006	318	312	(6)	ALT A	D	-	197
		\$ 1,845	\$ 1,876	\$ 31				\$ 515

Impairment:

The investment portfolio contained 99 securities with \$75.8 million of temporarily impaired fair value and \$1.9 million in unrealized losses at June 30, 2014. The total unrealized loss position has improved by \$1.6 million since year-end 2013.

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

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

(Dollars in thousands)	June 30, 2014								
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Total Fair Value	Unrealized Losses	Count
U.S. Government agency securities	\$ 2,078	\$ (2)	3	\$ 7,509	\$ (78)	13	\$ 9,587	\$ (80)	16
Municipal securities	10,051	(111)	14	15,070	(619)	21	25,121	(730)	35
Trust preferred securities	-	-	-	5,306	(625)	7	5,306	(625)	7
Agency mortgage-backed securities	20,400	(126)	21	14,472	(286)	17	34,872	(412)	38
Private-label mortgage-backed securities	-	-	-	879	(14)	2	879	(14)	2
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	\$ 32,529	\$ (239)	38	\$ 43,241	\$ (1,624)	61	\$ 75,770	\$ (1,863)	99

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

The municipal bond portfolio has the largest unrealized loss at \$730 thousand, but this is \$674 thousand less than at the prior-year end. The unrealized loss in this portfolio is deemed to be non-credit related and no other-than-temporary impairment charges have been recorded.

The trust preferred portfolio contains seven securities with a fair value of \$5.3 million and an unrealized loss of \$625 thousand. The trust-preferred securities held by the Bank are single entity issues, not pooled trust preferred securities. Therefore, the impairment review of these securities is based only on the issuer and the security cannot be impaired by the performance of other issuers as if it was a pooled trust-preferred bond. All of the Bank's trust preferred securities are

single issue, variable rate notes with long maturities (2027 – 2028). None of these bonds have suspended or missed a dividend payment. At June 30, 2014, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded.

The PLMBS sector shows a gross unrealized loss of \$14 thousand. 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 no impairment charge was required at quarter end. The Bank has recorded \$515 thousand of cumulative impairment charges on this portfolio. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. The Bank is currently participating in a class-action lawsuit against one PLMBS servicer that centers on defective warranties and representations made as part of the underwriting process.

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

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

Note 6. Loans

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

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

(Dollars in thousands)	June 30, 2014	December 31, 2013	Change	
			Amount	%
Residential Real Estate 1-4 Family				
Consumer first liens	\$ 102,849	\$ 103,573	\$ (724)	(0.7)
Consumer junior liens and lines of credit	35,131	34,636	495	1.4
Total consumer	137,980	138,209	(229)	(0.2)
Commercial first lien	58,639	58,466	173	0.3
Commercial junior liens and lines of credit	4,940	5,939	(999)	(16.8)
Total commercial	63,579	64,405	(826)	(1.3)
Total residential real estate 1-4 family	201,559	202,614	(1,055)	(0.5)
Residential real estate - construction				
Consumer	2,414	3,960	(1,546)	(39.0)
Commercial	8,868	8,559	309	3.6
Total residential real estate construction	11,282	12,519	(1,237)	(9.9)
Commercial real estate	322,465	329,373	(6,908)	(2.1)
Commercial	190,130	170,327	19,803	11.6
Total commercial	512,595	499,700	12,895	2.6
Consumer	7,283	8,580	(1,297)	(15.1)
	732,719	723,413	9,306	1.3
Less: Allowance for loan losses	(9,519)	(9,702)	183	1.9
Net Loans	\$ 723,200	\$ 713,711	\$ 9,489	1.3
Included in the loan balances are the following:				
Net unamortized deferred loan costs	\$ 472	\$ 372		
Unamortized discount on purchased loans	\$ (49)	\$ (92)		

Loans pledged as collateral for borrowings and commitments from:

FHLB	\$ 594,772	\$ 607,524
Federal Reserve Bank	57,689	45,809
	\$ 652,461	\$ 653,333

Note 7. Loan Quality

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

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial			Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Consumer	
Allowance at March 31, 2014	\$ 1,133	\$ 276	\$ 374	\$ 5,509	\$ 2,309	\$ 144	\$ 9,745
Charge-offs	(241)	-	-	(234)	(11)	(37)	(523)
Recoveries	-	-	-	-	13	18	31
Provision	187	(10)	(113)	137	55	10	266
Allowance at June 30, 2014	\$ 1,079	\$ 266	\$ 261	\$ 5,412	\$ 2,366	\$ 135	\$ 9,519
Allowance at December 31, 2013	\$ 1,108	\$ 278	\$ 291	\$ 5,571	\$ 2,306	\$ 148	\$ 9,702
Charge-offs	(257)	-	(27)	(348)	(12)	(80)	(724)
Recoveries	3	-	-	-	33	41	77
Provision	225	(12)	(3)	189	39	26	464
Allowance at June 30, 2014	\$ 1,079	\$ 266	\$ 261	\$ 5,412	\$ 2,366	\$ 135	\$ 9,519
Allowance at March 31, 2013	\$ 973	\$ 296	\$ 837	\$ 6,682	\$ 1,972	\$ 183	\$ 10,943
Charge-offs	(39)	-	-	-	(317)	(40)	(396)
Recoveries	1	-	-	3	68	16	88
Provision	430	(18)	(136)	45	479	3	803
Allowance at June 30, 2013	\$ 1,365	\$ 278	\$ 701	\$ 6,730	\$ 2,202	\$ 162	\$ 11,438
Allowance at December 31, 2012	\$ 913	\$ 306	\$ 899	\$ 6,450	\$ 1,620	\$ 191	\$ 10,379
Charge-offs	(39)	(45)	-	(167)	(327)	(84)	(662)
Recoveries	9	-	-	3	75	29	116
Provision	482	17	(198)	444	834	26	1,605
Allowance at June 30, 2013	\$ 1,365	\$ 278	\$ 701	\$ 6,730	\$ 2,202	\$ 162	\$ 11,438

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

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial		Consumer	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial		
June 30, 2014							
Loans evaluated for allowance:							
Individually	\$ 1,158	\$ 51	\$ 525	\$ 22,210	\$ 1,924	\$ -	\$ 25,868
Collectively	160,330	40,020	10,757	300,255	188,206	7,283	706,851
Total	\$ 161,488	\$ 40,071	\$ 11,282	\$ 322,465	\$ 190,130	\$ 7,283	\$ 732,719
Allowance established for loans evaluated:							
Individually	\$ -	\$ -	\$ -	\$ 68	\$ 957	\$ -	\$ 1,025
Collectively	1,079	266	261	5,344	1,409	135	8,494
Allowance at June 30, 2014	\$ 1,079	\$ 266	\$ 261	\$ 5,412	\$ 2,366	\$ 135	\$ 9,519
December 31, 2013							
Loans evaluated for allowance:							
Individually	\$ 2,354	\$ 50	\$ 537	\$ 25,107	\$ 1,996	\$ -	\$ 30,044
Collectively	159,685	40,525	11,982	304,266	168,331	8,580	693,369
Total	\$ 162,039	\$ 40,575	\$ 12,519	\$ 329,373	\$ 170,327	\$ 8,580	\$ 723,413
Allowance established for loans evaluated:							
Individually	\$ 9	\$ -	\$ -	\$ 89	\$ 1,002	\$ -	\$ 1,100
Collectively	1,099	278	291	5,482	1,304	148	8,602
Allowance at December 31, 2013	\$ 1,108	\$ 278	\$ 291	\$ 5,571	\$ 2,306	\$ 148	\$ 9,702

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

(Dollars in thousands)	Impaired Loans				
	With No Allowance		With Allowance		Related Allowance
	Recorded Investment	Principal Balance	Recorded Investment	Principal Balance	
Unpaid					
June 30, 2014					
Residential Real Estate 1-4 Family					
First liens	\$ 2,271	\$ 2,348	\$ -	\$ -	\$ -
Junior liens and lines of credit	120	145	-	-	-
Total	2,391	2,493	-	-	-
Residential real estate - construction	525	553	-	-	-
Commercial real estate	21,338	27,103	916	1,022	68
Commercial	139	392	1,898	2,019	957
Total	\$ 24,393	\$ 30,541	\$ 2,814	\$ 3,041	\$ 1,025

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

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

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

(Dollars in thousands)	Three Months Ended June 30, 2013		Six Months Ended June 30, 2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	\$ 3,439	\$ 4	\$ 4,283	\$ 8
Junior liens and lines of credit	679	4	722	1
Total	4,118	8	5,005	9
Residential real estate - construction	550	-	692	-
Commercial real estate	29,705	96	24,218	36
Commercial	2,454	-	4,219	36
Total	\$ 36,827	\$ 104	\$ 34,134	\$ 81

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

(Dollars in thousands)	Loans Past Due and Still Accruing					Non-Accrual	Total Loans
	Current	30-59 Days	60-89 Days	90 Days+	Total		
June 30, 2014							
Residential Real Estate 1-4 Family							
First liens	\$ 159,292	\$ 316	\$ 213	\$ 392	\$ 921	\$ 1,275	\$ 161,488
Junior liens and lines of credit	39,811	111	28	11	150	110	40,071
Total	199,103	427	241	403	1,071	1,385	201,559
Residential real estate - construction							
Commercial real estate	10,138	-	619	-	619	525	11,282
Commercial	303,567	546	2,167	-	2,713	16,185	322,465
Commercial	187,344	225	18	-	243	2,543	190,130
Consumer	7,160	84	31	8	123	-	7,283
Total	\$ 707,312	\$ 1,282	\$ 3,076	\$ 411	\$ 4,769	\$ 20,638	\$ 732,719

December 31, 2013

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