FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-Q
August 05, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013

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

For the transition period from__________ to___________

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

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

20 South Main Street, Chambersburg, PA	17201-0819
(Address of principal executive offices)	(Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

<u>Not Applicable</u>

(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 x 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 x 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 x

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

There were 4,139,133 outstanding shares of the Registrant’s common stock as of July 31, 2013.

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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 2013	December 31 2012
Assets		
Cash and due from banks	$ 14,789	$ 20,578
Interest-bearing deposits in other banks	79,326	57,256
Total cash and cash equivalents	94,115	77,834
Investment securities available for sale, at fair value	150,004	133,328
Restricted stock	2,135	3,571
Loans held for sale	238	67
Loans	729,167	753,579
Allowance for loan losses	(11,438)	(10,379)
Net Loans	717,729	743,200
Premises and equipment, net	16,599	17,037
Bank owned life insurance	21,229	20,925
Goodwill	9,016	9,016
Other intangible assets	910	1,123
Other real estate owned	5,264	5,127
Deferred tax asset	5,851	5,461
Other assets	9,551	10,674
Total assets	$ 1,032,641	$ 1,027,363
Liabilities		
Deposits		
Noninterest-bearing checking	$ 118,943	$ 123,623
Money management, savings and interest-bearing checking	627,910	572,698
Time	134,944	178,119
Total Deposits	881,797	874,440
Securities sold under agreements to repurchase	38,934	42,209
Long-term debt	12,406	12,410
Other liabilities	6,743	6,670
Total liabilities	939,880	935,729
Shareholders' equity		
Common stock, $1 par value per share,15,000,000 shares authorized with 4,526,300 shares issued and 4,133,967 shares outstanding at June 30, 2013 and 4,503,380 shares issued and 4,107,346 shares outstanding at December 31, 2012	4,526	4,503
	-	-

Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding		
Additional paid-in capital	36,106	35,788
Retained earnings	63,982	62,475
Accumulated other comprehensive loss	(4,838)	(4,050)
Treasury stock, 392,333 shares at June 30, 2013 and 396,034 shares at December 31, 2012, at cost	(7,015)	(7,082)
Total shareholders' equity	92,761	91,634
Total liabilities and shareholders' equity	$ 1,032,641	$ 1,027,363

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

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Consolidated Statements of Income

(Dollars in thousands, except per share data) (unaudited)	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2013	2012	2013	2012
Interest income				
Loans, including fees	$ 8,035	$ 9,112	$ 16,332	$ 18,210
Interest and dividends on investments:				
Taxable interest	365	451	718	885
Tax exempt interest	381	366	757	732
Dividend income	22	18	40	34
Deposits and obligations of other banks	73	55	131	91
Total interest income	8,876	10,002	17,978	19,952
Interest expense				
Deposits	1,162	1,304	2,265	2,758
Securities sold under agreements to repurchase	12	19	30	39
Long-term debt	122	488	243	980
Total interest expense	1,296	1,811	2,538	3,777
Net interest income	7,580	8,191	15,440	16,175
Provision for loan losses	803	825	1,605	2,775
Net interest income after provision for loan losses	6,777	7,366	13,835	13,400
Noninterest income				
Investment and trust services fees	1,130	1,059	2,148	2,026
Loan service charges	192	269	442	541
Mortgage banking activities	40	(27)	18	20
Deposit service charges and fees	452	479	888	954
Other service charges and fees	233	213	455	448
Debit card income	316	295	602	570
Increase in cash surrender value of life insurance	153	167	305	334
Other real estate owned (losses) gains, net	(141)	(10)	(141)	27
Other	47	27	89	115
OTTI losses recognized in earnings	(50)	-	(50)	-
Securities gains, net	29	21	29	21
Total noninterest income	2,401	2,493	4,785	5,056
Noninterest expense				
Salaries and employee benefits	4,018	4,157	8,232	7,956
Net occupancy expense	568	493	1,136	1,011
Furniture and equipment expense	244	218	491	427
Advertising	317	396	652	710
Legal and professional fees	359	260	639	539
Data processing	451	440	845	853

Pennsylvania bank shares tax	204	187	409	373
Intangible amortization	106	109	213	218
FDIC insurance	270	267	515	528
ATM/debit card processing	165	155	346	306
Other	923	915	1,730	1,685
Total noninterest expense	7,625	7,597	15,208	14,606
Income before federal income taxes	1,553	2,262	3,412	3,850
Federal income tax expense	198	356	506	575
Net income	$ 1,355	$ 1,906	$ 2,906	$ 3,275
Per share				
Basic earnings per share	$ 0.33	$ 0.47	$ 0.71	$ 0.81
Diluted earnings per share	$ 0.33	$ 0.47	$ 0.70	$ 0.81
Cash dividends declared	$ 0.17	$ 0.17	$ 0.34	$ 0.44

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 2013	2012	For the Six Months Ended June 30 2013	2012
Net Income	$ 1,355	$ 1,906	$ 2,906	$ 3,275
Securities:				
Unrealized (losses) gains arising during the period	(1,768)	238	(1,591)	500
Reclassification adjustment for losses (gains) included in net income	21	(21)	21	(21)
Net unrealized (losses) gains	(1,747)	217	(1,570)	479
Tax effect	594	(74)	534	(163)
Net of tax amount	(1,153)	143	(1,036)	316
Derivatives:				
Unrealized gains (losses) arising during the period	42	(93)	44	(63)
Reclassification adjustment for losses included in net income (1)	152	178	332	358
Net unrealized gains	194	85	376	295
Tax effect	(66)	(29)	(128)	(100)
Net of tax amount	128	56	248	195
Total other comprehensive (loss) income	(1,025)	199	(788)	511
Total Comprehensive Income	$ 330	$ 2,105	$ 2,118	$ 3,786
Reclassification adjustment / Statement line item	Tax expense (benefit)		Tax expense (benefit)	
(1) Derivatives / interest expense on deposits	$ (52)	$ (61)	$ (113)	$ (122)

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

Consolidated Statements of Changes in Shareholders' Equity

For the six months June 30, 2013 and 2012:

(Dollars in thousands, except per share data) (unaudited)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance at December 31, 2011	$4,419	$34,698	$60,280	$(5,131)	$(7,084)	$87,182

Net income	-	-	3,275	-	-	3,275
Other comprehensive income	-	-	-	511	-	511
Cash dividends declared, $.44 per share	-	-	(1,780)	-	-	(1,780)
Common stock issued under dividend reinvestment plan, 52,659 shares	53	687	-	-	-	740
Balance at June 30, 2012	$4,472	$35,385	$61,775	$(4,620)	$(7,084)	$89,928
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

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

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Consolidated Statements of Cash Flows

	Six Months Ended June 30	
	2013	2012
(Dollars in thousands) (unaudited)		
Cash flows from operating activities		
Net income	$ 2,906	$ 3,275
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	754	702
Net amortization of loans and investment securities	910	676
Amortization and net change in mortgage servicing rights valuation	33	56
Amortization of intangibles	213	218
Provision for loan losses	1,605	2,775
Net realized gains on sales of securities	(29)	(21)
Impairment writedown on securities recognized in earnings	50	-
Loans originated for sale	(5,270)	(4,473)
Proceeds from sale of loans	5,099	3,678
Writedown of other real estate owned	135	-
Net loss (gain) on sale or disposal of other real estate/other repossessed assets	6	(20)
Increase in cash surrender value of life insurance	(305)	(334)
Contribution to pension plan	-	(576)
Decrease (increase) in interest receivable and other assets	1,077	(97)
(Decrease) increase in interest payable and other liabilities	(265)	151
Other, net	705	(12)
Net cash provided by operating activities	7,624	5,998
Cash flows from investing activities		
Proceeds from sales and calls of investment securities available for sale	5,147	471
Proceeds from maturities and paydowns of investment securities available for sale	18,376	18,239
Purchase of investment securities available for sale	(42,743)	(26,107)
Net decrease in restricted stock	1,436	487
Net decrease (increase) in loans	23,614	(5,136)
Proceeds from sale of other real estate/other repossessed assets	15	195
Capital expenditures	(275)	(688)
Net cash provided by (used in) investing activities	5,570	(12,539)
Cash flows from financing activities		
Net increase in demand deposits, interest-bearing and savings accounts	50,532	60,094
Net (decrease) increase in time deposits	(43,175)	8,566
Net decrease in repurchase agreements	(3,275)	(2,075)
Long-term debt payments	(4)	(2,044)
Dividends paid	(1,399)	(1,780)
Treasury stock issued under stock option plans	47	-
Common stock issued under dividend reinvestment plan	361	740
Net cash provided by financing activities	3,087	63,501

Increase in cash and cash equivalents	16,281	56,960
Cash and cash equivalents as of January 1	77,834	34,144
Cash and cash equivalents as of June 30	$ 94,115	$ 91,104
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest on deposits and other borrowed funds	$ 2,607	$ 3,863
Income taxes	$ 300	$ -
Noncash Activities		
Loans transferred to Other Real Estate	$ 293	$ 241

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, 2013, 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 2012 Annual Report on Form 10-K. The consolidated results of operations for the period ended June 30, 2013 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 financial information at December 31, 2012 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements.

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

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

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(Dollars and shares in thousands, except per share data)	2013	2012	2013	2012
Weighted average shares outstanding (basic)	4,126	4,066	4,119	4,053
Impact of common stock equivalents	7	-	7	-
Weighted average shares outstanding (diluted)	4,133	4,066	4,126	4,053
Anti-dilutive options excluded from calculation	46	100	57	104
Net income	$ 1,355	$ 1,906	$ 2,906	$ 3,275
Basic earnings per share	$ 0.33	$ 0.47	$ 0.71	$ 0.81
Diluted earnings per share	$ 0.33	$ 0.47	$ 0.70	$ 0.81

Note 2. Recent Accounting Pronouncements

Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. ASU 2013-02 "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income," requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. The amendments are effective prospectively for reporting periods beginning after December 15, 2012. The Corporation adopted this ASU at March 31, 2013.

Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. The objective of this ASU is to address the limitation of ASU 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*. This ASU clarifies that the scope of ASU 2011-11 applies to derivatives accounted for in accordance with Topic 815, Derivatives and Hedging, which includes bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements. It also applies to securities borrowing and lending transactions that are offset in accordance with Section 210-20-45 or Section 215-10-45 or subject to an enforceable master netting arrangement or similar agreement. This Update will provide users of financial statements with comparable information as it relates to certain reconciling differences between financial statements prepared in accordance with U.S. GAAP and those prepared in accordance with International Financial Reporting Standards. This update requires that the gross amounts of the asset and offsetting liabilities be disclosed in the notes to the financial statements. The provisions of this ASU are effective for fiscal years beginning on or after January 1, 2013 and interim periods within those annual periods, the same effective date as Update 2011-11. The required disclosures are to be retrospectively applied for all comparative periods presented. The Corporation adopted this ASU at March 31, 2013.

Note 3. Accumulated Other Comprehensive Loss

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

(Dollars in thousands)	June 30, 2013	December 31, 2012
Net unrealized gains on securities	$ 973	$ 2,543
Tax effect	(331)	(865)
Net of tax amount	642	1,678
Net unrealized losses on derivatives	(727)	(1,103)
Tax effect	247	375
Net of tax amount	(480)	(728)
Accumulated pension adjustment	(7,576)	(7,576)
Tax effect	2,576	2,576
Net of tax amount	(5,000)	(5,000)
Total accumulated other comprehensive loss	$ (4,838)	$ (4,050)

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 $20.6 million and $28.2 million of standby letters of credit as of June 30, 2013 and December 31, 2012, 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, 2013 and December 31, 2012 for guarantees under standby letters of credit issued was not material.

Note 5. Investments

The investment portfolio increased $16.7 million since year-end 2012. The Bank has invested $42.7 million during the year with the majority of the purchases in U.S. Agency mortgage-backed securities. U.S. Agency mortgage-backed securities and municipal bonds continue to comprise the greatest portion of the portfolio at 45% and 40% of the portfolio respectively.

The investment portfolio had a net unrealized gain of $973 thousand at the end of the quarter compared to $2.5 million at the end of 2012. Bond prices fell at the end of the second quarter in what appears to have been a temporary over reaction to comments from the Federal Reserve. Prices have recovered somewhat since then. The municipal bond sector shows the largest net unrealized gain, while the trust-preferred sector has the largest net unrealized loss. The portfolio averaged $141.3 million for the year with a yield of 2.67% compared to an average of $129.1 million and a yield of 3.11% for the same period in 2012. 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 portfolios. During the second quarter, both the Bank and the Corporation sold equity securities and the amortized cost basis of this sector was reduced by 33%. The municipal bond portfolio is well diversified geographically (issuers from within 28 states) and is comprised primarily of general obligation bonds (71%). 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 twenty issuers in the state of Texas with a fair value of $10.1 million and eleven issuers in the state of Pennsylvania with a fair value of $6.3 million. The municipal bond portfolio contains $57.3 million of bonds rated A or higher, $629 thousand rated lower than A (but above noninvestment grade), and $2.1 million that are not rated by Moody’s rating agency. No municipal bonds are rated below investment grade. The Bank holds one variable rate corporate bond in the financial services sector and it is rated A3 by Moody’s.

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 $4.9 million. The Bank has six private-label mortgage backed securities (PLMBS) with an amortized cost of $2.3 million and a fair value of $2.3 million.

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2013 and December 31, 2012 is as follows:

(Dollars in thousands) June 30, 2013	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 1,399	$ 103	$ (23)	$ 1,479
U.S. Government agency securities	12,135	128	(39)	12,224
Municipal securities	58,513	2,105	(601)	60,017
Corporate debt securities	1,004	-	(5)	999
Trust preferred securities	5,914	-	(993)	4,921
Agency mortgage-backed securities	67,740	780	(471)	68,049
Private-label mortgage-backed securities	2,271	21	(29)	2,263
Asset-backed securities	55	-	(3)	52
	$ 149,031	$ 3,137	$ (2,164)	$ 150,004

(Dollars in thousands)		Gross	Gross	

December 31, 2012	Amortized cost	unrealized gains	unrealized losses	Fair value
Equity securities	$ 2,104	$ 92	$ (255)	$ 1,941
U.S. Government agency securities	12,657	156	(4)	12,809
Municipal securities	58,395	2,984	(163)	61,216
Corporate debt securities	1,005	-	(11)	994
Trust preferred securities	5,905	-	(1,075)	4,830
Agency mortgage-backed securities	48,121	1,029	(84)	49,066
Private-label mortgage-backed securities	2,539	10	(123)	2,426
Asset-backed securities	59	-	(13)	46
	$ 130,785	$ 4,271	$ (1,728)	$ 133,328

At June 30, 2013 and December 31, 2012, the fair value of investment securities pledged to secure public funds, trust balances, repurchase agreements, deposit and other obligations totaled $114.9 million and $119.8 million, respectively.

The amortized cost and estimated fair value of debt securities at June 30, 2013, 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)	Amorized cost	Fair value
Due in one year or less	$ 1,234	$ 1,249
Due after one year through five years	14,295	14,983
Due after five years through ten years	21,862	22,517
Due after ten years	40,230	39,464
	77,621	78,213
Mortgage-backed securities	70,011	70,312
	$ 147,632	$ 148,525

The following table provides additional detail about trust preferred securities as of June 30, 2013:

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	$934	$707	$(227)	BB	1	None	None
Huntington Cap Trust II	Single	Preferred Stock	883	706	(177)	BB	1	None	None
BankAmerica Cap III	Single	Preferred Stock	959	794	(165)	BB	1	None	None
Wachovia Cap Trust II	Single	Preferred Stock	275	253	(22)	BBB+	1	None	None
Corestates Captl Tr II	Single	Preferred Stock	930	844	(86)	BBB+	1	None	None
Chase Cap VI JPM	Single	Preferred Stock	960	821	(139)	BBB	1	None	None
Fleet Cap Tr V	Single	Preferred Stock	973	796	(177)	BB+	1	None	None
			$5,914	$4,921	$(993)				

The following table provides additional detail about private label mortgage-backed securities as of June 30, 2013:

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	$ 255	$254	$ (1)	ALT A	BBB+	12.02	$ -
MALT 2004-6 7A1	6/1/2004	498	511	13	ALT A	CCC	13.04	-
RALI 2005-QS2 A1	2/1/2005	381	388	7	ALT A	CC	6.54	-
RALI 2006-QS4 A2	4/1/2006	663	641	(22)	ALT A	D	-	278
GSR 2006-5F 2A1	5/1/2006	118	119	1	Prime	D	-	15
RALI 2006-QS8 A1	7/28/2006	356	350	(6)	ALT A	D	-	197
		$ 2,271	$2,263	$ (8)				$ 490

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Impairment:

The investment portfolio contained eighty-three securities with $56.7 million of temporarily impaired fair value and $2.2 million in unrealized losses. The unrealized loss position has increased over year-end 2012. The trust preferred sector continues to show the largest unrealized loss at $1.0 million on seven securities, a slight improvement 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 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, 2013, 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, 2013 and December 31, 2012:

	June 30, 2013								
	Less than 12 months			12 months or more			Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
Equity securities	$109	$(5)	1	$555	$(18)	4	$664	$(23)	5
U.S. Government agency securities	2,954	(30)	5	3,996	(9)	7	6,950	(39)	12
Municipal securities	15,031	(554)	21	1,189	(47)	1	16,220	(601)	22
Corporate debt securities	-	-	-	999	(5)	1	999	(5)	1
Trust preferred securities	-	-	-	4,921	(993)	7	4,921	(993)	7
Agency mortgage-backed securities	25,548	(470)	29	84	(1)	1	25,632	(471)	30
Private-label mortgage-backed securities	-	-	-	1,245	(29)	3	1,245	(29)	3
Asset-backed securities	-	-	-	52	(3)	3	52	(3)	3
Total temporarily impaired securities	$43,642	$(1,059)	56	$13,041	$(1,105)	27	$56,683	$(2,164)	83

	December 31, 2012								
	Less than 12 months			12 months or more			Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
Equity securities	$226	$(20)	3	$1,236	$(235)	13	$1,462	$(255)	16
U.S. Government agency securities	938	(1)	1	3,346	(3)	6	4,284	(4)	7
Municipal securities	8,789	(163)	10	-	-	-	8,789	(163)	10
Corporate debt securities	-	-	-	994	(11)	1	994	(11)	1
Trust preferred securities	-	-	-	4,830	(1,075)	7	4,830	(1,075)	7
Agency mortgage-backed securities	6,869	(68)	8	2,664	(16)	6	9,533	(84)	14
Private-label mortgage-backed securities	-	-	-	1,875	(123)	5	1,875	(123)	5
Asset-backed securities	-	-	-	46	(13)	3	46	(13)	3
Total temporarily impaired securities	$16,822	$(252)	22	$14,991	$(1,476)	41	$31,813	$(1,728)	63

As of June 30, 2013, three equity securities were determined to be other-than-temporarily impaired and an impairment charge of $50 thousand was recorded.

The trust preferred portfolio contains the largest unrealized loss in the portfolio. At June 30, 2013 this sector contained seven securities with a fair value of $4.9 million and an unrealized loss of $1.0 million, representing a slight improvement over year-end 2012. 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, 2013, 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 a gross unrealized loss of $29 thousand, an improvement over the $123 thousand unrealized loss at December 31, 2012. 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 $490 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 Bank held $2.1 million of restricted stock at June 30, 2013. 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 Pittsburgh has repurchased $1.4 million of its capital stock during the year. 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 mortgage loans include long-term loans to individuals and businesses secured by mortgages on the borrower's real property. 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 loans are made to businesses of various sizes for a variety of purposes including construction, property, plant and equipment, and working capital. Commercial loans also include 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, home equity 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, 2013	December 31, 2012	Change Amount	%
Residential Real Estate 1-4 Family				
Consumer first liens	$ 99,350	$ 93,790	$ 5,560	5.9
Consumer junior liens and lines of credit	32,724	35,494	(2,770)	(7.8)
Total consumer	132,074	129,284	2,790	2.2
Commercial first lien	57,063	60,809	(3,746)	(6.2)
Commercial junior liens and lines of credit	6,443	6,794	(351)	(5.2)
Total	63,506	67,603	(4,097)	(6.1)
Total residential real estate 1-4 family	195,580	196,887	(1,307)	(0.7)
Residential real estate - construction				
Consumer purpose	4,451	3,255	1,196	36.7
Commercial purpose	7,585	12,177	(4,592)	(37.7)
Total residential real estate construction	12,036	15,432	(3,396)	(22.0)
Commercial, industrial and agricultural real estate	359,563	363,874	(4,311)	(1.2)
Commercial, industrial and agricultural	152,423	166,734	(14,311)	(8.6)
Total commercial, industrial and agricultural	511,986	530,608	(18,622)	(3.5)
Consumer	9,565	10,652	(1,087)	(10.2)
	729,167	753,579	(24,412)	(3.2)
Less: Allowance for loan losses	(11,438)	(10,379)	(1,059)	10.2
Net Loans	$ 717,729	$ 743,200	$ (25,471)	(3.4)
Included in the loan balances are the following:				
Net unamortized deferred loan costs	$ 360	$ 456		

Unamortized discount on purchased loans	$ (109)	$ (129)
Loans pledged as collateral for borrowings and commitments from:		
FHLB	$ 592,412	$ 657,684
Federal Reserve Bank	79,460	112,613
	$ 671,872	$ 770,297

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Note 7. Loan Quality

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

	Residential Real Estate 1-4 Family			Commercial Industrial & Agricultural	Commercial		
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Industrial & Agricultural	Consumer	Total
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
Allowance at March 31, 2012	$ 932	$ 311	$ 878	$ 5,792	$ 1,388	$ 206	$ 9,507
Charge-offs	(144)	-	-	(262)	(312)	(36)	(754)
Recoveries	-	25	-	1	5	18	49
Provision	(11)	(15)	47	308	483	13	825
Allowance at June 30, 2012	$ 777	$ 321	$ 925	$ 5,839	$ 1,564	$ 201	$ 9,627
Allowance at December 31, 2011	$ 1,049	$ 308	$ 1,222	$ 5,257	$ 1,651	$ 236	$ 9,723
Charge-offs	(180)	(65)	-	(2,254)	(345)	(122)	(2,966)
Recoveries	-	25	-	9	7	54	95
Provision	(92)	53	(297)	2,827	251	33	2,775
Allowance at June 30, 2012	$ 777	$ 321	$ 925	$ 5,839	$ 1,564	$ 201	$ 9,627
Allowance at December 31, 2011	$ 1,049	$ 308	$ 1,222	$ 5,257	$ 1,651	$ 236	$ 9,723
Charge-offs	(251)	(71)	-	(3,298)	(861)	(236)	(4,717)
Recoveries	1	25	-	13	21	88	148
Provision	114	44	(323)	4,478	809	103	5,225

Allowance at December 31, 2012	$ 913	$ 306	$ 899	$ 6,450	$ 1,620	$ 191	$10,379

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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), and the amount of the allowance established in each category as of June 30, 2013 and December 31, 2012:

Residential Real Estate 1-4 Family		Commercial	
		Industrial &	Commercial
	Junior Liens &	Agricultural	Industrial &