FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-Q
August 04, 2017
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, 2017

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

For the transition period from__________ to___________

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

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

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

(717) 264-6116

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

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

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

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

Indicate by check mark whether the registrant is an emerging growth company as defined in Rule 405 of the Securities Act of 1933 (§230.405 of this chapter) or Rule 12b-2 of the Securities Exchange Act of 1934 (§240.12b-2 of this chapter).

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

There were 4,340,631 outstanding shares of the Registrant's common stock as of July 31, 2017.

INDEX

Part I - FINANCIAL INFORMATION

Item 1	Financial Statements	
	Consolidated Balance Sheets as of June 30, 2017 and December 31, 2016 (unaudited)	1
	Consolidated Statements of Income for the Three and Six Months ended June 30, 2017 and 2016 (unaudited)	2
	Consolidated Statements of Comprehensive Income for the Three and Six Months ended June 30, 2017 and 2016 (unaudited)	3
	Consolidated Statements of Changes in Shareholders' Equity for the Six Months ended June 30, 2017 and 2016 (unaudited)	3
	Consolidated Statements of Cash Flows for the Six Months ended June 30, 2017 and 2016 (unaudited)	4
	Notes to Consolidated Financial Statements (unaudited)	5
Item 2	Management's Discussion and Analysis of Results of Operations and Financial Condition	28
Item 3	Quantitative and Qualitative Disclosures about Market Risk	48
Item 4	Controls and Procedures	48

Part II - OTHER INFORMATION

Item 1	Legal Proceedings	49
Item 1A	Risk Factors	49
Item 2	Unregistered Sales of Equity Securities and Use of Proceeds	49
Item 3	Defaults Upon Senior Securities	49
Item 4	Mine Safety Disclosures	49
Item 5	Other Information	49
Item 6	Exhibits	50
SIGNATURE PAGE		51
EXHIBITS		

Part I FINANCIAL INFORMATION

Item 1 Financial Statements

Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)(unaudited)	June 30 2017	December 31 2016
Assets		
Cash and due from banks	$ 14,937	$ 16,888
Interest-bearing deposits in other banks	30,812	19,777
Total cash and cash equivalents	45,749	36,665
Investment securities available for sale, at fair value	136,036	143,875
Restricted stock	456	1,767
Loans held for sale	834	540
Loans	901,414	893,873
Allowance for loan losses	(11,307)	(11,075)
Net Loans	890,107	882,798
Premises and equipment, net	13,897	14,058
Bank owned life insurance	22,721	22,459
Goodwill	9,016	9,016
Other real estate owned	3,115	4,915
Deferred tax asset, net	6,180	5,844
Other assets	6,544	5,506
Total assets	$ 1,134,655	$ 1,127,443
Liabilities		
Deposits		
Noninterest-bearing checking	$ 173,030	$ 170,345
Money management, savings and interest checking	762,254	737,140
Time	72,094	74,635
Total Deposits	1,007,378	982,120
Short-term borrowings	-	24,270
Other liabilities	4,917	4,560
Total liabilities	1,012,295	1,010,950
Shareholders' equity		
Common stock, $1 par value per share,15,000,000 shares authorized with 4,688,349 shares issued and 4,340,430 shares outstanding at June 30, 2017 and 4,688,349 shares issued and 4,316,836 shares outstanding at December 31, 2016	4,688	4,688
Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding	-	-
Additional paid-in capital	40,096	39,752
Retained earnings	87,498	83,081

Accumulated other comprehensive loss	(3,542)	(4,215)
Treasury stock, 347,919 shares at June 30, 2017 and 371,513 shares at December 31, 2016, at cost	(6,380)	(6,813)
Total shareholders' equity	122,360	116,493
Total liabilities and shareholders' equity	$ 1,134,655	$ 1,127,443

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

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	
	2017	2016	2017	2016
Interest income				
Loans, including fees	$ 9,039	$ 7,964	$ 17,678	$ 16,053
Interest and dividends on investments:				
Taxable interest	518	584	1,049	1,160
Tax exempt interest	286	357	587	723
Dividend income	7	4	20	10
Deposits and obligations of other banks	88	79	149	141
Total interest income	9,938	8,988	19,483	18,087
Interest expense				
Deposits	590	548	1,156	1,091
Short-term borrowings	-	-	15	2
Total interest expense	590	548	1,171	1,093
Net interest income	9,348	8,440	18,312	16,994
Provision for loan losses	50	1,875	170	2,175
Net interest income after provision for loan losses	9,298	6,565	18,142	14,819
Noninterest income				
Investment and trust services fees	1,342	1,218	2,637	2,472
Loan service charges	309	189	455	415
Deposit service charges and fees	585	602	1,178	1,180
Other service charges and fees	332	313	656	616
Debit card income	362	375	738	722
Increase in cash surrender value of life insurance	131	132	262	267
Net loss on sale of other real estate owned	-	(2)	-	(10)
OTTI losses on debt securities	-	-	-	(20)
Securities gains, net	-	2	2	3
Other	94	27	153	164
Total noninterest income	3,155	2,856	6,081	5,809
Noninterest expense				
Salaries and employee benefits	4,871	4,346	9,497	8,716
Occupancy, net	535	553	1,119	1,152
Furniture and equipment	226	218	457	434
Advertising	294	262	541	543
Legal and professional	381	394	671	691
Data processing	535	504	1,076	1,001
Pennsylvania bank shares tax	243	260	486	496
FDIC insurance	93	169	199	326
ATM/debit card processing	222	200	440	428
Foreclosed real estate	13	13	71	76
Telecommunications	102	90	202	209

Other	646	721	1,359	1,453
Total noninterest expense	8,161	7,730	16,118	15,525
Income before federal income tax expense	4,292	1,691	8,105	5,103
Federal income tax expense	950	130	1,743	815
Net income	$ 3,342	$ 1,561	$ 6,362	$ 4,288
Per share				
Basic earnings per share	$ 0.77	$ 0.36	$ 1.47	$ 1.00
Diluted earnings per share	$ 0.77	$ 0.36	$ 1.46	$ 1.00
Cash dividends declared	$ 0.24	$ 0.21	$ 0.45	$ 0.40

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

2

Consolidated Statements of Comprehensive Income

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(Dollars in thousands) (unaudited)	2017	2016	2017	2016
Net Income	$ 3,342	$ 1,561	$ 6,362	$ 4,288
Securities:				
Unrealized gains arising during the period	567	1,006	1,021	2,051
Reclassification adjustment for net (gains) losses and OTTI included in net income (1)	-	(2)	(2)	17
Net unrealized gains	567	1,004	1,019	2,068
Tax effect	(193)	(340)	(346)	(702)
Net of tax amount	374	664	673	1,366
Total other comprehensive income	374	664	673	1,366
Total Comprehensive Income	$ 3,716	$ 2,225	$ 7,035	$ 5,654

Reclassification adjustment / Statement line item	Tax expense (benefit)			
(1) Securities / securities (gains) losses and OTTI losses, net	$ -	$ 1	$ 1	$ (6)

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

Consolidated Statements of Changes in Shareholders' Equity

For the Six Months Ended June 30, 2017 and 2016

(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, 2015	$ 4,659	$ 38,778	$ 78,517	$ (3,722)	$ (6,856)	$ 111,376
Net income	-	-	4,288	-	-	4,288
Other comprehensive income	-	-	-	1,366	-	1,366
Cash dividends declared, $.40 per share	-	-	(1,715)	-	-	(1,715)
Acquisition of 15,521 shares of treasury stock	-	-	-	-	(350)	(350)
Treasury shares issued under employer stock purchase plan, 188 shares	-	1	-	-	278	279
Treasury shares issued under dividend reinvestment plan, 15,372 shares	-	82	-	-	3	85
Common stock issued under dividend reinvestment plan, 25,230 shares	25	527	-	-	-	552
Common stock issued under incentive stock option plan, 500 shares	1	8	-	-	-	9
Stock option compensation expense	-	58	-	-	-	58
Balance at June 30, 2016	$ 4,685	$ 39,454	$ 81,090	$ (2,356)	$ (6,925)	$ 115,948
Balance at December 31, 2016	$ 4,688	$ 39,752	$ 83,081	$ (4,215)	$ (6,813)	$ 116,493
Net income	-	-	6,362	-	-	6,362
Other comprehensive income	-	-	-	673	-	673
Cash dividends declared, $.45 per share	-	-	(1,945)	-	-	(1,945)
Treasury shares issued under employee stock purchase plan, 6,327 shares	-	26	-	-	116	142
Treasury shares issued under dividend reinvestment plan, 17,267 shares	-	211	-	-	317	528
Stock option compensation expense	-	107	-	-	-	107
Balance at June 30, 2017	$ 4,688	$ 40,096	$ 87,498	$ (3,542)	$ (6,380)	$ 122,360

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

Consolidated Statements of Cash Flows

	Six Months Ended June 30	
	2017	2016
(Dollars in thousands) (unaudited)		
Cash flows from operating activities		
Net income	$ 6,362	$ 4,288
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	651	666
Net amortization of loans and investment securities	802	794
Amortization and net change in mortgage servicing rights valuation	27	27
Provision for loan losses	170	2,175
Gain on sales of securities	(2)	(3)
Impairment write-down on securities recognized in earnings	-	20
Loans originated for sale	(3,571)	(4,963)
Proceeds from sale of loans	3,277	4,937
Write-down of other real estate owned	49	46
Write-down on premises and equipment available for sale	45	-
Net loss (gain) on sale or disposal of other real estate/other repossessed assets	-	10
Increase in cash surrender value of life insurance	(262)	(267)
Stock option compensation	107	58
Decrease in other assets	(1,431)	(504)
Increase (decrease) in other liabilities	2	(2,588)
Net cash provided by operating activities	6,226	4,696
Cash flows from investing activities		
Proceeds from sales and calls of investment securities available for sale	475	1,765
Proceeds from maturities and pay-downs of securities available for sale	11,452	11,929
Purchase of investment securities available for sale	(3,900)	(16,605)
Net decrease in restricted stock	1,311	346
Net increase in loans	(7,448)	(46,522)
Capital expenditures	(650)	(288)
Proceeds from surrender of life insurance policy	-	436
Proceeds from sale of other assets	154	-
Proceeds from sale of other real estate	1,751	224
Net cash provided by (used in) investing activities	3,145	(48,715)
Cash flows from financing activities		
Net increase in demand deposits, interest-bearing checking, and savings accounts	27,799	52,147
Net decrease in time deposits	(2,541)	(5,105)

Net decrease in short-term borrowings	(24,270)	-
Dividends paid	(1,945)	(1,715)
Treasury shares issued under employee stock purchase plan	142	279
Treasury shares issued under dividend reinvestment plan	528	85
Common stock issued under stock option plans	-	9
Common stock issued under dividend reinvestment plan	-	552
Purchase of Treasury shares	-	(350)
Net cash (used) provided by financing activities	(287)	45,902
Increase in cash and cash equivalents	9,084	1,883
Cash and cash equivalents as of January 1	36,665	39,166
Cash and cash equivalents as of June 30	$ 45,749	$ 41,049
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest on deposits and other borrowed funds	$ 1,177	$ 1,097
Income taxes	$ 3,405	$ 2,100
Noncash Activities:		
Loans transferred to Other Real Estate	$ -	$ 23

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

4

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Franklin Financial Services Corporation (the Corporation), and its wholly-owned subsidiaries, Farmers and Merchants Trust Company of Chambersburg (the Bank) and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank that has one wholly-owned subsidiary, Franklin Financial Properties Corp. Franklin Financial Properties Corp. holds real estate assets that are leased by the Bank. Franklin Future Fund Inc. is a non-bank investment company. The activities of non-bank entities are not significant to the consolidated totals. All significant intercompany transactions and account balances have been eliminated.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of June 30, 2017, 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 2016 Annual Report on Form 10-K. The consolidated results of operations for the three month periods ended June 30, 2017 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, 2016 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)	2017	2016	2017	2016
Weighted average shares outstanding (basic)	4,331	4,294	4,326	4,289
Impact of common stock equivalents	21	4	21	3
Weighted average shares outstanding (diluted)	4,352	4,298	4,347	4,292
Anti-dilutive options excluded from calculation	-	43	-	44
Net income	$ 3,342	$ 1,561	$ 6,362	$ 4,288
Basic earnings per share	$ 0.77	$ 0.36	$ 1.47	$ 1.00
Diluted earnings per share	$ 0.77	$ 0.36	$ 1.46	$ 1.00

Note 2. Recent Accounting Pronouncements

Standard	Description	Effective Date	Effect on the financial statements or other significant matters
ASU 2016-15, Statements of Cash Flow (Topic 320): Classification of Certain Cash Receipts and Cash Payments	The standard clarifies how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are intended to reduce diversity in practice. The standard contains additional guidance clarifying when an entity should separate cash receipts and cash payments and classify them into more than one class of cash flows (including when reasonable judgement is required to estimate and allocate cash flows) versus when an entity should classify the aggregate amount into one class of cash flows on the basis of predominance.	January 1, 2018	We do not expect this guidance will have an effect on the Corporation's consolidated financial statements.
ASU 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments	This standard requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss (CECL) model). Under this model, entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments, but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument. The ASU replaces the current accounting model for purchased credit impaired loans and debt securities. The allowance for credit losses for purchased financial assets with a more-than insignificant amount of credit deterioration since origination (“PCD assets”), should be determined in a similar manner to other financial assets measured on an amortized cost basis. However, upon initial recognition,	January 1, 2020	We have formed an implementation team led by the Corporation's Risk Management function. The team is reviewing the requirements of the ASU and evaluating methods and models for implementation. The Corporation believes the new standard will result in earlier recognition of additions to the allowance for loan losses and possibly a larger allowance for loan loss balance with a corresponding increase in the provision for loan losses in results of operations; however, the Corporation is continuing to evaluate the impact of the pending adoption of the new standard on its consolidated financial statements.

	the allowance for credit losses is added to the purchase price ("gross up approach") to determine the initial amortized cost basis. The subsequent account for PCD financial assets is the same expected loss model described above.		
ASU 2014-09, Revenue from Contracts with Customers (Topic 606)	The amendments in this Update (ASU 2014-09) establish a comprehensive revenue recognition standard. 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. Three basic transition methods are available – full retrospective, retrospective with certain practical expedients, and a cumulative effect approach.	January 1, 2018	The majority of our revenue comes from net interest income, and is explicitly out of scope of the guidance. The contracts in noninterest income that are in scope of the guidance are primarily related to service charges and fees on deposit accounts, investment and trust income and other service charges and fees. We are analyzing the contracts in scope to determine if our current accounting will change.
ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities	The standard amends the guidance on the classification and measurement of financial instruments. Some of the amendments include the following: 1) requires equity investments to be measured at fair value with changes in fair value recognized in net income; 2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and 4) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others.	January 1, 2018	We do not expect this guidance will have a material effect on the Corporation's consolidated financial statements. We do not have a significant number of AFS equity securities. Additionally we do not have financial liabilities accounted for under the fair value option. The adoption of this guidance is not expected to be material.

ASU 2016-02, Leases (Topic 842)	From the lessee's perspective, the new standard established a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for a lessees. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as financing. If the lessor doesn't convey risks and rewards or control, an operating lease results.	January 1, 2019	The Corporation currently has real estate and equipment leases that it classifies as operating leases that are not recognized on the balance sheet. Under the new standard, these leases will move onto the balance sheet. The Corporation has identified a lease accounting model it expects to use to implement the standard. It is expected the model will be functional during the fourth quarter of 2017, but the Corporation does not plan to early adopt the standard. The Corporation believes the new standard will not have a material effect on its consolidated financial statements.
ASU 2017-04, Goodwill (Topic 350)	This guidance, among other things, removes step 2 of the goodwill impairment test thus eliminating the need to determine the fair value of individual assets and liabilities of the reporting unit. Upon adoption of this standard, goodwill impairment will be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. This may result in more or less impairment being recognized than under the current guidance.	January 1, 2020	We do not currently expect this guidance to have a material effect on the Corporation's consolidated financial statements based upon the most recent goodwill impairment analysis.
ASU 2016-09, Stock Compensation (Topic 718): Improvements to Employee Share-based Payment Accounting	The standard requires entities to recognize the income tax effects of share-based awards in the income statement when the awards vest or are settled (i.e. the additional paid-in capital pools will be eliminated). The guidance on employers' accounting for an employee's use of shares to satisfy the employer's statutory income tax withholding obligation and for forfeitures is changing. The standard also provides an entity the option to make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest or account for forfeitures when they occur.	January 1, 2017	We adopted the standard during the first quarter of 2017. Due to the type of stock compensation plans used by the Corporation, there was no effect on the Corporation's consolidated financial statements.
ASU 2017-09, Premium Amortization on Purchased Callable Debt Securities	The standard shortens the amortization period for premiums on purchased callable debt securities to the earliest call date, rather than amortizing over the full contractual term. The standard does change the standard for securities held at a discount. The amendments require	January 1, 2017	We adopted the standard during the first quarter of 2017, and there was no effect on the Corporation's consolidated financial statements.

	companies to reset the effective yield using the payment terms of the debt security if the call option is not exercised on the earliest call date. If the security has additional future called dates, any excess of the amortized cost basis over the amount repayable by the issuer at the next call date should be amortized to the next call date.		
ASU 2017-07, Employee Benefits Plan (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost	This standard requires an employer to report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations. The amendments in this update also allow only the service cost component to be eligible for capitalization when applicable.	January 1, 2018	We do not expect this standard will have an effect on the Corporation's consolidated financial statements.

7

Note 3. Accumulated Other Comprehensive Loss

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

(Dollars in thousands)	June 30 2017	December 31 2016
Net unrealized gains (losses) on securities	$ 999	$ (20)
Tax effect	(339)	7
Net of tax amount	660	(13)
Accumulated pension adjustment	(6,366)	(6,366)
Tax effect	2,164	2,164
Net of tax amount	(4,202)	(4,202)
Total accumulated other comprehensive loss	$ (3,542)	$ (4,215)

Note 4. Investments

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2017 and December 31, 2016 are as follows:

(Dollars in thousands) June 30, 2017	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 164	$ 192	$ -	$ 356
U.S. Government and Agency securities	12,032	134	(34)	12,132
Municipal securities	60,505	1,032	(192)	61,345
Trust preferred securities	5,989	3	(203)	5,789
Agency mortgage-backed securities	55,370	387	(386)	55,371
Private-label mortgage-backed securities	946	68	-	1,014
Asset-backed securities	31	-	(2)	29
	$ 135,037	$ 1,816	$ (817)	$ 136,036

(Dollars in thousands) December 31, 2016	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 164	$ 126	$ -	$ 290
U.S. Government and Agency securities	12,598	148	(26)	12,720
Municipal securities	62,763	793	(571)	62,985
Trust preferred securities	5,979	-	(518)	5,461
Agency mortgage-backed securities	61,305	431	(452)	61,284
Private-label mortgage-backed securities	1,053	56	(5)	1,104
Asset-backed securities	33	-	(2)	31
	$ 143,895	$ 1,554	$ (1,574)	$ 143,875

At June 30, 2017 and December 31, 2016, the fair value of investment securities pledged to secure public funds, trust balances, deposit and other obligations totaled $73.0 million and $79.1 million, respectively.

The amortized cost and estimated fair value of debt securities at June 30, 2017, 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	$ 951	$ 954
Due after one year through five years	11,535	11,701
Due after five years through ten years	35,626	36,037
Due after ten years	30,445	30,603
	78,557	79,295
Mortgage-backed securities	56,316	56,385
	$ 134,873	$ 135,680

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

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(Dollars in thousands)	2017	2016	2017	2016
Gross gains realized	$ -	$ 2	$ 2	$ 3
Gross losses realized	-	-	-	-
Net gains realized	$ -	$ 2	$ 2	$ 3

The following table provides additional detail about trust preferred securities as of June 30, 2017:

Trust Preferred Securities

(Dollars in thousands)

Deal Name	Maturity	Single Issuer or Pooled	Class	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Lowest Credit Rating Assigned
BankAmerica Cap III	1/15/2027	Single	Preferred Stock	$ 968	$ 932	$ (36)	BB+

Wachovia Cap Trust II	1/15/2027	Single	Preferred Stock	280	283	3	BBB
Huntington Cap Trust	2/1/2027	Single	Preferred Stock	948	899	(49)	BB
Corestates Captl Tr II	2/15/2027	Single	Preferred Stock	945	945	-	BBB+
Huntington Cap Trust II	6/15/2028	Single	Preferred Stock	903	845	(58)	BB
Chase Cap VI JPM	8/1/2028	Single	Preferred Stock	967	939	(28)	BBB-
Fleet Cap Tr V	12/18/2028	Single	Preferred Stock	978	946	(32)	BB+
				$ 5,989	$ 5,789	$ (200)	

The following table provides additional detail about private label mortgage-backed securities as of June 30, 2017:

Private Label Mortgage Backed Securities

(Dollars in thousands) Description	Origination Date	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
MALT 2004-6 7A1	6/1/2004	$ 252	$ 254	$ 2	ALT A	CCC	16.24	$ -
RALI 2005-QS2 A1	2/1/2005	129	144	15	ALT A	CC	0.71	15
RALI 2006-QS4 A2	4/1/2006	356	381	25	ALT A	Caa3	-	323
GSR 2006-5F 2A1	5/1/2006	35	42	7	Prime	D	-	15
RALI 2006-QS8 A1	7/28/2006	174	193	19	ALT A	Ca	-	242
		$ 946	$ 1,014	$ 68				$ 595

9

Impairment:

The investment portfolio contained eighty-three securities with $45.5 million of temporarily impaired fair value and $817 thousand in unrealized losses at June 30, 2017. The total unrealized loss position has improved from a $1.6 million unrealized loss at year-end 2016.

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, 2017, 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, 2017 and December 31, 2016:

	June 30, 2017								
	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
U.S. Government and Agency securities	$ 1,596	$ (9)	4	$ 3,020	$ (25)	9	$ 4,616	$ (34)	13
Municipal securities	6,671	(120)	12	2,146	(72)	3	8,817	(192)	15
Trust preferred securities	-	-	-	4,561	(203)	5	4,561	(203)	5
Agency mortgage-backed securities	19,063	(229)	32	8,457	(157)	17	27,520	(386)	49
Asset-backed securities	-	-	-	4	(2)	1	4	(2)	1
Total temporarily impaired securities	$ 27,330	$ (358)	48	$ 18,188	$ (459)	35	$ 45,518	$ (817)	83

December 31, 2016		
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
U.S. Government and Agency securities	$ 789	$ (9)	1	$ 3,413	$ (17)	10	$ 4,202	$ (26)	11
Municipal securities	23,407	(417)	43	1,598	(154)	2	25,005	(571)	45
Trust preferred securities	-	-	-	5,461	(518)	7	5,461	(518)	7
Agency mortgage-backed securities	26,995	(359)	39	4,656	(93)	11	31,651	(452)	50
Private-label mortgage-backed securities	281	(5)	1	-	-	-	281	(5)	1
Asset-backed securities	-	-	-	4	(2)	1	4	(2)	1
Total temporarily impaired securities	$ 51,472	$ (790)	84	$ 15,132	$ (784)	31	$ 66,604	$ (1,574)	115

The unrealized loss in the municipal bond portfolio decreased to $192 thousand from $571 thousand at December 31, 2016 as market prices improved during the quarter. There are fifteen securities in this portfolio with an unrealized loss and the loss in this portfolio is deemed to be non-credit related and no other-than-temporary impairment charges have been recorded.

The trust preferred portfolio contains five securities with a fair value of $4.6 million and an unrealized loss of $203 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, 2017, 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 is showing an unrealized gain of $68 thousand at quarter end. This is primarily a result of the cumulative OTTI charges recorded on this portfolio. Due to the nature of these bonds, they are evaluated closely. These bonds were all rated AAA at time of purchase, but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. The Bank has recorded $595 thousand of cumulative impairment charges on this portfolio. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue.

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

(Dollars in thousands)	Six Months Ended	
	2017	2016
Balance of cumulative credit-related OTTI at January 1	$ 595	$ 555
Additions for credit-related OTTI not previously recognized	-	20
Additional increases for credit-related OTTI previously recognized when there is no intent to sell and no requirement to sell before recovery of amortized cost basis	-	-
Decreases for previously recognized credit-related OTTI because there was an intent to sell	-	-
Reduction for increases in cash flows expected to be collected	-	-
Balance of credit-related OTTI at June 30	$ 595	$ 575

The Bank held $456 thousand of restricted stock at June 30, 2017. Except for $30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of $100 per share. The level of FHLB stock held is determined by FHLB and is comprised of a minimum membership amount plus a variable activity amount. FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. Management intends to remain a member of the FHLB and believes that it will be able to fully recover the cost basis of this investment.

Note 5. 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 class, at the end of the reporting periods is as follows:

(Dollars in thousands)	June 30, 2017	December 31, 2016
Residential Real Estate 1-4 Family		
Consumer first liens	$ 100,072	$ 103,125
Commercial first lien	63,178	65,445
Total first liens	163,250	168,570
Consumer junior liens and lines of credit	44,213	44,817
Commercial junior liens and lines of credit	5,480	5,396
Total junior liens and lines of credit	49,693	50,213
Total residential real estate 1-4 family	212,943	218,783
Residential real estate - construction		
Consumer	1,298	1,350
Commercial	9,928	7,625
Total residential real estate construction	11,226	8,975
Commercial real estate	386,784	390,584
Commercial	285,780	270,826
Total commercial	672,564	661,410
Consumer	4,681	4,705
	901,414	893,873
Less: Allowance for loan losses	(11,307)	(11,075)
Net Loans	$ 890,107	$ 882,798
Included in the loan balances are the following:		
Net unamortized deferred loan costs	$ 279	$ 242
Loans pledged as collateral for borrowings and commitments from:		
FHLB	$ 702,224	$ 711,682
Federal Reserve Bank	36,951	41,152
	$ 739,175	$ 752,834

Note 6. Loan Quality and Allowance for Loan Losses

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

	Residential Real Estate 1-4 Family							
				Commercial				
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Consumer	Unallocated	Total
ALL at March 31, 2017	$ 1,100	$ 321	$ 274	$ 6,126	$ 1,984	$ 99	$ 1,374	$ 11,278
Charge-offs	(5)	-	-	(5)	(2)	(24)	-	(36)
Recoveries	-	1	-	-	4	10	-	15
Provision	(20)	-	7	(69)	37	15	80	50
ALL at June 30, 2017	$ 1,075	$ 322	$ 281	$ 6,052	$ 2,023	$ 100	$ 1,454	$ 11,307
ALL at December 31, 2016	$ 1,105	$ 323	$ 224	$ 6,109	$ 1,893	$ 100	$ 1,321	$ 11,075
Charge-offs	(13)	-	-	(5)	(2)	(52)	-	(72)
Recoveries	1	1	-	-	106	26	-	134
Provision	(18)	(2)	57	(52)	26	26	133	170
ALL at June 30, 2017	$ 1,075	$ 322	$ 281	$ 6,052	$ 2,023	$ 100	$ 1,454	$ 11,307
ALL at March 31, 2016	$ 997	$ 316	$ 199	$ 6,181	$ 1,510	$ 99	$ 1,040	$ 10,342
Charge-offs	(46)	-	-	(1,951)	(3)	(42)	-	(2,042)
Recoveries	1	-	-	14	106	22	-	143
Provision	71	3	6	1,696	(17)	18	98	1,875
ALL at June 30, 2016	$ 1,023	$ 319	$ 205	$ 5,940	$ 1,596	$ 97	$ 1,138	$ 10,318
ALL at December 31, 2015	$ 989	$ 308	$ 194	$ 5,649	$ 1,519	$ 102	$ 1,325	$ 10,086
Charge-offs	(49)	-	-	(1,954)	(66)	(84)	-	(2,153)
Recoveries	33	-	-	14	121	42	-	210
Provision	50	11	11	2,231	22	37	(187)	2,175
ALL at June 30, 2016	$ 1,023	$ 319	$ 205	$ 5,940	$ 1,596	$ 97	$ 1,138	$ 10,318

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, 2017 and December 31, 2016:

	Residential Real Estate 1-4 Family							
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Commercial Real Estate	Commercial	Consumer	Unallocated	Total
June 30, 2017								
Loans evaluated for ALL:								
Individually	$ 818	$ 106	$ 473	$ 11,345	$ 100	$ -	$ -	$ 12,842
Collectively	162,432	49,587	10,753	375,439	285,680	4,681	-	888,572
Total	$ 163,250	$ 49,693	$ 11,226	$ 386,784	$ 285,780	$ 4,681	$ -	$ 901,414
ALL established for loans evaluated:								
Individually	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Collectively	1,075	322	281	6,052	2,023	100	1,454	11,307
ALL at June 30, 2017	$ 1,075	$ 322	$ 281	$ 6,052	$ 2,023	$ 100	$ 1,454	$ 11,307
December 31, 2016								
Loans evaluated for ALL:								
Individually	$ 628	$ 52	$ 480	$ 13,523	$ -	$ -	$ -	$ 14,683
Collectively	167,942	50,161	8,495	377,061	270,826	4,705	-	879,190
Total	$ 168,570	$ 50,213	$ 8,975	$ 390,584	$ 270,826	$ 4,705	$ -	$ 893,873
ALL established for loans evaluated:								
Individually	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Collectively	1,105	323	224	6,109	1,893	100	1,321	11,075
ALL at December 31, 2016	$ 1,105	$ 323	$ 224	$ 6,109	$ 1,893	$ 100	$ 1,321	$ 11,075

The following table shows additional information about those loans considered to be impaired at June 30, 2017 and December 31, 2016:

	Impaired Loans				
	With No Allowance		With Allowance		
(Dollars in thousands)		Unpaid		Unpaid	
	Recorded	Principal	Recorded	Principal	Related
June 30, 2017	Investment	Balance	Investment	Balance	Allowance
Residential Real Estate 1-4 Family					
First liens	$ 1,161	$ 1,231	$ -	$ -	$ -
Junior liens and lines of credit	115	120	-	-	-
Total	1,276	1,351	-	-	-
Residential real estate - construction	473	533	-	-	-
Commercial real estate	11,345	11,808	-	-	-
Commercial	121	133	-	-	-
Total	$ 13,215	$ 13,825	$ -	$ -	$ -
December 31, 2016					
Residential Real Estate 1-4 Family					
First liens	$ 956	$ 1,030	$ -	$ -	$ -
Junior liens and lines of credit	85	93	-	-	-
Total	1,041	1,123	-	-	-
Residential real estate - construction	480	535	-	-	-
Commercial real estate	13,523	14,133		-	-
Commercial	23	35	-	-	-
Total	$ 15,067	$ 15,826	$ -	$ -	$ -

15

The following table shows the average of impaired loans and related interest income for the three and six months ended June 30, 2017 and 2016:

(Dollars in thousands)	Three Months Ended June 30, 2017		Six Months Ended June 30, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	$ 1,168	$ 10	$ 1,039	$ 20
Junior liens and lines of credit	115	-	100	-
Total	1,283	10	1,139	20
Residential real estate - construction	476	-	478	-
Commercial real estate	12,043	102	12,104	218
Commercial	122	-	73	-
Total	$ 13,924	$ 112	$ 13,794	$ 238

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

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

(Dollars in thousands)		Loans Past Due and Still Accruing					Total
	Current	30-59 Days	60-89 Days	90 Days+	Total	Non-Accrual	Loans
June 30, 2017							
Residential Real Estate 1-4 Family							
First liens	$ 162,334	$ 174	$ 294	$ 61	$ 529	$ 387	$ 163,250
Junior liens and lines of credit	49,481	97	-	8	105	107	49,693
Total	211,815	271	294	69	634	494	212,943
Residential real estate - construction	10,753	-	-	-	-	473	11,226
Commercial real estate	384,513	117	185	-	302	1,969	386,784
Commercial	285,493	122	44	-	166	121	285,780
Consumer	4,647	26	8	-	34	-	4,681
Total	$ 897,221	$ 536	$ 531	$ 69	$ 1,136	$ 3,057	$ 901,414

December 31, 2016							
Residential Real Estate 1-4 Family							
First liens	$ 166,689	$ 1,236	$ 414	$ -	$ 1,650	$ 231	$ 168,570
Junior liens and lines of credit	50,031	96	-	-	96	86	50,213
Total	216,720	1,332	414	-	1,746	317	218,783
Residential real estate - construction	8,495	-	-	-	-	480	8,975
Commercial real estate	384,658	858	447	665	1,970	3,956	390,584
Commercial	270,478	250	75	-	325	23	270,826
Consumer	4,672	30	3	-	33	-	4,705
Total	$ 885,023	$ 2,470	$ 939	$ 665	$ 4,074	$ 4,776	$ 893,873

The following table reports the internal credit rating for the loan portfolio. Consumer purpose loans are assigned a rating of either pass or substandard based on the performance status of the loans. Substandard consumer loans are comprised of loans 90 days or more past due and still accruing, and nonaccrual loans. Commercial purpose loans may be assigned any rating in accordance with the Bank's internal risk rating system.

(Dollars in thousands)	Pass (1-5)	Special Mention (6)	Substandard (7)	Doubtful (8)	Total
June 30, 2017					
Residential Real Estate 1-4 Family					
First liens	$ 161,904	$ -	$ 1,346	$ -	$ 163,250
Junior liens and lines of credit	49,579	-	114	-	49,693
Total	211,483	-	1,460	-	212,943
Residential real estate - construction	10,146	-	1,080	-	11,226
Commercial real estate	375,919	-	10,865	-	386,784
Commercial	282,122	-	3,658	-	285,780
Consumer	4,681	-	-	-	4,681
Total	$ 884,351	$ -	$ 17,063	$ -	$ 901,414
December 31, 2016					
Residential Real Estate 1-4 Family					
First liens	$ 167,199	$ 227	$ 1,144	$ -	$ 168,570
Junior liens and lines of credit	50,017	28	168	-	50,213
Total	217,216	255	1,312	-	218,783
Residential real estate - construction	8,220	-	755	-	8,975
Commercial real estate	377,283	-	13,301	-	390,584
Commercial	267,901	957	1,968	-	270,826
Consumer	4,705	-	-	-	4,705
Total	$ 875,325	$ 1,212	$ 17,336	$ -	$ 893,873

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

(Dollars in thousands)	Troubled Debt Restructurings				Troubled Debt Restructurings That Have Defaulted on Modified Terms in the Last Twelve Months	
	Number of Contracts	Recorded Investment	Performing*	Nonperforming*	Number of Contracts	Recorded Investment
June 30, 2017						
Residential real estate - construction	1	$ 473	$ 473	$ -	-	$ -
Residential real estate	5	864	713	151	1	151
Commercial real estate	11	11,186	10,591	595	1	595
Total	17	$ 12,523	$ 11,777	$ 746	2	$ 746
December 31, 2016						
Residential real estate - construction	1	$ 480	$ 480	$ -	-	$ -
Residential real estate	5	875	724	151	1	151
Commercial real estate	11	12,064	10,814	1,250	1	1,250
Total	17	$ 13,419	$ 12,018	$ 1,401	2	$ 1,401

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

There were no new TDR loans during 2017.

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

	New During Period				
Six Months Ended June 30, 2016	Number of Contracts	Pre-TDR Modification	After-TDR Modification	Recorded Investment	Concession
Commercial real estate	1	$ 525	$ 525	$ 504	multiple

Note 7. Other Real Estate Owned

Changes in other real estate owned during the six months ended June 30, 2017 and 2016 were as follows:

	June 30	
(Dollars in thousands)	2017	2016
Balance at beginning of the period	$ 4,915	$ 6,451
Additions	-	23
Proceeds from dispositions	(1,751)	(224)
(Loss) gain on sales, net	-	(10)
Valuation adjustment	(49)	(46)
Balance at the end of the period	$ 3,115	$ 6,194

Note 8. Pension

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

	Three Months Ended June 30		Six Months Ended June 30	
(Dollars in thousands)	2017	2016	2017	2016
Components of net periodic cost:				
Service cost	$ 79	$ 83	$ 157	$ 164
Interest cost	167	180	333	360
Expected return on plan assets	(268)	(290)	(536)	(583)
Recognized net actuarial loss	137	120	274	231
Net period cost	$ 115	$ 93	$ 228	$ 172

The Bank expects its pension expense to decrease to approximately $459 thousand in 2017 compared to $922 thousand in 2016. This decrease is due to a pension settlement expense of approximately $564 thousand that was recorded in the second half of 2016, as a result of lump sum distributions. No pension contributions were made or are expected to be made in 2017.

Note 9. Fair Value Measurements and Fair Values of Financial Instruments

Management uses its best judgment in estimating the fair value of the Corporation's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Corporation could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective period-ends and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates maybe different than the amounts reported at each year-end.

FASB ASC Topic 820, "Financial Instruments", requires disclosure of the fair value of financial assets and liabilities, including those financial assets and liabilities that are not measured and reported at fair value on a recurring and nonrecurring basis. The Corporation does not report any nonfinancial assets at fair value. FASB ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC Topic 820 are as follows:

Level 1: Valuation is based on unadjusted, quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market. There may be substantial differences in the assumptions used for securities within the same level. For example, prices for U.S. Agency securities have fewer assumptions and are closer to level 1 valuations than the private label mortgage backed securities that require more assumptions and are closer to level 3 valuations.

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

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

The following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at June 30, 2017 and December 31, 2016.

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

Investment securities: The fair value of investment securities is determined in accordance with the methods described under FASB ASC Topic 820 as discussed below.

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

Loans held for sale: The fair value of loans held for sale is determined by the price set between the Bank and the purchaser prior to origination. These loans are usually sold at par.

Net loans (including impaired loans): The fair value of fixed-rate loans is estimated for each major type of loan (e.g. real estate, commercial, industrial and agricultural and consumer) by discounting the future cash flows associated with such loans using rates currently offered for loans with similar terms to borrowers of comparable credit quality. The model considers scheduled principal maturities, repricing characteristics, prepayment assumptions and interest cash flows. The discount rates used are estimated based upon consideration of a number of factors including the treasury yield curve, expense and service charge factors. For variable rate loans that reprice frequently and have no significant change in credit quality, carrying values approximate the fair value.

Accrued Interest Receivable: The carrying amount is a reasonable estimate of fair value.

Deposits and Short-term borrowings: The fair value of demand deposits, savings accounts, and money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-rate certificates of deposit is estimated by discounting the future cash flows using rates approximating those currently offered for certificates of deposit with similar remaining maturities. For short-term borrowings, the carrying value approximates a reasonable estimate of the fair value.

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

The following information regarding the fair value of the Corporation’s financial instruments should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation’s assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation’s disclosures and those of other companies may not be meaningful.

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

	June 30, 2017				
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	$ 45,749	$ 45,749	$ 45,749	$ -	$ -
Investment securities available for sale	136,036	136,036	356	135,680	-
Restricted stock	456	456	-	456	-
Loans held for sale	834	834	-	834	-
Net loans	890,107	891,933	-	-	891,933
Accrued interest receivable	3,409	3,409	-	3,409	-
Financial liabilities:					
Deposits	$ 1,007,378	$ 1,006,804	$ -	$ 1,006,804	$ -
Accrued interest payable	110	110	-	110	-

	December 31, 2016				
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	$ 36,665	$ 36,665	$ 36,665	$ -	$ -
Investment securities available for sale	143,875	143,875	290	143,585	-
Restricted stock	1,767	1,767	-	1,767	-
Loans held for sale	540	540	-	540	-
Net loans	882,798	889,910	-	-	889,910
Accrued interest receivable	3,592	3,592	-	3,592	-
Financial liabilities:					
Deposits	$ 982,120	$ 981,949	$ -	$ 981,949	$ -
Short-term debt	24,270	24,270	24,270	-	-
Accrued interest payable	116	116	-	116	-

Recurring Fair Value Measurements

For financial assets and liabilities measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2017 and December 31, 2016 are as follows:

(Dollars in Thousands	Fair Value at June 30, 2017			
Asset Description	Level 1	Level 2	Level 3	Total
Equity securities	$ 356	$ -	$ -	$ 356
U.S. Government and Agency securities	-	12,132	-	12,132
Municipal securities	-	61,345	-	61,345
Trust Preferred Securities	-	5,789	-	5,789
Agency mortgage-backed securities	-	55,371	-	55,371
Private-label mortgage-backed securities	-	1,014	-	1,014
Asset-backed securities	-	29	-	29
Total assets	$ 356	$ 135,680	$ -	$ 136,036

(Dollars in Thousands)	Fair Value at December 31, 2016			
Asset Description	Level 1	Level 2	Level 3	Total
Equity securities	$ 290	$ -	$ -	$ 290
U.S. Government and Agency securities	-	12,720	-	12,720
Municipal securities	-	62,985	-	62,985
Trust Preferred Securities	-	5,461	-	5,461
Agency mortgage-backed securities	-	61,284	-	61,284
Private-label mortgage-backed securities	-	1,104	-	1,104
Asset-backed securities	-	31	-	31
Total assets	$ 290	$ 143,585	$ -	$ 143,875

The Corporation used the following methods and significant assumptions to estimate the fair values for financial assets measured at fair value on a recurring basis.

Investment securities: Level 1 securities represent equity securities that are valued using quoted market prices from nationally recognized markets. Level 2 securities represent debt securities that are valued using a mathematical model based upon the specific characteristics of a security in relationship to quoted prices for similar securities.

Nonrecurring Fair Value Measurements

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2017 and December 31, 2016 are as follows:

(Dollars in Thousands)				
	Fair Value at June 30, 2017			
Asset Description	Level 1	Level 2	Level 3	Total
Other real estate owned (1)	-	-	177	177
Total assets	$ -	$ -	$ 177	$ 177

(Dollars in Thousands)	Fair Value at December 31, 2016			
Asset Description	Level 1	Level 2	Level 3	Total
Premises held-for-sale (1)	$ -	$ -	$ 200	$ 200
Other real estate owned (1)	-	-	2,407	2,407
Total assets	$ -	$ -	$ 2,607	$ 2,607

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

The Corporation used the following methods and significant assumptions to estimate the fair values for financial assets measured at fair value on a nonrecurring basis.

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

Other real estate: The fair value of other real estate, upon initial recognition, is estimated using Level 2 inputs within the fair value hierarchy based on observable market data and Level 3 inputs based on customized discounting criteria. In connection with the measurement and initial recognition of the foregoing assets, the Corporation recognizes charge-offs through the allowance for loan losses. Subsequent charge-offs are recognized as an expense.

The Corporation did not record any liabilities at fair value for which measurement of the fair value was made on a nonrecurring basis at June 30, 2017. For financial assets and liabilities measured at fair value on a recurring basis, there were no transfers of financial assets or liabilities between Level 1 and Level 2 during the period ending June 30, 2017.

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			
June 30, 2017		Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Other real estate owned		177	Appraisal	N/A	-
				Cost to sell	8% (8%)

December 31, 2016		Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Premises held-for-sale	$	200	Appraisal	Qualitative adjustment	5% (5%)
Other real estate owned		2,407	Appraisal	N/A	-
				Cost to sell	8% (8%)

Note 10. Capital Ratios

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as "Basel III." The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered "well capitalized" under Basel III are: (1) Common Equity Tier 1 (CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3) Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The CET1 ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.625%, 1.25% for 2017, 1.875% for 2018 and 2.50% for 2019 and thereafter. The capital conservation buffer will be applicable to all of the capital ratios except for the Tier1 Leverage ratio. The capital conservation buffer is equal to the lowest value of the three applicable capital ratios less the regulatory minimum for each respective capital measurement. The Bank's capital conservation buffer at June 30, 2017 was 8.72% (total risk-based capital 16.72% less 8.00%) compared to the 2017 regulatory buffer of 1.25%. Compliance with the capital conservation buffer is required in order to avoid limitations to certain capital distributions. As of June 30, 2017, the Bank was "well capitalized' under the Basel III requirements and believes it would be "well capitalized" on a fully-phased in basis had such a requirement been in effect.

The following table summarizes regulatory capital information as of June 30, 2017 and December 31, 2016 for the Corporation and the Bank.

			Regulatory Ratios	
(Dollars in thousands)	June 30, 2017	December 31, 2016	Adequately Capitalized Minimum	Well Capitalized Minimum
Common Equity Tier 1 Risk-based Capital Ratio (1)				
Franklin Financial Services Corporation	15.52%	14.41%	4.500%	N/A
Farmers & Merchants Trust Company	15.46%	14.29%	4.500%	6.50%
Tier 1 Risk-based Capital Ratio (2)				
Franklin Financial Services Corporation	15.52%	14.41%	6.000%	N/A
Farmers & Merchants Trust Company	15.46%	14.29%	6.000%	8.00%
Total Risk-based Capital Ratio (3)				
Franklin Financial Services Corporation	16.78%	15.67%	8.000%	N/A
Farmers & Merchants Trust Company	16.72%	15.55%	8.000%	10.00%
Tier 1 Leverage Ratio (4)				
Franklin Financial Services Corporation	10.39%	10.11%	4.000%	N/A
Farmers & Merchants Trust Company	10.35%	10.02%	4.000%	5.00%

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

31Note 11. Reclassification

Certain prior period amounts may have been reclassified to conform to the current year presentation. Such reclassifications did not affect the Corporation's financial position or results of operations.

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1Note 12. Contingencies

The nature of the Corporation's business generates a certain amount of litigation involving matters arising in the ordinary course of business, including, without limitation, the Kalan et al. v. Farmers and Merchants Trust Company of Chambersburg, et al. case filed in the United States District Court of the Eastern District of Pennsylvania.

In management's opinion, we are not able to anticipate, at the present time, whether the ultimate aggregate liability, if any, arising out of such litigation will have a material adverse effect on our financial position. We cannot now determine, whether or not any claims asserted against us, including the disclosed matter, will have a material adverse effect on our results of operations in any future reporting period, which will depend on, among other things, the amount of loss resulting from the claim and the amount of income otherwise reported for the reporting period. At the date of this filing, we are unable to provide an evaluation of the likelihood of an unfavorable outcome or an estimate of the amount or range of potential loss and, accordingly, have not yet established any specific accrual for this matter. In addition, no material proceedings are pending or are known to be threatened or contemplated against us by governmental authorities.

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

For the Three and Six Months Ended June 30, 2017 and 2016

Forward Looking Statements

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

Critical Accounting Policies

Management has identified critical accounting policies for the Corporation. These policies are particularly sensitive, requiring significant judgements, estimates and assumptions to be made by Management. There were no changes to the critical accounting policies disclosed in the 2016 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 2016 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Results of Operations

Year-to-Date Summary

At June 30, 2017, total assets were $1.135 billion. The investment portfolio declined during the year as maturing cash flow was reinvested in the loan portfolio. Growth in the loan portfolio was primarily in commercial loans. However, this growth was tempered by approximately $14 million in loan participations which were repurchased by the lead banks. Overall, deposits increased from growth in noninterest-bearing and interest-bearing checking and savings accounts, partially offset by a decrease in time deposits. Net income increased due to the growth in interest income from the loan portfolio as well as a decrease in provision for loan losses. The provision for loan losses decreased due to an improvement in loan quality and higher provision for loan losses in 2016 related to a large commercial loan charge-off. The increase in noninterest income was primarily from Investment and Trust Service nonrecurring fee income from assets under management and loan service charges from past due fees collected on the pay-off of a large nonaccrual loan. Noninterest expense increased primarily from increases in salaries and benefits.

Key performance ratios as of, or for the three months ended June 30, 2017 and 2016 and the year ended December 31, 2016 are listed below:

	June 30 2017	December 31 2016	June 30 2016
(Dollars in thousands, except per share)			
Balance Sheet Highlights			
Total assets	$ 1,134,655	$ 1,127,443	$ 1,084,046
Investment securities	136,036	143,875	163,557
Loans, net	890,107	882,798	816,338
Deposits	1,007,378	982,120	965,554
Shareholders' equity	122,360	116,493	115,948
Summary of Operations			
Interest income	$ 19,483	$ 36,979	$ 18,087
Interest expense	1,171	2,245	1,093
Net interest income	18,312	34,734	16,994
Provision for loan losses	170	3,775	2,175
Net interest income after provision for loan losses	18,142	30,959	14,819
Noninterest income	6,081	11,605	5,809
Noninterest expense	16,118	33,175	15,525
Income before income taxes	8,105	9,389	5,103
Federal income tax expense	1,743	1,302	815
Net income	$ 6,362	$ 8,087	$ 4,288
Performance Measurements			
Return on average assets*	1.13%	0.74%	0.80%
Return on average equity*	10.75%	7.04%	7.56%
Return on average tangible assets (1)*	1.14%	0.75%	0.81%
Return on average tangible equity (1)*	11.64%	7.64%	8.21%
Efficiency ratio (1)	62.77%	68.26%	65.08%
Net interest margin	3.72%	3.62%	3.63%
Shareholders' Value (per common share)			
Diluted earnings per share	$ 1.46	$ 1.88	$ 1.00
Basic earnings per share	1.47	1.88	1.00
Regular cash dividends paid	0.45	0.82	0.4
Book value	28.19	26.99	26.95
Tangible book value (1)	26.12	24.90	24.93
Market value	32.00	28.60	23.73
Market value/book value ratio	113.52%	105.97%	88.05%
Price/earnings multiple*	10.88	15.21	11.87
Current dividend yield*	3.00%	2.94%	3.54%
Dividend payout ratio	30.57%	43.56%	40.00%

Safety and Soundness			
Risk-based capital ratio (Total)	16.25%	15.67%	15.90%
Leverage ratio (Tier 1)	10.31%	10.11%	10.20%
Common equity ratio (Tier 1)	14.99%	14.41%	14.77%
Nonperforming loans/gross loans	0.35%	0.61%	1.00%
Nonperforming assets/total assets	0.55%	0.92%	1.33%
Allowance for loan losses as a % of loans	1.25%	1.24%	1.25%
Net (recoveries) charge-offs/average loans*	-0.10%	0.33%	0.48%
Trust assets under management (fair value)	$ 652,862	$ 622,630	$ 606,334

*Annualized

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

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

(Dollars in thousands, except per share)	Six months ended June 30, 2017	Twelve months ended December 31, 2016	Six months ended June 30, 2016
Return on Average Tangible Assets (non-GAAP)			
Net income	$ 6,362	$ 8,087	$ 4,288
Average assets	1,124,610	1,088,047	1,066,183
Less average intangible assets	(9,016)	(9,016)	(9,016)
Average assets (non-GAAP)	1,115,594	1,079,031	1,057,167
Return on average tangible assets (non-GAAP)	1.14%	0.75%	0.81%
Return on Tangible Equity (non-GAAP)			
Net income	$ 6,362	$ 8,087	$ 4,288
Average shareholders' equity	118,373	114,884	113,452
Less average intangible assets	(9,016)	(9,016)	(9,016)
Average shareholders' equity (non-GAAP)	109,357	105,868	104,436
Return on average tangible equity (non-GAAP)	11.64%	7.64%	8.21%
Tangible Book Value (per share) (non-GAAP)			
Shareholders' equity	$ 122,360	$ 116,493	$ 115,948
Less intangible assets	(9,016)	(9,016)	(9,016)
Shareholders' equity (non-GAAP)	113,344	107,477	106,932
Shares outstanding (in thousands)	4,340	4,317	4,290
Tangible book value (non-GAAP)	26.12	24.90	24.93
Efficiency Ratio			
Noninterest expense	$ 16,118	$ 33,175	$ 15,525
Net interest income	18,312	34,734	16,994
Plus tax equivalent adjustment to net interest income	1,285	2,246	1,051
Plus noninterest income, net of securities gains/losses & OTTI	6,079	11,623	5,826
Total revenue	13,518	48,603	23,871

Efficiency ratio	62.77%	68.26%	65.04%

Net Interest Income

The most important source of the Corporation's earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal categories of interest-earning assets are loans and securities, while deposits, short-term borrowings and long-term debt are the principal categories of interest-bearing liabilities. Demand deposits enhance net interest income because they are noninterest-bearing deposits. For the purpose of this discussion, balance sheet items refer to the average balance for the year and net interest income is adjusted to a fully taxable-equivalent basis. This tax-equivalent adjustment facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Corporation's 34% Federal statutory rate.

Comparison of the three months ended June 30, 2017 to the three months ended June 30, 2016:

Tax equivalent net interest income increased $1.1 million to $10.0 million in the second quarter of 2017 compared to $8.9 million in the same period in 2016. Balance sheet volume contributed $751 thousand to this increase and changes in interest rates added $299 thousand.

The following table presents average balances, tax-equivalent (T/E) interest income, and yields earned or rates paid on the assets or liabilities. All nontaxable interest income has been adjusted to a tax-equivalent basis using a tax rate of 34%.

	For the Three Months Ended June 30					
	2017			2016		
(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
Interest-earning assets:						
Interest-bearing obligations of other banks and federal funds sold	$ 29,614	$ 88	1.19%	$ 38,400	$ 79	0.83%
Investment securities:						
Taxable	91,167	525	2.31%	108,168	588	2.19%
Tax Exempt	44,494	429	3.86%	51,679	535	4.14%
Investments	135,661	954	2.82%	159,847	1,123	2.83%
Loans:						
Commercial, industrial and agricultural	754,164	7,943	4.17%	660,177	6,725	4.03%
Residential mortgage	75,147	745	3.97%	76,832	768	4.00%
Home equity loans and lines	71,368	815	4.58%	71,413	756	4.26%
Consumer	4,656	58	5.00%	5,715	60	4.22%
Loans	905,335	9,561	4.19%	814,137	8,309	4.05%
Total interest-earning assets	1,070,610	$ 10,603	3.97%	1,012,384	$ 9,511	3.78%
Other assets	63,074			67,771		
Total assets	$ 1,133,684			$ 1,080,155		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing checking	$ 277,619	$ 89	0.13%	$ 253,299	$ 81	0.13%
Money Management	410,610	364	0.36%	390,985	333	0.34%
Savings	79,218	30	0.15%	73,323	14	0.08%
Time	73,094	107	0.59%	81,957	120	0.59%
Total interest-bearing deposits	840,541	590	0.28%	799,564	548	0.28%
Other borrowings	11	-	1.06%	6	-	0.58%

Total interest-bearing liabilities	840,552	590	0.28%	799,570	548	0.28%
Noninterest-bearing deposits	168,005			161,209		
Other liabilities	5,384			5,003		
Shareholders' equity	119,743			114,373		
Total liabilities and shareholders' equity	$ 1,133,684			$ 1,080,155		
T/E net interest income/Net interest margin		10,013	3.75%		8,963	3.56%
Tax equivalent adjustment		(665)			(523)	
Net interest income		$ 9,348			$ 8,440	

30

Provision for Loan Losses

Provision expense for the second quarter was $50 thousand, compared to $1.9 million in 2016. The decrease in the provision expense was due to low net growth in the loan portfolio, as there were several large participation loan repurchases in the second quarter of 2017 by the lead banks, an improvement in loan quality and higher provision expense in 2016 related to a large commercial loan charge-off. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

Noninterest Income

For the second quarter of 2017, noninterest income increased $299 thousand from the same period in 2016. Investment and trust service fees increased due to an increase in recurring fee income from assets under management in 2017. Loan service charges increased from past due fees collected from a large pay-off on a nonaccrual loan. Other income was higher due to a vendor rebate.

The following table presents a comparison of noninterest income for the three months ended June 30, 2017 and 2016.

	For the Three Months Ended June 30		Change	
(Dollars in thousands)	2017	2016	Amount	%
Noninterest Income				
Investment and trust services fees	$ 1,342	$ 1,218	$ 124	10.2
Loan service charges	309	189	120	63.5
Deposit service charges and fees	585	602	(17)	(2.8)
Other service charges and fees	332	313	19	6.1
Debit card income	362	375	(13)	(3.5)
Increase in cash surrender value of life insurance	131	132	(1)	(0.8)
Net loss on sale of other real estate owned	-	(2)	2	100.0
Securities gains (losses), net	-	2	(2)	(100.0)
Other	94	27	67	248.1
Total noninterest income	$ 3,155	$ 2,856	$ 299	10.5

Noninterest Expense

Noninterest expense for the second quarter of 2017 increased $431 thousand compared to the same period in 2016. The increase in salaries and benefits was primarily due to $255 thousand increase for incentive plans, $94 thousand increase in health insurance costs, $80 thousand increase in salary expense due to merit increases and increased staffing levels and $37 thousand increase in stock option compensation compared to the same period in 2016. The change in data processing expenses is due to increased utilization of the Bank's mobile banking platforms. FDIC insurance decreased as the Bank's base assessment rate decreased. Other expenses decreased due to collection of legal fees ($52 thousand) from a pay-off on a large nonaccrual loan.

The following table presents a comparison of noninterest expense for the three months ended June 30, 2017 and 2016:

(Dollars in thousands)	For the Three Months Ended June 30		Change	
Noninterest Expense	2017	2016	Amount	%
Salaries and benefits	$ 4,871	$ 4,346	$ 525	12.1
Occupancy, net	535	553	(18)	(3.3)
Furniture and equipment	226	218	8	3.7
Advertising	294	262	32	12.2
Legal and professional	381	394	(13)	(3.3)
Data processing	535	504	31	6.2
Pennsylvania bank shares tax	243	260	(17)	(6.5)
FDIC insurance	93	169	(76)	(45.0)
ATM/debit card processing	222	200	22	11.0
Foreclosed real estate	13	13	-	-
Telecommunications	102	90	12	13.3
Other	646	721	(75)	(10.4)
Total noninterest expense	$ 8,161	$ 7,730	$ 431	5.6

Provision for Income Taxes

For the second quarter of 2017, the Corporation recorded a Federal income tax expense of $950 thousand compared to $130 thousand for the same quarter in 2016. The effective tax rate was 22.1% for the second quarter of 2017 compared to 7.7% for the same period in 2016. The increase in the effective tax rate was due to an increase in pretax income in 2017. Pre-tax income increased $2.6 million in 2017 due to an increase in net interest income and a $1.8 million decrease in the provision for loan losses expense. The variances from the federal statutory rate are generally due to tax-exempt income from investments, loans and bank-owned life insurance. All taxable income for the Corporation is taxed at a rate of 34%.

Comparison of the six months ended June 30, 2017 to the six months ended June 30, 2016:

Net Interest Income

Tax equivalent net interest income increased $1.6 million to $19.6 million in the first half of 2017 compared to $18.0 million in the same period in 2016. Balance sheet volume contributed $1.5 million to this increase and changes in interest rates added $13 thousand.

The following table presents average balances, tax-equivalent (T/E) interest income, and yields earned or rates paid on the assets or liabilities. All nontaxable interest income has been adjusted to a tax-equivalent basis using a tax rate of 34%.

	For the Six Months Ended June 30					
	2017			2016		
(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
Interest-earning assets:						
Interest-bearing obligations of other banks and federal funds sold	$ 25,199	$ 149	1.19%	$ 34,639	$ 141	0.82%
Investment securities:						
Taxable	92,957	1,070	2.32%	106,962	1,170	2.20%
Tax Exempt	45,423	880	3.88%	51,571	1,085	4.21%
Investments	138,380	1,950	2.84%	158,533	2,255	2.86%
Loans:						
Commercial, industrial and agricultural	745,665	15,432	4.12%	651,542	13,548	4.11%
Residential mortgage	75,826	1,499	3.95%	77,727	1,555	4.00%
Home equity loans and lines	71,833	1,614	4.53%	71,166	1,511	4.27%
Consumer	4,686	124	5.34%	5,635	128	4.57%
Loans	898,010	18,669	4.14%	806,070	16,742	4.12%
Total interest-earning assets	1,061,589	$ 20,768	3.95%	999,242	$ 19,138	3.85%
Other assets	63,021			66,941		

Total assets	$ 1,124,610			$ 1,066,183		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing checking	$ 266,740	$ 167	0.13%	$ 245,539	153	0.13%
Money Management	416,401	729	0.35%	390,626	666	0.34%
Savings	78,059	50	0.13%	71,637	27	0.08%
Time	73,590	210	0.58%	83,415	245	0.59%
Total interest-bearing deposits	834,790	1,156	0.28%	791,217	1,091	0.28%
Other borrowings	3,720	15	0.82%	791	2	0.60%
Total interest-bearing liabilities	838,510	1,171	0.28%	792,008	1,093	0.28%
Noninterest-bearing deposits	162,566			155,456		
Other liabilities	5,161			5,267		
Shareholders' equity	118,373			113,452		
Total liabilities and shareholders' equity	$ 1,124,610			$ 1,066,183		
T/E net interest income/Net interest margin		19,597	3.72%		18,045	3.63%
Tax equivalent adjustment		(1,285)			(1,051)	
Net interest income		$ 18,312			$ 16,994	

Provision for Loan Losses

Provision expense for the first half of 2017 was $170 thousand, compared to $2.2 million in 2016. The decrease in the provision for loan losses expense was due to low net growth in the loan portfolio, as there were several large participation loan repurchases in 2017 by the lead banks, an improvement in loan quality and a higher provision expense in 2016 related to a large commercial loan charge-off. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

Noninterest Income

For the first half of 2017, noninterest income increased $272 thousand from the same period in 2016. Investment and trust service fees increased due to an increase in recurring fee income from assets under management in 2017. Loan service charges increased from past due fees ($160 thousand) collected from a large pay-off on a nonaccrual loan and a large prepayment penalty ($60 thousand) was collected in 2016. The change in debit card income was due to increased usage by customers in the first half of 2017, compared to the same period in 2016. Other income was higher in 2016, due to a $76 thousand gain from the proceeds of a bank owned life insurance policy.

The following table presents a comparison of noninterest income for the six months ended June 30, 2017 and 2016.

	For the Six Months Ended June 30		Change	
(Dollars in thousands)	2017	2016	Amount	%
Noninterest Income				
Investment and trust services fees	$ 2,637	$ 2,472	$ 165	6.7
Loan service charges	455	415	40	9.6
Deposit service charges and fees	1,178	1,180	(2)	(0.2)
Other service charges and fees	656	616	40	6.5
Debit card income	738	722	16	2.2
Increase in cash surrender value of life insurance	262	267	(5)	(1.9)
Net loss on sale of other real estate owned	-	(10)	10	100.0
OTTI losses on debt securities	-	(20)	20	100.0
Securities gains (losses), net	2	3	(1)	(33.3)
Other	153	164	(11)	(6.7)
Total noninterest income	$ 6,081	$ 5,809	$ 272	4.7

Noninterest Expense

Noninterest expense for the first half of 2017 increased $593 thousand compared to the same period in 2016. The increase in salaries and benefits was due primarily to $209 thousand increase for incentive plans, $117 thousand increase in health insurance costs, $192 thousand increase in salary expense due to merit increases and increased staffing levels, $56 thousand increase in pension expense and $49 thousand increase in stock option compensation compared to the same period in 2016. The change in data processing expenses is due to increased utilization of the Bank's mobile banking platforms. FDIC insurance decreased as the Bank's base assessment rate decreased. Other expenses decreased due to collection of legal fees ($52 thousand) from a pay-off on a large nonaccrual loan in 2017.

The following table presents a comparison of noninterest expense for the six months ended June 30, 2017 and 2016:

(Dollars in thousands)	For the Six Months Ended June 30		Change	
Noninterest Expense	2017	2016	Amount	%
Salaries and benefits	$ 9,497	$ 8,716	$ 781	9.0
Occupancy, net	1,119	1,152	(33)	(2.9)
Furniture and equipment	457	434	23	5.3
Advertising	541	543	(2)	(0.4)
Legal and professional	671	691	(20)	(2.9)
Data processing	1,076	1,001	75	7.5
Pennsylvania bank shares tax	486	496	(10)	(2.0)
FDIC insurance	199	326	(127)	(39.0)
ATM/debit card processing	440	428	12	2.8
Foreclosed real estate	71	76	(5)	(6.6)
Telecommunications	202	209	(7)	(3.3)
Other	1,359	1,453	(94)	(6.5)
Total noninterest expense	$ 16,118	$ 15,525	$ 593	3.8

Provision for Income Taxes

For the first half of 2017, the Corporation recorded a Federal income tax expense of $1.7 million compared to $815 thousand for the same period in 2016. The effective tax rate was 21.5% for the first half of 2017 compared to 16.0% for the same period in 2016. The increase in the effective tax rate was due primarily to an increase in pretax income in 2017. Pre-tax income increased $3.0 million in 2017 due to an increase in net interest income and a $1.8 million decrease in the provision for loan losses expense. The variances from the federal statutory rate are generally due to tax-exempt income from investments, loans and bank-owned life insurance. All taxable income for the Corporation is taxed at a rate of 34%.

Financial Condition

Summary:

At June 30, 2017, assets totaled $1.135 billion, an increase of $7.2 million from the 2016 year-end balance of $1.127 billion. Investment securities decreased $7.8 million, while net loans increased $7.3 million (0.8%) due to growth in the commercial loan portfolio. Deposits increased $25.3 million (2.6%) during the first six months of 2017, mainly in interest-bearing deposits. Shareholders' equity increased $5.9 million during the first six months as retained earnings increased $4.4 million, accumulated other comprehensive loss decreased $673 thousand and the Corporation's Dividend Reinvestment Plan (DRIP) added an additional $528 thousand in new capital.

Cash and Cash Equivalents:

Cash and cash equivalents totaled $45.7 million at June 30, 2017, an increase of $9.1 million from the prior year-end balance of $36.7 million. Interest-bearing deposits are held primarily at the Federal Reserve ($24.0 million) and in short-term bank owned certificates of deposit ($6.5 million).

Investment Securities:

The investment portfolio has decreased $8.9 million on a cost basis, since year-end 2016. The composition of the portfolio has remained consistent with municipal securities and U.S. Agency mortgage-backed securities comprising the greatest portion of the portfolio at approximately 45% and 41% of the portfolio fair value, respectively. The average life of the portfolio was 3.73 years.

The investment portfolio had a net unrealized gain of $999 thousand at June 30, 2017 compared to a net unrealized loss of $20 thousand at the prior year-end. The increase in the unrealized gain is due primarily to the change in interest rates. The portfolio averaged $138.4 million with a yield of 2.84% for the first six months of 2017. This compares to an average of $158.5 million and a yield of 2.86% for the same period in 2016.

The Bank holds only one equity security, a Pennsylvania community bank. The municipal bond portfolio is well diversified geographically (issuers from within 28 states) and is comprised primarily of general obligation bonds (75%). Many municipal bonds have credit enhancements in the form of private bond insurance or other credit support. The largest geographic municipal bond exposure is to 14 issuers in the state of Texas with a fair value of $8.5 million and 10 issuers in the state of Pennsylvania with a fair value of $6.1 million. The average rating of the municipal portfolio from Moody's is Aa2. It contains $59.9 million of bonds rated A3 or higher and one bond of $600 thousand that is not rated by Moody's rating agency. No municipal bonds are rated below investment grade.

The holdings of trust preferred investments and private-label mortgage-backed securities (PLMBS) are unchanged since year-end and are detailed in separate tables.

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2017 and December 31, 2016 is as follows:

(Dollars in thousands) June 30, 2017	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 164	$ 192	$ -	$ 356
U.S. Government and Agency securities	12,032	134	(34)	12,132
Municipal securities	60,505	1,032	(192)	61,345
Trust preferred securities	5,989	3	(203)	5,789
Agency mortgage-backed securities	55,370	387	(386)	55,371
Private-label mortgage-backed securities	946	68	-	1,014
Asset-backed securities	31	-	(2)	29
	$ 135,037	$ 1,816	$ (817)	$ 136,036

(Dollars in thousands) December 31, 2016	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 164	$ 126	$ -	$ 290
U.S. Government and Agency securities	12,598	148	(26)	12,720
Municipal securities	62,763	793	(571)	62,985
Trust preferred securities	5,979	-	(518)	5,461
Agency mortgage-backed securities	61,305	431	(452)	61,284
Private-label mortgage-backed securities	1,053	56	(5)	1,104
Asset-backed securities	33	-	(2)	31
	$ 143,895	$ 1,554	$ (1,574)	$ 143,875

The investment portfolio contained eighty-three securities with $45.5 million of temporarily impaired fair value and $817 thousand in unrealized losses at June 30, 2017. The total unrealized loss position has improved from a $1.6 million unrealized loss at year-end 2016.

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, 2017, 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, 2017 and December 31, 2016:

	June 30, 2017								
	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
U.S. Government and Agency securities	$ 1,596	$ (9)	4	$ 3,020	$ (25)	9	$ 4,616	$ (34)	13
Municipal securities	6,671	(120)	12	2,146	(72)	3	8,817	(192)	15
Trust preferred securities	-	-	-	4,561	(203)	5	4,561	(203)	5
Agency mortgage-backed securities	19,063	(229)	32	8,457	(157)	17	27,520	(386)	49
Asset-backed securities	-	-	-	4	(2)	1	4	(2)	1
Total temporarily impaired securities	$ 27,330	$ (358)	48	$ 18,188	$ (459)	35	$ 45,518	$ (817)	83

	December 31, 2016								
	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
U.S. Government and Agency securities	$ 789	$ (9)	1	$ 3,413	$ (17)	10	$ 4,202	$ (26)	11
Municipal securities	23,407	(417)	43	1,598	(154)	2	25,005	(571)	45
Trust preferred securities	-	-	-	5,461	(518)	7	5,461	(518)	7
Agency mortgage-backed securities	26,995	(359)	39	4,656	(93)	11	31,651	(452)	50
Private-label mortgage-backed securities	281	(5)	1	-	-	-	281	(5)	1
Asset-backed securities	-	-	-	4	(2)	1	4	(2)	1
Total temporarily impaired securities	$ 51,472	$ (790)	84	$ 15,132	$ (784)	31	$ 66,604	$ (1,574)	115

The unrealized loss in the municipal bond portfolio decreased to $192 thousand from $571 thousand at December 31, 2016 as market prices improved during the quarter. There are fifteen securities in this portfolio with an unrealized loss and the loss in this portfolio is deemed to be non-credit related and no other-than-temporary impairment charges have been recorded.

The trust preferred portfolio contains five securities with a fair value of $4.6 million and an unrealized loss of $203 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, 2017, 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 is showing an unrealized gain of $68 thousand at quarter end. This is primarily a result of the cumulative OTTI charges recorded on this portfolio. Due to the nature of these bonds, they are evaluated closely. These bonds were all rated AAA at time of purchase, but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. The Bank has recorded $595 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 held $456 thousand of restricted stock at June 30, 2017. Except for $30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of $100 per share. The level of FHLB stock held is determined by FHLB and is comprised of a minimum membership amount plus a variable activity amount. FHLB stock is evaluated for impairment primarily based on an

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

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. The consumer purpose category represents traditional residential mortgage loans and home equity products (primarily junior liens and lines of credit). Commercial purpose loans in this category 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 and are not originated to be sold.

Total residential real estate loans decreased $5.8 million over 2016, primarily in the consumer first lien and consumer junior liens and lines of credit categories due to pay downs. For the first six months of 2017, the Bank originated $4.1 million in mortgages, including approximately $3.6 million for a fee through a third party brokerage agreement. The Bank does not originate or hold any loans that would be considered sub-prime or Alt-A, and does not generally originate mortgages outside of its primary market area.

Residential real estate construction: The largest component of this category represents loans to residential real estate developers ($9.9 million), while loans for individuals to construct personal residences totaled $1.3 million at June 30, 2017. The Bank's exposure to residential construction loans is concentrated primarily in south central Pennsylvania. Real estate construction loans, including residential real estate and land development loans, occasionally 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 June 30, 2017, the Bank had $1.3 million in residential real estate construction loans funded with an interest reserve and capitalized $48 thousand of interest from these reserves on active projects. These loans were comprised of $303 in residential construction and $1.0 million in commercial construction (reported in the commercial real estate category). 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 AIA documents (depending on the complexity of the project) detailing costs incurred by the borrower, on-site inspections, and a signature by the assigned loan officer for disbursement of funds.

Commercial real estate (CRE): This category includes commercial, industrial, farm and agricultural loans, where real estate serves as the primary collateral for the loans. Total commercial real estate loans decreased to $386.8 million from $390.6 million at the end of 2016, a decrease of $3.8 million. The decrease was primarily in multi-family units, as an $8.9 million participation loan was purchased by the lead bank in April. The largest sectors (by collateral) in the commercial real estate category are: office buildings ($57.5 million), land development ($45.3 million), hotels and motels ($44.4 million), auto dealerships ($31.9 million) and manufacturing ($31.3 million).

Commercial (C&I): This category includes commercial, industrial, farm, agricultural, and municipal loans. C&I loans increased $15.0 million to $285.8 million at June 30, 2017, compared to $270.8 million at the end of 2016, primarily in the municipal loan portfolio. The largest sectors (by industry) in the commercial loan category are: public administration ($82.9 million), utilities ($36.7 million), educational services ($28.0 million) and retail trade ($25.7

million). At June 30, 2017, the Bank had $173.9 million in tax-free loans. The Bank continues to reduce its portfolio of purchased participation commercial loans. At June 30, 2017, the Bank held $118.2 million in purchased loan participations in its portfolio, a decrease of $15.1 million from December 31, 2016 ($14.0 million due to participation loan purchases by the lead banks). The Bank expects that commercial lending will continue to be the primary area of loan growth in the future, via in-market lending, but it expects new purchase participations to decline.

Consumer loans: This category decreased $24 thousand due primarily to regular payments and maturities. The majority of the Bank's consumer loans, approximately $3.3 million, are personal lines of credit. The Bank believes the consumer portfolio will continue to decline.

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

(Dollars in thousands)	June 30, 2017	December 31, 2016	Change Amount	%
Residential Real Estate 1-4 Family				
Consumer first liens	$ 100,072	$ 103,125	$ (3,053)	(3.0)
Commercial first lien	63,178	65,445	(2,267)	(3.5)
Total first liens	163,250	168,570	(5,320)	(3.2)
Consumer junior liens and lines of credit	44,213	44,817	(604)	(1.3)
Commercial junior liens and lines of credit	5,480	5,396	84	1.6
Total junior liens and lines of credit	49,693	50,213	(520)	(1.0)
Total residential real estate 1-4 family	212,943	218,783	(5,840)	(2.7)
Residential real estate - construction				
Consumer	1,298	1,350	(52)	(3.9)
Commercial	9,928	7,625	2,303	30.2
Total residential real estate construction	11,226	8,975	2,251	25.1
Commercial real estate	386,784	390,584	(3,800)	(1.0)
Commercial	285,780	270,826	14,954	5.5
Total commercial	672,564	661,410	11,154	1.7
Consumer	4,681	4,705	(24)	(0.5)
	901,414	893,873	7,541	0.8
Less: Allowance for loan losses	(11,307)	(11,075)	(232)	2.1
Net Loans	$ 890,107	$ 882,798	$ 7,309	0.8

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 based on the performance status of the loans. Substandard consumer loans are loans that are 90 days or more past due and still accruing. 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-Special Mention or worse begin to receive enhanced monitoring and reporting by the Bank. Loans rated 7-Substandard or 8-Doubtful exhibit the greatest financial weakness and present the greatest possible risk of loss to the Bank. Nonaccrual loans are rated no better than 7-Substandard. 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, for pass credits, are generally reviewed annually for term debt and at renewal for revolving or renewing debt. The Bank monitors loan quality by reviewing four primary measurements: (1) loans rated 6-Special Mention or worse (collectively "watch list"), (2) delinquent loans, (3) net-charge-offs, and other real estate owned (OREO).

Watch list loans exhibit financial weaknesses that increase the potential risk of default or loss to the Bank. However, inclusion on the watch list, does not by itself, mean a loss is certain. The watch list totaled $17.0 million at quarter end and includes both performing and nonperforming loans. It is comprised entirely of loans rate 7- Substandard. The Bank has no loans rated 6-Special Mention, 8-Doubtful or 9-Loss. Included in the substandard total are $3.1 million of

nonaccrual loans. The watch list totaled $18.5 million at December 31, 2016. The credit composition of the portfolio, by primary collateral is shown in Note 6 of the accompanying financial statements. The Bank's Loan Management Committee reviews these loans and risk ratings on a quarterly basis in order to proactively identify and manage problem loans. In addition, a committee meets monthly to discuss possible workout strategies for OREO and all credits rated 7-Substandard or worse. Management also tracks other commercial loan risk measurements including high loan to value loans, concentrations, participations and policy exceptions and reports these to the Credit Risk Oversight Committee of the Board of Directors. The Bank also uses a third-party consultant to assist with internal loan review with a goal of reviewing 60% of commercial loans each year. The FDIC defines certain supervisory loan-to-value lending limits. The Bank's internal loan–to-value limits are all equal to, or have a lower loan-to-value limit, than the supervisory limits. At June 30, 2017, the Bank had loans of $31.1 million that exceeded the supervisory limit.

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 6 in the accompanying financial statements for a table 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 may or may not 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, nonaccrual loans, or impaired 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. Management continually monitors the status of nonperforming loans, the value of any collateral and potential of risk of loss. Nonaccrual loans are rated no better than 7-Substandard.

Loan quality, as measured by the balance of nonperforming loans has improved since year-end 2016. Nonaccrual loans have decreased $1.7 million since year-end 2016. This reduction was due to the pay-off of a $1.1 million loan that had been in nonaccrual status since December 2014 and a partial pay-down of $655 thousand on another loan. OREO declined during the year due to the sale in the first quarter of 2017 of a property that was carried at $1.8 million. Total OREO is essentially unchanged since the end of the first quarter.

The following table presents a summary of nonperforming assets:

(Dollars in thousands)	June 30, 2017	December 31, 2016
Nonaccrual loans		
Residential Real Estate 1-4 Family		
First liens	$ 387	$ 231
Junior liens and lines of credit	107	86
Total	494	317
Residential real estate - construction	473	480
Commercial real estate	1,969	3,956
Commercial	121	23
Total nonaccrual loans	3,057	4,776
Loans past due 90 days or more and not included above		
Residential Real Estate 1-4 Family		
First liens	61	-
Junior liens and lines of credit	8	-
Total	69	-
Commercial real estate	-	665
Total loans past due 90 days or more and still accruing	69	665
Total nonperforming loans	3,126	5,441

Other real estate owned	3,115	4,915
Total nonperforming assets	$ 6,241	$ 10,356
Nonperforming loans to total gross loans	0.35%	0.61%
Nonperforming assets to total assets	0.55%	0.92%
Allowance for loan losses to nonperforming loans	361.71%	203.55%

39

The following table identifies the most significant loans in nonaccrual status. These two nonaccrual loans account for 75% of the total nonaccrual balance. The table also indicates those significant nonaccrual loans that are classified as troubled debt restructurings (TDR). A TDR loan is maintained on nonaccrual status until a satisfactory repayment history is established. All loans on the watch list that are not on nonaccrual or past due 90 days more are considered potential problem loans. Potential problem loans at June 30, 2017 totaled $13.9 million compared to $17.1 million at year-end 2016. The following table provides information on the most significant nonaccrual loans as of June 30, 2017:

(Dollars in thousands)	Balance	ALL Reserve	Nonaccrual Date	TDR Status	Collateral	Location	Last Appraisal(1)	
Credit 1	1,688	-	Mar-12	Y	1st and 2nd liens on commercial real estate, residential real estate and business assets	PA	Jan-16	$ 3,810
Credit 2	595	-	Sep-16	Y	1st lien on farmland	PA	Jul-14	$ 2,391
	$ 2,283	$ -						

(1) Appraisal value, as reported, does not reflect the pay-off of any senior liens or the cost to liquidate the collateral, but does reflect only the Bank's share of the collateral if it is a participated loan.

Credit 1 is a TDR that is performing in accordance with the modified terms. Credit 2 paid down $655 thousand during the second quarter from the sale of real estate.

In addition to monitoring nonaccrual loans, 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. Nonaccrual loans (excluding consumer purpose loans) and TDR loans are considered impaired.

A loan is considered a troubled debt restructuring 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. These concessions may include lowering the rate, extending the maturity, re-amortization of the payment, or a combination of multiple concessions. The Bank reviews all loans rated 6-Special Mention or worse when it is providing a loan restructure, modification or new credit facility to determine if the action is a TDR. If a TDR loan is placed on nonaccrual status, it remains on nonaccrual status for at least six months to ensure performance.

In accordance with financial accounting standards, TDR loans are always considered impaired until they are paid off or in certain circumstances, refinanced. However, an impaired TDR loan can be a performing loan. Impaired loans totaled $13.2 million at quarter-end compared to $15.1 million at year-end 2016.

The following table shows the composition of impaired loans as of:

June 30, 2017

(Dollars in thousands)	Nonaccrual Non-TDR	TDR	Accruing TDR	Accruing Other (1)	Total Impaired
Residential Real Estate 1-4 Family					
First liens	$ 236	$ 151	$ 713	$ 61	$ 1,161
Junior liens and lines of credit	107	-	-	8	115
Total	343	151	713	69	1,276
Residential real estate - construction	-	473	-	-	473
Commercial real estate	159	1,810	9,376	-	11,345
Commercial	121	-	-	-	121
Total	$ 623	$ 2,434	$ 10,089	$ 69	$ 13,215

1) impaired consumer purpose loans not yet on nonaccrual

Allowance for Loan Losses:

Management performs a quarterly 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, historical charge-offs, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. The Bank begins enhanced monitoring of all loans rated 6 (Special Mention) or worse, and obtains a new appraisal or asset valuation for any loan rated 7 (Substandard) or worse. 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 losses, 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 June 30, 2017 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. Collateral values discounted for market conditions and selling costs are used to establish specific allocations for impaired loans. It is possible that as a result of the credit analysis, a specific reserve is not required for an impaired loan. For impaired commercial loans with balances less than $250 thousand and all consumer purpose loans, a specific reserve analysis is not performed and these loans are added to the general allocation pool. These loans totaled $372 thousand at June 30, 2017 and are comprised primarily of loans secured by residential real estate. Management does not believe that excluding these loans from the specific reserve analysis presents any additional risk. At June 30, 2017, impaired loans totaled $13.2 million compared to $15.1 million at year-end 2016. The Bank currently has no specific reserve established for any loans. Note 6 in the accompanying financial statements provide additional information about the ALL 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 twenty quarter rolling historical loan loss experience adjusted for factors derived from current economic and market conditions that have been determined to have an effect on the probability and magnitude of a loss. The historical loss experience factor for the general allocation was .83% ($7.5 million) of gross loans, compared to .84% at December 31, 2016.

The qualitative analysis utilizes a risk matrix that incorporates qualitative and environmental factors such as: loan volume, management, loan review process, credit concentrations, competition, and legal and regulatory issues. These factors are each risk rated from minimal to high risk and in total can add up to a maximum qualitative factor of 37.5 basis points. At June 30, 2017, these factors totaled 26 basis points ($2.3 million), unchanged from year-end 2016. The risk assessment of factors is determined on the basis of Management’s observation, judgment and experience. In addition to two factors above, there is an unallocated reserve of $1.5 million at June 30, 2017 compared to $1.3 million at the prior year-end.

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 effect on the determination of loan reserves, 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 or relationship migrates to risk rating of 7-Substandard or worse, an evaluation for impairment status is made based on the current information available at the time of downgrade and a new appraisal or collateral valuation is obtained.

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 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 loan class as of June 30, 2017 and December 31, 2016:

	Residential Real Estate 1-4 Family							
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Commercial Real Estate	Commercial	Consumer	Unallocated	Total
June 30, 2017								
Loans evaluated for ALL:								
Individually	$ 818	$ 106	$ 473	$ 11,346	$ 99	$ -	$ -	$ 12,842
Collectively	162,432	49,587	10,753	375,438	285,681	4,681	-	888,572
Total	$ 163,250	$ 49,693	$ 11,226	$ 386,784	$ 285,780	$ 4,681	$ -	$ 901,414
ALL established for loans evaluated:								
Individually	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Collectively	1,075	322	281	6,052	2,023	100	1,454	11,307
ALL at June 30, 2017	$ 1,075	$ 322	$ 281	$ 6,052	$ 2,023	$ 100	$ 1,454	$ 11,307
December 31, 2016								
Loans evaluated for ALL:								
Individually	$ 628	$ 52	$ 480	$ 13,523	$ -	$ -	$ -	$ 14,683
Collectively	167,942	50,161	8,495	377,061	270,826	4,705	-	879,190
Total	$ 168,570	$ 50,213	$ 8,975	$ 390,584	$ 270,826	$ 4,705	$ -	$ 893,873
ALL established for loans evaluated:								
Individually	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Collectively	1,105	323	224	6,109	1,893	100	1,321	11,075
ALL at December 31, 2016	$ 1,105	$ 323	$ 224	$ 6,109	$ 1,893	$ 100	$ 1,321	$ 11,075

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. Charged-off loans decrease the Bank's allowance for loan losses (ALL), while the recovery of previously charge-off loans and the provision for loan loss expense increase the ALL.

Year-to-date, the Bank recorded a net recovery on previously charged-off loans of $62 thousand. For the same period of 2016, the Bank recorded $1.9 million in net charge-offs, primarily the result of a $1.9 million charge-off on a commercial real estate loan.

The Bank recorded $50 thousand for the loan loss provision expense for the second quarter of 2017 and $170 thousand on a year-to-date basis. This compares to $1.9 million for the second quarter of 2017 and $2.2 million for the 2016 year-to-date period. The change in the provision expense year-over-year is due to the following: 1) several large participated loans repurchased by the lead banks during the second quarter of 2017, tempering net loan growth, 2) credit quality has improved during 2017, and 3) the 2016 charge-off of $1.9 million previously mentioned.

For the first six months of 2017, the allowance for loan losses increased $232 thousand to $11.3 million, or 1.25% of gross loans.

42

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

	Residential Real Estate 1-4 Family			Commercial				
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Consumer	Unallocated	Total
ALL at March 31, 2017	$ 1,100	$ 321	$ 274	$ 6,126	$ 1,984	$ 99	$ 1,374	$ 11,278
Charge-offs	(5)	-	-	(5)	(2)	(24)	-	(36)
Recoveries	-	1	-	-	4	10	-	15
Provision	(20)	-	7	(69)	37	15	80	50
ALL at June 30, 2017	$ 1,075	$ 322	$ 281	$ 6,052	$ 2,023	$ 100	$ 1,454	$ 11,307
ALL at December 31, 2016	$ 1,105	$ 323	$ 224	$ 6,109	$ 1,893	$ 100	$ 1,321	$ 11,075
Charge-offs	(13)	-	-	(5)	(2)	(52)	-	(72)
Recoveries	1	1	-	-	106	26	-	134
Provision	(18)	(2)	57	(52)	26	26	133	170
ALL at June 30, 2017	$ 1,075	$ 322	$ 281	$ 6,052	$ 2,023	$ 100	$ 1,454	$ 11,307

The allocation of the allowance for loan losses is based on estimates and is not intended to imply limitations on the usage of the allowance. The entire allowance is available to absorb any losses without regard to the category in which the loan is classified.

	Six months ended June 30, 2017	Year ended December 31, 2016	Six months ended June 30, 2016
Net loans charged-off as a percentage of average gross loans	-0.01%	0.33%	0.48%
Net loans charged-off as a percentage of the provision for loan losses	-36.47%	73.80%	0.89%
Allowance as a percentage of loans	1.25%	1.24%	1.25%
Net (recoveries) charge-offs	$ (62)	$ 2,786	$ 1,943

Other Real Estate Owned:

The Bank holds $3.1 million of other real estate owned (OREO), comprised of five properties compared to $4.9 million on the same five properties at December 31, 2016. A portion of one property carried at $1.8 million was sold during the first quarter of 2017. The most significant OREO holding is one property carried at $2.5 million (81% of total OREO) that is secured by 196 acres of land intended for residential real estate development. This property is under contract to be sold; however, the agreement allows for a due diligence period until November 2017. Therefore, the final outcome is not certain. This property was part of a participated loan and the workout is being handled by the lead bank. During 2017, the Bank recorded a write down of $49 thousand on one property and incurred expense of $22 thousand to hold and maintain OREO. Note 7 of the accompanying financial statements provides additional information on activity in OREO.

The Bank had $90 thousand of residential properties in the process of foreclosure at June 30, 2017 and December 31, 2016.

Deposits:

Total deposits increased $25.3 million during the first six months of 2017 to $1.007 billion. Non-interest bearing deposits increased $2.7 million, while interest-bearing checking and savings increased $25.1 million and time deposits decreased $2.5 million. Interest bearing checking increased by $33.2 million, primarily from nonprofit deposits. The Bank's Money Management product decreased $12.3 million, primarily in retail and municipal accounts. Retail time deposits decreased since year-end, as customers moved funds to more liquid accounts.

As of June 30, 2017, the Bank had $163.3 million placed in the ICS program ($99.0 million in interesting-bearing checking and $64.3 million in money management) and $3.4 million in reciprocal time deposits in the CDARS program included in brokered time deposits. These programs allow the Bank to offer full FDIC coverage to large depositors, but with the convenience to the customer of only having to deal with one bank. The Bank solicits these deposits from within its market and it believes they present no greater risk than any other local deposit. However, regulatory guidance requires that these deposits be classified as brokered deposits. The Bank had no wholesale brokered CDs at June 30, 2017.

			Change	
(Dollars in thousands)	June 30, 2017	December 31, 2016	Amount	%
Noninterest-bearing checking	$ 173,030	$ 170,345	$ 2,685	1.6
Interest-bearing checking	275,067	241,906	33,161	13.7
Money management	407,997	420,309	(12,312)	(2.9)
Savings	79,190	74,925	4,265	5.7
Total interest-bearing checking and savings	762,254	737,140	25,114	3.4
Retail time deposits	68,720	71,264	(2,544)	(3.6)
Brokered time deposits	3,374	3,371	3	0.1
Total time deposits	72,094	74,635	(2,541)	(3.4)
Total deposits	$ 1,007,378	$ 982,120	$ 25,258	2.6
Overdrawn deposit accounts reclassified as loans	$ 163	$ 181		

Borrowings:

The Corporation had no short-term borrowings at June 30, 2017, compared to $24.3 million at December 31, 2016.

Shareholders' Equity:

Total shareholders' equity increased $5.9 million to $122.4 million at June 30, 2017, compared to $116.5 million at the end of 2016. The increase in retained earnings from the Corporation's net income of $6.4 million was partially offset by the cash dividend of $1.9 million. The Corporation's dividend payout ratio was 30.6% for the first six months of 2017 compared to 43.6% in 2016.

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. For the second quarter of 2017, the Corporation paid a $0.24 per share dividend, compared to $0.21 paid in the second quarter of 2016. On July 13, 2017 the Board of Directors declared a $0.24 per share regular quarterly dividend for the third quarter of 2017, which will be paid on August 23, 2017.

In addition, the Corporation considers how dividend decisions may affect the Dividend Reinvestment Plan (DRIP), which has raised $528 thousand in new capital this year with 17,267 new shares purchased. No shares were repurchased in the first half of 2017. The 2016 stock repurchase plan expired on March 31, 2017 and there is currently no repurchase plan in place.

In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as "Basel III." The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered "well capitalized" under Basel III are: (1) Common Equity Tier 1 (CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3) Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The CET1 ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.625%, 1.25% for 2017, 1.875% for 2018 and 2.50% for 2019 and thereafter. The capital conservation buffer will be applicable to all of the capital ratios except for the Tier1 Leverage ratio. The capital conservation buffer is equal to the lowest value of the three applicable capital ratios less the regulatory minimum for each respective capital

measurement. The Bank's capital conservation buffer at June 30, 2017 was 8.72% (total risk-based capital 16.72% less 8.00%) compared to the 2017 regulatory buffer of 1.25%. Compliance with the capital conservation buffer is required in order to avoid limitations to certain capital distributions. As of June 30, 2017, the Bank was "well capitalized' under the Basel III requirements and believes it would be "well capitalized" on a fully-phased in basis had such a requirement been in effect.

The following table summarizes regulatory capital information as of June 30, 2017 and December 31, 2016 for the Corporation and the Bank.

			Regulatory Ratios	
			Adequately Capitalized	Well Capitalized
(Dollars in thousands)	June 30, 2017	December 31, 2016	Minimum	Minimum
Common Equity Tier 1 Risk-based Capital Ratio (1)				
Franklin Financial Services Corporation	15.52%	14.41%	4.500%	N/A
Farmers & Merchants Trust Company	15.46%	14.29%	4.500%	6.50%
Tier 1 Risk-based Capital Ratio (2)				
Franklin Financial Services Corporation	15.52%	14.41%	6.000%	N/A
Farmers & Merchants Trust Company	15.46%	14.29%	6.000%	8.00%
Total Risk-based Capital Ratio (3)				
Franklin Financial Services Corporation	16.78%	15.67%	8.000%	N/A
Farmers & Merchants Trust Company	16.72%	15.55%	8.000%	10.00%
Tier 1 Leverage Ratio (4)				
Franklin Financial Services Corporation	10.39%	10.11%	4.000%	N/A
Farmers & Merchants Trust Company	10.35%	10.02%	4.000%	5.00%

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

Economy

The Corporation's primary market area includes Franklin, Fulton, Cumberland and Huntingdon Counties, Pennsylvania. 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. Unemployment in the Bank's market area has remained virtually unchanged over the past year and ranges from a low of 4.1% in Cumberland County to 5.7% in Huntingdon County. The market area has a diverse economic base and local industries include warehousing, truck & rail shipping centers, light and heavy manufacturers, health-care, higher education institutions, farming and agriculture, and a varied service sector. The Corporation's primary market area is located in south central Pennsylvania and provides easy access to the major metropolitan markets on the east coast via trucking and rail transportation. Because of this, warehousing and distribution companies continue to find the area attractive. The local economy is not overly dependent on any one industry or business and Management believes that the Bank's primary market area continues to be well suited for growth.

45

The following provides selected economic data for the Bank's primary market:

Economic Data

	June 30, 2017	December 31, 2016
Unemployment Rate (seasonally adjusted)		
Market area range (1)	4.1% - 5.7%	4.2 - 6.6%
Pennsylvania	5.0%	5.7%
United States	4.3%	4.6%
Housing Price Index - year over year change		
PA, nonmetropolitan statistical area	1.6%	2.8%
United States	5.5%	5.6%
Building Permits - year over year change -12 moths		
Harrisburg-Carlisle, PA MSA & Chambersburg-Waynesboro, PA MSA		
Residential, estimated	-2.0%	20.9%
Multifamily, estimated	-28.3%	-31.7%

(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. In June 2017, the FOMC increased the federal funds rate target range by .25%, its fourth such increase since December 31, 2015. Despite these actions, the yield curve has flattened during the year. The Federal Reserve also announced it would begin to reduce the size of its balance sheet by not reinvesting cash-flow from maturing assets. Looking throughout 2017, the FOMC continues to state that the timing and magnitude of rate increases will be data dependent; therefore, the likelihood of any rate increase or decrease in 2017 is unknown, despite predictions of more increases.

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 it liquidity position by measuring its projected net cash flows (in and out) at a 30 and 90-day interval. The Bank stresses the measurements by assuming a level of deposit out-flows 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 of 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. Assumptions used for liquidity stress testing are subjective. Should an evolving liquidity situation or business cycle present new data, potential assumption changes will be considered. 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 investment securities 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. At June 30, 2017, the Bank had approximately $73.0 million (fair value) in its investment portfolio pledged as collateral for deposits. The Bank also has access to other wholesale funding via the brokered CD market.

The FHLB system has always been a major funding source for community banks. The Bank's maximum borrowing capacity with the FHLB at June 30, 2017 was $307 million with $307 million available to borrow. There are no indicators that lead the Bank to believe the FHLB would discontinue its lending function or restrict the Bank's ability to borrow if either of these events were to occur, it would have a negative effect on the Bank and it is unlikely that the Bank could replace the level of FHLB funding in a short time.

The Bank has established credit at the Federal Reserve Discount Window and as of quarter-end had the ability to borrow approximately $21 million.

Off Balance Sheet Commitments

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 $295.2 million and $301.3 million, respectively, at June 30, 2017 and December 31, 2016.

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 2016 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 six months ended June 30, 2017. For more information on market risk refer to the Corporation's 2016 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 June 30, 2017, 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. There were no changes in the Corporation's internal control over financial reporting during the quarterly period ended June 30, 2017, that have materially affected, or are reasonably likely to materially affect, the internal control over financial reporting.

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 including, without limitation, the Kalan et al. v. Farmers and Merchants Trust Company of Chambersburg, et al. (Case No. 2:15-CV-01435-WB) case filed in the United States District Court for the Eastern District of Pennsylvania and described in our current reports on Form 8-K filed July 29, 2016 and July 28, 2017. The impact that any matter may have upon our results of operation or financial condition in any future reporting period will depend upon, among other things, the amount of loss resulting from such matter and the amount of income otherwise reported for the period. No material proceedings are pending or are known to be threatened or contemplated against us by governmental authorities.

We establish accruals for legal proceedings when information related to the loss contingencies represented by those matters indicates both that a loss is probable and that the amount of loss can be reasonably estimated. When we are able to do so, we also determine estimates of possible losses or ranges of possible losses, whether in excess of any related accrued liability or where there is no accrued liability.

We have not yet established any specific accrual for the Kalan matter because we are not yet able to provide an evaluation of the likelihood of an unfavorable outcome or an estimate of the amount or range of potential loss. The damages sought by the Plaintiffs are as yet unspecified and uncertain. It is as yet unclear as to whether the case will be allowed to proceed as a class action and, if so, how the class would be defined. The case presents a number of legal uncertainties yet to be resolved including, whether Plaintiffs' claims are timely and whether, as a directed trustee, the Bank could be liable for the Plaintiffs' claims. There are significant facts in dispute and discovery is in early stages.

These assessments are based upon our analysis of currently available information and are subject to significant judgment and a variety of assumptions and uncertainties. As new information is obtained, we may change our assessments and, as a result, take or adjust the amounts of our accruals and change our estimates of possible losses or ranges of possible losses. Due to the inherent subjectivity of the assessments and unpredictability of outcomes of legal proceedings, any amounts that may be accrued or included in estimates of possible losses or ranges of possible losses may not represent the actual loss to the Corporation from the Kalan or any other legal proceeding. Our exposure and ultimate losses may be higher, possibly significantly higher, than amounts we may accrue or amounts we may estimate.

Item 1A. Risk Factors

Except as set forth below, there were no material changes in the Corporation's risk factors during the six months ended June 30, 2017. For more information, refer to the Corporation's 2016 Annual Report on Form 10-K.

Our business and financial results could be impacted materially by adverse results in legal proceedings.

The nature of the Corporation's business generates a certain amount of litigation involving matters arising in the ordinary course of business (and, in some cases, from the activities of companies we have acquired). These legal proceedings, whether founded or unfounded, could result in reputation damage and have an adverse effect on our financial condition and results of operation if they are not resolved in a manner favorable to the Corporation. Although we establish accruals for legal proceedings when information related to the loss contingencies represented by these matters indicates that both a loss is probable and that the amount of the loss can be reasonably estimated, we do not have accruals for all legal proceedings where we face a risk of loss. In addition, due to the

inherent subjectivity of the assessments and unpredictability of outcomes of legal proceedings, any amounts that may be accrued or included in estimates of possible losses or ranges of possible losses may not represent the actual loss to the Corporation. We discuss these matters further in Part II, Item 1 Legal Proceedings and in Note 12 Contingencies in the Notes to Consolidated Financial Statements in Part I, Item 1 of this Report.

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

None

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, 2014 and incorporated herein by reference.)

3.2 Bylaws of the Corporation. (Filed as Exhibit 3.2 to Annual Report on Form 10-K for the year ended December 31, 2016 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)

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

August 4, 2017	/s/ Timothy G. Henry Timothy G. Henry Chief Executive Office and President (Principal Executive Officer)
August 4, 2017	/s/ Mark R. Hollar Mark R. Hollar Treasurer and Chief Financial Officer (Principal Financial and Accounting Officer)