

FRANKLIN FINANCIAL SERVICES CORP /PA/

Form 10-Q

November 07, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

PENNSYLVANIA

(State or other jurisdiction of incorporation or organization)

25-1440803

(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

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

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

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

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

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

There were 4,299,317 outstanding shares of the Registrant’s common stock as of October 31, 2016.

---

INDEX

Part I - FINANCIAL INFORMATION

<u>Item 1</u>	<u>Financial Statements</u>	
	<u>Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015 (unaudited)</u>	1
	<u>Consolidated Statements of Income for the Three and Nine Months ended September 30, 2016 and 2015 (unaudited)</u>	2
	<u>Consolidated Statements of Comprehensive Income for the Three and Nine Months ended September 30, 2016 and 2015 (unaudited)</u>	3
	<u>Consolidated Statements of Changes in Shareholders' Equity for the Nine Months ended September 30, 2016 and 2015 (unaudited)</u>	4
	<u>Consolidated Statements of Cash Flows for the Nine Months ended September 30, 2016 and 2015 (unaudited)</u>	5
	<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
<u>Item 2</u>	<u>Management's Discussion and Analysis of Results of Operations and Financial Condition</u>	28
<u>Item 3</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	52
<u>Item 4</u>	<u>Controls and Procedures</u>	52

Part II - OTHER INFORMATION

<u>Item 1</u>	<u>Legal Proceedings</u>	53
<u>Item 1A</u>	<u>Risk Factors</u>	53
<u>Item 2</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	53
<u>Item 3</u>	<u>Defaults Upon Senior Securities</u>	53
<u>Item 4</u>	<u>Mine Safety Disclosures</u>	53
<u>Item 5</u>	<u>Other Information</u>	53
<u>Item 6</u>	<u>Exhibits</u>	53
	<u>SIGNATURE PAGE</u>	54
	<u>EXHIBITS</u>	

## Part I FINANCIAL INFORMATION

## Item 1 Financial Statements

## Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)(unaudited)	September 30 2016	December 31 2015
<b>Assets</b>		
Cash and due from banks	\$ 16,770	\$ 20,664
Interest-bearing deposits in other banks	23,824	18,502
Total cash and cash equivalents	40,594	39,166
Investment securities available for sale, at fair value	155,345	159,473
Restricted stock	1,118	782
Loans held for sale	367	461
Loans	858,576	782,016
Allowance for loan losses	(10,685)	(10,086)
Net Loans	847,891	771,930
Premises and equipment, net	14,322	14,759
Bank owned life insurance	22,327	22,364
Goodwill	9,016	9,016
Other real estate owned	5,872	6,451
Deferred tax asset, net	4,044	4,758
Other assets	6,224	6,135
<b>Total assets</b>	<b>\$ 1,107,120</b>	<b>\$ 1,035,295</b>
<b>Liabilities</b>		
<b>Deposits</b>		
Noninterest-bearing checking	\$ 174,390	\$ 152,095
Money management, savings and interest checking	726,845	680,686
Time	77,317	85,731
<b>Total Deposits</b>	<b>978,552</b>	<b>918,512</b>
Short-term borrowings	8,530	-
Other liabilities	3,159	5,407
<b>Total liabilities</b>	<b>990,241</b>	<b>923,919</b>
<b>Shareholders' equity</b>		
Common stock, \$1 par value per share, 15,000,000 shares authorized with 4,688,149 shares issued and 4,299,223 shares outstanding at September 30, 2016 and 4,659,319 shares issued and 4,275,879 shares outstanding at December 31, 2015	4,688	4,659
Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding	-	-
Additional paid-in capital	39,584	38,778
Retained earnings	82,262	78,517

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

Accumulated other comprehensive loss	(2,547)	(3,722)
Treasury stock, 388,926 shares at September 30, 2016 and 383,440 shares at December 31, 2015, at cost	(7,108)	(6,856)
Total shareholders' equity	116,879	111,376
Total liabilities and shareholders' equity	\$ 1,107,120	\$ 1,035,295

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		For the Nine Months Ended	
	September 30 2016	2015	September 30 2016	2015
Interest income				
Loans, including fees	\$ 8,343	\$ 7,665	\$ 24,394	\$ 22,518
Interest and dividends on investments:				
Taxable interest	569	584	1,729	1,832
Tax exempt interest	355	402	1,079	1,218
Dividend income	2	3	12	63
Deposits and obligations of other banks	79	66	220	192
Total interest income	9,348	8,720	27,434	25,823
Interest expense				
Deposits	559	554	1,650	1,813
Short-term borrowings	4	1	6	1
Total interest expense	563	555	1,656	1,814
Net interest income	8,785	8,165	25,778	24,009
Provision for loan losses	1,150	400	3,325	1,035
Net interest income after provision for loan losses	7,635	7,765	22,453	22,974
Noninterest income				
Investment and trust services fees	1,211	1,154	3,683	3,805
Loan service charges	102	288	518	784
Deposit service charges and fees	635	623	1,815	1,700
Other service charges and fees	325	309	941	916
Debit card income	373	346	1,095	1,021
Increase in cash surrender value of life insurance	131	137	399	416
Net (loss) gain on sale of other real estate owned	(20)	-	(31)	32
OTTI losses on debt securities	(10)	-	(30)	(20)
Gain on conversion of investment security	-	-	-	728
Securities gains, net	-	-	4	8
Other	56	126	219	363
Total noninterest income	2,803	2,983	8,613	9,753
Noninterest expense				
Salaries and employee benefits	4,566	4,214	13,282	12,500
Occupancy, net	556	535	1,708	1,706
Furniture and equipment	221	232	655	702
Advertising	296	336	839	807
Legal and professional	423	311	1,114	811
Data processing	539	524	1,540	1,547
Pennsylvania bank shares tax	203	206	699	608
Intangible amortization	-	-	-	181
FDIC insurance	188	170	514	479
ATM/debit card processing	214	193	642	566

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

Foreclosed real estate	18	322	93	341
Telecommunications	91	145	300	379
Other	665	675	2,119	2,385
Total noninterest expense	7,980	7,863	23,505	23,012
Income before federal income tax expense	2,458	2,885	7,561	9,715
Federal income tax expense	383	306	1,198	1,778
Net income	\$ 2,075	\$ 2,579	\$ 6,363	\$ 7,937

Per share

Basic earnings per share	\$ 0.48	\$ 0.61	\$ 1.48	\$ 1.87
Diluted earnings per share	\$ 0.48	\$ 0.61	\$ 1.48	\$ 1.87
Cash dividends declared	\$ 0.21	\$ 0.19	\$ 0.61	\$ 0.55

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

## Consolidated Statements of Comprehensive Income

(Dollars in thousands) (unaudited)	For the Three Months Ended September 30		For the Nine Months Ended September 30	
	2016	2015	2016	2015
Net Income	\$ 2,075	\$ 2,579	\$ 6,363	\$ 7,937
Securities:				
Unrealized (losses) gains arising during the period	(524)	1,097	1,528	561
Reclassification adjustment for losses (gains) included in net income (1)	10	-	26	(716)
Net unrealized (losses) gains	(514)	1,097	1,554	(155)
Tax effect	174	(373)	(528)	53
Net of tax amount	(340)	724	1,026	(102)
Derivatives:				
Unrealized gains arising during the period	-	-	-	31
Reclassification adjustment for losses included in net income (2)	-	-	-	160
Net unrealized gains	-	-	-	191
Tax effect	-	-	-	(65)
Net of tax amount	-	-	-	126
Pension:				
Change in plan assets and benefit obligations	-	-	-	-
Reclassification adjustment for losses included in net income (3)	225	-	225	-
Net unrealized losses	225	-	225	-
Tax effect	(76)	-	(76)	-
Net of tax amount	149	-	149	-
Total other comprehensive (loss) income	(191)	724	1,175	24
Total Comprehensive Income	\$ 1,884	\$ 3,303	\$ 7,538	\$ 7,961
Reclassification adjustment / Statement line item	Tax expense (benefit)			
(1) Securities / gain on conversion & securities (gains) losses, including OTTI losses, net	\$ (3)	\$ -	\$ (9)	\$ 243
(2) Derivatives / interest expense on deposits	-	-	-	(54)
(3) Pension / Salary & Benefits	(77)	-	(77)	-

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





## Consolidated Statements of Changes in Shareholders' Equity

For the Nine Months Ended September 30, 2016 and 2015:

	Common	Additional Paid-in	Retained	Accumulated Other Comprehensive	Treasury	Total
(Dollars in thousands, except per share data) (unaudited)	Stock	Capital	Earnings	Loss	Stock	Total
Balance at December 31, 2014	\$ 4,607	\$ 37,504	\$ 71,452	\$ (3,100)	\$ (6,942)	\$ 103,521
Net income	-	-	7,937	-	-	7,937
Other comprehensive income	-	-	-	24	-	24
Cash dividends declared, \$.55 per share	-	-	(2,330)	-	-	(2,330)
Treasury shares issued under stock option plans, 4,794 shares	-	6	-	-	86	92
Common stock issued under dividend reinvestment plan, 36,608 shares	36	833	-	-	-	869
Balance at September 30, 2015	\$ 4,643	\$ 38,343	\$ 77,059	\$ (3,076)	\$ (6,856)	\$ 110,113
Balance at December 31, 2015	\$ 4,659	\$ 38,778	\$ 78,517	\$ (3,722)	\$ (6,856)	\$ 111,376
Net income	-	-	6,363	-	-	6,363
Other comprehensive income	-	-	-	1,175	-	1,175
Cash dividends declared, \$.61 per share	-	-	(2,618)	-	-	(2,618)
Acquisition of 30,196 shares of treasury stock	-	-	-	-	(700)	(700)
Treasury shares issued under employer stock purchase plan, 539 shares	-	2	-	-	10	12
Treasury shares issued under dividend reinvestment plan, 24,171 shares	-	134	-	-	438	572
Common stock issued under dividend reinvestment plan, 25,230 shares	25	527	-	-	-	552
Common stock issued under incentive stock option plan, 3,600 shares	4	55	-	-	-	59
Stock option compensation expense	-	88	-	-	-	88
Balance at September 30, 2016	\$ 4,688	\$ 39,584	\$ 82,262	\$ (2,547)	\$ (7,108)	\$ 116,879

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

4

---

## Consolidated Statements of Cash Flows

	Nine Months Ended September 30	
	2016	2015
(Dollars in thousands) (unaudited)		
Cash flows from operating activities		
Net income	\$ 6,363	\$ 7,937
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,002	999
Net amortization of loans and investment securities	1,218	1,248
Amortization and net change in mortgage servicing rights valuation	41	20
Amortization of intangibles	-	181
Provision for loan losses	3,325	1,035
Gain on sales of securities	(4)	(8)
Impairment write-down on securities recognized in earnings	30	20
Gain on conversion of investment security	-	(728)
Loans originated for sale	(6,598)	(6,193)
Proceeds from sale of loans	6,692	6,206
Write-down of other real estate owned	46	250
Write-down on premises and equipment	-	60
Net loss (gain) on sale or disposal of other real estate/other repossessed assets	31	(32)
Increase in cash surrender value of life insurance	(399)	(416)
Gain from surrender of life insurance policy	-	(103)
Stock option compensation	88	-
Decrease in other assets	154	1,877
Decrease in other liabilities	(2,247)	(2,497)
Net cash provided by operating activities	9,742	9,856
Cash flows from investing activities		
Proceeds from sales and calls of investment securities available for sale	1,925	1,381
Proceeds from maturities and pay-downs of securities available for sale	18,984	21,607
Purchase of investment securities available for sale	(16,605)	(21,689)
Net increase in restricted stock	(336)	(417)
Net increase in loans	(79,275)	(47,110)
Capital expenditures	(515)	(765)
Proceeds from surrender of life insurance policy	436	-
Proceeds from sale of other real estate	625	129
Net cash used in investing activities	(74,761)	(46,864)
Cash flows from financing activities		
Net increase in demand deposits, interest-bearing checking, and savings accounts	68,454	45,360
Net decrease in time deposits	(8,414)	(9,094)
Net decrease in repurchase agreements	-	(9,079)
Net increase in short-term borrowings	8,530	3,500
Dividends paid	(2,618)	(2,330)
Common stock issued under stock option plans	71	92

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

Common stock issued under dividend reinvestment plan	1,124	869
Purchase of treasury stock	(700)	-
Net cash provided by financing activities	66,447	29,318
Increase (decrease) in cash and cash equivalents	1,428	(7,690)
Cash and cash equivalents as of January 1	39,166	48,593
Cash and cash equivalents as of September 30	\$ 40,594	\$ 40,903
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest on deposits and other borrowed funds	\$ 1,643	\$ 1,826
Income taxes	\$ 2,100	\$ 2,514
Noncash Activities		
Loans transferred to Other Real Estate	\$ 123	\$ 3,488

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

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

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

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of September 30, 2016, and for all other periods presented have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation's 2015 Annual Report on Form 10-K. The consolidated results of operations for the three and nine month periods ended September 30, 2016 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

The consolidated balance sheet at December 31, 2015 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements.

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

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

(Dollars and shares in thousands, except per share data)	For the Three Months Ended September 30		For the Nine Months Ended September 30	
	2016	2015	2016	2015
Weighted average shares outstanding (basic)	4,307	4,252	4,295	4,236
Impact of common stock equivalents	7	5	3	7
Weighted average shares outstanding (diluted)	4,314	4,257	4,298	4,243
Anti-dilutive options excluded from calculation	9	26	37	27
Net income	\$ 2,075	\$ 2,579	\$ 6,363	\$ 7,937
Basic earnings per share	\$ 0.48	\$ 0.61	\$ 1.48	\$ 1.87
Diluted earnings per share	\$ 0.48	\$ 0.61	\$ 1.48	\$ 1.87

## Note 2. Recent Accounting Pronouncements

Statements of Cash Flow (Topic 320). In August 2016, the FASB issued ASU 2016-15, "Classification of Certain Cash Receipts and Cash Payments (Topic 320)." ASU 2016-15 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 ASU 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. The amendments are effective fiscal years, and interim periods within those fiscal years, beginning after

December 15, 2017. The Corporation is currently evaluating the impact of the pending adoption of the amended standard on its consolidated financial statements.

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

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

Financial Instruments – Overall (Topic 825-10). In January 2016, the FASB issued ASU 2016-01, “Financial Instruments – Overall (Topic 825-10): “Recognition and Measurement of Financial Assets and Financial Liabilities.” ASU 2016-01 amends the guidance on the classification and measurement of financial instruments. Some of the amendments in ASU 2016-01 include the following: 1) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; 2) simplifies the impairment assessment of equity investments without



readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and 4) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others. For public business entities, the amendments of ASU 2016-01 are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Corporation does not believe ASU 2016-01 will have a material effect on its financial statements.

Leases (Topic 842). In February 2016, the FASB issued Accounting Standards Update (“ASU”) No. 2016-02, Leases. From the lessee’s perspective, the new standard established a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income

7

---

statement for a lessees. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as financing. If the lessor doesn't convey risks and rewards or control, an operating lease results.

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

### Note 3. Accumulated Other Comprehensive Loss

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

	September 30 2016	December 31, 2015
(Dollars in thousands)		
Net unrealized gains on securities	\$ 2,692	\$ 1,138
Tax effect	(915)	(387)
Net of tax amount	1,777	751
Accumulated pension adjustment	(6,552)	(6,777)
Tax effect	2,228	2,304
Net of tax amount	(4,324)	(4,473)
Total accumulated other comprehensive loss	\$ (2,547)	\$ (3,722)



## Note 4. Investments

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2016 and December 31, 2015 are as follows:

(Dollars in thousands)	Amortized	Gross	Gross	Fair
	cost	unrealized	unrealized	value
September 30, 2016		gains	losses	
Equity securities	\$ 164	\$ 86	\$ -	\$ 250
U.S. Government and Agency securities	12,728	292	(21)	12,999
Municipal securities	66,248	1,924	(92)	68,080
Trust preferred securities	5,973	-	(555)	5,418
Agency mortgage-backed securities	66,369	1,089	(79)	67,379
Private-label mortgage-backed securities	1,137	57	(7)	1,187
Asset-backed securities	34	-	(2)	32
	\$ 152,653	\$ 3,448	\$ (756)	\$ 155,345

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

At September 30, 2016 and December 31, 2015, the fair value of investment securities pledged to secure public funds, trust balances, deposit and other obligations totaled \$86.0 million and \$79.6 million, respectively.

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

(Dollars in thousands)	Amortized	
	cost	Fair value
Due in one year or less	\$ 2,073	\$ 2,094
Due after one year through five years	11,896	12,218
Due after five years through ten years	28,278	29,158
Due after ten years	42,736	43,059
	84,983	86,529
Mortgage-backed securities	67,506	68,566
	\$ 152,489	\$ 155,095

9

---

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

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
(Dollars in thousands)	2016	2015	2016	2015
Gross gains realized	\$ -	\$ -	\$ 4	\$ 8
Gross losses realized	-	-	-	-
Conversion gain	-	-	-	728
Net gains realized	\$ -	\$ -	\$ 4	\$ 736

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

#### Trust Preferred Securities

(Dollars in  
thousands)

Deal Name	Maturity	Single Issuer or Pooled	Class	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Lowest Credit Rating Assigned
BankAmerica Cap III	1/15/2027	Single	Preferred Stock	\$ 966	\$ 868	\$ (98)	BB+
Wachovia Cap Trust II	1/15/2027	Single	Preferred Stock	279	263	(16)	BBB
Huntington Cap Trust	2/1/2027	Single	Preferred Stock	945	842	(103)	BB
Corestates Captl Tr II	2/15/2027	Single	Preferred Stock	942	883	(59)	BBB+
Huntington Cap Trust II	6/15/2028	Single	Preferred Stock	899	815	(84)	BB
Chase Cap VI JPM	8/1/2028	Single	Preferred Stock	965	877	(88)	BBB-
Fleet Cap Tr V	12/18/2028	Single	Preferred Stock	977	870	(107)	BB+
				\$ 5,973	\$ 5,418	\$ (555)	

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

## Private Label Mortgage Backed Securities

(Dollars in thousands)	Origination	Amortized	Fair	Gross	Collateral	Lowest Credit	Credit	Cumulative
Description	Date	Cost	Value	Unrealized Gain (Loss)	Type	Rating Assigned	Support %	OTTI Charges
MALT 2004-6								
7A1	6/1/2004	\$ 317	\$ 310	\$ (7)	ALT A	CCC	15.01	\$ -
RALI 2005-QS2								
A1	2/1/2005	168	181	13	ALT A	CC	4.56	10
RALI 2006-QS4								
A2	4/1/2006	400	417	17	ALT A	D	-	323
GSR 2006-5F 2A1	5/1/2006	45	53	8	Prime	D	-	15
RALI 2006-QS8								
A1	7/28/2006	207	226	19	ALT A	D	-	237
		\$ 1,137	\$ 1,187	\$ 50				\$ 585

## Impairment:

The investment portfolio contained fifty securities with \$29.0 million of temporarily impaired fair value and \$756 thousand in unrealized losses at September 30, 2016. The total unrealized loss position has improved from a \$1.3 million unrealized loss at year-end 2015.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary

impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities and subject to assessment at September 30, 2016, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of September 30, 2016 and December 31, 2015:

(Dollars in thousands)	September 30, 2016								
	Less than 12 months			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	\$ -	\$ -	-	\$ 3,486	\$ (21)	10	\$ 3,486	\$ (21)	10
Municipal securities	2,657	(7)	5	2,275	(85)	3	4,932	(92)	8
Trust preferred securities	-	-	-	5,418	(555)	7	5,418	(555)	7
Agency mortgage-backed securities	8,900	(35)	12	5,998	(44)	11	14,898	(79)	23
Private-label mortgage-backed securities	310	(7)	1	-	-	-	310	(7)	1
Asset-backed securities	-	-	-	4	(2)	1	4	(2)	1
Total temporarily impaired securities	\$ 11,867	\$ (49)	18	\$ 17,181	\$ (707)	32	\$ 29,048	\$ (756)	50

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



securities									
Private-label mortgage-backed securities	-	-	-	246	(2)	1	246	(2)	1
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	\$ 25,262	\$ (251)	40	\$ 22,083	\$ (1,059)	39	\$ 47,345	\$ (1,310)	79

The unrealized loss in the municipal bond portfolio decreased to \$92 thousand from \$218 thousand at December 31, 2015 as market prices improved during the quarter. There are three securities in this portfolio with an unrealized loss and the loss in this portfolio is deemed to be non-credit related and no other-than-temporary impairment charges have been recorded.

The trust preferred portfolio contains seven securities with a fair value of \$5.4 million and an unrealized loss of \$555 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 September 30, 2016, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded.

There is one PLMBS bond showing a small unrealized loss of \$7 thousand. However, the PLMBS sector as a whole is showing a net unrealized gain of \$50 thousand at quarter end. This is primarily a result of the cumulative OTTI charges recorded on this portfolio. Due to the nature of these bonds, they are evaluated closely. These bonds were all rated AAA at time of purchase, but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. The Bank recorded a \$30 thousand impairment charge during the first nine months of 2016 and has recorded \$585 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 September 30:

(Dollars in thousands)	Nine Months Ended	
	2016	2015
Balance of cumulative credit-related OTTI at January 1	\$ 555	\$ 535
Additions for credit-related OTTI not previously recognized	30	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 September 30	\$ 585	\$ 555

The Bank held \$1.1 million of restricted stock at September 30, 2016. Except for \$30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of \$100 per share. The level of FHLB stock held is determined by FHLB and is comprised of a minimum membership amount plus a variable activity amount. FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. Management intends to remain a member of the FHLB and believes that it will be able to fully recover the cost basis of this investment.

#### Note 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)	September 30, 2016	December 31, 2015
Residential Real Estate 1-4 Family		
Consumer first liens	\$ 99,571	\$ 103,698
Commercial first lien	63,515	57,780
Total first liens	163,086	161,478
Consumer junior liens and lines of credit	46,688	44,996
Commercial junior liens and lines of credit	5,837	5,917
Total junior liens and lines of credit	52,525	50,913
Total residential real estate 1-4 family	215,611	212,391
Residential real estate - construction		
Consumer	1,589	545
Commercial	7,067	7,343
Total residential real estate construction	8,656	7,888
Commercial real estate	375,316	340,695
Commercial	254,274	215,942
Total commercial	629,590	556,637
Consumer	4,719	5,100
	858,576	782,016
Less: Allowance for loan losses	(10,685)	(10,086)
Net Loans	\$ 847,891	\$ 771,930
Included in the loan balances are the following:		
Net unamortized deferred loan costs	\$ 149	\$ 436
Loans pledged as collateral for borrowings and commitments from:		
FHLB	\$ 692,043	\$ 643,449
Federal Reserve Bank	41,806	45,111
	\$ 733,849	\$ 688,560

## Note 6. Loan Quality

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

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial			Unallocated	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Consumer		
ALL at June 30, 2016	\$ 1,023	\$ 319	\$ 205	\$ 5,940	\$ 1,596	\$ 97	\$ 1,138	\$ 10,318
Charge-offs	-	-	-	(776)	-	(42)	-	(818)
Recoveries	1	-	-	5	7	22	-	35
Provision	(3)	1	8	876	132	21	115	1,150
ALL at September 30, 2016	\$ 1,021	\$ 320	\$ 213	\$ 6,045	\$ 1,735	\$ 98	\$ 1,253	\$ 10,685
ALL at December 31, 2015	\$ 989	\$ 308	\$ 194	\$ 5,649	\$ 1,519	\$ 102	\$ 1,325	\$ 10,086
Charge-offs	(49)	-	-	(2,730)	(66)	(126)	-	(2,971)
Recoveries	34	-	-	18	129	64	-	245
Provision	47	12	19	3,108	153	58	(72)	3,325
ALL at September 30, 2016	\$ 1,021	\$ 320	\$ 213	\$ 6,045	\$ 1,735	\$ 98	\$ 1,253	\$ 10,685
ALL at June 30, 2015	\$ 1,014	\$ 281	\$ 207	\$ 5,179	\$ 1,442	\$ 110	\$ 1,217	\$ 9,450
Charge-offs	-	-	-	-	(47)	(75)	-	(122)
Recoveries	1	-	18	-	102	24	-	145
Provision	(16)	18	(27)	389	32	45	(41)	400
ALL at September 30, 2015	\$ 999	\$ 299	\$ 198	\$ 5,568	\$ 1,529	\$ 104	\$ 1,176	\$ 9,873
ALL at December 31, 2014	\$ 994	\$ 271	\$ 214	\$ 4,978	\$ 1,515	\$ 127	\$ 1,012	\$ 9,111
Charge-offs	(43)	(21)	-	-	(263)	(155)	-	(482)
Recoveries	4	-	18	14	116	57	-	209
Provision	44	49	(34)	576	161	75	164	1,035
ALL at September 30, 2015	\$ 999	\$ 299	\$ 198	\$ 5,568	\$ 1,529	\$ 104	\$ 1,176	\$ 9,873



Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

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 September 30, 2016 and December 31, 2015:

(Dollars in thousands)	Residential Real Estate 1-4 Family							Unallocated	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Commercial	Consumer		
September 30, 2016									
Loans evaluated for ALL:									
Individually	\$ 632	\$ 52	\$ 545	\$ 13,815	\$ -	\$ -	\$ -	\$ -	\$ 15,044
Collectively	162,454	52,473	8,111	361,501	254,274	4,719	-	-	843,532
Total	\$ 163,086	\$ 52,525	\$ 8,656	\$ 375,316	\$ 254,274	\$ 4,719	\$ -	\$ -	\$ 858,576
ALL established for loans evaluated:									
Individually	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Collectively	1,021	320	213	6,045	1,735	98	1,253	-	10,685
ALL at September 30, 2016	\$ 1,021	\$ 320	\$ 213	\$ 6,045	\$ 1,735	\$ 98	\$ 1,253	\$ -	\$ 10,685
December 31, 2015									
Loans evaluated for ALL:									
Individually	\$ 930	\$ 51	\$ 502	\$ 14,309	\$ 230	\$ -	\$ -	\$ -	\$ 16,022
Collectively	160,548	50,862	7,386	326,386	215,712	5,100	-	-	765,994
Total	\$ 161,478	\$ 50,913	\$ 7,888	\$ 340,695	\$ 215,942	\$ 5,100	\$ -	\$ -	\$ 782,016
ALL established for loans evaluated:									
Individually	\$ -	\$ -	\$ -	\$ -	\$ 9	\$ -	\$ -	\$ -	\$ 9
Collectively	989	308	194	5,649	1,510	102	1,325	-	10,077
ALL at December 31, 2015	\$ 989	\$ 308	\$ 194	\$ 5,649	\$ 1,519	\$ 102	\$ 1,325	\$ -	\$ 10,086





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

(Dollars in thousands)	Impaired Loans				
	With No Allowance		With Allowance		Related Allowance
	Recorded Investment	Unpaid Principal Balance	Recorded Investment	Unpaid Principal Balance	
September 30, 2016					
Residential Real Estate 1-4 Family					
First liens	\$ 1,189	\$ 1,263	\$ -	\$ -	\$ -
Junior liens and lines of credit	96	107	-	-	-
Total	1,285	1,370	-	-	-
Residential real estate - construction	545	597	-	-	-
Commercial real estate	13,815	14,372	-	-	-
Commercial	24	35	-	-	-
Total	\$ 15,669	\$ 16,374	\$ -	\$ -	\$ -

December 31, 2015					
Residential Real Estate 1-4 Family					
First liens	\$ 1,523	\$ 1,725	\$ -	\$ -	\$ -
Junior liens and lines of credit	105	133	-	-	-
Total	1,628	1,858	-	-	-
Residential real estate - construction	502	546	-	-	-
Commercial real estate	14,431	15,007	-	-	-
Commercial	267	330	9	10	9
Total	\$ 16,828	\$ 17,741	\$ 9	\$ 10	\$ 9

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

(Dollars in thousands)	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	\$ 1,196	\$ 10	\$ 1,262	\$ 30
Junior liens and lines of credit	96	-	90	-
Total	1,292	10	1,352	30
Residential real estate - construction	548	-	554	-
Commercial real estate	13,889	118	17,871	478
Commercial	25	-	34	-
Total	\$ 15,754	\$ 128	\$ 19,811	\$ 508

(Dollars in thousands)	Three Months Ended September 30, 2015		Nine Months Ended September 30, 2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	\$ 1,600	\$ 9	\$ 2,474	\$ 26
Junior liens and lines of credit	181	2	157	4
Total	1,781	11	2,631	30
Residential real estate - construction	510	-	651	-
Commercial real estate	14,836	126	21,774	452
Commercial	380	-	1,181	-
Total	\$ 17,507	\$ 137	\$ 26,237	\$ 482

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

(Dollars in thousands)	Loans Past Due and Still					Non-Accrual	Total Loans
	Current	Accruing 30-59 Days	60-89 Days	90 Days+	Total		
September 30, 2016							
Residential Real Estate 1-4 Family							
First liens	\$ 162,334	\$ 239	\$ 53	\$ 38	\$ 330	\$ 422	\$ 163,086
Junior liens and lines of credit	52,304	62	2	61	125	96	52,525
Total	214,638	301	55	99	455	518	215,611
Residential real estate - construction	8,111	-	-	-	-	545	8,656
Commercial real estate	369,833	200	559	568	1,327	4,156	375,316
Commercial	253,919	300	5	26	331	24	254,274
Consumer	4,699	10	10	-	20	-	4,719
Total	\$ 851,200	\$ 811	\$ 629	\$ 693	\$ 2,133	\$ 5,243	\$ 858,576
December 31, 2015							
Residential Real Estate 1-4 Family							
First liens	\$ 159,998	\$ 44	\$ 416	\$ 214	\$ 674	\$ 806	\$ 161,478
Junior liens and lines of credit	50,541	217	50	-	267	105	50,913
Total	210,539	261	466	214	941	911	212,391
Residential real estate - construction	7,209	177	-	-	177	502	7,888
Commercial real estate	330,953	5,713	196	152	6,061	3,681	340,695
Commercial	215,449	210	5	2	217	276	215,942
Consumer	5,041	55	4	-	59	-	5,100
Total	\$ 769,191	\$ 6,416	\$ 671	\$ 368	\$ 7,455	\$ 5,370	\$ 782,016

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

(Dollars in thousands)	Pass (1-5)	Special Mention (6)	Substandard (7)	Doubtful (8)	Total
September 30, 2016					
Residential Real Estate 1-4 Family					
First liens	\$ 159,758	\$ 1,942	\$ 1,386	\$ -	\$ 163,086
Junior liens and lines of credit	52,308	28	189	-	52,525
Total	212,066	1,970	1,575	-	215,611
Residential real estate - construction	7,833	-	823	-	8,656
Commercial real estate	360,788	359	14,169	-	375,316
Commercial	250,118	2,058	2,098	-	254,274
Consumer	4,719	-	-	-	4,719
Total	\$ 835,524	\$ 4,387	\$ 18,665	\$ -	\$ 858,576

## December 31, 2015

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

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

(Dollars in thousands)	Troubled Debt Restructurings			Troubled Debt Restructurings That Have Defaulted on Modified Terms in the Last Twelve Months		
	Number of Contracts	Recorded Investment	Performing*	Nonperforming*	Number of Contracts	Recorded Investment
September 30, 2016						
Residential real estate - construction	1	\$ 486	\$ 486	\$ -	-	\$ -
Residential real estate	5	879	728	151	-	-
Commercial real estate	11	12,211	10,930	1,281	1	1,281
Total	17	\$ 13,576	\$ 12,144	\$ 1,432	1	\$ 1,281
December 31, 2015						
Residential real estate - construction	1	\$ 502	\$ 502	\$ -	-	\$ -
Residential real estate	4	654	503	151	-	-
Commercial real estate	10	12,125	12,125	-	-	-
Total	15	\$ 13,281	\$ 13,130	\$ 151	-	\$ -

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

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

Nine Months Ended September 30, 2016	New During Period			Recorded Investment	Concession multiple maturity
	Number of Contracts	Pre-TDR Modification	After-TDR Modification		
Commercial real estate	1	\$ 525	\$ 525	\$ 515	
Residential real estate	1	238	238	238	
Total	2	\$ 763	\$ 763	\$ 753	

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

Note 7. OREO

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

(Dollars in thousands)	September 30	
	2016	2015
Balance at January 1	\$ 6,451	\$ 3,666
Additions	123	3,488
Proceeds from dispositions	(625)	(129)
(Loss) gain on sales, net	(31)	32
Valuation adjustment	(46)	(250)
Balance at September 30	\$ 5,872	\$ 6,807

## Note 8. Pension

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

(Dollars in thousands)	Three Months Ended September 30		Nine Months Ended September 30	
	2016	2015	2016	2015
Components of net periodic cost:				
Service cost	\$ 83	\$ 92	\$ 247	\$ 284
Interest cost	180	172	540	522
Expected return on plan assets	(290)	(296)	(873)	(888)
Settlement expense	225	-	225	-
Recognized net actuarial loss	120	123	351	377
Net period cost	\$ 318	\$ 91	\$ 490	\$ 295

The Bank expects its pension expense to increase to approximately \$922 thousand in 2016 compared to \$387 thousand in 2015. This increase is due to a pension settlement expense of approximately \$564 thousand that will be recorded during the second half of 2016, as a result of lump sum distributions. No pension contributions were made or are expected to be made in 2016.

## 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 September 30, 2016 and December 31, 2015.

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

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



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

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

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

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

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

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

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

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

(Dollars in thousands)	September 30, 2016		Level 1	Level 2	Level 3
	Carrying Amount	Fair Value			
Financial assets:					
Cash and cash equivalents	\$ 40,594	\$ 40,594	\$ 40,594	\$ -	\$ -
Investment securities available for sale	155,345	155,345	250	155,095	-
Restricted stock	1,118	1,118	-	1,118	-
Loans held for sale	367	367	-	367	-
Net loans	847,891	858,095	-	-	858,095
Accrued interest receivable	3,105	3,105	-	3,105	-
Financial liabilities:					
Deposits	\$ 978,552	\$ 978,487	\$ -	\$ 978,487	\$ -
Accrued interest payable	137	137	-	137	-
(Dollars in thousands)	December 31, 2015		Level 1	Level 2	Level 3
	Carrying Amount	Fair Value			
Financial assets:					
Cash and cash equivalents	\$ 39,166	\$ 39,166	\$ 39,166	\$ -	\$ -
Investment securities available for sale	159,473	159,473	233	159,240	-
Restricted stock	782	782	-	782	-
Loans held for sale	461	461	-	461	-
Net loans	771,930	779,742	-	-	779,742
Accrued interest receivable	3,164	3,164	-	3,164	-
Financial liabilities:					
Deposits	\$ 918,512	\$ 918,401	\$ -	\$ 918,401	\$ -
Accrued interest payable	124	124	-	124	-

## Recurring Fair Value Measurements

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

(Dollars in Thousands)	Fair Value at September 30, 2016			
	Level 1	Level 2	Level 3	Total
Asset Description				
Equity securities	\$ 250	\$ -	\$ -	\$ 250
U.S. Government and Agency securities	-	12,999	-	12,999
Municipal securities	-	68,080	-	68,080
Trust Preferred Securities	-	5,418	-	5,418
Agency mortgage-backed securities	-	67,379	-	67,379
Private-label mortgage-backed securities	-	1,187	-	1,187
Asset-backed securities	-	32	-	32
Total assets	\$ 250	\$ 155,095	\$ -	\$ 155,345

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

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

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



## Nonrecurring Fair Value Measurements

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

(Dollars in Thousands)

Asset Description	Fair Value at September 30, 2016			Total
	Level 1	Level 2	Level 3	
	Other real estate owned (1)	-	-	
Total assets	\$ -	\$ -	\$ 325	\$ 325

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

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

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

**Impaired loans:** Impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 3 inputs based on customized discounting criteria.

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

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

The Corporation did not record any liabilities at fair value for which measurement of the fair value was made on a nonrecurring basis at September 30, 2016. For financial assets and liabilities measured at fair value on a recurring basis, there were no transfers of financial assets or liabilities between Level 1 and Level 2 during the period ending September 30, 2016.

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

Quantitative Information about Level 3 Fair Value Measurements				
at September 30, 2016				
(Dollars in Thousands)				
Asset Description	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Other real estate owned (1)	325	Appraisal	Cost to sell	8% (8%)
at December 31, 2015				
Premises held-for-sale (1)	\$ 225	Appraisal	-	-
Other real estate owned (1)	6,128	Appraisal	Cost to sell	8% (8%)

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

## Note 10. Financial Derivatives

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

The Effect of Derivative Instruments on the Statement of Income for the Nine Months Ended September 30, 2016 and 2015 follows:

## Derivatives in ASC Topic 815 Cash Flow Hedging Relationships

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

There was no expense for the Swap in third quarter of 2015 or 2016, as the Swap matured in May, 2015.

## Interest Rate Swap Agreements (“Swap Agreements”)

As of September 30, 2016, the Bank had no swap agreements outstanding. The Bank had entered into interest rate swap agreements as part of its asset/liability management program. The swap agreements were free-standing derivatives and were recorded at fair value in the Corporation’s consolidated statements of condition. The Bank was party to master netting arrangements with its financial institution counterparties; however, the Bank did not offset assets and liabilities under these arrangements for financial statement presentation purposes. The master netting

arrangements provided for a single net settlement of all swap agreements, as well as collateral, in the event of default on, or termination of, any one contract. Collateral, in the form of marketable securities, was posted by the counterparty with net liability positions in accordance with contract thresholds.

#### Note 11. Capital Ratios

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as “Basel III.” The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered “well capitalized” under Basel III are: (1) Common Equity Tier 1(CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3) Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The CET1 ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.625%, increasing each year until fully implemented in 2019 at 2.5% above the minimum capital ratios required to avoid any capital distribution restrictions. The capital conservation buffer will be applicable to all of the capital ratios except for the Tier1 Leverage ratio. When fully implemented, the capital conservation buffer will have the effect of increasing the minimum capital ratios by 2.5%. As of September 30, 2016, the Bank was “well capitalized’ under the



Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

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 September 30, 2016 and December 31, 2015 (restated) for the Corporation and the Bank. The adequately capitalized minimum ratios, except for the Tier 1 Leverage Ratio, include the 0.625% Capital Conservation buffer effective for 2016.

(Dollars in thousands)	September 30, 2016	December 31, 2015	Regulatory Ratios	
			Adequately Capitalized Minimum	Well Capitalized Minimum
<b>Common Equity Tier 1 Risk-based Capital Ratio (1)</b>				
Franklin Financial Services Corporation	14.60%	14.77%	5.125%	N/A
Farmers & Merchants Trust Company	14.53%	14.76%	5.125%	6.50%
<b>Tier 1 Risk-based Capital Ratio (2)</b>				
Franklin Financial Services Corporation	14.60%	14.77%	6.625%	N/A
Farmers & Merchants Trust Company	14.53%	14.76%	6.625%	8.00%
<b>Total Risk-based Capital Ratio (3)</b>				
Franklin Financial Services Corporation	15.86%	16.03%	8.625%	N/A
Farmers & Merchants Trust Company	15.79%	16.02%	8.625%	10.00%
<b>Tier 1 Leverage Ratio (4)</b>				
Franklin Financial Services Corporation	10.07%	10.38%	4.000%	N/A
Farmers & Merchants Trust Company	10.03%	10.37%	4.000%	5.00%

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

31Note 12. 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.

27

---

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

For the Three and Nine Months Ended September 30, 2016 and 2015

Forward Looking Statements

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

Critical Accounting Policies

Management has identified critical accounting policies for the Corporation. These policies are particularly sensitive, requiring significant judgements, estimates and assumptions to be made by Management. There were no changes to the critical accounting policies disclosed in the 2015 Annual Report on Form 10-K in regards to application or related judgments and estimates used. Please refer to Item 7 of the Corporation's 2015 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Results of Operations

Year-to-Date Summary

At September 30, 2016, total assets were \$1.107 billion, an increase of \$71.8 million from December 31, 2015. Net loans increased to \$847.9 million and total deposits increased to \$978.6 million. The Corporation reported net income for the first nine months of 2016 of \$6.4 million. This is a 19.8% decrease versus net income of \$7.9 million for the same period in 2015. Net income for 2016 was negatively affected by a provision for loan loss expense that was \$2.3 million more than 2015, while 2015 was enhanced by two nonrecurring events that increased noninterest income by \$899 thousand. Despite the nonrecurring events in 2015, total revenue (interest income and noninterest income) for the first nine months of 2016 increased by \$471 thousand year-over-year. Interest income increased \$1.6 million, while interest expense decreased by \$158 thousand, resulting in a \$1.8 million increase in net interest income. The provision for loan losses was \$3.3 million for the first nine months of 2016, \$2.3 million more than in 2015, as a result of loan growth and one large loan charge-off. Noninterest income decreased \$1.1 million due to the nonrecurring

events in 2015, while noninterest expense increased \$493 thousand. Income tax expense decreased from \$1.8 million in 2015 to \$1.2 million in 2016. The effective tax rate decreased from 18.3% in 2015 to 15.8% in 2016. Diluted earnings per share decreased to \$1.48 in 2016 from \$1.87 in 2015.

28

---

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

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

	September 30 2016	December 31 2015	September 30 2015
(Dollars in thousands, except per share)			
<b>Balance Sheet Highlights</b>			
Total assets	\$ 1,107,120	\$ 1,035,295	\$ 1,036,323
Investment securities	155,345	159,473	169,516
Loans, net	847,891	771,930	760,802
Deposits	978,552	918,512	917,447
Shareholders' equity	116,879	111,376	110,113
<b>Summary of Operations</b>			
Interest income	\$ 27,434	\$ 34,615	\$ 25,823
Interest expense	1,656	2,371	1,814
Net interest income	25,778	32,244	24,009
Provision for loan losses	3,325	1,285	1,035
Net interest income after provision for loan losses	22,453	30,959	22,974
Noninterest income	8,613	12,652	9,753
Noninterest expense	23,505	31,136	23,012
Income before income taxes	7,561	12,475	9,715
Income tax	1,198	2,271	1,778
Net income	\$ 6,363	\$ 10,204	\$ 7,937
<b>Performance Measurements</b>			
Return on average assets*	0.79%	1.00%	1.04%
Return on average equity*	7.42%	9.52%	10.00%
Return on average tangible assets (1)*	0.79%	1.02%	1.06%
Return on average tangible equity (1)*	8.05%	10.52%	11.07%
Efficiency ratio (1)	65.21%	67.39%	66.59%
Net interest margin	3.61%	3.59%	3.59%
Current dividend yield*	3.46%	3.23%	3.32%
Dividend payout ratio	41.14%	30.76%	29.36%
<b>Shareholders' Value (per common share)</b>			
Diluted earnings per share	\$ 1.48	\$ 2.40	\$ 1.87
Basic earnings per share	1.48	2.40	1.87
Regular cash dividends paid	0.61	0.74	0.55
Book value	27.19	26.05	25.85
Tangible book value (1)	25.09	23.94	23.73
Market value	24.31	23.50	22.90
Market value/book value ratio	89.41%	90.21%	88.59%
Market value/tangible book value ratio	96.89%	98.16%	96.50%

Price/earnings multiple*	12.34	9.79	9.20
Safety and Soundness			
Risk-based capital ratio (Total)	15.86%	16.03%	15.69%
Leverage ratio (Tier 1)	10.07%	10.38%	10.33%
Common equity ratio (Tier 1)	14.60%	14.77%	14.44%
Nonperforming loans/gross loans	0.69%	0.73%	0.80%
Nonperforming assets/total assets	1.07%	1.18%	1.25%
Allowance for loan losses as a % of loans	1.24%	1.29%	1.28%
Net charge-offs/average loans*	0.44%	0.04%	0.05%
Trust assets under management (fair value)	\$ 617,289	\$ 586,664	\$ 569,484

\*Annualized

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

29

---

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

(Dollars in thousands, except per share)	Nine months ended		Nine months ended
	September 30, 2016	December 31, 2015	September 30, 2015
<b>Return on Average Tangible Assets (non-GAAP)</b>			
Net income	\$ 6,363	\$ 10,204	\$ 7,937
Plus intangible amortization (net of tax)	-	119	119
Net income (non-GAAP)	6,363	10,323	8,056
Average assets	1,079,250	1,021,275	1,017,853
Less average intangible assets	(9,016)	(9,066)	(9,116)
Average assets (non-GAAP)	1,070,234	1,012,209	1,008,737
Return on average tangible assets (non-GAAP)	0.79%	1.02%	1.06%
<b>Return on Tangible Equity (non-GAAP)</b>			
Net income	\$ 6,363	\$ 10,204	\$ 7,937
Plus intangible amortization (net of tax)	-	119	119
Net income (non-GAAP)	6,363	10,323	8,056
Average shareholders' equity	114,363	107,175	106,109
Less average intangible assets	(9,016)	(9,066)	(9,116)
Average shareholders' equity (non-GAAP)	105,347	98,109	96,993
Return on average tangible equity (non-GAAP)	8.05%	10.52%	11.07%
<b>Tangible Book Value (per share) (non-GAAP)</b>			
Shareholders' equity	\$ 116,879	\$ 111,376	\$ 110,113
Less intangible assets	(9,016)	(9,016)	(9,016)
Shareholders' equity (non-GAAP)	107,863	102,360	101,097
Shares outstanding (in thousands)	4,299	4,276	4,260
Tangible book value (non-GAAP)	25.09	23.94	23.73
<b>Efficiency Ratio</b>			
Noninterest expense	\$ 23,505	\$ 31,136	\$ 23,012
Net interest income plus noninterest income	34,391	44,896	33,762
	1,626	2,023	1,512

Plus tax equivalent adjustment to net interest income			
Less net securities gains (losses), and OTTI	(26)	716	716
Net interest income plus noninterest income	36,043	46,203	34,558
Efficiency ratio	65.21%	67.39%	66.59%

30

---



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

#### Net Interest Income

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

Tax equivalent net interest income increased \$699 thousand to \$9.4 million in the third quarter of 2016 compared to \$8.7 million in the same period in 2015. Balance sheet volume contributed \$853 thousand to this increase, but was reduced by \$154 thousand due to lower rates.

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

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%.

(Dollars in thousands)	For the Three Months Ended September 30, 2016			2015		
	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
<b>Interest-earning assets:</b>						
Interest-bearing obligations of other banks and federal funds sold	\$ 32,055	\$ 79	0.98%	\$ 37,098	\$ 66	0.71%
<b>Investment securities:</b>						
Taxable	107,998	571	2.10%	118,218	587	1.97%
Tax Exempt	52,444	533	4.07%	55,388	603	4.36%
Investments	160,442	1,104	2.74%	173,606	1,190	2.72%
<b>Loans:</b>						
Commercial, industrial and agricultural	691,245	7,135	4.04%	599,337	6,316	4.13%
Residential mortgage	76,776	763	3.98%	81,182	819	4.02%
Home equity loans and lines	71,990	777	4.29%	66,023	731	4.39%
Consumer	4,785	64	5.32%	5,759	93	6.41%
Loans	844,796	8,739	4.06%	752,301	7,959	4.16%
Total interest-earning assets	1,037,293	\$ 9,922	3.81%	963,005	\$ 9,215	3.80%
Other assets	67,808			67,315		
Total assets	\$ 1,105,101			\$ 1,030,320		
<b>Interest-bearing liabilities:</b>						
<b>Deposits:</b>						
Interest-bearing checking	\$ 259,986	\$ 87	0.13%	\$ 226,846	69	0.12%
Money Management	394,866	341	0.34%	382,202	327	0.34%
Savings	73,814	14	0.08%	67,664	12	0.07%
Time	79,084	117	0.59%	91,060	146	0.64%
Total interest-bearing deposits	807,750	559	0.28%	767,772	554	0.29%
Other borrowings	3,190	4	0.54%	1,452	1	0.35%
Total interest-bearing liabilities	810,940	563	0.28%	769,224	555	0.29%
Noninterest-bearing deposits	174,131			147,325		
Other liabilities	3,860			5,819		
Shareholders' equity	116,170			107,952		
Total liabilities and shareholders' equity	\$ 1,105,101			\$ 1,030,320		
T/E net interest income/Net interest margin		9,359	3.59%		8,660	3.57%
Tax equivalent adjustment		(574)			(495)	

Net interest income	\$ 8,785	\$ 8,165
---------------------	----------	----------

32

---

## Provision for Loan Losses

Provision expense for the third quarter was \$1.1 million, compared to \$400 thousand in 2015. The increase in the provision expense was due to a higher level of charge-offs and growth in the loan portfolio. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

## Noninterest Income

For the third quarter of 2016, noninterest income decreased \$180 thousand from the same period in 2015. Investment and trust service fees increased due to an increase in recurring fee income in 2016. Loan service charges decreased due to higher volume of prepayment penalties during the third quarter of 2015. The change in debit card income was due to increased usage by customers in the third quarter of 2016, compared to the same period in 2015. The loss on the sale of other real estate owned was from the sale of three properties in 2016 compared to none in 2015. The Corporation recorded an other than temporary impairment (OTTI) charge in 2016 a none in 2015. Other income was higher in 2015, due to a \$103 thousand gain from the proceeds of a bank owned life insurance policy.

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

(Dollars in thousands)	For the Three Months Ended		Change	
	September 30 2016	2015	Amount	%
Noninterest Income				
Investment and trust services fees	\$ 1,211	\$ 1,154	\$ 57	4.9
Loan service charges	102	288	(186)	(64.6)
Deposit service charges and fees	635	623	12	1.9
Other service charges and fees	325	309	16	5.2
Debit card income	373	346	27	7.8
Increase in cash surrender value of life insurance	131	137	(6)	(4.4)
Net (loss) gain on sale of other real estate owned	(20)	-	(20)	N/A
OTTI losses on debt securities	(10)	-	(10)	N/A
Other	56	126	(70)	(55.6)
Total noninterest income	\$ 2,803	\$ 2,983	\$ (180)	(6.0)

## Noninterest Expense

Noninterest expense for the third quarter of 2016 increased \$117 thousand compared to the same period in 2015. The increase in salaries and benefits was primarily due to a \$147 thousand increase in salary expense due to merit increases and increased staffing levels and a \$227 thousand increase in pension expense due to pension settlement expenses compared to the same period in 2015. Legal and professional fees increased due to fees associated with a lawsuit brought against the Corporation in 2015. This lawsuit was more thoroughly described on a Form 8-K that was filed on July 29, 2016. It is expected that the Corporation will incur additional legal expenses until this lawsuit is resolved. Foreclosed real estate expense decreased due to \$250 thousand write down on other real estate owned (OREO) property in 2015.

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

(Dollars in thousands)	For the Three Months Ended		Change	
	September 30 2016	2015	Amount	%
Noninterest Expense	\$ 4,566	\$ 4,214	\$ 352	8.4
Salaries and benefits	556	535	21	3.9
Net occupancy expense	221	232	(11)	(4.7)
Furniture and equipment expense	296	336	(40)	(11.9)
Advertising	423	311	112	36.0
Legal and professional fees	539	524	15	2.9
Pennsylvania bank shares tax	203	206	(3)	(1.5)
FDIC insurance	188	170	18	10.6
ATM/debit card processing	214	193	21	10.9
Foreclosed real estate	18	322	(304)	(94.4)
Telecommunications	91	145	(54)	(37.2)
Other	665	675	(10)	(1.5)
Total noninterest expense	\$ 7,980	\$ 7,863	\$ 117	1.5

## Provision for Income Taxes

For the third quarter of 2016, the Corporation recorded a Federal income tax expense of \$383 thousand compared to \$306 thousand for the same quarter in 2015. The effective tax rate was 15.6% for the third quarter of 2016 compared to 10.6% for the same period in 2015. The increase was due to a reduction in pretax income in 2016 from increased provision expense. In addition, the 2015 rate was lower than normal due to the reversal of \$250 thousand of the valuation allowance on the deferred tax asset due to the large security gain on the conversion of Integrity Bancshares. Without this reversal, the effective tax rate would have been 19.3% in 2015. The variances from the federal statutory rate are generally due to tax-exempt income from investments, loans and bank-owned life insurance. All taxable income for the Corporation is taxed at a rate of 34%.

Comparison of the nine months ended September 30, 2016 to the nine months ended September 30, 2015:

Net Interest Income

Tax equivalent net interest income increased \$1.9 million to \$27.4 million in 2016 compared to \$25.5 million in 2015. Balance sheet volume contributed \$2.3 million to this increase, but this was reduced by \$369 thousand due to lower rates. See the Financial Condition discussion for changes in the composition of the balance sheet.

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%.

34

---

For the Nine Months Ended September 30,  
2016

2015

(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
Interest-earning assets:						
Interest-bearing obligations of other banks and federal funds sold	\$ 34,639	\$ 220	0.85%	\$ 40,730	\$ 192	0.63%
Investment securities:						
Taxable	107,310	1,741	2.17%	120,054	1,895	2.11%
Tax Exempt	51,864	1,618	4.16%	55,186	1,828	4.42%
Investments	159,174	3,359	2.82%	175,240	3,723	2.84%
Loans:						
Commercial, industrial and agricultural	665,302	20,683	4.09%	583,151	18,463	4.18%
Residential mortgage	77,467	2,318	3.99%	80,996	2,479	4.07%
Home equity loans and lines	71,443	2,288	4.28%	64,534	2,185	4.53%
Consumer Loans	4,861	192	5.28%	6,237	293	6.28%
	819,073	25,481	4.10%	734,918	23,420	4.22%
Total interest-earning assets	1,012,886	\$ 29,060	3.83%	950,888	\$ 27,335	3.84%
Other assets	66,364			66,965		
Total assets	\$ 1,079,250			\$ 1,017,853		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing checking	\$ 250,390	\$ 239	0.13%	\$ 219,863	189	0.11%
Money Management	392,050	1,007	0.34%	383,011	1,128	0.39%
Savings	72,368	41	0.08%	65,558	36	0.07%
Time	81,960	363	0.59%	93,791	460	0.66%
Total interest-bearing deposits	796,768	1,650	0.28%	762,223	1,813	0.32%
Securities sold under agreements to repurchase	-	-	-	33	-	0.15%
Other borrowings	1,597	6	0.56%	497	1	0.35%
Total interest-bearing liabilities	798,365	1,656	0.28%	762,753	1,814	0.32%

Noninterest-bearing deposits	161,727		142,070	
Other liabilities	4,795		6,921	
Shareholders' equity	114,363		106,109	
Total liabilities and shareholders' equity	\$ 1,079,250		\$ 1,017,853	
T/E net interest income/Net interest margin	27,404	3.61%	25,521	3.59%
Tax equivalent adjustment	(1,626)		(1,512)	
Net interest income	\$ 25,778		\$ 24,009	

### Provision for Loan Losses

Provision expense for the first nine months of 2016 was \$3.3 million, compared to \$1.0 million in 2015. The increase in the provision expense was due to a higher level of charge-offs and growth in the loan portfolio compared. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

### Noninterest Income

For the first nine months of 2016, noninterest income decreased \$1.1 million from the same period in 2015. Investment and trust service fees decreased due to a decline in estate fees and insurance commissions from 2015 to 2016. Loan service charges decreased due to less loan prepayment fees in 2016, compared to 2015. Deposit service charges increased due to increased enrollment and use of the Bank's overdraft program. The change in debit card income was due to increased usage by customers in 2016. During 2016, five properties held as other real estate owned were sold with a total net loss, compared to one property sold at a gain in 2015. The Corporation recorded a nonrecurring gain on the conversion of an investment security in 2015. Other income in 2015 included a \$171 thousand gain from an investment the Corporation owned in an offshore insurance company that liquidated and paid out the investors.



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

(Dollars in thousands)	For the Nine Months Ended		Change	
	September 30 2016	2015	Amount	%
<b>Noninterest Income</b>				
Investment and trust services fees	\$ 3,683	\$ 3,805	\$ (122)	(3.2)
Loan service charges	518	784	(266)	(33.9)
Deposit service charges and fees	1,815	1,700	115	6.8
Other service charges and fees	941	916	25	2.7
Debit card income	1,095	1,021	74	7.2
Increase in cash surrender value of life insurance	399	416	(17)	(4.1)
Net (loss) gain on sale of other real estate owned	(31)	32	(63)	(196.9)
OTTI losses on debt securities	(30)	(20)	(10)	50.0
Gain on conversion of investment security	-	728	(728)	(100.0)
Securities gains, net	4	8	(4)	(50.0)
Other	219	363	(144)	(39.7)
<b>Total noninterest income</b>	<b>\$ 8,613</b>	<b>\$ 9,753</b>	<b>\$ (1,140)</b>	<b>(11.7)</b>

#### Noninterest Expense

Noninterest expense for the first nine months of 2016 increased \$493 thousand compared to the same period in 2015. The increase in salaries and benefits was primarily due to a \$436 thousand increase in salary expense due to merit increases and increased staffing levels, a \$194 thousand increase in pension expense due to pension settlement expenses and \$88 thousand for stock option compensation. Legal and professional fees increased due to fees associated with a lawsuit brought against the Corporation in 2015. This lawsuit was more thoroughly described on a Form 8-K that was filed on July 29, 2016. It is expected that the Corporation will incur additional legal expenses until this lawsuit is resolved. The shares tax increase was due to growth in the Bank's balance sheet and shareholders' equity that resulted in a higher premium. Intangible amortization expense decreased as the core deposit intangible was fully amortized as of June 2015. ATM/Debit card processing increased due to the purchase of EMV debit card inventory. Foreclosed real estate expense decreased in 2016, due to a \$250 thousand write-down on one property in 2015. Other expense decreased due to a one-time expense taken in 2015 to fund a deferred director's compensation plan and several one-time expenses the Bank took in 2015 related to branch assets taken out of service.

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

(Dollars in thousands)	For the Nine Months Ended		Change	
	September 30 2016	2015	Amount	%
Noninterest Expense				
Salaries and benefits	\$ 13,282	\$ 12,500	\$ 782	6.3
Net occupancy expense	1,708	1,706	2	0.1
Furniture and equipment expense	655	702	(47)	(6.7)
Advertising	839	807	32	4.0
Legal and professional fees	1,114	811	303	37.4
Data processing	1,540	1,547	(7)	(0.5)
Pennsylvania bank shares tax	699	608	91	15.0
Intangible amortization	-	181	(181)	(100.0)
FDIC insurance	514	479	35	7.3
ATM/debit card processing	642	566	76	13.4
Foreclosed real estate	93	341	(248)	(72.7)
Telecommunications	300	379	(79)	(20.8)
Other	2,119	2,385	(266)	(11.2)
Total noninterest expense	\$ 23,505	\$ 23,012	\$ 493	2.1

## Provision for Income Taxes

For the first nine months of 2016, the Corporation recorded a Federal income tax expense of \$1.2 million compared to \$1.8 million for the same period in 2015. The effective tax rate was 15.8% for the first nine months of 2016 compared to 18.3% for the same period in 2015. The decrease in 2016 was due to a reduction in pretax income from increased provision expense. In addition, the 2015 rate was lower than normal due to the reversal of \$250 thousand of the valuation allowance on the deferred tax asset, due to the large security gain on the conversion of Integrity Bancshares, established in prior years on other than temporary impairment charges in the equity portfolio. Without this reversal, the effective tax rate would have been 20.9% in 2015. The variances from the federal statutory rate are generally due to tax-exempt income from investments, loans and bank-owned life insurance. All taxable income for the Corporation is taxed at a rate of 34%.

## Financial Condition

### Summary:

At September 30, 2016, assets totaled \$1.107 billion, an increase of \$71.8 million from the 2015 year-end balance of \$1.035 billion. Investment securities decreased \$4.1 million, while net loans increased \$76.0 million (9.8%) due to growth in the commercial loan portfolio. Deposits increased \$60.0 million (6.5%) during the first nine months of 2016 due to increases in every deposit category except time deposits. Shareholders' equity increased \$5.5 million during the first nine months as retained earnings increased \$3.7 million, accumulated other comprehensive loss decreased \$1.2 million and the Corporation's Dividend Reinvestment Plan (DRIP) added an additional \$1.1 million in new capital.

### Cash and Cash Equivalents:

Cash and cash equivalents totaled \$40.6 million at September 30, 2016, an increase of \$1.4 million from the prior year-end balance of \$39.2 million. Interest-bearing deposits are held primarily at the Federal Reserve (\$1.1 million) and in short-term bank owned certificates of deposit (\$22.6 million).

### Investment Securities:

The investment portfolio has decreased \$5.7 million on a cost basis, since year-end 2015. The composition of the portfolio has remained consistent with municipal securities and U.S. Agency mortgage-backed securities comprising the greatest portion of the portfolio at approximately 44% and 43% of the portfolio fair value, respectively. The Bank invested \$16.6 million during the first nine months of 2016 with the purchases spread between, U.S. Agency mortgage-backed securities and municipal securities. The average life of the portfolio was 3.74 years.

The investment portfolio had a net unrealized gain of \$2.7 million at September 30, 2016 compared to \$1.1 million at the prior year-end. The increase in the unrealized gain is due primarily to the decline in intermediate and long term interest rates. The portfolio averaged \$159.2 million with a yield of 2.82% for the first nine months of 2016. This compares to an average of \$175.2 million and a yield of 2.84% for the same period in 2015.

The Bank holds only one equity security, a Pennsylvania community bank. The municipal bond portfolio is well diversified geographically (issuers from within 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 16 issuers in the state of Pennsylvania with a fair value

of \$9.0 million and 14 issuers in the state of Texas with a fair value of \$8.7 million. The average rating of the municipal portfolio from Moody's is Aa2. It contains \$68.1 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.

37

---

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2016 and December 31, 2015 is as follows:

(Dollars in thousands)	Amortized	Gross	Gross	Fair
	cost	unrealized	unrealized	value
September 30, 2016		gains	losses	
Equity securities	\$ 164	\$ 86	\$ -	\$ 250
U.S. Government and Agency securities	12,728	292	(21)	12,999
Municipal securities	66,248	1,924	(92)	68,080
Trust preferred securities	5,973	-	(555)	5,418
Agency mortgage-backed securities	66,369	1,089	(79)	67,379
Private-label mortgage-backed securities	1,137	57	(7)	1,187
Asset-backed securities	34	-	(2)	32
	\$ 152,653	\$ 3,448	\$ (756)	\$ 155,345

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

The investment portfolio contained fifty securities with \$29.0 million of temporarily impaired fair value and \$756 thousand in unrealized losses at September 30, 2016. The total unrealized loss position has improved from a \$1.3 million unrealized loss at year-end 2015.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities and subject to assessment at September 30, 2016, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.



Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of September 30, 2016 and December 31, 2015:

(Dollars in thousands)	September 30, 2016								
	Less than 12 months			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	\$ -	\$ -	-	\$ 3,486	\$ (21)	10	\$ 3,486	\$ (21)	10
Municipal securities	2,657	(7)	5	2,275	(85)	3	4,932	(92)	8
Trust preferred securities	-	-	-	5,418	(555)	7	5,418	(555)	7
Agency mortgage-backed securities	8,900	(35)	12	5,998	(44)	11	14,898	(79)	23
Private-label mortgage-backed securities	310	(7)	1	-	-	-	310	(7)	1
Asset-backed securities	-	-	-	4	(2)	1	4	(2)	1
Total temporarily impaired securities	\$ 11,867	\$ (49)	18	\$ 17,181	\$ (707)	32	\$ 29,048	\$ (756)	50

(Dollars in thousands)	December 31, 2015								
	Less than 12 months			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	\$ 479	\$ (1)	3	\$ 4,364	\$ (32)	10	\$ 4,843	\$ (33)	13
Municipal securities	5,806	(35)	8	4,785	(183)	7	10,591	(218)	15
Trust preferred securities	-	-	-	5,289	(669)	7	5,289	(669)	7
Agency mortgage-backed securities	18,977	(215)	29	7,394	(171)	13	26,371	(386)	42
Private-label mortgage-backed securities	-	-	-	246	(2)	1	246	(2)	1
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
	\$ 25,262	\$ (251)	40	\$ 22,083	\$ (1,059)	39	\$ 47,345	\$ (1,310)	79

Total temporarily  
impaired securities

The unrealized loss in the municipal bond portfolio decreased to \$92 thousand from \$218 thousand at December 31, 2015 as market prices improved during the quarter. There are three securities in this portfolio with an unrealized loss and the loss in this portfolio is deemed to be non-credit related and no other-than-temporary impairment charges have been recorded.

The trust preferred portfolio contains seven securities with a fair value of \$5.4 million and an unrealized loss of \$555 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 September 30, 2016, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded.

There is one PLMBS bond showing a small unrealized loss of \$7 thousand. However, the PLMBS sector as a whole is showing an unrealized gain of \$50 thousand at quarter end. This is primarily a result of the cumulative OTTI charges recorded on this portfolio. Due to the nature of these bonds, they are evaluated closely. These bonds were all rated AAA at time of purchase, but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. The Bank recorded a \$30 thousand impairment charge during the first nine months of 2016 and has recorded \$585 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 \$1.1 million of restricted stock at September 30, 2016. Except for \$30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of \$100 per share. The level of FHLB stock held is determined by FHLB and is comprised of a minimum membership amount plus a variable activity amount. FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. Management intends to remain a member of the FHLB and believes that it will be able to fully recover the cost basis of this investment.

#### 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 increased \$3.2 million over 2015, primarily in the commercial first lien and consumer junior liens and lines of credit categories due to a home equity special promotion in 2015 and 2016. For the first nine months of 2016, the Bank originated \$10.2 million in mortgages, including approximately \$6.6 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 (\$7.1 million), while loans for individuals to construct personal residences totaled \$1.6 million at September 30, 2016. 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 September 30, 2016, the Bank had \$7.3 million in residential real estate construction loans funded with an interest reserve and capitalized \$93 thousand of interest from these reserves on active projects. Real estate construction loans are monitored on a regular basis by either an independent third party inspector or the assigned loan officer depending on loan amount or complexity of the project. This monitoring process includes at a minimum, the submission of invoices and AIA documents of 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 increased to \$375.3 million from \$340.7 million at the end of 2015, an increase of \$34.6 million. The increases were primarily in commercial construction and multi-family units. The largest sectors (by collateral) in the commercial real estate category are: office buildings (\$57.7 million), hotels and motels (\$45.7 million), land development (\$42.9 million), apartment units (\$37.3 million), and auto dealerships (\$32.8 million).

Commercial (C&I): This category includes commercial, industrial, farm, agricultural, and municipal loans. C&I loans increased \$38.3 million to \$254.3 million at September 30, 2016, compared to \$215.9 million at the end of 2015, primarily in the municipal loan portfolio. The largest sectors (by industry) in the commercial loan category are: retail trade (\$25.3 million), manufacturing (\$15.8 million) and health care (\$15.6 million). At September 30, 2016, the Bank had \$137.8 million in municipal loans. The Bank is very active in its market in pursuing commercial lending opportunities, but has historically supplemented in-market growth with purchased loan participations, when appropriate. The Bank purchases commercial loan participations in an effort to increase its commercial lending and diversify its loan mix, both geographically and by industry sector. Purchased loans are originated primarily within the south central Pennsylvania market and are purchased from only a few select counter parties. For the first nine months of 2016, the Bank purchased \$12.2 million of loan participations and commitments. At September 30, 2016, the Bank held \$132.0 million in purchased loan participations in its portfolio.

Consumer loans decreased \$381 thousand due primarily to regular payments and maturities. The majority of the Bank's consumer loans, approximately \$3.0 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)	September 30, 2016	December 31, 2015	Change	
			Amount	%
Residential Real Estate 1-4 Family				
Consumer first liens	\$ 99,571	\$ 103,698	\$ (4,127)	(4.0)
Commercial first lien	63,515	57,780	5,735	9.9
Total first liens	163,086	161,478	1,608	1.0
Consumer junior liens and lines of credit	46,688	44,996	1,692	3.8
Commercial junior liens and lines of credit	5,837	5,917	(80)	(1.4)
Total junior liens and lines of credit	52,525	50,913	1,612	3.2
Total residential real estate 1-4 family	215,611	212,391	3,220	1.5
Residential real estate - construction				
Consumer	1,589	545	1,044	191.6
Commercial	7,067	7,343	(276)	(3.8)
Total residential real estate construction	8,656	7,888	768	9.7
Commercial real estate	375,316	340,695	34,621	10.2
Commercial	254,274	215,942	38,332	17.8
Total commercial	629,590	556,637	72,953	13.1
Consumer	4,719	5,100	(381)	(7.5)
	858,576	782,016	76,560	9.8
Less: Allowance for loan losses	(10,685)	(10,086)	(599)	5.9
Net Loans	\$ 847,891	\$ 771,930	\$ 75,961	9.8

#### 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. 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. 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 measurements: (1) loans rated 6 or worse (collectively “watch list”), (2) delinquent loans, (3) other real estate owned (OREO), and (4) net-charge-offs. Management compares trends in these measurements with the Bank’s internally established targets, as well as its national peer group.

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 \$23.1 million at quarter end and includes both performing and nonperforming loans. It is comprised of \$4.4 million rated 6 and \$18.7 million

rated 7. The Bank has no loans rated 8-doubtful or 9-loss. The watch list totaled \$27.3 million at June 30, 2016 and \$27.9 million at the prior year-end. The decrease in the watch list from year-end, and the prior quarter is due primarily to a \$5.6 million credit (year-end balance) that was partially charged-off in 2016 and sold during the third quarter of 2016 (see the Allowance for Loan Losses discussion). The credit composition of the portfolio, by primary collateral is shown in Note 7 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 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 September 30, 2016, the Bank had loans of \$18.5 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 note that presents the aging of payments in the loan portfolio.

Nonaccruing loans generally represent Management's determination that the borrower will be unable to repay the loan in accordance with its contractual terms and that collateral liquidation 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 declined from year-end. The following table presents a summary of nonperforming assets:

(Dollars in thousands)	September 30, 2016	December 31, 2015
Nonaccrual loans		
Residential Real Estate 1-4 Family		
First liens	\$ 422	\$ 806
Junior liens and lines of credit	96	105
Total	518	911
Residential real estate - construction	545	502
Commercial real estate	4,156	3,681
Commercial	24	276
Total nonaccrual loans	5,243	5,370
Loans past due 90 days or more and not included above		
Residential Real Estate 1-4 Family		
First liens	38	214
Junior liens and lines of credit	61	-
Total	99	214
Residential real estate - construction	-	-
Commercial real estate	568	152
Commercial	26	-
Consumer	-	2
Total loans past due 90 days or more and still accruing	693	368
Total nonperforming loans	5,936	5,738
Other real estate owned	5,872	6,451
Total nonperforming assets	\$ 11,808	\$ 12,189
Nonperforming loans to total gross loans	0.69%	0.73%
Nonperforming assets to total assets	1.07%	1.18%
Allowance for loan losses to nonperforming loans	180.00%	175.78%

The following table identifies the most significant loans in nonaccrual status. These three nonaccrual loans account for 80% 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 September 30, 2016 totaled \$17.1 million compared to \$22.1 million at year-end 2015.

(Dollars in thousands)	ALL		Nonaccrual	TDR	Collateral	Location	Last
	Balance	Reserve	Date	Status			Appraisal(1)
Credit 1 - Residential real estate	1,755	-	Mar-12	Y	1st and 2nd liens on commercial real estate, residential real estate and business assets	PA	Jan-16 \$ 3,810
Credit 2 - Commercial real estate	1,138	-	Dec-14	N	Hotel and entertainment complex	PA	Apr-16 \$ 4,200
Credit 3 - Agricultural	1,281	-	Sep-16	Y	1st lien on farmland	PA	Jul-14 \$ 2,391
	\$ 4,174	\$ -					

(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 is a hotel and entertainment complex being operated as part of an estate liquidation and is currently listed for sale. Credit 3 is a new nonaccrual loan as a result of a TDR default.

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 and TDR loans are always considered impaired. 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. In accordance with financial accounting standards, TDR loans are always considered impaired until they are paid off. However, an impaired TDR loan can be a performing loan. Impaired loans totaled \$15.7 million at quarter-end compared to \$16.8 million at year-end 2015.

A loan is considered a troubled debt restructuring (TDR) if the creditor (the Bank), for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. These concessions may include lowering the rate, extending the maturity, reamortization of the payment, or a combination of multiple concessions. The Bank reviews all loans rated 6 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. All TDR loans are in compliance with their modified terms. See Note 6 in the accompanying financial statements for information on TDR loans in the portfolio.





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

(Dollars in thousands)	September 30, 2016			
	Nonaccrual		Accruing	Total
	Non-TDR	TDR	TDR	Impaired
Residential Real Estate 1-4 Family				
First liens	\$ 271	\$ 151	\$ 728	\$ 1,150
Junior liens and lines of credit	96	-	-	96
Total	367	151	728	1,246
Residential real estate - construction	59	486	-	545
Commercial real estate	1,604	2,551	9,660	13,815
Commercial	24	-	-	24
Total	\$ 2,054	\$ 3,188	\$ 10,388	\$ 15,630

#### 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 (OAEM) 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 September 30, 2016 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. At September 30, 2016, impaired loans totaled \$15.7 million compared to \$16.8 million at year-end 2015. The Bank does not have a specific reserve established for any of its impaired loans. At year-end 2015, the Bank had one impaired loan with a specific reserve of \$9 thousand that paid-off during the first quarter of 2016. 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. Prior to 2015, the Bank was using an eight quarter rolling history for the quantitative analysis. The change to a longer historical period is based upon improving charge-offs and a more stable and slowly improving economy. As credit quality improved the Bank began to see lower charge-offs. The Bank believes that

45

---

an eight quarter historical period presented the loss history during a very favorable period and it may not accurately reflect historical trends. It believes that a twenty quarter period covers a longer economic cycle and more accurately reflects its loss history and therefore is a more appropriate factor for calculating the general reserve in the current environment. The historical loss experience factor for the general allocation was 1.02% of gross loans (\$8.8 million) at September 30, 2016 compared to 1.07% and \$8.4 million at the prior year-end. Included in the general loan loss reserve is an unallocated reserve of \$1.3 million, unchanged from December 31, 2015.

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 quarter-end, this factor was 22.5 basis points compared to 21.5 at year-end 2015. These factors are determined on the basis of Management's observation, judgment and experience.

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 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.

Edgar Filing: FRANKLIN FINANCIAL SERVICES CORP /PA/ - Form 10-Q

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 September 30, 2016 and December 31, 2015:

(Dollars in thousands)	Residential Real Estate 1-4 Family							Unallocated	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Commercial	Consumer		
September 30, 2016									
Loans evaluated for ALL:									
Individually	\$ 632	\$ 52	\$ 545	\$ 13,815	\$ -	\$ -	\$ -	\$ -	\$ 15,044
Collectively	162,454	52,473	8,111	361,501	254,274	4,719	-	-	843,532
Total	\$ 163,086	\$ 52,525	\$ 8,656	\$ 375,316	\$ 254,274	\$ 4,719	\$ -	\$ -	\$ 858,576
ALL established for loans evaluated:									
Individually	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Collectively	1,021	320	213	6,045	1,735	98	1,253	-	10,685
ALL at September 30, 2016	\$ 1,021	\$ 320	\$ 213	\$ 6,045	\$ 1,735	\$ 98	\$ 1,253	\$ -	\$ 10,685
December 31, 2015									
Loans evaluated for ALL:									
Individually	\$ 930	\$ 51	\$ 502	\$ 14,309	\$ 230	\$ -	\$ -	\$ -	\$ 16,022
Collectively	160,548	50,862	7,386	326,386	215,712	5,100	-	-	765,994
Total	\$ 161,478	\$ 50,913	\$ 7,888	\$ 340,695	\$ 215,942	\$ 5,100	\$ -	\$ -	\$ 782,016
ALL established for loans evaluated:									
Individually	\$ -	\$ -	\$ -	\$ -	\$ 9	\$ -	\$ -	\$ -	\$ 9
Collectively	989	308	194	5,649	1,510	102	1,325	-	10,077
ALL at December 31, 2015	\$ 989	\$ 308	\$ 194	\$ 5,649	\$ 1,519	\$ 102	\$ 1,325	\$ -	\$ 10,086

During the first nine months of 2016, the Bank recorded \$3.3 million for the loan loss provision expense compared to \$1.0 thousand during the prior year. Charged-off loans usually result from: (1) a borrower being legally relieved of loan repayment responsibility through bankruptcy, (2) insufficient collateral sale proceeds to repay a loan; or (3) the borrower and/or guarantor does not own other assets that, if sold, would generate sufficient sale proceeds to repay a loan. The Bank recorded net loan charge-offs of \$2.7 million for the first nine months of 2016.

At December 31, 2015, Special Mention loans included a \$5.4 million commercial real estate loan. The loan represented the Bank's portion of a participated loan transaction where the Bank was not the lead lender. The Bank placed the loan on nonaccrual at March 31, 2016 with a specific loan loss reserve of \$74 thousand. The reserve was determined using a September 2015 property appraisal obtained by the lead bank that showed a collateral value in excess of \$19.0 million. Based on its ownership percentage, the Bank discounted the appraised value by 30% plus costs, to calculate its specific loan loss reserve. The bank group subsequently negotiated a forbearance agreement with the borrower that required the sale of the property. A specialty broker was engaged by the lead bank to provide an opinion of value and to sell the property. The broker's opinion of value was less than half the September 2015 appraised value. Due to the significant decline in value since the 2015 appraisal, the Bank raised questions about the broker's valuation with the bank group. Despite objections raised by the Bank, the lead bank listed the property at a price consistent with the broker's valuation. This decision resulted in a \$1.9 million charge-off on this credit during the second quarter of 2016. During the third quarter of 2016, the bank group agreed to sell the loan and this decision resulted in an additional \$759 thousand charge-off. Overall, the total charge-off on this credit, \$2.7 million, accounted for 91% of the total gross charge-offs of \$3.0 million in 2016.

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

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial			Unallocated	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Consumer		
ALL at June 30, 2016	\$ 1,023	\$ 319	\$ 205	\$ 5,940	\$ 1,596	\$ 97	\$ 1,138	\$ 10,318
Charge-offs	-	-	-	(776)	-	(42)	-	(818)
Recoveries	1	-	-	5	7	22	-	35
Provision	(3)	1	8	876	132	21	115	1,150
ALL at September 30, 2016	\$ 1,021	\$ 320	\$ 213	\$ 6,045	\$ 1,735	\$ 98	\$ 1,253	\$ 10,685
ALL at December 31, 2015	\$ 989	\$ 308	\$ 194	\$ 5,649	\$ 1,519	\$ 102	\$ 1,325	\$ 10,086
Charge-offs	(49)	-	-	(2,730)	(66)	(126)	-	(2,971)
Recoveries	34	-	-	18	129	64	-	245
Provision	47	12	19	3,108	153	58	(72)	3,325
ALL at September 30, 2016	\$ 1,021	\$ 320	\$ 213	\$ 6,045	\$ 1,735	\$ 98	\$ 1,253	\$ 10,685

#### Other Real Estate Owned:

The Bank holds \$5.8 million of other real estate owned (OREO), comprised of four properties compared to \$6.5 million and seven properties at December 31, 2015. The most significant OREO holdings are listed in the table below. Property 1 was part of a participated loan and the workout is being handled by the lead bank. In early May 2016, an agreement of sale was executed. The agreement allows for a lengthy due diligence and approval process prior to settlement. Therefore, the final outcome is not certain. Property 2 was part of a participated loan and the workout is being handled by the lead bank. During 2016, the Bank sold five properties for a loss of \$31 thousand, recorded a write down of \$46 thousand on one property and incurred expense of \$47 thousand to hold and maintain OREO. Note 7 of the accompanying financial statements provides additional information on activity in OREO.

The following table provides additional information on significant other real estate owned properties:

September 30, 2016

(Dollars in thousands)

	Date Acquired	Balance	Collateral	Location
Property 1	2012	2,508	1st, 2nd, and 3rd liens residential development land - four tracts with 196 acres	PA
Property 2	2015	3,039 \$ 5,547	1st lien on 90 acres undeveloped commercial real estate	PA

At September 30, 2016, the Bank had \$349 thousand of residential properties in the process of foreclosure compared to \$218 thousand at the end of 2015.

48

---

## Deposits:

Total deposits increased \$60.0 million during the first nine months of 2016 to \$978.6 million. Non-interest bearing deposits increased \$22.3 million, while savings and interest-bearing checking increased \$46.2 million and time deposits decreased \$8.4 million. The increase in non-interest bearing checking accounts occurred primarily in state/municipal accounts (\$11.4 million) and small business checking accounts (\$10.6 million). Interest bearing checking increased by \$13.1 million, primarily from commercial deposits. The Bank's Money Management product increased \$26.9 million, primarily from state/municipal deposits. Retail time deposits decreased since year-end, as customers moved funds to more liquid accounts. As of September 30, 2016, the Bank had \$3.3 million in CDARS reciprocal time deposits included in brokered time deposits.

(Dollars in thousands)	September 30, 2016	December 31, 2015	Change	
			Amount	%
Noninterest-bearing checking	\$ 174,390	\$ 152,095	\$ 22,295	14.7
Interest-bearing checking	245,310	232,181	13,129	5.7
Money management	406,262	379,331	26,931	7.1
Savings	75,273	69,174	6,099	8.8
Total interest-bearing checking and savings	726,845	680,686	46,159	6.8
Retail time deposits	74,049	82,468	(8,419)	(10.2)
Brokered time deposits	3,268	3,263	5	0.2
Total time deposits	77,317	85,731	(8,414)	(9.8)
Total deposits	\$ 978,552	\$ 918,512	\$ 60,040	6.5
Overdrawn deposit accounts reclassified as loans	\$ 133	\$ 128		

## Borrowings:

The Corporation had short-term borrowings of \$8.5 million at September 30, 2016 and no borrowings at September 30, 2015.

## Shareholders' Equity:

Total shareholders' equity increased \$5.5 million to \$116.9 million at September 30, 2016, compared to \$111.4 million at the end of 2015. The increase in retained earnings from the Corporation's net income of \$6.4 million was partially offset by the cash dividend of \$2.6 million. The Corporation's dividend payout ratio is 41.1% for the first nine months of 2016 compared to 29.4% in 2015.

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. Year-to-date, the Corporation paid dividends of \$0.61 per share, compared to \$0.55 for the same period in 2015, a 10.9% increase. For the third quarter of 2016, the Corporation paid a \$0.21 per share dividend, compared to \$0.19 paid in the third quarter of 2015. On October 13, 2016 the Board of Directors declared a \$0.21 per share regular quarterly dividend for the fourth quarter of 2016, which will be paid on November 23, 2016.

In addition, the Corporation considers how dividend decisions may affect the Dividend Reinvestment Plan (DRIP), which has raised \$1.1 million in new capital this year with 49,401 new shares purchased. On April 14, 2016, the



Board of Directors approved a stock repurchase program that authorizes the repurchase of up to \$350,000 in shares of common stock during each calendar quarter through March 31, 2017. In 2016, the Corporation repurchased 30,196 shares of its common stock for \$700 thousand.

49

---

In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as “Basel III.” The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered “well capitalized” under Basel III are: (1) Common Equity Tier 1(CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3) Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The CET1 ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.625%, increasing each year until fully implemented in 2019 at 2.5% above the minimum capital ratios required to avoid any capital distribution restrictions. The capital conservation buffer will be applicable to all of the capital ratios except for the Tier1 Leverage ratio. When fully implemented, the capital conservation buffer will have the effect of increasing the minimum capital ratios by 2.5%. As of September 30, 2016, the Bank was “well capitalized” under the Basel III requirements and believes it would be “well capitalized” on a fully-phased in basis had such a requirement been in effect.

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

(Dollars in thousands)	September 30, 2016	December 31, 2015	Regulatory Ratios	
			Adequately Capitalized Minimum	Well Capitalized Minimum
<b>Common Equity Tier 1 Risk-based Capital Ratio (1)</b>				
Franklin Financial Services Corporation	14.60%	14.77%	5.125%	N/A
Farmers & Merchants Trust Company	14.53%	14.76%	5.125%	6.50%
<b>Tier 1 Risk-based Capital Ratio (2)</b>				
Franklin Financial Services Corporation	14.60%	14.77%	6.625%	N/A
Farmers & Merchants Trust Company	14.53%	14.76%	6.625%	8.00%
<b>Total Risk-based Capital Ratio (3)</b>				
Franklin Financial Services Corporation	15.86%	16.03%	8.625%	N/A
Farmers & Merchants Trust Company	15.79%	16.02%	8.625%	10.00%
<b>Tier 1 Leverage Ratio (4)</b>				
Franklin Financial Services Corporation	10.07%	10.38%	4.000%	N/A
Farmers & Merchants Trust Company	10.03%	10.37%	4.000%	5.00%

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

The Corporation's primary market area includes Franklin, Fulton, Cumberland and Huntingdon County, PA. This area is diverse in demographic and economic makeup. County populations range from a low of approximately 15,000 in Fulton County to over 238,000 in Cumberland County. Unemployment in the Bank's market area has remained virtually unchanged over the past year and ranges from a low of 4.7% in Cumberland County to high of 7.1% 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

50

---

or business and Management believes that the Bank's primary market area continues to be well suited for growth as the recession eases.

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

#### Economic Data

	September 30, 2016	December 31, 2015
Unemployment Rate (seasonally adjusted)		
Market area range (1)	4.7% - 7.1%	3.5 - 5.5%
Pennsylvania	5.2%	5.0%
United States	4.9%	5.0%
Housing Price Index - year over year change		
PA, nonmetropolitan statistical area	2.7%	2.0%
United States	5.6%	5.6%
Franklin County Building Permits - year over year change		
Residential, estimated	7.4%	-15.6%
Multifamily, estimated	10.5%	-65.0%

(1) Franklin, Cumberland, Fulton and Huntingdon Counties

Unlike many companies, the assets and liabilities of the Corporation are financial in nature. As such, interest rates and changes in interest rates may have a more significant effect on the Corporation's financial results than on other types of industries. Because of this, the Corporation watches the actions of the Federal Reserve Open Market Committee (FOMC) as it makes decisions about interest rate changes. The FOMC continues to hold short-term rates at historic lows. It continues to monitor employment and inflation data as it considers the timing of an increase in the Fed Funds rate.

#### Liquidity

The Corporation must meet the financial needs of the customers that it serves, while providing a satisfactory return on the shareholders' investment. In order to accomplish this, the Corporation must maintain sufficient liquidity in order to respond quickly to the changing level of funds required for both loan and deposit activity. The goal of liquidity management is to meet the ongoing cash flow requirements of depositors who want to withdraw funds and of borrowers who request loan disbursements. The Bank regularly reviews its liquidity position by measuring its projected net cash flows (in and out) at a 30 and 90-day interval. The Bank stresses this measurement by assuming a level of deposit out-flows 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 will help 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 September 30, 2016, the Bank had approximately \$86.0 million (fair value) in its investment portfolio pledged as collateral for deposits. Another source of available liquidity for the Bank is a line of credit with the FHLB. At September 30, 2016, the Bank had approximately \$130 million available on this line of credit and \$6.0 million of unsecured lines of credit at a correspondent bank. At September 30, 2016, the Bank had an excess borrowing capacity at FHLB of \$266.7 million, which includes the amount available on the line of credit. The Bank has

51

---

established credit at the Federal Reserve Discount Window and as of quarter-end had the ability to borrow approximately \$23 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 \$299.1 million and \$291.4 million, respectively, at September 30, 2016 and December 31, 2015.

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 2015 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 nine months ended September 30, 2016. For more information on market risk refer to the Corporation's 2015 Annual Report on Form 10-K.

#### Item 4. Controls and Procedures

##### Evaluation of Controls and Procedures

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2016, 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 September 30, 2016, 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 the matter disclosed in our Form 8-K filed July 29, 2016. In management's opinion, we do not anticipate, at the present time, that 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, however, 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. In addition, no material proceedings are pending or are known to be threatened or contemplated against us by governmental authorities.

## Item 1A. Risk Factors

There were no material changes in the Corporation's risk factors during the nine months ended September 30, 2016. For more information, refer to the Corporation's 2015 Annual Report on Form 10-K.

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

The Board of Directors approved a stock repurchase plan on April 14, 2016 that authorizes the repurchase of up to \$350,000 in shares of common stock during each calendar quarter through March 31, 2017.

As of September 30, 2016, 30,196 shares have been purchased under this plan. The following table reports stock repurchases made during the 2016 and total shares repurchased under this plan:

(Dollars in thousands, except per share)				
Period	Number of Shares Purchased	Weighted Average Price Paid per Share	Dollar Amount of Shares Purchased as Part of Publically Announced Program	Dollar Amount of Shares that May Yet Be Purchased Under Program
April 2016	15,521	\$ 22.55	\$ 350	\$ 1,050
August 2016	14,675	23.80	350	700
	30,196	\$ 23.16		

## 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, 2015 and incorporated herein by reference.)

3.2 Bylaws of the Corporation. (Filed as Exhibit 99 to Current Report on Form 8-K filed on December 20, 2014 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)

53

---

FRANKLIN FINANCIAL SERVICES CORPORATION

and SUBSIDIARIES

SIGNATURES

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

Franklin Financial Services Corporation

November 7, 2016      /s/ Timothy G. Henry  
Timothy G. Henry  
Chief Executive Office and President  
(Principal Executive Officer)

November 7, 2016      /s/ Mark R. Hollar  
Mark R. Hollar  
Treasurer and Chief Financial Officer  
(Principal Financial and Accounting Officer)