FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-Q
May 09, 2014
UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2014

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

For the transition period from__________ to___________

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

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

20 South Main Street, Chambersburg	PA17201-0819
(Address of principal executive offices)	(Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

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

Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [ ] Smaller reporting company [X]

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

There were 4,180,073 outstanding shares of the Registrant’s common stock as of April 30, 2014.

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Part I FINANCIAL INFORMATION

Item 1 Financial Statements

Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)	(unaudited) March 31 2014	December 31 2013
Assets		
Cash and due from banks	$ 16,806	$ 13,542
Interest-bearing deposits in other banks	62,575	27,203
Total cash and cash equivalents	79,381	40,745
Investment securities available for sale, at fair value	161,626	159,674
Restricted stock	1,906	1,906
Loans held for sale	156	349
Loans	726,058	723,413
Allowance for loan losses	(9,745)	(9,702)
Net Loans	716,313	713,711
Premises and equipment, net	16,006	16,145
Bank owned life insurance	21,673	21,530
Goodwill	9,016	9,016
Other intangible assets	594	698
Other real estate owned	4,307	4,708
Deferred tax asset, net	5,065	5,445
Other assets	10,408	10,660
Total assets	$ 1,026,451	$ 984,587
Liabilities		
Deposits		
Noninterest-bearing checking	$ 128,670	$ 121,565
Money management, savings and interest checking	653,902	610,245
Time	110,313	113,914
Total Deposits	892,885	845,724
Securities sold under agreements to repurchase	15,905	23,834
Long-term debt	12,401	12,403
Other liabilities	7,587	7,238
Total liabilities	928,778	889,199
Shareholders' equity		
Common stock, $1 par value per share,15,000,000 shares authorized with		

4,570,495 shares issued and 4,178,691 shares outstanding at March 31, 2014 and 4,560,700 shares issued and 4,168,673 shares outstanding at December 31, 2013	4,571	4,561
Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding	-	-
Additional paid-in capital	36,796	36,636
Retained earnings	67,014	65,897
Accumulated other comprehensive loss	(3,702)	(4,696)
Treasury stock, 391,804 at March 31, 2014 and 392,027 shares at December 31, 2013, at cost	(7,006)	(7,010)
Total shareholders' equity	97,673	95,388
Total liabilities and shareholders' equity	$ 1,026,451	$ 984,587

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

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Consolidated Statements of Income

(Dollars in thousands, except per share data) (unaudited)	For the Three Months Ended March 31	
	2014	2013
Interest income		
Loans, including fees	$ 7,511	$ 8,297
Interest and dividends on investments:		
Taxable interest	641	353
Tax exempt interest	358	376
Dividend income	25	18
Deposits and obligations of other banks	39	58
Total interest income	8,574	9,102
Interest expense		
Deposits	702	1,103
Securities sold under agreements to repurchase	7	18
Long-term debt	121	121
Total interest expense	830	1,242
Net interest income	7,744	7,860
Provision for loan losses	198	803
Net interest income after provision for loan losses	7,546	7,057
Noninterest income		
Investment and trust services fees	1,091	1,019
Loan service charges	167	250
Mortgage banking activities	12	(22)
Deposit service charges and fees	464	436
Other service charges and fees	267	221
Debit card income	306	285
Increase in cash surrender value of life insurance	143	152
Other real estate owned losses, net	(122)	-
Other	52	43

Total noninterest income	2,380	2,384
Noninterest expense		
Salaries and employee benefits	4,251	4,214
Net occupancy expense	675	568
Furniture and equipment expense	254	247
Advertising	316	335
Legal and professional fees	265	279
Data processing	391	394
Pennsylvania bank shares tax	173	205
Intangible amortization	104	106
FDIC insurance	232	245
ATM/debit card processing	179	181
Other	848	808
Total noninterest expense	7,688	7,582
Income before federal income tax expense	2,238	1,859
Federal income tax expense	412	308
Net income	$ 1,826	$ 1,551
Per share		
Basic earnings per share	$ 0.44	$ 0.38
Diluted earnings per share	$ 0.44	$ 0.38
Cash dividends declared	$ 0.17	$ 0.17

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

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Consolidated Statements of Comprehensive Income

	For the Three Months Ended March 31	
(Dollars in thousands) (unaudited)	2014	2013
Net Income	$ 1,826	$ 1,551
Securities:		
Unrealized gains arising during the period	1,420	177
Tax effect	(483)	(60)
Net of tax amount	937	117
Derivatives:		
Unrealized gains arising during the period	(8)	2
Reclassification adjustment for losses included in net income (1)	95	180
Net unrealized gains	87	182
Tax effect	(30)	(62)
Net of tax amount	57	120
Total other comprehensive income	994	237
Total Comprehensive Income	$ 2,820	$ 1,788

Reclassification adjustment / Statement line item	Tax expense (benefit)	
(1) Derivatives / interest expense on deposits	$ (32)	$ (61)

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

Consolidated Statements of Changes in Shareholders' Equity

For the three months March 31, 2014 and 2013:

(Dollars in thousands, except per share data) (unaudited)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance at December 31, 2012	$ 4,503	$ 35,788	$ 62,475	$ (4,050)	$ (7,082)	$ 91,634
Net income	-	-	1,551	-	-	1,551
Other comprehensive income	-	-	-	237	-	237
Cash dividends declared, $.17 per share	-	-	(698)	-	-	(698)
Treasury shares issued under stock option plans, 204 shares	-	(1)	-	-	4	3
Common stock issued under dividend reinvestment plan, 12,633 shares	13	180	-	-	-	193
Balance at March 31, 2013	$ 4,516	$ 35,967	$ 63,328	$ (3,813)	$ (7,078)	$ 92,920
Balance at December 31, 2013	$ 4,561	$ 36,636	$ 65,897	$ (4,696)	$ (7,010)	$ 95,388
Net income	-	-	1,826	-	-	1,826
Other comprehensive income	-	-	-	994	-	994
Cash dividends declared, $.17 per share	-	-	(709)	-	-	(709)
Treasury shares issued under stock option plans, 223 shares	-	-	-	-	4	4
Common stock issued under dividend reinvestment plan, 9,795 shares	10	160	-	-	-	170
Balance at March 31, 2014	$ 4,571	$ 36,796	$ 67,014	$ (3,702)	$ (7,006)	$ 97,673

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

Consolidated Statements of Cash Flows

	Three Months Ended March 31	
	2014	2013
(Dollars in thousands) (unaudited)		
Cash flows from operating activities		
Net income	$ 1,826	$ 1,551
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	372	385
Net amortization of loans and investment securities	428	461
Amortization and net change in mortgage servicing rights valuation	8	50
Amortization of intangibles	104	106
Provision for loan losses	198	803
Loans originated for sale	(1,443)	(2,648)
Proceeds from sale of loans	1,636	2,388
Writedown of other real estate owned	120	-
Net loss on sale or disposal of other real estate/other repossessed assets	2	-
Increase in cash surrender value of life insurance	(143)	(152)
Decrease in other assets	185	69
Increase in other liabilities	440	412
Other, net	(94)	747
Net cash provided by operating activities	3,639	4,172
Cash flows from investing activities		
Proceeds from maturities and paydowns of securities available for sale	5,844	9,853
Purchase of investment securities available for sale	(6,816)	(11,620)
Net decrease in restricted stock	-	521
Net (increase) decrease in loans	(2,787)	6,859
Proceeds from sale of other real estate/other repossessed assets	279	-
Capital expenditures	(218)	(222)

Net cash (used in) provided by investing activities	(3,698)	5,391
Cash flows from financing activities		
Net increase in demand deposits, NOW, and savings accounts	50,762	28,138
Net decrease in time deposits	(3,601)	(400)
Net decrease in repurchase agreements	(7,929)	(2,844)
Long-term debt payments	(2)	(2)
Dividends paid	(709)	(698)
Treasury stock issued under stock option plans	4	3
Common stock issued under dividend reinvestment plan	170	193
Net cash provided by financing activities	38,695	24,390
Increase in cash and cash equivalents	38,636	33,953
Cash and cash equivalents as of January 1	40,745	77,834
Cash and cash equivalents as of March 31	$ 79,381	$ 111,787
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest on deposits and other borrowed funds	$ 786	$ 1,121
Income taxes	$ 20	$ -
Noncash Activities		
Loans transferred to Other Real Estate	$ -	$ 293

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

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

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

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of March 31, 2014, and for all other periods presented have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation’s 2013 Annual Report on Form 10-K. The consolidated results of operations for the period ended March 31, 2014 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

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

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

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

	For the Three Months Ended March 31

(Dollars and shares in thousands, except per share data)	2014	2013
Weighted average shares outstanding (basic)	4,172	4,112
Impact of common stock equivalents	5	6
Weighted average shares outstanding (diluted)	4,177	4,118
Anti-dilutive options excluded from calculation	40	58
Net income	$ 1,826	$ 1,551
Basic earnings per share	$ 0.44	$ 0.38
Diluted earnings per share	$ 0.44	$ 0.38

Note 2. Recent Accounting Pronouncements

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

Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11 "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," require an entity with an unrecognized tax benefit that is 'not available' or not intended to be used at the reporting date to present the unrecognized tax benefit as a liability that should not be combined with deferred tax assets. Otherwise, the unrecognized tax benefit should be presented as a reduction to the related deferred tax asset. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. The amendments in ASU 2013-11 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Corporation adopted this ASU 2013-11 at March 31, 2014.

Note 3. Accumulated Other Comprehensive Loss

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

(Dollars in thousands)	March 31, 2014	December 31, 2013
Net unrealized gains (losses) on securities	$ 679	$ (741)
Tax effect	(231)	252
Net of tax amount	448	(489)
Net unrealized losses on derivatives	(474)	(561)
Tax effect	161	191
Net of tax amount	(313)	(370)
Accumulated pension adjustment	(5,814)	(5,814)
Tax effect	1,977	1,977
Net of tax amount	(3,837)	(3,837)
Total accumulated other comprehensive loss	$ (3,702)	$ (4,696)

Note 4. Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting these commitments. The Bank had $20.4 million and $20.2 million of standby letters of credit as of March 31, 2014 and December 31, 2013, respectively. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of March 31, 2014 and December 31, 2013 for guarantees under standby letters of credit issued was not material.

Note 5. Investments

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

(Dollars in thousands) March 31, 2014	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 1,472	$ 544	$ -	$ 2,016
U.S. Government agency securities	14,547	88	(96)	14,539
Municipal securities	55,531	1,568	(976)	56,123
Corporate debt securities	1,001	1	-	1,002
Trust preferred securities	5,928	-	(833)	5,095
Agency mortgage-backed securities	80,500	826	(444)	80,882
Private-label mortgage-backed securities	1,918	48	(44)	1,922
Asset-backed securities	50	-	(3)	47
	$ 160,947	$ 3,075	$ (2,396)	$ 161,626

(Dollars in thousands) December 31, 2013	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 1,472	$ 499	$ (1)	$ 1,970
U.S. Government agency securities	11,771	94	(114)	11,751
Municipal securities	56,861	1,400	(1,404)	56,857
Corporate debt securities	1,002	-	(1)	1,001
Trust preferred securities	5,922	-	(871)	5,051
Agency mortgage-backed securities	81,352	726	(1,051)	81,027
Private-label mortgage-backed securities	1,984	16	(31)	1,969
Asset-backed securities	51	-	(3)	48
	$ 160,415	$ 2,735	$ (3,476)	$ 159,674

At March 31, 2014 and December 31, 2013, the fair value of investment securities pledged to secure public funds, trust balances, repurchase agreements, deposit and other obligations totaled $104.8 million and $107.6 million, respectively.

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The amortized cost and estimated fair value of debt securities at March 31, 2014, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

(Dollars in thousands)	Amorized cost	Fair value
Due in one year or less	$ 1,446	$ 1,458
Due after one year through five years	13,149	13,676
Due after five years through ten years	26,751	26,868
Due after ten years	35,711	34,804
	77,057	76,806
Mortgage-backed securities	82,418	82,804
	$ 159,475	$ 159,610

The following table provides additional detail about trust preferred securities as of March 31, 2014:

Trust Preferred Securities

(Dollars in thousands)

Deal Name	Single Issuer or Pooled	Class	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Lowest Credit Rating Assigned	Number of Banks Currently Performing	Deferrals and Defaults as % of Original Collateral	Expected Deferral/ Defaults as a Percentage of Remaining Performing Collateral
Huntington Cap Trust	Single	Preferred Stock	$ 937	$ 811	$ (126)	BB+	1	None	None

Huntington Cap Trust II	Single	Preferred Stock	886	780	(106)	BB+	1	None	None
BankAmerica Cap III	Single	Preferred Stock	961	795	(166)	BB+	1	None	None
Wachovia Cap Trust II	Single	Preferred Stock	276	245	(31)	BBB+	1	None	None
Corestates Captl Tr II	Single	Preferred Stock	933	830	(103)	BBB+	1	None	None
Chase Cap VI JPM	Single	Preferred Stock	961	830	(131)	BBB	1	None	None
Fleet Cap Tr V	Single	Preferred Stock	974	804	(170)	BB+	1	None	None
			$ 5,928	$ 5,095	$ (833)				

The following table provides additional detail about private label mortgage-backed securities as of March 31, 2014:

Private Label Mortgage Backed Securities

(Dollars in thousands) Description	Origination Date	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
RALI 2004-QS4 A7	3/1/2004	$ 157	$ 164	$ 7	ALT A	BBB+	12.55	$ -
MALT 2004-6 7A1	6/1/2004	426	446	20	ALT A	CCC	14.26	-
RALI 2005-QS2 A1	2/1/2005	318	331	13	ALT A	C	5.82	10
RALI 2006-QS4 A2	4/1/2006	593	565	(28)	ALT A	D	-	293
GSR 2006-5F 2A1	5/1/2006	94	102	8	Prime	D	-	15
RALI 2006-QS8 A1	7/28/2006	330	314	(16)	ALT A	D	-	197
		$ 1,918	$ 1,922	$ 4				$ 515

Impairment:

The investment portfolio contained 84 securities with $68.8 million of temporarily impaired fair value and $2.4 million in unrealized losses at March 31, 2014.

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 March 31, 2014, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

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

	March 31, 2014								
	Less than 12 months			12 months or more			Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government agency securities	$ 4,051	$ (37)	5	$ 5,593	$ (59)	11	$ 9,644	$ (96)	16
Municipal securities	12,526	(483)	16	5,762	(493)	9	18,288	(976)	25
Trust preferred securities	-	-	-	5,095	(833)	7	5,095	(833)	7
Agency mortgage-backed securities	31,497	(358)	29	3,371	(86)	4	34,868	(444)	33
Private-label mortgage-backed securities	-	-	-	879	(44)	2	879	(44)	2
Asset-backed securities	-	-	-	5	(3)	1	5	(3)	1
Total temporarily impaired securities	$ 48,074	$ (878)	50	$ 20,705	$ (1,518)	34	$ 68,779	$ (2,396)	84

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

The municipal bond portfolio has the largest unrealized loss at $1.0 million, $400 thousand less than at the prior-year end. The unrealized loss in this portfolio is deemed to be non-credit related and no other-than-temporary impairment charges have been recorded.

The trust preferred portfolio contains seven securities with a fair value of $5.1 million and an unrealized loss of $833 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 March 31, 2014, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded.

The PLMBS sector shows a gross unrealized loss of $44 thousand. These bonds were all rated AAA at time of purchase, but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. As a result of the analysis on PLMBS it was determined that no impairment charge was required at quarter end. The Bank has recorded $515 thousand of cumulative impairment charges on this portfolio. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. The Bank is currently participating in a class-action lawsuit against one PLMBS servicer that centers on defective warranties and representations made as part of the underwriting process.

The Bank held $1.9 million of restricted stock at March 31, 2014. Except for $30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of $100 per share.

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

Note 6. Loans

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

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

					Change		
(Dollars in thousands)		March 31, 2014		December 31, 2013		Amount	%
Residential Real Estate 1-4 Family							
Consumer first liens	$	103,107	$	103,573	$	(466)	(0.4)
Consumer junior liens and lines of credit		34,606		34,636		(30)	(0.1)
Total consumer		137,713		138,209		(496)	(0.4)
Commercial first lien		62,002		58,466		3,536	6.0
Commercial junior liens and lines of credit		5,338		5,939		(601)	(10.1)
Total commercial		67,340		64,405		2,935	4.6
Total residential real estate 1-4 family		205,053		202,614		2,439	1.2
Residential real estate - construction							
Consumer		3,188		3,960		(772)	(19.5)
Commercial		8,565		8,559		6	0.1
Total residential real estate construction		11,753		12,519		(766)	(6.1)
Commercial real estate		322,450		329,373		(6,923)	(2.1)
Commercial		178,986		170,327		8,659	5.1
Total commercial		501,436		499,700		1,736	0.3
Consumer		7,816		8,580		(764)	(8.9)
		726,058		723,413		2,645	0.4
Less: Allowance for loan losses		(9,745)		(9,702)		(43)	(0.4)
Net Loans	$	716,313	$	713,711	$	2,602	0.4
Included in the loan balances are the following:							
Net unamortized deferred loan costs	$	446	$	372			
Unamortized discount on purchased loans	$	(74)	$	(92)			

Loans pledged as collateral for borrowings and commitments from:		
FHLB	$ 582,983	$ 607,524
Federal Reserve Bank	64,669	45,809
	$ 647,652	$ 653,333

Note 7. Loan Quality

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

	Residential Real Estate 1-4 Family			Commercial			
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Real Estate	Commercial	Consumer	Total
Allowance at December 31, 2013	$ 1,108	$ 278	$ 291	$ 5,571	$ 2,306	$ 148	$ 9,702
Charge-offs	(16)	-	(27)	(114)	(1)	(43)	(201)
Recoveries	3	-	-	-	20	23	46
Provision	38	(2)	110	52	(16)	16	198
Allowance at March 31, 2014	$ 1,133	$ 276	$ 374	$ 5,509	$ 2,309	$ 144	$ 9,745
Allowance at December 31, 2012	$ 913	$ 306	$ 899	$ 6,450	$ 1,620	$ 191	$ 10,379
Charge-offs	-	(45)	-	(171)	(7)	(44)	(267)
Recoveries	8	-	-	-	7	13	28
Provision	52	35	(62)	403	352	23	803
Allowance at March 31, 2013	$ 973	$ 296	$ 837	$ 6,682	$ 1,972	$ 183	$ 10,943

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 March 31, 2014 and December 31, 2013:

	Residential Real Estate 1-4 Family		Commercial
		Junior Liens &	

(Dollars in thousands)	First Liens	Lines of Credit	Construction	Real Estate	Commercial	Consumer	Total
March 31, 2014							
Loans evaluated for allowance:							
Individually	$ 2,310	$ 51	$ 530	$ 25,029	$ 1,953	$ -	$ 29,873
Collectively	162,799	39,893	11,223	297,421	177,033	7,816	696,185
Total	$ 165,109	$ 39,944	$ 11,753	$ 322,450	$ 178,986	$ 7,816	$ 726,058
Allowance established for loans evaluated:							
Individually	$ -	$ -	$ -	$ 247	$ 968	$ -	$ 1,215
Collectively	1,133	276	374	5,262	1,341	144	8,530
Allowance at March 31, 2014	$ 1,133	$ 276	$ 374	$ 5,509	$ 2,309	$ 144	$ 9,745
December 31, 2013							
Loans evaluated for allowance:							
Individually	$ 2,354	$ 50	$ 537	$ 25,107	$ 1,996	$ -	$ 30,044
Collectively	159,685	40,525	11,982	304,266	168,331	8,580	693,369
Total	$ 162,039	$ 40,575	$ 12,519	$ 329,373	$ 170,327	$ 8,580	$ 723,413
Allowance established for loans evaluated:							
Individually	$ 9	$ -	$ -	$ 89	$ 1,002	$ -	$ 1,100
Collectively	1,099	278	291	5,482	1,304	148	8,602
Allowance at December 31, 2013	$ 1,108	$ 278	$ 291	$ 5,571	$ 2,306	$ 148	$ 9,702

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

	Impaired Loans With No Allowance		With Allowance		
(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Recorded Investment	Unpaid Principal Balance	Related Allowance
March 31, 2014					
Residential Real Estate 1-4 Family					
First liens	$ 3,181	$ 3,649	$ -	$ -	$ -
Junior liens and lines of credit	110	135	-	-	-
Total	3,291	3,784	-	-	-
Residential real estate - construction	530	553	-	-	-
Commercial real estate	23,607	28,724	1,468	2,362	247
Commercial	140	144	1,928	2,029	968
Consumer	-	-	-	-	-
Total	$ 27,568	$ 33,205	$ 3,396	$ 4,391	$ 1,215
December 31, 2013					
Residential Real Estate 1-4 Family					
First liens	$ 3,030	$ 3,500	$ 9	$ 39	$ 9
Junior liens and lines of credit	108	127	-	-	-
Total	3,138	3,627	9	39	9
Residential real estate - construction	537	556	-	-	-
Commercial real estate	24,188	30,334	966	1,043	89
Commercial	88	89	1,970	2,043	1,002
Consumer	-	-	-	-	-
Total	$ 27,951	$ 34,606	$ 2,945	$ 3,125	$ 1,100

The following table shows the average of impaired loans and related interest income for the three months ended March 31, 2014 and 2013:

	Three Months Ended March 31, 2014		Three Months Ended March 31, 2013	
	Average	Interest	Average	Interest

(Dollars in thousands)	Recorded Investment	Income Recognized	Recorded Investment	Income Recognized
Residential Real Estate 1-4 Family				
First liens	$ 3,218	$ 14	$ 3,626	$ 4
Junior liens and lines of credit	126	4	742	1
Total	3,344	18	4,368	5
Residential real estate - construction	532	5	556	-
Commercial real estate	25,665	244	30,087	38
Commercial	2,092	31	4,480	-
Consumer	-	-	-	-
Total	$ 31,633	$ 298	$ 39,491	$ 43

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

(Dollars in thousands)		Loans Past Due and Still Accruing					Total
		30-59	60-89	90			
	Current	Days	Days	Days+	Total	Non-Accrual	Loans
March 31, 2014							
Residential Real Estate 1-4 Family							
First liens	$ 161,013	$ 1,514	$ 9	$ 229	$ 1,752	$ 2,344	$ 165,109
Junior liens and lines of credit	39,618	163	13	59	235	91	39,944
Total	200,631	1,677	22	288	1,987	2,435	205,053
Residential real estate - construction	10,641	373	209	-	582	530	11,753
Commercial real estate	300,573	2,912	-	-	2,912	18,965	322,450
Commercial	176,392	47	140	-	187	2,407	178,986
Consumer	7,703	93	13	7	113	-	7,816
Total	$ 695,940	$ 5,102	$ 384	$ 295	$ 5,781	$ 24,337	$ 726,058

December 31, 2013							
Residential Real Estate 1-4 Family							
First liens	$ 156,916	$ 1,725	$ 497	$ 302	$ 2,524	$ 2,599	$ 162,039
Junior liens and lines of credit	40,204	204	19	41	264	107	40,575
Total	197,120	1,929	516	343	2,788	2,706	202,614
Residential real estate - construction	11,458	523	-	-	523	538	12,519
Commercial real estate	309,531	634	-	207	841	19,001	329,373
Commercial	167,747	78	60	44	182	2,398	170,327
Consumer	8,430	117	23	10	150	-	8,580
Total	$ 694,286	$ 3,281	$ 599	$ 604	$ 4,484	$ 24,643	$ 723,413

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

(Dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
March 31, 2014					
Residential Real Estate 1-4 Family					
First liens	$ 156,291	$ 2,513	$ 6,305	$ -	$ 165,109
Junior liens and lines of credit	39,548	40	356	-	39,944
Total	195,839	2,553	6,661	-	205,053
Residential real estate - construction	10,148	-	1,605	-	11,753
Commercial real estate	283,566	4,508	34,376	-	322,450
Commercial	163,184	3,228	12,574	-	178,986
Consumer	7,809	-	7	-	7,816
Total	$ 660,546	$ 10,289	$ 55,223	$ -	$ 726,058

December 31, 2013					
Residential Real Estate 1-4 Family					
First liens	$ 150,762	$ 3,653	$ 7,624	$ -	$ 162,039
Junior liens and lines of credit	40,102	66	407	-	40,575
Total	190,864	3,719	8,031	-	202,614
Residential real estate - construction	10,955	-	1,564	-	12,519
Commercial real estate	281,857	11,861	35,655	-	329,373
Commercial	154,888	3,393	12,046	-	170,327
Consumer	8,570	-	10	-	8,580
Total	$ 647,134	$ 18,973	$ 57,306	$ -	$ 723,413

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 YTD	
	Number of Contracts	Recorded Investment	Performing*	Nonperforming*	Number of Contracts	Recorded Investment
March 31, 2014						
Residential real estate - construction	1	$ 530	$ -	$ 530	-	$ -
Residential real estate	5	608	608	-	-	-
Commercial real estate	12	15,723	14,188	1,535	-	-
Total	18	$ 16,861	$ 14,796	$ 2,065	-	$ -
December 31, 2013						
Residential real estate - construction	1	$ 537	$ -	$ 537	-	$ -
Residential real estate	5	625	625	-	-	
Commercial real estate	12	15,877	14,318	1,559	-	-
Total	18	$ 17,039	$ 14,943	$ 2,096	-	$ -

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

There were no new TDR loans made during 2014.

The following table reports TDR loans during 2013, concession granted and the recorded investment as of March 31, 2013:

	New During Period				
Three Months Ended March 31, 2013	Number of Contracts	Pre-TDR Modification	After-TDR Modification	Recorded Investment	Concession
Commercial real estate	1	$ 2,444	$ 2,731	$ 2,727	multiple

Note 8. Pension

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

	Three Months Ended March 31	
(Dollars in thousands)	2014	2013
Components of net periodic cost:		
Service cost	$ 86	$ 114
Interest cost	197	179
Expected return on plan assets	(290)	(312)
Recognized net actuarial loss	82	159
Net period cost	$ 75	$ 140

The Bank expects its pension expense to decrease to approximately $275 thousand in 2014 compared to $560 thousand in 2013.

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 year-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 March 31, 2014 and December 31, 2013.

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: 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.

Mortgage servicing rights: The fair value of mortgage servicing rights is based on observable market prices when available or the present value of expected future cash flows when not available. Assumptions such as loan default rates, costs to service, and prepayment speeds significantly affect the estimate of future cash flows. Mortgage servicing rights are carried at the lower of cost or fair value.

Deposits, Securities sold under agreements to repurchase and Long-term debt: 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 and long-term debt is estimated by discounting the future cash flows using rates approximating those currently offered for certificates of deposit and borrowings with similar remaining maturities. For securities sold under agreements to repurchase, the carrying value approximates a reasonable estimate of the fair value.

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

Derivatives: The fair value of the interest rate swaps is based on other similar financial instruments and is classified as Level 2.

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:

	March 31, 2014				
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	$ 79,381	$ 79,381	$ 79,381	$ -	$ -
Investment securities available for sale	161,626	161,626	2,016	159,610	-
Restricted stock	1,906	1,906	-	1,906	-
Loans held for sale	156	156	-	156	-
Net loans	716,313	722,589	-	-	722,589
Accrued interest receivable	2,812	2,812	-	2,812	-
Mortgage servicing rights	176	176	-	-	176
Financial liabilities:					
Deposits	$ 892,885	$ 893,360	$ -	$ 893,360	$ -
Securities sold under agreements to repurchase	15,905	15,905	-	15,095	-
Long-term debt	12,401	12,905	-	12,905	-
Accrued interest payable	273	273	-	273	-
Interest rate swaps	474	474	-	474	-

	December 31, 2013				
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3