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

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2013

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

For the transition period from__________ to___________

Commission file number 0-12126

<u>FRANKLIN FINANCIAL SERVICES CORPORATION</u>

(Exact name of registrant as specified in its charter)

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

20 South Main Street, Chambersburg, PA 17201-0819

(Address of principal executive offices) (Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 4,121,004 outstanding shares of the Registrant’s common stock as of April 30, 2013.

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Part I FINANCIAL INFORMATION

Item 1 Financial Statements

Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)	(unaudited) March 31 2013	December 31 2012
Assets		
Cash and due from banks	$ 12,578	$ 20,578
Interest-bearing deposits in other banks	99,209	57,256
Total cash and cash equivalents	111,787	77,834
Investment securities available for sale, at fair value	134,832	133,328
Restricted stock	3,050	3,571
Loans held for sale	327	67
Loans	746,164	753,579
Allowance for loan losses	(10,943)	(10,379)
Net Loans	735,221	743,200
Premises and equipment, net	16,897	17,037
Bank owned life insurance	21,076	20,925
Goodwill	9,016	9,016
Other intangible assets	1,017	1,123
Other real estate owned	5,420	5,127
Deferred tax asset	5,341	5,461
Other assets	10,212	10,674
Total assets	$ 1,054,196	$ 1,027,363
Liabilities		
Deposits		
Demand (noninterest-bearing)	$ 114,990	$ 123,623
Money management, savings and interest checking	609,469	572,698
Time	177,719	178,119
Total Deposits	902,178	874,440
Securities sold under agreements to repurchase	39,365	42,209
Long-term debt	12,408	12,410
Other liabilities	7,325	6,670
Total liabilities	961,276	935,729
Shareholders' equity		
Common stock, $1 par value per share,15,000,000 shares authorized with 4,516,013 shares issued and 4,120,183 shares outstanding at March 31, 2013 and 4,503,380 shares issued and 4,107,346 shares outstanding at December 31, 2012	4,516	4,503

Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding	-	-
Additional paid-in capital	35,967	35,788
Retained earnings	63,328	62,475
Accumulated other comprehensive loss	(3,813)	(4,050)
Treasury stock, 395,830 at March 31, 2013 and 396,034 shares at cost at December 31, 2012, respectively	(7,078)	(7,082)
Total shareholders' equity	92,920	91,634
Total liabilities and shareholders' equity	$ 1,054,196	$ 1,027,363

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

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Consolidated Statements of Income

(Dollars in thousands, except per share data) (unaudited)	For the Three Months Ended March 31	
	2013	2012
Interest income		
Loans, including fees	$ 8,297	$ 9,099
Interest and dividends on investments:		
Taxable interest	353	433
Tax exempt interest	376	366
Dividend income	18	16
Deposits and obligations of other banks	58	37
Total interest income	9,102	9,951
Interest expense		
Deposits	1,103	1,455
Securities sold under agreements to repurchase	18	20
Long-term debt	121	492
Total interest expense	1,242	1,967
Net interest income	7,860	7,984
Provision for loan losses	803	1,950
Net interest income after provision for loan losses	7,057	6,034
Noninterest income		
Investment and trust services fees	1,019	967
Loan service charges	250	272
Mortgage banking activities	(22)	47
Deposit service charges and fees	436	474
Other service charges and fees	221	235
Debit card income	285	275
Increase in cash surrender value of life insurance	152	167
Other real estate owned gains, net	-	38
Other	43	88
Total noninterest income	2,384	2,563
Noninterest expense		
Salaries and employee benefits	4,214	3,796
Net occupancy expense	568	519
Furniture and equipment expense	247	209
Advertising	335	315
Legal and professional fees	279	279
Data processing	394	413
Pennsylvania bank shares tax	205	187
Intangible amortization	106	109
FDIC insurance	245	261

ATM/debit card processing	181	151
Other	808	771
Total noninterest expense	7,582	7,010
Income before federal income taxes	1,859	1,587
Federal income tax expense	308	218
Net income	$ 1,551	$ 1,369
Per share		
Basic earnings per share	$ 0.38	$ 0.34
Diluted earnings per share	$ 0.38	$ 0.34
Cash dividends declared	$ 0.17	$ 0.27

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)	2013	2012
Net Income	$1,551	$1,369
Securities:		
Unrealized gains arising during the period	177	262
Tax effect	(60)	(89)
Net of tax amount	117	173
Derivatives:		
Unrealized gains arising during the period	2	29
Reclassification adjustment for losses included in net income (1)	180	181
Net unrealized gains	182	210
Tax effect	(62)	(71)
Net of tax amount	120	139
Total other comprehensive income	237	312
Total Comprehensive Income	$1,788	$1,681

Reclassification adjustment / Statement line item	Tax expense (benefit)	
(1) Derivatives / interest expense on deposits	$(61)	$(62)

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

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Consolidated Statements of Changes in Shareholders' Equity

For the three months March 31, 2013 and 2012:

(Dollars in thousands, except per share data) (unaudited)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance at December 31, 2011	$4,419	$34,698	$60,280	$(5,131)	$(7,084)	$87,182
Net income	-	-	1,369	-	-	1,369
Other comprehensive loss	-	-	-	312	-	312
Cash dividends declared, $.27 per share	-	-	(1,090)	-	-	(1,090)
Common stock issued under dividend reinvestment plan, 34,193 shares	34	455	-	-	-	489
Balance at March 31, 2012	$4,453	$35,153	$60,559	$(4,819)	$(7,084)	$88,262
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

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

Consolidated Statements of Cash Flows

	Three Months Ended March 31	
	2013	2012
(Dollars in thousands) (unaudited)		
Cash flows from operating activities		
Net income	$ 1,551	$ 1,369
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	385	354
Net amortization of loans and investment securities	461	320
Amortization and net change in mortgage servicing rights valuation	50	(7)
Amortization of intangibles	106	109
Provision for loan losses	803	1,950
Loans originated for sale	(2,648)	-
Proceeds from sale of loans	2,388	-
Net (gain) on sale or disposal of other real estate/other repossessed assets	-	(37)
Increase in cash surrender value of life insurance	(152)	(167)
Contribution to pension plan	-	(370)
Decrease (increase) in interest receivable and other assets	69	(424)
Increase (decrease) in interest payable and other liabilities	412	(326)
Other, net	747	502
Net cash provided by operating activities	4,172	3,273
Cash flows from investing activities		
Proceeds from maturities and paydowns of securities available for sale	9,853	10,277
Purchase of investment securities available for sale	(11,620)	(6,495)
Net decrease in restricted stock	521	250
Net decrease in loans	6,859	508
Proceeds from sale of other real estate/other repossessed assets	-	195
Capital expenditures	(222)	(246)
Net cash provided by investing activities	5,391	4,489
Cash flows from financing activities		
Net increase in demand deposits, NOW, and savings accounts	28,138	39,216
Net (decrease) increase in time deposits	(400)	8,332
Net decrease in repurchase agreements	(2,844)	(803)
Long-term debt payments	(2)	(1,677)
Dividends paid	(698)	(1,090)
Treasury stock issued under stock option plans	3	-
Common stock issued under dividend reinvestment plan	193	489
Net cash provided by financing activities	24,390	44,467
Increase in cash and cash equivalents	33,953	52,229
Cash and cash equivalents as of January 1	77,834	34,144
Cash and cash equivalents as of December 31	$ 111,787	$ 86,373

Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest on deposits and other borrowed funds	$ 1,121	$ 1,849
Income taxes	$ -	$ -
Noncash Activities		
Loans transferred to Other Real Estate	$ 293	$ 63

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

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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, 2013, and for all other periods presented have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation’s 2012 Annual Report on Form 10-K. The consolidated results of operations for the period ended March 31, 2013 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

The consolidated balance sheet at December 31, 2012 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements.

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

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

	For the Three Months Ended March 31	
(Dollars and shares in thousands, except per share data)	2013	2012
Weighted average shares outstanding (basic)	4,112	4,041
Impact of common stock equivalents	6	-
Weighted average shares outstanding (diluted)	4,118	4,041
Anti-dilutive options excluded from calculation	58	108
Net income	$1,551	$1,369
Basic earnings per share	$0.38	$0.34
Diluted earnings per share	$0.38	$0.34

Note 2. Recent Accounting Pronouncements

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

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

Testing Indefinite-Lived Intangible Assets for Impairment. In July, 2012, the FASB issued ASU 2012-02, “Testing Indefinite-Lived Intangible Assets for Impairment.” Similar to ASU 2011-08, “Intangibles – Goodwill and Other (Topic 250) – Testing Goodwill for Impairment”, ASU 2012-20 addresses the growing cost and complexity of performing an analysis to evaluate indefinite-lived intangible assets (other than goodwill) for impairment. Rather than requiring a purely quantitative impairment test, the ASU provides entities with the option to first examine qualitative factors, such as economic conditions and cash flow trends, to make this determination. Entities are required by the guidance to consider both positive and negative impacts of such factors before determining whether it is more-likely-than-not (i.e. greater than 50% probability) that the indefinite-lived asset is impaired. It should be noted that the qualitative portion of the analysis is optional for all issuers. This ASU is effective for impairment tests performed during fiscal years beginning after September 15, 2012, and may be early adopted if the entity’s financial statements for the most recent fiscal or interim period have not yet been issued. The Corporation adopted this ASU in 2012.

Note 3. Accumulated Other Comprehensive Loss

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

	March 31, 2013	December 31, 2012
(Dollars in thousands)		
Net unrealized gains on securities	$ 2,720	$ 2,542
Tax effect	(925)	(864)
Net of tax amount	1,795	1,678
Net unrealized losses on derivatives	(921)	(1,103)
Tax effect	313	375
Net of tax amount	(608)	(728)

Accumulated pension adjustment	(7,576)	(7,576)
Tax effect	2,576	2,576
Net of tax amount	(5,000)	(5,000)
Total accumulated other comprehensive loss	$ (3,813)	$ (4,050)

Note 4. Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting these commitments. The Bank had $21.4 million and $28.2 million of standby letters of credit as of March 31, 2013 and December 31, 2012, respectively. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of March 31, 2013 and December 31, 2012 for guarantees under standby letters of credit issued was not material.

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Note 5. Investments

The composition of the investment portfolio is virtually unchanged since year-end 2012. Municipal securities and U.S. Agency mortgage-backed securities continue to comprise the greatest portion of the portfolio at 45% and 38% of the portfolio respectively. The Bank invested $11.6 million during the first quarter divided almost equally between municipal and U.S. Agency mortgage-backed securities.

The investment portfolio had a net unrealized gain of $2.7 million at the end of the quarter. The municipal bond sector shows the largest net unrealized gain, while the trust-preferred sector has the largest net unrealized loss. The portfolio averaged $136.5 million for the year with a yield of 2.21% compared to an average of $126.9 million and a yield of 2.85% for the same period in 2012. The Bank expects the yield on the portfolio to continue to decline as higher yielding bonds pay-down or mature and reinvestment yields remain low.

The equity portfolio is comprised of bank stocks and the Bank and the Corporation each maintain separate equity portfolios. The municipal bond portfolio is well diversified geographically (issuers from within 27 states) and is comprised primarily of general obligation bonds (69%). Most municipal bonds have credit enhancements in the form of private bond insurance or other credit support. The largest geographic municipal bond exposure is to nineteen issuers in the state of Texas with a fair value of $9.8 million and eleven issuers in the state of Pennsylvania with a fair value of $6.5 million. The municipal bond portfolio contains $56.7 million of bonds rated A or higher, $637 thousand rated lower than A (but above noninvestment grade), and $2.9 million that are not rated by Moody's rating agency. No municipal bonds are rated below investment grade. The Bank holds one variable rate corporate bond in the financial services sector and it is rated A3 by Moody's.

The trust preferred investments are comprised of seven single issuer trust preferred securities with an amortized cost of $5.9 million and a fair value of $4.9 million. The Bank has six private-label mortgage backed securities (PLMBS) with an amortized cost of $2.4 million and a fair value of $2.4 million.

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

(Dollars in thousands)		Gross	Gross	
	Amortized	unrealized	unrealized	Fair
March 31, 2013	cost	gains	losses	value
Equity securities	$ 2,104	$ 217	$ (122)	$ 2,199
U.S. Government agency securities	12,448	137	(10)	12,575
Municipal securities	57,647	2,833	(242)	60,238

Corporate debt securities	1,004	-	(5)	999
Trust preferred securities	5,911	-	(994)	4,917
Agency mortgage-backed securities	50,536	1,025	(101)	51,460
Private-label mortgage-backed securities	2,407	29	(37)	2,399
Asset-backed securities	55	-	(10)	45
	$ 132,112	$ 4,241	$ (1,521)	$ 134,832

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

At March 31, 2013 and December 31, 2012, the fair value of investment securities pledged to secure public funds, trust balances, repurchase agreements, deposit and other obligations totaled $129.0 million and $119.8 million, respectively.

The amortized cost and estimated fair value of debt securities at March 31, 2013, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

(Dollars in thousands)	Amorized cost	Fair value
Due in one year or less	$ 2,435	$ 2,450
Due after one year through five years	13,999	14,770
Due after five years through ten years	21,233	22,302
Due after ten years	39,398	39,252
	77,065	78,774
Mortgage-backed securities	52,943	53,859
	$ 130,008	$ 132,633

The following table provides additional detail about trust preferred securities as of March 31, 2013:

Trust Preferred Securities

(Dollars in thousands)

Deal Name	Single Issuer or Pooled	Class	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Lowest Credit Rating Assigned	Number of Banks Currently Performing	Deferrals and Defaults as % of Original Collateral	Expected Deferral/ Defaults as a Percentage of Remaining Performing Collateral
Huntington Cap Trust	Single	Preferred Stock	$ 934	$ 735	$ (199)	BB	1	None	None
Huntington Cap Trust II	Single	Preferred Stock	881	721	(160)	BB	1	None	None
BankAmerica Cap III	Single	Preferred Stock	959	786	(173)	BB	1	None	None
Wachovia Cap Trust II	Single	Preferred Stock	275	247	(28)	BBB+	1	None	None
Corestates Captl Tr II	Single	Preferred Stock	930	821	(109)	BBB+	1	None	None
Chase Cap VI JPM	Single	Preferred Stock	959	825	(134)	BBB	1	None	None
Fleet Cap Tr V	Single		973	782	(191)	BB	1	None	None

Preferred Stock	$ 5,911	$4,917	$ (994)

The following table provides additional detail about private label mortgage-backed securities as of March 31, 2013:

Private Label Mortgage Backed Securities

(Dollars in thousands)

Description	Origination Date	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
RALI 2004-QS4 A7	3/1/2004	$ 287	$285	$ (2)	ALT A	BBB+	11.92	$ -
MALT 2004-6 7A1	6/1/2004	517	525	8	ALT A	CCC	12.46	-
RALI 2005-QS2 A1	2/1/2005	420	433	13	ALT A	C	6.49	-
RALI 2006-QS4 A2	4/1/2006	682	647	(35)	ALT A	D	-	278
GSR 2006-5F 2A1	5/1/2006	132	132	-	Prime	D	-	15
RALI 2006-QS8 A1	7/28/2006	369	377	8	ALT A	D	-	197
		$ 2,407	$2,399	$ (8)				$ 490

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Impairment:

The investment portfolio contained 63 securities with $33.5 million of temporarily impaired fair value and $1.5 million in unrealized losses. The unrealized loss position is less than at year-end 2012, but the number of impaired securities is unchanged. The trust preferred sector continues to show the largest unrealized loss at $1.0 million on seven securities, a slight improvement from the prior-year end.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities and subject to assessment at March 31, 2013, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of March 31, 2013 and December 31, 2012:

	March 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	$-	$ -	-	$766	$ (122)	10	$766	$ (122)	10
U.S. Government agency securities	2,956	(5)	3	3,293	(5)	6	6,249	(10)	9
Municipal securities	9,467	(242)	14	-	-	-	9,467	(242)	14
Corporate debt securities	-	-	-	999	(5)	1	999	(5)	1
Trust preferred securities	-	-	-	4,917	(994)	7	4,917	(994)	7
Agency mortgage-backed securities	9,127	(97)	13	969	(4)	4	10,096	(101)	17
Private-label mortgage-backed securities	-	-	-	932	(37)	2	932	(37)	2
Asset-backed securities	-	-	-	45	(10)	3	45	(10)	3
Total temporarily impaired securities	$21,550	$ (344)	30	$11,921	$ (1,177)	33	$33,471	$ (1,521)	63

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

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The trust preferred portfolio contains the largest unrealized loss in the portfolio. At March 31, 2013 this sector contained seven securities with a fair value of $4.9 million and an unrealized loss of $1.0 million, representing a slight improvement over year-end 2012. The trust-preferred securities held by the Bank are single entity issues, not pooled trust preferred securities. Therefore, the impairment review of these securities is based only on the issuer and the security cannot be impaired by the performance of other issuers as if it was a pooled trust-preferred bond. All of the Bank’s trust preferred securities are single issue, variable rate notes with long maturities (2027 – 2028). None of these bonds have suspended or missed a dividend payment. At March 31, 2013, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded. See the Trust Preferred Securities table for additional information.

The PLMBS sector shows a gross unrealized loss of $37 thousand, an improvement over the $123 thousand unrealized loss at December 31, 2012. These bonds were all rated AAA at time of purchase, but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. As a result of the analysis on PLMBS it was determined that no impairment charge was required at quarter end. The Bank has recorded $490 thousand of cumulative impairment charges on this portfolio. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. The Bank is currently participating in a class-action lawsuit against one PLMBS servicer that centers on defective warranties and representations made as part of the underwriting process. See the PLMBS table above for additional information.

The Bank held $3.1 million of restricted stock at March 31, 2013. Except for $30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of $100 per share. FHLB Pittsburgh has repurchased $521 thousand of its capital stock during the quarter. FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. Management intends to remain a member of the FHLB and believes that it will be able to fully recover the cost basis of this investment.

Note 6. Loans

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

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

(Dollars in thousands)	March 31, 2013	December 31, 2012	Change Amount	Change %
Residential Real Estate 1-4 Family				
Consumer first liens	$ 97,331	$ 93,790	$3,541	3.8
Consumer junior liens and lines of credit	34,152	35,494	(1,342)	(3.8)
Total consumer	131,483	129,284	2,199	1.7
Commercial first lien	56,569	60,809	(4,240)	(7.0)
Commercial junior liens and lines of credit	6,506	6,794	(288)	(4.2)
Total	63,075	67,603	(4,528)	(6.7)
Total residential real estate 1-4 family	194,558	196,887	(2,329)	(1.2)
Residential real estate - construction				
Consumer purpose	3,856	3,255	601	18.5
Commercial purpose	10,476	12,177	(1,701)	(14.0)
Total residential real estate construction	14,332	15,432	(1,100)	(7.1)
Commercial, industrial and agricultural real estate	364,439	363,874	565	0.2
Commercial, industrial and agricultural	162,808	166,734	(3,926)	(2.4)
Consumer	10,027	10,652	(625)	(5.9)
	746,164	753,579	(7,415)	(1.0)
Less: Allowance for loan losses	(10,943)	(10,379)	(564)	5.4
Net Loans	$ 735,221	$ 743,200	$(7,979)	(1.1)
Included in the loan balances are the following:				
Net unamortized deferred loan costs	$ 351	$ 456		
Unamortized discount on purchased loans	$ (123)	$ (129)		

Loans pledged as collateral for borrowings and commitments from:		
FHLB	$ 588,349	$ 657,684
Federal Reserve Bank	109,854	112,613
	$ 698,203	$ 770,297

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Note 7. Loan Quality

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

(Dollars in thousands)	Residential Real Estate 1-4 Family First Liens	Residential Real Estate 1-4 Family Junior Liens & Lines of Credit	Construction	Commercial Industrial & Agricultural Real Estate	Commercial Industrial & Agricultural	Consumer	Total
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
Allowance at December 31, 2011	$ 1,049	$ 308	$ 1,222	$ 5,257	$ 1,651	$ 236	$ 9,723
Charge-offs	(36)	(65)	-	(1,992)	(33)	(86)	(2,212)
Recoveries	-	-	-	8	2	36	46
Provision	(81)	68	(344)	2,519	(232)	20	1,950
Allowance at March 31, 2012	$ 932	$ 311	$ 878	$ 5,792	$ 1,388	$ 206	$ 9,507

The following table presents, by loan segment, loans that were evaluated for the ALL under the specific reserve (individually) and those that were evaluated under the general reserve (collectively) as of March 31, 2013 and December 31, 2012:

(Dollars in thousands)	Residential Real Estate 1-4 Family First Liens	Residential Real Estate 1-4 Family Junior Liens & Lines of Credit	Construction	Commercial Industrial & Agricultural Real Estate	Commercial Industrial & Agricultural	Consumer	Total
March 31, 2013							
Loans evaluated for allowance:							
Individually	$ 3,227	$ 429	$ 554	$ 31,481	$ 2,799	$ -	$ 38,490

Collectively	150,673	40,229	13,778	332,958	160,009	10,027	707,674
Total	$ 153,900	$ 40,658	$ 14,332	$ 364,439	$ 162,808	$ 10,027	$ 746,164
Allowance established for loans evaluated:							
Individually	$ 59	$ -	$ -	$ 354	$ 735	$ -	$ 1,148
Collectively	914	296	837	6,328	1,237	183	9,795
Allowance at March 31, 2013	$ 973	$ 296	$ 837	$ 6,682	$ 1,972	$ 183	$ 10,943
December 31, 2012							
Loans evaluated for allowance:							
Individually	$ 3,583	$ 692	$ 557	$ 30,949	$ 3,583	$ -	$ 39,364
Collectively	151,016	41,596	14,875	332,925	163,151	10,652	714,215
Total	$ 154,599	$ 42,288	$ 15,432	$ 363,874	$ 166,734	$ 10,652	$ 753,579
Allowance established for loans evaluated:							
Individually	$ 20	$ 3	$ -	$ 357	$ 467	$ -	$ 847
Collectively	893	303	899	6,093	1,153	191	9,532
Allowance at December 31, 2012	$ 913	$ 306	$ 899	$ 6,450	$ 1,620	$ 191	$ 10,379

The following table shows additional information about those loans considered to be impaired at March 31, 2013 and December 31, 2012:

(Dollars in thousands)	Impaired Loans With No Allowance		With Allowance		
	Recorded Investment	Unpaid Principal Balance	Recorded Investment	Unpaid Principal Balance	Related Allowance
March 31, 2013					
Residential Real Estate 1-4 Family					
First liens	$3,163	$3,216	$444	$ 607	$ 59
Junior liens and lines of credit	737	756	-	-	-
Total	3,900	3,972	444	607	59
Residential real estate - construction	554	566	-	-	-
Commercial, industrial and agricultural real estate	28,719	32,474	2,762	3,367	354
Commercial, industrial and agricultural	405	405	2,394	2,451	735
Consumer	-	-	-	-	-
Total	$33,578	$37,417	$5,600	$ 6,425	$ 1,148
December 31, 2012					
Residential Real Estate 1-4 Family					
First liens	$3,504	$3,715	$80	$80	$20
Junior liens and lines of credit	691	707	-	-	-
Total	4,195	4,422	80	80	20
Residential real estate - construction	557	567	-	-	-
Commercial, industrial and agricultural real estate	28,346	31,937	2,603	3,194	357
Commercial, industrial and agricultural	2,495	2,584	1,088	1,145	470
Consumer	-	-	-	-	-
Total	$35,593	$39,510	$3,771	$4,419	$847

The following table shows the average of impaired loans and related interest income for the three months ended March 31, 2013 and 2012:

(Dollars in thousands)	Three Months Ended March 31, 2013		Three Months Ended March 31, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	$3,626	$ 4	$4,600	$ 43
Junior liens and lines of credit	742	1	817	1
Total	4,368	5	5,417	44

Residential real estate - construction	556	-	9	-
Commercial, industrial and agricultural real estate	30,087	3	24,376	57
Commercial, industrial and agricultural	4,480	-	4,315	36
Consumer	-	-	-	-
Total	$39,491	$ 43	$34,117	$ 137

The following table presents a summary of nonperforming assets as of March 31, 2013 and December 31, 2012:

	March 31, 2013		December 31, 2012	
(Dollars in thousands)	Balance	% of Loan Segment	Balance	% of Loan Segment
Nonaccrual loans				
Residential Real Estate 1-4 Family				
First liens	$ 3,501	2.3	$ 3,584	2.3
Junior liens and lines of credit	705	1.7	758	1.8
Total	4,206	2.2	4,342	2.2
Residential real estate - construction	554	3.9	557	3.6
Commercial, industrial and agricultural real estate	26,760	7.3	28,659	7.9
Commercial, industrial and agricultural	2,800	1.7	2,836	1.7
Total nonaccrual loans	34,320		36,394	
Loans past due 90 days or more and not included above				
Residential Real Estate 1-4 Family				
First liens	51		120	
Junior liens and lines of credit	211		112	
Total	262		232	
Commercial, industrial and agricultural	62		315	
Consumer	14		16	
Total loans past due 90 days or more and still accruing	338		563	
Total nonaccrual and loans past due 90 days or more	34,658		36,957	
Other real estate owned	5,420		5,127	
Total nonperforming assets	$ 40,078		$ 42,084	

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