

FRANKLIN FINANCIAL SERVICES CORP /PA/

Form 10-Q

November 09, 2015

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, 2015

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

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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 4,261,022 outstanding shares of the Registrant’s common stock as of October 31, 2015.

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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)  | (unaudited)<br>September<br>30<br>2015 | December<br>31<br>2014 |
|---|--|------------------------|
| <b>Assets</b>   |  |                        |
| Cash and due from banks   | \$ 20,160                              | \$ 14,258              |
| Interest-bearing deposits in other banks  | 20,743                                 | 34,335                 |
| Total cash and cash equivalents   | 40,903                                 | 48,593                 |
| Investment securities available for sale, at fair value   | 169,516                                | 171,751                |
| Restricted stock  | 855                                    | 438                    |
| Loans held for sale   | 376                                    | 389                    |
| Loans   | 770,675                                | 726,531                |
| Allowance for loan losses   | (9,873)                                | (9,111)                |
| Net Loans   | 760,802                                | 717,420                |
| Premises and equipment, net   | 14,797                                 | 15,046                 |
| Bank owned life insurance   | 22,228                                 | 22,098                 |
| Goodwill  | 9,016                                  | 9,016                  |
| Other intangible assets   | -                                      | 181                    |
| Other real estate owned   | 6,807                                  | 3,666                  |
| Deferred tax asset, net   | 4,567                                  | 4,328                  |
| Other assets  | 6,456                                  | 8,522                  |
| Total assets  | \$ 1,036,323                           | \$ 1,001,448           |
| <b>Liabilities</b>  |  |                        |
| <b>Deposits</b>   |  |                        |
| Noninterest-bearing checking  | \$ 151,603                             | \$ 136,910             |
| Money management, savings and interest checking   | 676,339                                | 645,672                |
| Time  | 89,505                                 | 98,599                 |
| Total Deposits  | 917,447                                | 881,181                |
| Repurchase Agreements   | -                                      | 9,079                  |
| Short-Term Borrowings   | 3,500                                  | -                      |
| Other liabilities   | 5,263                                  | 7,667                  |
| Total liabilities   | 926,210                                | 897,927                |
| <b>Shareholders' equity</b>   |  |                        |
| Common stock, \$1 par value per share, 15,000,000 shares authorized with<br>4,643,172 shares issued and 4,259,732 shares outstanding at September 30, 2015 and<br>4,606,564 shares issued and 4,218,330 shares outstanding at December 31, 2014 | 4,643                                  | 4,607                  |

|   |              |              |
|---|--------------|--------------|
| Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding    | -            | -            |
| Additional paid-in capital  | 38,343       | 37,504       |
| Retained earnings   | 77,059       | 71,452       |
| Accumulated other comprehensive loss  | (3,076)      | (3,100)      |
| Treasury stock, 383,440 shares at September 30, 2015 and 388,234 shares at December 31, 2014, at cost | (6,856)      | (6,942)      |
| Total shareholders' equity  | 110,113      | 103,521      |
| Total liabilities and shareholders' equity  | \$ 1,036,323 | \$ 1,001,448 |

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 |              | For the Nine Months |              |
|---|---------------|--------------|---------------------|--------------|
|   | Months Ended  |              | Ended               |              |
|   | September 30  | September 30 | September 30        | September 30 |
|   | 2015          | 2014         | 2015                | 2014         |
| Interest income   |               |              |                     |              |
| Loans, including fees                                     | \$ 7,665      | \$ 7,706     | \$ 22,518           | \$ 22,865    |
| Interest and dividends on investments:                    |               |              |                     |              |
| Taxable interest  | 584           | 665          | 1,832               | 1,967        |
| Tax exempt interest                                       | 402           | 386          | 1,218               | 1,120        |
| Dividend income   | 3             | 24           | 63                  | 80           |
| Deposits and obligations of other banks                   | 66            | 49           | 192                 | 133          |
| Total interest income                                     | 8,720         | 8,830        | 25,823              | 26,165       |
| Interest expense  |               |              |                     |              |
| Deposits  | 554           | 679          | 1,813               | 2,076        |
| Securities sold under agreements to repurchase            | -             | 2            | -                   | 11           |
| Short-term borrowings                                     | 1             | -            | 1                   | -            |
| Long-term debt  | -             | 118          | -                   | 360          |
| Total interest expense                                    | 555           | 799          | 1,814               | 2,447        |
| Net interest income                                       | 8,165         | 8,031        | 24,009              | 23,718       |
| Provision for loan losses                                 | 400           | -            | 1,035               | 464          |
| Net interest income after provision for loan losses       | 7,765         | 8,031        | 22,974              | 23,254       |
| Noninterest income  |               |              |                     |              |
| Investment and trust services fees                        | 1,154         | 1,120        | 3,805               | 3,311        |
| Loan service charges                                      | 283           | 265          | 754                 | 682          |
| Mortgage banking activities                               | 5             | 15           | 30                  | 47           |
| Deposit service charges and fees                          | 623           | 563          | 1,700               | 1,553        |
| Other service charges and fees                            | 309           | 317          | 916                 | 901          |
| Debit card income   | 346           | 339          | 1,021               | 982          |
| Increase in cash surrender value of life insurance        | 137           | 139          | 416                 | 426          |
| Other real estate owned (losses) gains, net               | (250)         | -            | (218)               | (184)        |
| Other   | 126           | 30           | 363                 | 92           |
| OTTI losses recognized in earnings                        | -             | (20)         | (20)                | (20)         |
| Gain on conversion  | -             | -            | 728                 | -            |
| Securities gains, net                                     | -             | -            | 8                   | 221          |
| Total noninterest income                                  | 2,733         | 2,768        | 9,503               | 8,011        |
| Noninterest expense                                       |               |              |                     |              |
| Salaries and employee benefits                            | 4,214         | 4,191        | 12,500              | 12,548       |
| Net occupancy expense                                     | 535           | 555          | 1,706               | 1,817        |
| Furniture and equipment expense                           | 232           | 241          | 702                 | 732          |
| Advertising   | 336           | 312          | 807                 | 898          |
| Legal and professional fees                               | 311           | 361          | 811                 | 979          |
| Data processing   | 524           | 471          | 1,547               | 1,355        |
| Pennsylvania bank shares tax                              | 206           | 173          | 608                 | 520          |

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|                                    |          |          |          |          |
|------------------------------------|----------|----------|----------|----------|
| Intangible amortization            | -        | 104      | 181      | 311      |
| FDIC insurance                     | 170      | 236      | 479      | 690      |
| ATM/debit card processing          | 193      | 188      | 566      | 545      |
| Other                              | 892      | 916      | 2,855    | 2,656    |
| Total noninterest expense          | 7,613    | 7,748    | 22,762   | 23,051   |
| Income before federal income taxes | 2,885    | 3,051    | 9,715    | 8,214    |
| Federal income tax expense         | 306      | 641      | 1,778    | 1,659    |
| Net income                         | \$ 2,579 | \$ 2,410 | \$ 7,937 | \$ 6,555 |

Per share

|                            |         |         |         |         |
|----------------------------|---------|---------|---------|---------|
| Basic earnings per share   | \$ 0.61 | \$ 0.57 | \$ 1.87 | \$ 1.57 |
| Diluted earnings per share | \$ 0.61 | \$ 0.57 | \$ 1.87 | \$ 1.56 |
| Cash dividends declared    | \$ 0.19 | \$ 0.17 | \$ 0.55 | \$ 0.51 |

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

## Consolidated Statements of Comprehensive Income

| (Dollars in thousands) (unaudited)  | For the Three<br>Months Ended<br>September 30 |          | For the Nine<br>Months Ended<br>September 30 |          |
|---|---|----------|--|----------|
|   | 2015  | 2014     | 2015   | 2014     |
| Net Income  | \$ 2,579                                      | \$ 2,410 | \$ 7,937                                     | \$ 6,555 |
| Securities:   |   |          |  |          |
| Unrealized gains arising during the period                                | 1,097   | 275      | 561  | 2,469    |
| Reclassification adjustment for losses (gains) included in net income (1) | -   | 20       | (716)  | (201)    |
| Net unrealized gains (losses)   | 1,097   | 295      | (155)  | 2,268    |
| Tax effect  | (373)   | (100)    | 53   | (771)    |
| Net of tax amount   | 724   | 195      | (102)  | 1,497    |
| Derivatives:  |   |          |  |          |
| Unrealized gains (losses) arising during the period                       | -   | 2        | 31   | (10)     |
| Reclassification adjustment for losses included in net income (2)         | -   | 96       | 160  | 285      |
| Net unrealized gains  | -   | 98       | 191  | 275      |
| Tax effect  | -   | (34)     | (65)   | (94)     |
| Net of tax amount   | -   | 64       | 126  | 181      |
| Total other comprehensive income  | 724   | 259      | 24   | 1,678    |
| Total Comprehensive Income  | \$ 3,303                                      | \$ 2,669 | \$ 7,961                                     | \$ 8,233 |
| Reclassification adjustment / Statement line item                         | Tax expense (benefit)                         |          |  |          |
| (1) Securities / gain on conversion & securities (gains) losses, net      | \$ -  | \$ (7)   | \$ 243                                       | \$ 68    |
| (2) Derivatives / interest expense on deposits                            | -   | (33)     | (54)   | (97)     |

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



## Consolidated Statements of Changes in Shareholders' Equity

For the Nine months September 30, 2015 and 2014:

|   | Common   | Additional<br>Paid-in | Retained  | Accumulated<br>Other<br>Comprehensive | Treasury   | Total      |
|---|----------|-----------------------|-----------|---------------------------------------|------------|------------|
| (Dollars in thousands, except per share data) (unaudited)           | Stock    | Capital               | Earnings  | Loss                                  | Stock      | Total      |
| Balance at December 31, 2013  | \$ 4,561 | \$ 36,636             | \$ 65,897 | \$ (4,696)                            | \$ (7,010) | \$ 95,388  |
| Net income  | -        | -                     | 6,555     | -                                     | -          | 6,555      |
| Other comprehensive income  | -        | -                     | -         | 1,678                                 | -          | 1,678      |
| Cash dividends declared, \$.51 per share                            | -        | -                     | (2,132)   | -                                     | -          | (2,132)    |
| Treasury shares issued under stock option plans, 3,598 shares       | -        | (9)                   | -         | -                                     | 64         | 55         |
| Common stock issued under dividend reinvestment plan, 29,142 shares | 29       | 514                   | -         | -                                     | -          | 543        |
| Balance at September 30, 2014                                       | \$ 4,590 | \$ 37,141             | \$ 70,320 | \$ (3,018)                            | \$ (6,946) | \$ 102,087 |
| 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 |

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



## Consolidated Statements of Cash Flows

|   | Nine Months Ended<br>September 30 |          |
|---|-----------------------------------|----------|
|   | 2015                              | 2014     |
| (Dollars in thousands) (unaudited)  |                                   |          |
| Cash flows from operating activities  |                                   |          |
| Net income  | \$ 7,937                          | \$ 6,555 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |          |
| Depreciation and amortization   | 999                               | 1,078    |
| Net amortization of loans and investment securities                               | 1,248                             | 1,372    |
| Amortization and net change in mortgage servicing rights valuation                | 20                                | 12       |
| Amortization of intangibles   | 181                               | 311      |
| Provision for loan losses   | 1,035                             | 464      |
| Net realized gains on sales of securities   | (8)                               | (221)    |
| Impairment write-down on securities recognized in earnings                        | 20                                | 20       |
| Gain on conversion  | (728)                             | -        |
| Loans originated for sale   | (6,193)                           | (5,809)  |
| Proceeds from sale of loans   | 6,206                             | 4,825    |
| Write-down on premises and equipment  | 60                                | -        |
| Write-down of other real estate owned   | 250                               | 200      |
| Net gain on sale or disposal of other real estate/other repossessed assets        | (32)                              | (16)     |
| Increase in cash surrender value of life insurance                                | (416)                             | (426)    |
| Decrease (increase) in other assets   | 1,877                             | 236      |
| (Decrease) increase in other liabilities  | (2,497)                           | 1,259    |
| Net cash provided by operating activities   | 9,959                             | 9,860    |
| Cash flows from investing activities  |                                   |          |
| Proceeds from sales and calls of investment securities available for sale         | 1,381                             | 1,582    |
| Proceeds from maturities and pay-downs of securities available for sale           | 21,607                            | 19,998   |
| Purchase of investment securities available for sale                              | (21,689)                          | (36,956) |
| Net increase in restricted stock  | (417)                             | (32)     |
| Net increase in loans   | (47,110)                          | (8,509)  |
| Gain from surrender of life insurance policy                                      | (103)                             | -        |
| Capital expenditures  | (765)                             | (275)    |
| Proceeds from sale of other real estate/other repossessed assets                  | 129                               | 868      |
| Net cash used in investing activities   | (46,967)                          | (23,324) |
| Cash flows from financing activities  |                                   |          |
| Net increase in demand deposits, NOW, and savings accounts                        | 45,360                            | 64,267   |
| Net decrease in time deposits   | (9,094)                           | (11,126) |
| Net decrease in repurchase agreements   | (9,079)                           | (22,278) |
| Net increase in short-term borrowings   | 3,500                             | -        |
| Long-term debt payments   | -                                 | (403)    |
| Dividends paid  | (2,330)                           | (2,132)  |

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|  |           |           |
|--|-----------|-----------|
| Treasury stock issued under stock option plans       | 92        | 55        |
| Common stock issued under dividend reinvestment plan | 869       | 543       |
| Net cash provided by financing activities            | 29,318    | 28,926    |
| (Decrease) increase in cash and cash equivalents     | (7,690)   | 15,462    |
| Cash and cash equivalents as of January 1            | 48,593    | 40,745    |
| Cash and cash equivalents as of September 30         | \$ 40,903 | \$ 56,207 |
| Supplemental Disclosures of Cash Flow Information    |           |           |
| Cash paid during the year for:                       |           |           |
| Interest on deposits and other borrowed funds        | \$ 1,826  | \$ 2,434  |
| Income taxes   | \$ 2,514  | \$ 706    |
| Noncash Activities                                   |           |           |
| Loans transferred to Other Real Estate               | \$ 3,488  | \$ 82     |
| Fixed assets transferred to held for sale            | \$ 358    | \$ -      |

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, 2015, 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 2014 Annual Report on Form 10-K. The consolidated results of operations for the period ended September 30, 2015 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, 2014 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<br>Months Ended<br>September 30 |       | For the Nine<br>Months Ended<br>September 30 |       |
|--|---|-------|--|-------|
|  | 2015  | 2014  | 2015   | 2014  |
| (Dollars and shares in thousands, except per share data) |   |       |  |       |
| Weighted average shares outstanding (basic)              | 4,252   | 4,196 | 4,236  | 4,184 |
| Impact of common stock equivalents                       | 5   | 4     | 7  | 5     |
| Weighted average shares outstanding (diluted)            | 4,257   | 4,200 | 4,243  | 4,189 |

|   |          |          |          |          |
|---|----------|----------|----------|----------|
| Anti-dilutive options excluded from calculation | 26       | 34       | 27       | 45       |
| Net income                                      | \$ 2,579 | \$ 2,410 | \$ 7,937 | \$ 6,555 |
| Basic earnings per share                        | \$ 0.61  | \$ 0.57  | \$ 1.87  | \$ 1.57  |
| Diluted earnings per share                      | \$ 0.61  | \$ 0.57  | \$ 1.87  | \$ 1.56  |

## 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 was effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. ASU 2014-04 did not have a material effect on the Corporation’s 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.

### Note 3. Accumulated Other Comprehensive Loss

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

|  | September<br>30,<br>2015 | December<br>31,<br>2014 |
|--|--------------------------|-------------------------|
| (Dollars in thousands)                     |                          |                         |
| Net unrealized gains on securities         | \$ 2,197                 | \$ 2,352                |
| Tax effect                                 | (747)                    | (800)                   |
| Net of tax amount                          | 1,450                    | 1,552                   |
| Net unrealized losses on derivatives       | -                        | (191)                   |
| Tax effect                                 | -                        | 65                      |
| Net of tax amount                          | -                        | (126)                   |
| Accumulated pension adjustment             | (6,858)                  | (6,858)                 |
| Tax effect                                 | 2,332                    | 2,332                   |
| Net of tax amount                          | (4,526)                  | (4,526)                 |
| Total accumulated other comprehensive loss | \$ (3,076)               | \$ (3,100)              |

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 \$26.7 million and \$22.7 million of standby letters of credit as of September 30, 2015 and December 31, 2014, 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 September 30, 2015 and December 31, 2014 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 September 30, 2015 and December 31, 2014 are as follows:

| (Dollars in thousands)                   | Amortized  | Gross      | Gross      | Fair       |
|--|------------|------------|------------|------------|
| September 30, 2015                       | cost       | unrealized | unrealized | value      |
|  |            | gains      | losses     |            |
| Equity securities                        | \$ 164     | \$ 69      | \$ -       | \$ 233     |
| U.S. Government and Agency securities    | 15,820     | 243        | (24)       | 16,039     |
| Municipal securities                     | 69,537     | 1,700      | (246)      | 70,991     |
| Trust preferred securities               | 5,953      | -          | (515)      | 5,438      |
| Agency mortgage-backed securities        | 74,408     | 1,077      | (154)      | 75,331     |
| Private-label mortgage-backed securities | 1,397      | 49         | -          | 1,446      |
| Asset-backed securities                  | 40         | -          | (2)        | 38         |
|  | \$ 167,319 | \$ 3,138   | \$ (941)   | \$ 169,516 |

| (Dollars in thousands)                   | Amortized  | Gross      | Gross      | Fair       |
|--|------------|------------|------------|------------|
| December 31, 2014                        | cost       | unrealized | unrealized | value      |
|  |            | gains      | losses     |            |
| Equity securities                        | \$ 274     | \$ 779     | \$ -       | \$ 1,053   |
| U.S. Government and Agency securities    | 15,854     | 173        | (64)       | 15,963     |
| Municipal securities                     | 66,832     | 1,826      | (292)      | 68,366     |
| Trust preferred securities               | 5,940      | -          | (803)      | 5,137      |
| Agency mortgage-backed securities        | 78,779     | 932        | (217)      | 79,494     |
| Private-label mortgage-backed securities | 1,675      | 35         | (15)       | 1,695      |
| Asset-backed securities                  | 45         | -          | (2)        | 43         |
|  | \$ 169,399 | \$ 3,745   | \$ (1,393) | \$ 171,751 |

At September 30, 2015 and December 31, 2014, the fair value of investment securities pledged to secure public funds, trust balances, deposit and other obligations totaled \$79.6 million and \$91.6 million, respectively.



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The amortized cost and estimated fair value of debt securities at September 30, 2015, 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                | \$ 5,634   | \$ 5,677   |
| Due after one year through five years  | 11,690     | 11,959     |
| Due after five years through ten years | 29,254     | 30,048     |
| Due after ten years                    | 44,772     | 44,822     |
|  | 91,350     | 92,506     |
| Mortgage-backed securities             | 75,805     | 76,777     |
|  | \$ 167,155 | \$ 169,283 |

The following table provides additional detail about trust preferred securities as of September 30, 2015:

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 | \$ 964         | \$ 898     | \$ (66)                      | BB+                           |
| Wachovia Cap Trust II   | 1/15/2027  | Single                  | Preferred Stock | 278            | 257        | (21)                         | BBB                           |
| Huntington Cap Trust    | 2/1/2027   | Single                  | Preferred Stock | 942            | 840        | (102)                        | BB                            |
| Corestates Captl Tr II  | 2/15/2027  | Single                  | Preferred Stock | 938            | 856        | (82)                         | BBB+                          |
| Huntington Cap Trust II | 6/15/2028  | Single                  | Preferred Stock | 893            | 815        | (78)                         | BB+                           |
| Chase Cap VI JPM        | 8/1/2028   | Single                  | Preferred Stock | 963            | 850        | (113)                        | BBB-                          |
| Fleet Cap Tr V          | 12/18/2028 | Single                  | Preferred Stock | 975            | 922        | (53)                         | BB+                           |
|                         |            |                         |                 | \$ 5,953       | \$ 5,438   | \$ (515)                     |                               |

The following table provides additional detail about private label mortgage-backed securities as of September 30, 2015:

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 |
| RALI 2004-QS4 A7       | 3/1/2004    | \$ 17     | \$ 17    | \$ -                   | ALT A      | BBB+            | 11.85     | \$ -         |
| MALT 2004-6 7A1        | 6/1/2004    | 362       | 370      | 8                      | ALT A      | CCC             | 14.74     | -            |
| RALI 2005-QS2 A1       | 2/1/2005    | 215       | 229      | 14                     | ALT A      | CC              | 5.35      | 10           |
| RALI 2006-QS4 A2       | 4/1/2006    | 486       | 503      | 17                     | ALT A      | D               | -         | 313          |
| GSR 2006-5F 2A1        | 5/1/2006    | 63        | 71       | 8                      | Prime      | D               | -         | 15           |
| RALI 2006-QS8 A1       | 7/28/2006   | 254       | 256      | 2                      | ALT A      | D               | -         | 217          |
|                        |             | \$ 1,397  | \$ 1,446 | \$ 49                  |            |                 |           | \$ 555       |

Impairment:

The investment portfolio contained 72 securities with \$45.6 million of temporarily impaired fair value and \$941 thousand in unrealized losses at September 30, 2015. The total unrealized loss position has decreased from \$1.4 million at year-end 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 September 30, 2015, 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, 2015 and December 31, 2014:

| (Dollars in thousands)                | September 30, 2015 |                   |       | 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 | \$ 486             | \$ (1)            | 2     | \$ 4,435          | \$ (23)           | 10    | \$ 4,921   | \$ (24)           | 12    |
| Municipal securities                  | 9,802              | (111)             | 15    | 4,845             | (135)             | 7     | 14,647     | (246)             | 22    |
| Trust preferred securities            | -                  | -                 | -     | 5,438             | (515)             | 7     | 5,438      | (515)             | 7     |
| Agency mortgage-backed securities     | 15,603             | (74)              | 22    | 4,989             | (80)              | 8     | 20,592     | (154)             | 30    |
| Asset-backed securities               | -                  | -                 | -     | 5                 | (2)               | 1     | 5          | (2)               | 1     |
| Total temporarily impaired securities | \$ 25,891          | \$ (186)          | 39    | \$ 19,712         | \$ (755)          | 33    | \$ 45,603  | \$ (941)          | 72    |

| (Dollars in thousands)                | December 31, 2014 |                   |       | 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 | 4                 | -                 | 1     | 7,207             | (64)              | 14    | 7,211      | (64)              | 15    |
| Municipal securities                  | 5,651             | (33)              | 9     | 9,441             | (259)             | 14    | 15,092     | (292)             | 23    |
|                                       | -                 | -                 | -     | 5,137             | (803)             | 7     | 5,137      | (803)             | 7     |

|  |           |         |    |           |            |    |           |            |    |
|--|-----------|---------|----|-----------|------------|----|-----------|------------|----|
| Trust preferred securities               |           |         |    |           |            |    |           |            |    |
| Agency mortgage-backed securities        | 9,304     | (60)    | 13 | 8,199     | (157)      | 10 | 17,503    | (217)      | 23 |
| Private-label mortgage-backed securities | -         | -       | -  | 540       | (15)       | 1  | 540       | (15)       | 1  |
| Asset-backed securities                  | -         | -       | -  | 5         | (2)        | 1  | 5         | (2)        | 1  |
| Total temporarily impaired securities    | \$ 14,959 | \$ (93) | 23 | \$ 30,529 | \$ (1,300) | 47 | \$ 45,488 | \$ (1,393) | 70 |

The unrealized loss in the municipal bond portfolio decreased to \$246 thousand from \$604 thousand at June 30, 2015 as market prices improved during the quarter. The quarter end unrealized loss position in this sector is essentially unchanged from year-end 2014. There are 22 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 7 securities with a fair value of \$5.4 million and an unrealized loss of \$515 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, 2015, 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 private-label mortgage backed securities (PLMBS) sector shows a net unrealized gain \$49 thousand with all bonds showing an unrealized gain. Even though there is no unrealized loss, 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. As a result of the analysis on PLMBS it was determined that a \$20 thousand impairment charge was required at the end of the first quarter; however, no additional impairment charge was required at September 30, 2015. It is primarily a result of the cumulative OTTI charges that these bonds are showing an unrealized gain at quarter end. The Bank has recorded \$555 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 following table represents the cumulative credit losses on securities recognized in earnings as of September 30, 2015 and 2014.

| (Dollars in thousands)  | Nine Months Ended |        |
|---|-------------------|--------|
|   | 2015              | 2014   |
| Balance of cumulative credit-related OTTI at January 1  | \$ 535            | \$ 515 |
| Additions for credit-related OTTI not previously recognized   | 20                | -      |
| Additional increases for credit-related OTTI previously recognized when there is no intent to sell and no requirement to sell before recovery of amortized cost basis | -                 | -      |
| Decreases for previously recognized credit-related OTTI because there was an intent to sell   | -                 | -      |
| Reduction for increases in cash flows expected to be collected  | -                 | -      |
| Balance of credit-related OTTI at September 30  | \$ 555            | \$ 515 |

The composition of the net realized securities gains (losses) for the three and nine month periods ended are as follows:

| (Dollars in thousands) | For the Three Months Ended September 30 |      | For the Nine Months Ended September 30 |        |
|------------------------|---|------|--|--------|
|                        | 2015                                    | 2014 | 2015                                   | 2014   |
| Gross gains realized   | \$ -                                    | \$ - | \$ 8                                   | \$ 221 |
| Gross losses realized  | -                                       | -    | -                                      | -      |
| Conversion gain        | -                                       | -    | 728                                    | -      |
| Net gains realized     | \$ -                                    | \$ - | \$ 736                                 | \$ 221 |

The Bank held \$855 thousand of restricted stock at September 30, 2015. 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 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 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 primary collateral, at the end of the reporting periods is as follows:

| (Dollars in thousands)   |                       |                      | Change    |        |
|--|-----------------------|----------------------|-----------|--------|
|  | September<br>30, 2015 | December<br>31, 2014 | Amount    | %      |
| Residential Real Estate 1-4 Family                               |                       |                      |           |        |
| Consumer first liens   | \$ 104,881            | \$ 105,014           | \$ (133)  | (0.1)  |
| Commercial first lien  | 58,083                | 56,300               | 1,783     | 3.2    |
| Total first liens  | 162,964               | 161,314              | 1,650     | 1.0    |
| Consumer junior liens and lines of credit                        | 43,024                | 38,132               | 4,892     | 12.8   |
| Commercial junior liens and lines of credit                      | 6,014                 | 5,663                | 351       | 6.2    |
| Total junior liens and lines of credit                           | 49,038                | 43,795               | 5,243     | 12.0   |
| Total residential real estate 1-4 family                         | 212,002               | 205,109              | 6,893     | 3.4    |
| Residential real estate - construction                           |                       |                      |           |        |
| Consumer   | 890                   | 1,627                | (737)     | (45.3) |
| Commercial   | 7,155                 | 8,088                | (933)     | (11.5) |
| Total residential real estate construction                       | 8,045                 | 9,715                | (1,670)   | (17.2) |
| Commercial real estate   | 337,597               | 326,482              | 11,115    | 3.4    |
| Commercial   | 207,757               | 179,071              | 28,686    | 16.0   |
| Total commercial   | 545,354               | 505,553              | 39,801    | 7.9    |
| Consumer   | 5,274                 | 6,154                | (880)     | (14.3) |
|  | 770,675               | 726,531              | 44,144    | 6.1    |
| Less: Allowance for loan losses                                  | (9,873)               | (9,111)              | (762)     | (8.4)  |
| Net Loans  | \$ 760,802            | \$ 717,420           | \$ 43,382 | 6.0    |
| Included in the loan balances are the following:                 |                       |                      |           |        |
| Net unamortized deferred loan fees (costs)                       | \$ 318                | \$ (76)              |           |        |
| Loans pledged as collateral for borrowings and commitments from: |                       |                      |           |        |
| FHLB   | \$ 641,496            | \$ 602,633           |           |        |
| Federal Reserve Bank   | 48,554                | 56,367               |           |        |
|  | \$ 690,050            | \$ 659,000           |           |        |

At September 30, 2015, the Bank had \$61 thousand of residential properties in the process of foreclosure compared to \$763 thousand at the end of 2014.

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## Note 7. 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 |                      | Residential  |             | Commercial | Consumer | Total    |
|---------------------------------|-------------------------|----------------------|--------------|-------------|------------|----------|----------|
|                                 | 1-4 Family              | Junior Liens & Lines | Real Estate  | Commercial  |            |          |          |
|                                 | First Liens             | of Credit            | Construction | Real Estate | Commercial | Consumer | Total    |
| Allowance at June 30, 2015      | \$ 1,293                | \$ 359               | \$ 220       | \$ 5,686    | \$ 1,771   | \$ 121   | \$ 9,450 |
| Charge-offs                     | -                       | -                    | -            | -           | (51)       | (71)     | (122)    |
| Recoveries                      | 1                       | -                    | 18           | -           | 104        | 22       | 145      |
| Provision                       | (43)                    | 16                   | (29)         | 387         | 29         | 40       | 400      |
| Allowance at September 30, 2015 | \$ 1,251                | \$ 375               | \$ 209       | \$ 6,073    | \$ 1,853   | \$ 112   | \$ 9,873 |
| Allowance at December 31, 2014  | \$ 1,225                | \$ 334               | \$ 226       | \$ 5,417    | \$ 1,773   | \$ 136   | \$ 9,111 |
| Charge-offs                     | (43)                    | -                    | (21)         | -           | (269)      | (149)    | (482)    |
| Recoveries                      | 4                       | -                    | 18           | 14          | 118        | 55       | 209      |
| Provision                       | 65                      | 41                   | (14)         | 642         | 231        | 70       | 1,035    |
| Allowance at September 30, 2015 | \$ 1,251                | \$ 375               | \$ 209       | \$ 6,073    | \$ 1,853   | \$ 112   | \$ 9,873 |
| Allowance at June 30, 2014      | \$ 1,079                | \$ 266               | \$ 261       | \$ 5,412    | \$ 2,366   | \$ 135   | \$ 9,519 |
| Charge-offs                     | -                       | -                    | -            | -           | (611)      | (67)     | (678)    |
| Recoveries                      | 2                       | -                    | -            | 49          | 23         | 20       | 94       |
| Provision                       | 48                      | 56                   | (27)         | 33          | (149)      | 39       | -        |
| Allowance at September 30, 2014 | \$ 1,129                | \$ 322               | \$ 234       | \$ 5,494    | \$ 1,629   | \$ 127   | \$ 8,935 |
| Allowance at December 31, 2013  | \$ 1,108                | \$ 278               | \$ 291       | \$ 5,571    | \$ 2,306   | \$ 148   | \$ 9,702 |
| Charge-offs                     | (257)                   | -                    | (27)         | (348)       | (623)      | (147)    | (1,402)  |
| Recoveries                      | 5                       | -                    | -            | 49          | 56         | 61       | 171      |
| Provision                       | 273                     | 44                   | (30)         | 222         | (110)      | 65       | 464      |
| Allowance at September 30, 2014 | \$ 1,129                | \$ 322               | \$ 234       | \$ 5,494    | \$ 1,629   | \$ 127   | \$ 8,935 |



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, 2015 and December 31, 2014:

| (Dollars in thousands)                     | Residential Real Estate |                                | Residential              |             | Commercial | Consumer | Total      |
|--|-------------------------|--------------------------------|--------------------------|-------------|------------|----------|------------|
|  | 1-4 Family              | Junior Liens & Lines of Credit | Real Estate Construction | Real Estate |            |          |            |
| September 30, 2015                         |                         |                                |                          |             |            |          |            |
| Loans evaluated for allowance:             |                         |                                |                          |             |            |          |            |
| Individually                               | \$ 942                  | \$ 51                          | \$ 507                   | \$ 14,523   | \$ 231     | \$ -     | \$ 16,254  |
| Collectively                               | 162,022                 | 48,987                         | 7,538                    | 323,074     | 207,526    | 5,274    | 754,421    |
| Total                                      | \$ 162,964              | \$ 49,038                      | \$ 8,045                 | \$ 337,597  | \$ 207,757 | \$ 5,274 | \$ 770,675 |
| Allowance established for loans evaluated: |                         |                                |                          |             |            |          |            |
| Individually                               | \$ -                    | \$ -                           | \$ -                     | \$ -        | \$ 9       | \$ -     | \$ 9       |
| Collectively                               | 1,251                   | 375                            | 209                      | 6,073       | 1,844      | 112      | 9,864      |
| Allowance at September 30, 2015            | \$ 1,251                | \$ 375                         | \$ 209                   | \$ 6,073    | \$ 1,853   | \$ 112   | \$ 9,873   |
| December 31, 2014                          |                         |                                |                          |             |            |          |            |
| Loans evaluated for allowance:             |                         |                                |                          |             |            |          |            |
| Individually                               | \$ 1,171                | \$ 51                          | \$ 931                   | \$ 22,307   | \$ 1,298   | \$ -     | \$ 25,758  |
| Collectively                               | 160,143                 | 43,744                         | 8,784                    | 304,175     | 177,773    | 6,154    | 700,773    |
| Total                                      | \$ 161,314              | \$ 43,795                      | \$ 9,715                 | \$ 326,482  | \$ 179,071 | \$ 6,154 | \$ 726,531 |
| Allowance established for loans evaluated: |                         |                                |                          |             |            |          |            |
| Individually                               | \$ -                    | \$ -                           | \$ -                     | \$ 60       | \$ 171     | \$ -     | \$ 231     |
| Collectively                               | 1,225                   | 334                            | 226                      | 5,357       | 1,602      | 136      | 8,880      |
| Allowance at December 31, 2014             | \$ 1,225                | \$ 334                         | \$ 226                   | \$ 5,417    | \$ 1,773   | \$ 136   | \$ 9,111   |



The following table shows additional information about those loans considered to be impaired at September 30, 2015 and December 31, 2014:

| (Dollars in thousands)                 | Impaired Loans    |                     |                   |          |                   |
|--|-------------------|---------------------|-------------------|----------|-------------------|
|  | With No Allowance |                     | With Allowance    |          | Related Allowance |
|  | Unpaid            |                     | Unpaid            |          |                   |
| Recorded Investment                    | Principal Balance | Recorded Investment | Principal Balance |          |                   |
| September 30, 2015                     |                   |                     |                   |          |                   |
| Residential Real Estate 1-4 Family     |                   |                     |                   |          |                   |
| First liens                            | \$ 1,565          | \$ 1,763            | \$ -              | \$ -     | \$ -              |
| Junior liens and lines of credit       | 180               | 208                 | -                 | -        | -                 |
| Total                                  | 1,745             | 1,971               | -                 | -        | -                 |
| Residential real estate - construction | 507               | 548                 | -                 | -        | -                 |
| Commercial real estate                 | 14,645            | 15,185              | -                 | -        | -                 |
| Commercial                             | 364               | 427                 | 9                 | 10       | 9                 |
| Total                                  | \$ 17,261         | \$ 18,131           | \$ 9              | \$ 10    | \$ 9              |
| December 31, 2014                      |                   |                     |                   |          |                   |
| Residential Real Estate 1-4 Family     |                   |                     |                   |          |                   |
| First liens                            | \$ 1,804          | \$ 2,002            | \$ -              | \$ -     | \$ -              |
| Junior liens and lines of credit       | 169               | 195                 | -                 | -        | -                 |
| Total                                  | 1,973             | 2,197               | -                 | -        | -                 |
| Residential real estate - construction | 931               | 977                 | -                 | -        | -                 |
| Commercial real estate                 | 21,487            | 25,744              | 862               | 1,001    | 60                |
| Commercial                             | 78                | 80                  | 1,274             | 1,990    | 171               |
| Total                                  | \$ 24,469         | \$ 28,998           | \$ 2,136          | \$ 2,991 | \$ 231            |

The following table shows the average of impaired loans and related interest income for the three and nine months ended September 30, 2015 and 2014:

| (Dollars in thousands)                 | Three Months Ended<br>September 30, 2015 |                                  | Nine Months Ended<br>September 30, 2015 |                                  |
|--|--|----------------------------------|---|----------------------------------|
|  | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment       | Interest<br>Income<br>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                           |

| (Dollars in thousands)                 | Three Months Ended<br>September 30, 2014 |                                  | Nine Months Ended<br>September 30, 2014 |                                  |
|--|--|----------------------------------|---|----------------------------------|
|  | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized |
| Residential Real Estate 1-4 Family     |  |                                  |   |                                  |
| First liens                            | \$ 2,026                                 | \$ 11                            | \$ 2,666                                | \$ 35                            |
| Junior liens and lines of credit       | 131                                      | -                                | 127                                     | -                                |
| Total                                  | 2,157                                    | 11                               | 2,793                                   | 35                               |
| Residential real estate - construction | 1,155                                    | -                                | 739                                     | -                                |
| Commercial real estate                 | 20,488                                   | 83                               | 23,395                                  | 257                              |
| Commercial                             | 1,930                                    | -                                | 2,032                                   | 1                                |
| Total                                  | \$ 25,730                                | \$ 94                            | \$ 28,959                               | \$ 293                           |



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

| (Dollars in thousands)                 | Loans Past Due and Still Accruing |               |               |             |          |             | Total<br>Loans |
|--|-----------------------------------|---------------|---------------|-------------|----------|-------------|----------------|
|  | Current                           | 30-59<br>Days | 60-89<br>Days | 90<br>Days+ | Total    | Non-Accrual |                |
| September 30, 2015                     |                                   |               |               |             |          |             |                |
| Residential Real Estate 1-4 Family     |                                   |               |               |             |          |             |                |
| First liens                            | \$ 161,123                        | \$ 429        | \$ 123        | \$ 427      | \$ 979   | \$ 862      | \$ 162,964     |
| Junior liens and lines of credit       | 48,764                            | 50            | 44            | 64          | 158      | 116         | 49,038         |
| Total                                  | 209,887                           | 479           | 167           | 491         | 1,137    | 978         | 212,002        |
| Residential real estate - construction | 7,538                             | -             | -             | -           | -        | 507         | 8,045          |
| Commercial real estate                 | 327,850                           | 5,837         | 99            | -           | 5,936    | 3,811       | 337,597        |
| Commercial                             | 207,113                           | 141           | 130           | -           | 271      | 373         | 207,757        |
| Consumer                               | 5,230                             | 27            | 14            | 3           | 44       | -           | 5,274          |
| Total                                  | \$ 757,618                        | \$ 6,484      | \$ 410        | \$ 494      | \$ 7,388 | \$ 5,669    | \$ 770,675     |

December 31, 2014

|  |            |          |        |        |          |           |            |
|--|------------|----------|--------|--------|----------|-----------|------------|
| Residential Real Estate 1-4 Family     |            |          |        |        |          |           |            |
| First liens                            | \$ 158,197 | \$ 1,531 | \$ 297 | \$ 165 | \$ 1,993 | \$ 1,124  | \$ 161,314 |
| Junior liens and lines of credit       | 43,424     | 174      | 28     | -      | 202      | 169       | 43,795     |
| Total                                  | 201,621    | 1,705    | 325    | 165    | 2,195    | 1,293     | 205,109    |
| Residential real estate - construction | 8,784      | -        | -      | -      | -        | 931       | 9,715      |
| Commercial real estate                 | 317,576    | 336      | -      | 140    | 476      | 8,430     | 326,482    |
| Commercial                             | 177,407    | 12       | 15     | -      | 27       | 1,637     | 179,071    |
| Consumer                               | 6,056      | 59       | 22     | 17     | 98       | -         | 6,154      |
| Total                                  | \$ 711,444 | \$ 2,112 | \$ 362 | \$ 322 | \$ 2,796 | \$ 12,291 | \$ 726,531 |

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       | Special<br>Mention | Substandard | Doubtful | Total      |
|--|------------|--------------------|-------------|----------|------------|
| September 30, 2015                     |            |                    |             |          |            |
| Residential Real Estate 1-4 Family     |            |                    |             |          |            |
| First liens                            | \$ 159,117 | \$ 2,182           | \$ 1,665    | \$ -     | \$ 162,964 |
| Junior liens and lines of credit       | 48,698     | 28                 | 312         | -        | 49,038     |
| Total                                  | 207,815    | 2,210              | 1,977       | -        | 212,002    |
| Residential real estate - construction | 7,538      | -                  | 507         | -        | 8,045      |
| Commercial real estate                 | 316,439    | 5,829              | 15,329      | -        | 337,597    |
| Commercial                             | 203,881    | 2,532              | 1,344       | -        | 207,757    |
| Consumer                               | 5,271      | -                  | 3           | -        | 5,274      |
| Total                                  | \$ 740,944 | \$ 10,571          | \$ 19,160   | \$ -     | \$ 770,675 |

|  |            |           |           |      |            |
|--|------------|-----------|-----------|------|------------|
| December 31, 2014                      |            |           |           |      |            |
| Residential Real Estate 1-4 Family     |            |           |           |      |            |
| First liens                            | \$ 155,676 | \$ 1,919  | \$ 3,719  | \$ - | \$ 161,314 |
| Junior liens and lines of credit       | 43,559     | 29        | 207       | -    | 43,795     |
| Total                                  | 199,235    | 1,948     | 3,926     | -    | 205,109    |
| Residential real estate - construction | 8,784      | -         | 931       | -    | 9,715      |
| Commercial real estate                 | 301,149    | 10,578    | 14,755    | -    | 326,482    |
| Commercial                             | 170,774    | 5,413     | 2,884     | -    | 179,071    |
| Consumer                               | 6,137      | -         | 17        | -    | 6,154      |
| Total                                  | \$ 686,079 | \$ 17,939 | \$ 22,513 | \$ - | \$ 726,531 |

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, 2015                     |                              |                     |             |                |  |                     |
| Residential real estate - construction | 1                            | \$ 507              | \$ 507      | \$ -           | -  | \$ -                |
| Residential real estate                | 4                            | 657                 | 657         | -              | -  | -                   |
| Commercial real estate                 | 10                           | 12,231              | 12,231      | -              | -  | -                   |
| Total                                  | 15                           | \$ 13,395           | \$ 13,395   | \$ 0           | -  | \$ -                |
| December 31, 2014                      |                              |                     |             |                |  |                     |
| Residential real estate - construction | 1                            | \$ 521              | \$ -        | \$ 521         | -  | \$ -                |
| Residential real estate                | 5                            | 699                 | 673         | 26             | -  | -                   |
| Commercial real estate                 | 12                           | 15,748              | 14,283      | 1,465          | -  | -                   |
| Total                                  | 18                           | \$ 16,968           | \$ 14,956   | \$ 2,012       | -  | \$ -                |

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

There were no new TDR loans made in the first nine months of 2015 or 2014.

#### Note 8. Pension

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

| (Dollars in thousands)           | Three Months Ended |                   | Nine Months Ended |                   |
|----------------------------------|--------------------|-------------------|-------------------|-------------------|
|                                  | September 30 2015  | September 30 2014 | September 30 2015 | September 30 2014 |
| Components of net periodic cost: |                    |                   |                   |                   |
| Service cost                     | \$ 92              | \$ 84             | \$ 284            | \$ 253            |
| Interest cost                    | 172                | 194               | 522               | 585               |

|                                |       |       |        |        |
|--------------------------------|-------|-------|--------|--------|
| Expected return on plan assets | (296) | (291) | (888)  | (872)  |
| Recognized net actuarial loss  | 123   | 80    | 377    | 243    |
| Net period cost                | \$ 91 | \$ 67 | \$ 295 | \$ 209 |

The Bank expects its pension expense to increase to approximately \$387 thousand in 2015 compared to \$276 thousand in 2014. No pension contributions were made or are expected to be made in 2015.

In October, 2014, the Society of Actuaries released new mortality tables for pension plans. The new tables are expected to raise the assumed life of plan participants due to refinements in age and gender distribution of participants. This change is expected to result in higher pension contribution requirements, lower balance sheet funded status, pricier lump-sum payouts, and higher PBGC variable rate premiums. The Bank has not adopted the new mortality tables. If the tables had been adopted at year-end 2014, it is estimated that the new tables would reduce the funded status by \$1.6 million and increase the 2015 pension expense by \$272 thousand over the current 2015 estimate. The Bank is still in the process of reviewing the effect of the new tables and is also watching the IRS for its decision on adoption of the new table. Therefore an adoption date for the new tables has not been determined.

#### 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 may be 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, 2015 and December 31, 2014.

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, Short-term borrowings 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 and 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.

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:

| (Dollars in thousands)                   | September 30, 2015 |            | Level 1   | Level 2    | Level 3 |
|--|--------------------|------------|-----------|------------|---------|
|  | Carrying Amount    | Fair Value |           |            |         |
| <b>Financial assets:</b>                 |                    |            |           |            |         |
| Cash and cash equivalents                | \$ 40,903          | \$ 40,903  | \$ 40,903 | \$ -       | \$ -    |
| Investment securities available for sale | 169,516            | 169,516    | 233       | 169,283    | -       |
| Restricted stock                         | 855                | 855        | -         | 855        | -       |
| Loans held for sale                      | 376                | 376        | -         | 376        | -       |
| Net loans                                | 760,802            | 767,824    | -         | -          | 767,824 |
| Accrued interest receivable              | 2,998              | 2,998      | -         | 2,998      | -       |
| <b>Financial liabilities:</b>            |                    |            |           |            |         |
| Deposits                                 | \$ 917,447         | \$ 917,402 | \$ -      | \$ 917,402 | \$ -    |
| Short-term borrowings                    | 3,500              | 3,500      | -         | 3,500      | -       |
| Accrued interest payable                 | 157                | 157        | -         | 157        | -       |
| <br>                                     |                    |            |           |            |         |
| <b>December 31, 2014</b>                 |                    |            |           |            |         |
| (Dollars in thousands)                   | Carrying           | Fair       | Level 1   | Level 2    | Level 3 |
|  | Amount             | Value      |           |            |         |
| <b>Financial assets:</b>                 |                    |            |           |            |         |
| Cash and cash equivalents                | \$ 48,593          | \$ 48,593  | \$ 48,593 | \$ -       | \$ -    |
| Investment securities available for sale | 171,751            | 171,751    | 1,053     | 170,698    | -       |
| Restricted stock                         | 438                | 438        | -         | 438        | -       |
| Loans held for sale                      | 389                | 389        | -         | 389        | -       |

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|  |            |            |      |            |         |
|--|------------|------------|------|------------|---------|
| Net loans                                      | 717,420    | 721,680    | -    | -          | 721,680 |
| Accrued interest receivable                    | 3,038      | 3,038      | -    | 3,038      | -       |
| Mortgage servicing rights                      | 143        | 143        | -    | -          | 143     |
| Financial liabilities:                         |            |            |      |            |         |
| Deposits                                       | \$ 881,181 | \$ 881,289 | \$ - | \$ 881,289 | \$ -    |
| Securities sold under agreements to repurchase | 9,079      | 9,079      | -    | 9,079      | -       |
| Accrued interest payable                       | 169        | 169        | -    | 169        | -       |
| Interest rate swaps                            | 191        | 191        | -    | 191        | -       |

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## 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, 2015 and December 31, 2014 are as follows:

| (Dollars in Thousands)                   | Fair Value at September 30, 2015 |            |         |            |
|--|----------------------------------|------------|---------|------------|
|  | Level 1                          | Level 2    | Level 3 | Total      |
| Asset Description                        |                                  |            |         |            |
| Equity securities                        | \$ 233                           | \$ -       | \$ -    | \$ 233     |
| U.S. Government and Agency securities    | -                                | 16,039     | -       | 16,039     |
| Municipal securities                     | -                                | 70,991     | -       | 70,991     |
| Trust Preferred Securities               | -                                | 5,438      | -       | 5,438      |
| Agency mortgage-backed securities        | -                                | 75,331     | -       | 75,331     |
| Private-label mortgage-backed securities | -                                | 1,446      | -       | 1,446      |
| Asset-backed securities                  | -                                | 38         | -       | 38         |
| Total assets                             | \$ 233                           | \$ 169,283 | \$ -    | \$ 169,516 |

| (Dollars in Thousands)                   | Fair Value at December 31, 2014 |            |         |            |
|--|---------------------------------|------------|---------|------------|
|  | Level 1                         | Level 2    | Level 3 | Total      |
| Asset Description                        |                                 |            |         |            |
| Equity securities                        | \$ 1,053                        | \$ -       | \$ -    | \$ 1,053   |
| U.S. Government and Agency securities    | -                               | 15,963     | -       | 15,963     |
| Municipal securities                     | -                               | 68,366     | -       | 68,366     |
| Trust Preferred Securities               | -                               | 5,137      | -       | 5,137      |
| Agency mortgage-backed securities        | -                               | 79,494     | -       | 79,494     |
| Private-label mortgage-backed securities | -                               | 1,695      | -       | 1,695      |
| Asset-backed securities                  | -                               | 43         | -       | 43         |
| Total assets                             | \$ 1,053                        | \$ 170,698 | \$ -    | \$ 171,751 |
| Liability Description                    |                                 |            |         |            |
| Interest rate swaps                      | \$ -                            | \$ 191     | \$ -    | \$ 191     |
| Total liabilities                        | \$ -                            | \$ 191     | \$ -    | \$ 191     |

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.

Interest rate swaps: The interest rate swaps are valued using a discounted cash flow model that uses verifiable market environment inputs to calculate the fair value. This method is not dependent on the input of any significant judgments or assumptions by Management.

## 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, 2015 and December 31, 2014 are as follows:

(Dollars in Thousands)

| Asset Description           | Fair Value at September 30,<br>2015 |         |          | Total    |
|-----------------------------|-------------------------------------|---------|----------|----------|
|                             | Level 1                             | Level 2 | Level 3  |          |
|                             | Impaired loans (1)                  | \$ -    | \$ -     |          |
| Premises held-for-sale (1)  | -                                   | -       | 225      | 225      |
| Other real estate owned (1) | -                                   | -       | 5,996    | 5,996    |
| Total assets                | \$ -                                | \$ -    | \$ 6,221 | \$ 6,221 |

| Asset Description           | Fair Value at December 31,<br>2014 |         |          | Total    |
|-----------------------------|------------------------------------|---------|----------|----------|
|                             | Level 1                            | Level 2 | Level 3  |          |
|                             | Impaired loans (1)                 | \$ -    | \$ -     |          |
| Other real estate owned (1) | -                                  | -       | 760      | 760      |
| Mortgage servicing rights   | -                                  | -       | 143      | 143      |
| Total assets                | \$ -                               | \$ -    | \$ 4,372 | \$ 4,372 |

(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.

**Mortgage servicing rights:** The fair value of mortgage servicing rights, upon initial recognition, is estimated using a valuation model that calculates the present value of estimated future net servicing income. The model incorporates Level 3 assumptions such as cost to service, discount rate, prepayment speeds, default rates and losses.

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, 2015. 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, 2015.

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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, 2015  |            |                             |  |                                  |
| (Dollars in Thousands)   |            |                             |  |                                  |
| Asset Description  | Fair Value | Valuation Technique         | Unobservable Input<br>Appraisal Adjustments  | Range<br>(Weighted<br>Average)   |
| Premises held-for-sale (1)                                     | \$ 225     | Appraisal                   | (2)  | -                                |
| Other real estate owned (1)                                    | 5,996      | Appraisal                   | Appraisal Adjustments<br>(2)<br>Cost to sell | -<br>8% (8%)                     |
| at December 31, 2014   |            |                             |  |                                  |
| Impaired loans (1)   | \$ 3,469   | Appraisal                   | Appraisal Adjustments<br>(2)<br>Cost to sell | 0% - 100% (26%)<br>0% - 10% (5%) |
| Other real estate owned (1)                                    | 760        | Appraisal                   | Appraisal Adjustments<br>(2)<br>Cost to sell | 8% (8%)                          |
| Mortgage servicing rights                                      | 143        | Discounted Cash Flow<br>(3) |  |                                  |

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

(2) Qualitative adjustments are discounts specific to each asset and are made as needed.

(3) Valuation and inputs are determined by a third-party pricing service without adjustment.

Note 10. Financial Derivatives

The Board of Directors has given Management authorization to enter into additional 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. Management anticipates continuing to use derivatives, as permitted by its Board-approved policy, to manage interest rate risk.

Fair Value of Derivative Instruments in the Consolidated Balance Sheets was as follows as of September 30, 2015 and December 31, 2014:

Fair Value of Derivative Instruments  
(Dollars in thousands)

|                    |                         | Balance Sheet     |            |
|--------------------|-------------------------|-------------------|------------|
| Date               | Type                    | Location          | Fair Value |
| September 30, 2015 | Interest rate contracts | Other liabilities | \$ -       |
| December 31, 2014  | Interest rate contracts | Other liabilities | \$ 191     |

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The Effect of Derivative Instruments on the Statement of Income for the Three and Nine Months Ended September 30, 2015 and 2014 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships

| (Dollars in thousands)  |  |   |   | Location of<br>Gain or (Loss)<br>Recognized in   | Amount of<br>Gain<br>or (Loss)<br>Recognized in<br>Income on  |
|-------------------------|--|---|---|--|---|
| Date / Type             | Amount of<br>Gain<br>or (Loss)<br>Recognized<br>in OCI<br>net of tax<br>on<br>Derivative<br>(Effective<br>Portion) | Location of<br>Gain or (Loss)<br>Reclassified from<br>Accumulated OCI<br>into Income<br>(Effective Portion) | Amount of<br>Gain<br>or (Loss)<br>Reclassified<br>from<br>Accumulated<br>OCI<br>into Income<br>(Effective<br>Portion) | Income on<br>Derivative (Ineffective<br>Portion and Amount<br>Excluded from<br>Effectiveness<br>Testing) | Derivatives<br>(Ineffective<br>Portion<br>and Amount<br>Excluded<br>from<br>Effectiveness<br>Testing) |
| Interest rate contracts |  |   |   |  |   |
| Three months ended:     |  |   |   |  |   |
| September 30, 2015      | \$ -   | Interest Expense  | \$ -  | Other income (expense)   | \$ -  |
| September 30, 2014      | \$ 64  | Interest Expense  | \$ (96)   | Other income (expense)   | \$ -  |
| Nine months ended:      |  |   |   |  |   |
| September 30, 2015      | \$ 126   | Interest Expense  | \$ (160)  | Other income (expense)   | \$ -  |
| September 30, 2014      | \$ 181   | Interest Expense  | \$ (285)  | Other income (expense)   | \$ -  |

Interest Rate Swap Agreements (“Swap Agreements”)

As of September 30, 2015, 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.

Securities Sold Under Agreements to Repurchase (“Repurchase Agreements”)

As of September 30, 2015, the Bank had no repurchase agreements outstanding. The Bank entered into agreements under which it sold securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Bank may have transferred legal control over the assets but still retained effective control through an agreement that both entitled and obligated the Bank to repurchase the agreements. As a result, these repurchase agreements were accounted for as collateralized financing arrangements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities was reflected as a liability in the Corporation's consolidated statements of condition, while the securities underlying the repurchase agreements remained in the respective investment securities asset accounts. In other words, there was no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Bank did not enter into reverse repurchase agreements, there was no such offsetting to be done with repurchase agreements.



The following table presents the liabilities subject to an enforceable master netting arrangement or repurchase agreements as of September 30, 2015 and December 31, 2014. As of these dates, all of the Bank's swap agreement with an institutional counterparty was in a liability position. Therefore, there were no assets to be recognized in the consolidated statements of condition. The Bank has no swap agreements with our commercial banking customers.

|   | Gross<br>Amounts of<br>Recognized<br>Liabilities | Gross<br>Amounts<br>Offset in the<br>Statements<br>of<br>Condition | Net Amounts<br>of Liabilities<br>Presented in<br>the<br>Statements of<br>Condition | Gross Amounts Not Offset in the<br>Statements of Condition |                               |               |
|---|--|--|--|--|-------------------------------|---------------|
|   |  |  |  | Financial<br>Instruments                                   | Cash<br>Collateral<br>Pledged | Net<br>Amount |
| (Dollars in<br>thousands)<br>Interest Rate Swap<br>Agreements |  |  |  |  |                               |               |
| September 30, 2015  | \$ -   | \$ -   | \$ -   | \$ -   | \$ -                          | \$ -          |
| December 31, 2014   | 191  | -  | 191  | 191  | -                             | -             |

#### 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 U.S. Banks, generally referred to as "Basel III." Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those in place at the end of 2014. The capital ratios to be considered "well capitalized" under Basel III are: common equity tier 1 of 6.5%, Tier 1 leverage of 5%, Tier 1 risk-based capital of 8%, and Total Risk-Based capital of 10%. The common equity tier 1 ratio is a new capital ratio under Basel III. Common equity consists of common stock, additional paid-in capital and retained earnings. The Tier 1 risk-based capital ratio of 8% has been increased from 6%. The new rule also includes a provision for banks to make a one-time irrevocable choice to exclude accumulated other comprehensive income (AOCI) from its common equity Tier 1 capital. The Bank elected to exclude AOCI from the capital calculation with its March 31, 2015 regulatory filing. In addition, a capital conservation buffer will be required to be maintained above the minimum capital ratios to avoid any capital distribution restrictions. The capital conservation buffer will be phased in from 0% in 2015 to 2.5% in 2019. The Basel III capital rules took effect for the Corporation and the Bank on January 1, 2015. At September 30, 2015, the Corporation and the Bank were both well capitalized as defined by

the banking regulatory agencies.

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The following table summarizes regulatory capital information as of September 30, 2015 and December 31, 2014 on a consolidated basis and for the Bank, as defined. Regulatory capital ratios for September 30, 2015 were calculated in accordance with the Basel III rules, whereas the December 31, 2014 regulatory ratios were calculated in accordance with Basel I rules. The minimum regulatory ratios shown below define capital levels under Basel III rules.

| (Dollars in thousands)                                   | September 30,<br>2015 | December 31,<br>2014 | Regulatory Ratios                    |                                |
|--|-----------------------|----------------------|--------------------------------------|--------------------------------|
|  |                       |                      | Adequately<br>Capitalized<br>Minimum | Well<br>Capitalized<br>Minimum |
| <b>Common Equity Tier 1 Risk-based Capital Ratio (1)</b> |                       |                      |                                      |                                |
| Franklin Financial Services Corporation                  | 14.44%                | N/A                  | 4.50%                                | N/A                            |
| Farmers & Merchants Trust Company                        | 14.40%                | N/A                  | 4.50%                                | 6.50%                          |
| <b>Tier 1 Risk-based Capital Ratio (2)</b>               |                       |                      |                                      |                                |
| Franklin Financial Services Corporation                  | 14.44%                | 14.19%               | 6.00%                                | N/A                            |
| Farmers & Merchants Trust Company                        | 14.40%                | 13.96%               | 6.00%                                | 8.00%                          |
| <b>Total Risk-based Capital Ratio (3)</b>                |                       |                      |                                      |                                |
| Franklin Financial Services Corporation                  | 15.69%                | 15.49%               | 8.00%                                | N/A                            |
| Farmers & Merchants Trust Company                        | 15.66%                | 15.26%               | 8.00%                                | 10.00%                         |
| <b>Tier 1 Leverage Ratio (4)</b>                         |                       |                      |                                      |                                |
| Franklin Financial Services Corporation                  | 10.33%                | 9.69%                | 4.00%                                | N/A                            |
| Farmers & Merchants Trust Company                        | 10.17%                | 9.55%                | 4.00%                                | 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

1Note 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.



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

For the Three and Nine Months Ended September 30, 2015 and 2014

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 to include Allowance for Loan Losses, Other Than Temporary Investment Impairment, Goodwill, Deferred Taxes, Fair Value Measurements and Stock-based Compensation. There were no changes to the critical accounting policies disclosed in the 2014 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 2014 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, 2015, total assets were \$1.036 billion, an increase of \$34.9 million from December 31, 2014. Net loans increased to \$760.8 million and total deposits increased to \$917.4 million. The Corporation reported net income for the first nine months of 2015 of \$7.9 million. This is a 21.1% increase versus net income of \$6.6 million for the same period in 2014. Net income for 2015 was enhanced by two nonrecurring events that increased noninterest income by \$899 thousand. These events included a gain of \$171 thousand from the liquidation of an off-shore insurance company in which the Bank held an ownership interest and a \$728 thousand gain on the conversion of equity securities held by the Bank as the result of an acquisition. Without these events, net income for the first nine months would have been \$7.3 million, a 12% increase over the prior year. Total revenue (interest income and noninterest income) increased \$1.2 million year-over-year boosted by these nonrecurring items. Interest income decreased \$342 thousand, while interest expense decreased by \$633 thousand, resulting in a \$291 thousand increase

in net interest income. The provision for loan losses was \$1.0 million for the period, \$571 thousand more than in 2014. Noninterest income increased \$1.5 million, while noninterest expense decreased \$289 thousand. Income tax expense increased from \$1.7 million in 2014 to \$1.8 million in 2015. The effective tax rate decreased from 20.2% in 2014 to 18.3% in 2015 due to a partial reversal of approximately \$250 thousand of the valuation allowance on deferred tax assets due to the gain on conversion taken in 2015. Diluted earnings per share increased to \$1.87 in 2015 from \$1.56 in 2014.

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Key performance ratios as of, or for the nine months ended September 30, 2015 and 2014 and the year ended December 31, 2014 are listed below:

|  | September<br>30,<br>2015 | December<br>31,<br>2014 | September<br>30,<br>2014 |
|--|--------------------------|-------------------------|--------------------------|
| Performance measurements                   |                          |                         |                          |
| Return on average assets*                  | 1.04%                    | 0.83%                   | 0.86%                    |
| Return on average equity*                  | 10.00%                   | 8.44%                   | 8.90%                    |
| Net interest margin*                       | 3.59%                    | 3.56%                   | 3.56%                    |
| Current dividend yield*                    | 3.32%                    | 3.09%                   | 3.24%                    |
| Dividend payout ratio                      | 29.36%                   | 33.88%                  | 32.52%                   |
| Shareholders' Value (per common share)     |                          |                         |                          |
| Diluted earnings per share                 | \$ 1.87                  | \$ 2.00                 | \$ 1.56                  |
| Basic earnings per share                   | 1.87                     | 2.01                    | 1.57                     |
| Regular cash dividends paid                | 0.55                     | 0.68                    | 0.51                     |
| Book value                                 | 25.85                    | 24.54                   | 24.3                     |
| Market value                               | 22.90                    | 22.00                   | 21.00                    |
| Market value/book value ratio              | 88.59%                   | 89.65%                  | 86.42%                   |
| Price/earnings multiple*                   | 9.20                     | 11.00                   | 10.10                    |
| Safety and Soundness                       |                          |                         |                          |
| Risk-based capital ratio (Total)           | 15.69%                   | 15.49%                  | 15.04%                   |
| Leverage ratio (Tier 1)                    | 10.33%                   | 9.69%                   | 9.51%                    |
| Common equity ratio (Tier 1)               | 14.44%                   | -                       | -                        |
| Nonperforming loans/gross loans            | 0.80%                    | 1.74%                   | 2.59%                    |
| Nonperforming assets/total assets          | 1.25%                    | 1.63%                   | 2.21%                    |
| Allowance for loan losses as a % of loans  | 1.28%                    | 1.25%                   | 1.22%                    |
| Net charge-offs/average loans*             | 0.05%                    | 0.19%                   | 0.22%                    |
| Trust assets under management (fair value) | \$ 569,484               | \$ 605,796              | \$ 594,046               |

\* Annualized

Comparison of the three months ended September 30, 2015 to the three months ended September 30, 2014:

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, securities sold under agreements to repurchase (Repos), 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 for the third quarter of 2015 increased \$119 thousand quarter over quarter. Average interest-earning assets increased \$10.4 million from 2014, but the yield on these assets decreased to 3.80% from 3.89% in 2014. The average balance of investment securities decreased \$5.0 million while average loans increased \$19.3 million quarter over quarter. Average commercial loans increased \$17.0 million and average consumer loans increased \$3.9 million. These increases were partially offset by a decrease of \$1.7 million in the average balance of mortgage loans.

Interest expense was \$555 thousand for the third quarter, a decrease of \$244 thousand from the 2014 total of \$799 thousand. Average interest-bearing liabilities decreased \$9.9 million to \$769.2 million for 2015 from an average balance of \$779.1 million in 2014. The average cost of these liabilities decreased from 0.41% in 2014 to 0.29% in 2015. Average interest-bearing deposits increased \$5.0 million and the cost of these deposits decreased from 0.35% to 0.29%. The securities sold under agreements to repurchase (Repo) accounts were closed out in 2014 and transferred to other products. All long-term debt was paid off in 2014.



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The changes in the balance sheet and interest rates resulted in an increase in tax equivalent net interest income of \$119 thousand to \$8.7 million in 2015 compared to \$8.5 million in 2014. The increase in net interest income was due to a \$243 thousand increase from higher volume offset by a \$124 thousand decrease due to changes in rates.

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,<br>2015 |                         |                       | 2014               |                         |                       |
|--|--|-------------------------|-----------------------|--------------------|-------------------------|-----------------------|
|  | Average<br>balance                               | Income<br>or<br>expense | Average<br>yield/rate | Average<br>balance | Income<br>or<br>expense | Average<br>yield/rate |
| <b>Interest-earning assets:</b>                                    |  |                         |                       |                    |                         |                       |
| Interest-bearing obligations of other banks and federal funds sold | \$ 37,098  | \$ 66                   | 0.71%                 | \$ 40,881          | \$ 49                   | 0.48%                 |
| <b>Investment securities:</b>                                      |  |                         |                       |                    |                         |                       |
| Taxable  | 118,218  | 587                     | 1.97%                 | 129,489            | 689                     | 2.11%                 |
| Tax Exempt   | 55,388   | 603                     | 4.36%                 | 49,160             | 579                     | 4.71%                 |
| Investments  | 173,606  | 1,190                   | 2.72%                 | 178,649            | 1,268                   | 2.82%                 |
| <b>Loans:</b>  |  |                         |                       |                    |                         |                       |
| Commercial, industrial and agricultural                            | 599,337  | 6,316                   | 4.13%                 | 582,296            | 6,266                   | 4.21%                 |
| Residential mortgage   | 81,182   | 819                     | 4.02%                 | 82,850             | 856                     | 4.10%                 |
| Home equity loans and lines  | 66,023   | 731                     | 4.39%                 | 60,243             | 773                     | 5.09%                 |
| Consumer   | 5,759  | 93                      | 6.41%                 | 7,658              | 128                     | 6.63%                 |
| Loans  | 752,301  | 7,959                   | 4.16%                 | 733,047            | 8,023                   | 4.30%                 |
| Total interest-earning assets                                      | 963,005  | \$ 9,215                | 3.80%                 | 952,577            | \$ 9,340                | 3.89%                 |
| Other assets   | 67,315   |                         |                       | 71,324             |                         |                       |
| Total assets   | \$ 1,030,320                                     |                         |                       | \$ 1,023,901       |                         |                       |
| <b>Interest-bearing liabilities:</b>                               |  |                         |                       |                    |                         |                       |
| <b>Deposits:</b>   |  |                         |                       |                    |                         |                       |
| Interest-bearing checking  | \$ 226,846                                       | \$ 69                   | 0.12%                 | \$ 212,061         | \$ 62                   | 0.12%                 |
| Money Management   | 382,202  | 327                     | 0.34%                 | 382,623            | 418                     | 0.43%                 |
| Savings  | 67,664   | 12                      | 0.07%                 | 63,559             | 12                      | 0.08%                 |
| Time   | 91,060   | 146                     | 0.64%                 | 104,533            | 187                     | 0.71%                 |
| Total interest-bearing deposits                                    | 767,772  | 554                     | 0.29%                 | 762,776            | 679                     | 0.35%                 |
| <b>Securities sold under agreements to repurchase</b>              |  |                         |                       |                    |                         |                       |
|  | -  | -                       | -                     | 4,370              | 2                       | 0.15%                 |
| Other borrowings   | 1,452  | 1                       | 0.35%                 | 12,000             | 118                     | 3.95%                 |
| Total interest-bearing liabilities                                 | 769,224  | 555                     | 0.29%                 | 779,146            | 799                     | 0.41%                 |
| Noninterest-bearing deposits                                       | 147,325  |                         |                       | 135,574            |                         |                       |
| Other liabilities  | 5,819  |                         |                       | 8,542              |                         |                       |

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|   |              |       |              |       |
|---|--------------|-------|--------------|-------|
| Shareholders' equity                        | 107,952      |       | 100,639      |       |
| Total liabilities and shareholders' equity  | \$ 1,030,320 |       | \$ 1,023,901 |       |
| T/E net interest income/Net interest margin | 8,660        | 3.57% | 8,541        | 3.56% |
| Tax equivalent adjustment                   | (495)        |       | (510)        |       |
| Net interest income                         | \$ 8,165     |       | \$ 8,031     |       |

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## Provision for Loan Losses

Provision expense for the third quarter was \$400 thousand and as a result, the allowance for loan losses (ALL) increased \$423 thousand during the quarter. 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 2015, noninterest income decreased \$35 thousand from the same period in 2014. Investment and trust service fees increased due to higher recurring trust fees from a higher number of trust accounts and an increase in estate fees from the settlement of larger estates in 2015 compared to 2014. Deposit service charges increased due to increased enrollment in the Bank's overdraft program. The other real estate owned expense in 2015 was a write-down compared to none in 2014. Other income includes a \$103 thousand gain from the proceeds of a bank owned life insurance policy. The Corporation recorded an other than temporary impairment (OTTI) charge in 2014, but no OTTI charges in 2015.

The following table presents a comparison of noninterest income for the three months ended September 30, 2015 and 2014.

| (Dollars in thousands)                             | For the Three<br>Months Ended<br>September 30 |          | Change  |        |
|--|---|----------|---------|--------|
|  | 2015  | 2014     | Amount  | %      |
| Noninterest Income                                 |   |          |         |        |
| Investment and trust services fees                 | \$ 1,154                                      | \$ 1,120 | \$ 34   | 3.0    |
| Loan service charges                               | 283   | 265      | 18      | 6.8    |
| Mortgage banking activities                        | 5   | 15       | (10)    | (66.7) |
| Deposit service charges and fees                   | 623   | 563      | 60      | 10.7   |
| Other service charges and fees                     | 309   | 317      | (8)     | (2.5)  |
| Debit card income                                  | 346   | 339      | 7       | 2.1    |
| Increase in cash surrender value of life insurance | 137   | 139      | (2)     | (1.4)  |
| Other real estate owned                            | (250)   | -        | (250)   | N/A    |
| Other  | 126   | 30       | 96      | 320.0  |
| OTTI losses recognized in income                   | -   | (20)     | 20      | N/A    |
| Total noninterest income                           | \$ 2,733                                      | \$ 2,768 | \$ (35) | (1.3)  |

## Noninterest Expense

Noninterest expense for the third quarter of 2015 decreased \$135 thousand compared to the same period in 2014. The increase in salaries and benefits was primarily due to an \$83 thousand increase in health insurance, partially offset by a \$12 thousand decrease in salary expense due to open positions. Net occupancy expenses decreased compared to prior year due to less utility expense in 2015. Marketing expenses increased due to customer acquisition promotion. The increase in data processing was due to higher utilization of the Bank's various electronic banking products. 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. FDIC insurance expense decreased over prior year due to a reduction in the assessment rate used to calculate the premium.

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The following table presents a comparison of noninterest expense for the three months ended September 30, 2015 and 2014:

| (Dollars in thousands)          | For the Three<br>Months Ended |                      | Change   |        |
|---------------------------------|-------------------------------|----------------------|----------|--------|
|                                 | September 30<br>2015          | September 30<br>2014 | Amount   | %      |
| Noninterest Expense             | \$ 4,214                      | \$ 4,191             | \$ 23    | 0.5    |
| Salaries and benefits           | 535                           | 555                  | (20)     | (3.6)  |
| Net occupancy expense           | 232                           | 241                  | (9)      | (3.7)  |
| Furniture and equipment expense | 336                           | 312                  | 24       | 7.7    |
| Advertising                     | 311                           | 361                  | (50)     | (13.9) |
| Legal and professional fees     | 524                           | 471                  | 53       | 11.3   |
| Data processing                 | 206                           | 173                  | 33       | 19.1   |
| Pennsylvania bank shares tax    | -                             | 104                  | (104)    | N/A    |
| Intangible amortization         | 170                           | 236                  | (66)     | (28.0) |
| FDIC insurance                  | 193                           | 188                  | 5        | 2.7    |
| ATM/debit card processing       | 892                           | 916                  | (24)     | (2.6)  |
| Other                           | \$ 7,613                      | \$ 7,748             | \$ (135) | (1.7)  |
| Total noninterest expense       |                               |                      |          |        |

#### Provision for Income Taxes

For the third quarter of 2015, the Corporation recorded a Federal income tax expense of \$306 thousand compared to \$641 thousand for the same quarter in 2014. The effective tax rate was 10.6% for the third quarter of 2015 compared to 21.0% for the same period in 2014. Due to the large security gain on the conversion of Integrity Bancshares, in the third quarter the Corporation reversed \$250 thousand of the valuation allowance on the deferred tax asset, established in prior years on other than temporary impairment charges in the equity portfolio. Without this reversal, the effective tax rate would have been 19.3%. In the third quarter of 2015, the effective tax rate was reduced by an increase in tax-equivalent income from the death benefit of \$103 thousand on a bank owned life insurance policy (BOLI). 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, 2015 to the nine months ended September 30, 2014:

#### Net Interest Income

Tax equivalent net interest income for the first nine months of 2015 increased \$334 thousand from the prior year. Average interest-earning assets increased \$5.2 million from 2014 and the yield on these assets decreased from 3.91% in 2014 to 3.84% in 2015. The average balance of investment securities increased \$4.6 million while average loans increased \$5.2 million year over year. Average commercial loans increased \$3.6 million and average consumer loans increased \$3.4 million. These increases were partially offset by a decrease of \$1.8 million in the average

balance of mortgage loans.

Interest expense was \$1.8 million for the first nine months, a decrease of \$633 thousand from the 2014 total of \$2.4 million. Average interest-bearing liabilities decreased \$21.0 million to \$762.2 million for 2015 from an average balance of \$783.8 million in 2014. The average cost of these liabilities decreased from 0.42% in 2014 to 0.32% in 2015. Average interest-bearing deposits decreased \$470 thousand and the cost of these deposits decreased from 0.36% to 0.32%. The securities sold under agreements to repurchase (Repo) accounts were being closed out in 2014 and transferred to other products. The final Repo account closed in January 2015. Other borrowings reflect a short-term borrowing in 2015, as all long-term debt was paid off in 2014.

The changes in the balance sheet and interest rates resulted in an increase in tax equivalent net interest income of \$334 thousand to \$25.5 million in 2015 compared to \$25.2 million in 2014. The increase in tax equivalent net interest income was due to a \$515 thousand increase from higher volume offset by a \$181 thousand decrease due to changes in rates.

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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 Nine Months Ended September 30, |                         |                       |                    |                         |                       |
|--|---|-------------------------|-----------------------|--------------------|-------------------------|-----------------------|
|  | 2015                                    |                         |                       | 2014               |                         |                       |
|  | Average<br>balance                      | Income<br>or<br>expense | Average<br>yield/rate | Average<br>balance | Income<br>or<br>expense | Average<br>yield/rate |
| <b>Interest-earning assets:</b>                                    |   |                         |                       |                    |                         |                       |
| Interest-bearing obligations of other banks and federal funds sold | \$ 40,730                               | \$ 192                  | 0.63%                 | \$ 45,303          | \$ 133                  | 0.39%                 |
| <b>Investment securities:</b>                                      |   |                         |                       |                    |                         |                       |
| Taxable  | 120,054                                 | 1,895                   | 2.11%                 | 125,110            | 2,047                   | 2.19%                 |
| Tax Exempt   | 55,186                                  | 1,828                   | 4.42%                 | 45,577             | 1,680                   | 4.92%                 |
| Investments  | 175,240                                 | 3,723                   | 2.84%                 | 170,687            | 3,727                   | 2.92%                 |
| <b>Loans:</b>  |   |                         |                       |                    |                         |                       |
| Commercial, industrial and agricultural                            | 583,151                                 | 18,463                  | 4.18%                 | 579,503            | 18,445                  | 4.20%                 |
| Residential mortgage   | 80,996                                  | 2,479                   | 4.07%                 | 82,845             | 2,569                   | 4.15%                 |
| Home equity loans and lines  | 64,534                                  | 2,185                   | 4.53%                 | 59,460             | 2,332                   | 5.24%                 |
| Consumer   | 6,237                                   | 293                     | 6.28%                 | 7,935              | 428                     | 7.21%                 |
| Loans  | 734,918                                 | 23,420                  | 4.22%                 | 729,743            | 23,774                  | 4.31%                 |
| Total interest-earning assets                                      | 950,888                                 | \$ 27,335               | 3.84%                 | 945,733            | \$ 27,634               | 3.91%                 |
| Other assets   | 66,965                                  |                         |                       | 71,386             |                         |                       |
| Total assets   | \$ 1,017,853                            |                         |                       | \$ 1,017,119       |                         |                       |
| <b>Interest-bearing liabilities:</b>                               |   |                         |                       |                    |                         |                       |
| <b>Deposits:</b>   |   |                         |                       |                    |                         |                       |
| Interest-bearing checking  | \$ 219,863                              | \$ 189                  | 0.11%                 | \$ 202,394         | \$ 170                  | 0.11%                 |
| Money Management   | 383,011                                 | 1,128                   | 0.39%                 | 388,386            | 1,267                   | 0.44%                 |
| Savings  | 65,558                                  | 36                      | 0.07%                 | 62,741             | 36                      | 0.08%                 |
| Time   | 93,791                                  | 460                     | 0.66%                 | 108,232            | 603                     | 0.74%                 |
| Total interest-bearing deposits                                    | 762,223                                 | 1,813                   | 0.32%                 | 761,753            | 2,076                   | 0.36%                 |
| <b>Securities sold under agreements to repurchase</b>              |   |                         |                       |                    |                         |                       |
|  | 33                                      | -                       | 0.15%                 | 9,792              | 11                      | 0.15%                 |
| Other borrowings   | 497                                     | 1                       | 0.35%                 | 12,228             | 360                     | 3.93%                 |
| Total interest-bearing liabilities                                 | 762,753                                 | 1,814                   | 0.32%                 | 783,773            | 2,447                   | 0.42%                 |
| Noninterest-bearing deposits                                       | 142,070                                 |                         |                       | 127,109            |                         |                       |
| Other liabilities  | 6,921                                   |                         |                       | 7,900              |                         |                       |
| Shareholders' equity   | 106,109                                 |                         |                       | 98,337             |                         |                       |
| Total liabilities and shareholders' equity                         | \$ 1,017,853                            |                         |                       | \$ 1,017,119       |                         |                       |
| T/E net interest income/Net interest margin                        |   | 25,521                  | 3.59%                 |                    | 25,187                  | 3.56%                 |
| Tax equivalent adjustment  |   | (1,512)                 |                       |                    | (1,469)                 |                       |

|                     |           |           |
|---------------------|-----------|-----------|
| Net interest income | \$ 24,009 | \$ 23,718 |
|---------------------|-----------|-----------|

All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.



## Provision for Loan Losses

For the first nine months of 2015, the Bank recorded net charge-offs of \$273 thousand compared to \$1.2 million in 2014. Provision expense for the first nine months was \$1.0 million and as a result, the allowance for loan losses (ALL) increased \$762 thousand. The increase in the allowance is due primarily to an increase in the general allocation as a result of loan growth. 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 2015, noninterest income increased \$1.5 million from the same period in 2014. . Investment and trust service fees increased due to higher recurring trust fees from a higher number of trust accounts and an increase in estate fees from the settlement of larger estates in 2015 compared to 2014. Loan service charges increased primarily from a large commercial loan prepayment penalty. Deposit service charges increased due to increased enrollment in the Bank's overdraft program. The net loss in other real estate owned was from a write-down of \$250 thousand, net of a gain on a sale, compared to write-downs in 2014. Other income increased from an investment the Corporation owned in an offshore insurance company that liquidated (\$171 thousand) and paid out the investors and from a death benefit (\$103 thousand) on a BOLI policy. Other than temporary impairment charges were recorded on one bond in 2015 and 2014. The gain on conversion occurred in the equity portfolio and was the result of the Bank receiving shares of S&T Bancorp following its acquisition of Integrity Bancshares. Security gains were less in 2015, as the Corporation liquidated the majority of the equity portfolio in 2014.

The following table presents a comparison of noninterest income for the nine months ended September 30, 2015 and 2014.

| (Dollars in thousands)                             | For the Nine<br>Months Ended |          | Change   |        |
|--|------------------------------|----------|----------|--------|
|  | September 30<br>2015         | 2014     | Amount   | %      |
| Noninterest Income                                 |                              |          |          |        |
| Investment and trust services fees                 | \$ 3,805                     | \$ 3,311 | \$ 494   | 14.9   |
| Loan service charges                               | 754                          | 682      | 72       | 10.6   |
| Mortgage banking activities                        | 30                           | 47       | (17)     | (36.2) |
| Deposit service charges and fees                   | 1,700                        | 1,553    | 147      | 9.5    |
| Other service charges and fees                     | 916                          | 901      | 15       | 1.7    |
| Debit card income                                  | 1,021                        | 982      | 39       | 4.0    |
| Increase in cash surrender value of life insurance | 416                          | 426      | (10)     | (2.3)  |
| Other real estate owned                            | (218)                        | (184)    | (34)     | 18.5   |
| Other  | 363                          | 92       | 271      | 294.6  |
| OTTI losses recognized in income                   | (20)                         | (20)     | -        | -      |
| Gain on conversion                                 | 728                          | -        | 728      | N/A    |
| Securities gain (losses), net                      | 8                            | 221      | (213)    | (96.4) |
| Total noninterest income                           | \$ 9,503                     | \$ 8,011 | \$ 1,492 | 18.6   |

## Noninterest Expense

Noninterest expense for the first nine months of 2015 decreased \$289 thousand compared to the same period in 2014. The decrease in salaries and benefits was primarily due to a decrease in incentive pay expenses and split dollar plan expenses partially offset by increases in pension expense and health insurance expenses. Net occupancy expenses decreased compared to prior year due to less utility and snow removal expense in 2015. Advertising expenses decreased over prior year, due to the timing of various marketing campaigns. The decrease in legal and professional fees was driven by an \$81 thousand decrease in internal audit fees due to a change in firms. The increase in data processing was due to higher utilization by customers of the Bank's various electronic banking products, as well as one time fees from the migration to a new mortgage origination system. FDIC insurance expense decreased over prior year due to a reduction in the assessment rate used to calculate the premium. Other expenses increased due to one-time expenses the Bank took to fulfill the funding requirement of a deferred director's benefit plan established thirty years ago, as well as expenses related to branch assets taken out of service.

The following table presents a comparison of noninterest expense for the nine months ended September 30, 2015 and 2014:

| (Dollars in thousands)          | For the Nine Months Ended |           |          |        |
|---------------------------------|---------------------------|-----------|----------|--------|
|                                 | September 30              |           | Change   |        |
| Noninterest Expense             | 2015                      | 2014      | Amount   | %      |
| Salaries and benefits           | \$ 12,500                 | \$ 12,548 | \$ (48)  | (0.4)  |
| Net occupancy expense           | 1,706                     | 1,817     | (111)    | (6.1)  |
| Furniture and equipment expense | 702                       | 732       | (30)     | (4.1)  |
| Advertising                     | 807                       | 898       | (91)     | (10.1) |
| Legal and professional fees     | 811                       | 979       | (168)    | (17.2) |
| Data processing                 | 1,547                     | 1,355     | 192      | 14.2   |
| Pennsylvania bank shares tax    | 608                       | 520       | 88       | 16.9   |
| Intangible amortization         | 181                       | 311       | (130)    | (41.8) |
| FDIC insurance                  | 479                       | 690       | (211)    | (30.6) |
| ATM/debit card processing       | 566                       | 545       | 21       | 3.9    |
| Other                           | 2,855                     | 2,656     | 199      | 7.5    |
| Total noninterest expense       | \$ 22,762                 | \$ 23,051 | \$ (289) | (1.3)  |

#### Provision for Income Taxes

For the first nine months of 2015, the Corporation recorded a Federal income tax expense of \$1.8 million compared to \$1.7 million for the same period in 2014. The effective tax rate decreased to 18.3% for the first nine months of 2015 compared to 20.2% for 2014. Due to the large security gain on the conversion of Integrity Bancshares, in the third quarter the Corporation reversed \$250 thousand of the valuation allowance on the deferred tax asset, 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%. All taxable income for the Corporation is taxed at a rate of 34%. The variances from the federal statutory rate are generally due to tax-exempt income from investments, loans and bank-owned life insurance.

#### Financial Condition

##### Summary:

At September 30, 2015, assets totaled \$1.036 billion, an increase of \$34.9 million from the 2014 year-end balance of 1.001 billion. Investment securities increased \$4.7 million, while net loans decreased \$2.2 million. Deposits were up \$36.3 million for the first nine months of 2015 due to increases in every deposit category except time deposits and money management accounts. Shareholders' equity increased \$6.6 million during the first nine months as retained earnings increased approximately \$5.6 million, other comprehensive loss decreased \$24 thousand and the Corporation's Dividend Reinvestment Plan (DRIP) added an additional \$869 thousand in new capital.

Cash and Cash Equivalents:

Cash and cash equivalents totaled \$40.9 million at September 30, 2015, a decrease of \$7.7 million from the prior year-end balance of \$48.6 million. Interest-bearing deposits are held primarily at the Federal Reserve and in short-term bank owned certificates of deposit.

Investment Securities:

The investment portfolio has declined \$2.1 million on a cost basis, since year-end 2014. The composition of the portfolio is has remained consistent with municipal securities and U.S. Agency mortgage-backed securities comprising the greatest portion of the portfolio at approximately 42% and 44% of the portfolio fair value, respectively. The Bank invested \$21.7 million during the first nine months of 2015 with the purchases spread between, U.S. Agency mortgage-backed securities and municipal securities. However, no investment purchases were made during the third quarter as cash flow was reinvested in the loan portfolio. The average life of the portfolio was 4.11 years.

The investment portfolio had a net unrealized gain of \$2.2 million at September 30, 2015 compared to \$2.4 million at the prior year-end. The decline in the unrealized gain is primarily the result of a \$710 thousand reduction in the unrealized gain in equity securities as the Bank sold equity securities and recorded the gain from this portfolio. The portfolio averaged \$175.2 million with a yield of 2.84% for the first nine months of 2015. This compares to an average of \$170.7 million and a yield of 2.92% for the same period in 2014.

The Bank holds only one equity security, a Pennsylvania community bank. The municipal bond portfolio is well diversified geographically (issuers from within 29 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 18 issuers in the state of Texas with a fair value of \$10.2 million and 15 issuers in the state of Pennsylvania with a fair value of \$9.1 million. The average rating of the municipal portfolio from Moody's is Aa2. It contains \$69.1 million of bonds rated A3 or higher and \$1.9 million that are not rated by Moody's rating agency. No municipal bonds are rated below investment grade.

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

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2015 and December 31, 2014 is as follows:

| (Dollars in thousands)                   | Amortized  | Gross      | Gross      | Fair       |
|--|------------|------------|------------|------------|
| September 30, 2015                       | cost       | unrealized | unrealized | value      |
| Equity securities                        | \$ 164     | \$ 69      | \$ -       | \$ 233     |
| U.S. Government and Agency securities    | 15,820     | 243        | (24)       | 16,039     |
| Municipal securities                     | 69,537     | 1,700      | (246)      | 70,991     |
| Trust preferred securities               | 5,953      | -          | (515)      | 5,438      |
| Agency mortgage-backed securities        | 74,408     | 1,077      | (154)      | 75,331     |
| Private-label mortgage-backed securities | 1,397      | 49         | -          | 1,446      |
| Asset-backed securities                  | 40         | -          | (2)        | 38         |
|  | \$ 167,319 | \$ 3,138   | \$ (941)   | \$ 169,516 |

| (Dollars in thousands)                   | Amortized  | Gross      | Gross      | Fair       |
|--|------------|------------|------------|------------|
| December 31, 2014                        | cost       | unrealized | unrealized | value      |
| Equity securities                        | \$ 274     | \$ 779     | \$ -       | \$ 1,053   |
| U.S. Government and Agency securities    | 15,854     | 173        | (64)       | 15,963     |
| Municipal securities                     | 66,832     | 1,826      | (292)      | 68,366     |
| Trust preferred securities               | 5,940      | -          | (803)      | 5,137      |
| Agency mortgage-backed securities        | 78,779     | 932        | (217)      | 79,494     |
| Private-label mortgage-backed securities | 1,675      | 35         | (15)       | 1,695      |
| Asset-backed securities                  | 45         | -          | (2)        | 43         |
|  | \$ 169,399 | \$ 3,745   | \$ (1,393) | \$ 171,751 |



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The following table provides additional detail about the Bank's trust preferred securities as of September 30, 2015:

(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 | \$ 964         | \$ 898     | \$ (66)                      | BB+                           |
| Wachovia Cap Trust II   | 1/15/2027  | Single                  | Preferred Stock | 278            | 257        | (21)                         | BBB                           |
| Huntington Cap Trust    | 2/1/2027   | Single                  | Preferred Stock | 942            | 840        | (102)                        | BB                            |
| Corestates Captl Tr II  | 2/15/2027  | Single                  | Preferred Stock | 938            | 856        | (82)                         | BBB+                          |
| Huntington Cap Trust II | 6/15/2028  | Single                  | Preferred Stock | 893            | 815        | (78)                         | BB+                           |
| Chase Cap VI JPM        | 8/1/2028   | Single                  | Preferred Stock | 963            | 850        | (113)                        | BBB-                          |
| Fleet Cap Tr V          | 12/18/2028 | Single                  | Preferred Stock | 975            | 922        | (53)                         | BB+                           |
|                         |            |                         |                 | \$ 5,953       | \$ 5,438   | \$ (515)                     |                               |

The following table provides additional detail about private label mortgage-backed securities as of September 30, 2015:

(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         | \$ 17          | \$ 17      | \$ -                         | ALT A           | BBB+                          | 11.85            | \$ -                    |
| MALT 2004-6 7A1  | 6/1/2004         | 362            | 370        | 8                            | ALT A           | CCC                           | 14.74            | -                       |
| RALI 2005-QS2 A1 | 2/1/2005         | 215            | 229        | 14                           | ALT A           | CC                            | 5.35             | 10                      |
| RALI 2006-QS4 A2 | 4/1/2006         | 486            | 503        | 17                           | ALT A           | D                             | -                | 313                     |

|                 |           |          |          |       |       |   |   |        |
|-----------------|-----------|----------|----------|-------|-------|---|---|--------|
| GSR 2006-5F 2A1 | 5/1/2006  | 63       | 71       | 8     | Prime | D | - | 15     |
| RALI 2006-QS8   |           |          |          |       |       |   |   |        |
| A1              | 7/28/2006 | 254      | 256      | 2     | ALT A | D | - | 217    |
|                 |           | \$ 1,397 | \$ 1,446 | \$ 49 |       |   |   | \$ 555 |

The investment portfolio contained 72 securities with \$45.6 million of temporarily impaired fair value and \$941 thousand in unrealized losses at September 30, 2015. The total unrealized loss position has decreased from \$1.4 million at year-end 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 September 30, 2015, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.



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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, 2015 and December 31, 2014:

| (Dollars in thousands)                | September 30, 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 | \$ 486              | \$ (1)            | 2     | \$ 4,435          | \$ (23)           | 10    | \$ 4,921   | \$ (24)           | 12    |
| Municipal securities                  | 9,802               | (111)             | 15    | 4,845             | (135)             | 7     | 14,647     | (246)             | 22    |
| Trust preferred securities            | -                   | -                 | -     | 5,438             | (515)             | 7     | 5,438      | (515)             | 7     |
| Agency mortgage-backed securities     | 15,603              | (74)              | 22    | 4,989             | (80)              | 8     | 20,592     | (154)             | 30    |
| Asset-backed securities               | -                   | -                 | -     | 5                 | (2)               | 1     | 5          | (2)               | 1     |
| Total temporarily impaired securities | \$ 25,891           | \$ (186)          | 39    | \$ 19,712         | \$ (755)          | 33    | \$ 45,603  | \$ (941)          | 72    |

| (Dollars in thousands)                   | December 31, 2014   |                   |       |                   |                   |       |            |                   |       |
|--|---------------------|-------------------|-------|-------------------|-------------------|-------|------------|-------------------|-------|
|  | 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    | 4                   | -                 | 1     | 7,207             | (64)              | 14    | 7,211      | (64)              | 15    |
| Municipal securities                     | 5,651               | (33)              | 9     | 9,441             | (259)             | 14    | 15,092     | (292)             | 23    |
| Trust preferred securities               | -                   | -                 | -     | 5,137             | (803)             | 7     | 5,137      | (803)             | 7     |
| Agency mortgage-backed securities        | 9,304               | (60)              | 13    | 8,199             | (157)             | 10    | 17,503     | (217)             | 23    |
| Private-label mortgage-backed securities | -                   | -                 | -     | 540               | (15)              | 1     | 540        | (15)              | 1     |
| Asset-backed securities                  | -                   | -                 | -     | 5                 | (2)               | 1     | 5          | (2)               | 1     |
| Total temporarily impaired securities    | \$ 14,959           | \$ (93)           | 23    | \$ 30,529         | \$ (1,300)        | 47    | \$ 45,488  | \$ (1,393)        | 70    |

The unrealized loss in the municipal bond portfolio decreased to \$246 thousand from \$604 thousand at June 30, 2015 compared as market prices improved during the quarter. The quarter end unrealized loss position in this sector is essentially unchanged from year-end 2014. There are 22 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 7 securities with a fair value of \$5.4 million and an unrealized loss of \$515 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, 2015, 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 net unrealized gain \$49 thousand with all bonds showing an unrealized gain. Even though there is no unrealized loss, 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. As a result of the analysis on PLMBS it was determined that a \$20 thousand impairment charge was required at the end of the first quarter; however, no additional impairment charge was required at September 30, 2015. It is primarily a result of the cumulative OTTI charges that these bonds are showing an unrealized gain at quarter end. The Bank has recorded \$555 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 \$855 thousand of restricted stock at September 30, 2015. 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 \$6.9 million over 2014, primarily in the commercial first lien and consumer junior liens and lines of credit categories due to a home equity special promotion in the second and third quarters of 2015. For the first nine months of 2015, the Bank originated \$12.9 million in mortgages, including approximately \$6.2 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 (\$7.2 million), while loans for individuals to construct personal residences totaled \$890 thousand at September 30, 2015. 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. 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. The Bank does not currently have any residential real estate construction loans with an interest reserve.

Commercial loans and commercial real estate: Loans in this category include commercial, industrial, farm, agricultural, land development and municipal government loans. Collateral for these loans may include commercial real estate, farm real estate, equipment or other business assets. Total commercial real estate loans increased to \$337.6 million from \$326.5 million at the end of 2014. The largest sectors (by collateral) in the commercial real estate category are: office buildings (\$45.2 million), land development (\$43.0 million), hotels and motels (\$40.9 million), farm land (\$31.8 million), and apartment units (\$31.3 million). Commercial loans increased \$28.7 million compared to year end, with increases in commercial and industrial loans (\$15.6 million) and municipal loans (\$20.6 million), offset by a payoff of \$8.5 million from one borrower. The Bank booked \$119.5 million of new commercial loans in

the first nine months of 2015, but had unexpected pay-offs of \$25.7 million from three large commercial loans. The largest sectors (by industry) in the commercial loan category are: retail trade (\$73.6 million), construction (\$53.3 million), food services (\$47.4 million), manufacturing (\$39.9 million) and utilities (\$36.8 million). The Bank is very active in its market in pursuing commercial lending opportunities, but supplements in-market growth with purchased loan participations. 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. These loans usually represent an opportunity to participate in larger credits that are not available in market, with the benefit of lower origination and servicing costs. For the first nine months of 2015, the Bank purchased \$38.0 million of loan participations and commitments. At September 30, 2015, the Bank held \$139.0 million in purchased loan participations in its portfolio.

Consumer loans decreased \$880 thousand due primarily to regular payments and maturities. The Bank believes the consumer portfolio will continue to run-down, as consumers are unwilling to increase their debt and nearly all consumer auto financing has shifted to dealer financing.

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

| (Dollars in thousands)   | September<br>30, 2015 | December<br>31, 2014 | Change    |        |
|--|-----------------------|----------------------|-----------|--------|
|  |                       |                      | Amount    | %      |
| Residential Real Estate 1-4 Family                               |                       |                      |           |        |
| Consumer first liens   | \$ 104,881            | \$ 105,014           | \$ (133)  | (0.1)  |
| Commercial first lien  | 58,083                | 56,300               | 1,783     | 3.2    |
| Total first liens  | 162,964               | 161,314              | 1,650     | 1.0    |
| Consumer junior liens and lines of credit                        | 43,024                | 38,132               | 4,892     | 12.8   |
| Commercial junior liens and lines of credit                      | 6,014                 | 5,663                | 351       | 6.2    |
| Total junior liens and lines of credit                           | 49,038                | 43,795               | 5,243     | 12.0   |
| Total residential real estate 1-4 family                         | 212,002               | 205,109              | 6,893     | 3.4    |
| Residential real estate - construction                           |                       |                      |           |        |
| Consumer   | 890                   | 1,627                | (737)     | (45.3) |
| Commercial   | 7,155                 | 8,088                | (933)     | (11.5) |
| Total residential real estate construction                       | 8,045                 | 9,715                | (1,670)   | (17.2) |
| Commercial real estate   | 337,597               | 326,482              | 11,115    | 3.4    |
| Commercial   | 207,757               | 179,071              | 28,686    | 16.0   |
| Total commercial   | 545,354               | 505,553              | 39,801    | 7.9    |
| Consumer   | 5,274                 | 6,154                | (880)     | (14.3) |
|  | 770,675               | 726,531              | 44,144    | 6.1    |
| Less: Allowance for loan losses                                  | (9,873)               | (9,111)              | (762)     | (8.4)  |
| Net Loans  | \$ 760,802            | \$ 717,420           | \$ 43,382 | 6.0    |
| Included in the loan balances are the following:                 |                       |                      |           |        |
| Net unamortized deferred loan fees (costs)                       | \$ 318                | \$ (76)              |           |        |
| Loans pledged as collateral for borrowings and commitments from: |                       |                      |           |        |
| FHLB   | \$ 641,496            | \$ 602,633           |           |        |
| Federal Reserve Bank   | 48,554                | 56,367               |           |        |
|  | \$ 690,050            | \$ 659,000           |           |        |

## 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 includes both performing and nonperforming loans. Watch list loans totaled \$29.7 million at quarter-end, an improvement from \$40.5 million at the prior year-end. The watch list is comprised of \$10.6 million rated 6 and \$19.2 million rated 7. The Bank has no loans rated 8-doubtful or 9-loss. The credit composition of the portfolio, by primary collateral is shown in Note 7 of the accompanying financial statements. Included in the substandard loan total is \$5.7 million of nonaccrual loans. 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, 2015, the Bank had loans of \$27.5 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 7 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, is improving from year-end and the performance ratios related to nonperforming loans have also improved. The decline in nonaccrual loans occurred primarily in the commercial real estate category with \$3.0 million moving to other real estate owned. The following table presents a summary of nonperforming assets:

| (Dollars in thousands)                                  | September<br>30, 2015 | December<br>31, 2014 |
|---|-----------------------|----------------------|
| Nonaccrual loans  |                       |                      |
| Residential Real Estate 1-4 Family                      |                       |                      |
| First liens   | \$ 862                | \$ 1,124             |
| Junior liens and lines of credit                        | 116                   | 169                  |
| Total   | 978                   | 1,293                |
| Residential real estate - construction                  |                       |                      |
| Commercial real estate                                  | 507                   | 931                  |
| Commercial  | 3,811                 | 8,430                |
| Total nonaccrual loans                                  | 373                   | 1,637                |
|   | 5,669                 | 12,291               |
| Loans past due 90 days or more and not included above   |                       |                      |
| Residential Real Estate 1-4 Family                      |                       |                      |
| First liens   | 427                   | 165                  |
| Junior liens and lines of credit                        | 64                    | -                    |
| Total   | 491                   | 165                  |
| Commercial real estate                                  | -                     | 140                  |
| Consumer  | 3                     | 17                   |
| Total loans past due 90 days or more and still accruing | 494                   | 322                  |
| Total nonperforming loans                               | 6,163                 | 12,613               |
| Other real estate owned                                 | 6,807                 | 3,666                |
| Total nonperforming assets                              | \$ 12,970             | \$ 16,279            |
| Nonperforming loans to total gross loans                | 0.80%                 | 1.74%                |
| Nonperforming assets to total assets                    | 1.25%                 | 1.63%                |
| Allowance for loan losses to nonperforming loans        | 160.20%               | 72.23%               |



The following table identifies the most significant loans in nonaccrual status. These four nonaccrual loans account for 81% 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, 2015 totaled \$24.1 million compared to \$27.8 million at year-end 2014.

| (Dollars in thousands)  | Balance  | ALL     | Nonaccrual | TDR    | Collateral   | Location | Last            |
|---|----------|---------|------------|--------|--|----------|-----------------|
|   |          | Reserve | Date       | Status |  |          | Appraisal(1)    |
| Credit 1 - Residential real estate and commercial real estate | 540      | -       | Aug-11     | N      | 1st lien on commercial and residential properties and 70 acres of farmland               | PA       | Nov-14 \$ 880   |
| Credit 2 - Residential real estate                            | 1,903    | -       | Mar-12     | Y      | 1st and 2nd liens on commercial real estate, residential real estate and business assets | PA       | Oct-14 \$ 3,895 |
| Credit 3 - Commercial real estate                             | 1,451    | -       | Dec-14     | N      | Hotel and entertainment complex  | PA       | Feb-15 \$ 4,000 |
| Credit 4 - Commercial real estate                             | 655      | -       | Mar-14     | N      | 1st lien on commercial real estate   | PA       | Jun-13 \$ 1,550 |
|   | \$ 4,549 | \$ -    |            |        |  |          |                 |

(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 has sold another piece of real estate and the Bank received a pay down of \$158 thousand during the third quarter of 2015. The remaining balance is expected to be restructured into a new loan. Credit 2 is a TDR that is performing in accordance with the modified terms. Credit 3 is a hotel and entertainment complex being operated as part of an estate liquidation and is currently listed for sale. Credit 4 did not comply with a forbearance agreement and is scheduled for foreclosure in the fourth quarter of 2015.

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 \$17.3 million at quarter-end compared to \$26.6 million at year-end 2014. Included in the impaired loan total is \$11.3 million of accruing TDR loans and \$2.1 million of nonaccrual TDR loans. Note 7 of the accompanying financial statements provides additional information on the composition of the impaired loans, including the allowance for loan loss that has been established for impaired loans.

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. During the third quarter of 2015, two TDR loans for approximately \$3.1 million paid off. See Note 7 in the accompanying financial statements for a note that identifies TDR loans in the portfolio.

The Bank holds \$6.8 million of other real estate owned (OREO), comprised of eight properties compared to \$3.7 million and five properties at December 31, 2014. The most significant OREO holdings are listed in the table below. The appraised value for Property 2 reflects the commercial and industrial development potential of the property, which is the most likely use for the property. At December 31, 2014, the Bank reported this property with an "as is" valuation. Property 2 was written down by \$250 thousand during the quarter. Property 3 was added to OREO during the third quarter of 2015. During 2015, the Bank has incurred a net loss of \$218 thousand on the sale and write-down of OREO and an expense of \$91 thousand to hold and maintain OREO.

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

September 30, 2015

(Dollars in thousands)

|            | Date Acquired | Balance  | Collateral  | Location | Last Appraisal  |
|------------|---------------|----------|---|----------|-----------------|
| Property 1 | 2011          | \$ 488   | unimproved real estate for residential development                                | PA       | Jan-15 \$ 585   |
| Property 2 | 2012          | 2,758    | 1st, 2nd, and 3rd liens residential development land - four tracts with 196 acres | PA       | Apr-14 \$ 6,586 |
| Property 3 | 2015          | 3,039    | 1st lien on 90 acres undeveloped commercial real estate                           | PA       | Nov-14 \$ 5,686 |
|            |               | \$ 6,285 |   |          |                 |

At September 30, 2015, the Bank had \$61 thousand of residential properties in the process of foreclosure compared to \$763 thousand at the end of 2014.

#### 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, 2015 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, 2015, impaired loans totaled \$17.3 million compared to \$26.6 million at year-end 2014. Included in the September impaired loan total is one loan of with a specific reserve of \$9 thousand. The specific reserve has decreased \$222 thousand since year-end, primarily as the result of a second quarter charge-off of \$200 thousand on a large nonaccrual loan that eliminated the \$162 thousand specific reserve on this credit at December 31, 2014. This loan was then paid off. Note 7 in the accompanying financial statements provide additional information about the ALL established for impaired loans.

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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 March 31, 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 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 resulted in a general allocation of \$9.9 million (1.27% of gross loans) compared to \$8.9 million (1.00% of gross loans) at December 31, 2014. The Bank has \$1.2 million of its general ALL allocation designated as an unallocated allowance. 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 21.5 basis points unchanged from year-end 2014. 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.

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, 2015 and December 31, 2014:

| (Dollars in thousands)                     | Residential Real Estate |                                | Residential              |             | Commercial | Consumer | Total      |
|--|-------------------------|--------------------------------|--------------------------|-------------|------------|----------|------------|
|  | 1-4 Family              | Junior Liens & Lines of Credit | Real Estate Construction | Real Estate |            |          |            |
| September 30, 2015                         |                         |                                |                          |             |            |          |            |
| Loans evaluated for allowance:             |                         |                                |                          |             |            |          |            |
| Individually                               | \$ 942                  | \$ 51                          | \$ 507                   | \$ 14,523   | \$ 231     | \$ -     | \$ 16,254  |
| Collectively                               | 162,022                 | 48,987                         | 7,538                    | 323,074     | 207,526    | 5,274    | 754,421    |
| Total                                      | \$ 162,964              | \$ 49,038                      | \$ 8,045                 | \$ 337,597  | \$ 207,757 | \$ 5,274 | \$ 770,675 |
| Allowance established for loans evaluated: |                         |                                |                          |             |            |          |            |
| Individually                               | \$ -                    | \$ -                           | \$ -                     | \$ -        | \$ 9       | \$ -     | \$ 9       |
| Collectively                               | 1,251                   | 375                            | 209                      | 6,073       | 1,844      | 112      | 9,864      |
| Allowance at September 30, 2015            | \$ 1,251                | \$ 375                         | \$ 209                   | \$ 6,073    | \$ 1,853   | \$ 112   | \$ 9,873   |
| December 31, 2014                          |                         |                                |                          |             |            |          |            |
| Loans evaluated for allowance:             |                         |                                |                          |             |            |          |            |
| Individually                               | \$ 1,171                | \$ 51                          | \$ 931                   | \$ 22,307   | \$ 1,298   | \$ -     | \$ 25,758  |
| Collectively                               | 160,143                 | 43,744                         | 8,784                    | 304,175     | 177,773    | 6,154    | 700,773    |
| Total                                      | \$ 161,314              | \$ 43,795                      | \$ 9,715                 | \$ 326,482  | \$ 179,071 | \$ 6,154 | \$ 726,531 |
| Allowance established for loans evaluated: |                         |                                |                          |             |            |          |            |
| Individually                               | \$ -                    | \$ -                           | \$ -                     | \$ 60       | \$ 171     | \$ -     | \$ 231     |
| Collectively                               | 1,225                   | 334                            | 226                      | 5,357       | 1,602      | 136      | 8,880      |
| Allowance at December 31, 2014             | \$ 1,225                | \$ 334                         | \$ 226                   | \$ 5,417    | \$ 1,773   | \$ 136   | \$ 9,111   |

During the first nine months of 2015, the Bank recorded \$1.0 million for the loan loss provision expense, \$571 thousand more than the same period in 2014, due to increased loan growth. For the third quarter of 2015, the provision expense was \$400 thousand compared to \$0 for the same quarter of 2014.

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 \$273 thousand for the nine months of 2015.

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

| (Dollars in thousands)          | Residential Real Estate |                          | Residential Real Estate Construction | Commercial Real Estate | Commercial | Consumer | Total    |
|---------------------------------|-------------------------|--------------------------|--------------------------------------|------------------------|------------|----------|----------|
|                                 | 1-4 Family Liens        | Junior & Lines of Credit |                                      |                        |            |          |          |
| Allowance at June 30, 2015      | \$ 1,293                | \$ 359                   | \$ 220                               | \$ 5,686               | \$ 1,771   | \$ 121   | \$ 9,450 |
| Charge-offs                     | -                       | -                        | -                                    | -                      | (51)       | (71)     | (122)    |
| Recoveries                      | 1                       | -                        | 18                                   | -                      | 104        | 22       | 145      |
| Provision                       | (43)                    | 16                       | (29)                                 | 387                    | 29         | 40       | 400      |
| Allowance at September 30, 2015 | \$ 1,251                | \$ 375                   | \$ 209                               | \$ 6,073               | \$ 1,853   | \$ 112   | \$ 9,873 |
| Allowance at December 31, 2014  | \$ 1,225                | \$ 334                   | \$ 226                               | \$ 5,417               | \$ 1,773   | \$ 136   | \$ 9,111 |
| Charge-offs                     | (43)                    | -                        | (21)                                 | -                      | (269)      | (149)    | (482)    |
| Recoveries                      | 4                       | -                        | 18                                   | 14                     | 118        | 55       | 209      |
| Provision                       | 65                      | 41                       | (14)                                 | 642                    | 231        | 70       | 1,035    |
| Allowance at September 30, 2015 | \$ 1,251                | \$ 375                   | \$ 209                               | \$ 6,073               | \$ 1,853   | \$ 112   | \$ 9,873 |

|  | Nine months ended September 30, 2015 | Year ended December 31, 2014 | Nine months ended September 30, 2014 |
|--|--------------------------------------|------------------------------|--------------------------------------|
| Net loans charged-off as a percentage of average gross loans           | 0.05%                                | 0.19%                        | 0.22%                                |
| Net loans charged-off as a percentage of the provision for loan losses | 26.38%                               | 177.36%                      | 265.30%                              |
| Allowance as a percentage of loans                                     | 1.28%                                | 1.25%                        | 1.22%                                |
| Net charge-offs  | \$ 273                               | \$ 1,355                     | \$ 1,231                             |





## Deposits:

Total deposits increased \$36.3 million during the first nine months of 2015 to \$917.4 million. Non-interest bearing deposits increased \$14.7 million, while savings and interest-bearing checking increased \$30.7 million and time deposits decreased \$9.1 million. The increase in non-interest bearing checking accounts occurred primarily in retail checking accounts (\$5.6 million) and state/municipal checking accounts (\$4.1 million). Interest bearing checking increased by \$29.6 million, primarily from commercial deposits. The Bank's Money Management product decreased to \$384.3 million from \$388.0 million. Retail money management accounts increased \$1.9 million, but were offset by a decrease of \$5.9 million in commercial money management accounts. Retail time deposits decreased since year-end, as customers moved funds to more liquid accounts. As of September 30, 2015, the Bank had \$3.4 million in CDARS reciprocal time deposits included in brokered time deposits.

| (Dollars in thousands)                           | September<br>30, 2015 | December<br>31, 2014 | Change    |        |
|--|-----------------------|----------------------|-----------|--------|
|  |                       |                      | Amount    | %      |
| Noninterest-bearing checking                     | \$ 151,603            | \$ 136,910           | \$ 14,693 | 10.7   |
| Interest-bearing checking                        | 224,559               | 194,992              | 29,567    | 15.2   |
| Money management                                 | 384,255               | 388,043              | (3,788)   | (1.0)  |
| Savings  | 67,525                | 62,637               | 4,888     | 7.8    |
| Total interest-bearing checking and savings      | 676,339               | 645,672              | 30,667    | 4.7    |
| Retail time deposits                             | 86,144                | 92,973               | (6,829)   | (7.3)  |
| Brokered time deposits                           | 3,361                 | 5,626                | (2,265)   | (40.3) |
| Total time deposits                              | 89,505                | 98,599               | (9,094)   | (9.2)  |
| Total deposits                                   | \$ 917,447            | \$ 881,181           | \$ 36,266 | 4.1    |
| Overdrawn deposit accounts reclassified as loans | \$ 223                | \$ 138               |           |        |

## Borrowings:

The Corporation had short-term borrowings of \$3.5 million and no long-term borrowings at September 30, 2015.

## Shareholders' Equity:

Total shareholders' equity increased \$6.6 million to \$110.1 million at September 30, 2015, compared to \$103.5 million at the end of 2014. The increase in retained earnings from the Corporation's net income of \$7.9 million was partially offset by the cash dividend of \$2.3 million. The Corporation's dividend payout ratio is 29.4% for the first nine months of 2015 compared to 32.5% in 2014.

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 \$0.55 per share, compared to \$.051 for the same period in 2014, a 7.8% increase. For the third quarter of 2015, the Corporation paid a \$.19 per share dividend, compared to \$.17 paid in the third quarter of 2014. On October 22, 2015 the Board of Directors declared a \$0.19 per share regular quarterly dividend for the fourth quarter of 2015, which will be paid on November August 25, 2015.

In addition, the Corporation considers how dividend decisions may affect the Dividend Reinvestment Plan (DRIP), which has raised \$869 thousand in new capital this year with 36,608 new shares purchased. The Corporation

continually explores other sources of capital as part of its capital management plan for the Corporation and the Bank. The Corporation did not repurchase any shares of the Corporation's common stock during the first nine months of 2015.

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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 U.S. Banks, generally referred to as “Basel III.” Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those in place at the end of 2014. The capital ratios to be considered “well capitalized” under Basel III are: common equity tier 1 of 6.5%, Tier 1 leverage of 5%, Tier 1 risk-based capital of 8%, and Total Risk-Based capital of 10%. The common equity tier 1 ratio is a new capital ratio under Basel III. Common equity consists of common stock, additional paid-in capital and retained earnings. The Tier 1 risk-based capital ratio of 8% has been increased from 6%. The new rule also includes a provision for banks to make a one-time irrevocable choice to exclude accumulated other comprehensive income (AOCI) from its common equity Tier 1 capital. The Bank elected to exclude AOCI from the capital calculation with its March 31, 2015 regulatory filing. In addition, a capital conservation buffer will be required to be maintained above the minimum capital ratios to avoid any capital distribution restrictions. The capital conservation buffer will be phased in from 0% in 2015 to 2.5% in 2019. The Basel III capital rules took effect for the Corporation and the Bank on January 1, 2015. At September 30, 2015, the Corporation and the Bank were both well capitalized as defined by the banking regulatory agencies.

The following table summarizes regulatory capital information as of September 30, 2015 and December 31, 2014 on a consolidated basis and for the Bank, as defined. Regulatory capital ratios for September 30, 2015 were calculated in accordance with the Basel III rules, whereas the December 31, 2015 regulatory ratios were calculated in accordance with Basel I rules. The minimum regulatory ratios shown below define capital levels under Basel III rules.

| (Dollars in thousands)                                   | September 30,<br>2015 | December 31,<br>2014 | Regulatory Ratios         |                     |
|--|-----------------------|----------------------|---------------------------|---------------------|
|  |                       |                      | Adequately<br>Capitalized | Well<br>Capitalized |
|  |                       |                      | Minimum                   | Minimum             |
| <b>Common Equity Tier 1 Risk-based Capital Ratio (1)</b> |                       |                      |                           |                     |
| Franklin Financial Services Corporation                  | 14.44%                | N/A                  | 4.50%                     | N/A                 |
| Farmers & Merchants Trust Company                        | 14.40%                | N/A                  | 4.50%                     | 6.50%               |
| <b>Tier 1 Risk-based Capital Ratio (2)</b>               |                       |                      |                           |                     |
| Franklin Financial Services Corporation                  | 14.44%                | 14.19%               | 6.00%                     | N/A                 |
| Farmers & Merchants Trust Company                        | 14.40%                | 13.96%               | 6.00%                     | 8.00%               |
| <b>Total Risk-based Capital Ratio (3)</b>                |                       |                      |                           |                     |
| Franklin Financial Services Corporation                  | 15.69%                | 15.49%               | 8.00%                     | N/A                 |
| Farmers & Merchants Trust Company                        | 15.66%                | 15.26%               | 8.00%                     | 10.00%              |
| <b>Tier 1 Leverage Ratio (4)</b>                         |                       |                      |                           |                     |
| Franklin Financial Services Corporation                  | 10.33%                | 9.69%                | 4.00%                     | N/A                 |
| Farmers & Merchants Trust Company                        | 10.17%                | 9.55%                | 4.00%                     | 5.00%               |

(1) Common equity Tier 1 capital/ total risk-weighted assets (2) Tier 1 capital / total risk-weighted assets

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

## Economy

The Corporation's primary market area includes Franklin, Fulton, Cumberland and Huntingdon County, PA. This area is diverse in demographic and economic makeup. County populations range from a low of approximately 14,000 in Fulton County to over 220,000 in Cumberland County. Unemployment in the Bank's market area has remained virtually unchanged over the past year and ranges from a low of 4.6% 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

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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, 2015 | December 31, 2014 |
|--|--------------------|-------------------|
| Unemployment Rate (seasonally adjusted)                  |                    |                   |
| Market area range (1)                                    | 4.6% - 7.1%        | 3.6% - 5.8%       |
| Pennsylvania   | 5.4%               | 5.1%              |
| United States  | 5.1%               | 5.8%              |
| Housing Price Index - year over year change              |                    |                   |
| PA, nonmetropolitan statistical area                     | 2.8%               | 0.5%              |
| United States  | 5.2%               | 5.7%              |
| Franklin County Building Permits - year over year change |                    |                   |
| Residential, estimated                                   | -1.5%              | 32.7%             |
| Multifamily, estimated                                   | 67.2%              | 157.8%            |

(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. Many analysts believe that the FOMC might increase rates in December 2015.

#### 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, 2015, the Bank had approximately \$79.6 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, 2015, the Bank had approximately \$35 million available on this line of credit and \$16.0 million of unsecured lines of credit at correspondent banks. At September 30, 2015, the Bank had an excess borrowing capacity at FHLB of \$246.6 million, which includes the amount available on the line of credit. The Bank has

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established credit at the Federal Reserve Discount Window and as of quarter-end had the ability to borrow approximately \$26 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 \$275.5 million and \$248.3 million, respectively, at September 30, 2015 and December 31, 2014.

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 2014 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, 2015. For more information on market risk refer to the Corporation's 2014 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, 2015, 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, 2015, 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.

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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. However, in management's opinion, there are no proceedings pending to which the Corporation is a party or to which our property is subject, which, if determined adversely to the Corporation, would be material in relation to our shareholders' equity or financial condition. In addition, no material proceedings are pending or are known to be threatened or contemplated against us by governmental authorities or other parties.

Item 1A. Risk Factors

There were no material changes in the Corporation's risk factors during the nine months ended September 30, 2015. For more information, refer to the Corporation's 2014 Annual Report on Form 10-K.

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

None

Item 3. Defaults by the Company on its Senior Securities

None

Item 4. Mine Safety Disclosures

Not Applicable

Item 5. Other Information

None

Item 6. Exhibits

Exhibits

3.1 Articles of Incorporation of the Corporation. (Filed as Exhibit 3.1 to Annual Report on Form 10-K for the year ended December 31, 2014 and incorporated herein by reference.)

3.2 Bylaws of the Corporation. (Filed as Exhibit 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)

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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 9, 2015 /s/ William E. Snell, Jr  
William E. Snell, Jr.  
President and Chief Executive Officer  
(Principal Executive Officer)

November 9, 2015 /s/ Mark R. Hollar  
Mark R. Hollar  
Treasurer and Chief Financial Officer  
(Principal Financial and Accounting Officer)