FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-Q
August 11, 2014
UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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

For the transition period from__________ to___________

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

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

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

(717) 264-6116

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" 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 4,193,398 outstanding shares of the Registrant's common stock as of July 31, 2014.

INDEX

Part I FINANCIAL INFORMATION

Item 1 Financial Statements

Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)	(unaudited) June 30 2014	December 31 2013
Assets		
Cash and due from banks	$ 17,515	$ 13,542
Interest-bearing deposits in other banks	37,276	27,203
Total cash and cash equivalents	54,791	40,745
Investment securities available for sale, at fair value	175,419	159,674
Restricted stock	1,938	1,906
Loans held for sale	600	349
Loans	732,719	723,413
Allowance for loan losses	(9,519)	(9,702)
Net Loans	723,200	713,711
Premises and equipment, net	15,762	16,145
Bank owned life insurance	21,816	21,530
Goodwill	9,016	9,016
Other intangible assets	491	698
Other real estate owned	4,112	4,708
Deferred tax asset, net	4,717	5,445
Other assets	10,689	10,660
Total assets	$ 1,022,551	$ 984,587
Liabilities		
Deposits		
Noninterest-bearing checking	$ 129,270	$ 121,565
Money management, savings and interest checking	665,627	610,245
Time	105,807	113,914
Total Deposits	900,704	845,724
Securities sold under agreements to repurchase	2,264	23,834
Long-term debt	12,000	12,403
Other liabilities	7,624	7,238
Total liabilities	922,592	889,199
Shareholders' equity		
Common stock, $1 par value per share,15,000,000 shares authorized with 4,581,342 shares issued and 4,192,791 shares outstanding at June 30, 2014 and 4,560,700 shares issued and 4,168,673 shares outstanding at December 31, 2013	4,581	4,561

Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding	-	-
Additional paid-in capital	36,980	36,636
Retained earnings	68,623	65,897
Accumulated other comprehensive loss	(3,277)	(4,696)
Treasury stock, 388,551 shares at June 30, 2014 and 392,027 shares at December 31, 2013, at cost	(6,948)	(7,010)
Total shareholders' equity	99,959	95,388
Total liabilities and shareholders' equity	$ 1,022,551	$ 984,587

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

1

Consolidated Statements of Income

(Dollars in thousands, except per share data) (unaudited)	For the Three Months Ended June 30		For the Six Months Ended June 30	
	2014	2013	2014	2013
Interest income				
Loans, including fees	$ 7,648	$ 8,035	$ 15,159	$ 16,332
Interest and dividends on investments:				
Taxable interest	661	365	1,302	718
Tax exempt interest	376	381	734	757
Dividend income	31	22	56	40
Deposits and obligations of other banks	45	73	84	131
Total interest income	8,761	8,876	17,335	17,978
Interest expense				
Deposits	694	1,162	1,396	2,265
Securities sold under agreements to repurchase	2	12	9	30
Long-term debt	121	122	242	243
Total interest expense	817	1,296	1,647	2,538
Net interest income	7,944	7,580	15,688	15,440
Provision for loan losses	266	803	464	1,605
Net interest income after provision for loan losses	7,678	6,777	15,224	13,835
Noninterest income				
Investment and trust services fees	1,101	1,130	2,192	2,148
Loan service charges	250	192	418	442
Mortgage banking activities	19	40	32	18
Deposit service charges and fees	525	452	990	888
Other service charges and fees	317	233	584	455
Debit card income	337	316	643	602
Increase in cash surrender value of life insurance	144	153	286	305
Other real estate owned (losses) gains, net	(62)	(141)	(185)	(141)
Other	10	47	62	89
OTTI losses recognized in earnings	-	(50)	-	(50)
Securities gains, net	221	29	221	29
Total noninterest income	2,862	2,401	5,243	4,785
Noninterest expense				
Salaries and employee benefits	4,107	4,018	8,357	8,232
Net occupancy expense	586	568	1,262	1,136
Furniture and equipment expense	237	244	491	491
Advertising	270	317	586	652
Legal and professional fees	353	359	618	639
Data processing	493	451	884	845
Pennsylvania bank shares tax	173	204	347	409
Intangible amortization	104	106	207	213
FDIC insurance	222	270	454	515

ATM/debit card processing	178	165	357	346
Other	892	923	1,741	1,730
Total noninterest expense	7,615	7,625	15,304	15,208
Income before federal income taxes	2,925	1,553	5,163	3,412
Federal income tax expense	606	198	1,018	506
Net income	$ 2,319	$ 1,355	$ 4,145	$ 2,906
Per share				
Basic earnings per share	$ 0.55	$ 0.33	$ 0.99	$ 0.71
Diluted earnings per share	$ 0.55	$ 0.33	$ 0.99	$ 0.70
Cash dividends declared	$ 0.17	$ 0.17	$ 0.34	$ 0.34

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

Consolidated Statements of Comprehensive Income

(Dollars in thousands) (unaudited)	For the Three Months Ended June 30 2014	2013	For the Six Months Ended June 30 2014	2013
Net Income	$ 2,319	$ 1,355	$ 4,145	$ 2,906
Securities:				
Unrealized gains (losses) arising during the period	774	(1,768)	2,194	(1,591)
Reclassification adjustment for (gains) losses included in net income	(221)	21	(221)	21
Net unrealized (losses) gains	553	(1,747)	1,973	(1,570)
Tax effect	(188)	594	(671)	534
Net of tax amount	365	(1,153)	1,302	(1,036)
Derivatives:				
Unrealized (losses) gains arising during the period	(4)	42	(12)	44
Reclassification adjustment for losses included in net income (1)	94	152	189	332
Net unrealized gains	90	194	177	376
Tax effect	(30)	(66)	(60)	(128)
Net of tax amount	60	128	117	248
Total other comprehensive income (loss)	425	(1,025)	1,419	(788)
Total Comprehensive Income	$ 2,744	$ 330	$ 5,564	$ 2,118

Reclassification adjustment / Statement line item	Tax expense (benefit)		Tax expense (benefit)	
(1) Derivatives / interest expense on deposits	$ (32)	$ (52)	$ (64)	$ (113)

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

Consolidated Statements of Changes in Shareholders' Equity

For the Six months June 30, 2014 and 2013:

(Dollars in thousands, except per share data) (unaudited)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance at December 31, 2012	$ 4,503	$ 35,788	$ 62,475	$ (4,050)	$ (7,082)	$ 91,634
Net income	-	-	2,906	-	-	2,906
Other comprehensive loss	-	-	-	(788)	-	(788)
Cash dividends declared, $.34 per share	-	-	(1,399)	-	-	(1,399)
Treasury shares issued under stock option plans, 3,701 shares	-	(20)	-	-	67	47
Common stock issued under dividend reinvestment plan, 22,920 shares	23	338	-	-	-	361
Balance at June 30, 2013	$ 4,526	$ 36,106	$ 63,982	$ (4,838)	$ (7,015)	$ 92,761
Balance at December 31, 2013	$ 4,561	$ 36,636	$ 65,897	$ (4,696)	$ (7,010)	$ 95,388
Net income	-	-	4,145	-	-	4,145
Other comprehensive income	-	-	-	1,419	-	1,419
Cash dividends declared, $.34 per share	-	-	(1,419)	-	-	(1,419)
Treasury shares issued under stock option plans, 3,476 shares	-	(10)	-	-	62	52
Common stock issued under dividend reinvestment plan, 20,642 shares	20	354	-	-	-	374
Balance at June 30, 2014	$ 4,581	$ 36,980	$ 68,623	$ (3,277)	$ (6,948)	$ 99,959

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

Consolidated Statements of Cash Flows

	Six Months Ended June 30			
	2014		2013	
(Dollars in thousands) (unaudited)				
Cash flows from operating activities				
Net income	$	4,145	$	2,906
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization		732		754
Net amortization of loans and investment securities		893		910
Amortization and net change in mortgage servicing rights valuation		8		33
Amortization of intangibles		207		213
Provision for loan losses		464		1,605
Net realized gains on sales of securities		(221)		(29)
Impairment writedown on securities recognized in earnings		-		50
Loans originated for sale		(3,554)		(5,270)
Proceeds from sale of loans		3,303		5,099
Writedown of other real estate owned		200		135
Net (gain) loss on sale or disposal of other real estate/other repossessed assets		(15)		6
Increase in cash surrender value of life insurance		(286)		(305)
(Increase) decrease in other assets		(118)		1,077
Increase (decrease) in other liabilities		526		(265)
Other, net		87		705
		6,371		7,624

Net cash provided by operating activities		
Cash flows from investing activities		
Proceeds from sales and calls of investment securities available for sale	1,582	5,147
Proceeds from maturities and paydowns of securities available for sale	12,313	18,376
Purchase of investment securities available for sale	(28,362)	(42,743)
Net (increase) decrease in restricted stock	(32)	1,436
Net (increase) decrease in loans	(10,012)	23,614
Capital expenditures	(321)	(275)
Proceeds from sale of other real estate/other repossessed assets	493	15
Net cash (used in) provided by investing activities	(24,339)	5,570
Cash flows from financing activities		
Net increase in demand deposits, NOW, and savings accounts	63,087	50,532
Net decrease in time deposits	(8,107)	(43,175)
Net decrease in repurchase agreements	(21,570)	(3,275)
Long-term debt payments	(403)	(4)
Dividends paid	(1,419)	(1,399)
Treasury stock issued under stock option plans	52	47
Common stock issued under dividend reinvestment plan	374	361
Net cash provided by financing activities	32,014	3,087
Increase in cash and cash equivalents	14,046	16,281
Cash and cash equivalents as of January 1	40,745	77,834

Cash and cash equivalents as of June 30	$	54,791	$	94,115
Supplemental Disclosures of Cash Flow Information				
Cash paid during the year for:				
Interest on deposits and other borrowed funds	$	1,670	$	2,607
Income taxes	$	236	$	300
Noncash Activities				
Loans transferred to Other Real Estate	$	82	$	293

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

4

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

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

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of June 30, 2014, and for all other periods presented have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation's 2013 Annual Report on Form 10-K. The consolidated results of operations for the period ended June 30, 2014 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

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

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

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

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(Dollars and shares in thousands, except per share data)	2014	2013	2014	2013
Weighted average shares outstanding (basic)	4,184	4,126	4,178	4,119
Impact of common stock equivalents	7	7	6	7
Weighted average shares outstanding (diluted)	4,191	4,133	4,184	4,126

Anti-dilutive options excluded from calculation	34	46	37	57
Net income	$ 2,319	$ 1,355	$ 4,145	$ 2,906
Basic earnings per share	$ 0.55	$ 0.33	$ 0.99	$ 0.71
Diluted earnings per share	$ 0.55	$ 0.33	$ 0.99	$ 0.70

Note 2. Recent Accounting Pronouncements

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

Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11 "Presentation of an Unrecognized Tax Benefit

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

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 loss included in shareholders' equity are as follows:

	June 30 2014	December 31 2013
(Dollars in thousands)		
Net unrealized gains (losses) on securities	$ 1,232	$ (741)
Tax effect	(419)	252
Net of tax amount	813	(489)
Net unrealized losses on derivatives	(384)	(561)
Tax effect	131	191
Net of tax amount	(253)	(370)

Accumulated pension adjustment	(5,814)	(5,814)
Tax effect	1,977	1,977
Net of tax amount	(3,837)	(3,837)
Total accumulated other comprehensive loss	$ (3,277)	$ (4,696)

Note 4. Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Bank generally holds collateral and/or personal guarantees supporting these commitments. The Bank had $22.5 million and $20.2 million of standby letters of credit as of June 30, 2014 and

December 31, 2013, respectively. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of June 30, 2014 and December 31, 2013 for guarantees under standby letters of credit issued was not material.

Note 5. Investments

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2014 and December 31, 2013 is as follows:

(Dollars in thousands) June 30, 2014	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Equity securities	$ 110	$ 284	$ -	$ 394
U.S. Government agency securities	15,376	99	(80)	15,395
Municipal securities	64,018	1,762	(730)	65,050
Corporate debt securities	1,000	-	-	1,000
Trust preferred securities	5,931	-	(625)	5,306
Agency mortgage-backed securities	85,859	905	(412)	86,352
Private-label mortgage-backed securities	1,845	45	(14)	1,876
Asset-backed securities	48	-	(2)	46
	$ 174,187	$ 3,095	$ (1,863)	$ 175,419

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

$ 160,415	$ 2,735	$ (3,476)	$ 159,674

At June 30, 2014 and December 31, 2013, the fair value of investment securities pledged to secure public funds, trust balances, repurchase agreements, deposit and other obligations totaled $83.9 million and $107.6 million, respectively.

7

The amortized cost and estimated fair value of debt securities at June 30, 2014, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

(Dollars in thousands)	Amortized cost	Fair value
Due in one year or less	$ 2,741	$ 2,780
Due after one year through five years	11,474	11,911
Due after five years through ten years	27,749	28,064
Due after ten years	44,409	44,042
	86,373	86,797
Mortgage-backed securities	87,704	88,228
	$ 174,077	$ 175,025

The following table provides additional detail about trust preferred securities as of June 30, 2014:

Trust Preferred Securities

(Dollars in thousands)

Deal Name	Single Issuer or Pooled	Class	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Lowest Credit Rating Assigned	Number of Banks Currently Performing	Deferrals and Defaults as % of Original Collateral	Expected Deferral/ Defaults as a Percentage of Remaining Performing Collateral
Huntington Cap Trust	Single	Preferred Stock	$ 937	$ 844	$ (93)	BB+	1	None	None
Huntington Cap Trust II	Single	Preferred Stock	887	821	(66)	BB+	1	None	None
BankAmerica Cap III	Single	Preferred Stock	962	836	(126)	BB+	1	None	None
Wachovia Cap Trust II	Single	Preferred Stock	276	257	(19)	BBB+	1	None	None
Corestates Captl Tr II	Single	Preferred Stock	934	871	(63)	BBB+	1	None	None
Chase Cap VI JPM	Single	Preferred Stock	961	865	(96)	BBB	1	None	None

Fleet Cap Tr V	Single	Preferred Stock	974	812	(162)	BB+	1	None	None
			$ 5,931	$ 5,306	$ (625)				

The following table provides additional detail about private label mortgage-backed securities as of June 30, 2014:

Private Label Mortgage Backed Securities

(Dollars in thousands) Description	Origination Date	Amortized Cost	Fair Value	Gross Unrealized Gain (Loss)	Collateral Type	Lowest Credit Rating Assigned	Credit Support %	Cumulative OTTI Charges
RALI 2004-QS4 A7	3/1/2004	$ 129	$ 134	$ 5	ALT A	BBB+	12.53	$ -
MALT 2004-6 7A1	6/1/2004	424	444	20	ALT A	CCC	14.38	-
RALI 2005-QS2 A1	2/1/2005	308	321	13	ALT A	CC	5.78	10
RALI 2006-QS4 A2	4/1/2006	575	567	(8)	ALT A	D	-	293
GSR 2006-5F 2A1	5/1/2006	91	98	7	Prime	D	-	15
RALI 2006-QS8 A1	7/28/2006	318	312	(6)	ALT A	D	-	197
		$ 1,845	$ 1,876	$ 31				$ 515

Impairment:

The investment portfolio contained 99 securities with $75.8 million of temporarily impaired fair value and $1.9 million in unrealized losses at June 30, 2014. The total unrealized loss position has improved by $1.6 million since year-end 2013.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before the earlier of amortized cost recovery or maturity. Equity securities are assessed for other-than-temporary impairment based on the length of time of impairment, dollar amount of the impairment and general market and financial conditions relating to specific issues. The impairment identified on debt and equity securities and subject to assessment at June 30, 2014, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of June 30, 2014 and December 31, 2013:

	June 30, 2014								
	Less than 12 months			12 months or more			Total		
(Dollars in thousands)	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government agency securities	$ 2,078	$ (2)	3	$ 7,509	$ (78)	13	$ 9,587	$ (80)	16
Municipal securities	10,051	(111)	14	15,070	(619)	21	25,121	(730)	35
Trust preferred securities	-	-	-	5,306	(625)	7	5,306	(625)	7
Agency mortgage-backed securities	20,400	(126)	21	14,472	(286)	17	34,872	(412)	38
Private-label mortgage-backed securities	-	-	-	879	(14)	2	879	(14)	2
Asset-backed securities	-	-	-	5	(2)	1	5	(2)	1
Total temporarily impaired securities	$ 32,529	$ (239)	38	$ 43,241	$ (1,624)	61	$ 75,770	$ (1,863)	99

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

The municipal bond portfolio has the largest unrealized loss at $730 thousand, but this is $674 thousand less than at the prior-year end. The unrealized loss in this portfolio is deemed to be non-credit related and no other-than-temporary impairment charges have been recorded.

The trust preferred portfolio contains seven securities with a fair value of $5.3 million and an unrealized loss of $625 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

9

single issue, variable rate notes with long maturities (2027 – 2028). None of these bonds have suspended or missed a dividend payment. At June 30, 2014, the Bank believes it will be able to collect all interest and principal due on these bonds and no other-than-temporary-impairment charges were recorded.

The PLMBS sector shows a gross unrealized loss of $14 thousand. These bonds were all rated AAA at time of purchase, but have since experienced rating declines. Some have experienced increased delinquencies and defaults, while others have seen the credit support increase as the bonds paid-down. The Bank monitors the performance of the PLMBS investments on a regular basis and reviews delinquencies, default rates, credit support levels and various cash flow stress test scenarios. In determining the credit related loss, Management considers all principal past due 60 days or more as a loss. If additional principal moves beyond 60 days past due, it will also be considered a loss. As a result of the analysis on PLMBS it was determined that no impairment charge was required at quarter end. The Bank has recorded $515 thousand of cumulative impairment charges on this portfolio. Management continues to monitor these securities and it is possible that additional write-downs may occur if current loss trends continue. The Bank is currently participating in a class-action lawsuit against one PLMBS servicer that centers on defective warranties and representations made as part of the underwriting process.

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

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

Note 6. Loans

The Bank reports its loan portfolio based on the primary collateral of the loan. It further classifies these loans by the primary purpose, either consumer or commercial. The Bank's 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)	June 30, 2014	December 31, 2013	Change Amount	%
Residential Real Estate 1-4 Family				
Consumer first liens	$ 102,849	$ 103,573	$ (724)	(0.7)
Consumer junior liens and lines of credit	35,131	34,636	495	1.4
Total consumer	137,980	138,209	(229)	(0.2)
Commercial first lien	58,639	58,466	173	0.3
Commercial junior liens and lines of credit	4,940	5,939	(999)	(16.8)
Total commercial	63,579	64,405	(826)	(1.3)
Total residential real estate 1-4 family	201,559	202,614	(1,055)	(0.5)
Residential real estate - construction				
Consumer	2,414	3,960	(1,546)	(39.0)
Commercial	8,868	8,559	309	3.6
Total residential real estate construction	11,282	12,519	(1,237)	(9.9)
Commercial real estate	322,465	329,373	(6,908)	(2.1)
Commercial	190,130	170,327	19,803	11.6
Total commercial	512,595	499,700	12,895	2.6
Consumer	7,283	8,580	(1,297)	(15.1)
	732,719	723,413	9,306	1.3
Less: Allowance for loan losses	(9,519)	(9,702)	183	1.9
Net Loans	$ 723,200	$ 713,711	$ 9,489	1.3
Included in the loan balances are the following:				
Net unamortized deferred loan costs	$ 472	$ 372		
Unamortized discount on purchased loans	$ (49)	$ (92)		

Loans pledged as collateral for borrowings and commitments from:		
FHLB	$ 594,772	$ 607,524
Federal Reserve Bank	57,689	45,809
	$ 652,461	$ 653,333

Note 7. Loan Quality

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

	Residential Real Estate 1-4 Family						
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Commercial Real Estate	Commercial	Consumer	Total
Allowance at March 31, 2014	$ 1,133	$ 276	$ 374	$ 5,509	$ 2,309	$ 144	$ 9,745
Charge-offs	(241)	-	-	(234)	(11)	(37)	(523)
Recoveries	-	-	-	-	13	18	31
Provision	187	(10)	(113)	137	55	10	266
Allowance at June 30, 2014	$ 1,079	$ 266	$ 261	$ 5,412	$ 2,366	$ 135	$ 9,519
Allowance at December 31, 2013	$ 1,108	$ 278	$ 291	$ 5,571	$ 2,306	$ 148	$ 9,702
Charge-offs	(257)	-	(27)	(348)	(12)	(80)	(724)
Recoveries	3	-	-	-	33	41	77
Provision	225	(12)	(3)	189	39	26	464
Allowance at June 30, 2014	$ 1,079	$ 266	$ 261	$ 5,412	$ 2,366	$ 135	$ 9,519
Allowance at March 31, 2013	$ 973	$ 296	$ 837	$ 6,682	$ 1,972	$ 183	$ 10,943
Charge-offs	(39)	-	-	-	(317)	(40)	(396)
Recoveries	1	-	-	3	68	16	88
Provision	430	(18)	(136)	45	479	3	803
Allowance at June 30, 2013	$ 1,365	$ 278	$ 701	$ 6,730	$ 2,202	$ 162	$ 11,438
Allowance at December 31, 2012	$ 913	$ 306	$ 899	$ 6,450	$ 1,620	$ 191	$ 10,379
Charge-offs	(39)	(45)	-	(167)	(327)	(84)	(662)
Recoveries	9	-	-	3	75	29	116
Provision	482	17	(198)	444	834	26	1,605
Allowance at June 30, 2013	$ 1,365	$ 278	$ 701	$ 6,730	$ 2,202	$ 162	$ 11,438

The following table presents, by class, loans that were evaluated for the ALL under the specific reserve (individually) and those that were evaluated under the general reserve (collectively) and the amount of the ALL established in each class as of June 30, 2014 and December 31, 2013:

	Residential Real Estate 1-4 Family						
(Dollars in thousands)	First Liens	Junior Liens & Lines of Credit	Construction	Commercial Real Estate	Commercial	Consumer	Total
June 30, 2014							
Loans evaluated for allowance:							
Individually	$ 1,158	$ 51	$ 525	$ 22,210	$ 1,924	$ -	$ 25,868
Collectively	160,330	40,020	10,757	300,255	188,206	7,283	706,851
Total	$ 161,488	$ 40,071	$ 11,282	$ 322,465	$ 190,130	$ 7,283	$ 732,719
Allowance established for loans evaluated:							
Individually	$ -	$ -	$ -	$ 68	$ 957	$ -	$ 1,025
Collectively	1,079	266	261	5,344	1,409	135	8,494
Allowance at June 30, 2014	$ 1,079	$ 266	$ 261	$ 5,412	$ 2,366	$ 135	$ 9,519
December 31, 2013							
Loans evaluated for allowance:							
Individually	$ 2,354	$ 50	$ 537	$ 25,107	$ 1,996	$ -	$ 30,044
Collectively	159,685	40,525	11,982	304,266	168,331	8,580	693,369
Total	$ 162,039	$ 40,575	$ 12,519	$ 329,373	$ 170,327	$ 8,580	$ 723,413
Allowance established for loans evaluated:							
Individually	$ 9	$ -	$ -	$ 89	$ 1,002	$ -	$ 1,100
Collectively	1,099	278	291	5,482	1,304	148	8,602
Allowance at December 31, 2013	$ 1,108	$ 278	$ 291	$ 5,571	$ 2,306	$ 148	$ 9,702

The following table shows additional information about those loans considered to be impaired at June 30, 2014 and December 31, 2013:

	Impaired Loans With No Allowance		With Allowance		
(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Recorded Investment	Unpaid Principal Balance	Related Allowance
June 30, 2014					
Residential Real Estate 1-4 Family					
First liens	$ 2,271	$ 2,348	$ -	$ -	$ -
Junior liens and lines of credit	120	145	-	-	-
Total	2,391	2,493	-	-	-
Residential real estate - construction	525	553	-	-	-
Commercial real estate	21,338	27,103	916	1,022	68
Commercial	139	392	1,898	2,019	957
Total	$ 24,393	$ 30,541	$ 2,814	$ 3,041	$ 1,025
December 31, 2013					
Residential Real Estate 1-4 Family					
First liens	$ 3,030	$ 3,500	$ 9	$ 39	$ 9
Junior liens and lines of credit	108	127	-	-	-
Total	3,138	3,627	9	39	9
Residential real estate - construction	537	556	-	-	-
Commercial real estate	24,188	30,334	966	1,043	89
Commercial	88	89	1,970	2,043	1,002
Total	$ 27,951	$ 34,606	$ 2,945	$ 3,125	$ 1,100

14

The following table shows the average of impaired loans and related interest income for the three and six months ended June 30, 2014 and 2013:

(Dollars in thousands)	Three Months Ended June 30, 2014 Average Recorded Investment	Three Months Ended June 30, 2014 Interest Income Recognized	Six Months Ended June 30, 2014 Average Recorded Investment	Six Months Ended June 30, 2014 Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	$ 2,289	$ 15	$ 2,753	$ 25
Junior liens and lines of credit	120	-	123	-
Total	2,409	15	2,876	25
Residential real estate - construction	527	-	530	-
Commercial real estate	22,399	81	24,032	174
Commercial	2,056	-	2,074	1
Total	$ 27,391	$ 96	$ 29,512	$ 200

(Dollars in thousands)	Three Months Ended June 30, 2013 Average Recorded Investment	Three Months Ended June 30, 2013 Interest Income Recognized	Six Months Ended June 30, 2013 Average Recorded Investment	Six Months Ended June 30, 2013 Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	$ 3,439	$ 4	$ 4,283	$ 8
Junior liens and lines of credit	679	4	722	1
Total	4,118	8	5,005	9
Residential real estate - construction	550	-	692	-
Commercial real estate	29,705	96	24,218	36
Commercial	2,454	-	4,219	36
Total	$ 36,827	$ 104	$ 34,134	$ 81

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

(Dollars in thousands)		Loans Past Due and Still Accruing					Total
	Current	30-59 Days	60-89 Days	90 Days+	Total	Non-Accrual	Loans
June 30, 2014							
Residential Real Estate 1-4 Family							
First liens	$ 159,292	$ 316	$ 213	$ 392	$ 921	$ 1,275	$ 161,488
Junior liens and lines of credit	39,811	111	28	11	150	110	40,071
Total	199,103	427	241	403	1,071	1,385	201,559
Residential real estate - construction	10,138	-	619	-	619	525	11,282
Commercial real estate	303,567	546	2,167	-	2,713	16,185	322,465
Commercial	187,344	225	18	-	243	2,543	190,130
Consumer	7,160	84	31	8	123	-	7,283
Total	$ 707,312	$ 1,282	$ 3,076	$ 411	$ 4,769	$ 20,638	$ 732,719

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

16

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

(Dollars in thousands)	Pass	Special Mention	Substandard	Doubtful	Total
June 30, 2014					
Residential Real Estate 1-4 Family					
First liens	$ 153,596	$ 2,880	$ 5,012	$ -	$ 161,488
Junior liens and lines of credit	39,708	-	363	-	40,071
Total	193,304	2,880	5,375	-	201,559
Residential real estate - construction	10,128	-	1,154	-	11,282
Commercial real estate	285,623	6,514	30,328	-	322,465
Commercial	171,302	9,134	9,694	-	190,130
Consumer	7,275	-	8	-	7,283
Total	$ 667,632	$ 18,528	$ 46,559	$ -	$ 732,719

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

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

(Dollars in thousands)	Troubled Debt Restructurings				Troubled Debt Restructurings That Have Defaulted on Modified Terms YTD	
	Number of Contracts	Recorded Investment	Performing*	Nonperforming*	Number of Contracts	Recorded Investment
June 30, 2014						
Residential real estate - construction	1	$ 525	$ -	$ 525	-	$ -
Residential real estate	5	603	603	-	-	-
Commercial real estate	12	15,556	14,609	947	-	-
Total	18	$ 16,684	$ 15,212	$ 1,472	-	$ -
December 31, 2013						
Residential real estate - construction	1	$ 537	$ -	$ 537	-	$ -
Residential real estate	5	625	625	-	-	-
Commercial real estate	12	15,877	14,318	1,559	-	-
Total	18	$ 17,039	$ 14,943	$ 2,096	-	$ -

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

There were no new TDR loans made during 2014.

The following table reports new TDR loans made during 2013, concession granted and the recorded investment as of June 30, 2013:

	New During Period				
Three Months Ended June 30, 2013	Number of Contracts	Pre-TDR Modification	After-TDR Modification	Recorded Investment	Concession
Residential real estate	1	$ 75	$ 75	$ 75	multiple
Commercial real estate	1	8,014	8,014	8,014	multiple
	2	$ 8,089	$ 8,089	$ 8,089	
Six Months Ended June 30, 2013					
Residential real estate	1	$ 75	$ 75	$ 75	multiple
Commercial real estate	2	10,458	10,745	10,659	multiple
	3	$ 10,533	$ 10,820	$ 10,734	

Note 8. Pension

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

	Three Months Ended June 30		Six Months Ended June 30	
(Dollars in thousands)	2014	2013	2014	2013
Components of net periodic cost:				
Service cost	$ 83	$ 114	$ 169	$ 228
Interest cost	194	179	391	358
Expected return on plan assets	(291)	(312)	(581)	(624)
Recognized net actuarial loss	81	159	163	318
Net period cost	$ 67	$ 140	$ 142	$ 280

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

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

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

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

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

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

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

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

The following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at June 30, 2014 and December 31, 2013.

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

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

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

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

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

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

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

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

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

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

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

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

	June 30, 2014				
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	$ 54,791	$ 54,791	$ 54,791	$ -	$ -
Investment securities available for sale	175,419	175,419	394	175,025	-
Restricted stock	1,938	1,938	-	1,938	-
Loans held for sale	600	600	-	600	-
Net loans	723,200	726,748	-	-	726,748
Accrued interest receivable	3,210	3,210	-	3,210	-
Mortgage servicing rights	176	176	-	-	176
Financial liabilities:					
Deposits	$ 900,704	$ 901,068	$ -	$ 901,068	$ -
Securities sold under agreements to repurchase	2,264	2,264	-	2,264	-
Long-term debt	12,000	12,418	-	12,418	-
Accrued interest payable	206	206	-	206	-
Interest rate swaps	384	384	-	384	-

	December 31, 2013				
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	$ 40,745	$ 40,745	$ 40,745	$ -	$ -
Investment securities available for sale	159,674	159,674	1,970	157,704	-
Restricted stock	1,906	1,906	-	1,906	-
Loans held for sale	349	349	-	349	-
Net loans	713,711	722,119	-	-	722,119
Accrued interest receivable	3,087	3,087	-	3,087	-
Mortgage servicing rights	184	184	-	-	184
Financial liabilities:					
Deposits	$ 845,724	$ 846,289	$ -	$ 846,289	$ -
Securities sold under agreements to repurchase	23,834	23,834	-	23,834	-
Long-term debt	12,403	12,999	-	12,999	-
Accrued interest payable	229	229	-	229	-
Interest rate swaps	561	561	-	561	-

Recurring Fair Value Measurements

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at June 30, 2014 and December 31, 2013 are as follows:

(Dollars in Thousands)	Fair Value at June 30, 2014			
Asset Description	Level 1	Level 2	Level 3	Total
Equity securities	$ 394	$ -	$ -	$ 394
Obligations of U.S. Government agencies	-	15,395	-	15,395
Obligations of state and political subdivisions	-	65,050	-	65,050
Corporate debt securities	-	1,000	-	1,000
Trust Preferred Securities	-	5,306	-	5,306
Agency mortgage-backed securities	-	86,352	-	86,352
Private-label mortgage-backed securities	-	1,876	-	1,876
Asset-backed securities	-	46	-	46
Total assets	$ 394	$ 175,025	$ -	$ 175,419
Liability Description				
Interest rate swaps	$ -	$ 384	$ -	$ 384
Total liabilities	$ -	$ 384	$ -	$ 384

(Dollars in Thousands)	Fair Value at December 31, 2013			
Asset Description	Level 1	Level 2	Level 3	Total
Equity securities	$ 1,970	$ -	$ -	$ 1,970
Obligations of U.S. Government agencies	-	11,751	-	11,751
Obligations of state and political subdivisions	-	56,857	-	56,857
Corporate debt securities	-	1,001	-	1,001
Trust Preferred Securities	-	5,051	-	5,051
Agency mortgage-backed securities	-	81,027	-	81,027
Private-label mortgage-backed securities	-	1,969	-	1,969
Asset-backed securities	-	48	-	48
Total assets	$ 1,970	$ 157,704	$ -	$ 159,674
Liability Description				
Interest rate swaps	$ -	$ 561	$ -	$ 561
Total liabilities	$ -	$ 561	$ -	$ 561

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 June 30, 2014 and December 31, 2013 are as follows:

(Dollars in Thousands)

	Fair Value at June 30, 2014			
Asset Description	Level 1	Level 2	Level 3	Total
Impaired loans (1)	$ -	$ -	$ 2,730	$ 2,730
Other real estate owned (1)	-	-	831	831
Mortgage servicing rights	-	-	176	176
Total assets	$ -	$ -	$ 3,737	$ 3,737

(Dollars in Thousands)	Fair Value at December 31, 2013			
Asset Description	Level 1	Level 2	Level 3	Total
Impaired loans (1)	$ -	$ -	$ 8,588	$ 8,588
Other real estate owned (1)	-	-	498	498
Mortgage servicing rights	-	-	184	184
Total assets	$ -	$ -	$ 9,270	$ 9,270

(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.

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.

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 June 30, 2014. For financial assets and liabilities measured at fair value on a recurring basis, there were no transfers of financial assets or liabilities between Level 1 and Level 2 during the period ending June 30, 2014.

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

(Dollars in Thousands)	Quantitative Information about Level 3 Fair Value Measurements at June 30, 2014			
Asset Description	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans (1)	$ 2,730	Appraisal	Appraisal Adjustments (2)	0% - 100% (30.44%)
			Cost to sell	0% - 10% (4.70%)
Other real estate owned (1)	831	Appraisal	Appraisal Adjustments (2)	
			Cost to sell	8% (8%)
Mortgage servicing rights	176	Discounted Cash Flow (3)		
	at December 31, 2013			
Impaired loans (1)	$ 8,588	Appraisal	Appraisal Adjustments (2)	0% - 60% (5%)
			Cost to sell	5% - 13.5% (7%)
Other real estate owned (1)	498	Appraisal	Appraisal Adjustments (2)	
			Cost to sell	8% (8%)
Mortgage servicing rights	184	Discounted Cash Flow (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.

Information regarding the interest rate swaps as of June 30, 2014 follows:

(Dollars in thousands)				Amount Expected to be Expensed into
Notional	Maturity	Interest Rate		Earnings within the
Amount	Date	Fixed	Variable	next 12 Months
$ 10,000	5/30/2015	3.87%	0.04%	$ 351

Fair Value of Derivative Instruments in the Consolidated Balance Sheets were as follows as of June 30, 2014 and December 31, 2013:

Fair Value of Derivative Instruments (Dollars in thousands)		Balance Sheet	
			Fair
Date	Type	Location	Value
June 30, 2014	Interest rate contracts	Other liabilities	$ 384
December 31, 2013	Interest rate contracts	Other liabilities	$ 561

The Effect of Derivative Instruments on the Statement of Income for the Three and Six Months Ended June 30, 2014 and 2013 follows:

Derivatives in ASC Topic 815 Cash Flow Hedging Relationships

(Dollars in thousands)

Date / Type	Amount of Gain or (Loss) Recognized in OCI net of tax on Derivative (Effective Portion)	Location of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain or (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain or (Loss) Recognized in Income on Derivatives (Ineffective Portion and Amount Excluded from Effectiveness Testing)
Interest rate contracts					
Three months ended:					
June 30, 2014	$ 60	Interest Expense	$ (94)	Other income (expense)	$ -
June 30, 2013	$ 128	Interest Expense	$ (152)	Other income (expense)	$ -
Six months ended:					
June 30, 2014	$ 117	Interest Expense	$ (189)	Other income (expense)	$ -
June 30, 2013	$ 248	Interest Expense	$ (332)	Other income (expense)	$ -

Interest Rate Swap Agreements ("Swap Agreements")

The Bank has entered into interest rate swap agreements as part of its asset/liability management program. The swap agreements are free-standing derivatives and are recorded at fair value in the Corporation's consolidated statements of condition. The Bank is party to master netting arrangements with its financial institution counterparties; however, the Bank does not offset assets and liabilities under these arrangements for financial statement presentation purposes. The master netting arrangements provide 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, is posted by the counterparty with net liability positions in accordance with contract thresholds.

Securities Sold Under Agreements to Repurchase ("Repurchase Agreements")

The Bank enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Bank may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Bank to repurchase the agreements. As a result, these repurchase agreements are 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 is reflected as a liability in the Corporation's consolidated statements of condition, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. In other words, there is no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Bank does not enter into reverse repurchase agreements, there is 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 June 30, 2014 and December 31, 2013. 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.

(Dollars in thousands)	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Statements of Condition	Net Amounts of Liabilities Presented in the Statements of Condition	Gross Amounts Not Offset in the Statements of Condition: Financial Instruments	Cash Collateral Pledged	Net Amount
Interest Rate Swap Agreements						
June 30, 2014	$ 384	$ -	$ 384	$ 384	$ -	$ -
December 31, 2013	$ 561	$ -	$ 561	$ 561	$ -	$ -

1Note 11. Reclassification

Certain prior period amounts may have been reclassified to conform to the current year presentation. Such reclassifications did not affect reported net income.

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

For the Three and Six Months Ended June 30, 2014 and 2013

Forward Looking Statements

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

Critical Accounting Policies

Management has identified critical accounting policies for the Corporation to include Allowance for Loan Losses, Mortgage Servicing Rights, Financial Derivatives, Temporary Investment Impairment and Stock-based Compensation. There were no changes to the critical accounting policies disclosed in the 2013 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 2013 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Results of Operations

Year-to-Date Summary

At June 30, 2014, total assets were $1.023 billion, an increase of $38.0 million from December 31, 2013. Net loans increased to $723.2 million and total deposits increased to $900.7 million. The Corporation reported net income for the first six months of 2014 of $4.1 million. This is a 42.6% increase versus net income of $2.9 million for the same period in 2013. Total revenue (interest income and noninterest income) decreased $185 thousand year-over-year. Interest income decreased $643 thousand, while interest expense decreased by $891 thousand, resulting in a $248 thousand increase in net interest income. The provision for loan losses was $464 thousand for the period, $1.1 million less than in 2013. Noninterest income increased $458 thousand, while noninterest expense increased $96 thousand. Income tax expense doubled from $506 thousand in 2013 to $1.0 million in 2014. The effective tax rate increased from 14.8% in 2013 to 19.7% in 2014 due to tax exempt income comprising a less significant amount of income before federal income taxes. Diluted earnings per share increased to $.99 in 2014 from $.70 in 2013.

27

Key performance ratios as of, or for the six months ended June 30, 2014 and 2013 are listed below:

	June 30, 2014	2013
Performance measurements		
Return on average assets*	0.82%	0.56%
Return on average equity*	8.60%	6.34%
Return on average tangible assets (1)*	0.85%	0.59%
Return on average tangible equity (1)*	9.77%	7.38%
Efficiency ratio (1)	70.63%	72.66%
Net interest margin*	3.56%	3.35%
Current dividend yield*	3.42%	4.25%
Dividend payout ratio	34.23%	48.14%
Shareholders' Value (per common share)		
Diluted earnings per share	$ 0.99	$ 0.70
Basic earnings per share	0.99	0.71
Regular cash dividends paid	0.34	0.34
Book value	23.85	22.44
Tangible book value (1)	21.57	20.04
Market value	19.90	16.00
Market value/book value ratio	83.44%	71.30%
Price/earnings multiple*	10.05	11.43
Safety and Soundness		
Risk-based capital ratio (Total)	14.53%	13.06%
Leverage ratio (Tier 1)	9.26%	8.41%
Common equity ratio	9.78%	8.98%
Tangible common equity ratio (1)	8.93%	8.10%
Nonperforming loans/gross loans	2.87%	4.26%
Nonperforming assets/total assets	2.46%	3.52%
Allowance for loan losses as a % of loans	1.30%	1.57%
Net charge-offs/average loans*	0.18%	0.15%
Trust assets under management (fair value)	$ 582,647	