

FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-Q
November 09, 2009

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **September 30, 2009**

OR

**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 (P.O. BOX 6010), CHAMBERSBURG, PA 17201-0819

(Address of principal executive offices)

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 3,852,661 outstanding shares of the Registrant's common stock as of October 30, 2009.

INDEX

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

1

Consolidated Balance Sheets as of September 30, 2009 and December 31, 2008 (unaudited)

1

Consolidated Statements of Income for the Three and Nine Months ended September 30, 2009 and 2008 (unaudited)

2

Consolidated Statements of Changes in Shareholders' Equity for the Nine Months ended September 30, 2009 and 2008 (unaudited)

3

Consolidated Statements of Cash Flows for the Nine Months ended September 30, 2009 and 2008 (unaudited)

4

Notes to Consolidated Financial Statements (unaudited)

5

Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition For the Three and Nine Month Periods Ended September 30, 2009 and 2008

13

Item 3. Quantitative and Qualitative Disclosures about Market Risk

28

Item 4. Controls and Procedures

28

PART II OTHER INFORMATION

Item 1. Legal Proceedings

29

Item 1A. Risk Factors

29

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

29

Item 3. Defaults by the Company on its Senior Securities

29

Item 4. Submission of Matters to a Vote of Security Holders

29

Item 5. Other Information

29

Item 6. Exhibits

29

SIGNATURES

30

PART I FINANCIAL INFORMATION**Item 1****Financial Statements****FRANKLIN FINANCIAL SERVICES CORPORATION****CONSOLIDATED BALANCE SHEETS****(AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)****(UNAUDITED)**

| | September 30, 2009 | December 31, 2008 |
|---|-------------------------------|------------------------------|
| Assets | | |
| Cash and due from banks | \$ 11,493 | \$ 16,505 |
| Interest-bearing deposits in other banks | 15,184 | 208 |
| Total cash and cash equivalents | 26,677 | 16,713 |
| Investment securities available for sale | 156,404 | 147,559 |
| Restricted stock | 6,482 | 6,482 |
| Loans | 733,161 | 676,217 |
| Allowance for loan losses | (8,828) | (7,357) |
| Net Loans | 724,333 | 668,860 |
| Premises and equipment, net | 15,756 | 15,625 |
| Bank owned life insurance | 18,758 | 18,875 |
| Goodwill | 9,159 | 9,152 |
| Other intangible assets | 2,577 | 2,929 |
| Other assets | 15,444 | 16,265 |
| Total assets | \$ 975,590 | \$ 902,460 |
| Liabilities and Shareholders' Equity | | |
| Liabilities | | |
| Deposits | | |
| Demand (non-interest bearing) | \$ 77,181 | \$ 86,954 |
| Savings and interest checking | 366,000 | 335,418 |
| Time | 266,670 | 204,969 |

| | | |
|--|----------------|---------|
| Total Deposits | 709,851 | 627,341 |
| Securities sold under agreements to repurchase | 63,327 | 64,312 |
| Short-term borrowings | 9,900 | 18,850 |
| Long-term debt | 103,007 | 106,141 |
| Other liabilities | 11,869 | 12,757 |
| Total liabilities | 897,954 | 829,401 |

Shareholders' equity

| | | |
|--|-------------------|-------------------|
| Common stock \$1 par value per share, 15,000 shares authorized with 4,299 shares issued, and 3,852 shares and 3,825 shares outstanding at September 30, 2009 and December 31, 2008, respectively | 4,299 | 4,299 |
| Capital stock without par value, 5,000 shares authorized with no shares issued or outstanding | | |
| Additional paid-in capital | 32,847 | 32,883 |
| Retained earnings | 53,844 | 52,126 |
| Accumulated other comprehensive loss | (5,361) | (7,757) |
| Treasury stock, 447 shares and 474 shares at cost at September 30, 2009 and December 31, 2008, respectively | (7,993) | (8,492) |
| Total shareholders' equity | 77,636 | 73,059 |
| Total liabilities and shareholders' equity | \$ 975,590 | \$ 902,460 |

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

FRANKLIN FINANCIAL SERVICES CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

| | For the Three Months Ended September 30 | | For the Nine Months Ended September 30 | |
|--|--|---------------|---|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| Interest Income | | | | |
| Loans | \$ 9,559 | \$ 9,756 | \$ 28,214 | \$ 28,792 |
| Interest and dividends on investments: | | | | |
| Taxable interest | 954 | 1,263 | 3,059 | 3,881 |
| Tax exempt interest | 419 | 495 | 1,357 | 1,582 |
| Dividend income | 38 | 75 | 134 | 219 |
| Federal funds sold | 5 | | 11 | 36 |
| Deposits and obligations of other banks | 9 | 1 | 10 | 6 |
| Total interest income | 10,984 | 11,590 | 32,785 | 34,516 |
| Interest Expense | | | | |
| Deposits | 2,659 | 2,698 | 7,677 | 8,150 |
| Securities sold under agreements to repurchase | 40 | 337 | 130 | 1,295 |
| Short-term borrowings | 2 | 102 | 13 | 165 |
| Long-term debt | 1,040 | 843 | 3,145 | 2,320 |
| Total interest expense | 3,741 | 3,980 | 10,965 | 11,930 |
| Net interest income | 7,243 | 7,610 | 21,820 | 22,586 |
| Provision for loan losses | 1,644 | 273 | 2,663 | 778 |
| Net interest income after provision for loan losses | 5,599 | 7,337 | 19,157 | 21,808 |
| Noninterest Income | | | | |
| Investment and trust services fees | 866 | 891 | 2,622 | 2,651 |
| Loan service charges | 189 | 227 | 844 | 628 |

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

| | | | | |
|--|-----------------|-----------------|-----------------|----------------|
| Mortgage banking activities | 19 | (36) | 109 | 100 |
| Deposit service charges and fees | 678 | 674 | 1,911 | 1,900 |
| Other service charges and fees | 322 | 308 | 963 | 921 |
| Increase in cash surrender value of life insurance | 158 | 164 | 482 | 495 |
| Equity method investment | | (5) | | (127) |
| Other | 17 | 31 | 341 | 35 |
| Impairment writedown on equity securities | | (199) | (422) | (631) |
| Securities gains (losses), net | (267) | (144) | (212) | 185 |
| Total noninterest income | 1,982 | 1,911 | 6,638 | 6,157 |
| Noninterest Expense | | | | |
| Salaries and benefits | 3,121 | 2,940 | 9,400 | 9,024 |
| Net occupancy expense | 495 | 426 | 1,451 | 1,335 |
| Furniture and equipment expense | 216 | 206 | 646 | 632 |
| Advertising | 334 | 556 | 1,068 | 1,325 |
| Legal and professional fees | 614 | 348 | 1,158 | 872 |
| Data processing | 383 | 350 | 1,219 | 1,120 |
| Pennsylvania bank shares tax | 143 | 1 | 431 | 338 |
| Intangible amortization | 117 | 90 | 351 | 271 |
| FDIC insurance | 234 | | 1,148 | 105 |
| Other | 808 | 690 | 2,709 | 2,468 |
| Total noninterest expense | 6,465 | 5,607 | 19,581 | 17,490 |
| Income before federal income taxes | 1,116 | 3,641 | 6,214 | 10,475 |
| Federal income tax expense | 33 | 1,029 | 1,392 | 2,881 |
| Net income | \$ 1,083 | \$ 2,612 | \$ 4,822 | \$7,594 |
| Per share | | | | |
| Basic earnings per share | \$ 0.28 | \$ 0.68 | \$ 1.26 | \$ 1.98 |
| Diluted earnings per share | \$ 0.28 | \$ 0.68 | \$ 1.26 | \$ 1.98 |
| Regular cash dividends declared per share | \$ 0.27 | \$ 0.27 | \$ 0.81 | \$ 0.80 |

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

FRANKLIN FINANCIAL SERVICES CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008

(UNAUDITED)

| (Amounts in thousands, except share and per share data) | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total |
|--|--------------|----------------------------|-------------------|---|----------------|-----------|
| Balance at December 31, 2007 | \$ 4,299 | \$ 32,620 | \$ 47,946 | \$ 664 | \$ (7,887) | \$ 77,642 |
| Comprehensive income: | | | | | | |
| Net income | | | 7,594 | | | 7,594 |
| Unrealized loss on securities, net of reclassification adjustments and taxes | | | | (3,193) | | (3,193) |
| Unrealized loss on hedging activities, net of reclassification adjustments and taxes | | | | (213) | | (213) |
| Total Comprehensive income | | | | | | 4,188 |
| Cash dividends declared, \$.80 per share | | | (3,064) | | | (3,064) |
| Cumulative adjustment for change in | | | (422) | | | (422) |

| | | | | | | | | | | | | |
|--|----|-------|----|--------|--------------|--------|----|--------------|----|----------|----|--------|
| accounting principle | | | | | | | | | | | | |
| Acquisition of 43,083 shares of treasury stock | | | | | | (995) | | (995) | | | | |
| Treasury shares issued to dividend reinvestment plan: 22,993 shares | | 131 | | | | 406 | | 537 | | | | |
| Common stock issued under stock option plans | | 1 | | | | 6 | | 7 | | | | |
| Common stock issued from Treasury stock | | 4 | | | | 18 | | 22 | | | | |
| Stock option compensation | | 112 | | | | | | 112 | | | | |
| Balance at September 30, 2008 | \$ | 4,299 | \$ | 32,868 | \$ | 52,054 | \$ | (2,742) | \$ | (8,452) | \$ | 78,027 |
| Balance at December 31, 2008 | \$ | 4,299 | \$ | 32,883 | \$ | 52,126 | \$ | (7,757) | \$ | (8,492) | \$ | 73,059 |
| Comprehensive income: | | | | | | | | | | | | |
| Net income | | | | | 4,822 | | | 4,822 | | | | |
| Unrealized gain on securities, net of reclassification adjustments and taxes | | | | | | 1,742 | | 1,742 | | | | |
| Unrealized gain on hedging activities, net of reclassification adjustments and taxes | | | | | | 654 | | 654 | | | | |
| Total Comprehensive income | | | | | | | | 7,218 | | | | |

FRANKLIN FINANCIAL SERVICES CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

For the Nine Months Ended September 30

2009

2008

*(Amounts in thousands)***Cash flows from operating activities**

| | | | | |
|---|----|---------------|----|----------|
| Net income | \$ | 4,822 | \$ | 7,594 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | | 1,074 | | 971 |
| Net amortization (accretion) of loans and investment securities | | 92 | | (156) |
| Stock option compensation expense | | 29 | | 112 |
| Amortization and net change in mortgage servicing rights valuation | | 123 | | 241 |
| Amortization of intangibles | | 351 | | 271 |
| Provision for loan losses | | 2,663 | | 778 |
| Net realized loss (gains) on sales of securities | | 212 | | (185) |
| Impairment writedown on equity securities | | 422 | | 631 |
| Loans originated for sale | | (487) | | (3,702) |
| Proceeds from sales of loans | | 495 | | 3,989 |
| Gain on sales of loans | | (8) | | (73) |
| Loss on sales or disposal of premises and equipment | | 120 | | |
| Net loss on sale or disposal of other real estate/other repossessed assets | | (10) | | |
| Increase in cash surrender value of life insurance | | (485) | | (495) |
| Gain on life insurance benefits | | (278) | | |
| Loss on equity method investment | | | | 127 |
| Contribution to pension plan | | (172) | | (333) |
| Decrease in interest receivable and other assets | | 563 | | 205 |
| Decrease in interest payable and other liabilities | | (370) | | (1,672) |
| Other, net | | 69 | | (71) |
| Net cash provided by operating activities | | 9,225 | | 8,232 |

Cash flows from investing activities

| | | |
|--|------------------|-----------|
| Proceeds from sales of investment securities available for sale | 9,114 | 10,023 |
| Proceeds from maturities of investment securities available for sale | 21,513 | 36,249 |
| Purchase of investment securities available for sale | (37,295) | (36,202) |
| Net increase in restricted stock | | (2,571) |
| Net increase in loans | (59,066) | (84,364) |
| Capital expenditures | (1,219) | (1,727) |
| Proceeds from sale of other real estate/ other assets owned | 43 | 208 |
| Proceeds from surrender of life insurance policy | 878 | |
| Net cash used in investing activities | (66,032) | (78,384) |

Cash flows from financing activities

| | | |
|---|-----------------|-----------|
| Net increase (decrease) in demand deposits, NOW accounts and savings accounts | 20,809 | (20,291) |
| Net increase in certificates of deposit | 61,701 | 19,842 |
| Net (decrease) increase in short-term borrowings | (9,935) | 25,983 |
| Long-term debt payments | (3,394) | (3,488) |
| Long-term debt advances | 260 | 43,057 |
| Dividends paid | (3,104) | (3,064) |
| Common stock issued to dividend reinvestment plan | 574 | 537 |
| Common stock issued under stock option plans | 2 | 7 |
| Common stock issued from treasury shares | | 22 |
| Purchase of treasury shares | (142) | (995) |
| Net cash provided by financing activities | 66,771 | 61,610 |

| | | |
|---|------------------|------------------|
| Increase (decrease) in cash and cash equivalents | 9,964 | (8,542) |
| Cash and cash equivalents as of January 1 | 16,713 | 25,491 |
| Cash and cash equivalents as of September 30 | \$ 26,677 | \$ 16,949 |

Supplemental Disclosures of Cash Flow Information**Cash paid during the year for:**

| | | |
|---|------------------|------------------|
| Interest on deposits and other borrowed funds | \$ 10,835 | \$ 11,908 |
| Income taxes | \$ 1,944 | \$ 3,358 |

Noncash Activities

| | | |
|--|---------------|-----------|
| Loans transferred to Other Real Estate | \$ 504 | \$ |
|--|---------------|-----------|

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

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Franklin Financial Services Corporation (the Corporation), and its wholly-owned subsidiaries, Farmers and Merchants Trust Company of Chambersburg (the Bank), Franklin Financial Properties Corp., and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank that has one wholly-owned subsidiary, Franklin Realty Services Corporation. Franklin Realty Services Corporation is an inactive real-estate brokerage company. 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, 2009, 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 State 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 2008 Annual Report on Form 10-K. The consolidated results of operations for the period ended September 30, 2009 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through November 9, 2009, the date these consolidated financial statements were issued. See Note 9 for additional information on subsequent events.

The consolidated balance sheet at December 31, 2008 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by generally accepted accounting principles 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 is 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 September 30 | | For the Nine Months Ended September 30 | |
|---|--|-------------|---|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| (Amounts in thousands) | | | | |
| Weighted average shares outstanding (basic) | 3,841 | 3,824 | 3,835 | 3,831 |
| Impact of common stock equivalents | | 1 | | 3 |

| | | | | |
|---|-------|-------|-------|-------|
| Weighted average shares outstanding (diluted) | 3,841 | 3,825 | 3,835 | 3,834 |
|---|-------|-------|-------|-------|

Note 2 Recent Accounting Pronouncements

In June 2009, the FASB issued ASU No. 2009-01 (formerly Statement No. 168), Topic 105 Generally Accepted Accounting Principles FASB Accounting Standards Codification and the Heirarchy of Generally Accepted Accounting Principles. The Codification is the single source of authoritative nongovernmental U.A. generally accepted accounting principles (GAAP). The codification does not change current GAAP but is intended to simplify user access to all authoritative GAAP by providing all the authoritative literature related to a particular topic in one place. Rules and interpretive releases of the SEC under federal securities laws are also sources of authoritative GAAP for SEC registrants. The Corporation adopted this standard for the interim reporting period ending September 30, 2009. The adoption of this statement did not have a material impact on the Corporation's operating results or financial positions.

FRANKLIN FINANCIAL SERVICES CORPORATION AND SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

FSP FAS 132(R)-1 Employers Disclosures about Postretirement Benefit Plan Assets

In December 2008, the FASB issued FSP FAS 132(R)-1, (ASC 715) Employers Disclosures about Postretirement Benefit Plan Assets. ASC 715 provides guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. The disclosures about plan assets shall be provided for fiscal years ending after December 15, 2009. The Corporation is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R) (Not Yet Included in the Codification). Generally, SFAS 167 was issued to improve the financial reporting by companies involved with variable interest entities. Specifically, it addresses the effects on some provisions of FASB Interpretation No. 46 (revised December 2003) (ASC 810), Consolidation of Variable Interest Entities, namely, how to account for the elimination of the qualifying special purpose concept in FASB Statement No. 166, Accounting for Transfers of Financial Assets (see below). It also addresses concerns about the accounting and disclosures required by Interpretation 46 (R) (ASC 810-10-05), especially the timeliness and usefulness of information about an enterprise's involvement in a variable interest entity. The adoption of SFAS 167 will be effective as of the beginning of each reporting entity's first annual reporting period beginning after November 15, 2009, and all interim periods within that fiscal year and interim and annual reporting periods thereafter. The Corporation does not expect the adoption of SFAS 167 to have a material impact on its consolidated financial statements.

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140 (Not Yet Included in the Codification). SFAS 166 improves the relevance, representational faithfulness and comparability of the information that a reporting entity provides in its financial statements about transfers of financial assets. Furthermore, this Statement will address the effects of a transfer on an entity's financial position, performance and cash flow, as well as any continuing involvement by the transferor. The adoption of SFAS 166 will be effective for the financial statements issued for the first annual reporting period beginning after November 15, 2009, and all interim periods within those fiscal years and interim and annual reporting periods thereafter. The Corporation does not expect the adoption of SFAS 166 to have a material impact on its consolidated financial statements.

Note 3 Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on available-for-sale securities and derivatives and the change in plan assets and benefit obligations on the Bank's pension plan, net of tax, that are recognized as separate components of shareholders equity.

FRANKLIN FINANCIAL SERVICES CORPORATION AND SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The components of other comprehensive income (loss) and related tax effects are as follows:

| (Amounts in thousands) | For the Three Months Ended September 30 | | For the Nine Months Ended September 30 | |
|---|--|----------|---|----------|
| | 2009 | 2008 | 2009 | 2008 |
| Net Income | \$ 1,083 | \$ 2,612 | \$ 4,822 | \$ 7,594 |
| Securities: | | | | |
| Unrealized gains (losses) arising during the period | 2,201 | (2,176) | 2,005 | (5,285) |
| Reclassification adjustment for losses included in net income | 267 | 343 | 635 | 446 |
| Net unrealized gains (losses) | 2,468 | (1,833) | 2,640 | (4,839) |
| Tax effect | (839) | 623 | (898) | 1,646 |
| Net of tax amount | 1,629 | (1,210) | 1,742 | (3,193) |
| Derivatives: | | | | |
| Unrealized (losses) gains arising during the period | (424) | (317) | 461 | (548) |
| Reclassification adjustment for losses included in net income | 179 | 108 | 530 | 225 |
| Net unrealized (losses) gains | (245) | (209) | 991 | (323) |
| Tax effect | 84 | 72 | (337) | 110 |
| Net of tax amount | (161) | (137) | 654 | (213) |
| Total other comprehensive income (loss) | 1,468 | (1,347) | 2,396 | (3,406) |
| Total Comprehensive Income | \$ 2,551 | \$ 1,265 | \$ 7,218 | \$ 4,188 |

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

| | September 30 2009 | December 31 2008 |
|--------------------------------------|----------------------|---------------------|
| Net unrealized losses on securities | \$ (1,832) | \$ (4,471) |
| Tax effect | 623 | 1,520 |
| Net of tax amount | (1,209) | (2,951) |
| Net unrealized losses on derivatives | (1,486) | (2,477) |
| Tax effect | 505 | 842 |

| | | |
|--|-------------|-------------|
| Net of tax amount | (981) | (1,635) |
| Accumulated pension adjustment | (4,804) | (4,805) |
| Tax effect | 1,633 | 1,634 |
| Net of tax amount | (3,171) | (3,171) |
| Total accumulated other comprehensive loss | \$ (5,361) | \$ (7,757) |

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 \$23.9 million and \$32.1 million of standby letters of credit as of September 30, 2009 and December 31, 2008, 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, 2009 and December 31, 2008 for guarantees under standby letters of credit issued was not material.

FRANKLIN FINANCIAL SERVICES CORPORATION AND SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 5 Investments

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2009 and December 31, 2008 is:

| <i>Amounts in thousands)</i> | Gross | Gross | Estimated | |
|--|------------------|-------------------|-------------------|------------------|
| | Amortized | Unrealized | Unrealized | |
| 9/30/2009 | Cost | Gains | Losses | |
| | | | Fair | |
| | | | Value | |
| Equity securities | \$ 5,344 | \$ 55 | \$ (1,332) | \$ 4,067 |
| U.S. Treasury securities and obligations of U.S. | | | | |
| Government agencies | 41,374 | 595 | (192) | 41,777 |
| Obligations of state and political subdivisions | 42,048 | 1,892 | (25) | 43,916 |
| Corporate debt securities | 9,976 | | (3,016) | 6,960 |
| Mortgage-backed securities | | | | |
| Agency | 53,087 | 1,575 | (57) | 54,605 |
| Non Agency | 6,319 | | (1,288) | 5,031 |
| Asset-backed securities | 86 | | (39) | 47 |
| | \$ 158,236 | \$ 4,117 | \$ (5,949) | \$ 156,404 |
| | | Gross | Gross | Estimated |
| | Amortized | Unrealized | Unrealized | Fair |
| 12/31/2008 | Cost | Gains | Losses | Value |
| Equity securities | \$ 5,783 | \$ 18 | \$ (955) | \$ 4,846 |
| U.S. Treasury securities and obligations of U.S. | | | | |
| Government agencies | 29,548 | 770 | (287) | 30,031 |
| Obligations of state and political subdivisions | 45,518 | 824 | (659) | 45,683 |
| Corporate debt securities | 12,868 | | (3,888) | 8,980 |
| Mortgage-backed securities | | | | |
| Agency | 50,667 | 889 | (106) | 51,450 |
| Non Agency | 7,551 | | (1,033) | 6,518 |
| Asset-backed securities | 95 | | (44) | 51 |

\$ 152,030 \$ 2,501 \$ (6,972) \$ 147,559

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, 2009 and December 31, 2008:

| | September 30, 2009 | | | September 30, 2009 | | | Total | | Number |
|--|---------------------|-------------------|--------|--------------------|------------|--------|-------------------|-------------------|------------|
| | Less than 12 Months | | Number | 12 Months or more | | Number | Fair Value | Unrealized Losses | |
| Accounts in (thousands) | Fair Value | Unrealized Losses | | Number | Fair Value | | Unrealized Losses | Number | Fair Value |
| Equity securities | \$ 455 | \$ (433) | 6 | \$ 1,363 | \$ (899) | 21 | \$ 1,818 | \$ (1,332) | |
| Treasury securities and obligations of | | | | | | | | | |
| Government securities | 8,839 | (14) | 14 | 11,543 | (178) | 22 | 20,382 | (192) | |
| Obligations of state and local governments | 2,322 | (13) | 3 | 295 | (11) | 1 | 2,618 | (25) | |
| Corporate debt securities | | | | 6,860 | (3,016) | 11 | 6,860 | (3,016) | |
| Mortgage-backed securities | 9,769 | (57) | 7 | 99 | | 1 | 9,869 | (57) | |
| Agency securities | | | | 5,031 | (1,288) | 7 | 5,031 | (1,288) | |
| Asset-backed securities | | | | 47 | (39) | 3 | 47 | (39) | |
| Temporarily impaired securities | \$ 21,386 | \$ (517) | 30 | \$ 25,239 | \$ (5,431) | 66 | \$ 46,625 | \$ (5,949) | |

FRANKLIN FINANCIAL SERVICES CORPORATION AND SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

| | December 31, 2008 | | | | | | | | |
|---|---------------------|-------------------|--------|-------------------|-------------------|--------|------------|-------------------|--------|
| | Less than 12 Months | | | 12 Months or more | | | Total | | |
| (Amounts in thousands) | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Investment securities | \$ 1,933 | \$ (701) | 17 | \$ 382 | \$ (254) | 8 | \$ 2,315 | \$ (955) | |
| Treasury securities and other investments | | | | | | | | | |
| Government securities | 7,018 | (69) | 27 | 10,113 | (218) | 15 | 17,131 | (287) | |
| Investments of other financial institutions | 14,137 | (659) | 32 | | | | 14,137 | (659) | |
| Corporate debt securities | 3,722 | -448 | 4 | 5,158 | (3,440) | 9 | 8,880 | (3,888) | |
| Collateralized mortgage-backed securities | 6,689 | (70) | 9 | 1,257 | (36) | 4 | 7,946 | (106) | |
| Agency mortgage-backed securities | 6,517 | (1,033) | 7 | | | | 6,517 | (1,033) | |
| Other mortgage-backed securities | 16 | (7) | 1 | 35 | (37) | 2 | 51 | (44) | |
| Temporarily impaired securities | \$ 40,032 | \$ (2,987) | 97 | \$ 16,945 | \$ (3,985) | 38 | \$ 56,977 | \$ (6,972) | |

For more information concerning investments, refer to the Investment Securities discussion in the Financial Condition section.

Note 6 Pensions

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

| (Amounts in thousands) | For the Three Months Ended September 30 | | For the Nine Months Ended September 30 | |
|------------------------|--|------|---|------|
| | 2009 | 2008 | 2009 | 2008 |

Components of net periodic
(benefit) cost:

| | | | | | | | | |
|------------------------------------|----|--------|----|--------|----|--------|----|--------|
| Service cost | \$ | 85 | \$ | 88 | \$ | 340 | \$ | 358 |
| Interest cost | | 181 | | 138 | | 725 | | 678 |
| Expected return on plan assets | | (190) | | (233) | | (760) | | (929) |
| Amortization of prior service cost | | (31) | | 7 | | (125) | | (128) |
| Recognized net actuarial loss | | 82 | | | | 330 | | |
| Net periodic cost (benefit) | \$ | 127 | \$ | | \$ | 510 | \$ | (21) |

The Bank expects its pension expense to increase by more than \$500 thousand in 2009 compared to 2008 solely as a result of the low rate environment and its affect on plan performance. The Bank expects to contribute \$243 thousand to its pension plan for 2009. This amount represents the minimum required contribution as defined in the Pension Protection Act.

Note 7 Fair Value Measurements

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 may be different than the amounts reported at each year-end.

The Corporation adopted FASB ASC Topic 820, *Fair Value Measurements and Disclosures* for financial assets and liabilities on January 1, 2008, which 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:

Unadjusted quoted prices in active markets that are accessible at the measurement date for identical,unrestricted assets or liabilities.

FRANKLIN FINANCIAL SERVICES CORPORATION AND SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Level 2:

Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

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.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

(Dollars in Thousands)

| Asset Description | Fair Value at September 30, 2009 | | Level 1 | Level 2 | Level 3 |
|--|---|----------------|----------------|----------------|----------------|
| Investment securities available for sale | \$ | 156,404 | \$ | 4,067 | \$ |
| Total assets | \$ | 156,404 | \$ | 4,067 | \$ |

Liability Description

| | | | | | |
|---------------------|----|--------------|----|--------------|----|
| Interest rate swaps | \$ | 1,486 | \$ | 1,486 | \$ |
| Total liabilities | \$ | 1,486 | \$ | 1,486 | \$ |

The Corporation used the following methods and significant assumptions to estimate the fair value.

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 dependant on the input of any significant judgments or assumptions by Management.

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy are as follows:

(Dollars in Thousands)

| Asset Description | Fair Value at September 30, 2009 | Level 1 | Level 2 | Level 3 |
|-----------------------------|---|----------------|----------------|----------------|
| Impaired loans | \$ 19,971 | \$ | \$ | \$ 19,971 |
| Other real estate owned | 504 | | | 504 |
| Mortgaging servicing rights | 746 | | | 746 |
| Total assets | \$ 21,221 | \$ | \$ | \$ 21,221 |

The following information 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 following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at September 30, 2009:

FRANKLIN FINANCIAL SERVICES CORPORATION AND SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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.

Loans, net:

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:

The fair value of demand deposits, savings accounts, and money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-rate certificates of deposit is estimated by discounting the future cash flows using rates approximating those currently offered for certificates of deposit with similar remaining maturities.

Securities sold under agreements to repurchase:

The carrying amount is a reasonable estimate of fair value.

Short-term borrowings:

The carrying amount is a reasonable estimate of fair value.

Long-term debt:

The fair value of long-term debt is estimated by discounting the future cash flows using rates approximating those currently offered for borrowings with similar remaining maturities.

Accrued interest payable:

The carrying amount is a reasonable estimate of fair value.

Interest rate swaps:

The fair value of the interest rate swaps is determined in accordance with the methods described under FASB ASC Topic 820.

FRANKLIN FINANCIAL SERVICES CORPORATION AND SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Off balance sheet financial instruments:

Outstanding commitments to extend credit and commitments under standby letters of credit include fixed and variable rate commercial and consumer commitments. The fair value of the commitments is estimated using the fees currently charged to enter into similar agreements.

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

| (Amounts in thousands) | September 30, 2009 | | December 31, 2008 | |
|--|--------------------|------------|-------------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | | | | |
| Cash and equivalents | \$ 26,677 | \$ 26,677 | \$ 16,713 | \$ 16,713 |
| Investment securities available for sale | 156,404 | 156,404 | 147,559 | 147,559 |
| Restricted stock | 6,482 | 6,482 | 6,482 | 6,482 |
| Net loans | 724,333 | 723,789 | 668,860 | 692,239 |
| Accrued interest receivable | 3,828 | 3,828 | 3,751 | 3,751 |
| Mortgage servicing rights | 746 | 746 | 863 | 863 |
| Financial liabilities: | | | | |
| Deposits | \$ 709,851 | \$ 714,072 | \$ 627,341 | \$ 626,909 |
| Securities sold under agreements to repurchase | 63,327 | 63,327 | 64,312 | 64,312 |
| Short-term borrowings | 9,900 | 9,900 | 18,850 | 18,850 |
| Long-term debt | 103,007 | 106,492 | 106,141 | 111,193 |
| Accrued interest payable | 1,610 | 1,610 | 1,481 | 1,481 |
| Interest rate swaps | 1,486 | 1,486 | 2,477 | 2,477 |

Off Balance Sheet financial instruments:

Commitments to extend credit

Standby letters-of-credit

Note 8 Financial Derivatives

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

approved parameters. Management anticipates continuing to use derivatives, as permitted by its Board-approved policy, to manage interest rate risk. During 2008, the Bank entered into two interest rate swap transactions in order to hedge the Corporation's exposure to changes in cash flows attributable to the effect of interest rate changes on variable rate liabilities.

Information regarding the interest rate swap as of September 30, 2009 follows:

| (Dollars in Thousands) | | | | | Amount Expected to be Expensed into Earnings within the next 12 Months |
|---------------------------|------------------|---------------|----------|--|---|
| Notional Amount | Maturity Date | Interest Rate | | | |
| | | Fixed | Variable | | |
| \$10,000 | 5/30/2013 | 3.60 % | 0.17 % | | \$343 |
| \$10,000 | 5/30/2015 | 3.87 % | 0.17 % | | \$370 |

The variable rate is indexed to the 91-day Treasury Bill auction (discount) rate and resets weekly.

Derivatives with a positive fair value are reflected as other assets in the balance sheet while those with a negative fair value are reflected as other liabilities. The swaps added \$530 thousand to interest expense in the first nine months of 2009. As short-term interest rates decrease, the net expense of the swap increases. As short-term rates increase, the net expense of the swap decreases.

FRANKLIN FINANCIAL SERVICES CORPORATION AND SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Fair Value of Derivative Instruments in the Consolidated Balance Sheets were as follows as of September 30, 2009:

**Fair Value of Derivative Instruments Designated
as Hedging Instruments Under Statement 133**

(Dollars in thousands)

**Liability Derivatives
9/30/2009**

| Type | Balance Sheet Location | Fair Value |
|--------------------------------|--------------------------|-----------------|
| Interest rate contracts | Other liabilities | \$ 1,486 |

The Effect of Derivative Instruments on the Statement of Financial Performance for the Nine Months Ended September 30, 2009 follows:

Derivatives in Statement 133 Cash Flow Hedging Relationships

| Type | Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion) 9/30/2009 | 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) 9/30/2009 | 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 9/30/2009 |
|-------------------------|--|--|--|---|--|
| Interest rate contracts | \$ 654 | Interest Expense | \$ (530) | Other income (expense) | \$ |

Note 9 Subsequent Events

Subsequent events have been evaluated for potential recognition and/or disclosure through November 9, 2009, the date the consolidated financial statements were issued. The following information is disclosed as a nonrecognized subsequent event:

The Bank owns a \$1 million debt security (\$665 thousand market value) issued by CIT Group, Inc. that matures on November 3, 2010. On October 1, 2009 CIT announced a plan for debt restructuring (exchange offer) and a proposal for debt restructuring (bankruptcy reorganization). Under the plans, existing bondholders would receive a combination of new secured debt plus either preferred or common shares. The actual mix of debt and equity received is dependent on the vote of bondholders for or against either or both offers.

On November 2, 2009, CIT announced only the bankruptcy reorganization plan was approved by bondholders and CIT subsequently filed for bankruptcy. Under the bankruptcy organization, bondholders are expected to receive \$.70 per \$1.00 of bond value plus common equity shares. However, the total recovery of bondholders will not be known until CIT exits bankruptcy, expected by December 31, 2009. A current estimate of the final recovery by bondholders is expected to range from 65% - 85% of pre-bankruptcy value. However, the range could be larger than current estimates. Upon completion of the bankruptcy, the Bank will evaluate its bond and it is expected that a loss will be recorded prior to December 31, 2009.

Note 10 Federal Deposit Insurance Corporation (FDIC) Assessments

On September 29, 2009, the FDIC issued a proposal to amend its assessment regulations to require insured depository institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012. This proposal indicates that depository institutions are to prepay their assessments on December 30, 2009. Should this proposed rule become final, the Corporation estimates its prepaid assessment to be approximately \$4.0 million.

Note 11 Reclassifications

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

Item 2

Management's Discussion and Analysis of Results of Operations and Financial Condition For the Three and Nine Month Periods Ended September 30, 2009 and 2008

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 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 2008 Annual Report on Form 10-K in regards to application or related judgements and estimates used. Please refer to Item 7 of the Corporation's 2008 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Results of Operations

Year-to-Date Summary

The Corporation reported net income for the nine months ended September 30, 2009 of \$4.8 million. This is a 37% decrease versus net income of \$7.6 million for the same period in 2008. Total revenue (interest income and noninterest income) decreased \$1.3 million year-over-year, due primarily to the lower interest rate environment and its negative effect on interest income. The provision for loan losses was \$2.7 million for the period, \$1.9 million more than in 2008. Diluted earnings per share decreased to \$1.26 in 2009 from \$1.98 in 2008. Total assets were \$975.6 million at September 30, 2009, an increase of \$73.1 million from year-end 2008. Net loans grew to \$724.3 million, while total deposits grew to \$709.9 million.

Other key performance ratios as of, or for the nine months ended September 30, 2009 (on an annualized basis) are listed below:

| | |
|-------------|-------------|
| 2009 | 2008 |
|-------------|-------------|

| | | |
|--|----------------|---------|
| Return on average equity (ROE) | 8.34 % | 12.62 % |
| Return on average assets (ROA) | .66 % | 1.18 % |
| Return on average tangible average equity(1) | 10.79 % | 15.43 % |
| Return on average tangible average assets(1) | .73 % | 1.25 % |
| Net interest margin | 3.44 % | 4.04 % |
| Efficiency ratio | 65.50 % | 58.06 % |

(1)

The Corporation supplements its traditional GAAP measurements with Non-GAAP measurements. The Non-GAAP measurements include Return on Average Tangible Assets and Return on Average Tangible Equity. The purchase method of accounting was used to record the acquisition of Fulton Bancshares Corporation. As a result, intangible assets (primarily goodwill and core deposit intangibles) were created. The Non-GAAP disclosures are intended to eliminate the effects of the intangible assets and allow for better comparisons to periods when such assets did not exist. The following table shows the adjustments made between the GAAP and NON-GAAP measurements:

| GAAP Measurement | Calculation |
|-----------------------------------|--|
| Return on Average Assets | Net Income / Average Assets |
| Return on Average Equity | Net Income / Average Equity |
| Non- GAAP Measurement | Calculation |
| Return on Average Tangible Assets | Net Income plus Intangible Amortization / Average Assets less Average Intangible Assets |
| Return on Average Tangible Equity | Net Income plus Intangible Amortization / Average Equity less Average Intangible Assets |
| Efficiency Ratio | Noninterest Expense / Tax Equivalent Net Interest Income plus Noninterest Income (excluding Security Gains/Losses and Other Than Temporary Impairment) |

A more detailed discussion of the operating results for the three and nine months ended September 30, 2009 follows:

Comparison of the three months ended September 30, 2009 to the three months ended September 30, 2008:

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. All balance sheet amounts in the discussion of net interest income refer to either year-to-date or quarterly average balances.

Interest income for the third quarter of 2009 decreased to \$11.0 million from \$11.6 million during the third quarter of 2008. Average interest-earning assets increased by \$114.0 million from the third quarter of 2008, however the yield on these assets decreased by 102 basis points. The average balance on investment securities decreased \$5.7 million quarter over quarter due to pay downs and maturities in the portfolio, net of investment purchases. Total average loans increased \$82.9 million (13.1%) quarter over quarter. Average commercial loans increased \$98.8 million, but the increase was partially offset by a decrease in average mortgage and consumer loans. Average mortgage loans decreased \$9.7 million, as the majority of new mortgage originations are sold in the secondary market and the portfolio continues to runoff. Average consumer loans decreased \$12.4 million, as consumers continue to borrow less during the economic recession.

Interest expense was \$3.7 million for the third quarter, a decrease of \$239 thousand from the third quarter of 2008 total of \$4.0 million. Average interest-bearing liabilities increased to \$807.3 million in the third quarter of 2009 from an average balance of \$691.7 million during the same period in 2008, an increase of \$115.6 million. The average cost of these liabilities decreased from 2.29% to 1.84%. Average interest-bearing deposits increased \$119.2 million, due to increases in money management accounts (\$16.3 million) and certificates of deposit (\$91.0 million), but the cost decreased from 2.06% to 1.65%. Securities sold under agreements to repurchase have decreased \$12.4 million on

average over the prior year third quarter and the average rate has decreased from 1.75% to .25%. The average balance of long-term debt increased over \$25.8 million due to the Bank taking additional advances from the Federal Home Loan Bank of Pittsburgh (FHLB), near the end of 2008, and was the primary reason for the increase in interest expense for this liability. However, the cost of this funding has decreased as higher rate advances have matured or been paid-off.

The changes in the balance sheet and interest rates resulted in a decrease in net interest income of \$367 thousand to \$7.2 million for the third quarter of 2009 compared to \$7.6 million for the third quarter of 2008. The Bank's net interest margin decreased from 3.93% to 3.27% in 2009. The decrease in the net interest margin is due to the yield on interest-bearing assets (mainly variable rate commercial loans) decreasing 102 basis points, while the yield on interest-earning liabilities only decreased 45 basis points. An extended period of low market interest rates is likely to continue to reduce the net interest margin because liability rates can no longer be significantly reduced.

The following table shows a comparative analysis of average balances, asset yields and funding costs for the three months ended September 30, 2009 and 2008. These components drive changes in net interest income.

| (Dollars in thousands) | For the Three Months Ended September 30 | | | | | |
|--|--|---|------------------------------------|--------------------|---------------------------------------|---------------------------|
| | Average Balance | 2009 Tax Equivalent Interest | Average yield/ rate | Average Balance | 2008 Tax Equivalent Interest | Average yield/ rate |
| Interest-earning assets | | | | | | |
| Federal funds sold and interest-bearing balances | \$ 37,050 | \$ 14 | 0.15 % | \$ 316 | \$ 1 | 1.81 % |
| Investment securities | 155,018 | 1,601 | 4.13 % | 160,677 | 2,058 | 5.12 % |
| Loans | 717,620 | 9,621 | 5.29 % | 634,683 | 9,827 | 6.12 % |
| Total interest-earning assets | \$ 909,689 | 11,236 | 4.90 % | \$ 795,676 | 11,886 | 5.92 % |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing deposits | \$ 639,118 | 2,659 | 1.65 % | \$ 519,886 | 2,698 | 2.06 % |
| Securities sold under agreements to repurchase | 64,112 | 40 | 0.25 % | 76,514 | 337 | 1.75 % |
| Short-term borrowings | 954 | 2 | 0.83 % | 17,995 | 102 | 2.25 % |
| Long-term debt | 103,181 | 1,040 | 4.00 % | 77,350 | 843 | 4.32 % |
| Total interest-bearing liabilities | \$ 807,365 | 3,741 | 1.84 % | \$ 691,745 | 3,980 | 2.29 % |
| Interest spread | | | 3.06 % | | | 3.63 % |
| Tax equivalent net interest income/Net interest margin | | 7,495 | 3.27 % | | 7,906 | 3.93 % |

| | | |
|---------------------------|----------|----------|
| Tax equivalent adjustment | (252) | (296) |
| Net interest income | \$ 7,243 | \$ 7,610 |

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses.

Dividend income is reported as taxable income but is adjusted for the dividend received deduction. Loan balances include nonaccruing loans, loans held for sale, and are gross of the allowance for loan losses.

Provision for Loan Losses

For the third quarter of 2009, the provision expense was \$1.6 million versus \$273 thousand for the same period in 2008. For more information concerning loan quality and the allowance for loan losses, refer to the Loan discussion in the Financial Condition section.

Noninterest Income

For the three months ended September 30, 2009, noninterest income increased \$71 thousand to \$2.0 million, compared to \$1.9 million for the third quarter of 2008. Investment and trust service fees decreased in total, but asset management fees increased, while estate fees and investment commissions decreased quarter over quarter. Mortgage banking fees increased quarter to quarter due to a net impairment recovery in 2009, compared to net impairment charge in 2008. Deposit service charges and other service charges remained flat in 2009, but the composition of the fees changed. In 2009, account analysis fees have increased, while overdraft protection fees have decreased compared to 2008. No other than temporary impairment charges were recognized on equity securities in the quarter, compared to \$199 thousand in 2008. The Corporation took losses of \$267 thousand on one debt security and one equity security during the quarter ended September 30, 2009.

| | For the Three Months Ended September 30 | | Change | |
|--|--|----------|---------|----------|
| | 2009 | 2008 | Amount | % |
| Noninterest Income | | | | |
| Investment and trust services fees | \$ 866 | \$ 891 | (\$25) | (2.8) |
| Loan service charges | 189 | 227 | (38) | (16.7) |
| Mortgage banking activities | 19 | (36) | 55 | (152.8) |
| Deposit service charges and fees | 678 | 674 | 4 | 0.6 |
| Other service charges and fees | 322 | 308 | 14 | 4.5 |
| Increase in cash surrender value of life insurance | 158 | 164 | (6) | (3.7) |
| Equity method investment | | (5) | 5 | (100.0) |
| Other | 17 | 31 | (14) | (45.2) |
| Impairment writedown on equity securities | | (199) | 199 | (100.0) |
| Securities losses, net | (267) | (144) | (123) | 85.4 |
| Total noninterest income | \$ 1,982 | \$ 1,911 | \$ 71 | 3.7 |
| Noninterest Expense | | | | |

Noninterest expense for the third quarter of 2009 totaled \$6.5 million compared to \$5.6 million in the third quarter of 2008. The increase in salaries and benefits was due primarily to pension expense of \$127 thousand, compared to no pension expense in the same period in 2008. The increase in pension expense is the result of the low rate environment and its affect on pension plan performance and pension obligations. Health insurance expense also increased \$68 thousand quarter over quarter, due to adding additional employees and higher costs. Depreciation expense increased due to the renovations of several offices and the addition of the Camp Hill office and was the main cause of the increase in net occupancy expense. Advertising expense decreased \$222 thousand due to expenses in 2008 for the production of a customer education website. Legal fees increased over the same period in 2008 due to expenses from several ongoing lawsuits stemming from activities at Community Financial, Inc prior to its acquisition. The Pennsylvania bank shares tax expense increased \$142 in 2009, as 2008 included a tax adjustment from the Pennsylvania Department of Revenue. Intangible amortization increase \$27 thousand from the amortization of the customer list intangible asset booked with the acquisition of Community Financial, Inc. in the fourth quarter of 2008. FDIC Insurance increased \$234 thousand as the FDIC expense in 2008 was offset by the use of FDIC premium credits. The increase in other expenses was primarily the result of a reclassification of expenses in 2008 from other expenses to legal fees.

| | For the Three Months Ended September 30 | | Change | |
|----------------------------|--|----------|--------|-----|
| | 2009 | 2008 | Amount | % |
| Noninterest Expense | | | | |
| Salaries and benefits | \$ 3,121 | \$ 2,940 | \$ 181 | 6.2 |

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

| | | | | |
|----------------------------------|-----------------|-----------------|---------------|-------------|
| Net occupancy expense | 495 | 426 | 69 | 16.2 |
| Furniture and equipment expense | 216 | 206 | 10 | 4.9 |
| Advertising | 334 | 556 | (222) | (39.9) |
| Legal and professional fees | 614 | 348 | 266 | 76.4 |
| Data processing | 383 | 350 | 33 | 9.4 |
| Pennsylvania bank shares tax | 143 | 1 | 142 | 14,200.0 |
| Intangible amortization | 117 | 90 | 27 | 30.0 |
| FDIC insurance | 234 | | 234 | |
| Other | 808 | 690 | 118 | 17.1 |
| Total noninterest expense | \$ 6,465 | \$ 5,607 | \$ 858 | 15.3 |

Income taxes

Federal income tax expense was \$33 thousand for the third quarter of 2009 compared to \$1.0 million in 2008. The effective tax rate for the third quarter of 2009 was 3.0 and 28.3 for 2008. The decrease in the effective tax rate was caused by a significant reduction in pre-tax income in the third quarter caused by the increase in provision expense. All taxable income for the Corporation is taxed at a rate of 34%.

Comparison of the nine months ended September 30, 2009 to the nine months ended September 30, 2008:

Net Interest Income

Interest income for the first nine months of 2009 decreased to \$32.8 million from \$34.5 million during the first nine months of 2008. Average interest-earning assets increased by \$102.4 million, however the yield on these assets decreased by 96 basis points. The average balance on investment securities decreased \$10.2 million year over year due to pay downs and maturities in the portfolio, net of investment purchases. Total average loans increased \$95.3 million (15.7%) year over year. Average commercial loans increased \$111.5 million during the first nine months of 2009. However, new commercial loan production is at lower rates than much of the current portfolio, causing a reduction in portfolio yields. Continuing the trend from 2008, average outstanding mortgage loans decreased \$11.1 million as the majority of new mortgage originations are sold in the secondary market and the portfolio continues to runoff. Average consumer loans decreased \$5.1 million, as consumers continue to borrow less during the economic recession.

Interest expense was \$11.0 million for the first nine months of 2009, a decrease of \$965 thousand from \$11.9 million in 2008. Average interest-bearing liabilities increased to \$772.8 million compared to an average balance of \$667.7 million during the same period in 2008, an increase of \$105.1 million, due to increases in Now accounts and certificates of deposit. The average cost of these liabilities decreased from 2.39% to 1.90%, as liability rates followed the downward trend of market rates. Average interest-bearing deposits increased \$85.1 million due to increases in NOW accounts (\$15.0 million) and certificates of deposit (\$71.9 million), but the cost decreased from 2.12% to 1.72%. Securities sold under agreements to repurchase have decreased \$7.2 million on average over the prior year and the average rate decreased from 2.25% to .25%. The average balance of long-term debt increased \$34.1 million due to the Bank taking additional low-rate advances in the latter part of 2008 from FHLB and was the primary reason for the increase in interest expense for this liability.

The changes in the balance sheet and interest rates resulted in a decrease in net interest income of approximately \$766 thousand to \$21.8 million for the first nine months of 2009 compared to \$22.6 million for the same period in 2008. The Bank's net interest margin decreased from 4.04% to 3.44% in 2009. The decrease in the net interest margin is due to the yield on interest-bearing assets decreasing 96 basis points (mainly variable rate commercial loans), while the yield on interest-earning liabilities only decreased 49 basis points. An extended period of low market interest rates is likely to continue to reduce the net interest margin because liability rates can no longer be significantly reduced.

The following table shows a comparative analysis of average balances, asset yields and funding costs for the nine months ended September 30, 2009 and 2008. These components drive changes in net interest income.

For the Nine Months Ended September 30

| (Dollars in thousands) | Average balance | 2009 Tax Equivalent Interest | Average yield/ rate | Average balance | 2008 Tax Equivalent Interest | Average yield/ rate |
|--|------------------------|---|------------------------------------|-----------------|---------------------------------------|---------------------------|
| Interest-earning assets | | | | | | |
| Federal funds sold and interest-bearing balances | \$ 19,024 | \$ 21 | 0.15 % | \$ 1,686 | \$ 42 | 3.27 % |
| Investment securities | 152,735 | 5,164 | 4.51 % | 162,974 | 6,402 | 5.24 % |
| Loans | 700,647 | 28,401 | 5.39 % | 605,315 | 29,004 | 6.35 % |
| Total interest-earning assets | \$ 872,406 | 33,586 | 5.15 % | \$ 769,975 | 35,448 | 6.11 % |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing deposits | \$ 596,189 | 7,677 | 1.72 % | \$ 511,103 | 8,150 | 2.12 % |
| Securities sold under agreements to repurchase | 69,529 | 130 | 0.25 % | 76,749 | 1,295 | 2.25 % |
| Short-term borrowings | 2,546 | 13 | 0.68 % | 9,414 | 165 | 2.33 % |
| Long-term debt | 104,537 | 3,145 | 4.02 % | 70,445 | 2,320 | 4.39 % |
| Total interest-bearing liabilities | \$ 772,801 | 10,965 | 1.90 % | \$ 667,711 | 11,930 | 2.39 % |
| Interest spread | | | 3.25 % | | | 3.72 % |
| Tax equivalent net interest income/Net interest margin | | 22,621 | 3.44 % | | 23,518 | 4.04 % |
| Tax equivalent adjustment | | (801) | | | (932) | |

| | | |
|---------------------|-----------|-----------|
| Net interest income | \$ 21,820 | \$ 22,586 |
|---------------------|-----------|-----------|

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses.

Dividend income is reported as taxable income but is adjusted for the dividend received deduction. Loan balances include nonaccruing loans, loans held for sale, and are gross of the allowance for loan losses.

Provision for Loan Losses

The Corporation recorded \$2.7 million in provision expense during the first nine months of 2009 versus \$778 thousand for the same period in 2008. For more information concerning loan quality and the allowance for loan losses, refer to the Loan discussion in the Financial Condition section.

Noninterest Income

Noninterest income was \$6.6 million in the first nine months of 2009, \$481 thousand more than the first nine months of 2008 total of \$6.2 million. Investment and trust service fees remained flat, but asset management fees increased, while estate fees and investment commissions decreased year over year. Loan service charges increased by \$216 thousand due to a high volume of mortgage originations driven by the low rate environment. Mortgage banking fees have remained flat year over year; however, the composition of the fees has changed. The Corporation realized a larger net impairment recovery in the first nine months of 2009 versus the same period in 2008, while mortgage servicing income and gains on sale of mortgages decreased in 2009 compared to the same period in 2008. Deposit fees also remained flat and saw a change in the composition of deposit fees year over year. The Bank recorded less fee income from its overdraft protection program, but higher fees from commercial cash management services. Other service charges and fees increased primarily due to fee income from customer check orders. During 2008, the Corporation had an investment in American Home Bank, N.A (AHB) that was accounted for using the equity method of accounting. This investment produced a loss of \$127 thousand in the first nine months of 2008. On December 31, 2008, First Chester County Corporation (FCEC) completed its acquisition of AHB. The Corporation discontinued the equity method of accounting on this investment and no income was recognized in 2009 under the equity method of accounting. Other income increased \$306 thousand due to income from the benefits on a life insurance policy (\$278 thousand) in 2009. For the first nine months of 2009, the Corporation took write-downs of \$422 thousand on four equity securities it considered to be other than temporarily

impaired as compared to \$631 thousand the previous year. Net securities losses of \$212 thousand were recognized in the first nine months of 2009, compared to net securities gains of \$185 thousand in 2008.

The following table provides more information about noninterest income:

| | For the Three Months Ended September 30 | | Change | |
|--|--|----------|----------|----------|
| | 2009 | 2008 | Amount | % |
| Noninterest Income | | | | |
| Investment and trust services fees | \$ 2,622 | \$ 2,651 | \$ (29) | (1.1) |
| Loan service charges | 844 | 628 | 216 | 34.4 |
| Mortgage banking activities | 109 | 100 | 9 | 9.0 |
| Deposit service charges and fees | 1,911 | 1,900 | 11 | 0.6 |
| Other service charges and fees | 963 | 921 | 42 | 4.6 |
| Increase in cash surrender value of life insurance | 482 | 495 | (13) | (2.6) |
| Equity method investment | | (127) | 127 | (100.0) |
| Other | 341 | 35 | 306 | 874.3 |
| Impairment writedown on equity securities | (422) | (631) | 209 | (33.1) |
| Securities gains (losses), net | (212) | 185 | (397) | (214.6) |
| Total noninterest income | \$ 2,622 | \$ 6,157 | \$ 481 | 7.8 |
| Noninterest Expense | | | | |

During the first nine months of 2009, noninterest expense increased \$2.1 million to \$19.6 million from \$17.5 million in 2008. Salaries and benefits increased \$376 thousand primarily due to an increase in pension expense of \$383 thousand compared to the same period in 2008. The increase in pension expense is the result of the low rate environment and its affect on pension plan performance and pension obligations. Net occupancy increased \$116 thousand caused by increased depreciation expense from the renovations of several offices and the addition of the Camp Hill office. Advertising expense decreased \$257 thousand due to expenses in 2008 for the production of a customer education website. Data processing expenses were up \$99 thousand due to the implementation of remote deposit capture and electronic check presentment services. These services have provided convenience and service benefits to our customers and improved operational efficiency to the Bank. The Pennsylvania bank shares tax expense increased \$93 thousand, as 2008 included a tax adjustment from the Pennsylvania Department of Revenue. Intangible amortization increased \$80 thousand from the amortization of the customer list intangible asset booked with the acquisition of Community Financial, Inc. in the fourth quarter of 2008. Other noninterest expense increased \$241 thousand during the first nine months due to a prepayment penalty on a high-rate term loan from the FHLB and the write-down of leasehold improvements from closing a branch location in the second quarter.

FDIC insurance expense increased \$1.0 million to \$1.1 million compared to \$105 thousand for the same period in 2008 due to a \$450 thousand FDIC special assessment and an increase in the 2009 assessment rates. The FDIC insurance expense in the first nine months of 2008 was partially offset by the use of FDIC premium credits. These credits were completely used in 2008.

The following table provides more information about noninterest expense:

| | For the Nine Months Ended September 30 | | Change | |
|----------------------------------|---|------------------|-----------------|-------------|
| | 2009 | 2008 | Amount | % |
| Noninterest Expense | | | | |
| Salaries and benefits | \$ 9,400 | \$ 9,024 | \$ 376 | 4.2 |
| Net occupancy expense | 1,451 | 1,335 | 116 | 8.7 |
| Furniture and equipment expense | 646 | 632 | 14 | 2.2 |
| Advertising | 1,068 | 1,325 | (257) | (19.4) |
| Legal and professional fees | 1,158 | 872 | 286 | 32.8 |
| Data processing | 1,219 | 1,120 | 99 | 8.8 |
| Pennsylvania bank shares tax | 431 | 338 | 93 | 27.5 |
| Intangible amortization | 351 | 271 | 80 | 29.5 |
| FDIC insurance | 1,148 | 105 | 1,043 | 993.3 |
| Other | 2,709 | 2,468 | 241 | 9.8 |
| Total noninterest expense | \$ 19,581 | \$ 17,490 | \$ 2,091 | 12.0 |
| Income taxes | | | | |

Federal income tax expense was \$1.4 million in 2009 and \$2.9 million for 2008. The effective tax rate for 2009 was 22.4 and 27.5% for 2008. The decrease in the effective tax rate was caused by the reduction in income in the third quarter caused by the increase in provision expense and the FDIC special assessment. All taxable income for the Corporation is taxed at a rate of 34%.

Financial Condition

At September 30, 2009, assets totaled \$975.6 million, an increase of \$73.1 million from the 2008 year-end balance of \$902.5 million. Both deposit and loan growth have been strong with deposits up \$82.5 million and net loans up \$55.5 million. Because investment purchase activity has been limited, interest-bearing deposits at banks increased by approximately \$15.0 million since year-end.

Investment Securities:

The investment portfolio remained flat year over year. The Corporation's investment activity consisted primarily of replacing only those securities needed for collateral. The majority of the investment purchases in 2009 were comprised of U.S. Government Agency notes and mortgage backed securities.

The equity portfolio is comprised of bank stocks and the Bank and the Corporation each maintain separate equity investments. The municipal bond portfolio is well diversified geographically and is comprised primarily of general obligation bonds with credit enhancements in the form of private bond insurance or other credit enhancements. The Bank holds eleven corporate bonds. Seven bonds are single issuer trust preferred bonds. The majority of the mortgage backed security portfolio is comprised of U.S. Government Agency products. However, the Bank has 7 private label

Alt-A , mortgage backed securities. Alt-A loans are first-lien residential mortgages that generally conform to traditional prime credit guidelines; however, loan factors such as the loan-to-value ratio, loan documentation, occupancy status or property type cause these loans not to qualify for standard underwriting programs.

| <i>Amounts in thousands)</i> | | | | |
|---|------------------|-----------------------------|-----------------------------|---------------------------|
| | Amortized | Gross Unrealized | Gross Unrealized | Estimated Fair |
| 9/30/2009 | Cost | Gains | Losses | Value |
| Equity securities | \$ 5,344 | \$ 55 | \$ (1,332) | \$ 4,067 |
| U.S. Treasury securities and obligations of U.S. | | | | |
| Government agencies | 41,374 | 595 | (192) | 41,777 |
| Obligations of state and political subdivisions | 42,048 | 1,892 | (25) | 43,916 |
| Corporate debt securities | 9,976 | | (3,016) | 6,960 |
| Mortgage-backed securities | | | | |
| Agency | 53,087 | 1,575 | (57) | 54,605 |
| Non Agency | 6,319 | | (1,288) | 5,031 |
| Asset-backed securities | 86 | | (39) | 47 |
| | \$ 158,236 | \$ 4,117 | \$ (5,949) | \$ 156,404 |
| | Amortized | Gross Unrealized | Gross Unrealized | Estimated Fair |
| 12/31/2008 | Cost | Gains | Losses | Value |
| Equity securities | \$ 5,783 | \$ 18 | \$ (955) | \$ 4,846 |
| U.S. Treasury securities and obligations of U.S. | | | | |
| Government agencies | 29,548 | 770 | (287) | 30,031 |
| Obligations of state and political subdivisions | 45,518 | 824 | (659) | 45,683 |
| Corporate debt securities | 12,868 | | (3,888) | 8,980 |
| Mortgage-backed securities | | | | |
| Agency | 50,667 | 889 | (106) | 51,450 |
| Non Agency | 7,551 | | (1,033) | 6,518 |
| Asset-backed securities | 95 | | (44) | 51 |
| | \$ 152,030 | \$ 2,501 | \$ (6,972) | \$ 147,559 |

At September 30, 2009, the investment portfolio contained 96 securities with \$46.6 million of temporarily impaired fair value and \$5.9 million in unrealized losses. The fair value of temporarily impaired securities, the unrealized loss

and the number of securities are lower than at year-end 2008. Financial assets continue to experience pricing pressure as the recession moves throughout all sectors of the economy. For these securities, 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. The Bank does not intend to sell these securities and it is not expected that it will be required to sell these securities before maturity. Accordingly, the impairments identified on debt securities and subjected to the assessment at September 30, 2009 were deemed to be temporary and required no further adjustment to the financial statements.

The majority of the unrealized loss is in the corporate debt portfolio (\$3.0 million) and has existed for more than one year. Within this sector, \$2.5 million of the unrealized loss is in 7 trust preferred securities. However, this unrealized loss represents a slight improvement over the year-end trust preferred unrealized loss of \$2.7 million. The trust preferred securities held by the Bank are all single entity issues that continue to perform; however, due to the nature of trust-preferred securities, the long final maturities have compounded the price declines. All of the trust preferred issues are from companies that have received money from the Troubled Asset Relief Program (TARP) established by the Emergency Economic Stabilization Act of 2008 (EESA) in order to boost their capital position. Management believes that all of the trust preferred securities will continue to perform as expected until maturity.

The largest unrealized loss in the mortgage backed security portfolio is in the non-agency private label Alt-A sector. The Alt-A product is comprised of fixed-rate product that was originated between 2004 and 2006. All of these bonds have some type of credit support tranche that will absorb any loss prior to losses at the senior tranche held by the Bank. At September 30, 2009, the amount of credit support on these bonds ranged from 3.70% to 11.28%. The Bank monitors the performance of the Alt-A investments on a regular basis and reviews default rates, credit support levels and various cash flow stress test scenarios. Management believes that these investments do not offer any undue risk of loss.

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 conditions relating to specific issues. Unrealized losses on equity securities continued to increase throughout 2009, despite the recognition of other than temporary impairment charges. In 2008, most of the price depreciation occurred in regional and national bank stocks. In 2009, most the price depreciation has occurred in community bank stocks. Based on Management's review, equity write-downs of \$422 thousand were taken in 2009. It is possible that additional write-downs may be required in 2009.

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, 2009 and December 31, 2008:

| Amounts in (thousands) | September 30, 2009 | | | | | | | | |
|---|---------------------|----------------------|--------|-------------------|----------------------|--------|---------------|----------------------|--------|
| | Less than 12 Months | | | 12 Months or More | | | Total | | |
| | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |
| Equity securities | \$ 455 | \$ (433) | 6 | \$ 1,363 | \$ (899) | 21 | \$ 1,818 | \$ (1,332) | 27 |
| U.S. Treasury securities and obligations of U.S. Government agencies | 8,839 | (14) | 14 | 11,543 | (178) | 22 | 20,382 | (192) | 36 |
| Obligations of state and political divisions | 2,322 | (13) | 3 | 295 | (11) | 1 | 2,618 | (25) | 4 |
| Corporate debt securities | | | | 6,860 | (3,016) | 11 | 6,860 | (3,016) | 11 |
| Mortgage-backed securities | | | | | | | | | |
| Agency | 9,769 | (57) | 7 | 99 | | 1 | 9,869 | (57) | 8 |
| Non Agency | | | | 5,031 | (1,288) | 7 | 5,031 | (1,288) | 7 |
| Asset-backed securities | | | | 47 | (39) | 3 | 47 | (39) | 3 |
| Total temporarily impaired securities | \$ 21,386 | \$ (517) | 30 | \$ 25,239 | \$ (5,431) | 66 | \$ 46,625 | \$ (5,949) | 96 |
| Amounts in (thousands) | December 31, 2008 | | | | | | | | |
| | Less than 12 Months | | | 12 Months or More | | | Total | | |
| | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number | Fair Value | Unrealized Losses | Number |

| | | | | | | | | | |
|--|-----------|-------------|----|-----------|-------------|----|-----------|-------------|----|
| Equity securities | \$ 1,933 | \$ (701) | 17 | \$ 382 | \$ (254) | 8 | \$ 2,315 | \$ (955) | 2 |
| U.S. Treasury securities and obligations of U.S. government agencies | 7,018 | (69) | 27 | 10,113 | (218) | 15 | 17,131 | (287) | 4 |
| Obligations of state and political divisions | 14,137 | (659) | 32 | | | | 14,137 | (659) | 3 |
| Corporate debt securities | 3,722 | (448) | 4 | 5,158 | (3,440) | 9 | 8,880 | (3,888) | 1 |
| Mortgage-backed securities | | | | | | | | | |
| Agency | 6,689 | (70) | 9 | 1,257 | (36) | 4 | 7,946 | (106) | 1 |
| Non Agency | 6,517 | (1,033) | 7 | | | | 6,517 | (1,033) | |
| Asset-backed securities | 16 | (7) | 1 | 35 | (37) | 2 | 51 | (44) | |
| Other temporarily impaired securities | \$ 40,032 | \$ (2,987) | 97 | \$ 16,945 | \$ (3,985) | 38 | \$ 56,977 | \$ (6,972) | 13 |

The Bank held \$6.5 million of restricted stock at September 30, 2009. Except for \$30 thousand, this investment represents stock in the FHLB, which the Bank is required to hold to be a member of FHLB, and is carried at cost of \$100 per share. In December 2008, FHLB announced it would suspend its cash dividend and the repurchase of excess capital stock from its members due to deterioration in its financial condition. At September 30, 2009, the Bank held approximately \$1.2 million in excess FHLB stock that it would not have been required to hold prior to the suspension of the stock repurchase program. 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:

Net loans have increased \$55.5 million since year-end. Commercial lending activity continues to be good and these balances have increased more than \$75.8 million since year-end. The majority of the new commercial loans are variable rate and are secured by real estate. These loans are a mix of in-market production and purchased loans in south central Pennsylvania. However, the growth in commercial loans was partially offset by a decrease of approximately \$7.2 million in the residential mortgage loan portfolio and \$11.6 million in the consumer portfolio. The mortgage portfolio is expected to continue to run-off as the Bank is originating mortgages, but is not funding, servicing or retaining the loans. The decrease in the consumer loan portfolio is primarily from pay downs on home equity loans, much of which was a result of refinancing a first mortgage.

The following table presents a summary of loans outstanding at:

| <i>(Amounts in thousands)</i> | September 30, 2009 | December 31, 2008 | Change | |
|--|-------------------------------|------------------------------|---------------|----------|
| | | | Amount | % |
| Residential mortgage loans | \$ 69,465 | \$ 78,061 | \$ (8,596) | (11.0) |
| Residential construction loans | 1,766 | 408 | 1,358 | 332.8 |
| Commercial construction and land development | 109,502 | 99,027 | 10,475 | 10.6 |
| Commercial, industrial and agricultural | 431,580 | 366,261 | 65,319 | 17.8 |
| Consumer - home equity loans and lines of credit | 95,771 | 103,523 | (7,752) | (7.5) |
| Consumer - other | 25,077 | 28,937 | (3,860) | (13.3) |
| | 733,161 | 676,217 | 56,944 | 8.4 |
| Less: Allowance for loan losses | (8,828) | (7,357) | (1,471) | 20.0 |
| Net Loans | \$ 724,333 | \$ 668,860 | \$ 55,473 | 8.3 |

Included in the loan balances are the following:

| | | | | |
|---|------------------|-----------|--|--|
| Net unamortized deferred loan costs | \$ 609 | \$ 646 | | |
| Unamortized discount on purchased loans | \$ (304) | \$ (295) | | |

Total nonperforming assets as a percent of total assets increased from .44% at December 31, 2008 to 1.21% at September 30, 2009. Nonperforming loans drove the increase in nonperforming assets as evidenced by the increase in nonperforming loans as a percent of total gross loans, from .59% at December 31, 2008 to 1.53% at September 30, 2009.

Nonaccrual loans are up \$4.0 million since year-end with construction and land development loans, and loans secured by farm real estate responsible for the increase. There are three credits within these categories that account for the majority of the nonaccrual. Management has identified and specifically allocated for the associated risk of loss on these loans. Nonaccruing residential mortgages decreased due to the foreclosure of two properties. Foreclosed real estate increased from \$0 at December 31, 2008 to \$504 thousand, reflecting the addition of the two foreclosed properties. Subsequent to quarter-end three additional residential mortgages were placed into nonaccrual and management estimates a risk of loss on these loans.

Nonperforming loans (i.e., 90-days or more past due and still accruing interest [Ninety-day]) increased \$3.3 million to \$4.4 million at September 30, 2009. The increase was primarily comprised of residential mortgage, commercial real estate, and commercial and industrial loans. Ninety-Day residential mortgages increased by approximately \$1.4 million and the majority of these loans are secured by first liens. Ninety-Day commercial and agriculture related loans increased by \$1.8 million. Management continues to monitor the performance of these loans, the value of any collateral and potential of risk of loss.

The Bank has added \$1.5 million, above net charge-offs, to the allowance for loan losses during the year. However, the increase in nonperforming loans caused the coverage ratio (nonperforming loans / allowance for loan losses) to decrease from 183.93% to 78.55% at September 30, 2009.

The following table presents a summary of nonperforming assets:

| <i>(Dollars in thousands)</i> | 9/30/2009 | 12/31/2008 |
|---|------------------|------------|
| Nonaccrual loans | | |
| Consumer | \$ | \$ |
| Residential mortgage | 287 | 333 |
| Construction and land development | 4,471 | 1,286 |
| Farm real estate | 2,022 | |
| Commercial real estate | | |
| Commercial and industrial | | 1,252 |
| Agriculture | 48 | |
| Total nonaccrual loans | \$ 6,828 | \$ 2,871 |
| Loans past due 90 days or more and not included above | | |
| Consumer | \$ | \$ |
| Residential mortgage | 1,954 | 544 |
| Construction and land development | 750 | 429 |
| Farm real estate | 437 | |
| Commercial real estate | 626 | |
| Commercial and industrial | 488 | 33 |
| Agriculture | 0 | 0 |
| Total loans past due 90 days or more and still accruing | 4,411 | 1,129 |
| Total nonperforming loans | 11,239 | 4,000 |
| Repossessed assets | 52 | 14 |
| Foreclosed real estate | 504 | |
| Total nonperforming assets | \$ 11,795 | \$ 4,014 |
| Nonperforming loans to total gross loans | 1.53 % | 0.59 % |
| Nonperforming assets to total assets | 1.21 % | 0.44 % |
| Allowance for loan losses to nonperforming loans | 78.55 % | 183.28 % |

Year-to-date net charge-offs were \$1.2 million versus \$433 thousand through September 30, 2008. More than 50% of gross charge-offs were within contained in the construction and land development, and commercial and industrial loans. Consumer loan charge-offs were predominantly in the Bank's indirect installment loan portfolio. The annualized net charge-off ratio was .23% at September 30, 2009, compared to .10% at September 30, 2008 and .19% at December 31, 2008.

The year-to-date provision for loan loss expense at September 30, 2009 was \$2.7 million compared to \$778 thousand year-to-date at September 30, 2008. Management recognized additional provision expense based on the loan growth

and the establishment of specific reserves for nonperforming loans. The allowance for loan loss coverage ratio was 1.20% at September 30, 2009, comparing favorably to 1.18% at September 30, 2008 and 1.09% at December 2008.

The following table presents an analysis of the allowance for loan losses.

| | Nine Months Ended September 30 | | Twelve Months Ended December 31 | |
|---|---|-------------|--|--|
| | 2009 | 2008 | 2008 | |
| Balance at beginning of year | \$ 7,357 | \$ 7,361 | \$ 7,361 | |
| Charge-offs: | | | | |
| Consumer | (502) | (337) | (496) | |
| Residential mortgage | (94) | (23) | (224) | |
| Construction and land development | (350) | | (354) | |
| Farm real estate | | (28) | (28) | |
| Commercial real estate | (4) | | | |
| Commercial and industrial | (470) | (214) | (311) | |
| Agricultural | | (21) | (20) | |
| Total charge-offs | (1,420) | (623) | (1,433) | |
| Recoveries: | | | | |
| Consumer | 148 | 120 | 165 | |
| Residential mortgage | 20 | 17 | 24 | |
| Construction and land development | | | | |
| Farm real estate | | 28 | 28 | |
| Commercial real estate | | | | |
| Commercial and industrial | 7 | 25 | 19 | |
| Agricultural | 53 | | | |
| Total recoveries | 228 | 190 | 236 | |
| Net charge-offs | (1,192) | (433) | (1,197) | |
| Provision for loan losses | 2,663 | 778 | 1,193 | |
| Balance at end of year | \$ 8,828 | \$ 7,706 | \$ 7,357 | |
| Ratios: | | | | |
| Annualized net loans charged-off as a percentage of average loans | 0.23 % | 0.10 % | 0.19 % | |
| Net loans charged-off as a percentage of the provision for loan losses | 44.76 % | 55.66 % | 100.34 % | |
| Allowance as a percentage of loans | 1.20 % | 1.18 % | 1.09 % | |

Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy assessment monthly to the Board of Directors. Management believes that the allowance for loan losses is adequate.

Other Assets:

Other intangible assets are comprised of a core deposit intangible and a customer list and are being amortized over the estimated useful life of the asset.

Deposits:

Total deposits increased \$82.5 million during the first nine months of 2009 to \$709.9 million. Non-interest bearing deposits decreased \$9.8 million, but were more than offset by an increase in interest-bearing deposits. Savings and interest-bearing checking deposits increased \$30.6 million and time deposits increased \$61.7 million. The Bank's Money Management product increased \$22.3 million due in part to a promotion in selected markets and higher consumer savings levels. Retail time deposits increased since year-end due to a CD promotion and the acquisition of some large dollar municipal accounts. The Bank also took out brokered CDs in the amount of \$16.9 million in the first nine months of 2009, much of it at rates below local market rates. In 2008, the Bank became a member of the Promontory Network and began offering CDs through CDARS. CDARS places large deposits into CDs with other network member banks in increments less than the FDIC insurance maximum, thereby providing insurance coverage on the entire balance. As of September 30, 2009, the Bank had \$20.6 million in CDARS deposits included in brokered time deposits.

The following table presents a summary of deposits outstanding at:

| <i>(Amounts in thousands)</i> | September 30, 2009 | December 31, 2008 | Change | |
|--|-------------------------------|-------------------------|-------------|---------|
| | | | Amount | % |
| Demand, noninterest-bearing | \$ 77,181 | \$ 86,954 | \$ (9,773) | (11.2) |
| Interest-bearing checking | 92,498 | 86,241 | 6,257 | 7.3 |
| Savings: | | | | |
| Money market accounts | 225,452 | 203,171 | 22,281 | 11.0 |
| Passbook and statement savings | 48,050 | 46,006 | 2,044 | 4.4 |
| Total savings and interest checking | 366,000 | 335,418 | 30,582 | 9.1 |
| Time: | | | | |
| Deposits of \$100,000 and over | 56,976 | 50,510 | 6,466 | 12.8 |
| Brokered time deposits | 44,082 | 16,504 | 27,578 | 167.1 |
| Other time deposits | 165,612 | 137,955 | 27,657 | 20.0 |
| | 266,670 | 204,969 | 61,701 | 30.1 |
| Total deposits | \$ 709,851 | \$ 627,341 | \$ 82,510 | 13.2 |
| Overdrawn deposit accounts reclassified as loan balances | 206 | 181 | | |
| <i>Borrowings:</i> | | | | |

The Repo balance decreased \$985 thousand from year-end, while long-term debt from the FHLB decreased \$3.1 million due to scheduled pay downs and the prepayment of \$1.3 million high-rate term loan in the second quarter.

Shareholders Equity:

Total shareholders equity increased \$4.6 million to \$77.6 million at September 30, 2009, compared to \$73.1 million at the end of 2008. The increase in retained earnings from the Corporation's net income of \$4.8 million was partially offset by the cash dividend of \$3.1 million. The increase of \$2.4 million in accumulated other comprehensive loss is the result of an improvement in the market value of investment securities available for sale. The Corporation's dividend payout ratio of 64% for the first nine months exceeds the 2008 year-end ratio of 48%. The payout ratio is higher than normal due to lower third quarter earnings that were affected by higher provision expense, other than temporary impairment charges and the FDIC special assessment. As capital levels become increasingly important during this difficult economic period, the Corporation decided not to increase its third and fourth quarter dividend. Management views the dividend payout as a critical piece of its capital management plan. Additionally, the Corporation is currently exploring other sources of capital as part of its capital management plan for the Corporation and the Bank. The Corporation repurchased 8,640 shares of the Corporation's common stock for \$142 thousand during the first nine months of 2009.

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. At September 30, 2009, the Corporation was well capitalized as defined by the banking regulatory agencies. Regulatory capital ratios for the Corporation and the Bank are shown below:

| | September 30, 2009 | December 31, 2008 | Minimum | Well Capitalized Minimum |
|---|-----------------------|-------------------------|---------|--------------------------------|
| Total Risk Based Capital Ratio (1) | | | | |
| Franklin Financial Services Corporation | 10.82 % | 11.02 % | 8.00 % | n/a |
| Farmers & Merchants Trust Company | 10.38 % | 10.29 % | 8.00 % | 10.00 % |
| Tier 1 Capital Ratio (2) | | | | |
| Franklin Financial Services Corporation | 9.63 % | 9.96 % | 4.00 % | n/a |
| Farmers & Merchants Trust Company | 9.18 % | 9.21 % | 4.00 % | 6.00 % |
| Leverage Ratio (3) | | | | |
| Franklin Financial Services Corporation | 7.36 % | 7.84 % | 4.00 % | n/a |
| Farmers & Merchants Trust Company | 7.00 % | 7.26 % | 4.00 % | 5.00 % |

(1)

Total risk-based capital / total risk-weighted assets

(2)

Tier 1 capital / total risk-weighted assets

(3)

Tier 1 capital / average quarterly assets

Economy

The Corporation operates in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania. The general economic conditions in this market have deteriorated since year-end and unemployment rates are vastly different from county to county. Franklin County's unemployment rate was 8.8%, Cumberland County's rate was 7.1% and Fulton County's rate was 14.9% at September 30, 2009. These rates compare to the Pennsylvania state average of 8.6%. Management believes that the Bank's primary market area continues to be well suited for growth when the national recession eases. The Corporation is not overly dependent on any one industry within its market area and the industries located in its market area are well diversified. Housing prices have declined and housing sales have slowed; however, the Corporation's market area has not been affected as greatly by increased home foreclosures as much as other areas of the country have.

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 Fed continued to decrease rates through 2008. The fed funds target rate was decreased by 4% in 2008 from 4.25% to .25% at year-end and has remained unchanged in 2009. The effort by the Federal Reserve to reduce short-term rates has had a negative effect on the Corporation's net interest margin. If rates continue to remain low, it is unlikely that the net interest margin will improve in 2009 and possibly 2010.

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 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 investments 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, 2009, the Bank had approximately \$149 million of its investment portfolio pledged as collateral. Another source of liquidity for the Bank is a line of credit with the FHLB. The FHLB system has always been a major source of funding for community banks. The capital level of the FHLB, and the entire FHLB system, has been strained due to the declining value of mortgage related assets. The FHLB has implemented steps to improve its capital position that included a suspension of its dividend and an end to its practice of redeeming members' stock. Both of these actions are not favorable to the Bank. There are no indicators that lead the Bank to believe the FHLB will discontinue its lending function. If that were to occur, it would have a negative effect on the Bank and it is unlikely that the Bank could replace the level of FHLB funding in a short time. Another action

that may be considered by FHLB to increase its capital is to have a capital call on its member banks. This would require the member banks to invest more capital into the FHLB when most banks would prefer not make such an investment. At September 30, 2009, the Bank had approximately \$98 million available on this line of credit.

In addition, the Bank has \$26 million in unsecured lines of credit at three correspondent banks and approximately \$45 million in funding available at the Federal Reserve Discount Window. The Bank is continuing to increase its funding level at the discount window. The Bank also has the ability to access other funding sources including wholesale borrowings and brokered CDs.

Off Balance Sheet Commitments and Contractual Obligations

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 \$202.5 million and \$183.1 million, respectively, at September 30, 2009 and December 31, 2008.

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 2008 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 three months ended September 30, 2009. For more information on market risk refer to the Corporation's 2008 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, 2009, 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.

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.

Changes in Internal Controls

Management assessed the effectiveness of the Corporation's internal control over financial reporting as of September 30, 2009, using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework. Based on this assessment, management concluded that, as of September 30, 2009, the Corporation's internal control over financial reporting is effective based on those criteria.

There were no changes during the three months ended September 30, 2009 in the Corporation's internal control over financial reporting which materially affected, or which are reasonably likely to affect, the Corporation's internal control over financial reporting.

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 three months ended September 30, 2009. For more information, refer to the Corporation's 2008 Annual Report on Form 10-K.

Item 2.

Unregistered Sales of Equity Securities and Use of Proceeds

The Corporation announced a stock repurchase plan on July 9, 2009 to repurchase up to 100,000 shares of the Corporation's common stock over a 12 month time period. As of September 30, 2009, 3,000 shares have been purchased under this plan. The following chart reports stock repurchases made during the third quarter of 2009:

| Period | Number of Shares Purchased | Weighted Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Number of Shares that May Yet Be Purchased Under Program |
|----------------|----------------------------------|--|--|---|
| July 2009 | 3,000 | \$ 16.24 | 3,000 | 97,000 |
| August 2009 | | | | 97,000 |
| September 2009 | | | | 97,000 |
| Total | 3,000 | \$ 16.24 | 3,000 | |

Item 3.

Defaults by the Company on its Senior Securities

None

Item 4.

Submission of Matters to a Vote of Security Holders

None

Item 5.

Other Information

None

Item 6.

Exhibits

| Exhibits | Description |
|-----------------|---|
| <u>31.1</u> | Rule 13a 14(a)/15d-14(a) Certifications Chief Executive Officer |
| <u>31.2</u> | Rule 13a 14(a)/15d-14(a) Certifications Chief Financial Officer |
| <u>32.1</u> | Section 1350 Certifications Chief Executive Officer |
| <u>32.2</u> | Section 1350 Certifications Chief Financial Officer |

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,
2009

By:

/s/ William E. Snell, Jr.

William E. Snell, Jr.

President and Chief Executive Officer

November 9, 2009

By:

/s/ Mark R. Hollar

Mark R. Hollar

Treasurer and Chief Financial Officer