

FRANKLIN FINANCIAL SERVICES CORP /PA/  
Form 10-Q  
May 10, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2012,

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	25-1440803
(State or other jurisdiction of incorporation or organization)	(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 4,059,881 outstanding shares of the Registrant's common stock as of April 30, 2012.

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**Part I FINANCIAL INFORMATION****Item 1 Financial Statements****Consolidated Balance Sheets****(Dollars in thousands, except per share data)****(unaudited)**

	March 31 2012	December 31 2011
<b>Assets</b>		
Cash and due from banks	\$ 17,058	\$ 16,932
Interest-bearing deposits in other banks	69,315	17,212
Total cash and cash equivalents	86,373	34,144
Investment securities available for sale, at fair value	121,722	125,301
Restricted stock	4,772	5,022
Loans	763,636	766,410
Allowance for loan losses	(9,507 )	(9,723 )
Net Loans	754,129	756,687
Premises and equipment, net	15,961	16,041
Bank owned life insurance	20,440	20,273
Goodwill	9,016	9,016
Other intangible assets	1,449	1,558
Other real estate owned	3,123	3,224
Deferred tax assets	6,224	6,384
Other assets	12,689	12,598
Total assets	\$ 1,035,898	\$ 990,248
<b>Liabilities</b>		
<b>Deposits</b>		
Demand (non-interest bearing)	\$ 117,553	\$ 104,245
Savings and interest checking	521,334	495,426
Time	196,647	188,315
Total Deposits	835,534	787,986
Securities sold under agreements to repurchase	52,300	53,103
Long-term debt	46,659	48,336
Other liabilities	13,143	13,641
Total liabilities	947,636	903,066

Shareholders' equity

Common stock \$1 par value per share, 15,000,000 shares authorized with 4,453,452 shares issued and 4,057,278 shares outstanding at March 31, 2012 and 4,419,258 shares issued and 4,023,084 shares outstanding at December 31, 2011	4,453	4,419
Capital stock without par value, 5,000,000 shares authorized with no shares issued or outstanding	-	-
Additional paid-in capital	35,153	34,698
Retained earnings	60,559	60,280
Accumulated other comprehensive loss	(4,819 )	(5,131 )
Treasury stock, 396,174 shares at cost at March 31, 2012 and December 31, 2011, respectively	(7,084 )	(7,084 )
Total shareholders' equity	88,262	87,182
Total liabilities and shareholders' equity	\$1,035,898	\$990,248

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

**Consolidated Statements of Income****(Dollars in thousands, except per share data)****(unaudited)**

	For the Three Months Ended March 31	
	2012	2011
Interest income		
Loans, including fees	\$ 9,099	\$ 9,342
Interest and dividends on investments:		
Taxable interest	433	583
Tax exempt interest	366	343
Dividend income	16	25
Deposits and obligations of other banks	37	7
Total interest income	9,951	10,300
Interest expense		
Deposits	1,455	1,670
Securities sold under agreements to repurchase	20	33
Short-term borrowings	-	1
Long-term debt	492	701
Total interest expense	1,967	2,405
Net interest income	7,984	7,895
Provision for loan losses	1,950	900
Net interest income after provision for loan losses	6,034	6,995
Noninterest income		
Investment and trust services fees	967	932
Loan service charges	272	481
Mortgage banking activities	47	10
Deposit service charges and fees	474	536
Other service charges and fees	235	127
Debit card income	275	235
Increase in cash surrender value of life insurance	167	165
Other	126	25
Securities gains (losses), net	-	11
Total noninterest income	2,563	2,522
Noninterest Expense		
Salaries and benefits	3,796	3,713
Net occupancy expense	519	531
Furniture and equipment expense	209	223

Advertising	315	292
Legal and professional fees	279	271
Data processing	413	381
Pennsylvania bank shares tax	187	165
Intangible amortization	109	111
FDIC insurance	261	311
Other	922	1,024
Total noninterest expense	7,010	7,022
Income before federal income taxes	1,587	2,495
Federal income tax expense	218	646
Net income	\$ 1,369	\$ 1,849
Per share		
Basic earnings per share	\$ 0.34	\$ 0.47
Diluted earnings per share	\$ 0.34	\$ 0.47
Cash dividends declared per share	\$ 0.27	\$ 0.27

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



**Consolidated Statements of Comprehensive Income****(unaudited)**

(Dollars in thousands)	For the Three Months Ended	
	March 31	
	2012	2011
Net Income	\$ 1,369	\$ 1,849
Securities:		
Unrealized gains arising during the period	262	737
Reclassification adjustment for gains included in net income	-	(11 )
Net unrealized gains	262	726
Tax effect	(89 )	(247 )
Net of tax amount	173	479
Derivatives:		
Unrealized gains arising during the period	29	66
Reclassification adjustment for losses included in net income	181	175
Net unrealized gains	210	241
Tax effect	(71 )	(83 )
Net of tax amount	139	158
Total Other Comprehensive Income	312	637
Total Comprehensive Income	\$ 1,681	\$ 2,486

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

**Consolidated Statements of Changes in Shareholders' Equity****For the Three Months Ended March 31, 2012 and 2011****(unaudited)**

(Dollars in thousands, except per share data)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income		Treasury Stock	Total
				Loss			
Balance at December 31, 2010	\$ 4,317	\$ 33,096	\$ 57,984	\$ (5,642 )		\$ (7,116 )	\$ 82,639
Net income	-	-	1,849	-	-	-	1,849
Unrealized gain on securities, net of reclassification adjustments and taxes	-	-	-	479	-	-	479
Unrealized gain on hedging activities, net of reclassification adjustments and taxes	-	-	-	158	-	-	158
Cash dividends declared, \$.27 per share	-	-	(1,058 )	-	-	-	(1,058 )
Treasury shares issued under stock option plans, 26 shares	-	-	-	-	-	1	1
Common stock issued under dividend reinvestment plan, 13,790 shares	14	258	-	-	-	-	272
Balance at March 31, 2011	\$ 4,331	\$ 33,354	\$ 58,775	\$ (5,005 )		\$ (7,115 )	\$ 84,340
Balance at December 31, 2011	\$ 4,419	\$ 34,698	\$ 60,280	(\$ 5,131 )		(\$ 7,084 )	\$ 87,182
Net income	-	-	1,369	-	-	-	1,369
Unrealized gain on securities, net of reclassification adjustments and taxes	-	-	-	173	-	-	173
Unrealized gain on hedging activities, net of reclassification adjustments and taxes	-	-	-	139	-	-	139
Cash dividends declared, \$.27 per share	-	-	(1,090 )	-	-	-	(1,090 )
Common stock issued to dividend reinvestment plan: 34,193 shares	34	455	-	-	-	-	489
Balance at March 31, 2012	\$ 4,453	\$ 35,153	\$ 60,559	(\$ 4,819 )		(\$ 7,084 )	\$ 88,262

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

**Consolidated Statements of Cash Flows****(unaudited)**

	For the Three Months Ended March	
	31	
	2012	2011
(Dollars in thousands)		
Cash flows from operating activities		
Net income	\$ 1,369	\$ 1,849
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	354	349
Net amortization of loans and investment securities	320	159
Amortization and net change in mortgage servicing rights valuation	(7	) 36
Amortization of intangibles	109	111
Provision for loan losses	1,950	900
Net realized gains on sales of securities	-	(11
Net gain on sale or disposal of other real estate/other repossessed assets	(37	) -
Increase in cash surrender value of life insurance	(167	) (165
Contribution to pension plan	(370	) (102
Increase in interest receivable and other assets	(424	) (51
(Decrease) increase in interest payable and other liabilities	(326	) 1,622
Other, net	502	532
Net cash provided by operating activities	3,273	5,229
Cash flows from investing activities		
Proceeds from sales of investment securities available for sale	-	880
Proceeds from maturities and paydowns of investment securities available for sale	10,277	4,094
Purchase of investment securities available for sale	(6,495	) (11,223
Net decrease in restricted stock	250	307
Net decrease (increase) in loans	508	(15,636
Proceeds from sale of other real estate/other repossessed assets	195	124
Capital expenditures	(246	) (121
Net cash provided by (used in) investing activities	4,489	(21,575
Cash flows from financing activities		
Net increase in demand deposits, interest-bearing checking and savings accounts	39,216	24,458
Net increase (decrease) in time deposits	8,332	(1,482
Net (decrease) increase in short-term borrowings	(803	) 3,202
Long-term debt payments	(1,677	) (9,173
Dividends paid	(1,090	) (1,058
Common stock issued under dividend reinvestment plan	489	272
Common stock issued under stock option plans	-	1

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Net cash provided by financing activities	44,467	16,220	
Increase (decrease) in cash and cash equivalents	52,229	(126	)
Cash and cash equivalents at beginning of period	34,144	22,106	
Cash and cash equivalents at end of period	\$ 86,373	\$ 21,980	

Supplemental Disclosures of Cash Flow Information

Cash paid during the year for:

Interest on deposits and other borrowed funds	\$ 1,849	\$ 2,271
Income taxes	\$ -	\$ -
Noncash Activities		
Loans transferred to Other Real Estate	\$ 63	\$ 207

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

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Franklin Financial Services Corporation (the Corporation), and its wholly-owned subsidiaries, Farmers and Merchants Trust Company of Chambersburg (the Bank) and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank that has one wholly-owned subsidiary, Franklin Financial Properties Corp. During the first quarter of 2012, Franklin Realty Services Corporation (an inactive real-estate brokerage company and subsidiary of the Bank as of December 31, 2011) merged with Franklin Financial Properties Corp. (a subsidiary of the Corporation at December 31, 2011) with Franklin Financial Properties Corp. becoming the surviving entity and subsidiary of the Bank. Franklin Financial Property Corp. holds real estate assets that are leased by the Bank. Franklin Future Fund Inc. is a non-bank investment company. The activities of non-bank entities are not significant to the consolidated totals. All significant intercompany transactions and account balances have been eliminated.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of March 31, 2012, and for all other periods presented have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation's 2011 Annual Report on Form 10-K. The consolidated results of operations for the period ended March 31, 2012 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

The consolidated balance sheet at December 31, 2011 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements.

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

Earnings per share 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:

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(In thousands, except per share data)	For the Three Months Ended March 31	
	2012	2011
Weighted average shares outstanding (basic)	4,041	3,925
Impact of common stock equivalents	-	5
Weighted average shares outstanding (diluted)	4,041	3,930
Anti-dilutive options excluded from the calculation	108	70
Net income	\$ 1,369	\$ 1,849
Basic earnings per share	\$ 0.34	\$ 0.47
Diluted earnings per share	\$ 0.34	\$ 0.47

### Note 2 – Recent Accounting Pronouncements

There were no new accounting pronouncements affecting the Corporation during the period that were not already incorporated into the disclosures.

### Note 3 – Accumulated Other Comprehensive Loss

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

(Dollars in thousands)	March 31, 2012	December 31, 2011
Net unrealized gains on securities	\$ 1,689	\$ 1,427
Tax effect	(574 )	(485 )
Net of tax amount	1,115	942
Net unrealized losses on derivatives	(1,528)	(1,738 )
Tax effect	519	590
Net of tax amount	(1,009)	(1,148 )
Accumulated pension adjustment	(7,462)	(7,462 )
Tax effect	2,537	2,537
Net of tax amount	(4,925)	(4,925 )
Total accumulated other comprehensive loss	\$ (4,819)	\$ (5,131 )

### 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 \$28.7 million and \$28.2 million of standby letters of credit as of March 31, 2012 and December 31, 2011, respectively. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The amount of the liability as of March 31, 2012 and December 31, 2011 for guarantees under standby letters of credit issued was not material.



**Note 5 - Investments**

The amortized cost and estimated fair value of investment securities available for sale as of March 31, 2012 and December 31, 2011 are:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
March 31, 2012				
Equity securities	\$ 2,105	\$ 77	\$ (213 )	\$ 1,969
U.S. Government agency securities	11,380	83	(27 )	11,436
Municipal securities	44,488	2,529	(16 )	47,001
Corporate debt securities	2,484	51	(49 )	2,486
Trust preferred securities	5,895	-	(1,290 )	4,605
Agency mortgage-backed securities	50,473	1,034	(127 )	51,380
Private-label mortgage-backed securities	3,144	-	(346 )	2,798
Asset-backed securities	64	-	(17 )	47
	\$ 120,033	\$ 3,774	\$ (2,085 )	\$ 121,722

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
December 31, 2011				
Equity securities	\$ 2,105	\$ 11	\$ (357 )	\$ 1,759
U.S. Government agency securities	13,159	75	(5 )	13,229
Municipal securities	42,490	2,598	(7 )	45,081
Corporate debt securities	2,484	49	(119 )	2,414
Trust preferred securities	5,890	-	(1,272 )	4,618
Agency mortgage-backed securities	54,314	1,159	(188 )	55,285
Private-label mortgage-backed securities	3,366	1	(500 )	2,867
Asset-backed securities	66	-	(18 )	48
	\$ 123,874	\$ 3,893	\$ (2,466 )	\$ 125,301

The amortized cost of securities pledged as collateral to secure various funding sources was \$100.0 million at March 31, 2012 and \$112.1 million at December 31, 2011.

The amortized cost and fair value of debt securities as of March 31, 2012, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

(Dollars in thousands)	Amortized Cost	Fair Value
Due in one year or less	\$ 2,684	\$2,731
Due after one year through five years	12,239	12,838
Due after five years through ten years	17,649	18,540
Due after ten years	31,739	31,466
	64,311	65,575
Mortgage-backed securities	53,617	54,178
	\$ 117,928	\$ 119,753

The following table reflects temporary impairment in the investment portfolio (excluding restricted stock), aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of March 31, 2012 and December 31, 2011:

(Dollars in thousands)	March 31, 2012								
	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	\$425	\$ (18 )	3	\$946	\$ (195 )	12	\$1,371	\$ (213 )	15
U.S. Government agency securities	4,973	(25 )	5	1,276	(2 )	5	6,249	(27 )	10
Municipal securities	1,491	(16 )	2	-	-	-	1,491	(16 )	2
Corporate debt securities	-	-	-	1,958	(49 )	2	1,958	(49 )	2
Trust preferred securities	-	-	-	4,605	(1,290 )	7	4,605	(1,290 )	7
Agency mortgage-backed securities	8,008	(80 )	8	3,495	(47 )	4	11,503	(127 )	12
Private-label mortgage-backed securities	1,018								