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)

þ **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	**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 þ 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 þ 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 þ No þ

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

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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

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.

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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**

Cash dividends declared, $.81 per share			**(3,104)**			**(3,104)**
Acquisition of 5,640 shares of treasury stock					**(142)**	**(142)**
Treasury shares issued to dividend reinvestment plan: 23,496 shares		**(65)**			**639**	**574**
Common stock issued under stock option plans					**2**	**2**
Stock option compensation		**29**				**29**
Balance at September 30, 2009	**$ 4,299**	**$ 32,847**	**$ 53,844**	**$** (5,361)	**$ (7,993)**	**$ 77,636**

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

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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	
(Amounts in thousands)	**2009**	**2008**	**2009**	**2008**
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	December 31
	2009	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:

Amounts in thousands)								
				Gross		**Gross**		**Estimated**
		Amortized		**Unrealized**		**Unrealized**		**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

				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								
	Less than 12 Months			12 Months or more			Total		
ounts in sands)	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Number	Fair Value	Unrealized Losses	Numb
ty securities	$ 455	$ (433)	6	$ 1,363	$ (899)	21	$ 1,818	$ (1,332)	
Treasury rities and gations of ernment cies	8,839	(14)	14	11,543	(178)	22	20,382	(192)	
gations of and ical ivisions	2,322	(13)	3	295	(11)	1	2,618	(25)	
orate debt rities				6,860	(3,016)	11	6,860	(3,016)	
gage-backed rities									
ncy	9,769	(57)	7	99		1	9,869	(57)	
Agency				5,031	(1,288	7	5,031	(1,288)	
t-backed rities				47	(39)	3	47	(39)	
l temporarily ired rities	$ 21,386	$ (517)	30	$ 25,239	$ (5,431)	66	$ 46,625	$ (5,949)	

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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**		
unts in nds)	**Fair Value**	**Unrealized Losses**	**Number**	**Fair Value**	**Unrealized Losses**	**Number**	**Fair Value**	**Unrealized Losses**	**Nun**
y securities	$ 1,933	$ (701)	17	$ 382	$ (254)	8	$ 2,315	$ (955)	
Treasury ties and tions of rnment ies	7,018	(69)	27	10,113	(218)	15	17,131	(287)	
ations of nd al visions	14,137	(659)	32				14,137	(659)	
rate debt ties	3,722	-448	4	5,158	(3,440)	9	8,880	(3,888)	
age-backed ties									
cy	6,689	(70)	9	1,257	(36)	4	7,946	(106)	
Agency	6,517	(1,033)	7				6,517	(1,033)	
-backed ties	16	(7)	1	35	(37)	2	51	(44)	
temporarily red ties	$ 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:

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
(Amounts in thousands)	**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 maybe 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**	$ **152,337**	$
Total assets	$ **156,404**	$ **4,067**	$ **152,337**	$
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:

	September 30, 2009		December 31, 2008	
(Amounts in thousands)	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)

Notional Amount	Maturity Date	Interest Rate Fixed	Interest Rate Variable	Amount Expected to be Expensed into Earnings within the next 12 Months
$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

(Dollars in thousands)	**Amount of Gain or (Loss) Recognized in OCI on Derivative (Effective Portion)**	**Location of Gain or (Loss Reclassified from Accumulated OCI into Income (Effective Portion)**	**Amount of Gain or (Loss Reclassified from Accumulated OCI into Income (Effective Portion)**	**Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing**	**Amount of Gain or (Loss) Recognized in Income on Derivatives (Ineffective Portion and Amount Excluded from Effectiveness Testing**
Type	**9/30/2009**		**9/30/2009**		**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 ConditionFor 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.

	For the Three Months Ended September 30					
	2009			2008		
(Dollars in thousands)	**Average Balance**	**Tax Equivalent Interest**	**Average yield/ rate**	Average Balance	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 %**			