FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-K
March 09, 2016
UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2015

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

For the transition period from__________ to___________

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

PENNSYLVANIA	25-1440803
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
20 South Main Street, Chambersburg, PA	17201-0819
(Address of principal executive offices)	(Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act

NONE

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $1.00 per share

(Title of class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 periods 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company.

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

The aggregate market value of the 3,957,818 shares of the Registrant's common stock held by nonaffiliates of the Registrant as of June 30, 2015 based on the price of such shares was $97,164,432.

There were 4,289,124 outstanding shares of the Registrant's common stock as of February 29, 2016.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive annual proxy statement to be filed, pursuant to Reg. 14A within 120 days after December 31, 2015, are incorporated into Part III.

FRANKLIN FINANCIAL SERVICES CORPORATION

FORM 10-K

INDEX

Part I		Page
Item 1.	Business	3
Item 1A.	Risk Factors	7
Item 1B.	Unresolved Staff Comments	9
Item 2.	Properties	9
Item 3.	Legal Proceedings	9
Item 4.	Mine Safety Disclosures	9
Part II		
Item 5.	Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities	10
Item 6.	Selected Financial Data	13
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	41
Item 8.	Financial Statements and Supplementary Data	43
Item 9.	Changes in and Disagreements	85

	with Accountants on Accounting and Financial Disclosure	
Item 9A.	Controls and Procedures	85
Item 9B.	Other Information	87
Part III		
Item 10.	Directors, Executive Officer and Corporate Governance	87
Item 11.	Executive Compensation	87
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	87
Item 13.	Certain Relationships and Related Transaction, and Director Independence	87
Item 14.	Principal Accountant Fees and Services	88
Part IV		
Item 15.	Exhibits, Financial Statement Schedules	88
Signatures		89
Index of Exhibits		90

Part I

Item 1. Business

General

Franklin Financial Services Corporation (the “Corporation”) was organized as a Pennsylvania business corporation on June 1, 1983 and is a registered bank holding company under the Bank Holding Company Act of 1956, as amended (the “BHCA”). On January 16, 1984, pursuant to a plan of reorganization approved by the shareholders of Farmers and Merchants Trust Company of Chambersburg (“F&M Trust” or “the Bank”) and the appropriate regulatory agencies, the Corporation acquired all the shares of F&M Trust and issued its own shares to former F&M Trust shareholders on a share-for-share basis.

The Corporation’s common stock is thinly traded in the over-the-counter market. The Corporation’s stock is listed under the symbol “FRAF” www.otcmarkets.com/stock/FRAF/quote) on the OTCQX Market Tier of the OTC Markets. The Corporation’s Internet address is www.franklinfin.com. Electronic copies of the Corporation’s 2015 Annual Report on Form 10-K are available free of charge by visiting the “Investor Information” section of www.franklinfin.com. Electronic copies of quarterly reports on Form 10-Q and current reports on Form 8-K are also available at this Internet address. These reports are posted as soon as reasonably practicable after they are electronically filed with the Securities and Exchange Commission (SEC).

The Corporation conducts substantially all of its business through its direct banking subsidiary, F&M Trust, which is wholly owned. F&M Trust, established in 1906, is a full-service, Pennsylvania-chartered commercial bank and trust company, which is not a member of the Federal Reserve System. F&M Trust operates twenty-two community banking offices in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania. The Bank engages in general commercial, retail banking and trust services normally associated with community banks and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (the “FDIC”). F&M Trust offers a wide variety of banking services to businesses, individuals, and governmental entities. These services include, but are not necessarily limited to, accepting and maintaining checking, savings, and time deposit accounts, providing investment and trust services, making loans and providing safe deposit facilities. Franklin Future Fund Inc., a direct subsidiary of the Corporation, is a non-bank investment company that makes venture capital investments within the Corporation’s primary market area. Franklin Financial Properties Corp. is a “qualified real estate subsidiary”, a wholly owned subsidiary of F&M Trust and was established to hold real estate assets used by F&M Trust in its banking operations.

F&M Trust is not dependent upon a single customer or a few customers for a material part of its business. Thus, the loss of any customer or identifiable group of customers would not materially affect the business of the Corporation or the Bank in an adverse manner. Also, none of the Bank’s business is seasonal. The Bank’s lending activities consist primarily of commercial real estate, construction and land development, agricultural, commercial and industrial loans, installment and revolving loans to consumers and residential mortgage loans. Secured and unsecured commercial and industrial loans, including accounts receivable and inventory financing, and commercial equipment financing, are made to small and medium-sized businesses, individuals, governmental entities, and non-profit organizations.

The Bank classifies loans in this report by the type of collateral, primarily residential or commercial and agricultural real estate. Loans secured by residential real estate loans may be further broken down into consumer or commercial purpose. Consumer purpose residential real estate loans represent traditional residential mortgages and home equity products. Both of these products are underwritten in generally the same manner; however, home equity products may present greater risk since many of these loans are secured by a second lien position where the Bank may or may not hold the first lien position. Commercial purpose residential real estate loans represent loans made to businesses, but are secured by residential real estate. These loans are underwritten as commercial loans and the repayment ability may be dependent on the business operation, despite the residential collateral. In addition to the real estate collateral, it is possible that personal guarantees or UCC filings on business assets provide additional security. In certain situations, the Bank acquires properties through foreclosure on delinquent loans. The Bank initially records these properties at the estimated fair value less cost to sell with subsequent adjustments to fair value recorded as needed.

Commercial and agricultural real estate loans are secured by properties such as hotels, office buildings, apartment buildings, retail sites, and farmland or agricultural related properties. These loans are highly dependent on the business operations for repayment. Compared to residential real estate, this collateral may be more difficult to sell in the event of a delinquency.

Construction loans are made to finance the purchase of land and the construction of residential and commercial buildings, and are secured by mortgages on real estate. These loans are primarily comprised of loans to consumers to build a home, and loans to contractors and developers to construct residential properties for resale or rental. Construction loans present various risks that include, but are not limited to: schedule delays, cost overruns, changes in economic conditions during the construction period, and the inability to sell or rent the property upon completion.

Commercial loans are made to businesses and government municipalities of various sizes for a variety of purposes including operations, property, plant and equipment, and working capital. These loans are highly dependent on the business operations for repayment and are generally secured by business assets and personal guarantees. As such, this collateral may be more difficult to sell in the event of a delinquency. Commercial lending, including commercial real estate, is concentrated in the Bank's primary market, but also includes purchased loan participations originated primarily in south-central Pennsylvania.

Consumer loans are comprised of installment and unsecured personal lines of credit. While some of these loans are secured, the collateral behind the loans is often comprised of assets that lose value quickly (e.g. automobiles) and if repossessed, may not fully satisfy the loan in the event of default. Repayment of these loans is highly dependent on the borrowers' financial condition that can be affected by economic factors beyond their control and personal circumstances.

F&M Trust's Investment and Trust Services Department offers all of the personal and corporate trust services normally associated with trust departments including: estate planning and administration, corporate and personal trust fund management, pension, profit sharing and other employee benefit funds management, and custodial services. F&M Trust through licensed members of its Investment and Trust Services Department sells mutual funds, annuities and selected insurance products.

Competition

The Corporation and its banking subsidiary operate in a highly competitive environment. The principal market of F&M Trust is in south central Pennsylvania, primarily the counties of Franklin, Cumberland, Fulton and Huntingdon. There are 24 competing commercial banks that have offices within the Corporation's primary market area. These banks range from large regional banks to independent community banks. In addition, credit unions, savings and loan associations, mortgage banks, brokerage firms and other competitors with only an Internet site are present in the market. The Bank has 22 community offices and approximately 11% of the total deposits in its market. The majority of the Bank's loan and deposit customers are in Franklin County. There are 6 commercial bank competitors in Franklin County and the Bank has approximately 31% of the Franklin County deposit market share. The Bank's approximate deposit market share in other counties is: Fulton (35%), Cumberland (3%) and Huntingdon (2%).

Because of increasing competition, profit margins in the traditional banking business of lending and gathering deposits have declined and many nonbanking institutions offer services similar to those offered by the Bank. Some competitors have access to resources (e.g., financial and technological) that are unavailable to the Bank, thereby creating a competitive disadvantage for the Bank in terms of product, service pricing and delivery. The Bank utilizes various strategies including its long history of local customer service and convenience as part of a relationship management culture, a wide variety of products and services and, to a lesser extent, the pricing of loans and deposits, to compete. F&M Trust is the largest financial institution headquartered in Franklin County and had total assets of approximately $1.036 billion on December 31, 2015.

Staff

As of December 31, 2015, the Corporation and its banking subsidiary had 250 full-time equivalent employees. The officers of the Corporation are employees of the Bank. The Bank offers a 401(k) plan, employee stock purchase plans and incentive compensation plans and employees are also provided with group life and health insurance. Management considers employee relations to be excellent.

Supervision and Regulation

Various requirements and restrictions under the laws of the United States and under Pennsylvania law affect the Corporation and its subsidiaries.

General

The Corporation is registered as a bank holding company and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System under the Bank Holding Act of 1956, as amended. The Corporation has also made an effective election to be treated as a "financial holding company." Financial holding companies are bank holding companies that meet certain minimum capital and other standards and are therefore entitled to engage in financially related activities on an expedited basis; see further discussion below. Bank holding companies are required to file periodic reports with and are subject to examination by the Federal Reserve. The Federal Reserve has issued regulations under the Bank Holding Company Act that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve, pursuant to such regulations, may require the Corporation to stand ready to use its resources to provide adequate capital funds to its Bank subsidiary during periods of financial stress or adversity. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

The Bank Holding Company Act prohibits the Corporation from acquiring direct or indirect control of more than 5% of the outstanding shares of any class of voting stock, or substantially all of the assets of any bank, or from merging or consolidating with another bank holding company, without prior approval of the Federal Reserve Board. Additionally, the Bank Holding Company Act prohibits the Corporation from engaging in or from acquiring ownership or control of more than 5% of the outstanding shares of any class of voting stock of any company engaged in a non banking business, unless such business is determined by the Federal Reserve Board to be so closely related to banking as to be a proper incident thereto. Federal law and Pennsylvania law also require persons or entities desiring to acquire certain levels of share ownership (generally, 10% or more, or 5% or more for another bank holding company) of the Corporation to first obtain prior approval from the Federal Reserve and the Pennsylvania Department of Banking and Securities.

As a Pennsylvania bank holding company for purposes of the Pennsylvania Banking Code, the Corporation is also subject to regulation and examination by the Pennsylvania Department of Banking and Securities.

The Bank is a state chartered bank that is not a member of the Federal Reserve System, and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (FDIC). Accordingly, the Bank's primary federal regulator is the FDIC, and the Bank is subject to extensive regulation and examination by the FDIC and the Pennsylvania Department of Banking and Securities. The Bank is also subject to requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, and limitations on the types of investments that may be made and the types of services that may be offered. The Bank is subject to extensive regulation and reporting requirements in a variety of areas, including helping to prevent money laundering, to preserve financial privacy, and to properly report late payments, defaults, and denials of loan applications.

Community Reinvestment Act

The Community Reinvestment Act requires the Bank to help meet the credit needs of the entire community where the Bank operates, including low and moderate-income neighborhoods. The Bank's rating under the Community Reinvestment Act (CRA), assigned by the FDIC pursuant to an examination of the Bank, is important in determining whether the bank may receive approval for, or utilize certain streamlined procedures in, applications to engage in new activities. The Bank’s present CRA rating is “satisfactory.” Various consumer laws and regulations also affect the operations of the Bank.

Capital Adequacy Guidelines

The Corporation, as a bank holding company, is required to comply with the capital adequacy standards established by Federal Reserve Board. The Bank is required to comply with capital adequacy standards established by the FDIC. In addition, the Pennsylvania Department of Banking and Securities also requires state chartered banks to maintain minimum capital ratios, defined substantially the same as the federal regulations.

In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as “Basel III.” The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered “well capitalized” under Basel III are: (1) Common Equity Tier1 (CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3)Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The CET1 ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.125%, increasing each year until fully implemented in 2019 at 2.5% above the minimum capital ratios required to avoid any capital distribution restrictions. The capital conservation buffer will be applicable to all of the capital ratios except for the Tier1 Leverage ratio. When fully implemented, the capital conservation buffer will have the effect of increasing the minimum capital ratios by 2.5%. As of December 31, 2015, the Bank was “well capitalized’ under the Basel III requirements and believes it would be “well capitalized” on a fully-phased in basis had such a requirement been in effect. The minimum capital ratios (shown as “adequately capitalized”) and the “well capitalized” capital ratios are reported in Note 2 of the accompanying financial statements.

Prompt Corrective Action Rules

The federal banking agencies have regulations defining the levels at which an insured institution would be considered "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." The applicable federal bank regulator for a depository institution could, under certain circumstances, reclassify a "well capitalized" institution as "adequately capitalized" or require an "adequately capitalized" or "undercapitalized" institution to comply with supervisory actions as if it were in the next lower category. Such a reclassification could be made if the regulatory agency determines that the institution is in an unsafe or unsound condition (which could include unsatisfactory examination ratings). At December 31, 2015, the Corporation and the Bank each satisfied the criteria to be classified as "well capitalized" within the meaning of applicable regulations.

Regulatory Restrictions on Dividends

Dividend payments by the Bank to the Corporation are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from "accumulated net earnings" (generally, retained earnings). The Federal Reserve and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The

Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks that are not classified as well capitalized or adequately capitalized may not pay dividends.

Volker Rule

In December 2013, Federal banking regulators issued rules for complying with the Volker Rule provision of the Dodd-Frank Act. The Bank does not engage in, or expect to engage in, any transactions that are considered “covered activities” as defined by the Volker Rule. Therefore, the Bank does not have any compliance obligations under the Volker Rule.

Consumer Laws and Regulations

In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Real Estate Settlement and Procedures Act, the Fair Credit Reporting Act and the Federal Trade Commission Act, among others. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing customer relations.

Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau (“CFPB”) was created under the Dodd-Frank Act to centralize responsibility for consumer financial protection with broad rulemaking, supervision, and enforcement authority for a wide range of consumer protection laws that would apply to all banks and thrifts, including the Equal Credit Opportunity Act, Truth in Lending Act (“TILA”), Real Estate Settlement Procedures Act (“RESPA”), Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statues. It is likely that future CFPB rulemaking action will affect the Bank. Banks with total assets less than $10 billion are not subject to examination by the CFPB. However, the CFPB can require any bank to submit reports it deems necessary to fulfill its mission.

Ability to Repay / Qualified Mortgages

In July 2013, the Consumer Finance Protection Bureau adopted the final rules that implement the Ability to Repay (ATR) / Qualified Mortgages (QM) provisions of the Dodd-Frank Act. Regulators believe that the ATR/QM rules will prevent many of the loose underwriting practices that contributed to the mortgage crisis in 2008. The ATR/QM rule applies to almost all closed-end consumer credit transactions secured by a dwelling. The ATR rule provides eight specific factors that must be considered during the underwriting process. QMs generally have three types of requirements: restrictions on loan features, points and fees, and underwriting criteria. A QM is presumed to comply with the ATR requirements. The ATR/QM rule was effective January 10, 2014.

Commercial Real Estate Guidance

In December 2015, the federal banking agencies released a “Statement on Prudent Risk Management for Commercial Real Estate Lending” (the “CRE Statement”). The agencies stated that financial institutions should review their policies and practices related to CRE lending and should maintain risk management practices and capital levels commensurate with the level and nature of their CRE concentration risk, including maintaining underwriting discipline and exercising prudent risk management practices that identify, measure, monitor and manage the risks arising from their CRI lending activity. Financial institutions were directed to review the interagency guidance on “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” issued in 2006 providing that a financial institution is potentially exposed to significant CRE concentration risk, and should employ enhanced risk management practices where (1) total CRE loans represent 300% or more of total capital, and (2) the outstanding balance the CRE loan portfolio has increased by 50% or more during the prior 36 months. The agencies state in the CRE statement that they will focus on those financial institutions that have recently experienced, or whose lending strategy plans for, substantial growth in CRE lending activity, or that operate in markets or loan segments with increasing growth or risk fundamentals.

Pennsylvania Regulation and Supervision

In December 2012, the “Banking Law Modernization Package” became effective. The law permits banks to disclose formal enforcement actions initiated by the Pennsylvania Department of Banking and Securities, clarifies that the Department has examination and enforcement authority over subsidiaries as well as affiliates of regulated banks, and bolsters the Department’s enforcement authority over its regulated institutions by clarifying its ability to remove directors, officers and employees from institutions for violations of laws or orders or for any unsafe or unsound practice or breach of fiduciary duty. The Department also may assess civil money penalties of up to $25,000 per violation.

FDIC Insurance

The Bank is a member of the Deposit Insurance Fund (DIF), which is administered by the FDIC. The FDIC insures deposit accounts at the Bank, generally up to a maximum of $250,000 for each separately insured depositor. The FDIC charges a premium to depository institutions for deposit insurance. This rate is based on the risk category of the institution and the total premium is based on average total assets less average tangible equity. As of December 31, 2015, the Bank was in risk category 1 and its assessment rate was approximately 7 basis points of the assessment base. Dodd-Frank established a new minimum DIF ratio set at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020 and its efforts to achieve this ratio could greatly influence future premium rates.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. We do not currently know of any practice, condition or violation that might lead to termination of our deposit insurance.

In addition to the FDIC assessments, the Financing Corporation (“FICO”) is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature from 2017 to 2019. The Bank’s FICO assessment was approximately $54 thousand in 2015 and was included in FDIC insurance expense.

New Legislation

Congress is often considering new financial industry legislation, and the federal banking agencies routinely propose new regulations. The Corporation cannot predict how any new legislation, or new rules adopted by the federal banking agencies, may affect its business in the future.

Selected Statistical Information

Certain statistical information is included in this report as part of Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Item 1A. Risk Factors

The following is a summary of the primary risks associated with the Corporation’s business, financial condition and results of operations, and common stock.

Risk Factors Relating to the Corporation

A focus on real estate related loans may increase the risk of substantial credit losses.

The Bank offers a variety of loan products, including residential mortgage, consumer, construction and commercial loans. The Bank requires real estate as collateral for many of its loans. At December 31, 2015, approximately 71% of its loans were secured by real estate. Loans secured by real estate and the percent of the loan portfolio are reported in Table 15.   These real estate loans are located primarily in the Bank’s market area of south central Pennsylvania. Real estate values tend to follow changes in general economic cycles. If a loan becomes delinquent as the result of an economic downturn and the Bank becomes dependent on the real estate collateral as a source of repayment, it is likely that the value of the real estate collateral has also declined. A decline in real estate values means it is possible that the real estate collateral may be insufficient to cover the outstanding balance of a delinquent or foreclosed loan, resulting in a loss to the Bank. In addition, the real estate collateral is concentrated in a small market area of south central Pennsylvania. Localized events that affect real estate prices and collateral values could have a more negative affect on the Bank as compared to other competitors with a more geographically diverse portfolio.   As the Bank grows, it is expected that real estate secured loans will continue to comprise a significant part of its balance sheet. Risk of loan default is unavoidable in the banking industry, and Management tries to limit exposure to this risk by carefully monitoring the amount of loans in specific industries and by exercising prudent lending practices and securing appropriate collateral. However, this risk cannot be eliminated and substantial credit losses could result in reduced earnings or losses.

The allowance for loan losses may prove to be insufficient to absorb inherent losses in our loan portfolio.

The Bank maintains an allowance for loan losses that Management believes is appropriate to provide for any inherent losses in the loan portfolio. The amount of the allowance is determined through a periodic review and consideration of several factors, including an ongoing review of the quality, size and diversity of our loan portfolio; evaluation of nonperforming loans; historical loan loss experience; and the amount and quality of collateral, including guarantees, securing the loan.

Although Management believes the loan loss allowance is adequate to absorb inherent losses in the loan portfolio, such losses cannot be predicted and the allowance may not be adequate. Excessive loan losses could have a material adverse effect on the Bank's financial condition and results of operations.

The Bank's lending limit is smaller than many of our competitors, which affects the size of the loans it can offer customers.

The Bank's lending limit is approximately $17.3 million. Accordingly, the size of the loans that can be offered to customers is less than the size of loans that many of our competitors, with larger lending limits, can offer. This limit affects the Bank's ability to seek relationships with larger businesses in its market area. Loan amounts in excess of the lending limits can be accommodated through the sale of participations in such loans to other banks. However, there can be no assurance that the Bank will be successful in attracting or maintaining customers seeking larger loans or that it will be able to engage in participation of such loans or on terms favorable to the Bank.

There is strong competition in the Bank's primary market areas.

The Bank encounters strong competition from other financial institutions in its primary market area, which consists of Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania. In addition, established financial institutions not already operating in the Bank's primary market area may open branches there at future dates or can compete in the market via the Internet. In the conduct of certain aspects of banking business, the Bank also competes with savings institutions, credit unions, mortgage banking companies, consumer finance companies, insurance companies and other institutions, some of which are not subject to the same degree of regulation or restrictions as are imposed upon the Bank. Many of these competitors have substantially greater resources and lending limits and can offer services that the Bank does not provide. In addition, many of these competitors have numerous branch offices located throughout their extended market areas that provide them with a competitive advantage. No assurance can be given that such competition will not have an adverse effect on the Bank's financial condition and results of operations.

Changes in interest rates could have an adverse impact upon our results of operations.

The Bank's profitability is in part a function of the spread between interest rates earned on investments, loans and other interest-earning assets and the interest rates paid on deposits and other interest-bearing liabilities. Recently, interest rate spreads have generally narrowed due to changing market conditions and competitive pricing pressure. Interest rates are highly sensitive to many factors that are beyond the Bank's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, will influence not only the interest received on loans and investment securities and the amount of interest we pay on deposits and borrowings, but will also affect the Bank's ability to originate loans and obtain deposits and the value of our investment portfolio. If the rate of interest paid on deposits and other borrowings increases more than the rate of interest earned on loans and other investments, the Bank's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the rates on loans and other investments fall more quickly than those on deposits and other borrowings. While Management takes measures to guard against interest rate risk, there can be no assurance that such measures will be effective in minimizing the exposure to interest rate risk.

Our operational or security systems may experience interruption or breach in security, including cyber-attacks.

We rely heavily on communications and information systems to conduct our business. These systems include both our internal network and data systems, as well as those of third party vendors. Any failure, interruption or breach in security or these systems, including a cyber-attack, could result in the disclosure or misuse of confidential or proprietary information. While we have systems, policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of client business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our business, financial condition and results of operations.

Risk Factors Relating to the Common Stock

There is a limited trading market for the Corporation’s common stock.

There is currently only a limited public market for the Corporation’s common stock. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol “FRAF” (www.otcmarkets.com/stock/FRAF/quote). Because it is thinly traded, you may not be able to resell your shares of common stock for a price that is equal to the price that you paid for your shares. The Corporation currently has no plans to apply to have its common stock listed for trading on any stock exchange or the NASDAQ market.

The Bank's ability to pay dividends to the Corporation is subject to regulatory limitations that may affect the Corporation's ability to pay dividends to its shareholders.

As a holding company, the Corporation is a separate legal entity from the Bank and does not have significant operations of its own. It currently depends upon the Bank's cash and liquidity to pay dividends to its shareholders. The Corporation cannot assure you that in the future the Bank will have the capacity to pay dividends to the Corporation. Various statutes and regulations limit the availability of dividends from the Bank. It is possible; depending upon the Bank's financial condition and other factors, that the Bank's regulators could assert that payment of dividends by the Bank to the Corporation would constitute an unsafe or unsound practice. In the event that the Bank is unable to pay dividends to the Corporation, the Corporation may not be able to pay dividends to its shareholders.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The Corporation's headquarters is located in the main office of F&M Trust at 20 South Main Street, Chambersburg, Pennsylvania. This location also houses a community banking office as well as operational support services for the Bank. The Corporation owns or leases thirty-eight properties in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania, for banking operations, as described below:

Property	Owned	Leased
Community Banking Facilities	16	7
Remote ATM Sites	3	6
Other Properties	4	2

Included in Other Properties are two properties used for operational support service for the Bank, three offices that were closed as part of a branch consolidation in January 2015 and one other property leased for future use. Of the three offices closed in 2015, two are listed for sale and the third is a leased property with the lease expiring in 2016.

Item 3. Legal Proceedings

The nature of our 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 addition, no material proceedings are pending nor are known to be threatened or contemplated against us by governmental authorities.

Item 4. Mine Safety Disclosures

Not Applicable

Part II

Item 5. Market for Registrant’s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

Market and Dividend Information

The Corporation’s common stock is traded in the over-the-counter market. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol “FRAF” (www.otcmarkets.com/stock/FRAF/quote). The range of high and low prices is shown in the following table for the years 2015 and 2014, as well as cash dividends declared for those periods. The closing price of Franklin Financial Services Corporation common stock recorded from an actual transaction on December 31, 2015 was $23.50. The Corporation had 1,901 shareholders of record as of December 31, 2015.

Market and Dividend Information

	2015			2014		
(Dollars per share)			Dividends			Dividends
	High	Low	Declared	High	Low	Declared
First quarter	$ 24.05	$ 21.00	$ 0.17	$ 18.75	$ 17.00	$ 0.17
Second quarter	26.01	23.00	0.19	20.25	17.75	0.17
Third quarter	24.60	21.50	0.19	21.75	19.26	0.17
Fourth quarter	24.50	22.90	0.19	23.50	20.50	0.17
			$ 0.74			$ 0.68

Restrictions on the Payment of Dividends

For limitations on the Corporation’s ability to pay dividends, see “Supervision and Regulation – Regulatory Restrictions on Dividends” in Item 1 above.

Securities Authorized for Issuance under Equity Compensation Plans

The information related to equity compensation plans is incorporated by reference to the materials set forth under the heading “ Executive Compensation – Compensation Tables” in the Corporation’s Proxy Statement for the 2016 Annual Meeting of Shareholders.

Common Stock Repurchases

The Corporation frequently authorizes the repurchase of its common stock through a stock repurchase plan. There was no stock repurchase plan in place during 2015 under an approved repurchase plan. The common shares of the Corporation are purchased in the open market or in privately negotiated transactions. The Corporation uses the repurchased common stock (Treasury stock) for general corporate purposes including stock dividends and splits, employee benefit and executive compensation plans, and the dividend reinvestment plan. The Corporation did not repurchase any shares in 2015 or 2014.

Performance Graph

The following graph compares the cumulative total return to shareholders of Franklin Financial with the NASDAQ – Total U.S. Index (a broad market index prepared by the Center for Research in Security Prices at the University of Chicago Graduate School of Business), the SNL Northeast OTC-BB and Pink Banks Index, the SNL Mid-Atlantic Bank Index, and the SNL Mid-Atlantic Bank $1 billion - $2 billion asset size Index for the five year period ended December 31, 2015, in each case assuming an initial investment of $100 on December 31, 2010 and the reinvestment of all dividends. The Corporation believes that the two SNL Mid-Atlantic Bank Indexes represent a more appropriate peer group due to location and asset size than does the Northeast OTC-BB and Pink Banks Index. Accordingly, the Northeast OTC-BB and Pink Banks Index will be discontinued as a comparative index in the 2016 report.

	Period Ending					
Index	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15
Franklin Financial Services Corporation	$ 100.00	$ 72.00	$ 86.24	$ 109.90	$ 146.51	$ 161.48
NASDAQ Composite	$ 100.00	$ 99.21	$ 116.82	$ 163.75	$ 188.03	$ 201.40
SNL Northeast OTC-BB & Pink Banks	$ 100.00	$ 97.89	$ 112.76	$ 133.11	$ 152.60	$ 161.17
SNL Mid-Atlantic Bank	$ 100.00	$ 75.13	$ 100.64	$ 135.65	$ 147.79	$ 153.33
SNL Mid-Atlantic Bank $1B - $2B	$ 100.00	$ 91.79	$ 107.73	$ 143.97	$ 155.10	$ 159.13

Shareholders’ Information

Dividend Reinvestment Plan:

Franklin Financial Services Corporation offers a dividend reinvestment program whereby shareholders of the Corporation’s common stock may reinvest their dividends, or make optional cash payments, to purchase additional shares of the Corporation. Beneficial owners of shares of the Corporation’s common stock may participate in the program by making appropriate arrangements through their bank, broker or other nominee. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Dividend Direct Deposit Program:

Franklin Financial Services Corporation offers a dividend direct deposit program whereby shareholders of the Corporation’s common stock may choose to have their dividends deposited directly into the bank account of their choice on the dividend payment date. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Annual Meeting:

The Annual Shareholders’ Meeting will be held on Tuesday, April 26, 2016, at the Orchard Restaurant & Banquet Facility, 1580 Orchard Drive, Chambersburg, PA. The Business Meeting will begin at 9:00 a.m. with breakfast provided.

Websites:

Franklin Financial Services Corporation:	www.franklinfin.com
Farmers & Merchants Trust Company:	www.fmtrustonline.com

Stock Information:

The Corporation’s common stock is traded in the over-the-counter market. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol “FRAF” (www.otcmarkets.com/stock/FRAF/quote).

Registrar and Transfer Agent:

The registrar and transfer agent for Franklin Financial Services Corporation is:

Computershare
P.O. Box 30170
College Station, TX 77842-3170
1-800-368-5948

Item 6. Selected Financial Data

	Summary of Selected Financial Data for the Year Ended December 31				
	2015	2014	2013	2012	2011
(Dollars in thousands, except per share)					
Summary of Operations					
Interest income	$ 34,615	$ 34,794	$ 36,042	$ 39,142	$ 41,791
Interest expense	2,371	3,180	4,378	6,890	9,154
Net interest income	32,244	31,614	31,664	32,252	32,637
Provision for loan losses	1,285	764	2,920	5,225	7,524
Net interest income after provision for loan losses	30,959	30,850	28,744	27,027	25,113
Noninterest income	12,652	11,131	10,033	9,883	10,200
Noninterest expense	31,136	31,573	31,250	31,033	28,333
Income before income taxes	12,475	10,408	7,527	5,877	6,980
Income tax	2,271	2,006	1,295	512	411
Net income	$ 10,204	$ 8,402	$ 6,232	$ 5,365	$ 6,569
Performance Measurements					
Return on average assets	1.00%	0.83%	0.61%	0.51%	0.66%
Return on average equity	9.52%	8.44%	6.72%	6.00%	7.68%
Return on average tangible assets (1)	1.02%	0.87%	0.64%	0.55%	0.70%
Return on average tangible equity (1)	10.50%	9.72%	7.86%	7.14%	9.30%
Efficiency ratio (1)	67.39%	70.83%	72.01%	70.44%	63.46%
Net interest margin	3.59%	3.56%	3.47%	3.50%	3.73%
Current dividend yield	3.23%	3.09%	3.98%	4.86%	8.74%
Dividend payout ratio	30.76%	33.88%	45.09%	59.09%	65.05%
Shareholders' Value (per common share)					
Diluted earnings per share	$ 2.40	$ 2.00	$ 1.51	$ 1.32	$ 1.66
Basic earnings per share	2.40	2.01	1.51	1.32	1.66
Regular cash dividends paid	0.74	0.68	0.68	0.78	1.08
Book value	26.05	24.54	22.88	22.31	21.67
Tangible book value (1)	23.94	22.36	20.55	19.84	19.04
Market value	23.50	22.00	17.10	14.00	12.35
Market value/book value ratio	90.25%	89.65%	74.74%	62.75%	56.99%
Price/earnings multiple	9.79	11.00	11.32	10.61	7.44
Balance Sheet Highlights					
Total assets	$ 1,035,295	$ 1,001,448	$ 984,587	$ 1,027,363	$ 990,248
Investment securities	159,473	171,751	159,674	133,328	125,301
Loans, net	771,930	717,420	713,711	743,200	756,687
Deposits and customer repurchase agreements	918,512	890,260	869,558	916,649	841,089
Shareholders' equity	111,376	103,521	95,388	91,634	87,182

Safety and Soundness					
Risk-based capital ratio (Total)	16.34%	15.49%	14.24%	12.60%	12.14%
Leverage ratio (Tier 1)	10.59%	9.69%	9.14%	8.29%	8.40%
Common equity ratio (Tier 1)	15.08%	-	-	-	-
Nonperforming loans/gross loans	0.73%	1.74%	3.49%	4.90%	2.94%
Nonperforming assets/total assets	1.18%	1.63%	3.04%	4.10%	2.60%
Allowance for loan losses as a % of loans	1.29%	1.25%	1.34%	1.38%	1.27%
Net charge-offs/average loans	0.04%	0.19%	0.49%	0.60%	0.86%
Trust assets under management (fair value)	$ 586,664	$ 605,796	$ 574,680	$ 520,434	$ 481,536

(1) See the section titled “GAAP versus Non-GAAP Presentation” of the Application of Critical Accounting Policies in Management’s Discussion and Analysis of Financial Condition and Results of Operations

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Application of Critical Accounting Policies:

Disclosure of the Corporation's significant accounting policies is included in Note 1 to the consolidated financial statements. These policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by Management. Senior management has discussed the development of such estimates, and related Management Discussion and Analysis disclosure, with the Audit Committee of the Board of Directors. The following accounting policies are identified by management to be critical to the results of operations:

Allowance for Loan Losses – The allowance for loan losses is the estimated amount considered adequate to cover credit losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, charged against income. In determining the allowance for loan losses, Management makes significant estimates and, accordingly, has identified this policy as probably the most critical for the Corporation.

Management monitors loan performance on a monthly basis and performs a quarterly evaluation of the adequacy of the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate including, but not limited to: current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, borrowers' actual or perceived financial and managerial strengths, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

The analysis has two components, specific and general allocations. Expected cash flow or collateral values discounted for market conditions and selling costs are used to establish specific allocations. The Bank's historical loan loss experience and other qualitative factors derived from economic and market conditions are used to establish general allocations for the remainder of the portfolio. The allowance for loan losses was $10.1 million at December 31, 2015.

Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy assessment quarterly to the Credit Risk Oversight Committee of the Board of Directors.

Financial Derivative – As part of its interest rate risk management strategy, the Bank has entered into an interest rate swap agreement. A swap agreement is a contract between two parties to exchange cash flows based upon an underlying notional amount. Under the swap agreement, the Bank pays a fixed rate and receives a variable rate from an unrelated financial institution serving as counter-party to the agreement. The swap is designated as a cash flow hedge and is designed to minimize the variability in cash flows of the Bank's variable rate liabilities attributable to changes in interest rates. The swap in effect converts a portion of a variable rate liability to a fixed rate liability.

The interest rate swap is recorded on the balance sheet at fair value as an asset or liability. To the extent the swap is effective in accomplishing its objective, changes in the fair value are recorded in other comprehensive income. To the extent the swap is not effective, changes in fair value are recorded in interest expense. Cash flow hedges are determined to be highly effective when the Bank achieves offsetting changes in the cash flows of the risk being hedged. The Bank measures the effectiveness of the hedges on a quarterly basis and it has determined the hedges are highly effective. Fair value is heavily dependent upon the market's expectations for interest rates over the remaining term of the swaps. The final swap transaction matured in 2015.

Restricted Stock - Restricted stock, which is carried at cost, consists of stock of the Federal Home Loan Bank of Pittsburgh (FHLB) and Atlantic Community Bankers Bank (ACBB). Management evaluates the restricted stock for impairment in accordance with ASC Topic 320. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the banks as compared to the capital stock amount for the banks and the length of time this situation has persisted, (2) commitments by the banks to make payments required by law or regulation and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the banks.

Federal Income Taxes – Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance, when in the opinion of Management, it is more likely than not that some portion or all deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted through the provision for income taxes for the effects of changes in tax laws and rates on the date of enactment. ASC Topic 740 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more-likely-than-not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. ASC Topic 740, "Income Taxes" also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties.

Other-Than-Temporary Investment Impairment – Investment securities are written down to their net realizable value when there is impairment in value that is considered to be "other-than-temporary." The determination of whether or not "other-than-temporary" impairment exists is a matter of judgment. Management reviews investment securities regularly for possible impairment that is "other-than-temporary" by analyzing the facts and circumstances of each investment and the expectations for that investment's performance. "Other-than-temporary" impairment in the value of an investment may be indicated by the length of time and the extent to which market value has been less than cost; the financial condition and near term prospects of the issuer; and whether the Corporation has the intent to sell or is likely to be forced to sell the investment prior to any anticipated recovery in market value.

GAAP versus non-GAAP Presentations – The Corporation supplements its traditional GAAP measurements with certain non-GAAP measurements to evaluate its performance and to eliminate the effect of intangible assets. By eliminating intangible assets, the Corporation believes it presents a measurement that is comparable to companies that have no intangible assets or to companies that have eliminated intangible assets in similar calculations. However, not all companies may use the same calculation method for each measurement. The non-GAAP measurements are not intended to be used as a substitute for the related GAAP measurements. The following table shows the calculation of the non-GAAP measurements.

(Dollars in thousands, except per share)	For the Year Ended December 31				
	2015	2014	2013	2012	2011
Return on Average Tangible Assets (non-GAAP)					
Net income	$ 10,204	$ 8,402	$ 6,232	$ 5,365	$ 6,569
Plus intangible amortization (net of tax)	119	341	281	287	294
Net income (non-GAAP)	10,323	8,743	6,513	5,652	6,863
Average assets	1,021,275	1,015,995	1,029,895	1,041,816	991,866
Less average intangible assets	(9,066)	(9,516)	(9,937)	(10,368)	(10,805)
Average assets (non-GAAP)	1,012,209	1,006,479	1,019,958	1,031,448	981,061
Return on average tangible assets (non-GAAP)	1.02%	0.87%	0.64%	0.55%	0.70%
Return on Tangible Equity (non-GAAP)					
Net income	$ 10,204	$ 8,402	$ 6,232	$ 5,365	$ 6,569
Plus intangible amortization (net of tax)	119	341	281	287	294
Net income (non-GAAP)	10,323	8,743	6,513	5,652	6,863
Average shareholders' equity	107,175	99,512	92,786	89,551	85,572
Less average intangible assets	(9,066)	(9,516)	(9,937)	(10,368)	(10,805)
Average shareholders' equity (non-GAAP)	98,109	89,996	82,849	79,183	74,767

Return on average tangible equity (non-GAAP)	10.52%	9.72%	7.86%	7.14%	9.18%
Tangible Book Value (per share) (non-GAAP)					
Shareholders' equity	$ 111,376	$ 103,521	$ 95,388	$ 91,634	$ 87,182
Less intangible assets	(9,016)	(9,197)	(9,714)	(10,139)	(10,574)
Shareholders' equity (non-GAAP)	102,360	94,324	85,674	81,495	76,608
Shares outstanding (000's)	4,276	4,218	4,169	4,107	4,023
Tangible book value (non-GAAP)	23.94	22.36	20.55	19.84	19.04
Efficiency Ratio					
Noninterest expense	$ 31,136	$ 31,573	$ 31,250	$ 31,033	$ 28,333
Net interest income plus noninterest income	44,896	42,745	41,697	42,085	42,837
Plus tax equivalent adjustment to net interest income	2,023	1,978	1,596	1,683	1,730
Net securities gains (losses), and OTTI	(716)	(260)	42	56	83
Net interest income plus noninterest income	46,203	44,463	43,335	43,824	44,650
Efficiency ratio	67.39%	71.01%	72.11%	70.81%	63.46%

Results of Operations:

Management's Overview

The following discussion and analysis is intended to assist the reader in reviewing the financial information presented and should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein.

Franklin Financial Services Corporation reported a 21.4% increase in net income for 2015. Net interest income increased $630 thousand over 2014 due to a small increase in earning assets, and an increase in the net interest margin, resulting from a .10% reduction in the cost of interest-bearing deposits. The provision for loan losses increased $521 thousand due to loan growth. Noninterest income increased nearly 14% ($1.5 million) in 2015 compared to 2014, with nearly every category of noninterest income showing an increase. Noninterest income was boosted by two non-recurring events (as discussed later) that increased non-interest income by $899, pre-tax. Noninterest expense declined $437 thousand when compared to 2014. Despite an increase in pre-tax income, the effective tax rate decreased from 2014 due to a $250 reduction of a deferred tax valuation allowance related to a capital loss. Diluted earnings per share increased from $2.00 in 2014 to $2.40 in 2015. The Corporation declared and paid a dividend of $0.74 per share. The balance sheet grew by approximately $34 million fueled by strong loan growth in the second half of 2015, primarily in the commercial loan area. Deposits increased approximately $37 million due primarily to increases in checking accounts. Shareholders' equity continued to increase during the year from retained earnings and investments from the dividend reinvestment plan. Other key performance measurements are presented in Item 6.

A more detailed discussion of the areas that had the greatest effect on the reported results follows.

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. For the purpose of this discussion, balance sheet items refer to the average balance for the year and net interest income is adjusted to a fully taxable-equivalent basis. This tax-equivalent adjustment facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Corporation's 34% Federal statutory rate. The components of net interest income are detailed in Tables 1, 2 and 3.

2015 versus 2014

Summary: Tax equivalent net interest income increased by only 2% (Table 1) in 2015 compared to 2014. Interest income declined slightly; however, interest expense declined by $809 thousand thereby resulting in a $675 thousand increase in net interest income. A reduction in interest expense and a larger benefit from tax-free income was sufficient to offset the reduction in interest income. Average interest earning assets increased during the year and the yield declined by .05%. Average interest bearing liabilities declined and the cost of these funds fell by .10%. Non-interest bearing balances help increase the net interest margin and the average balance of these accounts increased during 2015. As a result, tax-equivalent net interest income increased $675 thousand and the net interest margin improved to 3.59% from 3.56% in 2014.

Assets: Table 3 shows the average balance and yield on the major asset classes on the Corporation's balance sheet. Total average interest-earning assets increased by approximately $9 million and the yield fell by .05%. The low interest rate environment that continued through 2015 continued to push asset yields down on both new assets and the repricing of existing assets.

Interest bearing balances held by the Corporation declined as money was put into the loan portfolio; however, the yield on these balances increased during 2015 as Bank owned short-term certificates of deposit (with higher rates) made up a greater percentage of the total balance in 2015 than in 2014.

The average balance of the investment portfolio increased slightly. As loan growth improved during the second half of 2015 investment cash-flow was reinvested into the loan portfolio. The Bank purchased $21.7 million of investment securities during 2015, primarily in mortgage-backed and municipal securities, but generated $30.1 million in cash flow from the portfolio. The yield on the portfolio declined by .08% year-over-year.

The average balance of the loan portfolio increased by approximately $15 million during 2015 as compared to 2014. Commercial loans recorded the largest increase year-over-year. Commercial lending activity picked up in the second half of 2015 and the majority of the commercial loan growth occurred during this time period. The Bank was able to maintain the yield on this portfolio, down only a .03%, compared to a decline of .17% from 2013 to 2014. Residential mortgages declined during the year, but home equity balances increased during the year due primarily to a successful home equity line-of-credit promotion during the year. Consumer loans declined again in 2015 and the Bank does not see this trend changing due to the highly competitive nature and ease of access to these loans from other sources. Approximately 85% of the commercial loan portfolio is variable rate with the majority of these loans tied to the prime rate. Until there is a significant increase in short-term rates, the yield on the commercial loan portfolio is unlikely to change significantly.

Liabilities: Table 3 shows the average balance and cost of the Bank's interest-bearing liabilities. Average interest-bearing liabilities declined by $14.6 million in 2015. This decline was driven primarily by a $10.8 million decrease in long-term debt as all of the Bank's long-term debt matured in 2014. Time deposits (CDs) declined by approximately $14 million as consumers do not want to lock up their money for longer terms in this low rate environment. Interest-bearing checking increased by approximately $17 million, while the money management product declined by $ 2.8 million. Securities sold under a repurchase agreement was a product that has been discontinued and all accounts have been transitioned to a fully-insured interest-bearing checking product.

Table 2 shows the affect volume and rate had on the change in tax equivalent net interest income in 2015.

2014 versus 2013

Summary: Tax equivalent net interest income increased by only 1% (Table 1) in 2014 compared to 2013. A reduction in interest expense and a larger benefit from tax-free income was sufficient to offset the reduction in interest income. Average interest earning assets (Table 3) declined during 2014 compared to the 2013 average, and the yield on these assets declined slightly by 4 basis points year over year. Likewise, average interest bearing liabilities and the cost of these liabilities declined as compared to 2013. These changes resulted in a $332 thousand increase in tax equivalent net interest income and an improvement in the net interest margin from 3.47% in 2013 to 3.56% in 2014.

Assets: Total average interest-earning assets decreased by $13.0 million and the yield fell from 3.93% in 2013 to 3.89% in 2014. The low interest rate environment that continues to be supported by Federal Reserve actions continues to push asset yields down on both new assets and the repricing of existing assets.

Interest bearing balances held by the Corporation declined as money was put into the investment portfolio; however, the yield on these balances increased during 2014 as Bank owned short-term certificates of deposit (with higher rates) made up a greater percentage of the total balance in 2014 than in 2013.

The average balance of the investment portfolio increased by approximately 12% during 2014 as short-term cash was moved to higher yielding assets. The Bank purchased $41.2 million of securities during 2014, primarily in mortgage-backed and municipal securities. The yield on the portfolio improved by .23% as prepayment on mortgage backed securities slowed.

The average balance of the loan portfolio declined by approximately $5 million for 2014 as compared to the average balance for 2013. Residential mortgage and home equity balances increased during the year, but these increases were not sufficient enough to offset the decline in commercial and consumer loans. Commercial lending continued to be very competitive in 2014, with a lot of low rate competition seeking out the best customers. The decline in the 2014 average commercial loan portfolio was driven by some accelerated payoffs at the end of 2013 and the beginning of 2014. However, from year-end 2013 to year-end 2014, the commercial loan portfolio increased. The average balance of the mortgage portfolio increased due to more refinancing activity during the year. Home equity production in 2014 was good, and was boosted by a low rate promotion. The average yield on the loan portfolio declined to 4.33% in 2014 from 4.54% in 2013. All categories, except consumer loans, experienced a lower yield in 2014

Liabilities: Table 3 shows the average balance and cost of the major interest-bearing liabilities classes on the Corporation's balance sheet. Average interest-bearing liabilities declined by $33.9 million in 2014. This decline was driven primarily by a $41.5 million decrease in time deposits (CDs). The majority of the decline in CDs was a $23.2 million decrease in brokered CDs from maturities in 2013 that the Bank did not replace. Interest-bearing checking increased by approximately $31 million, fueled in part, by the Bank's action to close its sweep repurchase product and move these accounts to a fully-insured interest-bearing checking product. As CDs mature, the cost of this product continues to decline and this contributed to a 14 basis point reduction in the cost of interest-bearing liabilities in 2014. Securities sold under a repurchase agreement declined for the reason discussed above. Average long-term debt declined slightly, but by the end of 2014, the Bank had paid off all of its long-term debt.

Table 1. Net Interest Income

		Change			Change		
(Dollars in thousands)	2015	$	%	2014	$	%	2013
Interest income	$ 34,615	$ (179)	(0.5)	$ 34,794	$ (1,248)	(3.5)	$ 36,042
Interest expense	2,371	(809)	(25.4)	3,180	(1,198)	(27.4)	4,378
Net interest income	32,244	630	2.0	31,614	(50)	(0.2)	31,664
Tax equivalent adjustment	2,023	45		1,978	382		1,596
Tax equivalent net interest income	$ 34,267	$ 675	2.0	$ 33,592	$ 332	1.0	$ 33,260

Table 2 identifies increases and decreases in tax equivalent net interest income to either changes in average volume or to changes in average rates for interest-earning assets and interest-bearing liabilities. Numerous and simultaneous balance and rate changes occur during the year. The amount of change that is not due solely to volume or rate is allocated proportionally to both. All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.

Table 2. Rate-Volume Analysis of Tax Equivalent Net Interest Income

	2015 Compared to 2014			2014 Compared to 2013		
Increase (Decrease) due to:	Increase (Decrease) due to:			Increase (Decrease) due to:		
(Dollars in thousands)	Volume	Rate	Net	Volume	Rate	Net
Interest earned on:						
Interest-bearing obligations in other banks and Federal funds sold	$ (32)	$ 97	$ 65	$ (96)	$ 65	$ (31)
Investment securities:						
Taxable	(148)	(88)	(236)	271	584	855
Nontaxable	373	(231)	142	214	(167)	47
Loans:						
Commercial, industrial and agricultural	535	(157)	378	(351)	(1,001)	(1,352)
Residential mortgage	(83)	(56)	(139)	190	(147)	43
Home equity loans and lines	272	(453)	(181)	23	(364)	(341)
Consumer	(100)	(63)	(163)	(154)	67	(87)
Loans	624	(729)	(105)	(292)	(1,445)	(1,737)
Total net change in interest income	817	(951)	(134)	97	(963)	(866)
Interest expense on:						
Interest-bearing checking	20	8	28	31	41	72
Money management	(12)	(212)	(224)	(2)	(197)	(199)
Savings	3	(2)	1	2	(7)	(5)
Time deposits	(98)	(83)	(181)	(411)	(553)	(964)
Securities sold under agreements to repurchase	(13)	-	(13)	(36)	1	(35)
Short-term borrowings	4	-	4	-	-	-

Long-term debt	(424)	-	(424)	(64)	(3)	(67)
Total net change in interest expense	(520)	(289)	(809)	(480)	(718)	(1,198)
Change in tax equivalent net interest income	$ 1,337	$ (662)	$ 675	$ 577	$ (245)	$ 332

The following table presents average balances, tax-equivalent (T/E) interest income and expense, and yields earned or rates paid on the assets or liabilities. All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.

Table 3. Analysis of Net Interest Income

	2015			2014			2013		
(Dollars in thousands)	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Averag yield/r
Interest-earning assets:									
Interest-bearing obligations of other banks and federal funds sold	$ 36,732	$ 247	0.67%	$ 43,457	$ 182	0.42%	$ 70,115	$ 213	0.30
Investment securities:									
Taxable	117,973	2,482	2.10%	124,903	2,718	2.18%	110,194	1,863	1.69
Nontaxable	54,854	2,410	4.39%	46,663	2,268	4.86%	42,399	2,221	5.24
Investments	172,827	4,892	2.83%	171,566	4,986	2.91%	152,593	4,084	2.68
Loans:									
Commercial, industrial and agricultural	592,010	24,915	4.21%	579,314	24,537	4.24%	587,359	25,889	4.41
Residential mortgage	80,679	3,270	4.05%	82,706	3,409	4.12%	78,185	3,366	4.31
Home equity loans and lines	65,687	2,921	4.45%	60,099	3,102	5.16%	59,706	3,443	5.77
Consumer	6,196	393	6.34%	7,693	556	7.23%	9,902	643	6.49
Loans	744,572	31,499	4.23%	729,812	31,604	4.33%	735,152	33,341	4.54
Total interest-earning assets	954,131	36,638	3.84%	944,835	36,772	3.89%	957,860	37,638	3.93
Other assets	67,144			71,160			72,035		
Total assets	$ 1,021,275			$ 1,015,995			$ 1,029,895		
Interest-bearing liabilities:									
Deposits:									
	$ 220,314	256	0.12%	$ 203,065	228	0.11%	$ 172,079	156	0.09

Interest-bearing checking Money Management	384,499	1,463	0.38%	387,297	1,687	0.44%	387,607	1,886	0.49
Savings	66,134	49	0.07%	62,603	48	0.08%	60,147	53	0.09
Time	92,212	599	0.65%	106,391	780	0.73%	147,915	1,744	1.18
Total interest-bearing deposits	763,159	2,367	0.31%	759,356	2,743	0.36%	767,748	3,839	0.50
Securities sold under agreements to repurchase	25	-	0.15%	8,539	13	0.15%	32,407	48	0.15
Short- term borrowings	923	4	0.38%	-	-	-	3	-	0.75
Long- term debt	-	-	-	10,778	424	3.93%	12,409	491	3.96
Total interest-bearing liabilities	764,107	2,371	0.31%	778,673	3,180	0.41%	812,567	4,378	0.54
Noninterest-bearing deposits	143,374			129,748			116,724		
Other liabilities	6,619			8,062			7,818		
Shareholders' equity	107,175			99,512			92,786		
Total liabilities and shareholders' equity	$ 1,021,275			$ 1,015,995			$ 1,029,895		
T/E net interest income/Net interest margin		34,267	3.59%		33,592	3.56%		33,260	3.47
Tax equivalent adjustment		(2,023)			(1,978)			(1,596)	
Net interest income		$ 32,244							