ORRSTOWN FINANCIAL SERVICES INC
Form 10-K
March 15, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2011 December 31, 2011

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: 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.

(Exact Name of Registrant as Specified in its Charter)

Pennsylvania	**23-2530374**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
77 East King Street, P. O. Box 250,	
Shippensburg, Pennsylvania	**17257**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s Telephone Number, Including Area Code: (717) 532-6114

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

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, No Par Value	The Nasdaq Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

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

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 x

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) 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. x

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 accelerated filer, large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	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 x

The aggregate market value of the voting stock held by non-affiliates of the registrant, based on the last price the registrant s Common Stock was sold as of June 30, 2011, $26.31 per share, was $202 million based on 7,683,850 shares of Common Stock outstanding less shares held by affiliates. For purposes of this calculation, the term affiliate refers to all directors and executive officers of the registrant, and all persons beneficially owning more than 5% of the registrant s common stock.

Number of shares outstanding of the registrant s Common Stock as of February 24, 2012: 8,056,139.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2012 Annual Meeting of Shareholders are incorporated by reference in Part III of this Form 10-K.

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ORRSTOWN FINANCIAL SERVICES, INC.

FORM 10-K

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PART I

ITEM 1 BUSINESS

Orrstown Financial Services, Inc. (the Company), a Pennsylvania corporation, is the holding company for Orrstown Bank (the Bank). The Company s executive offices are located at 77 East King Street, Shippensburg, Pennsylvania, 17257. The Company was organized on November 17, 1987, for the purpose of acquiring the Bank and such other banks and bank related activities as are permitted by law and desirable. The Bank provides banking and bank related services in South Central Pennsylvania, principally in Franklin, Perry and Cumberland Counties in Pennsylvania and in Washington County, Maryland. The twenty-one offices of the Bank are located in Shippensburg (2), Carlisle (5), Spring Run, Orrstown, Chambersburg (3), Greencastle, Mechanicsburg (2), Camp Hill, Newport (2), Duncannon, and New Bloomfield, Pennsylvania and Hagerstown, Maryland.

The Company files periodic reports with the Securities and Exchange Commission (SEC) in the form of quarterly reports on Form 10-Q, annual reports on Form 10-K, annual proxy statements and current reports on Form 8-K for any significant events that may arise during the year. Copies of these reports, and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), may be obtained free of charge through the SEC s internet site at www.sec.gov or by accessing the Company s website at www.orrstown.com as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the SEC. Information on our website shall not be considered a part of this Form 10-K.

History and Acquisitions

The Bank was originally organized in 1919 as a state-chartered bank. On March 8, 1988, in a bank holding company reorganization transaction, the Company acquired 100% ownership of the Bank, issuing 131,455 shares of the Company s common stock to the former shareholders of the Bank.

On May 1, 2006, the Company completed its acquisition of The First National Bank of Newport (First National), a national banking institution with $120 million in assets at the time of the acquisition. The final consideration paid in the transaction to stockholders of First National consisted of approximately 699,949 shares of the Company s common stock and $8.9 million in cash. The transaction was valued at approximately $34 million in the aggregate. As a result of this transaction, the Company added four branches located in Perry County, Pennsylvania, $120 million in assets, $72 million in loans and $106 million in deposits to its franchise. First National remained a separate subsidiary banking institution of the Company until June 15, 2007 when First National merged with and into the Bank with the Bank as the surviving institution.

Business

The Company s primary activity consists of owning and supervising its subsidiary, the Bank. The day-to-day management of the Company is conducted by the Bank s officers. The Company derives a majority of its current income through dividends from the Bank. As of December 31, 2011, the Company, on a consolidated basis, had total assets of $1,444,097,000, total shareholders equity of $128,197,000 and total deposits of approximately $1,216,902,000.

The Company has no employees. Its five officers are employees of the Bank. On December 31, 2011, the Bank had 296 full-time and 49 part-time employees.

The Bank is engaged in commercial banking and trust business as authorized by the Pennsylvania Banking Code of 1965. This involves accepting demand, time and savings deposits, and granting loans. The Bank grants commercial, residential, consumer and agribusiness loans in its market areas of Franklin, Perry and Cumberland Counties in Pennsylvania and in Washington County, Maryland. The concentrations of credit by type of loan are set forth in Note 4, Loans Receivable and Allowance for Loan Losses filed herewith in Part II, Item 8,

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Financial Statements and Supplementary Data . The Bank maintains a diversified loan portfolio and evaluates each customer s credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon the extension of credit, is based on management s credit evaluation of the customer pursuant to collateral standards established in the Bank s lending policies and procedures.

Lending

All secured loans are supported with appraisals or evaluations of collateral. Business equipment and machinery, inventories, accounts receivable, and farm equipment are considered appropriate security, provided they meet acceptable standards for liquidity and marketability. Loans secured by equipment and/or other non real estate collateral generally do not exceed 70% of appraised value or cost, whichever is lower. Loans secured by residential real estate generally do not exceed 80% of the appraised value of the property. Loan to collateral values are monitored as part of the loan review process, and appraisals are updated as deemed appropriate under the circumstances.

Commercial Lending

A majority of the Company s loan assets are loans for business purpose. Approximately 75% of the loan portfolio is comprised of commercial loans. The Bank makes commercial real estate, equipment, working capital and other commercial purpose loans as required by the broad range of borrowers across the Bank s various markets. The average size loan in the Bank s commercial loan portfolio is approximately $280,000.

The Bank s loan policy dictates the underwriting requirements for the various types of loans the Bank would extend to borrowers. The policy covers such requirements as debt coverage ratios, advance rate against different forms of collateral, LTV and maximum term.

Approximately 50% of the Bank s commercial portfolio is owner occupied or non-owner occupied commercial real estate loans including multi family. The typical loan in this type is secured by a commercial property with a maximum LTV of 75% of the appraised value of the property. The maximum term and amortization typically does not exceed 20 years. Interest rates charged on these loans are primarily fixed for a period of 3 to 7 years and then adjust to an index and spread after the fixed rate period. The average size of a loan in this type is approximately $414,000.

Approximately 38% of the Bank s commercial portfolio consists of loans for general commercial purpose and include permanent working capital, short term working capital and machinery and equipment financing. These types of loans can either be in the form of lines of credit or term loans. These loans are secured by the borrower s accounts receivable, inventory and machinery and equipment. In a majority of these loans, the collateral also includes the business real estate or the business owner s personal real estate or assets. The personal guarantee of the business owner is also taken. In the case of term loans, the average term of a loan is primarily driven by the use of the loan proceeds and the useful life of the collateral. Interest rates charged are either fixed or variable. If the interest rate is or will become variable at any point in the life of a particular loan, an interest rate floor is typically placed on the loan. The average size of a loan in this type is approximately $71,000.

Consumer Lending

The Bank provides home equity loans, home equity lines of credit and other consumer loans through its branch network. A large majority of the consumer loans are secured by either a first or second lien position on the borrower s primary residential real estate. The Bank requires a LTV of no greater than 90% of the value of the real estate being taken as collateral. The Bank s underwriting standards typically require a borrower to have a debt to income ratio of 38% or less.

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Residential Lending

The Bank provides residential mortgages throughout its various markets through a network of mortgage loan officers. A majority of the residential mortgages originated are sold to secondary market investors, primarily Fannie Mae and the Federal Home Loan Bank of Pittsburgh. All mortgages, regardless of being sold or held in the Bank s portfolio, are underwritten to secondary market industry standards for prime mortgages. The Bank requires a LTV of no greater than 80% of the value of the real estate being taken as collateral, without the borrower obtaining private mortgage insurance.

Loan Review

Administration and supervision over the lending process is provided by the Bank s Credit Administration Committee which is comprised of outside directors. Executive officers and loan department personnel regularly meet with and report to the Credit Administration Committee. The loan origination process is continuous, commencing with the approval of a loan. Each new loan is reviewed by the Loan Department for compliance with banking regulations and lending policy requirements for documentation, collateral standards, and approvals. The Bank employed a Loan Review Officer, who was independent from the loan origination function and reported directly to the Credit Administration Committee. Effective July 2011, the Bank outsourced its independent loan review to a third party provider, which continually monitors and evaluates loan customers utilizing risk-rating criteria established in the Loan Policy in order to spot deteriorating trends and detect conditions which might indicate potential problem loans. The Loan Review Firm reports the results of the loan reviews at least quarterly to the Credit Administration Committee for approval and provides the basis for evaluating the adequacy of the allowance for loan losses.

During 2010, we implemented a centralized consumer underwriting solution, which enables us to process loans more efficiently, providing our customers with faster turnaround times. As a result, we increased our mortgage origination sales force. Our team is supported by a state of the art system that enables them to take applications at the customer s home or business via laptop. Additionally, we added several new mortgage products including Federal Home Administration (FHA), Veterans Administration (VA) and USDA Guaranteed Rural Housing programs. Customers now have the ability to apply for mortgages electronically. Consumer loan pre-approvals are instant, and most loan decisions are made within 24 hours. After approval, the entire process is simplified and expedited, enabling the Bank to handle a much larger volume of lending without significant increases in support staff.

A new website was launched in 2011 and provides the platform for a new consumer loan and mortgage products and other enhancements to improve the customer experience. A customer relationship management (CRM) system will also be implemented which will enable our sales staff to more effectively meet all our customers needs. The new system will provide real time sales management tools and metrics to support the growth of all our lines of business.

Orrstown Financial Advisors (OFA)

Through its trust department, the Bank renders services as trustee, executor, administrator, guardian, managing agent, custodian, investment advisor, and other fiduciary activities authorized by law under the trade name Orrstown Financial Advisors. OFA offers retail brokerage services through a third party broker/dealer arrangement with Financial Network Investment Company (FNIC). As of December 31, 2011, trust assets under management were $947,273,000.

Regulation and Supervision

The Company is a financial holding company, and is registered as such with the Board of Governors of the Federal Reserve System (the Federal Reserve). As a registered bank holding company and financial holding company, the Company is subject to regulation under the Bank Holding Company Act of 1956 and to inspection, examination, and supervision by the Federal Reserve.

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The operations of the Bank are subject to federal and state statutes applicable to banks chartered under the banking laws of the United States, and to banks whose deposits are insured by the Federal Deposit Insurance Company (FDIC). The Bank s operation is also subject to regulations of the Pennsylvania Department of Banking (PDB), the Federal Reserve and the FDIC.

Several of the more significant regulatory provisions applicable to banks and financial holding companies to which the Company and the Bank are subject are discussed below, along with certain regulatory matters concerning the Company and the Bank. To the extent that the following information describes statutory or regulatory provisions, it is qualified in its entirety by reference to the particular statutory provisions. Any change in applicable law or regulation may have a material effect on the business and prospects of the Company and the Bank.

Financial and Bank Holding Company Activities

As a financial holding company, the Company may engage in, and acquire companies engaged in, activities that are considered financial in nature , as defined by the Gramm-Leach-Bliley Act and Federal Reserve interpretations. These activities include, among other things, securities underwriting, dealing and market-making, sponsoring mutual funds and investment companies, insurance underwriting and agency activities, and merchant banking. If any banking subsidiary of the Company ceases to be well capitalized or well managed under applicable regulatory standards, the Federal Reserve may, among other things, place limitations on the Company s ability to conduct the broader financial activities permissible for financial holding companies or, if the deficiencies persist, require the Company to divest the banking subsidiary. In addition, if any banking subsidiary of the Company receives a Community Reinvestment Act rating of less than satisfactory, the Company would be prohibited from engaging in any additional activities other than those permissible for bank holding companies that are not financial holding companies. The Company may engage directly or indirectly in activities considered financial in nature, either de novo or by acquisition, as long as it gives the Federal Reserve after-the-fact notice of the new activities.

FDIC Insurance and Assessments

The Bank s deposits are insured to applicable limits by the FDIC. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the maximum deposit insurance amount was permanently increased from $100,000 to $250,000 and unlimited deposit insurance was extended to non-interest-bearing transaction accounts until December 31, 2012. Prior to the Dodd-Frank Act, the FDIC had established a Temporary Liquidity Guarantee Program under which, for the payment of an additional assessment by insured banks that did not opt out, the FDIC fully guaranteed all non- interest-bearing transaction accounts until December 31, 2010 (the Transaction Account Guarantee Program) and all senior unsecured debt of insured depository institutions or their qualified holding companies issued between October 14, 2008 and October 31, 2009, with the FDIC s guarantee expiring by December 31, 2012 (the Debt Guarantee Program). The Company and the Bank opted out of the Debt Guarantee Program. The Bank did not opt out of the Transaction Account Guarantee Program.

The FDIC has adopted a risk-based premium system that provides for quarterly assessments based on an insured institution s ranking in one of four risk categories based on their examination ratings and capital ratios. Within its risk category, an institution is assigned an initial base assessment which is then adjusted to determine its final assessment rate based on its level of brokered deposits, secured liabilities and unsecured debt. Starting in 2009, the FDIC significantly raised the assessment rate in order to restore the reserve ratio of the Deposit Insurance Fund to the statutory minimum of 1.15%.

The FDIC imposed a special assessment equal to five basis points of assets less Tier 1 capital as of June 30, 2009 payable on September 30, 2009 and reserved the right to impose additional special assessments. In lieu of further special assessments, on November 12, 2009 the FDIC required all insured depository institutions to

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prepay their estimated risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012 on December 30, 2009. For purposes of estimating future assessments, an institution would assume 5% annual growth in the assessment base and a three basis point increase in the current assessment rate for 2011 and 2012. The prepaid assessment would be applied against the actual assessment until exhausted. Any funds remaining after June 30, 2013 would be returned to the institution. At this point, it is unlikely there will be any refunds to the Bank at June 30, 2013.

The Dodd-Frank Act required the FDIC to take such steps as necessary to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020. In setting the assessments, the FDIC is required to offset the effect of the higher reserve ratio against insured depository institutions with total consolidated assets of less than $10 billion. The Dodd-Frank Act also broadened the base for FDIC insurance assessments so that assessments will be based on the average consolidated total assets less average tangible equity capital of a financial institution rather than on its insured deposits.

Pursuant to these requirements, the FDIC adopted new assessment regulations effective April 1, 2011 that redefined the assessment base as average consolidated assets less average tangible equity. Insured banks with more than $1.0 billion in assets must calculate quarterly average assets based on daily balances while smaller banks and newly chartered banks may use weekly averages. In the case of a merger, the average assets of the surviving bank for the quarter must include the average assets of the merged institution for the period in the quarter prior to the merger. Average assets would be reduced by goodwill and other intangibles. Average tangible equity equals Tier 1 capital. For institutions with more than $1.0 billion in assets average tangible equity is calculated on a weekly basis while smaller institutions may use the quarter-end balance. The base assessment rate for insured institutions in Risk Category I will range between 5 to 9 basis points and for institutions in Risk Categories II, III, and IV will be 14, 23 and 35 basis points. An institution s assessment rate will be reduced based on the amount of its outstanding unsecured long-term debt and for institutions in Risk Categories II, III and IV may be increased based on their brokered deposits. Risk Categories are eliminated for institutions with more than $10 billion in assets which will be assessed at a rate between 5 and 35 basis points.

In addition, all FDIC-insured institutions are required to pay assessments to the FDIC to fund interest payments on bonds issued by the Financing Corporation (FICO), an agency of the Federal government established to recapitalize the Federal Savings and Loan Insurance Corporation. The FICO assessment rates, which are determined quarterly, averaged .007% of the assessment base of tangible assets on an annualized basis in fiscal year 2011. These assessments will continue until the FICO bonds mature in 2017.

Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act was intended to affect a fundamental restructuring of federal banking regulation. Among other things, the Dodd-Frank Act created a new Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators new authority to take control of and liquidate financial firms. The Dodd-Frank Act additionally created a new independent federal regulator to administer federal consumer protection laws. The Dodd-Frank Act is expected to have a significant impact on our business operations as its provisions take effect. Among the provisions that are likely to affect us are the following:

Holding Company Capital Requirements. The Dodd-Frank Act requires the Federal Reserve to apply consolidated capital requirements to depository institution holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities are excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010 by a bank holding company with less than $15 billion in assets. The Dodd-Frank Act additionally required capital requirements to be countercyclical so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

Deposit Insurance. The Dodd-Frank Act permanently increased the maximum deposit insurance amount for banks, savings institutions and credit unions to $250,000 per depositor, and extended unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. The Dodd-Frank Act also broadens the base for FDIC insurance assessments. Assessments will now be based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act required the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Effective one year from the date of enactment, the Dodd-Frank Act eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

Corporate Governance. The Dodd-Frank Act required publicly traded companies to give stockholders a non-binding vote on executive compensation at their first annual meeting taking place six months after the date of enactment and at least every three years thereafter and on so-called golden parachute payments in connection with approvals of mergers and acquisitions unless previously voted on by shareholders. The legislation also authorized the SEC to promulgate rules that would allow stockholders to nominate their own candidates using a company s proxy materials. Additionally, the Dodd-Frank Act directed the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of $1.0 billion, regardless of whether the company is publicly traded or not. The Dodd-Frank Act gave the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

Prohibition Against Charter Conversions of Troubled Institutions. Effective one year after enactment, the Dodd-Frank Act prohibits a depository institution from converting from a state to federal charter or vice versa while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the conversion application with its current federal regulator which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating hereto.

Interstate Branching. The Dodd-Frank Act authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted to branch. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks will be able to enter new markets more freely.

Limits on Derivatives. Effective 18 months after enactment, the Dodd-Frank Act prohibits state-chartered banks from engaging in derivatives transactions unless the loans to one borrower limits of the state in which the bank is chartered takes into consideration credit exposure to derivatives transactions. For this purpose, derivative transaction includes any contract, agreement, swap, warrant, note or option that is based in whole or in part on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities securities, currencies, interest or other rates, indices or other assets.

Transactions with Affiliates and Insiders. The Dodd-Frank Act expands the definition of affiliate for purposes of quantitative and qualitative limitations of Section 23A of the Federal Reserve Act to include mutual funds advised by a depository institution or its affiliates. The Dodd-Frank Act will apply Section 23A and Section 22(h) of the Federal Reserve Act (governing transactions with insiders) to derivative transactions, repurchase agreements and securities lending and borrowing transaction that create credit exposure to an affiliate or an insider. Any such transactions with affiliates must be fully secured. The current exemption from Section 23A for transactions with financial subsidiaries will be eliminated. The Dodd-Frank Act will additionally prohibit an insured depository institution from purchasing an asset from or selling an asset to an insider unless the transaction is on market terms and, if representing more than 10% of capital, is approved in advance by the disinterested directors.

Debit Card Interchange Fees. Effective July 21, 2011, the Dodd-Frank Act requires that the amount of any interchange fee charged by a debit card issuer with respect to a debit card transaction must be reasonable and proportional to the cost incurred by the issuer. Within nine months of enactment, the Federal Reserve is required to establish standards for reasonable and proportional fees which may take into account the costs of preventing fraud. While the restrictions on interchange fees do not apply to banks that, together with their affiliates, have assets of less than $10 billion, the rule could affect the competitiveness of debit cards issued by smaller banks.

Consumer Financial Protection Bureau. The Dodd-Frank Act created a new, independent federal agency called the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB will have examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions will be subject to rules promulgated by the CFPB but will continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB will have authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower s ability to repay. In addition, the Dodd-Frank Act will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a qualified mortgage as defined by the CFPB. The Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

Liability for Banking Subsidiaries

Under Federal Reserve policy, a bank holding company such as the Company is expected to act as a source of financial and managerial strength to each of its subsidiary banks and to commit resources to their support. This support may be required at times when the bank holding company may not have the resources to provide it. Similarly, under the cross-guarantee provisions of the Federal Deposit Insurance Act, the FDIC can hold any FDIC-insured depository institution liable for any loss suffered or anticipated by the FDIC in connection with (1) the default of a commonly controlled FDIC-insured depository institution; or (2) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default .

Capital Requirements

Information concerning the compliance of the Company and the Bank with respect to capital requirements is incorporated by reference from Note 14, Shareholders Equity and Regulatory Capital , of the Notes to Consolidated Financial Statements included under Item 8 of this report, and from the Capital Adequacy and Regulatory Matters section of the Management s Discussion and Analysis of Consolidated Financial Condition and Results of Operations , included under Item 7 of this report.

Pennsylvania Banking Law

The Pennsylvania Banking Code (Banking Code) contains detailed provisions governing the organization, location of offices, rights and responsibilities of directors, officers, and employees, as well as corporate powers, savings and investment operations and other aspects of the Bank and its affairs. The Banking Code delegates extensive rule-making power and administrative discretion to the PDB so that the supervision and regulation of state chartered banks may be flexible and readily responsive to changes in economic conditions and in savings and lending practices.

The Federal Deposit Insurance Corporation Act (FDIA), however, prohibits state chartered banks from making new investments, loans, or becoming involved in activities as principal and equity investments which are not permitted for national banks unless (1) the FDIC determines the activity or investment does not pose a

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significant risk of loss to the Deposit Insurance Fund and (2) the bank meets all applicable capital requirements. Accordingly, the additional operating authority provided to the Bank by the Banking Code is significantly restricted by the FDIA.

Dividend Restrictions

The Company s funding for cash distributions to its shareholders is derived from a variety of sources, including cash and temporary investments. One of the principal sources of those funds has historically been dividends received from the Bank. Various federal and state laws limit the amount of dividends the Bank can pay to the Company without regulatory approval. In addition, federal bank regulatory agencies have authority to prohibit the Bank from engaging in an unsafe or unsound practice in conducting its business. The payment of dividends, depending upon the financial condition of the bank in question, could be deemed to constitute an unsafe or unsound practice. The ability of the Bank to pay dividends in the future is currently, and could be further, influenced by bank regulatory policies and capital guidelines. In 2009, the Federal Reserve notified all bank holding companies that dividends should be eliminated, deferred or significantly reduced if the bank holding company s net income for the past four quarters, net of dividends paid during that period, is not sufficient to fully fund the dividends; the bank holding company s prospective rate of earnings retention is not consistent with the bank holding company s capital needs and overall, current and prospective financial conditions; or the bank holding company will not meet, or is in danger of meeting, its minimum regulatory capital adequacy ratios. Additional information concerning the Company and the Bank with respect to dividends is incorporated by reference from the risk factors entitled We expect to be subject to restrictions and conditions of formal agreements to be issued by the Federal Reserve Bank of Philadelphia and the Pennsylvania Department of Banking. Failure to comply with the expected formal agreements could result in additional enforcement action against us, including the imposition of monetary penalties, and We recently discontinued our quarterly cash dividend and suspended our stock repurchase program based on regulatory requirements and we do not anticipate being able to resume either in the near future included under Item 1A of this report and Note 15, Restrictions on Dividends, Loans and Advances , of the Notes to Consolidated Financial Statements included under Item 8 of this report, and the Capital Adequacy and Regulatory Matters section of Management s Discussion and Analysis of Consolidated Financial Condition and Results of Operations , included under Item 7 of this report.

Other Federal Laws and Regulations

The Company s operations are subject to additional federal laws and regulations applicable to financial institutions, including, without limitation:

- Privacy provisions of the Gramm-Leach-Bliley Act and related regulations, which require us to maintain privacy policies intended to safeguard customer financial information, to disclose the policies to our customers and to allow customers to opt out of having their financial service providers disclose their confidential financial information to non-affiliated third parties, subject to certain exceptions;

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

- Consumer protection rules for the sale of insurance products by depository institutions, adopted pursuant to the requirements of the Gramm-Leach-Bliley Act; and

- USA Patriot Act, which requires financial institutions to take certain actions to help prevent, detect and prosecute international money laundering and the financing of terrorism.

Future Legislation

Changes to the laws and regulations in the states where the Company and the Bank do business can affect the operating environment of both the Company and the Bank in substantial and unpredictable ways. The Company cannot accurately predict whether those changes in laws and regulations will occur, and, if those changes occur, the ultimate effect they would have upon the financial condition or results of operations of the Company. This is also true of federal legislation, particularly given the current challenging economic environment.

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NASDAQ Capital Market

The Company s common stock is listed on The NASDAQ Capital Market under the trading symbol ORRF and is subject to NASDAQ s rules for listed companies.

Forward Looking Statements

Additional information concerning the Company and the Bank with respect to forward looking statements is incorporated by reference from the Important Factors Relating to Forward Looking Statements section of the Management s Discussion and Analysis of Financial Condition and Results of Operations, included in this report under Item 7.

Competition

The Bank s principal market area consists of Franklin County, Perry County and Cumberland County, Pennsylvania, and Washington County, Maryland. The Bank services a substantial number of depositors in this market area, with the greatest concentration in Chambersburg, Shippensburg, and Carlisle, Pennsylvania and the surrounding areas.

The Bank, like other depository institutions, has been subjected to competition from less heavily regulated entities such as credit unions, brokerage firms, money market funds, consumer finance and credit card companies, and other commercial banks, many of which are larger than the Bank. The principal methods of competing effectively in the financial services industry include improving customer service through the quality and range of services provided, improving efficiencies and pricing services competitively. The Bank is competitive with the financial institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

The Bank continues to implement strategic initiatives focused on expanding our core businesses and to explore, on an ongoing basis, acquisition, divestiture, and joint venture opportunities. We analyze each of our products and businesses in the context of customer demands, competitive advantages, industry dynamics, and growth potential**.**

ITEM 1A RISK FACTORS

Our financial conditions and results of operations may be adversely affected by various factors, many of which are beyond our control. These risk factors include the following:

We expect to be subject to restrictions and conditions of formal agreements to be issued by the Federal Reserve Bank of Philadelphia and the Pennsylvania Department of Banking. Failure to comply with the expected formal agreements could result in additional enforcement action against us, including the imposition of monetary penalties.

The Federal Reserve Bank of Philadelphia and the Pennsylvania Department of Banking have recently advised the Company and the Bank that we will become subject to formal written agreements with each of these regulators. We have received drafts of the proposed agreements and we expect the final agreements will require us to discontinue a number of practices and to take a number of actions. In particular, we expect that the Federal Reserve will order us to, among other things to prepare and submit plans regarding: (i) strengthen credit risk management practices and underwriting, (ii) the repayment or disposition of properties classified as OREO and nonperforming or criticized assets, (iii) the allowance for loan loss methodology, (iv) capital, (v) a management review. These formal agreements will also restrict the ability of the Company and the Bank to pay dividends, to repurchase stock or to incur indebtedness without prior regulatory approval. We intend to fully comply with the formal agreements when issued. However, if we fail to comply, the Federal Reserve and/or the Pennsylvania Department of Banking could take additional enforcement action against us. Possible enforcement actions against us could include the issuance of a cease and desist order that could be judicially enforced, the imposition of civil monetary penalties, the issuance of directives to increase capital or to enter into a strategic transaction, whether by merger or otherwise, with a third party, the appointment of a conservator or receiver, the termination of insurance of deposits, the issuance of removal and prohibition orders against institution-affiliated parties and the enforcement of such actions through injunctions or restraining orders. Any remedial measure or enforcement action, whether formal or informal, could impose restrictions on our ability to operate our business and adversely affect our business, prospects, financial condition or results of operations. In addition, any formal enforcement action could harm our reputation and our ability to retain and attract customers and impact the trading price of our common stock.

We have incurred and expect to continue to incur significant additional regulatory compliance expense in connection with the expected formal agreement. Such additional regulatory compliance costs could have a material adverse impact on our results of operations and financial condition. In addition, deviations from our business plan will likely have to be approved by the regulators, which could limit our ability to make any changes to our business. This could negatively impact the scope and flexibility of our business activities.

We recently discontinued our quarterly cash dividend and suspended our stock repurchase program based on regulatory requirements and we do not anticipate being able to resume either in the near future.

The Company is a holding company regulated by the Federal Reserve. In October 2011, the Company announced it had discontinued its quarterly dividend, which was the result of regulatory guidance from the Federal Reserve indicating that the Company s dividend application would not be approved. Due to subsequent regulatory restrictions which we expect to be included in formal agreements with our regulators the Company does not anticipate being permitted to declare a cash dividend or resuming its stock repurchase program in the near future. Accordingly, there can no assurances as to whether, or in what amounts, cash dividends will be declared in the future or, if resumed, whether they will continue or be suspended or discontinued.

We may be required to make further increases in our provisions for loan losses and to charge off additional loans in the future, which could materially adversely affect us.

There is no precise method of predicting loan losses. For 2011, we recorded a provision for loan losses of $58,575,000. We also recorded net loan charge-offs of $30,880,000 in 2011 as compared to $3,972,000 in 2010. Our risk element assets, including nonperforming loans, troubled debt restructurings, loans greater than 90 days past due still accruing, and other real estate owned, increased in 2011 from $18,436,000 at December 31, 2010 to $113,779,000 at December 31, 2011. Further, loans that are classified as special mention, substandard, doubtful or loss totaled $241,277,000 at December 31, 2011. We can give no assurance that our allowance for loan losses is or will be sufficient to absorb actual loan losses. We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, that represents management s best estimate of probable incurred losses within the existing portfolio of loans. The level of the allowance reflects management s evaluation of, among other factors, the status of specific impaired loans, trends in historical loss experience, delinquency trends, credit concentrations and economic conditions within our market area. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan losses. Increases in nonperforming loans have a significant impact on our allowance for loan losses.

In addition, bank regulatory agencies periodically review our allowance for loan losses and may require us to increase the provision for loan losses or to recognize further loan charge-offs, based on judgments that differ from those of management. If loan charge-offs in future periods exceed our allowance for loan losses, we will need to record additional provisions to increase our allowance for loan losses. Furthermore, growth in our loan portfolio would generally lead to an increase in the provision for loan losses. Generally, increases in our allowance for loan losses will result in a decrease in net income and stockholders equity, and may have a material adverse effect on our financial condition, results of operations and cash flows.

Our allowance for loan losses was 4.53% of total loans and 39% of nonaccrual and restructured loans still accruing at December 31, 2011, compared to 1.66% of total loans and 106% of nonaccrual and restructured loans still accruing at December 31, 2010. Material additions to our allowance could materially decrease our net income. In addition, at December 31, 2011, our top 25 lending relationships individually had commitments in excess of $242,253,000, and a total outstanding loan balance of $207,436,000, or nearly 21.5% of the loan portfolio. The deterioration of one or more of these loans could result in a significant increase in our nonperforming loans and our provisions for loan losses, which would negatively impact our results of operations.

Unfavorable economic and market conditions due to the current global financial crisis may materially and adversely affect us.

Economic and market conditions in the United States and around the world have deteriorated significantly in recent years and may remain depressed for the foreseeable future. Conditions such as slowing or negative growth and the sub-prime debt devaluation crisis have resulted in a low level of liquidity in many financial markets and extreme volatility in credit, equity and fixed income markets. These economic developments could have various effects on us, including insolvency of major customers and a negative impact on the investment income we are able to earn on our investment portfolio.

Lending money is an essential part of our business. Due to the current challenging economic conditions, customers may be unable or unwilling to borrow money or repay funds already borrowed. The risk of non-payment is affected by credit risks attributable to a particular customer, changes in economic conditions, the duration of the loan and, in the case of a collateralized loan, uncertainties as to the future value of the collateral and other factors. The potential effects of the current global financial crisis are difficult to forecast and mitigate. As a consequence, our operating results for a particular period are difficult to predict. The impact of this situation, together with concerns regarding the financial strength of financial institutions, has led to distress in credit markets and liquidity issues for financial institutions. Some financial institutions around the world have failed; others have been forced to seek acquisition partners. The United States and other governments have taken unprecedented steps to try to stabilize the financial system, including investing in financial institutions. Our business and our financial condition and results of operations could be adversely affected by (1) continued or accelerated disruption and volatility in financial markets, (2) continued capital and liquidity concerns regarding financial institutions generally and our counterparties specifically, (3) limitations resulting from further governmental action in an effort to stabilize or provide additional regulation of the financial system, or (4) recessionary conditions that are deeper or last longer than currently anticipated.

Governmental regulation and regulatory actions against us may impair our operations or restrict our growth.

We are subject to extensive regulation and supervision under federal and state laws and regulations. The requirements and limitations imposed by such laws and regulations limit the manner in which we conduct our business, undertake new investments and activities and obtain financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit our shareholders. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is within our control. Federal and state regulatory agencies also frequently adopt changes to their regulations or change the manner in which existing regulations are applied or enforced. We cannot predict the substance or impact of pending or future legislation, regulation or the application thereof. Compliance with such current and potential regulation and scrutiny may significantly increase our costs, impede the efficiency of our internal business processes, require us to increase our regulatory capital and limit our ability to pursue business opportunities in an efficient manner. Bank regulations can hinder our ability to compete with financial services companies that are not regulated in the same manner or are subject to less regulation.

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Furthermore, if we fail to meet any regulatory capital requirement, we will be subject to the prompt corrective action framework of the Federal Deposit Insurance Corporation Improvement Act of 1991, which imposes progressively more restrictive constraints on operations, management and capital distributions as the capital category of an institution declines, up to and including the appointment of a conservator or receiver for the Bank. A failure to meet regulatory capital requirements could also subject us to capital raising requirements.

The Dodd-Frank Wall Street Reform and Consumer Protection Act may affect our financial condition, results of operations, liquidity and stock price.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act, or the Dodd-Frank Act, was signed into law. The Dodd-Frank Act includes provisions affecting large and small financial institutions, including several provisions that will profoundly affect how community banks and bank holding companies will be regulated in the future. Among other things, these provisions relax rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, change the scope of federal deposit insurance coverage and impose new capital requirements on bank holding companies. In addition, there is significant uncertainty about the full impact of the Dodd-Frank Act because many of its provisions require subsequent regulatory rule making.

The Dodd-Frank Act establishes the Bureau of Consumer Financial Protection as an independent entity within the Federal Reserve, which will be given authority to promulgate consumer protection regulations applicable to all entities offering financial services or products, including banks. Additionally, the Dodd-Frank Act includes a series of provisions covering mortgage loan origination standards affecting, among other things, originator compensation, minimum repayment standards and pre-payments.

The Dodd-Frank Act contains numerous other provisions affecting financial institutions of all types, many of which may have an impact on the Company s operating environment in substantial and unpredictable ways. Consequently, the Dodd-Frank Act is likely to affect our cost of doing business, it may limit or expand the activities in which Orrstown permissibly may engage and it may affect the competitive balance within the Company s industry and market areas.

The Dodd-Frank Act and the regulations to be adopted thereunder are expected to subject us and other financial institutions to additional restrictions, oversight and costs that may have an adverse impact on our business, financial condition, results of operations or the price of the Company s common stock and the Company s ability to continue to conduct business consistent with historical practices.

The recent repeal of federal prohibitions on the payment of interest on demand deposits could increase our interest expense and reduce our net interest margin.

All federal prohibitions on the ability of financial institutions to pay interest on demand deposit accounts were repealed as part of the Dodd-Frank Act. As a result, beginning on July 21, 2011, financial institutions could commence offering interest on demand deposits to compete for clients. We do not know what interest rates or products other institutions may offer. Our interest expense could increase and our net interest margin could decrease if we begin offering interest on demand deposits to attract additional customers or maintain current customers. Consequently, our business, financial condition or results of operations could be adversely affected.

We have a significant deferred tax asset and cannot assure you that it will be fully realized.

We had net deferred tax assets of $18,182,000 as of December 31, 2011. There is no valuation allowance against our federal net deferred tax assets as of December 31, 2011 because we believe that it is more likely than not these assets will be realized. In evaluating the need for a valuation allowance, we considered the reversal of deferred tax liabilities, tax planning strategies and estimated future taxable income based on management prepared forecasts. This process required significant judgment by management about matters that are by nature uncertain. If future events differ significantly from our current forecasts, we may need to establish a valuation allowance, which could have a material adverse effect on our results of operations and financial condition.

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Our inability to use a short form registration statement on Form S-3 may affect our short-term ability to access the capital markets, if needed.

A registration statement on Form S-3 permits an eligible issuer to incorporate by reference its past and future filings and reports made under the Exchange Act. In addition, Form S-3 enables eligible issuers to conduct primary offerings off the shelf under Rule 415 of the Securities Act. The shelf registration process under Form S-3 combined with the ability to incorporate information on a forward basis, allows issuers to avoid additional delays and interruptions in the offering process and to access the capital markets in a more expeditions and efficient manner than raising capital in a standard offering on Form S-3. One of the requirements for Form S-3 eligibility is for an issuer to have a market capitalization held by the public (a public float) of $75 million or more. As of the date of the filing of this Form 10-K, because our stock price has declined, our public float is less than $75 million and we would not be eligible to use Form S-3 to raise additional capital unless the stock price increased. As a result, if we wanted to raise capital in the capital markets during a period of time that we are unable to use Form S-3, we may experience delays. Any such delay may result in offering terms that may not be advantageous to us or may cause us not to obtain capital in a timely fashion to execute our business strategies.

Changes in interest rates could adversely impact our financial condition and results of operations.

Our operating income, net income and liquidity depend to a great extent on our net interest margin, i.e., the difference between the interest yields we receive on loans, securities and other interest earning assets and the interest rates we pay on interest-bearing deposits, borrowings and other liabilities. These rates are highly sensitive to many factors beyond our control, including competition, general economic conditions and monetary and fiscal policies of various governmental and regulatory authorities, including the Board of Governors of the Federal Reserve System, or the Federal Reserve. If the rate of interest we pay on our interest-bearing deposits, borrowings and other liabilities increases more than the rate of interest we receive on loans, securities and other interest earning assets, our net interest income, and therefore our earnings, and liquidity could be materially adversely affected. Our earnings and liquidity could also be materially adversely affected if the rates on our loans, securities and other investments fall more quickly than those on our deposits, borrowings and other liabilities. Our operations are subject to risks and uncertainties surrounding our exposure to changes in the interest rate environment.

Additionally, based on our analysis of the interest rate sensitivity of our assets, an increase in the general level of interest rates will negatively affect the market value of our investment portfolio because of the relatively long duration of the securities included in our investment portfolio.

Changes in interest rates also can affect: (1) our ability to originate loans; (2) the value of our interest-earning assets, which would negatively impact stockholders equity, and our ability to realize gains from the sale of such assets; (3) our ability to obtain and retain deposits in competition with other available investment alternatives; and (4) the ability of our borrowers to repay adjustable or variable rate loans.

Increases in FDIC insurance premiums may have a material adverse effect on our results of operations.

During the past few years, higher levels of bank failures have dramatically increased resolution costs of the FDIC, and depleted the deposit insurance fund. In addition, the FDIC and the U.S. Congress have taken action to increase federal deposit insurance coverage, placing additional stress on the deposit insurance fund.

To further support the rebuilding of the Deposit Insurance Fund, the FDIC imposed a special assessment on each insured institution, equal to five basis points of the institution s total assets minus Tier 1 capital as of September 30, 2009. For the Bank, this represented an aggregate charge of approximately $515,000. In lieu of imposing an additional special assessment, the FDIC required all institutions to prepay their assessments for all of 2010, 2011 and 2012, which for us totaled $4,489,000. The FDIC has indicated that future special assessments are possible, although it has not determined the magnitude or timing of any future assessments.

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In 2011, the FDIC finalized its new assessment for insurance, as required by the Dodd-Frank Act. The final rule, which took effect April 1, 2011, bases the assessment on what the Bank holds in assets, minus tangible equity, instead of the previous method which was based on deposit holdings.

We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures, we may be required to pay even higher FDIC premiums. Our expenses for the year ended December 31, 2011, have been significantly and adversely affected by these increased premiums and the special assessment. These increases and assessment and any future increases in insurance premiums or additional special assessments may materially adversely affect our results of operations.

If we fail to maintain an effective system of internal control over financial reporting and disclosure controls and procedures, we may be unable to accurately report our financial results and comply with the reporting requirements under the Securities Exchange Act of 1934. As a result, current and potential shareholders may lose confidence in our financial reporting and disclosure required under the Securities Exchange Act of 1934, which could adversely affect our business and could subject us to regulatory scrutiny.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, referred to as Section 404, we are required to include in our Annual Reports on Form 10-K, our management s report on internal control over financial reporting. As of December 31, 2011, the Company reported a material weakness in its internal controls over financial reporting in this annual report on Form 10-K as it pertains to its loan ratings and resulting impact on the allowance for loan losses calculation. Compliance with the requirements of Section 404 is expensive and time-consuming. If, in the future, we fail to remediate our material weakness or complete this evaluation in a timely manner, or if our independent registered public accounting firm cannot timely attest to our evaluation, we could be subject to regulatory scrutiny and a loss of public confidence in our internal control over financial reporting. In addition, our inability to establish an effective system of disclosure controls and procedures could cause our current and potential shareholders and customers to lose confidence in our financial reporting and disclosure required under the Securities Exchange Act of 1934, which could adversely affect our business.

We are a holding company dependent for liquidity on payments from the Bank, our sole subsidiary, which are subject to restrictions.

We are a holding company and depend on dividends, distributions and other payments from the Bank, our only subsidiary to fund dividend payments, if permitted, and to fund all payments on obligations. The Bank is subject to laws that restrict dividend payments or authorize regulatory bodies to block or reduce the flow of funds from it to us. We anticipate being subject to formal regulatory restrictions prohibiting any dividend from the Bank to us without prior regulatory approval. In addition, our right to participate in a distribution of assets upon the Bank s liquidation or reorganization is subject to the prior claims of the Bank s creditors.

Because our business is concentrated in South Central Pennsylvania and Washington County, Maryland, our financial performance could be materially adversely affected by economic conditions and real estate values in these market areas.

Our operations and the properties securing our loans are primarily in South Central Pennsylvania (principally Franklin, Perry and Cumberland Counties) and in Washington County, Maryland. Our operating results depend largely on economic conditions and real estate valuations in these and surrounding areas. A further deterioration in the economic conditions in these market areas could materially adversely affect our operations and increase loan delinquencies, increase problem assets and foreclosures, increase claims and lawsuits, decrease the demand for our products and services and decrease the value of collateral securing loans, especially real estate, in turn reducing customers borrowing power, the value of assets associated with nonperforming loans and collateral coverage.

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Our commercial real estate lending may expose us to a greater risk of loss and hurt our earnings and profitability.

Our business strategy involves making loans secured by commercial real estate. These types of loans generally have higher risk-adjusted returns and shorter maturities than traditional one-to-four family residential mortgage loans. At December 31, 2011, our loans secured by commercial real estate totaled approximately $368,010,000, which represented 38% of total loans. Loans secured by commercial real estate properties are generally for larger amounts and may involve a greater degree of risk than one-to-four family residential mortgage loans. Payments on loans secured by these properties are often dependent on the income produced by the underlying properties which, in turn, depends on the successful operation and management of the properties. Accordingly, repayment of these loans is subject to adverse conditions in the real estate market or the local economy. In addition, many economists believe that deterioration in income producing commercial real estate is likely to worsen as vacancy rates continue to rise and absorption rates of existing square footage continue to decline. Because of the current challenging economic environment, these loans represent higher risk, could result in an increase in our total net-charge offs and could require us to increase our allowance for loan losses, which could have a material adverse effect on our financial condition or results of operations. In addition, our regulators may require us to limit or cease this type of lending in the future. While we seek to minimize these risks in a variety of ways, there can be no assurance that these measures will protect against credit-related losses.

Our construction loans and land development loans involve a higher degree of risk than other segments of our loan portfolio.

Construction financing typically involves a higher degree of credit risk than financing on improved, owner-occupied real estate. Risk of loss on a construction loan is largely dependent upon the accuracy of the initial estimate of the property s value at completion of construction and the bid price and estimated cost (including interest) of construction. If the estimate of construction costs proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of the value proves to be inaccurate, we may be confronted, at or prior to the maturity of the loan, with a project whose value is insufficient to assure full repayment. When lending to builders, the cost of construction breakdown is provided by the builder, as well as supported by the appraisal. Although our underwriting criteria are designed to evaluate and minimize the risks of each construction loan, there can be no guarantee that these practices will safeguard against material delinquencies and losses to our operations. In addition, our regulators may request us to limit or cease this type of lending in the future. At December 31, 2011, we had loans of approximately $84,662,000, or 9% of total loans, outstanding to finance construction and land development. Construction and land development loans are dependent on the successful completion of the projects they finance, however, in many cases such construction and development projects in our primary market areas are not being completed in a timely manner, if at all.

We are required to make a number of judgments in applying accounting policies and different estimates and assumptions in the application of these policies could result in a decrease in capital and/or other material changes to our reports of financial condition and results of operations. Also, changes in accounting standards can be difficult to predict and can materially impact how we record and report our financial condition and results of operations.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses and reserve for unfunded lending commitments and the fair value of certain financial instruments (securities, derivatives, and privately held investments). While we have identified those accounting policies that are considered critical and have procedures in place to facilitate the associated judgments, different assumptions in the application of these policies could result in a decrease to net income and, possibly, capital and may have a material adverse effect on our financial condition and results of operations.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time, the Financial Accounting Standards Board changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations.

Competition from other banks and financial institutions in originating loans, attracting deposits and providing various financial services may adversely affect our profitability and liquidity.

We have substantial competition in originating loans, both commercial and consumer, in our market area. This competition comes principally from other banks, savings institutions, mortgage banking companies and other lenders. Some of our competitors enjoy advantages, including greater financial resources and access to capital, stronger regulatory ratios, and higher lending limits, a wider geographic presence, more accessible branch office locations, the ability to offer a wider array of services or more favorable pricing alternatives, as well as lower origination and operating costs. This competition could reduce our net income and liquidity by decreasing the number and size of loans that we originate and the interest rates we may charge on these loans.

In attracting business and consumer deposits, we face substantial competition from other insured depository institutions such as banks, savings institutions and credit unions, as well as institutions offering uninsured investment alternatives, including money market funds. Some of our competitors enjoy advantages, including greater financial resources and access to capital, stronger regulatory ratios, stronger asset quality and performance, more aggressive marketing campaigns, better brand recognition and more branch locations. These competitors may offer higher interest rates than we do, which could decrease the deposits that we attract or require us to increase our rates to retain existing deposits or attract new deposits. Increased deposit competition could materially adversely affect our ability to generate the funds necessary for lending operations. As a result, we may need to seek other sources of funds that may be more expensive to obtain and could increase our cost of funds.

Impairment of investment securities, goodwill, other intangible assets, could require charges to earnings, which could result in a negative impact on our results of operations.

In assessing the impairment of investment securities, we consider the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuers, and our intent and ability to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. Under current accounting standards, goodwill and certain other intangible assets with indeterminate lives are no longer amortized but, instead, are assessed for impairment periodically or when impairment indicators are present. Assessment of goodwill and such other intangible assets could result in circumstances where the applicable intangible asset is deemed to be impaired for accounting purposes. As a result of the Company s annual goodwill testing, the Company recorded a non-cash goodwill impairment charge of $19,447,000 during the quarter ended December 31, 2011. Although all goodwill was removed from the Company s balance sheet as of December 31, 2011, any goodwill generated in the future will be subject to periodic assessment for impairment and may result in future charges to earnings.

Our business strategy includes the continuation of moderate growth plans, and our financial condition and results of operations could be negatively affected if we fail to grow or fail to manage our growth effectively.

Our assets increased $635,066,000, or 80% from $809,031,000 at January 1, 2007, to $1,444,097,000 at December 31, 2011, primarily due to organic growth through increases in residential mortgage loans and commercial real estate loans and securities available for sale funded by growth in deposits. Over the long term, we expect to continue to experience growth in the amount of our assets, the level of our deposits and the scale of our operations. However, in the immediate future we expect our growth to be limited as we attempt to work through asset quality issues and preserve capital. Achieving our growth targets requires us to successfully execute our business strategies, which include continuing to grow our loan portfolio thereby recognizing the value of our investments in personnel in that area. Our ability to successfully grow will also depend on the continued availability of loan opportunities that meet underwriting standards and our ability to meet minimum capital ratios to be considered well capitalized. In addition, once our asset quality metrics return to more historical levels, we may consider the acquisition of other financial institutions and branches within or outside of our market area, the success of which will depend on a number of factors, including our ability to integrate the acquired branches into the current operations of the Company, our ability to limit the outflow of deposits held by customers of the acquired institution or branch locations, our ability to control the incremental increase in non-interest expense arising from any acquisition and our ability to retain and integrate the appropriate personnel of the acquired institution or branches. While we believe we have the resources and internal systems in place to successfully achieve and manage our future growth, there can be no assurance growth opportunities will be available or that we will successfully manage our growth. If we do not manage our growth effectively, we may not be able to achieve our business plan, and our business and prospects could be harmed.

If we want to, or are compelled to, raise additional capital in the future, that capital may not be available when it is needed and on terms favorable to current shareholders.

Federal banking regulators require us and our banking subsidiaries to maintain adequate levels of capital to support our operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by our management and board of directors based on capital levels that, they believe, are necessary to support our business operations. At December 31, 2011, all three capital ratios for us and our banking subsidiary were above well capitalized levels under current bank regulatory guidelines. To be well capitalized, banking companies generally must maintain a tier 1 leverage ratio of at least 5%, a Tier 1 risk-based capital ratio of at least 6%, and a total risk-based capital ratio of at least 10%. However, our regulators may require us or our banking subsidiary to operate with higher capital levels. For example, regulators recently have required some banks to attain a Tier 1 leverage ratio of at least 8%, a Tier 1 risk-based capital ratio of at least 10%, and a total risk-based capital ratio of at least 12%.

Our ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside of our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital on terms and time frames acceptable to us or to raise additional capital at all. If we cannot raise additional capital in sufficient amounts when needed, our ability to comply with regulatory capital requirements could be materially impaired. Additionally, the inability to raise capital in sufficient amounts may adversely affect our operations, financial condition and results of operating. Our ability to borrow could also be impaired by factors that are nonspecific to us, such as severe disruption of the financial markets or negative news and expectations about the prospects for the financial services industry as a whole as evidenced by recent turmoil in the domestic and worldwide credit markets. If we raise capital through the issuance of additional shares of our common stock or other securities, we would likely dilute the ownership interests of current investors and could dilute the per share book value and earnings per share of our common stock. Furthermore, a capital raise through issuance of additional shares may have an adverse impact on our stock price.

We may be adversely affected by technological advances.

Technological advances impact our business. The banking industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to improving customer services, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend, in part, on our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in operations. Many competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or successfully market such products and services to its customers.

The soundness of other financial institutions could adversely affect us.

Our ability to engage in routine funding and other transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. As a result, defaults by, or even rumors or

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questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems, losses of depositor, creditor and counterparty confidence and could lead to losses or defaults by us or by other institutions. We could experience increases in deposits and assets as a result of other banks difficulties or failure, which would increase the capital we need to support such growth.

A substantial decline in the value of our Federal Home Loan Bank of Pittsburgh common stock may adversely affect our financial condition.

We own common stock of the Federal Home Loan Bank of Pittsburgh, or the FHLB, in order to qualify for membership in the Federal Home Loan Bank system, which enables us to borrow funds under the Federal Home Loan Bank advance program. The carrying value and fair market value of our FHLB common stock was $9,573,000 as of December 31, 2011.

Published reports indicate that certain member banks of the Federal Home Loan Bank system may be subject to asset quality risks that could result in materially lower regulatory capital levels. In December 2008, the FHLB had notified its member banks that it had suspended dividend payments and the repurchase of capital stock until further notice is provided. In an extreme situation, it is possible that the capitalization of a Federal Home Loan Bank, including the FHLB, could be substantially diminished or reduced to zero. Consequently, given that there is no market for our FHLB common stock, we believe that there is a risk that our investment could be deemed other-than-temporarily impaired at some time in the future. If this occurs, it may adversely affect our results of operations and financial condition. If the FHLB were to cease operations, or if we were required to write-off our investment in the FHLB, our business, financial condition, liquidity, capital and results of operations may be materially adversely affected.

An interruption or breach in security with respect to our information system, or our outsourced service providers, could adversely impact our reputation and have an adverse impact on our financial condition or results of operations.

We rely on software, communication, and information exchange on a variety of computing platforms and networks and over the Internet. Despite numerous safeguards, we cannot be certain that all of our systems are entirely free from vulnerability to attack or other technological difficulties or failures. We rely on the services of a variety of vendors to meet our data processing and communication needs. If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and we could be exposed to claims from customers. Any of these results could have a material adverse effect on our financial condition, results of operations or liquidity.

ITEM 1B UNRESOLVED STAFF COMMENTS

None.

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ITEM 2 PROPERTIES

The Bank owns and leases properties in Cumberland, Perry and Franklin Counties, Pennsylvania and Washington County, Maryland as branch banking offices and an operations center. The Company and the Bank maintain headquarters at the Bank s King Street Office in Shippensburg, Pennsylvania. A summary of these properties is as follows:

Office and Address	Acquired/Built	Office and Address	Acquired/Built
Properties Owned		**Land Lease / Premises Owned**	
Orrstown Office 3580 Orrstown Road Orrstown, PA 17244	1919	Orchard Drive Office 1355 Orchard Drive Chambersburg, PA 17201	2003
Lurgan Avenue Office 121 Lurgan Avenue Shippensburg, PA 17257	1981	Red Hill Office 18 Newport Plaza Newport, PA 17074	2007
King Street Office 77 E. King Street Shippensburg, PA 17257	1986	**Leased**	
Stonehedge Office 427 Village Drive Carlisle, PA 17015	1994	Hanover Street 22 S. Hanover St. Carlisle, PA 17013	1997
Path Valley Office 16400 Path Valley Road Spring Run, PA 17262	1995	North Middleton Office 2250 Spring Road Carlisle, PA 17013	2002
Norland Avenue Office 625 Norland Avenue Chambersburg, PA 17201	1997	Camp Hill 3045 Market St. Camp Hill, PA 17011	2005
Silver Spring Office 3 Baden Powell Lane Mechanicsburg, PA 17050	2000	Carlisle Fairgrounds 1000 Bryn Mawr Road Carlisle, PA 17013	2011
Seven Gables Office 1 Giant Lane Carlisle, PA 17013	2003		
Lincoln Way East Office 1725 Lincoln Way East Chambersburg, PA 17202	2004		
Greencastle Office 308 Carolle Street Greencastle, PA 17225	2006		
Simpson Street Office 1110 East Simpson Street Mechanicsburg, PA 17055	2006		
Newport Office Center Square Newport, PA 17074	2007		
Duncannon Office 403 North Market Street Duncannon, PA 17020	2007		
New Bloomfield Office 1 South Carlisle Street	2007		

New Bloomfield, PA 17068

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Office and Address	Acquired/Built	Office and Address	Acquired/Built
Eastern Blvd. Office 1020 Professional Court Hagerstown, MD 21740	2008		
North Pointe Business (Operations) Center 2695 Philadelphia Avenue Chambersburg, PA 17201	2007		

ITEM 3 LEGAL PROCEEDINGS

The Company is an occasional party to legal actions arising in the ordinary course of its business. In the opinion of management, the Company has adequate legal defenses and/or insurance coverage respecting any and each of these actions and does not believe that they will materially affect the Company s operations or financial position.

ITEM 4 MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5 MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock began trading on The NASDAQ Capital Market under the symbol ORRF as of April 28, 2009, and continues to be listed there as of the date hereof. At the close of business on February 24, 2012, there were approximately 3,103 shareholders of record.

The following table sets forth, for the fiscal periods indicated, the high and low sales prices for our common stock for the two most recent fiscal years. Trading prices are based on published financial sources.

	2011			2010		
	Market Price		Quarterly	Market Price		Quarterly
	High	**Low**	**Dividend**	**High**	**Low**	**Dividend**
First quarter	**$ 28.48**	**$ 24.37**	**$ 0.23**	$ 36.50	$ 24.92	$ 0.22
Second quarter	**29.50**	**22.94**	**0.23**	26.64	20.45	0.22
Third quarter	**27.11**	**12.00**	**0.23**	24.59	20.00	0.225
Fourth quarter	**13.87**	**7.90**	**0.00**	27.95	22.82	0.225
			$0.69			$ 0.89

In October 2011, the Company announced it had discontinued its quarterly dividend, as a result of regulatory guidance indicating that the dividend application would not be approved. There can be no assurances as to whether, or in what amounts, cash dividends will be declared in the future or, if declared, whether they will continue, be suspended or discontinued. See Note 15, Restrictions on Dividends, Loans and Advances, in the Notes to Consolidated Financial Statements included in Item 8 hereof for a description of the restrictions on the payment of dividends which description is incorporated by reference herein.

Issuer Purchases of Equity Securities

On April 27, 2006, Orrstown Financial Services, Inc. announced a Stock Repurchase Plan approving the purchase of up to 150,000 shares as conditions allow. 106,999 shares were repurchased pursuant to that program. On September 23, 2010, Orrstown Financial Services, Inc. announced an extension of the Stock Repurchase Plan authorizing the repurchase of an additional 150,000 shares, including the 43,001 shares remaining to be purchased under the plan as originally approved. The plan may be suspended at any time without prior notice and has no prescribed time limit in which to fill the authorized repurchase amount. The maximum number of shares that may yet be purchased under the plan is 189,694 shares at December 31, 2011. The Company has recently suspended our Stock Repurchase Plan based on regulatory requirements and we do not anticipate being able to resume repurchases in the near future.

For the quarter ending December 31, 2011, there were no repurchases of common equity securities by the Company under the announced Stock Repurchase Plan.

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PERFORMANCE GRAPH

The following graph shows a five-year comparison of the cumulative total return on the Company s common stock as compared to other indexes: the SNL index of banks with assets between $1 billion and $5 billion, the S&P 500 Index, and the NASDAQ Composite index. Shareholder returns on the Company s common stock are based upon trades on the NASDAQ Stock Market. The shareholder returns shown in the graph are not necessarily indicative of future performance.

Orrstown Financial Services, Inc.

	Period Ending					
Index	**12/31/06**	**12/31/07**	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**
Orrstown Financial Services, Inc.	100.00	88.34	81.83	108.87	88.55	27.51
SNL Bank $1B-$5B	100.00	72.84	60.42	43.31	49.09	44.77
S&P 500	100.00	105.49	66.46	84.05	96.71	98.76
NASDAQ Composite	100.00	110.66	66.42	96.54	114.06	113.16

In accordance with the rules of the SEC, this section captioned Performance Graph shall not be incorporated by reference into any of our future filings made under the Exchange Act or the Securities Act of 1933, as amended (the Securities Act). The Performance Graph and its accompanying table are not deemed to be soliciting material or to be filed under the Exchange Act or the Securities Act.

Recent Sales of Unregistered Securities

The Company has not sold any securities within the past three years which were not registered under the Securities Act.

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ITEM 6 SELECTED FINANCIAL DATA

(Dollars in thousands)	Year Ended December 31, 2011	2010	2009	2008	2007
Summary of Operations					
Interest income	**$ 60,361**	$ 58,423	$ 53,070	$ 52,313	$ 53,106
Interest expense	**10,754**	12,688	16,500	19,408	22,986
Net interest income	**49,607**	45,735	36,570	32,905	30,120
Provision for loan losses	**58,575**	8,925	4,865	1,450	750
Net interest income after provision for loan losses	**(8,968)**	36,810	31,705	31,455	29,370
Securities gains (losses)	**6,224**	3,636	1,661	(27)	58
Other operating income	**20,396**	19,340	15,549	15,322	13,186
Goodwill impairment charge	**19,447**	0	0	0	0
Other operating expenses (excluding goodwill impairment charge)	**41,032**	36,735	31,492	28,165	24,859
Income (loss) before income taxes (benefit)	**(42,827)**	23,051	17,423	18,585	17,755
Income tax expense (benefit)	**(10,863)**	6,470	4,050	5,482	5,197
Net income (loss)	**$ (31,964)**	$ 16,581	$ 13,373	$ 13,103	$ 12,558
Net income (loss) excluding goodwill impairment charge	**$ (12,968)**	$ 16,581	$ 13,373	$ 13,103	$ 12,558
Per Common Share Data*					
Net income (loss)	**$ (3.98)**	$ 2.18	$ 2.09	$ 2.04	$ 1.95
Diluted net income (loss)	**(3.98)**	2.17	2.07	2.03	1.94
Diluted net income (loss) excluding goodwill impairment charge	**(1.62)**	2.17	2.07	2.03	1.94
Cash dividend paid	**0.69**	0.89	0.88	0.87	0.82
Book value at December 31	**15.92**	20.10	17.21	16.18	14.97
Tangible book value at December 31	**15.79**	17.50	13.96	12.87	11.64
Average shares outstanding basic	**8,017,307**	7,609,933	6,406,106	6,421,022	6,428,853
Average shares outstanding diluted	**8,026,726**	7,637,824	6,458,752	6,466,391	6,480,710
Stock Price Statistics*					
Close	**$ 8.25**	$ 27.41	$ 34.88	$ 27.00	$ 30.00
High	**29.50**	36.50	40.00	33.96	36.19
Low	**7.90**	20.00	22.00	27.00	28.00
Price earnings ratio at close	**(2.1)**	12.6	16.7	13.2	15.4
Diluted price earnings ratio at close	**(2.1)**	12.6	16.8	13.3	15.5
Price to book at close	**0.5**	1.4	2.0	1.7	2.0
Price to tangible book at close	**0.5**	1.6	2.5	2.1	2.6
Year-End Balance Sheet Data					
Total assets	**$ 1,444,097**	$ 1,511,722	$ 1,196,432	$ 1,051,783	$ 884,979
Total loans	**967,993**	966,986	881,074	820,468	701,964
Total investment securities	**322,123**	440,570	204,309	128,353	96,355
Deposits noninterest bearing	**111,930**	104,646	90,676	84,261	91,365
Deposits interest bearing	**1,104,972**	1,083,731	824,494	673,107	554,991
Total deposits	**1,216,902**	1,188,377	915,170	757,368	646,356
Repurchase agreements	**15,013**	87,850	64,614	63,407	55,580
Borrowed money	**73,798**	65,178	64,858	118,887	78,453
Total shareholders equity	**128,197**	160,484	110,886	103,347	96,124

Trust assets under management market value	**947,273**	929,327	740,028	599,320	755,314
Performance Statistics					
Average equity / average assets	**10.36%**	10.76%	9.55%	10.45%	10.98%
Return on average equity	**(20.33)%**	11.22%	12.48%	13.20%	13.64%
Return on average tangible equity	**(9.17)%**	13.19%	15.73%	17.02%	18.02%
Return on average assets	**(2.11)%**	1.21%	1.19%	1.38%	1.50%
Return on average tangible assets	**(0.86)%**	1.23%	1.23%	1.43%	1.56%

** Per share amounts have been restated to reflect a 5% stock dividend paid June 15, 2007.

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Supplemental Reporting of Non-GAAP-Based Financial Measures

Net income (loss) excluding impairment charges, and the related net income (loss) per share impact, are non-GAAP based financial measures. Management feels they are a more accurate comparison of year to year performance that excludes the effect of the non-cash goodwill impairment charge. Management utilizes net income (loss) excluding impairment charge and related per share impact, as it is believed to better reflect the sustainable operating performance of the Company. A reconciliation of net income (loss) to net income (loss) excluding impairment charge follows:

	Year Ended December 31,				
(Dollars in thousands, except per share data)	**2011**	**2010**	**2009**	**2008**	**2007**
Net income (loss) (GAAP basis)	**$ (31,964)**	$ 16,581	$ 13,373	$ 13,103	$ 12,558
Effect of goodwill impairment charge, net of tax	**18,996**	0	0	0	0
Net income (loss) excluding goodwill impairment charge, net of tax	**$ (12,968)**	$ 16,581	$ 13,373	$ 13,103	$ 12,558

Return on average tangible assets and return on average tangible equity are also non-GAAP-based financial measures calculated using non-GAAP-based amounts. The most directly comparable measure is return on average assets and return on average equity, which are calculated using GAAP-based amounts. The Company calculates the return on average tangible assets and equity by excluding the balance of intangible assets and their related amortization expense from the calculation of return on average assets and equity. Management uses returns on average tangible assets and equity to assess the Company s core operating results and believes that they are better measures of our operating performance as they are based on the Company s tangible assets and capital. Further we believe that by excluding the impact of purchase accounting adjustments it allows for a meaningful comparison with the Company s peers, particularly those that may not have acquired other companies. In addition, this is consistent with the treatment by bank regulatory agencies, which exclude goodwill and other intangible assets from the calculation of risk-based capital ratios. However, these non-GAAP financial measures are supplemental and are not a substitute for an analysis based on GAAP measures. A reconciliation of return on average assets and equity to the return on average tangible assets and equity, respectively, is set forth below.

	Year Ended December 31,				
	2011	**2010**	**2009**	**2008**	**2007**
Return on average assets (GAAP basis)	**(2.11)%**	1.21%	1.19%	1.38%	1.50%
Effect of excluding average intangible assets and related amortization, net of tax	**1.25%**	0.02%	0.04%	0.05%	0.06%
Return on average tangible assets	**(0.86)%**	1.23%	1.23%	1.43%	1.56%
Return on average equity (GAAP basis)	**(20.33)%**	11.22%	12.48%	13.20%	13.64%
Effect of excluding average intangible assets and related amortization, net of tax	**11.16%**	1.97%	3.25%	3.82%	4.38%
Return on average tangible equity	**(9.17)%**	13.19%	15.73%	17.02%	18.02%

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Tangible book value, another non-GAAP financial measure, is computed by dividing shares outstanding into tangible common equity. Management uses tangible book value per share because it believes such ratio is useful in understanding the Company s capital position and ratios. A reconciliation of book value per share to tangible book value per share is set forth below.

	Year Ended December 31,				
(Dollars in thousands, except per share data)	2011	2010	2009	2008	2007
Shareholders equity	**$ 128,197**	$ 160,484	$ 110,886	$ 103,347	$ 96,124
Less: Intangible assets	**1,041**	20,698	20,938	21,186	21,368
Tangible equity	**$ 127,156**	$ 139,786	$ 89,948	$ 82,161	$ 74,756
Book value per share	**$ 15.92**	$ 20.10	$ 17.21	$ 16.18	$ 14.97
Less: Intangible assets per share	**0.13**	2.60	3.25	3.31	3.33
Tangible book value per share	**$ 15.79**	$ 17.50	$ 13.96	$ 12.87	$ 11.64

Tax-equivalent net interest income is also a non-GAAP financial measure. Tax-equivalent net interest income is derived from GAAP interest income and net interest income using an assumed tax rate of 35%. We believe the presentation of net interest income on a tax equivalent basis ensures comparability of net interest income arising from both taxable and tax-exempt sources and is consistent with industry practice.

The following reconciles net interest income to net interest income on a fully taxable equivalent basis for the years ended December 31:

(Dollars in Thousands)	2011	2010	2009
Net interest income, tax equivalent basis	**$ 52,412**	$ 47,676	$ 37,848
Effect of tax exempt income	**(2,805)**	(1,941)	(1,278)
Net interest income	**$ 49,607**	$ 45,735	$ 36,570

ITEM 7 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The following is a discussion of our consolidated financial condition and results of operations for each of the three years ended December 31, 2011, 2010 and 2009. The following discussion and analysis should be read in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements presented in this report to assist in the evaluation of the Company s 2011 performance. Certain prior period amounts presented in this discussion and analysis have been reclassified to conform to current period classifications.

Important Factors Relating to Forward Looking Statements

This report contains statements that are considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. In addition, the Company may make other written and oral communications, from time to time, that contain such statements. Forward-looking statements, including statements as to industry trends, future expectations and other matters that do not relate strictly to historical facts, are based on certain assumptions by management, and are often identified by words or phrases such as anticipated , believe , expect , intend , seek , plan , objective , trend , and goal . Forward-looking statements are subject to various assumptions, risks, and un which change over time, and speak only as of the date they are made.

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In addition to factors mentioned elsewhere in this Report or previously disclosed in our SEC reports (accessible on the SEC s website at www.sec.gov or on our website at www.orrstown.com), the following factors, among others, could cause actual results to differ materially from forward-looking statements and future results could differ materially from historical performance:

- general political and economic conditions may be less favorable than expected;
- developments concerning credit quality in various corporate lending industry sectors as well as consumer and other types of credit, may result in an increase in the level of our provision for credit losses, nonperforming assets, net charge-offs and reserve for credit losses;
- customer borrowing, repayment, investment, and deposit practices generally may be less favorable than anticipated; and interest rate and currency fluctuations, equity and bond market fluctuations, and inflation may be greater than expected;
- changes in interest rates or the mix of interest rates and maturities of our interest earning assets and interest bearing liabilities (primarily loans and deposits) may be less favorable than expected;
- competitive product and pricing pressures among financial institutions within our markets may increase;
- legislative or regulatory developments, including changes in laws or regulations concerning taxes, banking, securities, capital requirements and risk-based capital guidelines, reserve methodologies, deposit insurance and other aspects of the financial services industry, may adversely affect the businesses in which we are engaged or our financial results;
- legal and regulatory proceedings, included changes resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act and related matters with respect to the financial services industry, including those directly involving the Company and its subsidiaries, could adversely affect the Company or the financial services industry generally;
- pending and proposed changes in accounting rules, policies, practices, and procedures could adversely affect our financial results;
- instruments and strategies used to manage exposure to various types of market and credit risk could be less effective than anticipated, and we may not be able to effectively mitigate our risk exposures in particular market environments or against particular types of risk;
- terrorist activities or other hostilities, including the situation surrounding Iraq, may adversely affect the general economy, financial and capital markets, specific industries, and the Company; and
- technological changes may be more difficult or expensive than anticipated.

The Company undertakes no obligation to update any forward-looking statements. Actual results could differ materially from those anticipated in forward-looking statements and future results could differ materially from historical performance.

Critical Accounting Policies

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP) and follow general practices within the financial services industry in which it operates. Management, in order to prepare the Company s consolidated financial statements, is required to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the balance sheet date through the date the financial statements are filed with the SEC. As this information changes, the consolidated financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than

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originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources.

The most significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, the Company has identified the adequacy of the allowance for loan losses, evaluation of goodwill for potential impairment, and accounting for income taxes as critical accounting policies.

The allowance for loan losses represents Management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheet.

Goodwill has been recorded on the books of the Company in connection with its acquisitions. Goodwill is reviewed for potential impairment on an annual basis, or more often if events or circumstances indicate that there may be impairment. Goodwill is tested for impairment at the reporting unit level and an impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. Various market valuation methodologies are used to determine the fair value of the reporting unit. If the fair value of the reporting units exceeds its book values, no write-downs of recorded goodwill are necessary. If the fair value of the reporting unit is less than its book value, an impairment expense may be required to be recorded to write down the related goodwill to the proper carrying value. As a result of the Company s annual goodwill testing, the Company recorded a non-cash goodwill impairment charge of $19,447,000 during the quarter ended December 31, 2011, which resulted from several factors, the most prominent being decreases in trading multiples of the Company s common stock, overall valuations of comparable organizations, a deterioration in asset quality of the commercial real estate portfolio, and the negative impact of deteriorating asset quality on expected cash flows.

The Company recognizes deferred tax assets and liabilities for the future effects of temporary differences and tax credits. Enacted tax rates are applied to cumulative temporary differences based on expected taxable income in the periods in which the deferred tax asset or liability is anticipated to be realized. Future tax rate changes could occur that would require the recognition of income or expense in the statement of operations in the period in which they are enacted. Deferred tax assets must be reduced by a valuation allowance if in management s judgment it is more likely than not that some portion of the asset will not be realized. Management may need to modify their judgments in this regard from one period to another should a material change occur in the business environment, tax legislation, or in any other business factor that could impair the Company s ability to benefit from the asset in the future. As of December 31, 2011, Management has concluded that a valuation allowance is not needed on its net deferred tax asset.

Readers of the consolidated financial statements should be aware that the estimates and assumptions used in the Company s current financial statements may need to be updated in future financial presentations for changes in circumstances, business or economic conditions in order to fairly represent the condition of the Company at that time.

Corporate Profile and Significant Developments

The Company is a financial holding company headquartered in Shippensburg, Pennsylvania with consolidated assets of $1,444,097,000 at December 31, 2011. The consolidated financial information presented herein reflects the Company and its wholly-owned commercial bank subsidiary, the Bank.

The Bank, with total assets of $1,440,781,000 at December 31, 2011, is a Pennsylvania chartered commercial bank with 21 offices. Twenty of those offices are located in Pennsylvania and one in Maryland. On May 21, 2006, the Company acquired The First National Bank of Newport, located in Perry County, Pennsylvania. On June 15, 2007, The First National Bank of Newport was merged into the Bank. The Bank s deposit services include a variety of checking, savings, time and money market deposits along with related debit card and merchant services. Lending services include commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Orrstown Financial Advisors, a division of the Bank, offers a diverse line of financial services to our customers, including, but not limited to, brokerage, mutual funds, trusts, estate planning, investments and insurance products. At December 31, 2011, approximately $947,273,000 of assets under management were serviced by Orrstown Financial Advisors.

Economic Climate, Inflation and Interest Rates

During 2008, the U.S. economy faced significant challenges resulting in an overall economic downturn. Poor economic conditions, which were initially evident within the residential housing market beginning in 2007, spread throughout most sectors of the economy in 2008. The economic malaise has continued through 2011.

The majority of the assets and liabilities of a financial institution are monetary in nature, and therefore, differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation does have an impact on the growth of total assets and on noninterest expenses, which tend to rise during periods of general inflation. Inflationary pressures over the last five years have been modest, although the potential for future inflationary pressure is present given changing trends in the economy.

As the Company s balance sheet consists primarily of financial instruments, interest income and interest expense is greatly influenced by the interest rates and the slope of the interest rate curve. During the five years presented in this financial statement review, interest rates were relatively high when the economy was perceived as strong; however, as the national and local economy began experiencing financial difficulties and higher levels of unemployment, rates decreased quickly. One example of this is the prime lending rate, which reached a high during the five-year period of 8.25% in September 2007. However, the prime lending rate was reduced 500 basis points over a 15 month period, coinciding with the country s economic struggles, and ended 2008 with a published prime lending rate of 3.25%. The published prime lending rate remained at 3.25% at December 31, 2011. Management recognizes that asset/liability management, including the effect of rate changes on interest earning assets and interest bearing liabilities, is of critical importance.

Despite the challenging economic conditions during 2010 and into 2011, the Company believes it is positioned to withstand these conditions through its strong capital and liquidity positions, high quality loan and debt securities portfolios and prudent management of credit and interest rate risk.

Results of Operations

Summary

For the year ended December 31, 2011, the Company incurred a net loss of $31,964,000, compared to net income of $16,581,000 and $13,373,000 in 2010 and 2009, resulting in diluted earnings (loss) per share of ($3.98), $2.17 and $2.07 for the years 2011, 2010 and 2009. As a result of the net loss for 2011, the Company s return on assets and return on tangible equity ratios were negative for the year, compared to 1.21% and 13.19% respectively for 2010, and 1.19% and 15.73% in 2009. Net loss excluding goodwill impairment, net of tax, was $12,968,000 for the year ended December 31, 2011, and diluted loss per share excluding goodwill impairment charge was $1.62 for the period.

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In addition to the nonrecurring goodwill impairment charge, the Company s performance for the year was also negatively affected by a significantly elevated level of the provision for loan losses which totaled $58,575,000 for the year ended December 31, 2011 compared to $8,925,000 and $4,865,000 recorded in 2010 and 2009. The increase in risk assets experienced in 2011, which include nonaccrual loans, restructured loans and real estate owned, resulted in increases in staff to work through these assets and mitigate the Company s risk of loss, as well as other noninterest expenses. The Company was able to increase its net interest income to $49,607,000 for the year ended December 31, 2011, compared to $45,735,000 and $36,570,000 in 2010 and 2009, however this increase was not sufficient to offset the goodwill impairment charge and the elevated provision for loan losses.

Net Interest Income

The primary component of the Company s revenue is net interest income, which is the difference between interest income and fees on interest-earning assets and interest expense on interest-bearing liabilities. Earning assets include loans, securities and federal funds sold. Interest bearing liabilities include deposits and borrowed funds. To compare the tax-exempt yields to taxable yields, amounts are adjusted to pretax equivalents based on a 35% federal corporate tax rate.

Net interest income is affected by changes in interest rates, volumes of interest-earning assets and interest-bearing liabilities and the composition of those assets and liabilities. The net interest spread and net interest margin (NIM) are two common statistics related to changes in net interest income. The net interest rate spread represents the difference between the yields earned on interest-earning assets and the rates paid for interest-bearing liabilities. The net interest margin is defined as the ratio of net interest income to average earning assets. Through the use of demand deposits and stockholders equity, the net interest margin exceeds the net interest rate spread, as these funding sources are non-interest bearing.

The Analysis of Net Interest Income table presents net interest income on a fully taxable equivalent basis, net interest rate spread and net interest margin for the years ending December 31, 2011, 2010 and 2009. The Changes in Taxable Equivalent Net Interest Income table below analyzes the changes in net interest income for the same periods broken down by their rate and volume components.

2011 versus 2010

For the year ended December 31, 2011 net interest income, measured on a fully tax equivalent basis, increased $4,736,000, or 9.9%, to $52,412,000 from $47,676,000 in 2010. The primary reason for the increase in net interest income was an increase in average earning assets from $1,280,530,000 in 2010 to $1,432,991,000 in 2011. Slightly offsetting the growth in volume was a decrease in net interest margin (NIM) of 7 basis points, from 3.73% in 2010 to 3.66% for 2011. As summarized on the rate/volume table, $5,796,000 of the growth in net interest income was achieved from volume, offset by a decrease of $1,060,000 attributable to the decrease in NIM.

The largest portion of the increase in interest income was the result of interest earned on the securities portfolio, which totaled $12,906,000 for the year ended December 31, 2011, an increase of $1,979,000, or 18.1%, over 2010. Year-over-year, average securities increased $52,205,000, or 15.2%. Supplementing the increase on securities earnings due to volume was an increase in the interest rate earned of 3.17% in 2010 to 3.26% in 2011. The higher yield on securities despite a generally lower interest rate environment was the result of the mix of the securities, in which a greater proportion of securities was invested in tax-exempt securities, which generally yield higher returns on a tax equivalent basis. In the fourth quarter of 2011, the Company has experienced contraction in the yield earned on securities, which totaled 3.04% for the period, less than the 3.26% average earned in 2011. Management anticipates a lower yield in 2012 as interest rates are forecasted to remain low, and as securities mature, they will be reinvested at lower rates.

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The growth in securities was funded principally through the growth in money market and time deposit accounts. Average interest bearing deposits increased $120,089,000, or 10.7%, resulting from the Company s overall customer service model, its market position in several attractive markets, and due to the favorable rating the Bank has received from IDC Financial Publishing, Inc. (IDC), an independent bank safety rating agency which uses its unique rankings of financial ratios to determine the quality ratings of financial institutions. This favorable rating facilitated the Company s ability to attract time deposits and brokered deposits, particularly in the first half of the year. Despite an increase in the average balance of time deposits of $64,653,000 for the year ended December 31, 2011 compared to 2010, the total interest expense was lowered by $480,000. The average volume resulted in an increase of interest expense of $1,015,000, which was more than offset by the decrease in interest expense of $1,495,000 that resulted from a 26 basis points decrease in the yield paid on time deposits from 2010 to 2011. The Company recognizes that brokered funds are a more volatile funding source than core deposits. However, given the current interest rate environment and the steepness of the interest rate curve, the Company elected to collect these funds and earn a spread on them in order to enhance net interest income. Given the increased volatility in brokered deposits, the Company invested a large portion of these amounts in mortgage-backed securities, which provide a regular stream of monthly cash flows, which can be used to meet the maturity needs of time and brokered deposits. We have matched cash flows from the debt securities portfolio with brokered deposits to enable us to unwind the strategy if loan demand increased or if the yield curve flattens. As a result of the recent regulatory climate related to nontraditional funding sources, management anticipates it will not utilize brokered deposits as heavily in the future, and we anticipate that brokered deposits will decline, which will likely result in a decline in the securities portfolio as well.

The year-over-year growth in the loan portfolio also contributed to the increase in net interest income. Year-over-year, average loans increased $83,430,000, or 9.2%, from the year ended December 31, 2010 to December 31, 2011. The growth experienced in the loan portfolio in the second half of 2010, supplemented with the loan demand in the first quarter of 2011, provided the strong growth in average loan balances. This growth has come principally in some of the Company s less mature markets, in which we have hired additional lending officers, which has increased opportunities for growth in these markets served. In light of deteriorating asset quality conditions during the second half of 2011 however, the Company curbed its loan growth in order to address and enhance credit administration and underwriting processes and procedures, and at year-end, loan growth remained flat on a year-over-year basis. The $83,430,000 growth in average balances of loans contributed $4,686,000 in additional interest income in 2011 compared to 2010. However, the rate earned on loans of 5.04% was 38 basis points less than in 2010, and offset interest income by $3,885,000 resulting in a net increase of $801,000 for the year. The lower yield earned on loans was the result of several factors, including generally a lower interest rate environment in 2011 than 2010, greater number of loans on nonaccrual status, and approximately $261,000 that was earned in 2011 on the Company s floating for fixed rate interest rate swaps that was included in interest income, compared to $778,000 in 2010. During 2011, the Company settled its outstanding floating for fixed rate swaps which qualified as cash flow hedges, and negatively impacted loan yields. Due to the variable nature of a large portion of the loan portfolio, along with the implementation of floors as loans renewed, the Company was able to limit the decline in the average rate earned on loans. Management does not expect it will continue to experience the same level of growth in loans that it did in 2010 and the beginning of 2011, given competitive conditions and the regulatory climate. The increase in the Company s nonaccrual loan balances will also put continued pressure on the rate earned on loans in 2012.

As noted above, the Company has been able to increase its deposit base. Part of the increase in the average balance in deposits was the result of certain customers, whose accounts migrated from repurchase agreements and were previously included as short-term borrowings in the balance sheet. These deposits continue to be secured through pledged securities, however, due to regulatory pressure related to non-traditional funding sources, which include repurchase agreements, we enhanced our interest bearing demand product to have them migrate to a funding source viewed as more traditional. This strategy resulted in a decline in the average balance of short-term borrowings from $91,872,000 for the year ended December 31, 2010 to $63,271,000, which resulted in lower interest expense of $152,000 on a year over year basis, while a slight decline in rates paid of 53 basis points to 50 basis points between the two periods also resulted in $21,000 of the lower interest expense.

The Company has placed less reliance on more costly long-term borrowings in 2011 as compared to 2010. As a result, interest expense on long-term debt decreased $447,000 from $1,519,000 for the year ended December 31, 2010 to $1,072,000 in 2011. Reduction in average daily balance of $9,578,000 for 2011 compared to 2010 reduced interest expense by $280,000, and the reduction in the rate paid on long-term borrowing of 40 basis points reduced interest expense by $167,000.

Generally lower interest rates for the year ended December 31, 2011 compared to 2010, combined with an increase in nonaccrual loans, has resulted in the Company experiencing declines in net interest spread and net interest margin. Despite the low interest rate environment, the Company has been able to manage its blend of interest earning assets and liabilities so that the net interest margin has only declined marginally, from 3.73% for the year ended December 31, 2010 to 3.66% in 2011, which included the lowering of its overall cost of funds. The average rates earned on assets was 4.41% for the year ended December 31, 2011 compared to 4.71% in 2010, whereas the rates paid on interest bearing liabilities declined from 0.98% in 2010 to 0.75% in 2011. This resulted in a net interest rate spread of 3.54% in 2011 compared to 3.57% in 2010.

2010 versus 2009

For the year ended December 31, 2010 net interest income, measured on a full tax equivalent basis, increased $9,828,000, or 26.0%, to $47,676,000 from $37,848,000 in 2009. The primary reason for the increase in net interest income was an increase in average earning assets from $1,033,105,000 in 2009 to $1,280,530,000 in 2010. Supplementing the growth in volume was an increase in net interest margin of 7 basis points, from 3.66% in 2009 to 3.73% for 2010. As summarized on the rate/volume table, $7,338,000 of the growth in net interest income was achieved from volume, and $2,490,000 was achieved through an increase in net interest margin.

The largest portion of the increase in interest income was the result of interest earned on the securities portfolio, which totaled $10,927,000 for the year ended December 31, 2010, an increase of $4,861,000, or 80%, over 2009. Year-over-year, average securities increased $181,344,000, or 111%. Partially offsetting the increase on securities earnings due to volume was a reduction in the average interest rate earned from 3.72% in 2009 to 3.17% in 2010.

The growth in the securities portfolio was funded principally through the growth in money market and time deposit accounts. Average interest bearing deposits increased $201,216,000, or 22.0%, resulting from the Company s overall customer service model, its market position in several attractive markets, and due to the Bank s favorable IDC rating. Despite an increase in the average balance of time deposits of $145,349,000 for the year ended December 31, 2010 compared to 2009, the total interest expense was lowered by $1,108,000. The average volume increase resulted in an increase of interest expense of $3,635,000, which was more than offset by the $4,743,000 decrease in interest expense that resulted from a decrease in the average rate paid on time deposits, of 93 basis points from 2009 to 2010. The Company recognizes that brokered funds are more volatile funding source than core deposits.

The growth in the loan portfolio also contributed to the increase in net interest income. Year-over-year, average loans increased $61,676,000, or 7.3%, from the year ended December 31, 2009 to December 31, 2010. The increase in average loans was the result of the Company s desire to continue to grow its loan portfolio and deploy its capital. This growth came principally in some of the Company s less mature markets, in which we have hired additional lending officers, which has increased opportunities in these markets served. The growth experienced in the loan portfolio was achieved primarily in the second half of the year, in which approximately two-thirds of the 2010 growth was achieved. The $61,676,000 growth in average balance in loans contributed $3,600,000 in additional interest income in 2010 compared to 2009. However, the rate earned on loans of 5.42% was 26 basis points less than in 2009, resulting in a decrease in interest income by $2,492,000. The Company continued to have $30,000,000 in notional amount of interest rate swaps which serve as a hedge against variable

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rate commercial loans linked to prime and converts them to a fixed rate of interest. The interest rate swaps that the Company had outstanding during 2010 yielded $778,000, which was credited and included as commercial loan interest income.

The Company had been able to increase its deposit base. As a result, less reliance had been placed on more costly long-term borrowings. Interest expense on long-term debt has decreased $2,065,000 from $3,584,000 for the year ended December 31, 2009 to $1,519,000 in 2010. Reduction in average daily balance of long term debt of $48,458,000 for 2010 compared to 2009 reduced interest expense by $1,731,000, and the reduction in the rate paid on long-term borrowing of 64 basis points reduced interest expense by $334,000.

The growth that the Company had experienced, and its ability to lower its cost of funding by an amount greater than its reduction in rates earned on interest-earning assets, resulted in a slight improvement in both the interest rate spread and net interest margin. While the average rates earned on assets was 4.71% for the year ended December 31, 2010 compared to 5.26% in 2009, the average rate paid on interest bearing liabilities declined from 1.60% in 2009 to 0.98% in 2010. This resulted in a net interest rate spread of 3.57% in 2010 compared to 3.46% in 2009.

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ANALYSIS OF NET INTEREST INCOME

The following table presents interest income on a fully taxable equivalent basis, net-interest spread and net interest margin for the years ended December 31:

	2011			2010			2009		
(Dollars in thousands)	**Average Balance**	**Tax Equivalent Interest**	**Tax Equivalent Rate**	**Average Balance**	**Tax Equivalent Interest**	**Tax Equivalent Rate**	**Average Balance**	**Tax Equivalent Interest**	**Tax Equivalent Rate**
Assets									
Federal funds sold and interest bearing bank balances	**$ 42,690**	**$ 138**	**0.32%**	$ 25,864	$ 116	0.45%	$ 21,459	$ 69	0.32%
Taxable securities	**318,185**	**8,334**	**2.62**	290,328	7,744	2.67	135,851	4,260	3.14
Tax-exempt securities	**78,288**	**4,572**	**5.84**	53,940	3,183	5.90	27,073	1,806	6.67
Total securities	**396,473**	**12,906**	**3.26**	344,268	10,927	3.17	162,924	6,066	3.72
Taxable loans	**940,063**	**46,680**	**4.97**	874,226	46,958	5.37	822,054	46,370	5.64
Tax-exempt loans	**53,765**	**3,442**	**6.40**	36,172	2,363	6.53	26,668	1,843	6.91
Total Loans	**993,828**	**50,122**	**5.04**	910,398	49,321	5.42	848,722	48,213	5.68
Total interest-earning assets	**1,432,991**	**63,166**	**4.41**	1,280,530	60,364	4.71	1,033,105	54,348	5.26
Cash and due from banks	**13,577**			13,230			13,950		
Bank premises and equipment	**27,404**			28,662			30,382		
Other assets	**68,569**			65,157			51,973		
Allowance for loan losses	**(24,773)**			(13,562)			(7,618)		
Total	**$ 1,517,768**			$ 1,374,017			$ 1,121,792		
Liabilities and Shareholders Equity									
Interest bearing demand deposits	**$ 486,793**	**$ 1,710**	**0.35%**	$ 400,474	$ 2,517	0.63	$ 307,968	$ 3,171	1.03
Savings deposits	**71,059**	**140**	**0.20**	63,763	167	0.26	60,494	204	0.34
Time deposits	**574,079**	**7,518**	**1.31**	509,426	7,998	1.57	364,077	9,106	2.50
Short-term borrowings	**63,271**	**314**	**0.50**	91,872	487	0.53	83,322	435	0.52
Long- term debt	**42,308**	**1,072**	**2.53**	51,886	1,519	2.93	100,344	3,584	3.57
Total interest bearing liabilities	**1,237,510**	**10,754**	**0.87**	1,117,421	12,688	1.14	916,205	16,500	1.80
Demand deposits	**113,157**			99,636			89,797		
Other	**9,901**			9,229			8,652		
Total Liabilities	**1,360,568**			1,226,286			1,014,654		
Shareholders Equity	**157,200**			147,731			107,138		
Total	**$ 1,517,768**		**0.75%**	$ 1,374,017		0.98%	$ 1,121,792		1.60%
Net interest income (FTE)/net interest spread		**52,412**	**3.54**		47,676	3.57		37,848	3.46
Net interest margin			**3.66%**			3.73%			3.66%
Tax-equivalent adjustment		**(2,805)**			(1,941)			(1,278)	