

ORRSTOWN FINANCIAL SERVICES INC  
Form 10-Q  
August 09, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 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)

**Commonwealth of Pennsylvania**  
(State or other jurisdiction of

**23-2530374**  
(I.R.S. Employer

incorporation or organization)

Identification No.)

**77 East King Street, P.O. Box 250, Shippensburg, Pennsylvania**  
(Address of principal executive offices)

**17257**  
(Zip Code)

**(717) 532-6114**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

As of August 1, 2011, 8,017,392 shares of common stock, no par value, of the registrant were outstanding.

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

**ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY**

## Consolidated Balance Sheets (Unaudited)

| <i>(Dollars in Thousands, Except per Share Data)</i>   | <b>June 30,<br/>2011</b> | December 31,<br>2010 |
|--|--------------------------|----------------------|
| <b>Assets</b>  |                          |                      |
| Cash and due from banks  | \$ 14,470                | \$ 10,400            |
| Federal funds sold   | 2,230                    | 8,800                |
| Cash and cash equivalents  | 16,700                   | 19,200               |
| Short-term investments   | 2,728                    | 2,728                |
| Interest bearing deposits with banks   | 3,585                    | 925                  |
| Restricted investments in bank stock   | 9,331                    | 8,798                |
| Securities available for sale  | 421,073                  | 431,772              |
| Loans held for sale  | 4,945                    | 2,693                |
| Loans  | 999,033                  | 964,293              |
| Less: Allowance for loan losses  | (27,212)                 | (16,020)             |
| Net loans  | 976,766                  | 950,966              |
| Premises and equipment, net  | 27,340                   | 27,774               |
| Cash surrender value of life insurance   | 23,670                   | 22,649               |
| Goodwill and intangible assets   | 20,593                   | 20,698               |
| Accrued interest receivable  | 5,685                    | 5,715                |
| Other assets   | 23,819                   | 20,497               |
| <b>Total assets</b>  | <b>\$ 1,531,290</b>      | <b>\$ 1,511,722</b>  |
| <b>Liabilities</b>   |                          |                      |
| Deposits:  |                          |                      |
| Non-interest bearing   | \$ 112,495               | \$ 104,646           |
| Interest bearing   | 1,147,711                | 1,083,731            |
| Total deposits   | 1,260,206                | 1,188,377            |
| Short-term borrowings  | 62,878                   | 87,850               |
| Long-term debt   | 44,753                   | 65,178               |
| Accrued interest and other liabilities   | 10,012                   | 9,833                |
| <b>Total liabilities</b>   | <b>1,377,849</b>         | <b>1,351,238</b>     |
| <b>Shareholders Equity</b>   |                          |                      |
| Preferred stock \$1.25 par value per share; 500,000 shares authorized; no shares issued or outstanding | 0                        | 0                    |

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|  |                     |                     |
|--|---------------------|---------------------|
| Common stock, no par value - \$0.05205 stated value per share; 50,000,000 shares authorized; 8,014,722 and 7,986,966 shares issued; 8,013,910 and 7,985,667 shares outstanding | 417                 | 416                 |
| Additional paid-in capital   | 121,962             | 121,508             |
| Retained earnings  | 28,207              | 38,680              |
| Accumulated other comprehensive income (loss)  | 2,875               | (88)                |
| Treasury stock - common, 812 and 1,299 shares, at cost   | (20)                | (32)                |
| <b>Total shareholders equity</b>   | <b>153,441</b>      | <b>160,484</b>      |
| <b>Total liabilities and shareholders equity</b>   | <b>\$ 1,531,290</b> | <b>\$ 1,511,722</b> |

*The Notes to Consolidated Financial Statements are an integral part of these statements.*

**Table of Contents****ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY**

Consolidated Statements of Operations (Unaudited)

|  | <b>Three Months Ended</b> |                 |
|--|---------------------------|-----------------|
|  | <b>June 30,</b>           | <b>June 30,</b> |
|  | <b>2011</b>               | <b>2010</b>     |
| <i>(Dollars in Thousands, Except per Share Data)</i>       |                           |                 |
| <b>Interest and dividend income</b>                        |                           |                 |
| Interest and fees on loans                                 | \$ 12,383                 | \$ 12,205       |
| Interest and dividends on investment securities            |                           |                 |
| Taxable  | 2,364                     | 1,890           |
| Tax-exempt   | 769                       | 408             |
| Short term investments                                     | 21                        | 33              |
| <b>Total interest and dividend income</b>                  | <b>15,537</b>             | <b>14,536</b>   |
| <b>Interest expense</b>                                    |                           |                 |
| Interest on deposits                                       | 2,359                     | 2,747           |
| Interest on short-term borrowings                          | 95                        | 81              |
| Interest on long-term debt                                 | 273                       | 408             |
| <b>Total interest expense</b>                              | <b>2,727</b>              | <b>3,236</b>    |
| <b>Net interest income</b>                                 | <b>12,810</b>             | <b>11,300</b>   |
| Provision for loan losses                                  | 21,230                    | 5,000           |
| <b>Net interest income after provision for loan losses</b> | <b>(8,420)</b>            | <b>6,300</b>    |
| <b>Other income</b>  |                           |                 |
| Service charges on deposit accounts                        | 1,645                     | 1,593           |
| Other service charges, commissions and fees                | 327                       | 633             |
| Trust department income                                    | 1,034                     | 904             |
| Brokerage income   | 484                       | 370             |
| Mortgage banking activities                                | 636                       | 664             |
| Earnings on life insurance                                 | 250                       | 443             |
| Merchant processing fees                                   | 285                       | 288             |
| Other income   | 79                        | 806             |
| Investment securities gains                                | 469                       | 1,781           |
| <b>Total other income</b>                                  | <b>5,209</b>              | <b>7,482</b>    |
| <b>Other expenses</b>                                      |                           |                 |
| Salaries and employee benefits                             | 4,176                     | 4,478           |
| Occupancy and equipment                                    | 477                       | 475             |
| Furniture and equipment                                    | 692                       | 659             |
| Data processing  | 349                       | 309             |
| Telephone  | 165                       | 184             |
| Advertising and bank promotions                            | 296                       | 230             |
| FDIC insurance   | 762                       | 290             |
| Professional services                                      | 546                       | 154             |
| Taxes other than income                                    | 205                       | 222             |
| Intangible asset amortization                              | 53                        | 63              |

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|   |                    |                 |
|---|--------------------|-----------------|
| Other operating expense                   | 2,001              | 1,454           |
| <b>Total other expenses</b>               | <b>9,722</b>       | <b>8,518</b>    |
| Income (loss) before income tax (benefit) | (12,933)           | 5,264           |
| <b>Income tax expense (benefit)</b>       | <b>(2,310)</b>     | <b>1,360</b>    |
| <b>Net income (loss)</b>                  | <b>\$ (10,623)</b> | <b>\$ 3,904</b> |

**Per share information:**

|                                   |           |         |
|-----------------------------------|-----------|---------|
| Basic earnings (loss) per share   | \$ (1.33) | \$ 0.49 |
| Diluted earnings (loss) per share | (1.33)    | 0.49    |
| Dividends per share               | 0.23      | 0.22    |

*The Notes to Consolidated Financial Statements are an integral part of these statements*

**Table of Contents****ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY**

Consolidated Statements of Operations (Unaudited)

|  | Six Months Ended |                 |
|--|------------------|-----------------|
|  | June 30<br>2011  | June 30<br>2010 |
| <i>(Dollars in Thousands, Except per Share Data)</i>       |                  |                 |
| <b>Interest and dividend income</b>                        |                  |                 |
| Interest and fees on loans                                 | \$ 24,818        | \$ 24,044       |
| Interest and dividends on investment securities            |                  |                 |
| Taxable  | 4,459            | 3,436           |
| Tax-exempt   | 1,540            | 776             |
| Short term investments                                     | 45               | 63              |
| <b>Total interest and dividend income</b>                  | <b>30,862</b>    | 28,319          |
| <b>Interest expense</b>                                    |                  |                 |
| Interest on deposits                                       | 4,884            | 5,427           |
| Interest on short-term borrowings                          | 218              | 245             |
| Interest on long-term debt                                 | 562              | 850             |
| <b>Total interest expense</b>                              | <b>5,664</b>     | 6,522           |
| <b>Net interest income</b>                                 | <b>25,198</b>    | 21,797          |
| Provision for loan losses                                  | 24,425           | 6,420           |
| <b>Net interest income after provision for loan losses</b> | <b>773</b>       | 15,377          |
| <b>Other income</b>  |                  |                 |
| Service charges on deposit accounts                        | 3,130            | 3,032           |
| Other service charges, commissions and fees                | 697              | 1,029           |
| Trust department income                                    | 2,046            | 1,664           |
| Brokerage income   | 888              | 743             |
| Mortgage banking activities                                | 1,332            | 1,025           |
| Earnings on life insurance                                 | 580              | 605             |
| Merchant processing fees                                   | 540              | 545             |
| Other income   | 224              | 1,007           |
| Investment securities gains                                | 848              | 2,179           |
| <b>Total other income</b>                                  | <b>10,285</b>    | 11,829          |
| <b>Other expenses</b>                                      |                  |                 |
| Salaries and employee benefits                             | 9,008            | 9,076           |
| Occupancy and equipment                                    | 1,039            | 1,034           |
| Furniture and equipment                                    | 1,373            | 1,260           |
| Data processing  | 661              | 603             |
| Telephone  | 341              | 356             |
| Advertising and bank promotions                            | 554              | 411             |
| FDIC insurance   | 1,312            | 834             |
| Professional services                                      | 868              | 447             |
| Taxes other than income                                    | 410              | 355             |
| Intangible asset amortization                              | 105              | 128             |



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|   |                   |          |
|---|-------------------|----------|
| Other operating expense                   | 3,490             | 2,674    |
| <b>Total other expense</b>                | <b>19,161</b>     | 17,178   |
| Income (loss) before income tax (benefit) | <b>(8,103)</b>    | 10,028   |
| <b>Income tax expense (benefit)</b>       | <b>(1,307)</b>    | 2,718    |
| <b>Net income (loss)</b>                  | <b>\$ (6,796)</b> | \$ 7,310 |

**Per share information:**

|                                   |               |         |
|-----------------------------------|---------------|---------|
| Basic earnings (loss) per share   | \$ (0.85)     | \$ 1.01 |
| Diluted earnings (loss) per share | <b>(0.85)</b> | 1.01    |
| Dividends per share               | <b>0.46</b>   | 0.44    |

*The Notes to Consolidated Financial Statements are an integral part of these statements*

**Table of Contents****ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY**

## Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

| <i>(Dollars in thousands)</i>                             | Six Months Ended June 30, 2011 and 2010 |                            |                   |   |                | Total Shareholders' Equity |
|---|---|----------------------------|-------------------|---|----------------|----------------------------|
|   | Common Stock                            | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock |                            |
| Balance, January 1, 2010                                  | \$ 337                                  | \$ 82,895                  | \$ 28,857         | (\$ 501)                                      | (\$ 702)       | \$ 110,886                 |
| <b>Comprehensive income</b>                               |   |                            |                   |   |                |                            |
| Net income  | 0                                       | 0                          | 7,310             | 0   | 0              | 7,310                      |
| Net unrealized securities gains                           | 0                                       | 0                          | 0                 | 3,594   | 0              | 3,594                      |
| Net unrealized gains on derivatives                       | 0                                       | 0                          | 0                 | 635   | 0              | 635                        |
| Comprehensive income                                      |   |                            |                   |   |                | 11,539                     |
| Cash dividends (\$0.44 per share)                         | 0                                       | 0                          | (3,168)           | 0   | 0              | (3,168)                    |
| Stock-based compensation plans:                           |   |                            |                   |   |                |                            |
| Compensation expense                                      | 0                                       | 27                         | 0                 | 0   | 0              | 27                         |
| Issuance of stock   | 0                                       | 150                        | 0                 | 0   | 0              | 150                        |
| Issuance of stock through dividend reinvestment plan      | 1                                       | 331                        | 0                 | 0   | 0              | 332                        |
| Issuance of treasury stock (24,474 shares)                | 0                                       | (62)                       | 0                 | 0   | 649            | 587                        |
| Proceeds from issuance of common stock (1,481,481 shares) | 77                                      | 37,473                     | 0                 | 0   | 0              | 37,550                     |
| Balance, June 30, 2010                                    | \$ 415                                  | \$ 120,814                 | \$ 32,999         | \$ 3,728                                      | (\$ 53)        | \$ 157,903                 |
| Balance, January 1, 2011                                  | \$ 416                                  | \$ 121,508                 | \$ 38,680         | (\$ 88)                                       | (\$ 32)        | \$ 160,484                 |
| <b>Comprehensive income</b>                               |   |                            |                   |   |                |                            |
| Net income (loss)   | 0                                       | 0                          | (6,796)           | 0   | 0              | (6,796)                    |
| Net unrealized securities gains                           | 0                                       | 0                          | 0                 | 3,124   | 0              | 3,124                      |
| Net unrealized losses on derivatives                      | 0                                       | 0                          | 0                 | (161)   | 0              | (161)                      |
| Comprehensive income (loss)                               |   |                            |                   |   |                | (3,833)                    |
| Cash dividends (\$0.46 per share)                         | 0                                       | 0                          | (3,677)           | 0   | 0              | (3,677)                    |
| Stock-based compensation plans:                           |   |                            |                   |   |                |                            |
| Issuance of stock   | 1                                       | 473                        | 0                 | 0   | 0              | 474                        |
| Purchase of treasury stock (2,232 shares)                 | 0                                       | 0                          | 0                 | 0   | (54)           | (54)                       |
| Issuance of treasury stock (2,719 shares)                 | 0                                       | (19)                       | 0                 | 0   | 66             | 47                         |
| Balance, June 30, 2011                                    | \$ 417                                  | \$ 121,962                 | \$ 28,207         | \$ 2,875                                      | (\$ 20)        | \$ 153,441                 |

The Notes to Consolidated Financial Statements are an integral part of these statements

**Table of Contents****ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY**

## Consolidated Statements of Cash Flows (Unaudited)

|  | Six Months Ended |                  |
|--|------------------|------------------|
|  | June 30,<br>2011 | June 30,<br>2010 |
| <i>(Dollars in Thousands, Except per Share Data)</i>                                       |                  |                  |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                  |                  |
| Net income (loss)  | \$ (6,796)       | \$ 7,310         |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities:   |                  |                  |
| Amortization of premiums on securities available for sale                                  | 2,787            | 1,086            |
| Depreciation and amortization  | 1,391            | 1,345            |
| Provision for loan losses  | 24,425           | 6,420            |
| Net change in loans held for sale  | (2,252)          | (3,581)          |
| Net (gain) loss on disposal of other real estate owned                                     | (30)             | 16               |
| Writedown of other real estate owned   | 181              | 0                |
| Net gain on disposal of bank premises and equipment  | 0                | (119)            |
| Investment securities gains  | (848)            | (2,179)          |
| Gain on sale of rate swap  | (118)            | (778)            |
| Earnings on cash surrender value of life insurance   | (521)            | (580)            |
| (Increase) decrease in accrued interest receivable   | 30               | (157)            |
| Increase (decrease) in accrued interest payable  | 26               | (141)            |
| Other, net   | (5,098)          | (326)            |
| <b>Net cash provided by operating activities</b>   | <b>13,177</b>    | <b>8,316</b>     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |                  |                  |
| Net (increase) decrease in interest bearing deposits with banks and short term investments | (2,660)          | 742              |
| Sales of available for sale securities   | 36,679           | 157,529          |
| Maturities, repayments and calls of available for sale securities                          | 29,359           | 24,903           |
| Purchases of available for sale securities   | (52,539)         | (307,424)        |
| Net purchases of restricted investments in bank stocks                                     | (533)            | 0                |
| Net increase in loans  | (48,546)         | (16,817)         |
| Investment in limited partnerships   | (55)             | (825)            |
| Purchases of bank premises and equipment   | (600)            | (317)            |
| Proceeds from disposal of other real estate owned  | 388              | 225              |
| Proceeds from disposal of bank premises and equipment                                      | 0                | 373              |
| Proceeds from sale of rate swap  | 118              | 868              |
| Purchases of bank owned life insurance   | (500)            | (1,730)          |
| Redemption of cash surrender value upon death  | 0                | 1,202            |
| <b>Net cash (used) by investing activities</b>   | <b>(38,889)</b>  | <b>(141,271)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |                  |                  |
| Net increase in deposits   | 71,819           | 174,380          |
| Net decrease in short term purchased funds   | (24,972)         | (52,547)         |
| Payments on long-term debt   | (20,425)         | (7,726)          |
| Dividends paid   | (3,677)          | (3,168)          |
| Proceeds from issuance of common stock   | 474              | 38,032           |
| Purchase of treasury stock   | (54)             | 0                |
| Net proceeds from issuance of treasury stock   | 47               | 587              |
| <b>Net cash provided by financing activities</b>   | <b>23,212</b>    | <b>149,558</b>   |

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|  |           |           |
|--|-----------|-----------|
| Net increase (decrease) in cash and cash equivalents | (2,500)   | 16,603    |
| Cash and cash equivalents at beginning of period     | 19,200    | 21,940    |
| Cash and cash equivalents at end of period           | \$ 16,700 | \$ 38,543 |

**Supplemental disclosures of cash flow information:**

Cash paid during the period for:

|              |          |          |
|--------------|----------|----------|
| Interest     | \$ 5,638 | \$ 6,663 |
| Income taxes | 3,591    | 3,400    |

**Supplemental schedule of noncash investing activities:**

|   |        |        |
|---|--------|--------|
| Other real estate acquired in settlement of loans | \$ 556 | \$ 439 |
|---|--------|--------|

*The Notes to Consolidated Financial Statements are an integral part of these statements*

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**ORRSTOWN FINANCIAL SERVICES, INC.**

Notes to Consolidated Financial Statements

June 30, 2011

**NOTE 1. SUMMARY OF CONSOLIDATED SIGNIFICANT ACCOUNTING POLICIES**

*Nature of Operations* - Orrstown Financial Services, Inc. (the Company) is a financial holding company whose primary activity consists of supervising its wholly-owned subsidiary, Orrstown Bank (the Bank). The Company operates through its office in Shippensburg, Pennsylvania. Orrstown Bank provides services through its network of offices in Franklin, Cumberland and Perry Counties of Pennsylvania and in Washington County, Maryland. The Bank engages in lending services for commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Deposit services include checking, savings, time and money market deposits. The Bank also provides investment and brokerage services through its Orrstown Financial Advisors division. The Bank has twenty-one branches located in Shippensburg (2), Carlisle (5), Spring Run, Orrstown, Chambersburg (3), Mechanicsburg (2), Camp Hill, Greencastle, Newport (2), Duncannon, and New Bloomfield, Pennsylvania and Hagerstown, Maryland. The Company and its subsidiary are subject to the regulation of certain federal and state agencies and undergo periodic examinations by such regulatory authorities.

*Basis of Presentation* - The unaudited financial statements of the Company and its subsidiary are presented for the three and six months ended June 30, 2011 and 2010 and have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. However, unaudited information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, considered necessary for a fair presentation of the financial position, results of operations and cash flows for the interim period. Information presented at December 31, 2010 is condensed from audited year-end financial statements. For further information, refer to the audited consolidated financial statements and footnotes thereto, included in the annual report on Form 10-K for the year ended December 31, 2010.

All significant intercompany transactions and accounts have been eliminated. Operating results for the three and six months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

*Use of Estimates* - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowance for losses on loans and foreclosed real estate, management obtains independent appraisals for significant properties.

While management uses available information to recognize losses on loans and foreclosed real estate, future additions to the allowances may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for losses on loans and foreclosed real estate. Such agencies may require the Company to recognize additions to the allowance based on their judgments concerning information available to them at the time of their examination. Because of these factors, management's estimate of credit losses inherent in the loan portfolio and the related allowance may change in the near term.

*Subsequent Events* - Generally accepted accounting principles establishes standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The subsequent events principle sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements, identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that should be made about events or transactions that occur after the balance sheet date. In preparing these financial

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statements, the Company evaluated the events and transactions that occurred after June 30, 2011, through the date these financial statements were filed with the Commission.

*Concentration of Credit Risk* - The Company grants agribusiness, commercial, residential and consumer loans to customers in its market area. Although the Company maintains a diversified loan portfolio, a significant portion of its customers' ability to honor their contracts is dependent upon economic sectors for construction contractors, residential and non-residential building operators, sales finance, sub-dividers and developers. Management evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if collateral is deemed necessary by the Company upon the extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but generally includes real estate and equipment.

The types of securities the Company invests in are included in Note 2, and the type of lending the Company engages in are included in Note 3.

*Cash and Cash Equivalents* - For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash, balances due from banks and federal funds sold all of which have original maturities of 90 days or less.

*Loans Held for Sale* - Loans originated and intended for sale in the secondary market are carried at lower of aggregate cost or fair value (LOCM). Gains and losses on loans sales (sales proceeds minus carrying value) are recorded in non-interest income.

*Securities* - Certain debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. As of the periods presented, the Company has no held to maturity or trading securities. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Company follows accounting guidance related to recognition and presentation of other-than-temporary impairment (Financial Accounting Standards Board Accounting Standards Codification FASB ASC 320-10). This accounting guidance specifies that (a) if a company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income.

The Company had no debt securities it deemed to be other than temporarily impaired for the periods presented.

The Company's securities are exposed to various risks, such as interest rate, market risk, currency and credit risks. Due to the level of risk associated with certain investments and the level of uncertainty related to changes in the value of investments, it is at least reasonably possible that changes in risks in the near term would materially affect investment assets reported in the consolidated financial statements.

For equity securities, when the Company has decided to sell an impaired available-for-sale security and the entity does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made.

*Loans* - The Company grants commercial, mortgage, and consumer loans to its customers located principally in south-central Pennsylvania and northern Maryland. The ability of the Company's debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the

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allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and amortized as a yield adjustment over the respective term of the loan.

For all classes of loans, the accrual of interest income on loans, including impaired loans, ceases when principal or interest is past due 90 days or more or immediately if, in the opinion of management, full collection is unlikely. Interest will continue to accrue on loans past due 90 days or more if the collateral is adequate to cover principal and interest, and the loan is in the process of collection. Interest accrued, but not collected, as of the date of placement on nonaccrual status, is reversed and charged against current interest income, unless fully collateralized. Subsequent payments received are either applied to the outstanding principal balance or recorded as interest income, depending upon management's assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan classes, when all the principal and interest amounts contractually due are brought current, has performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contractual terms of the loan for all loan classes.

Loans the terms of which are modified are classified as troubled debt restructurings if a concession was granted, for legal or economic reasons, related to a debtor's financial difficulties. Concessions granted under a troubled debt restructuring typically involve a temporary deferral of scheduled loan payments, an extension of a loan's stated maturity date, temporary reduction in interest rates, or below market rates. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual troubled debt restructurings are restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for six months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. Troubled debt restructurings are evaluated individually for impairment if they have been restructured during the most recent calendar year, or if they are not performing according to their modified terms.

*Allowance for Loan Losses* - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

See Note 3, Loans Receivable and Allowance for Loan Losses, for additional details.

*Stock Compensation Plans* - The Company has stock option plans for its employees and non-employee directors. Stock compensation accounting guidance (FASB ASC 718, *Compensation - Stock Compensation*) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost is measured based on the grant date fair value of the stock options, using a Black-Scholes model. Compensation cost for all stock awards are calculated and recognized over the employees' service period, generally defined as the vesting period.

*Income Taxes* - The Company accounts for income taxes in accordance with income tax accounting guidance (FASB ASC 740, *Income Taxes*). The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur. For interim financial reporting, the Company computes its income tax expense (benefit) based on its estimated annual effective tax rate for the year, as noted in FASB ASC 740-270-25.

*Earnings Per Share* - Basic earnings (loss) per share represent income (loss) available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share reflect the additional common shares that would have been outstanding if

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dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate solely to outstanding stock options. Treasury shares are not deemed outstanding for earnings per share calculations.

*Comprehensive Income* - Comprehensive income (loss) consists of net income (loss) and other comprehensive income. Other comprehensive income includes unrealized gains on securities available for sale, and unrealized losses related to factors other than credit on debt securities and unrealized gains and losses on cash flow hedges.

*Derivative Instruments* - Generally accepted accounting principles require that all derivatives be recognized in the Consolidated Financial Statements at their fair values. On the dates that derivative contracts are entered into, the Company designates derivatives as (a) hedges of fair values of recognized assets or liabilities or of unrecognized firm commitments (fair-value hedges); (b) hedges of forecasted transactions or variable cash flows to be received or paid in conjunction with recognized assets or liabilities (cash-flow hedges) or (c) instruments that are held for trading or non-hedging purposes (trading or economic-hedging instruments). For a derivative treated as a fair-value hedge, the effective portion of a change in fair value is recorded as an adjustment to the hedged item. The ineffective portion of the fair-value hedge is recognized in current period earnings. Upon termination of a fair-value hedge of a debt instrument, the resulting gain or loss is amortized to earnings through the maturity date of the debt instrument. For a derivative treated as a cash flow hedge, the ineffective portion of changes in fair value is reported in current period earnings. The effective portion of the cash flow hedge is recorded as an adjustment to the hedged item through other comprehensive income. For a derivative treated as a trading or economic hedging instrument, changes in fair value are reported in current period earnings. Fair values are determined based upon quoted market prices and mathematical models using current and historical data.

The Company formally assesses, both at the hedge inception, and on an on-going basis, whether derivatives used in hedging transactions have been highly effective in offsetting changes in fair values or cash flows of hedged items and whether those derivatives are expected to remain highly effective in subsequent periods. The Company discontinues hedge accounting when (a) it determines that a derivative is no longer effective in offsetting changes in fair value or cash flows of a hedged item; (b) the derivative expires or is sold, terminated or exercised; (c) probability exists that the forecasted transaction will no longer occur or (d) management determines that designating the derivative as a hedging instrument is no longer appropriate. In all cases in which hedge accounting is discontinued and a derivative remains outstanding, the Company will carry the derivative at fair value in the Consolidated Financial Statements, recognizing changes in fair value in current period income in the statement of income.

The Company follows generally accepted accounting principles, regarding disclosures about derivative instruments and hedging activities, which includes disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows.

*Segment Reporting* - The Company only operates in one significant segment - Community Banking. The Company's non-banking activities are insignificant to the consolidated financial statements.

*Reclassifications* - Certain amounts in the 2010 consolidated financial statements have been reclassified to conform to the 2011 presentation.

*Recent Accounting Pronouncements* - In January 2010, the FASB issued ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 was effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures were effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. The new disclosure guidance significantly expanded the existing requirements leading to greater transparency into the company's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period was



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effective for annual reporting periods ending on or after December 15, 2010 and has been presented in Note 3 to the Consolidated Financial Statements. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures was required to be adopted for periods beginning on or after December 15, 2010, and are also incorporated in Note 3.

In December 2010, the FASB issued ASU 2010-28, Intangibles *Goodwill and Other (Topic 350), When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts*. ASU 2010-28 affects all entities that have recognized goodwill and have one or more reporting units whose carrying amount for purposes of performing Step 1 of the goodwill impairment test is zero or negative. ASU 2010-28 modifies Step 1 so that for those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that impairment may exist. The qualitative factors are consistent with existing guidance, which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This guidance is effective for the Company for fiscal years, and interim periods within those years, beginning after December 15, 2010. Adoption of ASU 2010-28 guidance did not have a material impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU 2011-2, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*. This guidance clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for the purpose of recording an impairment charge and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-2, that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. As allowed by the guidance, the Company adopted the provisions of ASU 2011-2 in the quarter ending June 30, 2011. See further discussion in Note 3 Loans Receivable and Allowance for Loan Losses.

In June 2011, the FASB issued ASU 2011-5, *Presentation of Comprehensive Income*. This guidance amends existing guidance to improve the comparability of financial reporting and to increase the prominence of items reported in other comprehensive income. The guidance eliminated the option to present components of other comprehensive income as part of the changes in shareholders' equity and requires all changes in shareholders' equity to be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance also requires entities to present all reclassification adjustments from other comprehensive income to net income on the face of the financial statements. The guidance did not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The guidance is effective for fiscal years and interim periods within those years, beginning after December 15, 2011, and early adoption is permitted. The Company does not anticipate the adoption of ASU 2011-5 will have a material impact on the Company's consolidated financial statements.

**NOTE 2. SECURITIES AVAILABLE FOR SALE**

At June 30, 2011 and December 31, 2010, the investment securities portfolio was comprised exclusively of securities classified as available for sale, resulting in investment securities being carried at fair value. The amortized cost and fair values of investment securities available for sale at June 30, 2011 and December 31, 2010 were:

| <i>(Dollars in thousands)</i>               | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value     |
|---|-------------------|---------------------|----------------------|-------------------|
| <b>June 30, 2011</b>                        |                   |                     |                      |                   |
| U.S. Government Sponsored Enterprises (GSE) | \$ 97,804         | \$ 1,307            | \$ 1,113             | \$ 97,998         |
| States and political subdivisions           | 97,962            | 1,295               | 492                  | 98,765            |
| GSE residential mortgage-backed securities  | 219,460           | 2,887               | 146                  | 222,201           |
| <b>Total debt securities</b>                | <b>415,226</b>    | <b>5,489</b>        | <b>1,751</b>         | <b>418,964</b>    |
| Equity securities                           | 2,095             | 130                 | 116                  | 2,109             |
| <b>Totals</b>                               | <b>\$ 417,321</b> | <b>\$ 5,619</b>     | <b>\$ 1,867</b>      | <b>\$ 421,073</b> |



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| <i>(Dollars in thousands)</i>               | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|---------------------|----------------------|---------------|
| <b>December 31, 2010</b>                    |                   |                     |                      |               |
| U.S. Government Sponsored Enterprises (GSE) | \$ 120,318        | \$ 1,491            | \$ 1,523             | \$ 120,286    |
| States and political subdivisions           | 98,133            | 566                 | 1,551                | 97,148        |
| GSE residential mortgage-backed securities  | 212,260           | 960                 | 1,044                | 212,176       |
| Total debt securities                       | 430,711           | 3,017               | 4,118                | 429,610       |
| Equity securities                           | 2,114             | 93                  | 45                   | 2,162         |
| Totals                                      | \$ 432,825        | \$ 3,110            | \$ 4,163             | \$ 431,772    |

The following table shows gross unrealized losses and fair value of the Company's available for sale securities that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i>               | Less than 12 Months |                      | 12 Months or More |                      | Total         |                      |
|---|---------------------|----------------------|-------------------|----------------------|---------------|----------------------|
|   | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| <b>June 30, 2011</b>                        |                     |                      |                   |                      |               |                      |
| U.S. Government Sponsored Enterprises (GSE) | \$ 43,945           | \$ 1,113             | \$ 0              | \$ 0                 | \$ 43,945     | \$ 1,113             |
| States and political subdivisions           | 26,603              | 396                  | 578               | 96                   | 27,181        | 492                  |
| GSE residential mortgage-backed securities  | 35,958              | 146                  | 0                 | 0                    | 35,958        | 146                  |
| Total debt securities                       | 106,506             | 1,655                | 578               | 96                   | 107,084       | 1,751                |
| Equity securities                           | 782                 | 115                  | 5                 | 1                    | 787           | 116                  |
| Total temporarily impaired securities       | \$ 107,288          | \$ 1,770             | \$ 583            | \$ 97                | \$ 107,871    | \$ 1,867             |
| <b>December 31, 2010</b>                    |                     |                      |                   |                      |               |                      |
| GSEs  | \$ 44,737           | \$ 1,523             | \$ 0              | \$ 0                 | \$ 44,737     | \$ 1,523             |
| States and political subdivisions           | 61,718              | 1,303                | 1,026             | 248                  | 62,744        | 1,551                |
| GSE residential mortgage-backed securities  | 124,685             | 1,044                | 0                 | 0                    | 124,685       | 1,044                |
| Total debt securities                       | 231,140             | 3,870                | 1,026             | 248                  | 232,166       | 4,118                |
| Equity securities                           | 312                 | 12                   | 312               | 33                   | 624           | 45                   |
| Total temporarily impaired securities       | \$ 231,452          | \$ 3,882             | \$ 1,338          | \$ 281               | \$ 232,790    | \$ 4,163             |

The Company had 72 securities and 126 securities at June 30, 2011 and December 31, 2010, respectively, in which the amortized cost exceeds their values, as discussed below.

*U.S. Government Sponsored Enterprises (GSE).* 29 GSE securities, including mortgage-backed securities, have amortized costs which exceed their fair values, all of which are in the less than 12 months at June 30, 2011. At December 31, 2010, the Company had 50 GSE with unrealized losses, all of which were less than 12 months. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2011 or at December 31, 2010.

*State and Political Subdivisions.* 29 state and political subdivision securities have amortized cost which exceeds their fair value, including 1 of which has been for greater than 12 months at June 30, 2011. At December 31, 2010, 63 state and political subdivisions had unrealized losses, 3 of which were greater than 12 months. These unrealized losses have been caused by a rise in interest rates from the time the securities were

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purchased. The security which has had an unrealized loss for over 24 months at June 30, 2011 is a California issue that is carrying a low market value due to it being a zero coupon bond, which is hindered by the state's economic issues, and not the underlying credit worthiness of the issuer. This security carries an investment

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grade rating. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2011.

*Equity Securities.* 14 equity securities have cost which exceeds their fair value, including 1 of which has been greater than 12 month at June 30, 2011. At December 31, 2010, 13 equity securities had unrealized losses, of which 7 had unrealized losses for greater than 12 months. These securities are among various industries, including financial, industrial, consumer, energy, health care and a large cap fund, In considering whether the equity securities are other-than-temporarily impaired, management reviews the severity and duration of decline in fair value, research reports, analysts recommendations, credit rating changes, news stories and other relevant information. Management believes the equity securities are not other-than-temporarily impaired and will equal or exceed our cost basis within a reasonable period of time. Since these companies are considered viable and carry the possibility of price appreciation in the future, impairments are considered temporary. The Company recorded no other than temporary impairment expense on equity securities for the quarters or six months ended June 30, 2011 and December 31, 2010.

The amortized cost and fair values of securities available for sale at June 30, 2011 by contractual maturity are shown below. Contractual maturities will differ from expected maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| <i>(Dollars in thousands)</i>              | Available for Sale |            |
|--|--------------------|------------|
|  | Amortized Cost     | Fair Value |
| Due in one year or less                    | \$ 12,964          | \$ 13,031  |
| Due after one year through five years      | 13,083             | 13,317     |
| Due after five years through ten years     | 98,527             | 99,031     |
| Due after ten years                        | 71,192             | 71,384     |
| GSE residential mortgage-backed securities | 219,460            | 222,201    |
| Total debt securities                      | 415,226            | 418,964    |
| Equity securities                          | 2,095              | 2,109      |
|  | \$ 417,321         | \$ 421,073 |

Proceeds from sales of securities available for sale for the quarters ended June 30, 2011 and 2010 were \$36,679,000 and \$157,529,000. Gross gains on the sales of securities were \$921,000 and \$2,500,000 for the quarters ended June 30, 2011 and 2010. Gross losses on securities available for sale were \$73,000 and \$321,000.

Securities with a fair value of \$294,714,000 and \$271,689,000 at June 30, 2011 and December 31, 2010 were pledged to secure public funds and for other purposes as required or permitted by law.

**NOTE 3. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES**

The Bank's loan portfolio is broken down into segments to an appropriate level of disaggregation to allow management to monitor the performance by the borrower and to monitor the yield on the portfolio. In 2010, management incorporated the provisions of ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Loan Losses*, resulting in a refinement in its portfolio segregation. Consistent with the standard, the segments were further broken down into classes, to allow for differing risk characteristics within a segment.

The risks associated with lending activities differ among the various loan classes, and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans, and general economic conditions. All of these factors may adversely impact the borrower's ability to repay its loans, and impact the associated collateral.

The Company has various types of commercial real estate which have differing levels of credit risk associated with them. Owner-occupied commercial real estate loans are generally dependent upon the successful operation of the borrowers business, with the cash flows generated from the business being the primary source of repayment of the loan. If the business suffers a downturn in sales or profitability, the borrower's

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ability to repay the loan could be in jeopardy. In order to minimize this credit risk, the Company has conservative underwriting standards which include the credit worthiness of the borrower, limitation on loan amounts to 75% of the value of the property securing the loan, and strong debt service coverage ratios.

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Non-owner occupied and multi-family commercial real estate loans present a different credit risk to the Company than owner-occupied commercial real estate, as the repayment of the loan is dependent upon the borrower's ability to generate a sufficient level of occupancy to produce rental income that exceeds debt service requirement and operating expenses. Lower occupancy or lease rates may result in reduction in cash flows, which hinder the ability of the borrower to meet debt service requirements, and may result in lower collateral values. The Company generally follows the same underwriting standards as with owner-occupied commercial real estate, but recognizes the greater risk inherent in these credit relationships in its loan pricing.

Acquisition and development loans consist of 1-4 family residential construction and commercial and land development loans. The risk of loss on these loans is largely dependent on the Company's ability to assess the property's value at the completion of the project, which should exceed the property's construction costs. During the construction phase, a number of factors could potentially negatively impact the collateral value, including cost overruns, delays in completing the project, competition, and real estate market conditions which may change based on the supply of similar properties in the area. In the event the collateral value at the completion of the project is not sufficient to cover the outstanding loan balance, the Company must rely upon other repayment sources, including the guarantors of the project or other collateral securing the loan. The Company attempts to mitigate credit risk through strict underwriting standards including evaluation of the credit worthiness of the borrower and their success in other projects, aggressive release fees, loan-to-value ratios not to exceed 75%, and continual monitoring of the project during its construction phase to determine the impact that overruns and delays may have on the project.

Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest rated borrowers, the majority of 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. Commercial and industrial loans present credit exposure to the Company, as they are more susceptible to risk of loss during a downturn in the economy, as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline. The Company attempts to mitigate this risk through strict underwriting standards, including evaluating the credit worthiness of the borrower and to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and meetings with the borrowers are common. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

The Company originates loans to its retail customers, including fixed-rate and adjustable first lien mortgage loans with the underlying 1-4 family owner-occupied residential property securing the credit. The Company's risk exposure is minimized in these types of loans through the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and underwriting standards which limits the loan-to-value ratio to generally no more than 80%, unless the borrower obtains private mortgage insurance.

Home equity loans, including term loans and lines of credit, present a slightly higher risk to the Company than 1-4 family first liens, as these loans can be first or second liens on 1-4 family owner occupied residential property, but can have loan-to-value ratios of no greater than 90% of the value of the real estate taken as collateral. The credit worthiness of the borrower is considered including credit scores and debt-to-income ratios, which generally cannot exceed 38%.

Installment and other loans' credit risk are mitigated through conservative underwriting standards, including the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and if secured, the collateral value of the assets. As these loans can be unsecured or secured by assets the value of which may depreciate quickly or may fluctuate, they present a greater risk to the Company than 1-4 family residential loans.

The loan portfolio, excluding residential loans held for sale, broken out by classes as of June 30, 2011 and December 31, 2010 is as follows:

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| <i>(Dollars in thousands)</i>       | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|-------------------------------------|--------------------------|------------------------------|
| Commercial real estate:             |                          |                              |
| Owner-occupied                      | \$ 198,495               | \$ 172,000                   |
| Non-owner occupied                  | 134,191                  | 143,372                      |
| Multi-family                        | 27,880                   | 24,649                       |
| Acquisition and development:        |                          |                              |
| 1-4 family residential construction | 13,887                   | 29,297                       |
| Commercial and land development     | 95,607                   | 88,105                       |
| Commercial and industrial           | 283,029                  | 263,943                      |
| Residential mortgage:               |                          |                              |
| First lien                          | 118,954                  | 119,450                      |
| Home equity - term                  | 39,584                   | 40,818                       |
| Home equity - Lines of credit       | 75,392                   | 71,547                       |
| Installment and other loans         | 12,014                   | 11,112                       |
|                                     | <b>\$ 999,033</b>        | <b>\$ 964,293</b>            |

In order to monitor ongoing risk associated with its loan portfolio and specific credits within the segments, management uses an eight point internal grading system. The first four rating categories, representing the lowest risk to the Bank, are combined and given a Pass rating. The Special Mention category includes loans that have potential weaknesses that may, if not monitored or corrected, weaken the asset or inadequately protect the Bank's position at some future date. These assets pose elevated risk, but their weakness does not yet justify a more severe, or criticized rating. Management generally follows regulatory definitions in assigning criticized ratings to loans, including substandard, doubtful or loss. Substandard loans are classified as they have a well-defined weakness, or weaknesses that jeopardize liquidation of the debt. These loans are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Substandard loans include loans that management has determined not to be impaired, as well as loans considered to be impaired. A doubtful loan has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification of loss is deferred.

Loss assets are considered uncollectible, as the underlying borrowers are often in bankruptcy, have suspended debt repayments, or ceased business operations. Once a loan is classified as Loss, there is little prospect of collecting the loan's principal or interest and it is generally written off.

The Bank has a loan review policy and program which is designed to reduce and control risk in the lending function. The Credit Administration Committee, comprised of members of the Board, is charged with the overall credit quality and risk exposure of the Company's loan portfolio. This includes the monitoring of the lending activities of all bank personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The loan review program provides the Bank with an internal, independent review of the Bank's loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession or death of the borrower occurs, which heightens awareness as to a possible credit event.

The Loan Review department performs annual reviews of all commercial relationships with a committed loan balance in excess of \$750,000, with ratification of the rating from the Board of Directors' Credit Administration Committee for loans between \$750,000 - \$1,000,000. Loans reviewed in excess of \$1,000,000 are presented to the Credit Administration Committee with a formal review and rating. All relationships rated Substandard, Doubtful or Loss are reviewed by the Credit Administration Committee on a quarterly basis, including reaffirmation of the rating, review of detailed collateral analysis and the development of an action plan. In addition to the policy guidelines noted above, the Company expanded its review coverage during the second quarter in light of softness in overall economic conditions and deterioration of underlying collateral securing lending relationships. As a result, all commercial real estate, construction and development loans, and commercial loans in excess of \$500,000, representing over 75% coverage of these portfolios, have been reviewed and assigned a loan rating.

The following summarizes the Bank's ratings based on its internal risk rating system as of June 30, 2011 and December 31, 2010:



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| <i>(Dollars in thousands)</i>       | Pass       | Special<br>Mention | Non-Impaired<br>Substandard | Impaired -<br>Substandard | Doubtful | Total      |
|-------------------------------------|------------|--------------------|-----------------------------|---------------------------|----------|------------|
| <b>June 30, 2011:</b>               |            |                    |                             |                           |          |            |
| Commercial real estate:             |            |                    |                             |                           |          |            |
| Owner-occupied                      | \$ 171,679 | \$ 10,563          | \$ 13,952                   | \$ 1,612                  | \$ 689   | \$ 198,495 |
| Non-owner occupied                  | 95,439     | 13,298             | 23,376                      | 1,527                     | 551      | 134,191    |
| Multi-family                        | 19,001     | 1,270              | 4,544                       | 3,065                     | 0        | 27,880     |
| Acquisition and development:        |            |                    |                             |                           |          |            |
| 1-4 family residential construction | 9,206      | 293                | 4,256                       | 132                       | 0        | 13,887     |
| Commercial and land development     | 54,488     | 13,167             | 17,489                      | 10,463                    | 0        | 95,607     |
| Commercial and industrial           | 203,533    | 14,591             | 35,225                      | 29,295                    | 385      | 283,029    |
| Residential mortgage:               |            |                    |                             |                           |          |            |
| First lien                          | 116,681    | 0                  | 1,809                       | 464                       | 0        | 118,954    |
| Home equity - term                  | 38,451     | 0                  | 423                         | 710                       | 0        | 39,584     |
| Home equity - Lines of credit       | 75,166     | 0                  | 226                         | 0                         | 0        | 75,392     |
| Installment and other loans         | 12,014     | 0                  | 0                           | 0                         | 0        | 12,014     |
|                                     | \$ 795,658 | \$ 53,182          | \$ 101,300                  | \$ 47,268                 | \$ 1,625 | \$ 999,033 |

**December 31, 2010**

|                                     |            |           |           |           |          |            |
|-------------------------------------|------------|-----------|-----------|-----------|----------|------------|
| Commercial real estate:             |            |           |           |           |          |            |
| Owner-occupied                      | \$ 162,968 | \$ 2,035  | \$ 6,311  | \$ 0      | \$ 686   | \$ 172,000 |
| Non-owner occupied                  | 120,633    | 4,274     | 15,495    | 2,970     | 0        | 143,372    |
| Multi-family                        | 20,030     | 676       | 3,853     | 0         | 90       | 24,649     |
| Acquisition and development:        |            |           |           |           |          |            |
| 1-4 family residential construction | 24,199     | 2,297     | 2,801     | 0         | 0        | 29,297     |
| Commercial and land development     | 79,391     | 2,487     | 6,134     | 93        | 0        | 88,105     |
| Commercial and industrial           | 221,111    | 17,062    | 14,992    | 9,770     | 1,008    | 263,943    |
| Residential mortgage:               |            |           |           |           |          |            |
| First lien                          | 117,607    | 0         | 1,373     | 470       | 0        | 119,450    |
| Home equity - term                  | 39,279     | 0         | 828       | 711       | 0        | 40,818     |
| Home equity - Lines of credit       | 71,364     | 0         | 183       | 0         | 0        | 71,547     |
| Installment and other loans         | 11,062     | 0         | 50        | 0         | 0        | 11,112     |
|                                     | \$ 867,644 | \$ 28,831 | \$ 52,020 | \$ 14,014 | \$ 1,784 | \$ 964,293 |

Classified loans may also be evaluated for impairment. For commercial real estate, acquisition and development and commercial and industrial loans, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Generally, loans that are more than 90 days past due are assigned a Substandard rating. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Nonaccrual loans in the commercial and commercial real estate portfolios are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates on fair values are obtained, which may include updated appraisals. The updated fair values will be incorporated into the impairment analysis as of the next reporting period. In the event an updated appraisal that requires a higher impairment reserve is received after a reporting period, but prior to the issuance of the financial statements, an evaluation is made as to the significance of the difference and whether the amounts need to be reflected in the financial statements not yet issued.

Loan charge-offs, which may include, from time-to-time, a partial charge-off, are taken on an impaired loan that is collateral dependent if the loan's carrying balance exceeds its collateral's appraised value, the loan has been identified as uncollectible, and it is deemed to be a confirmed loss. Typically, impaired loans with a charge-off or partial charge-off will continue to be considered impaired, unless the note is split into two,

and

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management expects the performing note to continue to perform and is adequately secured. The second, or non-performing note, would be charged-off. As of the periods presented, the Company has no loans to borrowers that resulted from splitting impaired loans into multiple notes. Further, an impaired loan with a partial charge-off may continue to have an impairment reserve on it after the partial charge-off, if factors warrant.

As of June 30, 2011 and December 31, 2010, nearly all of the Company's impaired loans' extent of impairment was measured based on the estimated fair value of the collateral securing the credit, except for troubled debt restructurings. By definition, troubled debt restructurings are considered impaired, however, nearly all restructured loans' impairment was determined based on discounted cash flows. In addition to the policy guidelines noted above, the Company expanded its review coverage during the second quarter in light of softness in overall economic conditions and deterioration of underlying collateral securing lending relationships. As a result, all commercial real estate, construction and development loans, and commercial loans in excess of \$500,000, representing over 75% coverage of these portfolios, have been reviewed and assigned a loan rating. For real estate loans, collateral generally consists of commercial real estate, but in the case of commercial and industrial loans, it would also consist of accounts receivable, inventory, equipment or other business assets. Commercial and industrial loans may also have real estate collateral.

At the time a real-estate secured loan is deemed impaired, management determines whether an updated certified appraisal of the real estate is necessary to assist in determining the extent of an impairment reserve, if any. The decision for requiring an updated appraisal takes into consideration the age of the most recent appraisal, the loan-to-value ratio based on the original certified appraisal, the Company's recent experience and knowledge of market conditions, recent list prices or broker opinions, the condition of the property, and environmental factors. If market conditions have changed significantly from the date of the most recent appraisal, an updated appraisal will be obtained. The appraised value provided in the appraisal is often used as the fair value of the collateral in determining impairment, unless circumstances, such as subsequent improvements, approvals, or other circumstances dictate that another value provided by the appraiser is more appropriate.

Generally impaired loans secured by real estate were measured at fair value using certified real estate appraisals that had been completed within the last year. Appraised values are further discounted for estimated costs to sell the property and other selling considerations to arrive at the properties' fair value.

In those situations in which it is determined an updated appraisal is not required for loans individually evaluated for impairment, fair values are based on one or a combination of the following approaches. In those situations in which a combination of approaches is considered, the factor that carries the most consideration will be the one management believes is warranted. The approaches are as follows:

Original appraisal - if the original appraisal provides a strong loan-to-value (generally 80% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the loan review staff that there has not been a significant deterioration in the collateral value, the original certified appraised value will be used. Discounts as deemed appropriate for selling costs are factored into the appraised value in arriving at fair value.

Discounted cash flows - In limited cases, discounted cash flows may be used on projects in which the collateral is liquidated to reduce the borrowings outstanding, and is used to validate collateral values derived from other approaches.

Collateral on certain impaired loans is not limited to real estate, and consists of accounts receivable, inventory, equipment or other business assets. Estimated fair values are determined based on borrowers' financial statements, inventory ledgers, accounts receivable agings or appraisals from individuals with knowledge in the business. Stated balances are generally discounted for the age of the financial information or the quality of the assets. In determining fair value, liquidation discounts are applied to this collateral based on existing loan evaluation policies.

In the fourth quarter of 2010, the Company began to distinguish Substandard loans on both an impaired and non-impaired basis, as it placed less emphasis on a loan's classification, and increased reliance on whether the loan was performing in accordance with the contractual terms.

Substandard classification does not automatically meet the definition of impaired. A substandard credit is one that is inadequately protected by current sound worth, paying capacity of the obligor or the collateral pledged, if any. Extensions of credit so classified have well-defined weaknesses which may jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard. As a result, the Company revised its methodology in its evaluation of certain accruing commercial real estate, acquisition and development and commercial and industrial loans



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rated substandard collectively for impairment as opposed to evaluating these loans individually for impairment. Although we believe these loans have well defined weaknesses and meet the definition of substandard, they are generally performing and management has concluded that it is likely it will be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Approximately \$53,201,000 of loans that were in previous years evaluated individually for impairment were collectively evaluated for impairment at December 31, 2010, resulting in an additional allowance for loan losses allocation of \$3,710,000.

Larger groups of smaller balance homogenous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

The following summarizes impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required as of June 30, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i>       | Impaired Loans with a Specific Allowance |  |                   | Impaired Loans with No Specific Allowance |  |
|-------------------------------------|--|--|-------------------|---|--|
|                                     | Recorded Investment (Book Balance)       | Unpaid Principal Balance (Legal Balance) | Related Allowance | Recorded Investment (Book Balance)        | Unpaid Principal Balance (Legal Balance) |
| <b>June 30, 2011</b>                |  |  |                   |   |  |
| Commercial real estate:             |  |  |                   |   |  |
| Owner-occupied                      | \$ 2,301                                 | \$ 2,301                                 | \$ 623            | \$ 0                                      | \$ 0                                     |
| Non-owner occupied                  | 1,527                                    | 1,527                                    | 388               | 551                                       | 1,101                                    |
| Multi-family                        | 3,065                                    | 3,065                                    | 578               | 0   | 0  |
| Acquisition and development:        |  |  |                   |   |  |
| 1-4 family residential construction | 132                                      | 132                                      | 33                | 0   | 0  |
| Commercial and land development     | 10,462                                   | 10,462                                   | 1,479             | 0   | 0  |
| Commercial and industrial           | 28,805                                   | 28,805                                   | 5,609             | 875                                       | 875                                      |
| Residential mortgage:               |  |  |                   |   |  |
| First lien                          | 464                                      | 464                                      | 4                 | 0   | 0  |
| Home equity - term                  | 710                                      | 710                                      | 6                 | 0   | 0  |
|                                     | \$ 47,466                                | \$ 47,466                                | \$ 8,720          | \$ 1,426                                  | \$ 1,976                                 |
| <b>December 31, 2010</b>            |  |  |                   |   |  |
| Commercial real estate:             |  |  |                   |   |  |
| Owner-occupied                      | \$ 686                                   | \$ 687                                   | \$ 181            | \$ 0                                      | \$ 0                                     |
| Non-owner occupied                  | 2,064                                    | 2,065                                    | 980               | 0   | 0  |
| Multi-family                        | 90                                       | 90                                       | 90                | 0   | 0  |
| Commercial and industrial           | 9,600                                    | 10,191                                   | 3,232             | 1,118                                     | 1,118                                    |
| Residential mortgage:               |  |  |                   |   |  |
| First lien                          | 470                                      | 470                                      | 12                | 0   | 0  |
| Home equity - term                  | 711                                      | 711                                      | 8                 | 0   | 0  |
|                                     | \$ 13,621                                | \$ 14,214                                | \$ 4,503          | \$ 1,118                                  | \$ 1,118                                 |

The following summarizes the average recorded investment in impaired loans and related interest income recognized for the three and six months ended June 30, 2011:

| <i>(Dollars in thousands)</i> | Three Months Ended       |                            | Six Months Ended         |                            |
|-------------------------------|--------------------------|----------------------------|--------------------------|----------------------------|
|                               | Average Impaired Balance | Interest Income Recognized | Average Impaired Balance | Interest Income Recognized |
|                               |                          |                            |                          |                            |

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|                                     |           |        |           |        |
|-------------------------------------|-----------|--------|-----------|--------|
| Commercial real estate:             |           |        |           |        |
| Owner-occupied                      | \$ 1,727  | \$ 16  | \$ 1,380  | \$ 40  |
| Non-owner occupied                  | 1,589     | 13     | 1,747     | 26     |
| Multi-family                        | 1,533     | 6      | 1,052     | 43     |
| Acquisition and development:        |           |        |           |        |
| 1-4 family residential construction | 66        | 1      | 44        | 2      |
| Commercial and land development     | 5,231     | 36     | 3,487     | 89     |
| Commercial and industrial           | 20,182    | 237    | 17,027    | 495    |
| Residential mortgage:               |           |        |           |        |
| First lien                          | 466       | 3      | 467       | 6      |
| Home equity - term                  | 710       | 2      | 710       | 4      |
| Total                               | \$ 31,504 | \$ 314 | \$ 25,914 | \$ 705 |

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In the second quarter of 2011, the Company early adopted the provisions of ASU No. 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* (ASU No. 2011-02). As a result of adopting the amendments in ASU No. 2011-02, the Company reassessed terms and conditions to customers on restructured loans that had been completed in the past several months. In many instances, the Company was able to increase the interest rate on the loans and obtain additional collateral support for the borrowings, in exchange for extension of the loans terms. However, the new interest rate charged was considered to be at a below-market rate, which was determined to be a concession to its borrowers that were experiencing financial difficulties. Prior to their classification as troubled debt restructurings, these loans had been collectively evaluated for impairment consistent with the guidance in Subtopic 450-20. Upon identifying these receivables as troubled debt restructurings, the Company identified them as impaired under the guidance in ASC 310-10-35. The amendments in ASU No. 2011-02 require prospective application of the impairment measurement guidance in Section 310-10-35 for those receivables newly identified as impaired. At the end of the first interim period of adoption, or June 30, 2011, the recorded investment in receivables for which the allowance for loan losses was previously measured under a general allowance methodology and are now considered impaired under Section 310-10-35 was \$33,670,000, and the allowance for loan losses associated with those receivables, on the basis of a current evaluation, was \$5,700,000.

The following presents impaired loans that are troubled debt restructurings, with the recorded investment being both the pre-modification and post-modification balances, as well as the number of loans modified during the three and twelve month periods, as of June 30, 2011 and December 31, 2010.

|                                     | Troubled Debt Restructurings |                     | New Troubled Debt Restructurings |                     |
|-------------------------------------|------------------------------|---------------------|----------------------------------|---------------------|
|                                     | Number of Contracts          | Recorded Investment | Number of Contracts              | Recorded Investment |
| <i>(Dollars in thousands)</i>       |                              |                     |                                  |                     |
| <b>June 30, 2011</b>                |                              |                     |                                  |                     |
| Accruing:                           |                              |                     |                                  |                     |
| Commercial real estate:             |                              |                     |                                  |                     |
| Owner-occupied                      | 1                            | \$ 932              | 1                                | \$ 932              |
| Non-owner occupied                  | 2                            | 1,527               | 2                                | 1,527               |
| Multi-family                        | 1                            | 893                 | 1                                | 893                 |
| Acquisition and development:        |                              |                     |                                  |                     |
| 1-4 family residential construction | 1                            | 132                 | 1                                | 132                 |
| Commercial and land development     | 4                            | 3,830               | 4                                | 3,830               |
| Commercial and industrial           | 23                           | 26,356              | 23                               | 26,356              |
| Residential mortgage:               |                              |                     |                                  |                     |
| First lien                          | 1                            | 464                 | 0                                | 0                   |
| Home equity - term                  | 1                            | 710                 | 0                                | 0                   |
|                                     | 34                           | \$ 34,844           | 32                               | \$ 33,670           |
| <b>December 31, 2010</b>            |                              |                     |                                  |                     |
| Accruing:                           |                              |                     |                                  |                     |
| Residential mortgage:               |                              |                     |                                  |                     |
| First lien                          | 1                            | \$ 470              | 1                                | \$ 470              |
| Home equity - term                  | 1                            | 711                 | 1                                | 711                 |
|                                     | 2                            | \$ 1,181            | 2                                | \$ 1,181            |

The loans presented above were considered troubled debt restructurings as the result of the Company agreeing to below market interest rates, or for residential mortgage loans, a temporary reduction in interest rates for periods not exceeding 12 months in order to assist the borrowers to improve cash flows during such periods. No additional commitments have been made to borrowers whose loans are considered troubled debt restructurings.

Management further monitors the performance and credit quality of the loan portfolio by analyzing the length of time a portfolio is past due, by aggregating loans based on its delinquencies. The following table presents the classes of loan portfolio summarized by aging categories of performing loans and nonaccrual loans as of June 30, 2011 and December 31, 2010:





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|                                     | Days Past Due |          |          |                         | Total<br>Past Due | Non-<br>Accrual | Total<br>Loans |
|-------------------------------------|---------------|----------|----------|-------------------------|-------------------|-----------------|----------------|
|                                     | Current       | 30-59    | 60-89    | 90+<br>(still accruing) |                   |                 |                |
| <b>June 30, 2011</b>                |               |          |          |                         |                   |                 |                |
| Commercial real estate:             |               |          |          |                         |                   |                 |                |
| Owner-occupied                      | \$ 193,930    | \$ 2,639 | \$ 766   | \$ 0                    | \$ 3,405          | \$ 1,160        | \$ 198,495     |
| Non-owner occupied                  | 133,585       | 0        | 55       | 0                       | 55                | 551             | 134,191        |
| Multi-family                        | 25,708        | 0        | 0        | 0                       | 0                 | 2,172           | 27,880         |
| Acquisition and development:        |               |          |          |                         |                   |                 |                |
| 1-4 family residential construction | 13,783        | 0        | 104      | 0                       | 104               | 0               | 13,887         |
| Commercial and land development     | 87,617        | 814      | 542      | 2                       | 1,358             | 6,632           | 95,607         |
| Commercial and industrial           | 273,704       | 2,127    | 1,796    | 1,528                   | 5,451             | 3,874           | 283,029        |
| Residential mortgage:               |               |          |          |                         |                   |                 |                |
| First lien                          | 115,792       | 1,068    | 191      | 1,561                   | 2,820             | 342             | 118,954        |
| Home equity - term                  | 38,582        | 644      | 77       | 254                     | 975               | 27              | 39,584         |
| Home equity - Lines of credit       | 75,124        | 42       | 0        | 226                     | 268               | 0               | 75,392         |
| Installment and other loans         | 11,809        | 147      | 9        | 46                      | 202               | 3               | 12,014         |
|                                     | \$ 969,634    | \$ 7,481 | \$ 3,540 | \$ 3,617                | \$ 14,638         | \$ 14,761       | \$ 999,033     |

|                                     | Days Past Due |          |          |                         | Total<br>Past Due | Non-<br>Accrual | Total<br>Loans |
|-------------------------------------|---------------|----------|----------|-------------------------|-------------------|-----------------|----------------|
|                                     | Current       | 30-59    | 60-89    | 90+<br>(still accruing) |                   |                 |                |
| <b>December 31, 2010</b>            |               |          |          |                         |                   |                 |                |
| Commercial real estate:             |               |          |          |                         |                   |                 |                |
| Owner-occupied                      | \$ 169,030    | \$ 986   | \$ 832   | \$ 466                  | \$ 2,284          | \$ 686          | \$ 172,000     |
| Non-owner occupied                  | 141,095       | 213      | 0        | 0                       | 213               | 2,064           | 143,372        |
| Multi-family                        | 24,559        | 0        | 0        | 0                       | 0                 | 90              | 24,649         |
| Acquisition and development:        |               |          |          |                         |                   |                 |                |
| 1-4 family residential construction | 29,297        | 0        | 0        | 0                       | 0                 | 0               | 29,297         |
| Commercial and land development     | 87,995        | 1        | 16       | 0                       | 17                | 93              | 88,105         |
| Commercial and industrial           | 252,144       | 287      | 466      | 420                     | 1,174             | 10,625          | 263,943        |
| Residential mortgage:               |               |          |          |                         |                   |                 |                |
| First lien                          | 116,182       | 1,359    | 535      | 1,095                   | 2,989             | 279             | 119,450        |
| Home equity - term                  | 40,503        | 161      | 62       | 75                      | 298               | 17              | 40,818         |
| Home equity - Lines of credit       | 71,215        | 60       | 89       | 142                     | 291               | 41              | 71,547         |
| Installment and other loans         | 10,793        | 251      | 17       | 50                      | 318               | 1               | 11,112         |
|                                     | \$ 942,813    | \$ 3,318 | \$ 2,017 | \$ 2,248                | \$ 7,584          | \$ 13,896       | \$ 964,293     |

The Bank maintains the allowance for loan losses at a level believed adequate by management to absorb losses inherent in the portfolio. It is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the allowance for loan losses utilizing a defined methodology, which considers specific credit evaluation of impaired loans as discussed above, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC Section 310-10-35 for loans individually identified as impaired, and ASC Subtopic 450-20 for loans collectively evaluated for impairment, and other bank regulatory guidance.

For each loan class presented above, general allowances are provided for loans that are collectively evaluated for impairment, which is based on quantitative factors, principally historical loss trends for the respective loan class, adjusted for qualitative factors. As of December 31, 2010, the historical loss factor was based on average charge-offs for the last 8 quarters (e.g. January 1, 2009 – December 31, 2010), whereas prior to December 31, 2010, the historical loss factor was based on an equally weighted rolling 12 quarters. Effective December 31, 2010, for loans rated special mention and substandard not deemed impaired, a weighted average rolling 8 quarters average charge-off percentage on the related graded loan type, with a two-third weight to the most recent four quarters, and a one-third weight for the furthest four quarters was utilized. For non-rated loans evaluated collectively for impairment, the charge-off factor for the last 8 quarters is factored into the reserve allocation. The refinement to the methodology was made as management determined that the most recent eight quarters, and in particular, the most recent four quarters for rated loans, is a better reflection of the losses.



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inherent in the loan portfolio at December 31, 2010. Additional reserve allocations of approximately \$730,000 resulted due to the change to the most recent 8 quarter history, which management believes is a better reflection of losses inherent in the portfolio based on recent loss history. In making this determination, management considered current economic and real estate conditions, trends in historical charge-off percentages at the Company as well as peers, and feedback from regulators.

In addition to the quantitative analysis, additional reserves are allocated on loans collectively evaluated for impairment based on additional qualitative factors. The qualitative factors used by management to adjust the historical loss percentage to the anticipated loss allocation, which range from 0 to 10 bp per factor, include:

*National and local economic trends (five factors)* Ratios and factors considered include trends in the consumer price index (CPI); unemployment rates; housing price index; housing starts compared to the prior year; and bankruptcy rates.

*Credit quality trends (four factors)* Ratios and factors considered include trends in delinquency ratios; 90 days plus and nonaccrual loans; average net loan losses to loans outstanding; and classified loans to total loans.

*Underwriting policies (three factors)* Factors considered including the number of exceptions to loan policy; supervisory loan to value exceptions; and the instances of repeat criticisms of ratings.

*Experience, ability and depth of lending and loan review staff (four factors)* Factors considered include the years experience of the lending and loan review staff; turnover of the staff; instances of loan grade migration; and the penetration of loans reviewed.

*Other (two factors)* Other factors considered include concentrations of credit from loan type or shifts in industry or geographic region.

Activity in the allowance for loan losses for three months ended June 30, 2011 is as follows:

| <i>(Dollars in thousands)</i> | Commercial<br>Real<br>Estate | Acquisition<br>and<br>Development | Commercial<br>and<br>Industrial | Residential<br>Mortgage | Installment<br>and<br>Other | Unallocated | Total     |
|-------------------------------|------------------------------|-----------------------------------|---------------------------------|-------------------------|-----------------------------|-------------|-----------|
| Balance, beginning of period  | \$ 4,884                     | \$ 3,245                          | \$ 8,212                        | \$ 1,712                | \$ 93                       | \$ 252      | \$ 18,398 |
| Provision for loan losses     | 2,894                        | 4,357                             | 12,138                          | 517                     | 13                          | 1,311       | 21,230    |
| Charge-offs                   | (542)                        | (2,576)                           | (9,218)                         | (79)                    | (17)                        | 0           | (12,432)  |
| Recoveries                    | 8                            | 0                                 | 0                               | 0                       | 8                           | 0           | 16        |
| Balance, end of period        | \$ 7,244                     | \$ 5,026                          | \$ 11,132                       | \$ 2,150                | \$ 97                       | \$ 1,563    | \$ 27,212 |

Activity in the allowance for loan losses for six months ended June 30, 2011 is as follows:

| <i>(Dollars in thousands)</i> | Commercial<br>Real<br>Estate | Acquisition<br>and<br>Development | Commercial<br>and<br>Industrial | Residential<br>Mortgage | Installment<br>and<br>Other | Unallocated | Total     |
|-------------------------------|------------------------------|-----------------------------------|---------------------------------|-------------------------|-----------------------------|-------------|-----------|
| Balance, beginning of period  | \$ 5,324                     | \$ 1,767                          | \$ 6,795                        | \$ 1,863                | \$ 106                      | \$ 165      | \$ 16,020 |
| Provision for loan losses     | 3,165                        | 5,835                             | 13,600                          | 427                     | 0                           | 1,398       | 24,425    |
| Charge-offs                   | (1,253)                      | (2,576)                           | (9,263)                         | (140)                   | (24)                        | 0           | (13,256)  |
| Recoveries                    | 8                            | 0                                 | 0                               | 0                       | 15                          | 0           | 23        |
| Balance, end of period        | \$ 7,244                     | \$ 5,026                          | \$ 11,132                       | \$ 2,150                | \$ 97                       | \$ 1,563    | \$ 27,212 |

The rollforward of the allowance for loan losses for the three and six months ended June 30, 2010 is as follows:

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| <i>(Dollars in Thousands)</i>  | <b>Three Months<br/>Ended</b> | <b>Six Months<br/>Ended</b> |
|--------------------------------|-------------------------------|-----------------------------|
| Balance at beginning of period | \$ 12,020                     | \$ 11,067                   |
| Provision for loan losses      | 5,000                         | 6,420                       |
| Recoveries                     | 67                            | 85                          |
| Loans charged-off              | (2,505)                       | (2,990)                     |
| Balance at end of period       | \$ 14,582                     | \$ 14,582                   |

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The following summarizes the ending loan balance individually evaluated for impairment based upon loan segment, as well as the related allowance for loan loss allocation for each at June 30, 2011 and December 31, 2010:

*(Dollars in thousands)*

|                                       | Commercial<br>Real Estate | Acquisition<br>and<br>Development | Commercial<br>and<br>Industrial | Residential<br>Mortgage | Installment<br>and Other | Unallocated | Total      |
|---------------------------------------|---------------------------|-----------------------------------|---------------------------------|-------------------------|--------------------------|-------------|------------|
| <b>June 30, 2011</b>                  |                           |                                   |                                 |                         |                          |             |            |
| Loans allocated by:                   |                           |                                   |                                 |                         |                          |             |            |
| Individually evaluated for impairment | \$ 7,444                  | \$ 10,594                         | \$ 29,680                       | \$ 1,174                | \$ 0                     | \$ 0        | \$ 48,892  |
| Collectively evaluated for impairment | 353,122                   | 98,900                            | 253,349                         | 232,756                 | 12,014                   | 0           | 950,141    |
|                                       | \$ 360,566                | \$ 109,494                        | \$ 283,029                      | \$ 233,930              | \$ 12,014                | \$ 0        | \$ 999,033 |

|   |          |          |           |          |       |          |           |
|---|----------|----------|-----------|----------|-------|----------|-----------|
| Allowance for loan losses allocated by: |          |          |           |          |       |          |           |
| Individually evaluated for impairment   | \$ 1,589 | \$ 1,512 | \$ 5,609  | \$ 10    | \$ 0  | \$ 0     | \$ 8,720  |
| Collectively evaluated for impairment   | 5,655    | 3,514    | 5,523     | 2,140    | 97    | 1,563    | 18,492    |
|   | \$ 7,244 | \$ 5,026 | \$ 11,132 | \$ 2,150 | \$ 97 | \$ 1,563 | \$ 27,212 |

**December 31, 2010**

|                                       |            |            |            |            |           |      |            |
|---------------------------------------|------------|------------|------------|------------|-----------|------|------------|
| Loans allocated by:                   |            |            |            |            |           |      |            |
| Individually evaluated for impairment | \$ 2,840   | \$ 0       | \$ 10,718  | \$ 1,181   | \$ 0      | \$ 0 | \$ 14,739  |
| Collectively evaluated for impairment | 337,181    | 117,402    | 253,225    | 230,634    | 11,112    | 0    | 949,554    |
|                                       | \$ 340,021 | \$ 117,402 | \$ 263,943 | \$ 231,815 | \$ 11,112 | \$ 0 | \$ 964,293 |

|   |          |          |          |          |        |        |           |
|---|----------|----------|----------|----------|--------|--------|-----------|
| Allowance for loan losses allocated by: |          |          |          |          |        |        |           |
| Individually evaluated for impairment   | \$ 1,251 | \$ 0     | \$ 3,232 | \$ 20    | \$ 0   | \$ 0   | \$ 4,503  |
| Collectively evaluated for impairment   | 4,073    | 1,767    | 3,563    | 1,843    | 106    | 165    | 11,517    |
|   | \$ 5,324 | \$ 1,767 | \$ 6,795 | \$ 1,863 | \$ 106 | \$ 165 | \$ 16,020 |

**NOTE 4. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITY**

The Company entered into three (3) rate swap agreements during 2008 and 2009 related to fixed rate loans. The Company uses these interest rate swaps to reduce interest rate risks and to manage interest income. By entering into these agreements, the Company converts floating rate assets into fixed rate assets. These interest rate swap agreements are considered cash flow hedge derivative instruments that qualify for hedge accounting. A portion of the amount included in other comprehensive income is reclassified from other comprehensive income to the appropriate income statement line item as net settlements occur.

The notional amounts of the interest rate swaps are not exchanged and do not represent exposure to credit loss. In the event of default by a counter party, the risk in these transactions is the cost of replacing the agreements at current market rates. During the three months ended March 31, 2011, the Company sold one of its rate swaps and recognized a \$118,000 gain on the sale, which is included in the ineffective portion of the following table, once it no longer qualified as a hedge.

The balances of the derivative instruments on the consolidated financial statements as of June 30, 2011 and December 31, 2010 are as follows:

| <i>(Dollars in thousands)</i> | Notional/<br>Contract<br>Amount | Estimated<br>Net Fair<br>Value | Fair Value<br>Balance Sheet<br>Location | Expiration<br>Date | Fixed<br>Rate |
|-------------------------------|---------------------------------|--------------------------------|---|--------------------|---------------|
|-------------------------------|---------------------------------|--------------------------------|---|--------------------|---------------|

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**June 30, 2011:**

|                                       |           |        |              |            |       |
|---------------------------------------|-----------|--------|--------------|------------|-------|
| Interest rate swap - 5 year cash flow | \$ 20,000 | \$ 791 | other assets | 11/26/2013 | 5.28% |
|---------------------------------------|-----------|--------|--------------|------------|-------|

**December 31, 2010:**

|                                       |        |     |              |            |       |
|---------------------------------------|--------|-----|--------------|------------|-------|
| Interest rate swap - 5 year cash flow | 20,000 | 804 | other assets | 11/26/2013 | 5.28% |
|---------------------------------------|--------|-----|--------------|------------|-------|

|                                       |        |     |              |            |       |
|---------------------------------------|--------|-----|--------------|------------|-------|
| Interest rate swap - 4 year cash flow | 10,000 | 209 | other assets | 05/27/2013 | 4.54% |
|---------------------------------------|--------|-----|--------------|------------|-------|

|  |           |          |  |  |       |
|--|-----------|----------|--|--|-------|
|  | \$ 30,000 | \$ 1,013 |  |  | 5.03% |
|--|-----------|----------|--|--|-------|

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The effects of the interest rate swaps on the Company's income statement for the quarters and six months ended June 30, 2011 and 2010 are as follows:

| Derivatives in cash flow hedging relationships<br>(Dollars in thousands) | Amount of Gain (Loss)<br>Recognized in OCI on<br>Derivatives<br>(Effective Portion) |               | Location of Gain<br>or (Loss)<br>Recognized in<br>Income on<br>Derivative<br>(Ineffective Portion) | Amount of Gain (Loss)<br>Reclassified from<br>Accumulated OCI<br>into<br>Income<br>(Realized portion) |               |
|--|---|---------------|--|---|---------------|
|  | 2011  | 2010          |  | 2011  | 2010          |
| <b>For three months ended June 30</b>                                    |   |               |  |   |               |
| Interest rate swap - 4 year cash flow                                    | \$ 0  | \$ (406)      | Interest income  | \$ 0  | \$ 0          |
| Interest rate swap - 5 year cash flow                                    | 141   | 535           | Interest income  | 103   | 101           |
| Interest rate swap - 4 year cash flow                                    | 0   | 228           | Interest income  | 0   | 32            |
|  | <b>\$ 141</b>   | <b>\$ 357</b> |  | <b>\$ 103</b>   | <b>\$ 133</b> |
|  | <b>2011</b>   | <b>2010</b>   |  | <b>2011</b>   | <b>2010</b>   |
| <b>For six months ended June 30</b>                                      |   |               |  |   |               |
| Interest rate swap - 4 year cash flow                                    | \$ 0  | \$ (152)      | Interest income  | \$ 0  | \$ 243        |
| Interest rate swap - 5 year cash flow                                    | (38)  | 781           | Interest income  | 204   | 202           |
| Interest rate swap - 4 year cash flow                                    | (92)  | 348           | Interest income  | 32  | 64            |
|  | <b>\$ (130)</b>   | <b>\$ 977</b> |  | <b>\$ 236</b>   | <b>\$ 509</b> |

| Derivatives in cash flow hedging relationships<br>(Dollars in thousands) | Location of Gain or<br>(Loss) Recognized in<br>Income on Derivative<br>(Ineffective Portion) | Amount of Gain (Loss)<br>Recognized in Income on<br>Derivative<br>(Ineffective Portion) |                |
|--|--|---|----------------|
|  |  | 2011  | 2010           |
| <b>For three months ended June 30</b>                                    |  |   |                |
| Interest rate swap - 4 year cash flow                                    | Other income   | \$ 0  | \$ (22)        |
| Interest rate swap - 5 year cash flow                                    | Other income   | 13  | 11             |
| Interest rate swap - 4 year cash flow                                    | Other income   | 0   | 0              |
|  |  | <b>\$ 13</b>  | <b>\$ (11)</b> |
|  |  | <b>2011</b>   | <b>2010</b>    |
| <b>For six months ended June 30</b>                                      |  |   |                |
| Interest rate swap - 4 year cash flow                                    | Other income   | \$ 0  | \$ (5)         |
| Interest rate swap - 5 year cash flow                                    | Other income   | 25  | 22             |
| Interest rate swap - 4 year cash flow                                    | Other income   | 118   | 0              |
|  |  | <b>\$ 143</b>   | <b>\$ 17</b>   |

Under the terms of the agreement, the Bank pays interest monthly at the rate equivalent to Wall Street Journal prime and receives interest income monthly at the fixed rate shown above. In July 2011, the Company sold its remaining \$20,000,000 notional value interest rate swap at an approximate \$673,000 gain.

**NOTE 5. SHAREHOLDERS' EQUITY AND REGULATORY CAPITAL**

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On February 9, 2010, the Company filed a shelf registration statement on Form S-3 with the Securities and Exchange Commission that provided the Company the ability to raise capital, from time to time, up to an aggregate of \$80,000,000, through the sale of stock, preferred stock, debt securities, warrants and other securities. The Company completed a public stock offering of 1,481,481 shares of common stock at a price of \$27.00 per share, for gross proceeds of approximately \$40,000,000 during the first quarter of 2010. Net proceeds after underwriting commissions and expenses were \$37,585,000. The Company believes that with this additional capital, it positions itself well to weather the economy and take advantage of future opportunities that may arise. The Company has no current plans to issue additional shares of common stock.

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**Table of Contents****NOTE 6. EARNINGS PER SHARE**

Earnings per share for the three and six months ended June 30, 2011 and 2010 were as follows:

| <i>(Dollars In Thousands, except per share data)</i> | <b>Three Months Ended</b> |                          | <b>Six Months Ended</b>  |                          |
|--|---------------------------|--------------------------|--------------------------|--------------------------|
|  | <b>June 30,<br/>2011</b>  | <b>June 30,<br/>2010</b> | <b>June 30,<br/>2011</b> | <b>June 30,<br/>2010</b> |
| Net income   | \$ (10,623)               | \$ 3,904                 | \$ (6,796)               | \$ 7,310                 |
| Weighted average shares outstanding (basic)          | 8,000                     | 7,962                    | 7,994                    | 7,233                    |
| Impact of common stock equivalents                   | 0                         | 17                       | 19                       | 33                       |
| Weighted average shares outstanding (diluted)        | 8,000                     | 7,979                    | 8,013                    | 7,266                    |
| <b>Per share information:</b>                        |                           |                          |                          |                          |
| Basic earnings per share                             | \$ (1.33)                 | \$ 0.49                  | \$ (0.85)                | \$ 1.01                  |
| Diluted earnings per share                           | \$ (1.33)                 | \$ 0.49                  | \$ (0.85)                | \$ 1.01                  |

Stock options for 371,000 and 251,000 shares of common stock were not considered in computing diluted earnings per share for the three months ended June 30, 2011 and 2010, as their exercise would have been antidilutive. Stock options for 289,000 and 197,000 shares of common stock were not considered for the six months ended June 30, 2011 and 2010 as they were antidilutive. The shares were antidilutive either due to the Company recognizing a net loss for the period or the options exercise price exceeded the average market value.

**NOTE 7. COMPREHENSIVE INCOME**

The Company's other comprehensive income (loss) items are limited to unrealized gains on securities available for sale and unrealized gains (losses) on derivatives used for cash flow hedges. The components of other comprehensive income (loss) for the three and six months ended June 30, 2011 and 2010 are as follows:

| <i>(Dollars in thousands)</i>  | <b>Three Months Ended</b> |                          | <b>Six Months Ended</b>  |                          |
|--|---------------------------|--------------------------|--------------------------|--------------------------|
|  | <b>June 30,<br/>2011</b>  | <b>June 30,<br/>2010</b> | <b>June 30,<br/>2011</b> | <b>June 30,<br/>2010</b> |
| Unrealized holding gains on securities available for sale arising during the period      | \$ 4,729                  | \$ 6,262                 | \$ 5,654                 | \$ 7,708                 |
| Reclassification adjustment for gains realized in net income                             | (469)                     | (1,781)                  | (848)                    | (2,179)                  |
| Net unrealized gains   | 4,260                     | 4,481                    | 4,806                    | 5,529                    |
| Tax effect   | (1,491)                   | (1,568)                  | (1,682)                  | (1,935)                  |
|  | 2,769                     | 2,913                    | 3,124                    | 3,594                    |
| Unrealized holding gains (losses) in fair value of derivatives used for cash flow hedges | 140                       | 356                      | (129)                    | 1,755                    |
| Reclassification adjustment for gains realized in net income                             | 0                         | 0                        | (118)                    | (778)                    |
| Net unrealized gains (losses)  | 140                       | 356                      | (247)                    | 977                      |
| Tax effect   | (49)                      | (125)                    | 86                       | (342)                    |
|  | 91                        | 231                      | (161)                    | 635                      |
| Total other comprehensive income, net of tax and reclassification adjustments            | \$ 2,860                  | \$ 3,144                 | \$ 2,963                 | \$ 4,229                 |

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The components of accumulated other comprehensive income, net of taxes, are as follows:

|  | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|--|--------------------------|------------------------------|
| Unrealized gains (losses) on securities available for sale | \$ 2,439                 | \$ (685)                     |
| Unrealized gains on derivatives used for cash flow hedges  | 436                      | 597                          |
|  | <b>\$ 2,875</b>          | <b>\$ (88)</b>               |

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**NOTE 8. OTHER COMMITMENTS**

In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities which are not reflected in the accompanying financial statements. These commitments include various guarantees and commitments to extend credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company's subsidiary bank evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. Standby letters of credit and financial guarantees written are conditional commitments to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Bank holds collateral supporting those commitments when deemed necessary by management. At June 30, 2011 and December 31, 2010, \$27,970,000 and \$29,558,000 of performance standby letters of credit have been issued. The Company does not anticipate any losses as a result of these transactions.

**NOTE 9. FAIR VALUE DISCLOSURES**

*Fair Value Measurements* under generally accepted accounting principles defines fair value, describes a framework for measuring fair value and requires disclosures about fair value measurements by establishing a three-level hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the assets or liabilities fall within different levels of the hierarchy, the classification is based on the lowest level input that is significant to the fair value measurement of the asset or liability. Classification of assets and liabilities within the hierarchy considers the markets in which the assets and liabilities are traded and the reliability and transparency of the assumptions used to determine fair value.

The three levels are defined as follows: Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar instruments in markets that are not active or by model-based techniques in which all significant inputs are observable in the market for the asset or liability, for substantially the full term of the financial instrument. Level 3-the valuation methodology is derived from model-based techniques in which at least one significant input is unobservable to the fair value measurement and based on the Company's own assumptions about market participants' assumptions.

Following is a description of the valuation methodologies used for instruments measured on a recurring basis at estimated fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

**Securities**

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, securities are classified within Level 2 and fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. All of the Company's securities are classified as available for sale.

**Interest Rate Swaps**

Cash flow interest rate swaps are classified within Level 2 with fair values determined by quoted market prices and mathematical models using current and historical data.

The Company had no fair value liabilities at June 30, 2011 or December 31, 2010. A summary of assets at June 30, 2011 and December 31, 2010, measured at estimated fair value on a recurring basis were as follows:

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| <i>(Dollars in Thousands)</i>               | Level 1  | Level 2    | Level 3 | Total Fair Value Measurements |
|---|----------|------------|---------|-------------------------------|
| <b>June 30, 2011</b>                        |          |            |         |                               |
| Securities available for sale:              |          |            |         |                               |
| U.S. Government Sponsored Enterprises (GSE) | \$ 0     | \$ 97,998  | \$ 0    | \$ 97,998                     |
| States and political subdivisions           | 0        | 98,765     | 0       | 98,765                        |
| GSE residential mortgage-backed securities  | 0        | 222,201    | 0       | 222,201                       |
| Total debt securities                       | 0        | 418,964    | 0       | 418,964                       |
| Equity securities:                          |          |            |         |                               |
| Diversified                                 | 52       | 0          | 0       | 52                            |
| Energy                                      | 242      | 0          | 0       | 242                           |
| Financial services                          | 251      | 70         | 0       | 321                           |
| Industrials                                 | 135      | 0          | 0       | 135                           |
| Technology                                  | 476      | 0          | 0       | 476                           |
| Other                                       | 883      | 0          | 0       | 883                           |
| Total equity securities                     | 2,039    | 70         | 0       | 2,109                         |
| Total securities                            | \$ 2,039 | \$ 419,034 | \$ 0    | \$ 421,073                    |
| Interest rate swaps                         | \$ 0     | \$ 791     | \$ 0    | \$ 791                        |
| <b>December 31, 2010</b>                    |          |            |         |                               |
| Securities available for sale:              |          |            |         |                               |
| U.S. Government Sponsored Enterprises (GSE) | \$ 0     | \$ 120,286 | \$ 0    | \$ 120,286                    |
| States and political subdivisions           | 0        | 97,148     | 0       | 97,148                        |
| GSE residential mortgage-backed securities  | 0        | 212,176    | 0       | 212,176                       |
| Total debt securities                       | 0        | 429,610    | 0       | 429,610                       |
| Equity securities:                          |          |            |         |                               |
| Diversified                                 | 267      | 0          | 0       | 267                           |
| Energy                                      | 60       | 0          | 0       | 60                            |
| Financial services                          | 351      | 279        | 0       | 630                           |
| Industrials                                 | 208      | 0          | 0       | 208                           |
| Technology                                  | 147      | 0          | 0       | 147                           |
| Other                                       | 784      | 66         | 0       | 850                           |
| Total equity securities                     | 1,817    | 345        | 0       | 2,162                         |
| Total securities                            | \$ 1,817 | \$ 429,955 | \$ 0    | \$ 431,772                    |
| Interest rate swaps                         | \$ 0     | \$ 1,013   | \$ 0    | \$ 1,013                      |

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with accounting principles generally accepted in the United States. Adjustments to the fair value of these assets usually result from the application of lower-of-cost or fair value accounting or write-down of individual assets.

The following describes the valuation techniques used by the Company to measure certain financial assets recorded at fair value on a nonrecurring basis in the financial statements.

**Impaired Loans**

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Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due, according to the contractual terms of the loan agreement, will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loan, less estimated costs to sell. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The value of the real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is older than two years, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal, if deemed significant, or the net book value on the applicable business financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans with an allocation to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statement of income. Specific

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allocations to the allowance for loan losses were \$8,720,000 and \$4,503,000 at June 30, 2011 and December 31, 2010, respectively.

**Foreclosed Real Estate Owned**

Other real estate property acquired through foreclosure is initially recorded at fair value of the property at the transfer date less estimated selling cost. Subsequently, other real estate owned is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. There were 2 other real estate owned properties with cumulative write-downs totaling \$40,000 for June 30, 2011.

**Mortgage Servicing Rights**

The fair value of mortgage servicing rights is estimated to be equal to its carrying value, unless the quarterly valuation model calculates the present value of the estimated net servicing income is less than its carrying value, in which case a lower of cost or market (LOCM) charge is taken. In the fourth quarter of 2010, a \$200,000 lower of cost or market charge was taken on the mortgage servicing right portfolio. Due to increases in mortgage servicing rights values, this LOCM reserve was reversed in the first quarter of 2011.

A summary of assets at June 30, 2011 and December 31, 2010 measured at fair value on a nonrecurring basis is as follows:

| <i>(Dollars in Thousands)</i> | Level 1 | Level 2 | Level 3   | Total Fair Value Measurements |
|-------------------------------|---------|---------|-----------|-------------------------------|
| <b>June 30, 2011</b>          |         |         |           |                               |
| Impaired loans, net           | \$ 0    | \$ 0    | \$ 38,746 | \$ 38,746                     |
| Foreclosed real estate        | 0       | 0       | 56        | 56                            |
| <b>December 31, 2010</b>      |         |         |           |                               |
| Impaired loans, net           | \$ 0    | \$ 0    | \$ 9,118  | \$ 9,118                      |
| Foreclosed real estate        | 0       | 0       | 259       | 259                           |
| Mortgage servicing rights     | 0       | 0       | 2,057     | 2,057                         |

**Fair values of financial instruments**

The Company meets the requirements for disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Certain financial instruments and all non-financial instruments are excluded from disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

In addition to those disclosed above, the following methods and assumptions were used by the Company in estimating fair values of financial instruments as disclosed herein:

**Cash, Due from Banks, Short-Term Investments, Interest Bearing Deposits with Banks and Federal Funds Sold**

The carrying amounts of cash, due from banks, short-term investments, interest bearing deposits with banks and federal funds sold approximate their fair value.

**Loans Held for Sale**

Loans held for sale are carried at the lower of cost or fair value. These loans typically consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale.

**Loans Receivable**

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For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered in the market for loans with similar terms to borrowers of similar credit quality.

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**Table of Contents****Restricted Investment in Bank Stock**

These investments are carried at cost. The Company is required to maintain minimum investment balances in these stocks, which are not actively traded and therefore have no readily determinable market value.

**Deposit Liabilities**

The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposits and IRAs are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market to a schedule of aggregated expected maturities on time deposits.

**Short-Term Borrowings**

The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within 90 days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

**Long-Term Debt**

The fair value of the Company's fixed rate long-term borrowings is estimated using a discounted cash flow analysis based on the Company's current incremental borrowing rate for similar types of borrowing arrangements. The carrying amounts of variable-rate long-term borrowings approximate their fair values at the reporting date.

**Accrued Interest**

The carrying amounts of accrued interest approximate their fair values.

**Off-Balance-Sheet Instruments**

The Company generally does not charge commitment fees. Fees for standby letters of credit and other off-balance-sheet instruments are not significant.

The estimated fair values of the Company's financial statements were as follows at June 30, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i>        | June 30, 2011   |                | December 31, 2010 |                |
|--------------------------------------|-----------------|----------------|-------------------|----------------|
|                                      | Carrying Amount | Fair Value     | Carrying Amount   | Fair Value     |
| <b>Financial Assets</b>              |                 |                |                   |                |
| Cash and due from banks              | \$ 14,470       | 14,470         | \$ 10,400         | \$ 10,400      |
| Federal funds sold                   | 2,230           | 2,230          | 8,800             | 8,800          |
| Short-term investments               | 2,728           | 2,728          | 2,728             | 2,728          |
| Interest bearing deposits with banks | 3,585           | 3,585          | 925               | 925            |
| Restricted investments in bank stock | 9,331           | 9,331          | 8,798             | 8,798          |
| Securities available for sale        | 421,073         | 421,073        | 431,772           | 431,772        |
| Loans held for sale                  | 4,945           |                | 2,693             |                |
| Loans                                | 999,033         |                | 964,293           |                |
| Allowance for loan losses            | (27,212)        |                | (16,020)          |                |
| <b>Net loans</b>                     | <b>976,766</b>  | <b>936,993</b> | <b>950,966</b>    | <b>937,928</b> |
| Accrued interest receivable          | 5,685           | 5,685          | 5,715             | 5,715          |
| Mortgage servicing rights            | 2,227           | 2,419          | 2,057             | 2,057          |
| Interest rate swaps                  | 791             | 791            | 1,013             | 1,013          |



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| <b>Financial Liabilities</b>  |              |              |              |              |
|-------------------------------|--------------|--------------|--------------|--------------|
| Deposits                      | \$ 1,260,206 | \$ 1,264,750 | \$ 1,188,377 | \$ 1,192,028 |
| Short-term borrowings         | 62,878       | 62,878       | 87,850       | 87,850       |
| Long-term debt                | 44,753       | 45,893       | 65,178       | 66,397       |
| Accrued interest payable      | 1,079        | 1,079        | 1,053        | 1,053        |
| Off-balance sheet instruments | 0            | 0            | 0            | 0            |

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**PART I - FINANCIAL INFORMATION**

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

**OVERVIEW**

Orrstown Financial Services, Inc. (the Company) is a financial holding Company with a wholly-owned bank subsidiary, Orrstown Bank (the Bank). The following is a discussion of our consolidated financial condition at June 30, 2011 and results of operations for the three and six months ended June 30, 2011 and June 30, 2010. Throughout this discussion, the yield on earning assets is stated on a fully taxable-equivalent basis and balances represent average daily balances unless otherwise stated. The discussion and analysis should be read in conjunction with our Condensed Consolidated Financial Statements (Unaudited) and Notes thereto presented in this report. Certain prior period amounts, presented in this discussion and analysis, have been reclassified to conform to current period classifications.

Certain statements appearing herein which are not historical in nature are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements refer to a future period or periods, reflecting management's current views as to likely future developments, and use words like may, will, expect, estimate, anticipate or similar terms. Because forward-looking statements involve certain risks, uncertainties and other factors over which the Company has no direct control, actual results could differ materially from those contemplated in such statements. These factors include (but are not limited to) the following: general economic conditions, changes in interest rates, changes in the Company's cost of funds, changes in government monetary policy, changes in government regulation and taxation of financial institutions, including changes resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act and related regulations, changes in the rate of inflation, changes in technology, the intensification of competition within the Company's market area and other similar factors. For a discussion of these forward-looking statements and important factors that could cause results to differ materially from the forward-looking statements contained in this Report, see Important Factors Relating to Forward Looking Statements contained in our Annual Report on Form 10-K for the year ended December 31, 2010.

**Critical Accounting Policies**

Orrstown'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 Commission. 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 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

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susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheet.

Goodwill and other intangible assets have been recorded on the books of the Company in connection with its acquisitions. Goodwill and other intangible assets are 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 values of the reporting units exceed their 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. To date, the Company has not had to take an impairment charge on its goodwill.

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 June 30, 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.

**SUMMARY OF FINANCIAL RESULTS**

The Company recorded a net loss of \$10.6 million for the second quarter of 2011 compared to net income of \$3.9 million for the same period in 2010, representing a decrease of \$14.5 million or 372%. Diluted earnings (loss) per share for the second quarter of 2011 were (\$1.33), compared to \$0.49 for the second quarter of 2010. Earnings per share declined in 2011 compared to 2010, primarily the result of posting a net loss for the period. On a year-to-date basis, the net loss recorded for the period was \$6.8 million for 2011, compared to net income of \$7.3 million in 2010. Diluted earnings (loss) per share totaled (\$0.85) for the six months ended June 30, 2011 compared to \$1.01 in 2010.

Included below are ratios for the return on average tangible assets (ROTA) and return on average tangible equity (ROTE) which exclude intangibles from the balance sheet and related amortization and tax expense from net income due to the associated goodwill and intangibles from the acquisition of companies and purchased deposits.

|                                   | Three Months Ended |                | Six Months Ended |                |
|-----------------------------------|--------------------|----------------|------------------|----------------|
|                                   | June, 30, 2011     | June, 30, 2010 | June, 30, 2011   | June, 30, 2010 |
| Return on average assets          | (2.77%)            | 1.18%          | (0.90%)          | 1.15%          |
| Return on average tangible assets | (2.80%)            | 1.22%          | (0.90%)          | 1.18%          |
| Return on average equity          | (26.03%)           | 10.20%         | (8.44%)          | 11.04%         |
| Return on average tangible equity | (29.69%)           | 12.02%         | (9.57%)          | 13.23%         |
| Average equity / average assets   | 10.65%             | 11.56%         | 10.65%           | 10.42%         |

**Supplemental Reporting of Non-GAAP-based Financial Measures**

Tangible book value per share 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 as follows:

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| <i>(Dollars in thousands, except per share data)</i> | <b>June 30, 2011</b> | <b>December 31, 2010</b> |
|--|----------------------|--------------------------|
| Common shareholder's equity                          | \$ 153,441           | \$ 160,484               |
| Less: intangible assets                              | 20,593               | 20,698                   |
| <b>Tangible common equity</b>                        | <b>\$ 132,848</b>    | <b>\$ 139,786</b>        |
| Book value per share                                 | \$ 19.15             | \$ 20.10                 |
| Less: intangible assets per share                    | 2.57                 | 2.60                     |
| <b>Tangible book value per share</b>                 | <b>\$ 16.58</b>      | <b>\$ 17.50</b>          |
| <b>Total assets</b>                                  | <b>\$ 1,531,290</b>  | <b>\$ 1,511,722</b>      |
| Less intangible assets                               | 20,593               | 20,698                   |
| <b>Tangible assets</b>                               | <b>\$ 1,510,697</b>  | <b>\$ 1,491,024</b>      |

Return on average tangible assets and return on average tangible equity are 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, net of tax, from the calculation of return on average assets and equity. Management uses the return on average tangible assets and equity to assess the Company's core operating results and believes that this is a better measure of our operating performance as it is 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. Lastly, the exclusion of goodwill and other intangible assets is consistent with the treatment by bank regulatory agencies from the calculation of risk-based capital ratios, which excludes these amounts. 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, is set forth below.

| <b>For Quarter Ended:</b>  | <b>June 30, 2011</b> | June 30, 2010 |
|--|----------------------|---------------|
| Return on Average Assets (GAAP basis)  | (2.77%)              | 1.18%         |
| Effect of excluding average intangible assets and related amortization, net of tax | (0.03%)              | 0.04%         |
| <b>Return on Average Tangible Assets</b>   | <b>(2.80%)</b>       | 1.22%         |
| Return on Average Equity (GAAP basis)  | (26.03%)             | 10.20%        |
| Effect of excluding average intangible assets and related amortization, net of tax | (3.66%)              | 1.82%         |
| <b>Return on Average Tangible Equity</b>   | <b>(29.69%)</b>      | 12.02%        |
| <b>For Six Months Ended:</b>   | <b>June 30, 2011</b> | June 30, 2010 |
| Return on Average Assets (GAAP basis)  | (0.90%)              | 1.15%         |
| Effect of excluding average intangible assets and related amortization, net of tax | 0.00%                | 0.03%         |
| <b>Return on Average Tangible Assets</b>   | <b>(0.90%)</b>       | 1.18%         |
| Return on Average Equity (GAAP basis)  | (8.44%)              | 11.04%        |

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|  |         |        |
|--|---------|--------|
| Effect of excluding average intangible assets and related amortization, net of tax | (1.13%) | 2.19%  |
| Return on Average Tangible Equity  | (9.57%) | 13.23% |

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**RESULTS OF OPERATIONS**

**QUARTER ENDED JUNE 30, 2011 COMPARED TO QUARTER ENDED JUNE 30, 2010**

Net loss for the quarter ended June 30, 2011 was \$10.6 million, compared to net income of \$3.9 million in 2010, resulting in diluted earnings (loss) per share of (\$1.33) and \$0.49 for the periods. As a result of the net loss for the 2011 period, the Company's return on assets and return on tangible equity ratios were negative for the period, compared to 1.18% and 12.02%, respectively, in 2010.

**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 Average Balances and Interest Rates table presents net interest income on a fully taxable equivalent basis, net interest rate spread and net interest margin for the quarters ended June 30, 2011 and 2010.

Net interest income measured on a fully tax equivalent basis, totaled \$13.5 million for the three months ended June 30, 2011, a \$1.8 million, or 15.6%, increase over 2010. The growth in net income came principally through an increase in interest earning assets, which averaged \$1.45 billion for the quarter ended June 30, 2011, compared to \$1.23 billion in 2010. Slightly offsetting the growth in interest earning assets was a 6 basis point decline in net interest margin. Despite the low interest rate environment, the Company has been able to manage its blend of interest earnings assets and liabilities so that net interest margin has only declined slightly, from 3.77% for the three months ended June 30, 2010 to 3.71% in 2011. On a linked-quarter basis, net interest margin increased from 3.68% for the quarter ended March 31, 2011 to 3.71% for the second quarter of 2011. The Company has been able to lower its overall cost of funds to 0.76% for the period, an improvement over the prior year's cost of funds of 1.05% and the prior quarter's cost of 0.84%. The net interest spread has steadily been increasing the last four quarters, and was 3.60% for the quarter ended June 30, 2011 versus 3.59% in the previous quarter and 3.54% for 2010's fourth quarter.

Average interest bearing deposits increased \$183.3 million, or 17.2%, 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 strong rating facilitates the Company's ability to attract time deposits and brokered deposits. Average balance of time deposits of \$596.1 million for the quarter ended June 30, 2011 exceeded 2010's average balance of \$483.8 million by 23.2%. Interest expense decreased \$509,000, or 15.7% from \$3.2 million for the quarter ended June 30, 2010 to \$2.7 million for the quarter ended June 30, 2011. The Company recognizes that brokered funds are 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, and can be used to meet the maturity needs of time and brokered deposits. We have matched cash flows from the debt securities portfolio with nontraditional cash flows to enable us to unwind the strategy if loan demand continues to increase or if the yield curve flattens.

Interest income earned on loans increased from \$12.4 million for the quarter ended June 30, 2010 to \$12.7 million in 2011, a 2.5% increase. The growth in the loan portfolio was the primary reason for the increase in net interest income. Average loans increased \$111.3 million, or 12.3%, from the quarter ended

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June 30, 2010 to June 30, 2011. The increase in average loans is the result of the Company's desire to continue to grow its loan portfolio and deploy its capital. 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 in these markets served. The growth experienced in the loan portfolio in the second half of 2010, supplemented with the loan demand in the first half of 2011, provided the strong growth in average loan balances. Due to the variable nature of a large portion of the loan portfolio, along with the implementation of floors as loans renewed, the decline in average rate earned on loans was not as severe as the securities portfolio or that paid on longer term borrowings. The rate earned on loans was 4.96%, or 49 b.p. less than 2010, and partially offset the increase in interest income that resulted from higher average balances.

As a result of the increase in its deposit base, the Company has placed less reliance on more costly long-term borrowings. Interest expense on long-term debt has decreased \$135,000 from \$408,000 for the quarter ended June 30, 2010 to \$273,000 in the corresponding quarter in 2011. Reduction in average daily balance of \$5.6 million for 2011 compared to 2010 and the lower rate paid of 2.43% in 2011 compared to 3.19% in 2010 contributed to reduced interest expense.

The Company's net interest margin declined by 6 b.p. in the quarter ended June 30, 2011 compared to 2010. Given the continued low interest rate, reduced rates earned on interest earning assets outpaced the reduction in rates that we could pass on to our customers, and resulted in the lower interest rate spread and margin.

The table that follows shows average balances and interest yields on a fully taxable equivalent basis (FTE):

**Average Balances and Interest Rates**

|   | June 30, 2011   |                         |                     | Three Months Ended |                                       |                     |
|---|-----------------|-------------------------|---------------------|--------------------|---------------------------------------|---------------------|
|   | Average Balance | Tax Equivalent Interest | Tax Equivalent Rate | Average Balance    | June 30, 2010 Tax Equivalent Interest | Tax Equivalent Rate |
| <i>(Dollars in thousands)</i>                       |                 |                         |                     |                    |                                       |                     |
| <b>Assets</b>                                       |                 |                         |                     |                    |                                       |                     |
| Federal funds sold & interest bearing bank balances | \$ 29,556       | \$ 21                   | 0.28%               | \$ 32,301          | \$ 33                                 | 0.41%               |
| Securities  | 406,048         | 3,547                   | 3.50                | 298,894            | 2,518                                 | 3.41                |
| Loans   | 1,013,111       | 12,687                  | 4.96                | 901,812            | 12,383                                | 5.45                |
| Total interest-earning assets                       | 1,448,715       | 16,255                  | 4.47                | 1,233,007          | 14,934                                | 4.82                |
| Other assets  | 88,585          |                         |                     | 94,011             |                                       |                     |
| Total   | \$ 1,537,300    |                         |                     | \$ 1,327,018       |                                       |                     |
| <b>Liabilities and Shareholders' Equity</b>         |                 |                         |                     |                    |                                       |                     |
| Interest bearing demand deposits                    | \$ 466,086      | \$ 416                  | 0.36                | \$ 402,872         | \$ 732                                | 0.73                |
| Savings deposits                                    | 71,806          | 36                      | 0.20                | 63,679             | 45                                    | 0.28                |
| Time deposits                                       | 596,138         | 1,907                   | 1.28                | 483,824            | 1,970                                 | 1.63                |
| Short term borrowings                               | 72,943          | 95                      | 0.52                | 67,571             | 81                                    | 0.48                |
| Long term debt                                      | 44,936          | 273                     | 2.43                | 50,620             | 408                                   | 3.19                |
| Total interest bearing liabilities                  | 1,251,909       | 2,727                   | 0.87                | 1,068,566          | 3,236                                 | 1.22                |
| Non-interest bearing demand deposits                | 111,957         |                         |                     | 96,099             |                                       |                     |
| Other   | 9,753           |                         |                     | 8,896              |                                       |                     |
| Total Liabilities                                   | 1,373,619       |                         |                     | 1,173,561          |                                       |                     |
| Shareholders' Equity                                | 163,681         |                         |                     | 153,457            |                                       |                     |
| Total   | \$ 1,537,300    |                         | 0.76%               | \$ 1,327,018       |                                       | 1.05%               |

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|   |                  |              |           |              |
|---|------------------|--------------|-----------|--------------|
| Net interest income (FTE)/net interest spread | <b>13,528</b>    | <b>3.60%</b> | \$ 11,698 | 3.60%        |
| Net interest margin                           |                  | <b>3.71%</b> |           | <b>3.77%</b> |
| Tax-equivalent adjustment                     | <b>(718)</b>     |              | (398)     |              |
| Net interest income                           | <b>\$ 12,810</b> |              | \$ 11,300 |              |

NOTES: Yields and interest income on tax-exempt assets have been computed on a fully taxable equivalent basis assuming a 35% tax rate. For yield calculation purposes, nonaccruing loans are included in the average loan balance.

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### **Provision for Loan Losses**

The provision for loan losses for the three months ended June 30, 2011 totaled \$21.2 million, an increase over the second quarter 2010 provision of \$5.0 million. The increase in the provision for loan losses was attributable to the following factors:

An elevated charge-off of \$5.6 million above that which was initially reserved on a previously reported commercial credit in which the borrower is currently in bankruptcy. As a result of the Bank's recent termination of its involvement with the borrower's Plan of Reorganization exit financing, it was determined prudent to charge-off the entire loan balance, as the Bank is presently listed as an unsecured non-priority claimant in the pre-petition indebtedness.

Management reviewed several lending relationships with other borrowers in light of the issuance of new accounting guidance in 2011, as discussed further in the Allowance for Loan Losses section. During the past few months, the Bank proactively took actions with these borrowers to enable them to repay their loans under revised terms and conditions, which was felt to mitigate loss potential to the Bank while allowing the borrowers to work through these soft economic times. In many instances, the Bank was able to increase the interest rate on the loans and obtain additional collateral support for the borrowings, in exchange for extension of the loan terms. According to the recently issued accounting guidance, these loans were determined to be restructured loans in the second quarter of 2011, and valuation reserves totaling \$5.8 million were established on them, based principally on discounted cash flows. All restructured loans are currently performing in accordance with their modified conditions.

Prolonged softening real estate conditions, particularly in the Bank's southern market, have resulted in additional loan loss provision levels, as the allowance for loan losses was replenished for a \$2.6 million real estate construction loan that was charged-off in the quarter. The underlying collateral securing the loan is currently listed for sale at a price in excess of the recently received independent appraised value. Real estate values are depressed due to lack of growth in the market, abundance of properties available, and appraiser conservatism in their assignment of values.

The Bank's recognition of continuing softness in overall economic conditions and deterioration of underlying collateral securing lending relationships resulted in an ongoing credit review process during the quarter that covered 75% of the commercial loan portfolio as measured in dollars. This led to downgraded internal risk ratings on many existing credits, and subsequently raised reserve levels. Loans classified as substandard or doubtful have increased to \$150.2 million, compared to \$90.4 million and \$67.8 million at March 31, 2011 and December 31, 2010, respectively.

The continued economic pressures on customers and valuations on underlying collateral resulted in management increasing its qualitative reserve allocations on its loan portfolios to reflect these conditions. In addition, the \$13.2 million in net charge-offs experienced in 2011 resulted in increased quantitative reserve allocations to specific loan portfolios.

### **Other Income**

Noninterest income, excluding securities gains, totaled \$4.7 million for the three months ended June 30, 2011, compared to \$5.7 million in 2010. Included in 2010's income was \$239,000 recognized in life insurance death benefits upon the death of a former director and a gain on the sale of fixed rate for floating rate interest rate swap in the amount of \$778,000 and is included in other income. Excluding these items, noninterest income remained consistent between the two periods, with some shift to deposit accounts charges, and less loan related fees received on prepayment penalties, letters of credit fees and other loan services.

Trust department and brokerage income increased \$244,000, or 19.2% for the quarter ended June 30, 2011 compared to 2010, as a result of the stock market starting to show signs of recovery, and additional trust assets under management, which increased from \$840.8 million at June 30, 2010 to \$964.8 million at June 30, 2011.

Service charges on deposit accounts increased 3.3%, to \$1.6 million for the quarter ended June 30, 2011. The increase was principally the result of increased revenues earned on debit cards, partially offset by a decline in overdraft charges to depositors in the period.



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Securities gains totaled \$469,000 for the three months ended June 30, 2011, compared to \$1.8 million in 2010. The difference in gains taken between the two periods was the result of interest rate and market conditions, and the Company's asset liability management strategies.

The Company continues to advertise and market itself in order for consumers to recognize the broad range of financial services and products the Company has to offer, and to increase its brand recognition. Through the use of enhanced technology, the Company expects it will be able to reach a broader market which will allow it to continue to grow its customer base.

### **Other Expenses**

As a result of the growth the Company has experienced, noninterest expenses rose from \$8.5 million during the second quarter of 2010 to \$9.7 million for the same period in 2011, an increase of \$1.2 million, or 14.3%.

The following contributed to the net increase in other expenses:

Salaries decreased \$302,000, from \$4.5 million for the second quarter of 2010 to \$4.2 million for the second quarter of 2011. The decrease was primarily attributable to the reduction in employee benefit accruals based on the Company's performance, including discretionary executive bonuses and profit sharing accruals. Offsetting the reduction in these accruals was a growth in the number of full-time equivalents from 276 at June 30, 2010 to 302, at June 30, 2011.

Advertising and bank promotions increased \$66,000 for the second quarter of 2011 as compared to 2010. The increase in expense is a result of commitments to the communities that the Bank serves as we continue to build relationships and expand our presence in these market areas.

FDIC insurance increased \$472,000, from \$290,000 for the three months ended June 30, 2010 to \$762,000 for the same period in 2011. The increase is due to higher deposit balances and increased assessments recorded in 2011 compared to 2010.

Professional services totaled \$546,000 for the three months ended June 30, 2011, an increase of \$392,000 over \$154,000 in 2010. The increase in expenses can be attributed to increased professional services, including third party loan review assistance, legal costs associated with loan workouts and foreclosures, and increased audit fees due to increasing complexity and additional requirements of financial and regulatory reporting.

Collection and other real estate owned expenses, included in other operating expenses, increased approximately \$81,000, from \$136,000 for the quarter ended June 30, 2010 to \$217,000 for the quarter ended June 30, 2011. These expenses have increased as a result of the loans classified as corrective action and work-out plans are outlined with the customers in order to protect the Company from risk of loss.

The Company established a \$250,000 reserve for off-balance sheet commitments during the three months ended June 30, 2011, which is included in other expenses. As noted in the provision for loan losses section, the continuing softness in overall economic conditions and deterioration of underlying collateral resulted in the need for a reserve for unfunded commitments, particularly construction and development loans which need completed.

The Company has held a real estate property for several years for possible branch or operations expansions. During the quarter ended June 30, 2011, the Company obtained an updated appraisal on this property, and deemed it appropriate to record a \$156,000 charge to mark the property to its fair value. This charge is included in other expenses.

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The remainder of the increase in other expenses is primarily the result of the growth experiences by the Company. In order to better understand how other expenses increased in relation to related increases in revenue, operating expense levels are often measured in the financial services industry by the efficiency ratio, which expresses non-interest expense, as a percentage of tax-equivalent net interest income and noninterest income. The Company's efficiency ratio was 52.6% for the quarter ended June 30, 2011, compared to 48.7% in 2010, but improved sequentially from 52.9% during the first quarter of 2011.

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**Income Tax Expense**

The Company recorded an income tax benefit of \$2.3 million for the quarter ended June 30, 2011, compared to income tax expense of \$1.4 million for the same period in 2010. A meaningful comparison of income tax expense to levels of pre-tax income is its effective tax rate, which is less than the 35% federal statutory rate, primarily due to tax-exempt loan and security income, life insurance earnings and tax credits associated with low-income housing and historic projects, offset by certain non-deductible expenses and state income taxes.

The Company's effective tax rate declined to 17.9% for the quarter ended June 30, 2011 compared to 25.8% for the corresponding prior year period. For interim financial reporting, the Company computes its income tax expense (benefit) based on its estimated effective tax rate for the year, as noted in ASC 740-270-25. The lower effective tax rate in 2011 is the direct result of greater levels of tax-free income as a percentage of estimated taxable income anticipated to be earned for the year. The large provision for loan losses recorded during the quarter ended June 30, 2011 results in lower estimated taxable income for the year, and in a lower estimated effective tax rate.

As a result of utilizing the estimated annual effective tax rate in calculating the income tax benefit, the full benefit of the higher than normal provision for loan losses was not recognized in this quarter. It is anticipated the effective tax rate for the last two quarters of 2011 will remain lower than the historical 2010 and first quarter of 2011's rate. By year end, the full income tax benefit of the higher than normal provision for loan losses will be recognized.

**SIX MONTHS ENDED JUNE 30, 2011 COMPARED TO JUNE 30, 2010**

Net loss for the six months ended June 30, 2011 was \$6.8 million compared to net income of \$7.3 million in 2010, resulting in diluted earnings (loss) per share of (\$0.85) and \$1.01 for the periods. As a result of the net loss for the 2011 period, the Company's return on assets and return on tangible equity ratios were negative for the period, compared to 1.15% and 13.23%, respectively, in 2010.

**Net Interest Income**

The Average Balances and Interest Rates YTD table presents net interest income on a fully taxable equivalent basis, net interest rate spread and net interest margin for the six ended June 30, 2011 and 2010.

For the six months ended June 30, 2011, net interest income measured on a full tax equivalent basis, increased \$4.0 million, or 17.8%, to \$26.6 million from \$22.6 million in the corresponding period in 2010. The primary reason for the increase in net interest income was an increase in average earning assets from \$1.88 billion for the first six months of 2010 to \$1.434 billion in 2011. Offsetting the growth in average interest earning assets was a decline in net interest margin by 6 basis points (b. p.), from 3.77% in 2010 to 3.70% for 2011. The net interest spread for the six months ending June 30, 2011 was 3.58%, compared to 3.64% for the same period in 2010.

The largest portion of the increase in interest income was the result of interest earned on the securities portfolio, which totaled \$6.8 million for the six months ended June 30, 2011, an increase of 47.5%, or \$2.2 million over 2010.

The growth in securities was funded principally through the growth in time deposit accounts. Average interest bearing deposits increased \$209.6 million, or 23.3%, 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. Average balance of time deposits of \$598.0 million for the six months ended June 30, 2011 exceeded 2010's average balance of \$462.6 million by 29.3%, however, interest expense only increased \$19,000, or 0.5%. 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, and can be used to meet the maturity needs of time and brokered deposits. We have matched cash flows from the debt securities portfolio with nontraditional cash flows to enable us to unwind the strategy if loan demand continues to increase or if the yield curve flattens.

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Interest income earned on loans increased from \$24.4 million for the first six months ended June 30, 2010 to \$25.4 million in 2011, a 4.0% increase. For the first half of 2011, average loans increased \$98.8 million, or 11.0%, to \$994.7 million from \$896.0 million in the first half of 2010. The increase in average loans is the result of the Company's desire to continue to grow its loan portfolio and deploy its capital. 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 in these markets served. 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. Due to the variable nature of a large portion of the loan portfolio, along with the implementation of floors as loans renewed, the decline in average rate earned on loans was not as severe as that paid on longer term borrowings.

As a result of the increase in its deposit base, the Company has placed less reliance on more costly long-term borrowings. Interest expense on long-term debt has decreased \$288,000 from \$850,000 for the six months ended June 30, 2010 to \$562,000 in the corresponding quarter in 2011. Reduction in average daily balance of \$4.5 million for 2011 compared to 2010, and the lower rate paid of 2.38% in 2011 compared to 3.28% in 2010 contributed to the reduced interest expense.

The Company's net interest spread has declined by 6 b.p., and the net interest margin has declined by 7 b.p. each for the six months ended June 30, 2011 compared to 2010. Given the continued low interest rate, reduced rates earned on interest earning assets outpaced the reduction in rates that we could pass on to our customers, and resulted in the lower interest rate spread and margin. The net interest spread was 3.58% and net interest margin was 3.70% for the first six months of 2011.

The table that follows shows average balances and interest yields on a fully taxable equivalent basis (FTE):

**Average Balances and Interest Rates**

|   | June 30, 2011   |                         |                     | Six Months Ended |                                       |                     |
|---|-----------------|-------------------------|---------------------|------------------|---------------------------------------|---------------------|
|   | Average Balance | Tax Equivalent Interest | Tax Equivalent Rate | Average Balance  | June 30, 2010 Tax Equivalent Interest | Tax Equivalent Rate |
| <i>(Dollars in thousands)</i>                       |                 |                         |                     |                  |                                       |                     |
| <b>Assets</b>                                       |                 |                         |                     |                  |                                       |                     |
| Federal funds sold & interest bearing bank balances | \$ 23,749       | \$ 45                   | 0.38%               | \$ 28,031        | \$ 63                                 | 0.45%               |
| Securities  | 415,787         | 6,828                   | 3.29                | 264,061          | 4,630                                 | 3.51                |
| Loans   | 994,729         | 25,393                  | 5.10                | 895,971          | 24,409                                | 5.43                |
| Total interest-earning assets                       | 1,434,265       | 32,266                  | 4.50                | 1,188,063        | 29,102                                | 4.89                |
| Other assets  | 90,422          |                         |                     | 93,842           |                                       |                     |
| Total   | \$ 1,524,687    |                         |                     | \$ 1,281,905     |                                       |                     |
| <b>Liabilities and Shareholders' Equity</b>         |                 |                         |                     |                  |                                       |                     |
| Interest bearing demand deposits                    | \$ 443,289      | \$ 865                  | 0.39                | \$ 376,749       | \$ 1,411                              | 0.76                |
| Savings deposits                                    | 69,735          | 74                      | 0.21                | 62,078           | 90                                    | 0.29                |
| Time deposits                                       | 597,975         | 3,945                   | 1.33                | 462,590          | 3,926                                 | 1.68                |
| Short term borrowings                               | 84,489          | 218                     | 0.52                | 94,554           | 245                                   | 0.52                |
| Long term debt                                      | 47,467          | 562                     | 2.38                | 51,950           | 850                                   | 3.28                |
| Total interest bearing liabilities                  | 1,242,955       | 5,664                   | 0.92                | 1,047,921        | 6,522                                 | 1.25                |
| Non-interest bearing demand deposits                | 109,551         |                         |                     | 92,235           |                                       |                     |
| Other   | 9,801           |                         |                     | 8,215            |                                       |                     |
| Total Liabilities                                   | 1,362,307       |                         |                     | 1,148,371        |                                       |                     |
| Shareholders' Equity                                | 162,380         |                         |                     | 133,534          |                                       |                     |

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|   |                     |              |              |       |
|---|---------------------|--------------|--------------|-------|
| Total   | <b>\$ 1,524,687</b> | <b>0.80%</b> | \$ 1,281,905 | 1.12% |
| Net interest income (FTE)/net interest spread | <b>26,602</b>       | <b>3.58%</b> | \$ 22,580    | 3.64% |
| Net interest margin                           |                     | <b>3.70%</b> |              | 3.77% |
| Tax-equivalent adjustment                     | <b>(1,404)</b>      |              | (783)        |       |
| Net interest income                           | <b>\$ 25,198</b>    |              | \$ 21,797    |       |

NOTES: Yields and interest income on tax-exempt assets have been computed on a fully taxable equivalent basis assuming a 35% tax rate. For yield calculation purposes, nonaccruing loans are included in the average loan balance.

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### **Provision for Loan Losses**

The provision for loan losses for the six months ended June 30, 2011 totaled \$24.4 million, an increase over the prior year's amount of \$6.4 million. The factors attributable to the increase in the provision for loan losses were consistent with the factors mentioned above under the Quarter Ended June 30, 2011 Compared to June 30, 2010 discussion, and include specifically identifiable charge-offs of two relationships totaling \$8.2 million, and the establishment of valuation reserves of \$5.8 million, determined principally through discounted cash flows, on restructured loans. Additionally, the elevated provision for loan losses resulted from downgrades in internal risk ratings of loans and loans considered impaired, which were influenced by continuing softness in economic conditions and deterioration of underlying collateral securing the loans.

### **Other Income**

Noninterest income excluding securities gains, totaled \$9.4 million for the six months ended June 30, 2011, compared to \$9.7 million in 2010. Noninterest income generation increased across most business lines including Orrstown Financial Advisors, mortgage originations, and retail deposits. These business lines have been able to capitalize on favorable market conditions, which include:

Service charges on deposit accounts increased 3.2%, from \$3.0 million for the six months ended June 30, 2010 to \$3.1 million in 2011. The increase was principally the result of increased revenues earned on debit cards. Partially offsetting the increase was a decline in overdraft charges to depositors during the period, as we have experienced customers being more cautious in their spending given the economic times, and less likely to overdraw their accounts.

Other service charges, commissions and fees declined \$332,000 during the period, from \$1.0 million for the six months ended June 30, 2010 to \$697,000 for the corresponding period in 2011. The decrease is primarily the result of loan service fees, in which we have seen reduced frequency of customers willing to pay prepayment penalties and the need for letter of credit facilities.

Trust department and brokerage income increased \$527,000, or 21.9% for the six months ended June 30, 2011 compared to 2010. The increase was a result of increases in trust and brokerage activity as the stock market has started to show signs of recovery, and additional trust assets under management, which increased from \$840.8 million at June 30, 2010 to \$964.8 million at June 30, 2011.

During the first six months of 2011, the continued low interest rate environment and additional mortgage originators have led to an increase in new mortgage loan applications as well as refinancing activities compared to the same period in 2010. Given this low interest rate environment, the Company generally sells its 30-year conforming loans to investors. As a result, income on mortgage banking increased \$307,000 to \$1.3 million for six months ended June 30, 2011 compared to \$1.0 million in 2010. The increase was attributable to an increase in the gain on sale of loans, as well as growth in mortgage servicing income, as the Company's servicing portfolio increases. Included in the 2011's results is the reversal of a \$200,000 lower of cost or market charge on mortgage servicing rights taken in 2010, which was recovered when prepayment speeds slowed during 2011. The Company has recently seen a decline in refinancing activity, as mortgage rates have been low for a sustained period of time, and values of homes have been impacted by real estate conditions, which have limited customers' abilities to refinance.

Earnings on life insurance decreased \$25,000 from \$605,000 for the six months ended June 30, 2010 to \$580,000 for the six months ended June 30, 2011. The decline in earnings was the combination of \$239,000 recognized in life insurance benefits upon the death of a former director in 2010, offset by higher average balances of bank owned life insurance during 2011 than in 2010 which enhanced earnings on the investments.

Included in other income in 2010 was gain on the sale of a fixed rate for floating rate interest swap in the amount of \$778,000, with no similar gain taken in 2011.

Securities gains totaled \$848,000 for the six months ended June 30, 2011, compared to \$2.179 million in 2010. The difference in gains taken between the two periods was the result of interest rate and market conditions, and the Company's asset liability management strategies.



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The Company continues to advertise and market itself in order for consumers to recognize the broad range of financial services and products the Company has to offer, and to increase its brand recognition.

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Through the use of enhanced technology, the Company expects it will be able to reach a broader market which will allow it to continue to grow its customer base.

### **Other Expenses**

As a result of the growth the Company has experienced, noninterest expenses rose from \$17.2 million during the first six months of 2010 to \$19.2 for the same period in 2011, an increase of \$2.0 million, or 11.0%. The following contributed to the net increase in other expenses.

Salaries and employee benefits decreased slightly to \$9.0 million for the six months ended June 30, 2011 from \$9.1 million for the corresponding period in 2010. The decrease was attributable to the reduction in employee benefit accruals based on the Company's performance, including discretionary executive bonuses and profit sharing accruals. Offsetting the reduction in these accruals was a growth in the number of full-time equivalents from 276 at June 30, 2010 to 302 at June 30, 2011. As the Company's operating performance improves during the last half of the year, additional discretionary employee benefits may be recorded.

Advertising and bank promotions increased \$143,000 for the first six months of 2011 to \$554,000 compared to \$411,000 in 2010. The increase in expense is a result of commitments to the communities that the Bank serves as we continue to build relationships and expand our presence in these market areas.

FDIC insurance expense increased \$478,000, or 57%, to \$1.3 million for the six months ended June 30, 2011 from \$834,000 for the same period in 2010. The increase is due to higher deposit balances and increased assessments recorded in 2011 compared to 2010.

Professional services totaled \$868,000 for the six months ended June 30, 2011, an increase of \$421,000 over 2010's total of \$447,000. The increase in expenses can be attributed to increased professional services, including third party loan review assistance, legal costs associated with loan workouts and foreclosures, and increased audit fees due to increasing complexity and additional requirements of financial and regulatory reporting.

Taxes, other than income, increased from \$355,000 during the first six months of 2010 to \$410,000 in 2011, a \$55,000 increase. Pennsylvania's Bank Shares Tax Expense is based on the last six years' rolling average equity, as defined. The increase in expense was a direct result of the growth that the bank has experienced in its average shareholders' equity, principally the result of the \$18 million capital infusion from the Company during 2010 and the roll-off of 2004's balance.

Collection and real estate owned expenses, included in other operating expenses, increased approximately \$209,000, from \$200,000 for the six months ended June 30, 2010 to \$409,000 in 2011. These expenses have increased as a result of loans classified, as corrective action and work-out plans are outlined with the customers in order to protect the Company from risk of loss. It is anticipated these charges will continue to increase as the Company works through its classified loans.

The Company established a \$250,000 reserve for off-balance sheet commitments during the six months ended June 30, 2011, which is included in other expenses. As noted in the provision for loan losses section, the continuing softness in overall economic conditions and deterioration of underlying collateral resulted in the need for a reserve for unfunded commitments, particularly construction and development loans which will need completed.

The Company has held a real estate property for several years for possible branch or operations expansion. During 2011, the Company obtained an updated appraisal for this property, and deemed it appropriate to record a \$156,000 charge to mark the property to its fair value. This charge is included in other expenses.

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The remainder of the increase in other expenses is primarily the result of the growth experiences by the Company. In order to better understand how other expenses increased in relation to related increases in revenue, operating expense levels are often measured in the financial services industry by the efficiency ratio, which expresses non-interest expense, as a percentage of tax-equivalent net interest income and noninterest income. The Company's efficiency ratio was 52.6% for the six months ended June 30, 2011, an improvement on 2010's ratio of 52.9%.

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### **Income Tax Expense**

The Company recorded an income tax benefit of \$1.3 million for the six months ended June 30, 2011, compared to income tax expense of \$2.7 million in the same period in 2010. A meaningful comparison of income tax expense to levels of pre-tax income is its effective tax rate, which is less than the 35% federal statutory rate, primarily due to tax-exempt loan and security income, life insurance earnings and tax credits associated with low-income housing and historic projects, offset by certain non-deductible expenses and state income taxes.

The Company's effective tax rate declined to 16.1% for the six months ended June 30, 2011 compared to 27.1% for the corresponding prior year period. For interim financial reporting, the Company computes its income tax expense (benefit) based on its estimated effective tax rate for the year, as noted in ASC 740-270-25. The lower effective tax rate in 2011 is the direct result of greater levels of tax-free income as a percentage of estimated taxable income for the year. The large provision for loan losses recorded during 2011 results in lowering taxable income for the year, and in a lower estimated effective tax.

As a result of utilizing the estimated annual effective tax rate in calculating the income tax benefit for the six month period, the full income tax benefit of the higher than normal provision for loan losses was not recognized in this period. It is anticipated that the effective tax rate for the last two quarters of 2011, will remain lower than the historical 2010 and first quarter 2011 rates. By year-end, the full income tax benefit of the higher than normal provision for loan losses will be recognized.

### **Financial Condition**

A substantial amount of time is devoted by management to overseeing the investment of funds in loans and securities and the formulation of policies directed toward the profitability and minimization of risk associated with such investments.

### **Securities Available for Sale**

The Company utilizes securities available for sale as a tool for managing interest rate risk, enhancing income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings. As of June 30, 2011, securities available for sale were \$421.1 million, a decrease of \$10.7 million from the December 31, 2010 balance of \$431.8 million.

The decline in securities available for sale was in the U.S. Government Sponsored Enterprises bullet securities, which declined by \$22.3 million, with partial reinvestment of funds into the mortgage-backed securities portfolio, which increased by \$10.0 million from December 31, 2010 to June 30, 2011. The cash flows received from principal pay downs, maturities, and sales of securities from these portfolios were used to fund loan growth, or in anticipation of future loan commitments or securities that may arise in the near future.

The available for sale securities portfolio of \$421.1 million at June 30, 2011 has increased since March 31, 2011's balance of \$395.8 million. Federal funds sold at March 31, 2011 were invested in securities, as the Company's anticipated loan demand is not as strong as that experienced in the latter part of 2010 and the beginning of 2011, and the liquidity needs have been reduced.

### **Loan Portfolio**

The Company offers various products to meet the credit needs of our borrowers, and principally consists of commercial real estate loans, commercial and industrial loans, and retail loans consisting of loans securitized by residential properties, and to a lesser extent, installment loans. Generally speaking, the Company follows conservative lending practices and continues to carry a high quality loan portfolio with no unusual or undue concentrations of credit. No loans are extended to non domestic borrowers or governments.

The Company's loan portfolio is broken down into segments to an appropriate level of disaggregation to allow management to monitor the performance by the borrower and to monitor the yield on the portfolio. In 2010, management incorporated the provisions of ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Loan Losses*, resulting in the refinement in its portfolio segregation. Consistent with this standard, the segments were further broken down into classes, to allow for differing risk characteristics within a segment.

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The risks associated with lending activities differ among the various loan classes, and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans, and general economic conditions. All of these factors may adversely impact the borrower's ability to repay its loans, and impact the associated collateral.

The Company has various types of commercial real estate which have differing levels of credit risk associated with them. Owner-occupied commercial real estate loans are generally dependent upon the successful operation of the borrower's business, with the cash flows generated from the business being the primary source of repayment of the loan. If the business suffers a downturn in sales or profitability, the borrower's ability to repay the loan could be in jeopardy. In order to minimize this credit risk, the Company has conservative underwriting standards which include the credit worthiness of the borrower, limitation on loan amounts to 75% of the value of the property securing the loan, and strong debt service coverage ratios.

Non-owner occupied and multi-family commercial real estate loans present a different credit risk to the Company than owner-occupied commercial real estate, as the repayment of the loan is dependent upon the borrower's ability to generate a sufficient level of occupancy to produce rental income that exceeds debt service requirement and operating expenses. Lower occupancy or lease rates may result in reduction in cash flows, which hinder the ability of the borrower to meet debt service requirements, and may result in lower collateral values. The Company generally follows the same underwriting standards as with owner-occupied commercial real estate, but recognizes the greater risk inherent in these credit relationships in its loan pricing.

Acquisition and development loans consists of 1-4 family residential construction and commercial and land development loans. The risk of loss on these loans is largely dependent on the Company's ability to assess the property's value at the completion of the project, which should exceed the property's construction costs. During the construction phase, a number of factors could potentially negatively impact the collateral value, including cost overruns, delays in completing the project, competition, and real estate market conditions which may change based on the supply of similar properties in the area. In the event the collateral value at the completion of the project is not sufficient to cover the outstanding loan balance, the Company must rely upon other repayment sources, including the guarantors of the project or other collateral securing the loan. The Company attempts to mitigate credit risk through strict underwriting standards including evaluation of the credit worthiness of the borrower and their success in other projects, aggressive release fees, loan-to-value ratios not to exceed 75%, and continual monitoring of the project during its construction phase to determine the impact that overruns and delays may have on the project.

Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest rated borrowers, the majority of 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. Commercial and industrial loans present credit exposure to the Company, as they are more susceptible to risk of loss during a downturn in the economy, as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline. The Company attempts to mitigate this risk through strict underwriting standards, including evaluating the credit worthiness of the borrower and to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and meetings with the borrowers are common. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

The Company originates loans to its retail customers, including fixed-rate and adjustable first lien mortgage loans with the underlying 1-4 family owner-occupied residential property securing the credit. The Company's risk exposure is minimized in these types of loans through the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and underwriting standards which limits the loan-to-value ratio to generally no more than 80%, unless the borrower obtains private mortgage insurance.

Home equity loans, including term loans and lines of credit, present a slightly higher risk to the Company than 1-4 family first liens, as these loans can be first or second liens on 1-4 family owner occupied residential property, but can have loan-to-value ratios of no greater than 90% of the value of the real estate taken as collateral. The credit worthiness of the borrower is considered including credit scores and debt-to-income ratios, which generally cannot exceed 38%.

Installment and other loans' credit risk are mitigated through conservative underwriting standards, including the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and if

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secured, the collateral value of the assets. As these loans can be unsecured or secured by assets the value of which may depreciate quickly or may fluctuate, they present a greater risk to the Company than 1-4 family residential loans.

The loan portfolio, excluding residential loans held for sale, broken out by classes as of June 30, 2011 and December 31, 2010 is as follows:

| <i>(Dollars in thousands)</i>       | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|-------------------------------------|--------------------------|------------------------------|
| <b>Commercial real estate:</b>      |                          |                              |
| Owner-occupied                      | \$ 198,495               | \$ 172,000                   |
| Non-owner occupied                  | 134,191                  | 143,372                      |
| Multi-family                        | 27,880                   | 24,649                       |
| <b>Acquisition and development:</b> |                          |                              |
| 1-4 family residential construction | 13,887                   | 29,297                       |
| Commercial and land development     | 95,607                   | 88,105                       |
| Commercial and industrial           | 283,029                  | 263,943                      |
| <b>Residential mortgage:</b>        |                          |                              |
| First lien                          | 118,954                  | 119,450                      |
| Home equity - term                  | 39,584                   | 40,818                       |
| Home equity - Lines of credit       | 75,392                   | 71,547                       |
| Installment and other loans         | 12,014                   | 11,112                       |
|                                     | <b>\$ 999,033</b>        | <b>\$ 964,293</b>            |

The loan portfolio at June 30, 2011 has grown 3.6%, from \$964.2 million at December 31, 2010 to \$999.0 million at June 30, 2011. Owner occupied commercial real estate has experienced the most growth, increasing from \$172.0 million at December 31, 2010 to \$198.5 million at June 30, 2011, a 15.4% increase. Commercial and industrial loans also grew, increasing from \$263.9 million at December 31, 2010 to \$283.0 million at June 30, 2011, a 7.2% increase. Several experienced lenders have joined the Company in the past two years, which has led to additional opportunities in some of the Company's emerging markets.

Non-owner occupied commercial real estate declined \$9.1 million to \$134.1 million at June 30, 2011. This decrease was principally the result of two motels that paid off during 2011. A decline was also noted in 1-4 family residential construction loans which decreased \$15.4 from December 31, 2010 to June 30, 2011. A large portion of this movement in 1-4 family construction was the result of an approximate \$9.0 million townhouse development in which the construction phase ended and the loan moved to permanent financing, and is now included in the commercial category. Management intends to retain some shorter-lived 1-4 residential mortgages, generally with maturities of 10-20 years, to help diversify its loan portfolio, as these mortgages earn more attractive rates than alternative investments, including federal funds sold and securities available for sale. Longer term residential mortgage loans continue to be sold on the secondary market, as they present greater interest rate risk. The Company continues to experience paydowns on its first lien residential mortgages, with the principal reductions offsetting the increases noted from the permanent financing of the townhomes and the growth in the 10-20 year mortgages.

**Asset Quality****Risk Elements**

The Company's loan portfolios are subject to varying degrees of credit risk. Credit risk is mitigated through conservative underwriting standards, on-going credit review, and monitoring asset quality measures. Additionally, loan portfolio diversification, limiting exposure to a single industry or borrower, and requiring collateral also mitigate the Company's risk of credit loss.

The Company's loan portfolio is principally to borrowers in south central Pennsylvania and Washington County, Maryland. As the majority of loans are concentrated in this geographic region, a substantial portion of the debtor's ability to honor their obligations may be affected by the level of economic activity in the market area.

Nonperforming assets include nonaccrual and restructured loans and foreclosed real estate. In addition, loans past due 90 days or more and still accruing are also deemed to be a risk asset. For all loan classes, the accrual of interest income on loans, including impaired loans, ceases when principal or interest is past due 90 days or more and collateral is inadequate to cover principal and interest or immediately if, in the opinion of

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management, full collection is unlikely. Interest will continue to accrue on loans past due 90 days or more if the collateral is adequate to cover principal and interest, and the loan is in the process of collection.

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Interest accrued, but not collected, as of the date of placement on nonaccrual status, is generally reversed and charged against interest income, unless fully collateralized. Subsequent payments received are either applied to the outstanding principal balance or recorded as interest income, depending on management's assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan classes, when all the principal and interest amounts contractually due are brought current, has performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contract terms of the loan for all loan classes.

Loans the terms of which are modified are classified as troubled debt restructurings if a concession was granted, for legal or economic reasons, related to a debtor's financial difficulties. Concessions granted under a troubled debt restructuring typically involve a temporary deferral of scheduled loan payments, an extension of a loan's stated maturity date, temporary reduction in interest rates, or below market rates. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual troubled debt restructurings are restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for six months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. Troubled debt restructurings are evaluated individually for impairment if they have been restructured during the most recent calendar year, or if they are not performing according to their modified terms.

The following table presents the Company's risk elements, including information concerning the aggregate balances of nonaccrual, restructured, loans past due 90 days or more, and foreclosed real estate as of June 30, 2011, December 31, 2010, and June 30, 2010. Relevant asset quality ratios are also presented.

| <i>(Dollars in Thousands)</i>  | <b>June 30, 2011</b> | <b>December 31, 2010</b> | <b>June 30, 2010</b> |
|--|----------------------|--------------------------|----------------------|
| Loans on nonaccrual (cash) basis   | \$ 14,762            | \$ 13,896                | \$ 14,496            |
| Other real estate owned (OREO)   | 1,240                | 1,112                    | 1,264                |
| <b>Total nonperforming assets</b>  | <b>16,002</b>        | <b>15,008</b>            | <b>15,760</b>        |
| Restructured loans still accruing  | 34,844               | 1,181                    | 0                    |
| Loans past due 90 or more days and still accruing                                      | 3,617                | 2,248                    | 7,255                |
| <b>Total nonperforming and other risk assets</b>                                       | <b>\$ 54,463</b>     | <b>\$ 18,437</b>         | <b>\$ 23,015</b>     |
| <b>Loans greater than 30-89 days past due</b>  | <b>\$ 11,021</b>     | <b>\$ 5,335</b>          | <b>\$ 10,332</b>     |
| Ratio of total nonperforming loans to loans  | 1.48%                | 1.44%                    | 1.62%                |
| Ratio of total nonperforming assets to assets  | 1.05%                | 0.99%                    | 1.16%                |
| Ratio of total nonperforming assets to total loans and OREO                            | 1.60%                | 1.55%                    | 1.76%                |
| Ratio of total risk assets to total loans and OREO                                     | 5.44%                | 1.91%                    | 2.57%                |
| Ratio of total risk assets to total assets   | 3.56%                | 1.22%                    | 1.69%                |
| Allowance for loan losses to nonperforming loans and restructured loans still accruing | 54.86%               | 106.25%                  | 100.59%              |

The Company continues to monitor its classified loans in light of the continued softness in economic conditions and collateral values. As a result of this monitoring, additional nonperforming assets and other risk elements were identified during the quarter ended June 30, 2011. Total risk elements, which include nonaccrual loans, other real estate owned, restructured loans and still accruing and loans past due 90 days or more still accruing, increased to \$54.5 million at June 30, 2011 from \$18.4 and \$23.0 million at December 31, 2010 and June 30, 2010.

The largest increase in risk elements was restructured loans still accruing, which totaled \$34.8 million at June 30, 2011, compared to \$1.2 million and \$0 at December 31, 2010 and June 30, 2010. In the second quarter of 2011, the Company early adopted the provisions of ASU No. 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* (ASU No. 2011-02). As a result of adopting the amendments in ASU No. 2011-02, the Company reassessed terms and conditions to customers on restructured loans that had been completed in the past several months. In many instances, the Company was able to increase the interest rate on the loans and obtain additional collateral support for the borrowings, in exchange for extension of the loans' terms. However, the new interest rate charged was considered to be at a below-market rate, which was determined to be a concession to its borrowers that were experiencing financial difficulties. Prior to their classification as troubled debt restructurings, these loans had been collectively evaluated for impairment consistent with the guidance in Subtopic 450-20. Upon identifying these





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receivables as troubled debt restructurings, the Company identified them as impaired under the guidance in Section 310-10-35, and totaled \$33.7 million at June 30, 2011.

In 2010, the Company restructured two residential mortgages in order to assist the borrowers who were experiencing financial difficulties. The restructured loans resulted in concessions that the Bank made in interest rates for a short (less than twelve months) period of the remaining amortization schedule, and resulted in a reduction of the discounted cash flows of the loans, based on the original loans' interest rate, of approximately \$20,000.

Nonaccrual loans increased from \$13.9 million at December 31, 2010 to \$14.8 million at June 30, 2011, an increase of 6.2%, or \$866,000. The net increase in nonaccrual loans is the result of \$10.3 million of loans, classified as nonaccrual at December 31, 2010, being charged-off and loans totaling \$11.2 million being moved to nonaccrual status during the period.

During the quarter ended June 30, 2011, the nonaccrual loan balance increased \$11.2 million for loans newly placed in nonaccrual status. The first relationship moved to nonaccrual totaled \$5.2 million and is to a land developer in the Company's southern market. As a result of the downturn in the economy, the borrower has had difficulties in finding ground lease tenants and has had difficulties meeting the conditions in selling pad sites on a different project. As a result of the cash flow problems the borrower is experiencing and related delinquencies, the three loans have been placed in nonaccrual status. The loans are secured by the real estate projects and guarantors that have little liquidity.

A second relationship with loans totaling \$3.4 million was moved to nonaccrual status during the second quarter of 2011. These loans relate to a real estate investor in our southern market. Increased vacancy on the borrower's projects has led to reduced cash flows, and the inability to meet monthly debt service requirements on the related loan obligations. The loans are secured by the real estate, and the borrower has little liquidity to meet debt service requirements until occupancy levels improve.

A third relationship moved to nonaccrual during the quarter ended June 30, 2011 is for a loan whose proceeds were to build out a residential subdivision in the Company's southern market. As a result of the downturn in the economy and lack of growth in this market, the development of the project was delayed, and the property is currently on the market for sale. The relationship was current based on an interest reserve that was funding monthly interest payments, however, in light of a recent appraisal, it was determined that the collateral securing this collateral dependent loan was not sufficient to cover the loan balance, and the loan was moved to nonaccrual status. A second loan to the borrower with a second lien position on the collateral, totaling \$2.6 million, was written off during the quarter ended June 30, 2011 once the updated appraisal was received and it was concluded that the real estate had no value to support the second lien position. These loans were not previously considered impaired, as they were current and the property was listed for sale with a realtor in excess of the loan balances.

The Company has other loans that remain in nonaccrual status as of June 30, 2011, including a loan secured by a mixed use building, consisting of residential apartments and commercial retail space that has had difficulties in securing leases from tenants that will enable it to meet its debt service requirements. The Bank is working with the borrower through the lease up period, in order to allow sufficient time to increase the building's occupancy. This loan is secured by the commercial real estate property and has a loan carrying balance at June 30, 2011 of \$551,000. During the quarter ending June 30, 2011, the Company charged off approximately \$550,000 of the loan balance, which was previously reserved.

Another relationship that remains in nonaccrual status from December 31, 2010 to June 30, 2011 is a loan collateralized by several parcels of farm land and one parcel that was acquired for development. The Company is in the process of legal actions against the borrower, including foreclosure proceedings. The loan has a balance of \$875,000 at June 30, 2011, and the Company feels it is adequately secured as the loan has a low loan-to-value ratio.

None of the other 8 relationships in nonaccrual status have balances in excess of \$500,000. The Company believes through the combination of the collateral securing the loans and the reserves allocated for these nonaccrual loans totaling \$2.9 million, it has provided for the potential losses that it may incur on these relationships as of June 30, 2011. However, as additional time passes on these relationships, additional information may become known that could result in additional reserve allocations, or, alternatively, it may be deemed that the reserve allocations exceed that which is needed.

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The real estate owned balance consists of 7 properties held by the Company at June 30, 2011 acquired through foreclosure proceedings. One property represents 50% of the balance, or \$624,000, and represents a unique residential property which the Company is carrying below the recently appraised value, less costs to sell. As such, no loss is anticipated on this property. The remaining properties carrying values are not significant, and are each being carried below their appraised values, all of which have been valued within the past year.

A further breakdown of nonaccrual loans, loans past due 90 days or more still accruing, and other delinquency information as of June 30, 2011 and December 31, 2010 is as follows:

|                                     | Days Past Due |          |          |                         | Total<br>Past Due | Non-<br>Accrual | Total<br>Loans |
|-------------------------------------|---------------|----------|----------|-------------------------|-------------------|-----------------|----------------|
|                                     | Current       | 30-59    | 60-89    | 90+<br>(still accruing) |                   |                 |                |
| <b>June 30, 2011</b>                |               |          |          |                         |                   |                 |                |
| Commercial real estate:             |               |          |          |                         |                   |                 |                |
| Owner-occupied                      | \$ 193,930    | \$ 2,639 | \$ 766   | \$ 0                    | \$ 3,405          | \$ 1,160        | \$ 198,495     |
| Non-owner occupied                  | 133,585       | 0        | 55       | 0                       | 55                | 551             | 134,191        |
| Multi-family                        | 25,708        | 0        | 0        | 0                       | 0                 | 2,172           | 27,880         |
| Acquisition and development:        |               |          |          |                         |                   |                 |                |
| 1-4 family residential construction | 13,783        | 0        | 104      | 0                       | 104               | 0               | 13,887         |
| Commercial and land development     | 87,617        | 814      | 542      | 2                       | 1,358             | 6,632           | 95,607         |
| Commercial and industrial           | 273,704       | 2,127    | 1,796    | 1,528                   | 5,451             | 3,874           | 283,029        |
| Residential mortgage:               |               |          |          |                         |                   |                 |                |
| First lien                          | 115,792       | 1,068    | 191      | 1,561                   | 2,820             | 342             | 118,954        |
| Home equity - term                  | 38,582        | 644      | 77       | 254                     | 975               | 27              | 39,584         |
| Home equity - Lines of credit       | 75,124        | 42       | 0        | 226                     | 268               | 0               | 75,392         |
| Installment and other loans         | 11,809        | 147      | 9        | 46                      | 202               | 3               | 12,014         |
|                                     | \$ 969,634    | \$ 7,481 | \$ 3,540 | \$ 3,617                | \$ 14,638         | \$ 14,761       | \$ 999,033     |

|                                     | Days Past Due |          |          |                         | Total<br>Past Due | Non-<br>Accrual | Total<br>Loans |
|-------------------------------------|---------------|----------|----------|-------------------------|-------------------|-----------------|----------------|
|                                     | Current       | 30-59    | 60-89    | 90+<br>(still accruing) |                   |                 |                |
| <b>December 31, 2010</b>            |               |          |          |                         |                   |                 |                |
| Commercial real estate:             |               |          |          |                         |                   |                 |                |
| Owner-occupied                      | \$ 169,030    | \$ 986   | \$ 832   | \$ 466                  | \$ 2,284          | \$ 686          | \$ 172,000     |
| Non-owner occupied                  | 141,095       | 213      | 0        | 0                       | 213               | 2,064           | 143,372        |
| Multi-family                        | 24,559        | 0        | 0        | 0                       | 0                 | 90              | 24,649         |
| Acquisition and development:        |               |          |          |                         |                   |                 |                |
| 1-4 family residential construction | 29,297        | 0        | 0        | 0                       | 0                 | 0               | 29,297         |
| Commercial and land development     | 87,995        | 1        | 16       | 0                       | 17                | 93              | 88,105         |
| Commercial and industrial           | 252,144       | 287      | 466      | 420                     | 1,174             | 10,625          | 263,943        |
| Residential mortgage:               |               |          |          |                         |                   |                 |                |
| First lien                          | 116,182       | 1,359    | 535      | 1,095                   | 2,989             | 279             | 119,450        |
| Home equity - term                  | 40,503        | 161      | 62       | 75                      | 298               | 17              | 40,818         |
| Home equity - Lines of credit       | 71,215        | 60       | 89       | 142                     | 291               | 41              | 71,547         |
| Installment and other loans         | 10,793        | 251      | 17       | 50                      | 318               | 1               | 11,112         |
|                                     | \$ 942,813    | \$ 3,318 | \$ 2,017 | \$ 2,248                | \$ 7,584          | \$ 13,896       | \$ 964,293     |

Past due loans increased from \$7.6 million at December 31, 2010 to \$14.6 million at June 30, 2011, an increase of \$7.0 million. The majority of the increase was in the less severe category, of 30-59 days past due, which increased \$4.2 million. The increase experienced was across different loan segments and borrowers within those classes. The Company has experienced migration in its delinquency categories, as loans 60-89 days past due have increased \$1.5 million and loans greater than 90 days still accruing have increased \$1.4 million. The rise in delinquencies can be attributed to continued economic conditions and customer fatigue, in which certain customers have had difficulties in maintaining current status in light of cash flow difficulties.



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During the quarter ended June 30, 2011, the Company increased the number of personnel in its loan workout and credit review departments and outsourced certain credit review responsibilities in order to mitigate the Company's risk of loss, and to reduce its level of nonaccrual and classified loans.

### **Credit Risk Management**

#### **Allowance for Loan Losses**

Historically, the Company has had an enviable record regarding its control of loan losses, but lending is a banking service that inherently contains elements of risk. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The Company maintains the allowance for loan losses at a level believed adequate by management to absorb losses inherent in the portfolio. It is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the allowance for loan losses utilizing a defined methodology, which considers specific credit evaluation of impaired loans as discussed above, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC Section 310-10-35 for loans individually identified as impaired, and ASC Subtopic 450-20 for loans collectively evaluated for impairment, and other bank regulatory guidance.

In order to monitor ongoing risk associated with its loan portfolio and specific credits within the segments, management uses an eight point internal grading system. The first four rating categories, representing the lowest risk to the Bank, are combined and given a "Pass" rating. The

"Special Mention" category includes loans that have potential weaknesses that may, if not monitored or corrected, weaken the asset or inadequately protect the Bank's position at some future date. These assets pose elevated risk, but their weakness does not yet justify a more severe, or criticized rating. Management generally follows regulatory definitions in assigning criticized ratings to loans, including substandard, doubtful or loss. Substandard loans are classified as they have a well-defined weakness, or weaknesses that jeopardize liquidation of the debt. These loans are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Substandard loans include loans that management has determined not to be impaired, as well as loans considered to be impaired. A doubtful loan has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification of loss is deferred.

Loss assets are considered uncollectible, as the underlying borrowers are often in bankruptcy, have suspended debt repayments, or ceased business operations. Once a loan is classified as Loss, there is little prospect of collecting the loan's principal or interest and it is generally written off.

The Bank has a loan review policy and program which is designed to reduce and control risk in the lending function. The Credit Administration Committee, comprised of members of the Board, is charged with the overall credit quality and risk exposure of the Company's loan portfolio. This includes the monitoring of the lending activities of all bank personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The loan review program provides the Bank with an internal, independent review of the Bank's loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession or death of the borrower occurs, which heightens awareness as to a possible credit event.

The Loan Review department, by policy, performs annual reviews of all commercial relationships with a committed loan balance in excess of \$750,000, with ratification of the rating from the Board of Directors' Credit Administration Committee for loans between \$750,000 - \$1,000,000. Loans reviewed in excess of \$1,000,000 are presented to the Credit Administration Committee with a formal review and rating. All relationships rated Substandard, Doubtful or Loss are reviewed by the Credit Administration Committee on a quarterly basis, including reaffirmation of the rating, review of detailed collateral analysis and the development of an action plan.

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The following summarizes the Bank's ratings based on its internal risk rating system as of June 30, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i>       | Pass       | Special<br>Mention | Non-Impaired<br>Substandard | Impaired -<br>Substandard | Doubtful | Total      |
|-------------------------------------|------------|--------------------|-----------------------------|---------------------------|----------|------------|
| <b>June 30, 2011:</b>               |            |                    |                             |                           |          |            |
| Commercial real estate:             |            |                    |                             |                           |          |            |
| Owner-occupied                      | \$ 171,679 | \$ 10,563          | \$ 13,952                   | \$ 1,612                  | \$ 689   | \$ 198,495 |
| Non-owner occupied                  | 95,439     | 13,298             | 23,376                      | 1,527                     | 551      | 134,191    |
| Multi-family                        | 19,001     | 1,270              | 4,544                       | 3,065                     | 0        | 27,880     |
| Acquisition and development:        |            |                    |                             |                           |          |            |
| 1-4 family residential construction | 9,206      | 293                | 4,256                       | 132                       | 0        | 13,887     |
| Commercial and land development     | 54,488     | 13,167             | 17,489                      | 10,463                    | 0        | 95,607     |
| Commercial and industrial           | 203,533    | 14,591             | 35,225                      | 29,295                    | 385      | 283,029    |
| Residential mortgage:               |            |                    |                             |                           |          |            |
| First lien                          | 116,681    | 0                  | 1,809                       | 464                       | 0        | 118,954    |
| Home equity - term                  | 38,451     | 0                  | 423                         | 710                       | 0        | 39,584     |
| Home equity - Lines of credit       | 75,166     | 0                  | 226                         | 0                         | 0        | 75,392     |
| Installment and other loans         | 12,014     | 0                  | 0                           | 0                         | 0        | 12,014     |
|                                     | \$ 795,658 | \$ 53,182          | \$ 101,300                  | \$ 47,268                 | \$ 1,625 | \$ 999,033 |

**December 31, 2010:**

|                                     |            |           |           |           |          |            |
|-------------------------------------|------------|-----------|-----------|-----------|----------|------------|
| Commercial real estate:             |            |           |           |           |          |            |
| Owner-occupied                      | \$ 162,968 | \$ 2,035  | \$ 6,311  | \$ 0      | \$ 686   | \$ 172,000 |
| Non-owner occupied                  | 120,633    | 4,274     | 15,495    | 2,970     | 0        | 143,372    |
| Multi-family                        | 20,030     | 676       | 3,853     | 0         | 90       | 24,649     |
| Acquisition and development:        |            |           |           |           |          |            |
| 1-4 family residential construction | 24,199     | 2,297     | 2,801     | 0         | 0        | 29,297     |
| Commercial and land development     | 79,391     | 2,487     | 6,134     | 93        | 0        | 88,105     |
| Commercial and industrial           | 221,111    | 17,062    | 14,992    | 9,770     | 1,008    | 263,943    |
| Residential mortgage:               |            |           |           |           |          |            |
| First lien                          | 117,607    | 0         | 1,373     | 470       | 0        | 119,450    |
| Home equity - term                  | 39,279     | 0         | 828       | 711       | 0        | 40,818     |
| Home equity - Lines of credit       | 71,364     | 0         | 183       | 0         | 0        | 71,547     |
| Installment and other loans         | 11,062     | 0         | 50        | 0         | 0        | 11,112     |
|                                     | \$ 867,644 | \$ 28,831 | \$ 52,020 | \$ 14,014 | \$ 1,784 | \$ 964,293 |

Classified loans may also be evaluated for impairment. For commercial real estate, acquisition and development and commercial and industrial loans, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Generally, loans that are more than 90 days past due are assigned a Substandard rating. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Nonaccrual loans in the commercial and commercial real estate portfolios are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates on fair values are obtained, which may include updated appraisals. The updated fair values will be incorporated into the impairment analysis as of the next reporting period. In the event an updated appraisal that requires a higher impairment reserve is received after a reporting period, but prior to the issuance of the financial statements, an evaluation is made as to the significance of the difference and whether the amounts need to be reflected in the financial statements not yet issued.



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Loan charge-offs, which may include, from time-to-time, a partial charge-off, are taken on an impaired loan that is collateral dependent if the loan's carrying balance exceeds its collateral's appraised value, the loan has been identified as uncollectible, and it is deemed to be a confirmed loss. Typically, impaired loans with a charge-off or partial charge-off will continue to be considered impaired, unless the note is split into two, and management expects the performing note to continue to perform and is adequately secured. The second, or non-performing note, would be charged-off. As of the periods presented, the Company has no loans to borrowers that resulted from splitting impaired loans into multiple notes. Further, an impaired loan with a partial charge-off may continue to have an impairment reserve on it after the partial charge-off, if factors warrant.

As of June 30, 2011 and December 31, 2010 nearly all of the Company's impaired loans' extent of impairment was measured based on the estimated fair value of the collateral securing the credit, except for troubled debt restructurings. By definition, troubled debt restructurings are considered impaired, however, nearly all restructured loans' impairment was determined based on discounted cash flows. For real estate loans, collateral generally consists of commercial real estate, but in the case of commercial and industrial loans, it would also consist of accounts receivable, inventory, equipment or other business assets. Commercial and industrial loans may also have real estate collateral.

For collateral dependent impaired loans, at the time a real-estate secured loan is deemed impaired, management determines whether an updated certified appraisal of the real estate is necessary to assist in determining the extent of an impairment reserve, if any. The decision for requiring an updated appraisal takes into consideration the age of the most recent appraisal, the loan-to-value ratio based on the original certified appraisal, the Company's recent experience and knowledge of market conditions, recent list prices or broker opinions, the condition of the property, and environmental factors. If market conditions have changed significantly from the date of the most recent appraisal, an updated appraisal will be obtained. The as is value provided in the appraisal is often used as the fair value of the collateral in determining impairment, unless circumstances, such as subsequent improvements, approvals, or other circumstances dictate that another value provided by the appraiser is more appropriate.

Generally impaired loans secured by real estate were measured at fair value using certified real estate appraisals that had been completed within the last year. Appraised values are further discounted for estimated costs to sell the property and other selling considerations to arrive at the properties' fair value.

In those situations in which it is determined an updated appraisal is not required for loans individually evaluated for impairment, fair values are based on one or a combination of the following approaches. In those situations in which a combination of approaches is considered, the factor that carries the most consideration will be the one management believes is warranted. The approaches are as follows:

**Original appraisal** – if the original appraisal provides a strong loan-to-value (generally 80% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the loan review staff that there has not been a significant deterioration in the collateral value, the original certified appraised value will be used. Discounts as deemed appropriate for selling costs are factored into the appraised value in arriving at fair value.

**Discounted cash flows** – In limited cases, discounted cash flows may be used on projects in which the collateral is liquidated to reduce the borrowings outstanding, and is used to validate collateral values derived from other approaches.

Collateral on certain impaired loans is not limited to real estate, and consists of accounts receivable, inventory, equipment or other business assets. Estimated fair values are determined based on borrowers' financial statements, inventory ledgers, accounts receivable agings or appraisals from individuals with knowledge in the business. Stated balances are generally discounted for the age of the financial information or the quality of the assets. In determining fair value, liquidation discounts are applied to this collateral based on existing loan evaluation policies.

In the fourth quarter of 2010, the Company began to distinguish Substandard loans on both an impaired and non-impaired basis, as it placed less emphasis on a loan's classification, and increased reliance on whether the loan was performing in accordance with the contractual terms.

Substandard classification does not automatically meet the definition of impaired. A substandard credit is one that is inadequately protected by current sound worth, paying capacity of the obligor or the collateral pledged, if any. Extensions of credit so classified have well-defined weaknesses which may jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard. As a result, the Company revised its methodology in its evaluation





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of certain accruing commercial real estate, acquisition and development and commercial and industrial loans rated substandard collectively for impairment as opposed to evaluating these loans individually for impairment. Although we believe these loans have well defined weaknesses and meet the definition of substandard, they are generally performing and management has concluded that it is likely it will be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Approximately \$53,201,000 of loans that were in previous years evaluated individually for impairment were collectively evaluated for impairment at December 31, 2010, resulting in an additional allowance for loan losses allocation of \$3,710,000.

Larger groups of smaller balance homogenous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

The following summarizes impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required as of June 30, 2011 and December 31, 2010:

|                                     | Impaired Loans with a Specific Allowance |  |                      | Impaired Loans with No Specific Allowance   |  |
|-------------------------------------|--|--|----------------------|---|--|
|                                     | Recorded<br>Investment<br>(Book Balance) | Unpaid<br>Principal Balance<br>(Legal Balance) | Related<br>Allowance | Recorded<br>Investment<br>(Book<br>Balance) | Unpaid<br>Principal<br>Balance<br>(Legal<br>Balance) |
| <i>(Dollars in thousands)</i>       |  |  |                      |   |  |
| <b>June 30, 2011</b>                |  |  |                      |   |  |
| Commercial real estate:             |  |  |                      |   |  |
| Owner-occupied                      | \$ 2,301                                 | \$ 2,301                                       | \$ 623               | \$ 0  | \$ 0   |
| Non-owner occupied                  | 1,527                                    | 1,527  | 388                  | 551   | 1,101  |
| Multi-family                        | 3,065                                    | 3,065  | 578                  | 0   | 0  |
| Acquisition and development:        |  |  |                      |   |  |
| 1-4 family residential construction | 132                                      | 132  | 33                   | 0   | 0  |
| Commercial and land development     | 10,462                                   | 10,462   | 1,479                | 0   | 0  |
| Commercial and industrial           | 28,805                                   | 28,805   | 5,609                | 875   | 875  |
| Residential mortgage:               |  |  |                      |   |  |
| First lien                          | 464                                      | 464  | 4                    | 0   | 0  |
| Home equity - term                  | 710                                      | 710  | 6                    | 0   | 0  |
|                                     | \$ 47,466                                | \$ 47,466                                      | \$ 8,720             | \$ 1,426                                    | \$ 1,976   |
| <b>December 31, 2010</b>            |  |  |                      |   |  |
| Commercial real estate:             |  |  |                      |   |  |
| Owner-occupied                      | \$ 686                                   | \$ 687   | \$ 181               | \$ 0  | \$ 0   |
| Non-owner occupied                  | 2,064                                    | 2,065  | 980                  | 0   | 0  |
| Multi-family                        | 90                                       | 90   | 90                   | 0   | 0  |
| Commercial and industrial           | 9,600                                    | 10,191   | 3,232                | 1,118                                       | 1,118  |
| Residential mortgage:               |  |  |                      |   |  |
| First lien                          | 470                                      | 470  | 12                   | 0   | 0  |
| Home equity - term                  | 711                                      | 711  | 8                    | 0   | 0  |
|                                     | \$ 13,621                                | \$ 14,214                                      | \$ 4,503             | \$ 1,118                                    | \$ 1,118   |

In the second quarter of 2011, the Company early adopted the provisions of ASU No. 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* (ASU No. 2011-02). As a result of adopting the amendments in ASU No. 2011-02, the Company reassessed terms and conditions to customers on restructured loans that had been completed in the past several months. In many instances, the Company was able to increase the interest rate on the loans and obtain additional collateral support for the borrowings, in exchange for extension of the loans terms. However, the new interest rate charged was considered to be at a below-market rate, which was determined to be a concession to its borrowers that were experiencing financial difficulties. Prior to their classification as troubled debt restructurings, these loans had been collectively evaluated for impairment consistent with the guidance in Subtopic 450-20. Upon identifying

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these receivables as troubled debt restructurings, the Company identified them as impaired under the guidance in Section 310-10-35. The amendments in ASU No. 2011-02 require prospective application of the impairment measurement guidance in Section 310-10-35 for those receivables newly identified as impaired. At the end of the first interim period of adoption, or June 30, 2011, the recorded investment in receivables for which the allowance for loan losses was previously measured under a general allowance methodology and are now considered impaired under Section 310-10-35 was \$33.7 million, and the allowance for loan losses associated with those receivables, on the basis of a current evaluation, was \$5.8 million.

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The following presents impaired loans that are troubled debt restructurings, with the recorded investment being both the pre-modification and post-modification balances, as well as the number of loans modified during the six and twelve month periods, as of June 30, 2011 and December 31, 2010.

| <i>(Dollars in thousands)</i>       | Troubled Debt Restructurings |                        | New Troubled Debt Restructurings                    |                        |
|-------------------------------------|------------------------------|------------------------|---|------------------------|
|                                     | Number of<br>Contracts       | Recorded<br>Investment | During Current YTD Period<br>Number of<br>Contracts | Recorded<br>Investment |
| <b>June 30, 2011</b>                |                              |                        |   |                        |
| Accruing:                           |                              |                        |   |                        |
| Commercial real estate:             |                              |                        |   |                        |
| Owner-occupied                      | 1                            | \$ 932                 | 1   | \$ 932                 |
| Non-owner occupied                  | 2                            | 1,527                  | 2   | 1,527                  |
| Multi-family                        | 1                            | 893                    | 1   | 893                    |
| Acquisition and development:        |                              |                        |   |                        |
| 1-4 family residential construction | 1                            | 132                    | 1   | 132                    |
| Commercial and land development     | 4                            | 3,830                  | 4   | 3,830                  |
| Commercial and industrial           | 23                           | 26,356                 | 23  | 26,356                 |
| Residential mortgage:               |                              |                        |   |                        |
| First lien                          | 1                            | 464                    | 0   | 0                      |
| Home equity - term                  | 1                            | 710                    | 0   | 0                      |
|                                     | 34                           | \$ 34,844              | \$ 32   | \$ 33,670              |
| <b>December 31, 2010</b>            |                              |                        |   |                        |
| Accruing:                           |                              |                        |   |                        |
| Residential mortgage:               |                              |                        |   |                        |
| First lien                          | 1                            | \$ 470                 | 1   | \$ 470                 |
| Home equity - term                  | 1                            | 711                    | 1   | 711                    |
|                                     | 2                            | \$ 1,181               | 2   | \$ 1,181               |

The loans presented above were considered troubled debt restructurings as the result of the Company agreeing to below market interest rates, or for residential mortgage loans, a temporary reduction in interest rates for periods not exceeding 12 months in order to assist the borrowers to improve cash flows during such periods. No additional commitments have been made to borrowers whose loans are considered troubled debt restructurings.

Potential problem loans are defined as performing loans, which have characteristics that cause management to have serious doubts as to the ability of the borrower to perform under present loan repayment terms and which may result in the reporting of these loans as non-performing loans in the future. Generally, management feels that substandard loans that are currently performing and not considered impaired, result in some doubt as to the borrower's ability to continue to perform under the terms of the loan, and represent potential problem loans.

Management further monitors the performance and credit quality of the loan portfolio by analyzing the length of time a portfolio is past due, by aggregating loans based on its delinquencies. For each loan class presented in the delinquency table previously presented, general allowances are provided for loans that are collectively evaluated for impairment, which is based on quantitative factors, principally historical loss trends for the respective loan class, adjusted for qualitative factors. As of December 31, 2010, the historical loss factor was based on average charge-offs for the last 8 quarters (e.g. January 1, 2009 – December 31, 2010), whereas prior to December 31, 2010, the historical loss factor was based on an equally weighted rolling 12 quarters. Effective December 31, 2010, for loans rated special mention and substandard not deemed impaired, a weighted average rolling 8 quarters average charge-off percentage on the related graded loan type, with a two-third weight to the most recent four quarters, and a one-third weight for the furthest four quarters was utilized. For non-rated loans evaluated collectively for impairment, the charge-off factor for the last 8 quarters is factored into the reserve allocation. The refinement to the methodology was made as management determined that the most recent eight quarters, and in particular, the most recent four quarters for rated loans, is a better reflection of the losses inherent in the loan portfolio at December 31, 2010. Additional reserve allocations of approximately \$730,000 resulted due to the change to the most recent 8 quarter history, which management believes is a better reflection of losses inherent in the portfolio based on recent loss history. In

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making this determination, management considered current economic and real estate conditions, trends in historical charge-off percentages at the Company as well as peers, and feedback from regulators.

In addition to the quantitative analysis, additional reserves are allocated on loans collectively evaluated for impairment based on additional qualitative factors. The qualitative factors used by management to adjust the historical loss percentage to the anticipated loss allocation, which range from 0 10 bp per factor, include:

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*National and local economic trends (five factors)* Ratios and factors considered include trends in the consumer price index (CPI); unemployment rates; housing price index; housing starts compared to the prior year; and bankruptcy rates.

*Credit quality trends (four factors)* Ratios and factors considered include trends in delinquency ratios; 90 days plus and nonaccrual loans; average net loan losses to loans outstanding; and classified loans to total loans.

*Underwriting policies (three factors)* Factors considered including the number of exceptions to loan policy; supervisory loan to value exceptions; and the instances of repeat criticisms of ratings.

*Experience, ability and depth of lending and loan review staff (four factors)* Factors considered include the years experience of the lending and loan review staff; turnover of the staff; instances of loan grade migration; and the penetration of loans reviewed.

*Other (two factors)* Other factors considered include concentrations of credit from loan type or shifts in industry or geographic region.

Activity in the allowance for loan losses for three months ended June 30, 2011 is as follows:

| <i>(Dollars in thousands)</i> | Commercial<br>Real Estate | Acquisition and<br>Development | Commercial<br>and Industrial | Residential<br>Mortgage | Installment<br>and<br>Other | Unallocated | Total     |
|-------------------------------|---------------------------|--------------------------------|------------------------------|-------------------------|-----------------------------|-------------|-----------|
| Balance, beginning of period  | \$ 4,884                  | \$ 3,245                       | \$ 8,212                     | \$ 1,712                | \$ 93                       | \$ 252      | \$ 18,398 |
| Provision for loan losses     | 2,894                     | 4,357                          | 12,138                       | 517                     | 13                          | 1,311       | 21,230    |
| Charge-offs                   | (542)                     | (2,576)                        | (9,218)                      | (79)                    | (17)                        | 0           | (12,432)  |
| Recoveries                    | 8                         | 0                              | 0                            | 0                       | 8                           | 0           | 16        |
| Balance, end of period        | \$ 7,244                  | \$ 5,026                       | \$ 11,132                    | \$ 2,150                | \$ 97                       | \$ 1,563    | \$ 27,212 |

Activity in the allowance for loan losses for six months ended June 30, 2011 is as follows:

| <i>(Dollars in thousands)</i> | Commercial<br>Real<br>Estate | Acquisition and<br>Development | Commercial<br>and Industrial | Residential<br>Mortgage | Installment<br>and<br>Other | Unallocated | Total     |
|-------------------------------|------------------------------|--------------------------------|------------------------------|-------------------------|-----------------------------|-------------|-----------|
| Balance, beginning of period  | \$ 5,324                     | \$ 1,767                       | \$ 6,795                     | \$ 1,863                | \$ 106                      | \$ 165      | \$ 16,020 |
| Provision for loan losses     | 3,165                        | 5,835                          | 13,600                       | 427                     | 0                           | 1,398       | 24,425    |
| Charge-offs                   | (1,253)                      | (2,576)                        | (9,263)                      | (140)                   | (24)                        | 0           | (13,256)  |
| Recoveries                    | 8                            | 0                              | 0                            | 0                       | 15                          | 0           | 23        |
| Balance, end of period        | \$ 7,244                     | \$ 5,026                       | \$ 11,132                    | \$ 2,150                | \$ 97                       | \$ 1,563    | \$ 27,212 |

The roll forward of the allowance for loan losses for the three and six months ended June 30, 2010 is as follows:

| <i>(Dollars in Thousands)</i>  | Three Months<br>Ended | Six Months<br>Ended |
|--------------------------------|-----------------------|---------------------|
| Balance at beginning of period | \$ 12,020             | \$ 11,067           |
| Provision for loan losses      | 5,000                 | 6,420               |
| Recoveries                     | 67                    | 85                  |
| Loans charged-off              | (2,505)               | (2,990)             |
| Balance at end of period       | \$ 14,582             | \$ 14,582           |

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The following summarizes the ending loan balances individually and collectively evaluated for impairment based upon loan segment, as well as the related allowance for loan losses allocation at June 30, 2011 and December 31, 2010:

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| <i>(Dollars in thousands)</i>           | Commercial<br>Real Estate | Acquisition and<br>Development | Commercial<br>and Industrial | Residential<br>Mortgage | Installment<br>and Other | Unallocated | Total      |
|---|---------------------------|--------------------------------|------------------------------|-------------------------|--------------------------|-------------|------------|
| <b>June 30, 2011</b>                    |                           |                                |                              |                         |                          |             |            |
| Loans allocated by:                     |                           |                                |                              |                         |                          |             |            |
| Individually evaluated for impairment   | \$ 7,444                  | \$ 10,594                      | \$ 29,680                    | \$ 1,174                | \$ 0                     | \$ 0        | \$ 48,892  |
| Collectively evaluated for impairment   | 353,122                   | 98,900                         | 253,349                      | 232,756                 | 12,014                   | 0           | 950,141    |
|   | \$ 360,566                | \$ 109,494                     | \$ 283,029                   | \$ 233,930              | \$ 12,014                | \$ 0        | \$ 999,033 |
| Allowance for loan losses allocated by: |                           |                                |                              |                         |                          |             |            |
| Individually evaluated for impairment   | \$ 1,589                  | \$ 1,512                       | \$ 5,609                     | \$ 10                   | \$ 0                     | \$ 0        | \$ 8,720   |
| Collectively evaluated for impairment   | 5,655                     | 3,514                          | 5,523                        | 2,140                   | 97                       | 1,563       | 18,492     |
|   | \$ 7,244                  | \$ 5,026                       | \$ 11,132                    | \$ 2,150                | \$ 97                    | \$ 1,563    | \$ 27,212  |
| <b>December 31, 2010</b>                |                           |                                |                              |                         |                          |             |            |
| Loans allocated by:                     |                           |                                |                              |                         |                          |             |            |
| Individually evaluated for impairment   | \$ 2,840                  | \$ 0                           | \$ 10,718                    | \$ 1,181                | \$ 0                     | \$ 0        | \$ 14,739  |
| Collectively evaluated for impairment   | 337,181                   | 117,402                        | 253,225                      | 230,634                 | 11,112                   | 0           | 949,554    |
|   | \$ 340,021                | \$ 117,402                     | \$ 263,943                   | \$ 231,815              | \$ 11,112                | \$ 0        | \$ 964,293 |
| Allowance for loan losses allocated by: |                           |                                |                              |                         |                          |             |            |
| Individually evaluated for impairment   | \$ 1,251                  | \$ 0                           | \$ 3,232                     | \$ 20                   | \$ 0                     | \$ 0        | \$ 4,503   |
| Collectively evaluated for impairment   | 4,073                     | 1,767                          | 3,563                        | 1,843                   | 106                      | 165         | 11,517     |
|   | \$ 5,324                  | \$ 1,767                       | \$ 6,795                     | \$ 1,863                | \$ 106                   | \$ 165      | \$ 16,020  |

The provision for loan losses increased to \$21.0 and \$24.4 million for the three and six months ended June 30, 2011, as compared to \$5.0 million and \$6.4 million for corresponding periods in 2010. The factors attributable to the increase in the provision for loan losses include specifically identifiable charge-offs of two relationships totaling \$8.2 million and the establishment of valuation reserves of \$5.8 million, determined principally through discounted cash flows, on restructured loans. Additionally, the elevated provision for loan losses resulted from downgrades in internal risk ratings of loans and loans considered impaired, which were influenced by continuing softness in economic conditions and deterioration of underlying collateral securing the loans. The provision for loan loss for the first six months of 2011 was nearly 1.85x net charge-offs for the period, which enabled the Company to bolster the allowance for loan losses to 2.73% of loans outstanding.

See further discussion in the *Provision for Loan Losses* section noted in the Results of Operations for the Quarter Ended June 30, 2011 compared to June 30, 2010.

Management believes the allocation of the allowance for loan losses between the various loan segments adequately reflects the inherent risk in each portfolio, and is based on the methodology previously discussed.

The largest component of the reserve remains allocated to the commercial and industrial portfolio. This reflects the inherent greater risk associated with this portfolio, as evidenced by the greater amounts of net charge-offs within the portfolio. Since December 31, 2010, the reserve allocated to the commercial and industrial portfolio has increased \$4.3 million from \$6.8 million to \$11.1 million. During the six months ended June 30, 2011, the largest percentage increase in the reserve allocation was within the acquisition and development loan portfolio, which increased from \$1.8 million at December 31, 2010 to \$5.0 million at June 30, 2011. In connection with managements heightened awareness of the economic conditions that plague our commercial and acquisition and development customers, numerous loans were re-evaluated with subsequent downgrades to the loans rating made. Non-impaired substandard loans increased from \$15.0 million at December 31, 2010 to \$35.2 million at June 30, 2011 on commercial and industrial loans, and from \$8.9 million to \$21.7 million on acquisition and development loans during the period. As a result, additional quantitative and qualitative reserves were established on these rated loans collectively evaluated for impairment.



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The unallocated portion of the allowance for loan losses reflects estimated inherent losses within the portfolio that have not been detected. This reserve results due to risk of error in the specific and general reserve allocation, other potential exposure in the loan portfolio, variances in management's assessment of national and local economic conditions and other factors management believes appropriate at the time. The unallocated portion represents 5.8% of the reserve balance at June 30, 2011. The increase from \$165,000 at

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December 31, 2010 to \$1.6 million at June 30, 2011 reflects greater uncertainty in how loan the economic conditions will remain soft and collateral values will continue to depreciate.

While management believes the Company's allowance for loan losses is adequate based on information currently available, future adjustments to the reserve and enhancements to the methodology may be necessary due to changes in economic conditions, regulatory guidance, or management's assumptions as to future delinquencies or loss rates.

### **Deposits**

On an average daily basis, total deposits grew 22.8%, or \$226.9 million, from \$993.6 million for the six months ended June 30, 2010 to \$1.221 billion for the corresponding 2011 period. Each category of time deposits experienced growth on an average daily basis in the first six months of 2011 compared to 2010. The two categories that have experienced the most significant growth were interest bearing demand deposits, which grew \$66.5 million, or 17.7%, and time deposits, which grew by \$135.4 million, or 29.9% on an average daily balance basis. Given current economic times and market conditions, it has been noted that consumers are saving more, combined with our strong capital position, strong focus on our customer needs and service, and competitive pricing has allowed the Company to attract more demand deposits, including checking and money market products.

Additionally, the Company has a strong IDC Financial Publishing, Inc. (IDC) rating, an independent bank safety rating which uses unique rankings of financial ratios to determine the quality ratings of financial institutions. This strong rating allows the Company to attract larger types of deposits, including time deposits, those in excess of \$100,000, and brokered deposits. As of June 30, 2011, the Company had brokered deposits of \$188.5 million, a 9.9% increase over the December 31, 2010 brokered deposit balance of \$171.6 million. As noted above, the Bank's IDC rating has led to an opportunity to obtain this relatively cheap funding source, which it can use to reduce its reliance on more expensive other borrowing types, or invest in loans or securities. The Company recognizes that brokered funds result in greater volatility as a funding source, but given the current interest rate environment and the steepness of the interest rate curve, elected to use these funds and earn a spread on them to increase net interest as previously discussed. Given the increased volatility in brokered deposits, the Company invested a large portion of these amounts in mortgage backed securities, which provide a steady stream of cash flows, which are used to meet the maturity needs of time deposits demand requirements of time and brokered deposits.

Management continually evaluates interest rate conditions, including the interest rate curve. Brokered and other time deposit balances may be less emphasized in the future if interest rate conditions are less advantageous to the Company's net interest income.

### **Capital Adequacy and Regulatory Matters**

The management of capital in a regulated financial services industry must properly balance return on equity to its stockholders while maintaining sufficient levels of capital and related risk-based regulatory capital ratios to satisfy statutory regulatory requirements. The Company's capital management strategies have been developed to provide attractive rates of returns to its shareholders, while maintaining a well capitalized position of regulatory strength.

Total shareholders' equity decreased \$7.0 million from \$160.4 million at December 31, 2010 to \$153.4 million at June 30, 2011. The decrease in shareholders' equity was principally the result of the \$3.8 million comprehensive loss recorded for the period, which included \$3.1 million of unrealized gains in securities. Dividends declared of \$3.7 million also contributed to the decrease in shareholders' equity. Shares issued under stock compensation plans added \$467,000 to capital. Historically, earnings retention, defined as net income less dividends declared, has served as a primary source of capital to the Company. As a result of the net loss posted during the three months ended June 30, 2011, dividends declared have exceeded the years' net income. Quarterly, management evaluates its ability to pay a dividend in light of regulatory guidance, capital needed for growth initiatives and minimum regulatory capital ratios.

On February 9, 2010, the Company filed a shelf registration statement on Form S-3, with the Securities and Exchange Commission, that provided the Company the ability to raise capital, from time to time, up to an aggregate of \$80 million, through the sale of stock, preferred stock, debt securities, warrants and other securities. The Company completed a public stock offering of 1,481,481 shares of common stock at a price of \$27.00 per share, for gross proceeds of approximately \$40,000,000 during the first quarter of 2010. Net proceeds after underwriting commissions and expenses were \$37,585,000. Although the Company

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recognized this offering would initially dilute earnings per share and reduce return on equity and tangible equity performance measurements, management felt it was necessary in order to support the continued growth of the Company. The additional capital allowed the Company to bolster its regulatory capital ratios during a time of an uncertain economy and the potential for increased government oversight and perhaps higher regulatory capital requirements. As noted below, the Company's capital ratios continue to exceed the minimums to be well capitalized. The Company believes that with this additional capital, it positions itself to weather the economy and take advantage of future opportunities that may arise. The Company has no current plans to issue additional shares of common stock.

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. Prompt corrective action provisions are not applicable to financial holding companies.

As of June 30, 2011, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category. The Company and the Bank's actual capital ratios as of June 30, 2011 and December 31, 2010 are presented as follows:

|  | Actual     |       | Minimum Capital Requirement |       | Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|--|------------|-------|-----------------------------|-------|--|-------|
|  | Amount     | Ratio | Amount                      | Ratio | Amount   | Ratio |
| <i>(Dollars in thousands)</i>          |            |       |                             |       |  |       |
| <b>June 30, 2011</b>                   |            |       |                             |       |  |       |
| Total capital to risk weighted assets  |            |       |                             |       |  |       |
| Orrstown Financial Services, Inc.      | \$ 142,845 | 13.9% | \$ 82,306                   | 8.0%  | n/a  | n/a   |
| Orrstown Bank                          | 126,684    | 12.4% | 81,910                      | 8.0%  | \$ 102,388   | 10.0% |
| Tier 1 capital to risk weighted assets |            |       |                             |       |  |       |
| Orrstown Financial Services, Inc.      | 129,846    | 12.6% | 41,153                      | 4.0%  | n/a  | n/a   |
| Orrstown Bank                          | 113,731    | 11.1% | 40,955                      | 4.0%  | 61,433   | 6.0%  |
| Tier 1 capital to average assets       |            |       |                             |       |  |       |
| Orrstown Financial Services, Inc.      | 129,846    | 8.6%  | 60,666                      | 4.0%  | n/a  | n/a   |
| Orrstown Bank                          | 113,731    | 7.6%  | 59,900                      | 4.0%  | 74,875   | 5.0%  |
| <b>December 31, 2010</b>               |            |       |                             |       |  |       |
| Total capital to risk weighted assets  |            |       |                             |       |  |       |
| Orrstown Financial Services, Inc.      | \$ 152,550 | 14.8% | \$ 82,486                   | 8.0%  | n/a  | n/a   |
| Orrstown Bank                          | 129,844    | 12.7% | 81,808                      | 8.0%  | \$ 102,260   | 10.0% |
| Tier 1 capital to risk weighted assets |            |       |                             |       |  |       |
| Orrstown Financial Services, Inc.      | 139,623    | 13.5% | 41,243                      | 4.0%  | n/a  | n/a   |
| Orrstown Bank                          | 117,027    | 11.4% | 40,904                      | 4.0%  | 61,356   | 6.0%  |
| Tier 1 capital to average assets       |            |       |                             |       |  |       |
| Orrstown Financial Services, Inc.      | 139,623    | 9.4%  | 59,385                      | 4.0%  | n/a  | n/a   |
| Orrstown Bank                          | 117,027    | 8.0%  | 58,629                      | 4.0%  | 73,287   | 5.0%  |

**Liquidity**

The primary function of asset/liability management is to assure adequate liquidity and sensitivity to changing interest rates. Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Our primary sources of funds consist of deposit inflows, loan repayments, maturities and sales of investment securities and borrowings from the Federal Home Loan Bank of Pittsburgh. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.



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We regularly adjust our investments in liquid assets based upon our assessment of (1) expected loan demand, (2) expected deposit flows, (3) yields available on interest-earning deposits and securities and (4) the objectives of our asset/liability management policy.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Market risk is defined as the exposure to interest rate risk, foreign currency exchange rate risk, commodity price risk, and other relevant market rate or price risks. For domestic banks, including the Company, the majority of market risk is related to interest rate risk.

Interest rate sensitivity management requires the maintenance of an appropriate balance between interest sensitive assets and liabilities. Interest bearing assets and liabilities that are maturing or repricing should be adequately balanced to avoid fluctuating net interest margins and to enhance consistent growth of net interest income through periods of changing interest rates. The Company has consistently followed a strategy of pricing assets and liabilities according to prevailing market rates while largely matching maturities, within the guidelines of sound marketing and competitive practices. Rate sensitivity is measured by monthly gap analysis, quarterly rate shocks, and periodic simulation.

The Company has been able to significantly reduce its liability sensitivity, and increased its asset sensitivity during the past several months. In the first half of the year, the Company sold its \$10 million notional amount interest rate swap, and in July 2011, the remaining interest rate swap, with a notional value of \$20 million was sold as well. Both cash flow swaps converted variable rate earnings to fixed rate. The settlement of these swaps was done in an effort to increase our asset sensitivity in the event of rising rates, and the sale of the \$20 million notional amount in July will increase risk sensitive assets by \$20 million. While the Company was liability sensitive at September 30, 2010, we have moved the position, as measured by cumulative gaps, to asset sensitive on the short-end, and are balanced at longer cumulative maturities, which we believe positions us for the possibility that interest rates may rise in the future. The following gap summary demonstrates the shift in RSA/RSL (cumulative) position since year end:

|                   | 0-3 Months | 0-6 Months | 0-12 Months | 0-36 Months |
|-------------------|------------|------------|-------------|-------------|
| December 31, 2010 | 1.08       | 0.97       | 0.90        | 1.05        |
| March 31, 2011    | 1.19       | 1.02       | 0.95        | 1.08        |
| June 30, 2011     | 1.13       | 1.03       | 0.91        | 1.16        |

The cumulative gap position at 12 months is negative at \$58.6 million at June 30, 2011 and the RSA/RSL cumulative ratio is 0.91, versus a cumulative negative gap position at 12 months of \$65.8 million or 0.90 RSA/RSL cumulative ratio reported at December 31, 2010. Overall, the Company maintains a balanced position that does not place it at undue risk under any interest rate scenario. Many of the deposit dollars in transaction accounts are discretionarily priced so management maintains significant pricing flexibility.

**Item 4. Controls and Procedures****(a) Evaluation of disclosure controls and procedures:**

The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of June 30, 2011. Based on such evaluation, such officers have concluded that, as of June 30, 2011, the Company's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Company (including its consolidated subsidiary) required to be included in the Company's periodic filings under the Exchange Act.

**(b) Changes in internal controls:**

The Company regularly assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. During the second quarter of 2011, the Company supplemented its internal loan review function in rating credits within the commercial portfolios by engaging an independent third party loan review company to participate in the review process. Management's decision to supplement its internal loan review was consistent with its desire to review every loan within these portfolios in excess of \$500,000 and to obtain at least 75% coverage of the portfolio as measured in dollars. This level of review was necessitated based upon management's conclusion that a current review of credits was required in light of the



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continuing softness in overall economic conditions and deterioration of underlying collateral based upon recent appraisals of the collateral securing the loans. All relationships reviewed by either internal or contracted resources were reviewed with the Company's Credit Administration Committee, who reaffirmed the rating after a review of the loans cash flows, detailed collateral analysis and the development of action plans.

With the exception of the engagement by the Company of the independent loan review firm noted above, there have not been any other significant changes in the Company's internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, such controls during the quarter ended June 30, 2011. Effective July 1, 2011, the Company outsourced its loan review function to a third party loan review firm to complete independent loan reviews and validate management's loan ratings.

**PART II - OTHER INFORMATION**

**Item 1 Legal Proceedings**

The nature of the Company's business generates a certain amount of litigation involving matters arising out of the ordinary course of business. In the opinion of management, there are no legal proceedings that might have a material effect on the results of operations, liquidity, or the financial position of the Company at this time.

**Item 1A Risk Factors**

There have been no material changes from the risk factors as disclosed in the Annual Report on Form 10-K for the year ended December 31, 2010.

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

The table below summarizes the Company's repurchase of common equity securities during the quarter ended June 30, 2011:

|                        | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid per<br>Share | Total Number of Shares<br>Purchased as Part of<br>Publicly Announced<br>Plans or Programs (1) | Maximum Number of Shares<br>that may Yet be Purchased<br>Under the Plans or Programs<br>(1) |
|------------------------|---|---------------------------------------|---|---|
| 4/1/11 through 4/30/11 | 0   | \$ 0                                  | N/A   | 191,926   |
| 5/1/11 through 5/31/11 | 0   | 0                                     | N/A   | 191,926   |
| 6/1/11 through 6/30/11 | 2,232                                     | 24.02                                 | N/A   | 189,694   |
| <b>Total</b>           | <b>2,232</b>                              | <b>\$ 24.02</b>                       |   |   |

(1) On April 27, 2006, the Company 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, the Company 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. As of June 30, 2011, 110,306 shares have been purchased under the program.

The Company did not sell any unregistered securities during the quarter ended June 30, 2011.

**Item 3 Defaults upon Senior Securities**

Not applicable

**Item 4 (Removed and Reserved)**

**Item 5 Other Information**

None

Item 6 Exhibits

- 3.1 Articles of Incorporation, as amended, incorporated by reference to Exhibit 3.1 of the Registrant's Report on Form 8-K filed on January 29, 2010.
- 3.2 By-laws, as amended, incorporated by reference to Exhibit 3.2 of the Registrant's Report on Form 8-K filed on January 29, 2010.
- 4 Instruments defining the rights of security holders including indentures. The rights of the holders of Registrant's common stock are contained in:
  - (i) Articles of Incorporation, as amended, incorporated by reference to Exhibit 3.1.

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- (ii) By-laws, as amended, incorporated by reference to Exhibit 3.2.
- 31.1 Rule 13a - 14(a)/15d-14(a) Certification (Principal Executive Officer) filed herewith
- 31.2 Rule 13a - 14(a)/15d-14(a) Certifications (Principal Financial Officer) filed herewith
- 32.1 Section 1350 Certifications (Principal Executive Officer) filed herewith
- 32.2 Section 1350 Certifications (Principal Financial Officer) filed herewith
- 101. The following materials from Orrstown Financial Services, Inc.'s Quarterly Report on Form 10-Q for the period ended June 30, 2011, formatted in XBRL: (i) the Consolidated Balance Sheets at June 30, 2011 and December 31, 2010, (ii) the Consolidated Statements of Operations for the three and six month ended June 30, 2011 and June 30, 2010, (iii) the Consolidated Statements of Stockholders Equity for the six months ended June 30, 2011 and 2010, (iv) the Consolidated Statements of Cash Flows for the six months ended June 30, 2011 and 2010 and (v) the Notes to Consolidated Financial Statements tagged as blocks of text.

(These interactive data files shall not be deemed filed for purposes of Section 11 or Section 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liabilities under these Sections.)

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

/s/ Thomas R. Quinn, Jr.  
Thomas R. Quinn, Jr., President & CEO  
(Duly Authorized Officer)

/s/ Bradley S. Everly  
Bradley S. Everly, Executive  
Vice President and CFO  
(Principal Financial Officer)

Date: August 9, 2011

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ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

EXHIBIT INDEX

|         |  |
|---------|--|
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| 32.1    | Section 1350 Certifications (Principal Executive Officer)  |
| 32.2    | Section 1350 Certifications (Principal Financial Officer)  |
| 101.    | Interactive Data File  |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase   |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase  |
| 101.INS | XBRL Instance Document   |
| 101.SCH | XBRL Taxonomy Extension Schema   |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase   |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase  |