

ORRSTOWN FINANCIAL SERVICES INC  
Form 10-Q  
August 08, 2008  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**FORM 10 - Q**

**QUARTERLY REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 30, 2008

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 33-18888

**ORRSTOWN FINANCIAL SERVICES, INC.**

(Exact name of registrant as specified in its charter)

**Commonwealth of Pennsylvania**  
(State or other jurisdiction of incorporation or organization)

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

## Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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 June 30, 2008, 6,425,040 shares of common stock, no par value, of the registrant were outstanding.

**Table of Contents**

ORRSTOWN FINANCIAL SERVICES, INC.

INDEX

	<b>Page</b>
Part I - FINANCIAL INFORMATION	
Item 1. Financial Statements (unaudited)	
<u>Condensed consolidated balance sheets - June 30, 2008 and December 31, 2007</u>	3
<u>Condensed consolidated statements of income - Three months ended June 30, 2008 and 2007</u>	4
<u>Condensed consolidated statements of income - Six months ended June 30, 2008 and 2007</u>	5
<u>Condensed consolidated statements of changes in shareholders' equity - Six months ended June 30, 2008 and 2007</u>	6
<u>Condensed consolidated statements of comprehensive income - Three and Six months ended June 30, 2008 and 2007</u>	7
<u>Condensed consolidated statements of cash flows - Six months ended June 30, 2008 and 2007</u>	8
<u>Notes to condensed consolidated financial statements</u>	9 12
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13 19
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	20
Item 4. <u>Controls and Procedures</u>	20
PART II - OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	21
Item 1A. <u>Risk Factors</u>	21
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	21
Item 3. <u>Defaults upon Senior Securities</u>	22
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	22
Item 5. <u>Other Information</u>	22
Item 6. <u>Exhibits</u>	22
<u>SIGNATURES</u>	23
<u>EXHIBIT INDEX</u>	24

**Table of Contents**

## PART I - FINANCIAL INFORMATION

**Item 1. Financial Statements**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)	(Unaudited) June 30, 2008	(Audited) * December 31, 2007
<b>ASSETS</b>		
Cash and due from banks	\$ 20,973	\$ 17,625
Federal funds sold	3,949	808
Cash and cash equivalents	24,922	18,433
Interest bearing deposits with banks	286	231
Member stock, at cost which approximates market value	6,737	5,751
Securities available for sale	82,169	90,604
Loans	752,697	701,964
Allowance for loan losses	(6,429)	(6,141)
Net Loans	746,268	695,823
Premises and equipment, net	29,828	25,980
Goodwill and intangible assets	21,261	21,368
Cash surrender value of life insurance	16,348	16,067
Accrued interest receivable	3,442	3,490
Other assets	8,258	7,232
Total assets	\$ 939,519	\$ 884,979
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits:		
Non-interest bearing	\$ 87,844	\$ 91,365
Interest bearing	589,292	554,991
Total deposits	677,136	646,356
Short term borrowings	65,327	58,130
Long term debt	88,038	75,903
Accrued interest payable	1,026	1,172
Other liabilities	8,301	7,294
Total liabilities	839,828	788,855
Common stock, no par value - \$.05205 stated value per share; 50,000,000 shares authorized; 6,452,845 and 6,452,845 shares issued		
	336	336
Additional paid - in capital	82,419	82,488
Retained earnings	17,698	13,868
Accumulated other comprehensive income	146	567
Treasury stock, 27,805 and 33,303 shares, at cost	(908)	(1,135)
Total shareholders equity	99,691	96,124

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

Total liabilities and shareholders' equity	\$ 939,519	\$ 884,979
--	------------	------------

\* Condensed from audited financial statements

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

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

<b>(Dollars in Thousands)</b>	<b>Three Months Ended</b>	
	<b>June</b>	<b>June</b>
	<b>2008</b>	<b>2007</b>
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 11,726	\$ 11,857
Interest and dividends on investment securities	905	974
Interest on short term investments	54	189
<b>Total interest income</b>	<b>12,685</b>	<b>13,020</b>
<b>INTEREST EXPENSE</b>		
Interest on deposits	3,299	4,665
Interest on short-term borrowings	239	580
Interest on long-term debt	983	415
<b>Total interest expense</b>	<b>4,521</b>	<b>5,660</b>
<b>Net interest income</b>	<b>8,164</b>	<b>7,360</b>
Provision for loan losses	257	90
<b>Net interest income after provision for loan losses</b>	<b>7,907</b>	<b>7,270</b>
<b>OTHER INCOME</b>		
Service charges on deposits	1,718	1,393
Other service charges	1,119	554
Trust department income	713	648
Brokerage income	377	383
Other income	218	176
Non-recurring revenue	0	219
Securities gains / (losses)	(1)	16
<b>Total other income</b>	<b>4,144</b>	<b>3,389</b>
<b>OTHER EXPENSES</b>		
Salaries and employee benefits	3,811	3,588
Occupancy and equipment	1,072	898
Data processing	247	194
Advertising	145	108
Non-recurring expense	0	78
Other operating expense	1,610	1,259
<b>Total other expense</b>	<b>6,885</b>	<b>6,125</b>
<b>Income before income taxes</b>	<b>5,166</b>	<b>4,534</b>
Income tax expense	1,563	1,314
<b>Net income</b>	<b>\$ 3,603</b>	<b>\$ 3,220</b>

## PER SHARE DATA

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

Basic earnings per share	\$ 0.56	\$ 0.50
Diluted earnings per share	\$ 0.54	\$ 0.48
Dividends per share	\$ 0.22	\$ 0.20

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

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

<b>(Dollars in Thousands)</b>	<b>Six Months Ended</b>	
	<b>June</b>	<b>June</b>
	<b>2008</b>	<b>2007</b>
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 23,971	\$ 23,198
Interest and dividends on investment securities	1,923	1,980
Interest on short term investments	179	401
<b>Total interest income</b>	<b>26,073</b>	<b>25,579</b>
<b>INTEREST EXPENSE</b>		
Interest on deposits	7,384	9,168
Interest on short-term borrowings	650	1,080
Interest on long-term debt	1,958	811
<b>Total interest expense</b>	<b>9,992</b>	<b>11,059</b>
<b>Net interest income</b>	<b>16,081</b>	<b>14,520</b>
Provision for loan losses	415	150
<b>Net interest income after provision for loan losses</b>	<b>15,666</b>	<b>14,370</b>
<b>OTHER INCOME</b>		
Service charges on deposits	3,253	2,621
Other service charges	1,827	1,040
Trust department income	1,423	1,258
Brokerage income	756	739
Other income	448	367
Non-recurring revenue	0	219
Securities gains	48	70
<b>Total other income</b>	<b>7,755</b>	<b>6,314</b>
<b>OTHER EXPENSES</b>		
Salaries and employee benefits	7,828	7,292
Occupancy and equipment	2,029	1,795
Data processing	478	418
Advertising	243	186
Non-recurring expense	0	78
Other operating expense	3,007	2,325
<b>Total other expense</b>	<b>13,585</b>	<b>12,094</b>
<b>Income before income taxes</b>	<b>9,836</b>	<b>8,590</b>
Income tax expense	2,983	2,507
<b>Net income</b>	<b>\$ 6,853</b>	<b>\$ 6,083</b>

## PER SHARE DATA

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

Basic earnings per share	\$ 1.07	\$ 0.95
Diluted earnings per share	\$ 1.02	\$ 0.90
Dividends per share	\$ 0.43	\$ 0.40

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

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

(Dollars in thousands)	Six Months Ended June 30, 2008 and 2007					
	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Shareholders' Equity
Beginning Balance, January 1, 2007	\$ 320	\$ 72,023	\$ 16,934	\$ 507	(\$ 396)	\$ 89,388
<b>Comprehensive income</b>						
Net income	0	0	6,083	0	0	6,083
Change in unrealized gain on investment securities available for sale, net of tax	0	0	0	(488)	0	(488)
Total comprehensive income						5,595
Cash dividends (\$.40 per share)	0	0	(2,573)	0	0	(2,573)
Stock dividends issued	16	10,314	(10,330)	0	0	0
Cash paid in lieu of fractional stock dividends	0	0	(23)	0	0	(23)
Stock-based compensation plans:						
Compensation expense	0	18	0	0	0	18
Issuance of stock	0	15	0	0	0	15
Purchase of treasury stock (17,000 shares)	0	0	0	0	(589)	(589)
Issuance of treasury stock (1,978 shares)	0	(14)	0	0	73	59
Balance, June 30, 2007	\$ 336	\$ 82,356	\$ 10,091	\$ 19	(\$ 912)	\$ 91,890
Beginning Balance, January 1, 2008	\$ 336	\$ 82,488	\$ 13,868	\$ 567	(\$ 1,135)	\$ 96,124
<b>Comprehensive income</b>						
Net income	0	0	6,853	0	0	6,853
Change in unrealized gain on investment securities available for sale, net of tax	0	0	0	(421)	0	(421)
Total comprehensive income						6,432
Cash dividends (\$.43 per share)	0	0	(2,760)	0	0	(2,760)
Split dollar post retirement plan	0	0	(263)	0	0	(263)
Stock-based compensation plans:						
Compensation expense	0	(8)	0	0	0	(8)
Purchase of treasury stock (3,962 shares)	0	0	0	0	(123)	(123)
Issuance of treasury stock (9,460 shares)	0	(61)	0	0	350	289
Balance, June 30, 2008	\$ 336	\$ 82,419	\$ 17,698	\$ 146	(\$ 908)	\$ 99,691

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

**Table of Contents**

ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

<b>(Dollars in Thousands)</b>	<b>Three Months Ended</b>	
	<b>June</b>	<b>June</b>
	<b>2008</b>	<b>2007</b>
<b>COMPREHENSIVE INCOME</b>		
Net Income	\$ 3,603	\$ 3,220
Other comprehensive income, net of tax		
Unrealized (loss) on investment securities available for sale	(788)	(535)
<b>Comprehensive Income</b>	<b>\$ 2,815</b>	<b>\$ 2,685</b>

<b>(Dollars in Thousands)</b>	<b>Six Months Ended</b>	
	<b>June</b>	<b>June</b>
	<b>2008</b>	<b>2007</b>
<b>COMPREHENSIVE INCOME</b>		
Net Income	\$ 6,853	\$ 6,083
Other comprehensive income, net of tax		
Unrealized (loss) on investment securities available for sale	(421)	(488)
<b>Comprehensive Income</b>	<b>\$ 6,432</b>	<b>\$ 5,595</b>

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

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in Thousands)	Six Months Ended	
	June 2008	June 2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 6,853	\$ 6,083
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,028	937
Provision for loan losses	415	150
Other, net	(601)	(1,829)
<b>Net cash provided by operating activities</b>	<b>7,695</b>	<b>5,341</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net (increase) decrease in interest bearing deposits with banks	(55)	348
Purchases of available for sale securities	(25,791)	(4,109)
Sales and maturities of available for sale securities	33,631	11,178
Purchase of intangible assets	18	51
Net (increase) in loans	(50,860)	(34,443)
Purchases of bank premises and equipment	(4,680)	(2,861)
Other, net	(986)	(542)
<b>Net cash (used) by investing activities</b>	<b>(48,723)</b>	<b>(30,378)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	30,780	15,042
Dividends paid	(2,760)	(2,573)
Net proceeds from issuance of common stock	0	1
Purchase of treasury stock	(123)	(589)
Net proceeds from issuance of treasury stock	288	73
Net change in short-term borrowings	7,197	6,746
Proceeds from long-term borrowings	13,000	4,000
Repayment of long-term borrowings	(865)	(7,958)
Other, net	0	(23)
<b>Net cash provided by financing activities</b>	<b>47,517</b>	<b>14,719</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>6,489</b>	<b>(10,318)</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>18,433</b>	<b>39,134</b>
<b>Cash and cash equivalents at end of period</b>	<b>\$ 24,922</b>	<b>\$ 28,816</b>
<b>Supplemental disclosure of cash flow information:</b>		
<b>Cash paid during the period for:</b>		
Interest	\$ 10,138	\$ 11,241
Income Taxes	3,025	2,725
<b>Supplemental schedule of noncash investing and financing activities:</b>		
Unrealized (loss) on investments available for sale (net of deferred taxes of \$(222) and \$(263) at June 30, 2008 and 2007, respectively)	(421)	(488)

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



## Table of Contents

ORRSTOWN FINANCIAL SERVICES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

June 30, 2008

Note 1: Summary of Significant Accounting Policies

Basis of Presentation

The unaudited financial statements of Orrstown Financial Services, Inc. (the Company) and its subsidiary are presented at and for the three and six months ended June 30, 2008 and 2007 and have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and instructions to Form 10-Q. 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, necessary for a fair presentation of the financial position, results of operations and cash flows for the interim period. Information presented at December 31, 2007 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, 2007.

Operating

Orrstown Financial Services, Inc. is a financial holding company including its wholly-owned subsidiary, Orrstown Bank. All significant intercompany transactions and accounts have been eliminated. Operating results for the three and six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

Cash Flows

For purposes of the Statements of Cash Flows, cash and cash equivalents include Cash and due from banks and Federal funds sold. As permitted by Statement of Financial Accounting Standards No. 104, the Company has elected to present the net increase or decrease in deposits with banks, loans and deposits in the Statement of Cash Flows.

Federal Income Taxes

For financial reporting purposes, the provision for loan losses charged to operating expense is based on management's judgment, whereas for federal income tax purposes the amount allowable under present tax law is deducted. Additionally, deferred compensation is charged to operating expense in the period the liability is incurred for financial reporting purposes, whereas for federal income tax purposes these expenses are deducted when paid. As a result of the aforementioned timing differences plus the timing differences associated with depreciation expense, deferred income taxes are provided in the financial statements. Income tax expense is less than the amount calculated using the statutory tax rate primarily as a result of tax exempt income earned from state and political subdivision obligations and tax free loans.

Investment Securities

Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold securities until maturity, they are classified as securities held to maturity and carried at amortized historical cost. Securities to be held for indefinite periods of time, and not intended to be held to maturity, are classified as available for sale and carried at fair value. Securities held for indefinite periods of time include securities that management intends to use as part of its asset and liability management strategy and that may be sold in response to changes in interest rates, resultant prepayment risk, and other factors related to interest rate and resultant prepayment risk changes.

Realized gains and losses on dispositions are based on the net proceeds and the adjusted book value of the securities sold, using the specific identification method. Unrealized gains and losses on investment securities available for sale are based on the difference between book value and fair value of each security. These gains and losses are credited or charged to other comprehensive income, whereas realized gains and losses flow through the Company's results of operations.

## Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

The Company has classified all investment securities as available for sale . At December 31, 2007, fair value exceeded amortized cost by \$865,000 and at June 30, 2008 fair value exceeded amortized cost by \$223,000. In shareholders equity, the balance of accumulated other comprehensive income decreased to \$146,000 at June 30, 2008 from \$567,000 at December 31, 2007.

**Table of Contents**

## Stock-Based Compensation

The Company maintains two stock-based compensation plans. These plans provide for the granting of stock options to the Company's directors and the Bank's employees. FAS Statement No 123R, Share-Based Payment requires financial statement recognition of compensation cost for stock options and other stock-based awards. Both of the Company's stock-based compensation plans are fully vested when granted and, therefore, are expensed on the date of grant using the Black-Scholes option-pricing model.

## Earnings per Share of Common Stock

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect the addition of an incremental number of shares added as a result of converting common stock equivalents. A reconciliation of the weighted average shares outstanding used to calculate basic net income per share and diluted net income per share follows.

Earnings per share for the three and six months ended June 30, have been computed as follows:

	Three Months Ended		Six Months Ended	
	June 2008	June 2007	June 2008	June 2007
<b>(In Thousands, except per share data)</b>				
Net Income	\$ 3,603	\$ 3,220	\$ 6,853	\$ 6,083
Weighted average shares outstanding (basic)	6,422	6,431	6,421	6,434
Impact of common stock equivalents	318	291	321	289
Weighted average shares outstanding (diluted)	6,740	6,722	6,742	6,723
Per share information:				
Basic earnings per share	\$ 0.56	\$ 0.50	\$ 1.07	\$ 0.95
Diluted earnings per share	\$ 0.54	\$ 0.48	\$ 1.02	\$ 0.90
Change in Accounting Principle				

In September of 2006, the Emerging Issues Task Force of the FASB (EITF) issued EITF 06-04. This pronouncement affects the recording of post retirement costs of insurance of bank owned life insurance policies in instances where the Company has promised a continuation of life insurance coverage to persons post retirement. EITF 06-04 requires that a liability equal to the present value of the cost of post retirement insurance be recorded during the insured employees' term of service. The terms of this pronouncement require the initial recording of this liability with a corresponding adjustment to retained earnings to reflect the implementation of the pronouncement. This EITF became effective for fiscal years beginning after December 15, 2007. The effect of this change on January 1, 2008 was a reduction in retained earnings and an increase in accrued benefit liabilities of \$263,000.

## Recent Accounting Pronouncements

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), Business Combinations (SFAS 141(R)). The Statement replaces SFAS No. 141, Business Combinations. This statement retains the fundamental requirements of SFAS 141 that the acquisition method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity's first year annual reporting period that begins after December 15, 2008. The Company does not expect the implementation of SFAS 141(R) to have a material impact on its financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Noncontrolling Interest in Consolidated Financial Statements an Amendment of ARB No. 51 (SFAS 160). The Standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interest in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008, with early adoption permitted. The Company does not expect the implementation of SFAS 160 to have a material impact on its financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related

---

## Table of Contents

hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company does not expect the implementation of SFAS 161 to have a material impact on its financial statements.

### Note 2: 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. As of June 30, 2008, \$26,354,000 of performance standby letters of credit have been issued. The Company does not anticipate any losses as a result of these transactions.

### Note 3: Fair Value Measurements

SFAS 157, *Fair Value Measurements*, (SFAS 157) defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, establishes a three-level valuation hierarchy for disclosure of fair value measurement and expands disclosures requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The definition of fair value is clarified by SFAS No. 157 to be the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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.

### Loans Held for Sale

Loans held for sale which is required to be measured at the lower of cost or fair value. Under SFAS No 157, market value is to represent fair value. Management obtains quotes or bids on all or part of these loans directly from the purchasing financial institutions. Premiums received or to be received on the quotes or bids are indicative of the fact that cost is lower than fair value. At June 30, 2008, loans held for sale were included in total loans on the balance sheet and were recorded at cost.

**Table of Contents**

**Impaired Loans**

SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, Accounting by Creditors for Impairment of a Loan, including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

**Other Real Estate Owned**

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of SFAS No. 157.

The Company had no estimated fair value liabilities at June 30, 2008. A summary of assets at June 30, 2008 measured at estimated fair value on a recurring basis were as follows:

<b>(Dollars in Thousands)</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total Fair Value Measurements</b>
Securities available for sale	\$ 1,283	\$ 80,886	\$ 0	\$ 82,169

**Table of Contents**

## 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 following is a discussion of our consolidated financial condition at June 30, 2008 and results of operations for the three and six months ended June 30, 2008 and three and six months ended June 30, 2007. 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.

Some statements and information may contain forward-looking statements. Factors that could cause actual results to differ materially from forward-looking statements include, but are not limited to: general political and economic conditions, unforeseen changes in the general interest rate environment, developments concerning credit quality in various corporate lending industry sectors, legislative or regulatory developments, legal proceedings, and pending or proposed changes in accounting rules, policies, practices, and procedures. Each of these factors could affect estimates and assumptions used to produce forward looking statements causing actual results to differ materially from those anticipated. Future results could also differ materially from historical performance.

## Critical Accounting Policies

The Bank policy related to the allowance for loan losses is considered to be a critical accounting policy because the allowance for loan losses represents a particularly sensitive accounting estimate. The amount of the allowance is based on management's evaluation of the collectibility of the loan portfolio, including the nature of the loan portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, and economic conditions.

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible, based on evaluations of the collectibility of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, grouping of like loans, grading of individual loan quality, review of specific problem loans, the examination of underlying collateral and current economic conditions that may affect the borrowers' ability to pay.

## SUMMARY OF FINANCIAL RESULTS

Orrstown Financial Services, Inc. recorded net income of \$3,603,000 for the second quarter of 2008 compared to \$3,220,000 for the same period in 2007, representing an increase of \$383,000 or 11.9%. Basic earnings per share (EPS) increased \$0.06 to \$0.56 in the recent quarter from the \$0.50 earned during the second quarter of 2007. Diluted earnings per share for the second quarter were \$0.54 versus \$0.48 last year.

Net income for the first six months of 2008 was \$6,853,000 compared to \$6,083,000 for the same period in 2007, representing an increase of \$770,000 or 12.7%. Basic earnings per share for the first half of 2008 increased by \$0.12 to \$1.07 from the \$0.95 earned for the same period in 2007. Diluted earnings per share for the first six months were \$1.02 versus \$0.90 last year.

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.

The following statistics compare the second quarter and year-to-date performance of 2008 to that of 2007:

	Three Months Ended		Six Months Ended	
	June	June	June	June
	2008	2007	2008	2007
Return on average assets	1.57%	1.57%	1.51%	1.51%

## Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

Return on average tangible assets	1.63%	1.63%	1.57%	1.57%
Return on average equity	14.69%	14.16%	14.11%	13.56%
Return on average tangible equity	18.94%	18.75%	18.27%	18.04%
Average equity / Average assets	10.71%	11.07%	10.72%	11.10%

**Table of Contents**

## RESULTS OF OPERATIONS

Quarter ended June 30, 2008 compared to Quarter ended June 30, 2007

Net interest income for the second quarter of 2008 was \$8,164,000 representing a growth of \$804,000, or 10.9% over the \$7,360,000 realized during the second quarter last year. On a fully taxable equivalent basis (FTE), net interest income for the second quarter of 2008 and 2007 was \$8,394,000 and \$7,612,000, respectively.

The table that follows states rates on a fully taxable equivalent basis (FTE):

(Dollars in thousands)	Three Months Ended					
	Average Balance	June 2008 Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	June 2007 Tax Equivalent Interest	Tax Equivalent Rate
<b>Interest Earning Assets:</b>						
Federal funds sold & interest bearing bank balances	\$ 9,875	\$ 54	2.20%	\$ 14,040	\$ 189	5.40%
Investment securities	87,746	1,052	4.82%	87,136	1,143	5.28%
Total loans	740,164	11,809	6.34%	647,956	11,940	7.32%
<b>Total interest-earning assets</b>	<b>837,785</b>	<b>12,915</b>	<b>6.12%</b>	<b>749,132</b>	<b>13,272</b>	<b>7.04%</b>
<b>Interest Bearing Liabilities:</b>						
Interest bearing demand deposits	\$ 248,181	\$ 910	1.47%	\$ 193,930	\$ 939	1.94%
Savings deposits	62,553	156	1.00%	76,421	382	2.00%
Time deposits	268,666	2,233	3.34%	288,371	3,344	4.65%
Short term borrowings	56,966	239	1.69%	46,960	580	4.95%
Long term borrowings	88,260	983	4.41%	34,787	415	4.73%
<b>Total interest bearing liabilities</b>	<b>724,626</b>	<b>4,521</b>	<b>2.51%</b>	<b>640,469</b>	<b>5,660</b>	<b>3.54%</b>
<b>Net interest income / net interest spread</b>		<b>\$ 8,394</b>	<b>3.61%</b>		<b>\$ 7,612</b>	<b>3.49%</b>
<b>Net interest margin</b>			<b>3.96%</b>			<b>4.01%</b>

FTE interest income totaled \$12,915,000 for the second quarter of 2008 versus \$13,272,000 for the same period last year, a decline of \$357,000, or 2.7%. On average, interest earning assets increased by 11.8% during this time period. Although the Company had a substantial increase in volume variance over all, the rate variance was the contributing factor to the decline in the earning asset yield from 7.04% during the second quarter 2007 to 6.12% for the second quarter 2008. The 325 basis point drop in the prime lending rate over the last 12 months, plus declines in the treasury rates, LIBOR and the federal funds rate, contributed to the decline in the overall earning asset yield. These drops in rates affect the variable rate loans immediately and semi-fixed loans over a period of time.

Loan demand continued to be strong over this period as loans grew \$92.2 million, or 14.2%. Commercial loans continue to represent the largest segment of loan growth, increasing by \$85.8 million. Consumer loans have shown a steady growth in balances throughout 2008, increasing by \$12.6 million. Mortgage loan balances, as a whole, have decreased by \$6.3 million, due in part, to selling qualifying residential mortgage originations on the secondary market. The secondary mortgage market program has produced significant fee income and overall profitability. The balances of federal funds sold dropped by \$4.5 million while investment securities and other interest earning assets remained relatively flat.

**Interest Expense**

Interest expense decreased \$1,139,000 or 20.1%, to \$4,521,000. Balances of interest bearing liabilities increased by \$84.2 million to \$724.6 million, or 13.1%. The rate paid on interest bearing liabilities decreased from 3.54% during second quarter 2007 to 2.51% for second quarter 2008.

## Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

The reward checking product introduced early in the second quarter of 2007 has grown to \$41.1 million at June 30, 2008. Over the past year's falling rate cycle, the Reward Checking product continues to generate a higher average interest rate than other interest checking account products. So, the rate on interest bearing demand has not declined commiserate with other products. The premium interest rate is offset by noninterest income and expense opportunities, however. Money market account deposits grew significantly over the past year, adding \$29.2 million in deposits.

---

## **Table of Contents**

Savings account balances have declined \$13.9 million from the second quarter 2007 with some disintermediation to higher rate deposit products. Time deposit accounts have decreased by \$19.7 million versus the second quarter of 2007 due to the declining interest rate environment and a competitive market.

Borrowed funds in the form of repurchase agreements and other short term borrowings have increased by \$10.0 million, but interest expense has declined due to the falling rate environment. Long term borrowing balances have increased by \$53.5 million and are the only area of increased interest expense this quarter. The purchase of \$13.0 million in long term debt during the first quarter of 2008 was obtained at competitive rates. This lowered the overall rate paid by 32 basis points, but associated interest expense still increased due to volume increases. The Bank still maintains adequate availability of \$196 million at the Federal Home Loan Bank.

### **Net Interest Income**

Net interest income has continued to increase each quarter primarily due to volume factors as growth has remained strong, particularly in the commercial loan area. Although the Company has had steady growth in net interest income, the net interest margin continues to decline gradually. The tightening of the net interest margin from 4.01% during the second quarter 2007 to 3.96% in the current quarter is due, in part, to the falling rate environment over the past 12 months. In addition, the Bank is experiencing some disintermediation of existing deposits to higher rate products. The Company is positioned adequately, however, to avoid material earnings damage under either a rising or falling interest rate environment.

### **Noninterest Income**

Total noninterest income, excluding securities gains, increased \$772,000, or 22.9%, from \$3,373,000 to \$4,145,000. Net securities gains in the second quarter 2007 were \$16,000 compared to the \$1,000 of net losses taken in the second quarter of 2008. Service charges on deposits increased 23.3% or \$325,000. Overdraft protection fees rose \$132,000, or 15.4%, while revenue from debit card utilization grew \$131,000 due to changing consumer habits and the popularity of our reward checking product. Other service charges increased by \$565,000, or 102.0% driven by loan modification fees as customers seek lower commercial loan rates from higher lock rates and are willing to pay fees for the opportunity. The secondary market mortgage program also contributed significantly to the increase, growing fees by \$268,000 due to refinancing demands and servicing fees.

Asset management fees contributed \$65,000 of growth, or 10.0%, while brokerage fees remained steady. Orrstown Financial Advisors continues to grow in both assets managed and profitability even though the stock market retreated in June of this year. The sale of an insurance agency affiliate during the second quarter of 2007 produced \$219,000 of non recurring pretax gain. Other income increased by \$42,000 due primarily to rental income associated with the purchase of the North Pointe Business Center in October of 2007. The building is being used predominately as an operations center but contains two rental units.

### **Noninterest Expense**

Other expenses rose from \$6,125,000 during the second quarter 2007 to \$6,885,000 during the second quarter of 2008, an increase of \$760,000, or 12.4%. The increase in salaries and benefits of 6.2%, or \$223,000 was the major contributor to noninterest expense and our largest expense apart from interest expense. Occupancy and equipment expense rose 19.4%, or \$174,000. Depreciation expense increased by \$63,000 as fixed assets for the new operations center were put into use with its opening in May 2008. Maintenance and repairs to equipment added \$35,000, while building maintenance increased by \$23,000. These increases in noninterest expenses are commiserate with the growth of the Company.

Nonrecurring pretax expenses related to the combination of the two bank charters during the second quarter of 2007 amounted to \$78,000. Other operating expenses increased to \$1,610,000 or 27.9%. The increase is due, in part, to the move to the new operations center in the second quarter 2008 as well as overall growth of the Company. Costs of supplies and additional telephone connections and usage contributed to increases in both printing and supplies of \$41,000 and telephone expense of \$65,000. Mortgage servicing expense increased by \$71,000 due to the increased loan demand for secondary market mortgage loans. The FDIC insurance expense increased by \$39,000 due to the expiration of credits used in the prior year. FDIC insurance expense could be impacted if the rate of failed banks continues to grow. The Hanover Street Senior Apartments, a limited partnership investment, was placed in service at the end of 2007 which has increased the associated expense starting in January 2008. For the second quarter 2008, this expense increased by \$39,000 compared to the same quarter last year. The project will generate significant income tax credits.

**Table of Contents**

The overhead efficiency ratio for Orrstown Financial Services, Inc. improved to 54.3% for the current quarter versus the 55.1% produced during the second quarter 2007. The Company is pleased to have held its efficiency ratio below 60% consistently, which is admirable for a banking company with less than \$1 billion of assets.

**Six months ended June 30, 2008 compared to Six months ended June 30, 2007****Net Interest Income**

Net interest income for the first six months of 2008 was \$16,081,000 representing a growth of \$1,561,000, or 10.8% over the \$14,520,000 realized during the same period last year. On a fully taxable equivalent basis (FTE), net interest income for the first six months of 2008 and 2007 was \$16,547,000 and \$15,014,000, respectively.

The table that follows states rates on a fully taxable equivalent basis (FTE):

(Dollars in thousands)	Six Months Ended					
	Average Balance	June 2008 Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	June 2007 Tax Equivalent Interest	Tax Equivalent Rate
<b>Interest Earning Assets:</b>						
Federal funds sold & interest bearing bank balances	\$ 13,593	\$ 179	2.65%	\$ 15,098	\$ 401	5.36%
Investment securities	88,712	2,222	5.05%	88,581	2,316	5.26%
Total loans	727,065	24,138	6.60%	636,870	23,356	7.32%
<b>Total interest-earning assets</b>	<b>829,370</b>	<b>26,539</b>	<b>6.36%</b>	<b>740,549</b>	<b>26,073</b>	<b>7.03%</b>
<b>Interest Bearing Liabilities:</b>						
Interest bearing demand deposits	\$ 240,448	\$ 2,013	1.68%	\$ 186,970	\$ 1,693	1.83%
Savings deposits	62,759	370	1.19%	78,734	806	2.06%
Time deposits	271,302	5,001	3.71%	290,530	6,669	4.63%
Short term borrowings	56,531	650	2.27%	43,890	1,080	4.89%
Long term borrowings	87,391	1,958	4.43%	33,946	811	4.75%
<b>Total interest bearing liabilities</b>	<b>718,431</b>	<b>9,992</b>	<b>2.80%</b>	<b>634,070</b>	<b>11,059</b>	<b>3.52%</b>
<b>Net interest income / net interest spread</b>		<b>\$ 16,547</b>	<b>3.56%</b>		<b>\$ 15,014</b>	<b>3.51%</b>
<b>Net interest margin</b>			<b>3.94%</b>			<b>4.02%</b>

Interest income totaled \$26,539,000 for the first six months of 2008 versus \$26,073,000 for the same period last year, a growth of \$466,000. The 1.8% increase in interest income earned was relatively flat even though the Company enjoyed a 12.0% growth in the volume of total earning assets. The increase in volume variance of earning assets was mostly offset by the decline in the interest rate variance. The Corporation's earning asset yield decreased 67 basis points from the prior year's 7.03% to 6.36% for the first six months of 2008. The decline in interest rates was a direct reflection of the decline in the prime rate and other market rates over the past twelve months. The prime rate has decreased 325 basis points from January 1, 2007 to April 30, 2008 and continues to hold at 5.0% currently with the federal funds rate at 2.0%.

Interest earned on federal funds sold decreased \$219,000 due primarily to the decline in the federal funds sold rate. Investment securities were flat during this period while interest earned on total loans increased by 3.3%. The balances of the total loan portfolio increased by \$90.2 million, or 14.2%, over the same period last year. The growth in the loan portfolio's volume variance overcame the decreases of the rate variance. The majority of the growth continues to be in the commercial loan portfolio which increased from \$421.9 million to \$505.2 or 19.8%. In house mortgage loans dropped by \$4.7 million, while the volume of mortgages originated and sold in the secondary market, grew considerably. Consumer loans and consumer lines of credit increased by 13.0% or \$11.5 million combined.



**Table of Contents****Interest expense**

Total interest expense decreased \$1,067,000 from \$11,059,000 to \$9,992,000, or 9.6%, over the first six months of 2007. Balances of interest bearing demand deposits have increased over the first six months of 2007 by \$53.4 million. Non-interest demand deposits have increased by \$4.3 million in the same period. Growth in money market deposit accounts of \$36.5 million offset the decrease in savings account products of \$16.0 million. Interest earning checking account balances have also increased with the introduction of the reward checking product last year. Reward checking balances have grown to \$32.9 million, on average, during the first six months of 2008. Interest expense paid on these balances has increased by \$491,000.

Time deposits balances have decreased by \$19.2 million, or 6.6%, even though certificates of deposits \$100,000 and over have grown by \$14.0 million. The decline in time deposits has been caused somewhat by the low interest rate environment and market competition for deposits.

Short term borrowings have increased in volume by \$12.6 million with \$7.1 million of this growth contributed by the repurchase agreements product. Short term FLHB advances of \$10.0 million, taken down over the first six months of 2008, will mature in the third and fourth quarter of this year. Growth of \$53.4 million in long term debt over last year has pushed the balance to \$88.0 million at June 30, 2008. Many of these borrowings will mature in 2009 and 2010. Interest paid on long term debt increased by \$1,147,000, or 141.4%. The increased balances in long term debt are due to the Bank's continued strong loan demand and the slowed growth of deposit balances.

Earning asset yields have decreased by 67 basis points and the rate on interest bearing liabilities has decreased by 72 basis points, causing an upturn in the net interest spread from 3.51% for the first six months of 2007 to 3.56% in 2008. The net interest margin, which factors in noninterest bearing funds, has decreased from 4.02% to 3.94% during the same period.

**Noninterest Income**

Other income, excluding securities gains, increased \$1,463,000, or 23.4%, from \$6,244,000 to \$7,707,000. Securities gains (losses) decreased from \$70,000 of net gains in 2007 to \$48,000 in 2008. Service charges on deposits increased 24.1% or \$632,000. Overdraft protection revenue increased \$329,000, while debit card fees added \$240,000 and merchant account service charges added \$44,000.

Other service charges increased by \$787,000. Secondary market mortgage fees and servicing income has grown by \$487,000, or 111.3%. Orrstown Bank services the secondary market loans it originates. These loans have continued to grow from \$79.8 million at June 30, 2007 to \$111.0 million at June 30, 2008, contributing significantly to noninterest income. Loan fees, not including secondary market loan fees, generated \$298,000 versus the prior year. The demand for loan modifications helped to increase this amount by \$288,000 while letter of credit fees increased by \$33,000. The increase in loan modifications is a reflection of the falling rate environment and commercial development loans have contributed to a demand for letters of credit during the first six months of 2008.

Trust revenue grew by \$165,000, or 13.1%, while brokerage income increased \$17,000 over the first six months of 2007. Trust assets under management reached \$418 million at June 30, 2008, which was down slightly from the \$422 million reported at March 31, 2008 due to the downturn of the stock market in June of this year. The sale of the Bank's investment in CBIA contributed \$219,000 of nonrecurring gains during 2007.

**Noninterest Expense**

Other expenses rose from \$12,094,000 during the first six months of 2007 to \$13,585,000 during the same period of 2008, an increase of \$1,491,000, or 12.3%. Salary expense increased by \$290,000, or 5.7%, over the prior year. Annual salary increases and the addition of new employees are commensurate with the growth of the Company. Benefit expense grew overall by \$246,000. Employee insurance plan expenses have increased by \$77,000, and employment tax expense increased by \$22,000. Profit sharing expense grew by \$98,000.

Occupancy and equipment expense rose \$234,000, or 13.0%. Depreciation expense contributed \$84,000 of the increase along with an increase of \$38,000 in building maintenance and \$47,000 in equipment maintenance and repairs. The variance of occupancy expense will continue to widen as the year progresses due to expenses associated with the new operations center, opened in May 2008.

Nonrecurring expense of \$78,000 arose with the combination of the two bank subsidiaries into one bank charter in June 2007, and included payments for severance, printing expenses, postage, legal fees and other costs. Other operating expenses increased by \$682,000, or 29.3%. Telephone expenses have grown by \$102,000 with the addition of the operations center's phone connections and increased usage of mobile devices. Printing and supplies increased by \$50,000 due to outfitting the new operations center with a supply of forms and paper. Collection expense increased by \$71,000 and debit card expenses grew by \$72,000 during the normal course of business. Expense associated with the

secondary market mortgage program has risen by \$111,000 due to growth of the servicing portfolio.

**Table of Contents**

The overhead efficiency ratio decreased to 55.4% for the first six months of 2008 compared to the 56.3% last year. The decreases in interest expense as well as increases in interest and noninterest income produced a lower efficiency ratio. Orrstown has held its efficiency ratio below 60% consistently, which is admirable for a banking company with less than \$1 billion of assets.

**INCOME TAX EXPENSE**

Income tax expense increased \$249,000, or 18.9%, during the second quarter of 2008 versus the second quarter of 2007. For the first six months of 2008 the income tax expense rose \$476,000, or 19.0% over the same period 2007. The marginal federal income tax bracket is 38% for 2008 and 2007, but the use of tax free investments and an increase in low income housing credit investments has helped lower the effective income tax rate.

Effective income tax rates were as follows:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June</b>	<b>June</b>	<b>June</b>	<b>June</b>
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Effective income tax rate	30.3%	29.0%	30.3%	29.2%

**PROVISION AND ALLOWANCE FOR LOAN LOSSES**

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible based on evaluations of the collectibility of loans and prior loan loss experience. The evaluations take into consideration factors such as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Through this review and evaluation process, an amount deemed adequate to meet current growth and future loss expectations is charged to operations. The unallocated portion of the reserve ensures that any additional unforeseen losses that are not otherwise identifiable will be able to be absorbed. It is intended to provide for imprecise estimates in assessing projected losses, uncertainties in economic conditions and allocating pool reserves. Management deems the total of the allocated and unallocated portions of the allowance for loan losses to be adequate to absorb any losses at this time.

The provision for loan losses amounted to \$257,000 and \$90,000 for the second quarter of 2008 and 2007, respectively. The reserve to loan ratio for the Company was 0.85% at June 30, 2008 compared to 0.86% on June 30, 2007. These provisions compared to net charge-offs of \$15,000 during the second quarter 2008 and \$67,000 during the same period last year.

For the first six months of 2008 the provision for loan losses was \$415,000 compared to \$150,000 taken in the first half of 2007. The year to date net charge-offs for 2008 were \$127,000 compared to \$77,000 of net charge-offs for the same period 2007. The increased provision during 2008 is due primarily to general economic conditions, including a perceived slowing in certain industries. Overall loan quality, however, remains strong.

The provision for loan losses and the other changes in the allowance for loan losses are shown below:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June</b>	<b>June</b>	<b>June</b>	<b>June</b>
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>(Dollars in Thousands)</b>				
Balance at beginning of period	\$ 6,187	\$ 5,570	\$ 6,141	\$ 5,520
Provision for loan losses	257	90	415	150
Recoveries	20	7	26	17
Loan charge-offs	(35)	(74)	(153)	(94)
Balance at end of period	\$ 6,429	\$ 5,593	\$ 6,429	\$ 5,593



**Table of Contents**

## NONPERFORMING ASSETS / RISK ELEMENTS

Nonperforming assets at June 30, are as follows:

(Dollars in Thousands)	2008	2007
Loans on nonaccrual (cash) basis	\$ 166	\$ 46
Loans whose terms have been renegotiated	0	0
OREO	227	387
 Total nonperforming loans and OREO	 393	 433
 Loans past due 90 or more days and still accruing	 5,661	 2,573
 Total nonperforming and other risk assets	 \$ 6,054	 \$ 3,006
 Ratio of total risk assets to total loans and OREO	 0.80%	 0.46%
Ratio of total risk assets to total assets	0.64%	0.36%

Any loans classified for regulatory purposes as loss, doubtful, substandard or special mention that have not been disclosed under Item III of Industry Guide 3 do not represent or result from trends or uncertainties which management reasonably expects will materially impact future operating results, liquidity or capital resources.

## CAPITAL

Orrstown Financial Services, Inc. is a financial holding company and, as such, must maintain a well capitalized status in its bank subsidiary. Management foresees no problem in maintaining capital ratios well in excess of regulatory minimums. A comparison of Orrstown Financial Services, Inc.'s capital ratios to regulatory minimum requirements at June 30, 2008 are as follows:

	Orrstown Financial Services, Inc.	Regulatory Minimum	Regulatory Well Capitalized Minimum
Leverage Ratio	8.6%	4%	5%
Risk Based Capital Ratios:			
Tier I Capital Ratio	10.6%	4%	6%
Total (Tier I & II) Capital Ratio (core capital plus allowance for loan losses)	11.4%	8%	10%

All growth experienced during 2008 has been supported by capital growth in the form of retained earnings. Equity represented 10.6% of assets at June 30, 2008 and 10.9% at December 31, 2007.

Management is not aware of any current recommendations by regulatory authorities which, if implemented, would have a material effect on the Company's liquidity, capital resources or operations.

## LIQUIDITY

The primary function of asset/liability management is to assure adequate liquidity while minimizing interest rate risk. 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. Sources of liquidity include investment securities, loan and lease income and payments, and increases in customer's deposit accounts. Additionally, Orrstown Bank is a Federal Home Loan Bank (FHLB) member, and standard credit arrangements available to FHLB members provide increased liquidity. Recognizing the need for varied funding sources we have established modest relationships using other nontraditional sources, as provided for in our contingency funding plan. We have tested those facilities and are comfortable with our relationships. Funds provided from financing activities, including proceeds from long-term borrowings, were a significant source of liquidity for the first six months of 2008. Additional liquidity was provided by operating activities and

the sale and maturities of available for sale securities.

**Table of Contents**

PART I - FINANCIAL INFORMATION

**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, 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 cumulative gap position at 12 months is slightly positive at \$28.1 million at June 30, 2008 and the RSA/ RSL cumulative ratio was 1.07%, which is an increase from the 0.99% at December 31, 2007. The cumulative RSA/RSL at June 30, 2008 is 1.12% at three months and 1.09% at six months. The Company enjoys a closely 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-14(c) under the Securities Exchange Act of 1934, as amended) as of June 30, 2008. Based on such evaluation, such officers have concluded that, as of June 30, 2008, 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. There have not been any 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, 2008.

**Table of Contents**

## PART II - OTHER INFORMATION

**Item 1 - Legal Proceedings**

The nature of Orrstown Financial Services, Inc.'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 are a number of significant risks and uncertainties, including those specified below, that may adversely affect the Company's business, financial results or stock price. Additional risks that the Company currently does not know about or currently views as immaterial may also impair the Company's business or adversely impact its financial results or stock price.

Factors that might cause such differences include, but are not limited to the following: (1) competitive pressures among financial institutions increasing significantly in the markets where the Company operates; (2) general business and economic conditions, either nationally or locally being less favorable than expected; (3) changes in the domestic interest rate environment could reduce the Company's net interest income; (4) legislation or regulatory changes which adversely affect the ability of the Company to conduct its current or future operations; (5) acts or threats of terrorism and political or military actions taken by the United States or other governments and natural disasters globally or nationally could adversely affect general economic or industry conditions; (6) operational losses related to or resulting from: the risk of fraud by employees or persons outside of the Company, the execution of unauthorized transactions by employees, errors relating to transaction processing and technology, breaches of the internal control system, business continuation and disaster recovery, as well as security risks associated with hacking and identity theft; (7) negative publicity could damage the Company's reputation and adversely impact its business and/or stock trades and prices; (8) acquisitions may not produce revenue enhancements or cost savings at levels or within timeframes originally anticipated and may result in unforeseen integration difficulties; (9) the Company relies on other companies to provide key components of business infrastructure in the form of third party vendors. Third party vendors could adversely affect the ability of the Company to perform its normal course of business or deliver products and services to its customers; (10) and other risk factors that may occur in current or future operations.

**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, 2008:

	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that may Yet be Purchased Under the Plans or Programs (1)
4/1/08 through 4/30/08	1,000	\$ 30.54		105,705
5/1/08 through 5/31/08	980	30.66		104,725
6/1/08 through 6/30/08	1,400	31.63	N/A	103,325
Total	3,380	\$ 31.03		

- (1) On April 27, 2006, Orrstown Financial Services, Inc. announced a Stock Repurchase Plan approving the purchase of up to 150,000 shares as conditions allow. 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, 2008, 46,675 shares have been purchased under the program. The Company did not sell any unregistered securities.

**Table of Contents**

**Item 3 - Defaults upon Senior Securities**

Not applicable

**Item 4 - Submission of Matters to a Vote of Security Holders**

The 2008 Annual Meeting of Shareholders of Orrstown Financial Services, Inc. was held on May 13, 2008. The only matter submitted to a vote of shareholders was the election of three directors to Class A for three year terms expiring in 2011. There was no solicitation in opposition to the nominees of the Board of Directors for election to the Board. All nominees of the Board of Directors were elected. The number of votes cast FOR, as well as the number of votes WITHHELD for each of the nominees was as follows:

Nominee:	Votes FOR	Votes WITHHELD
Jeffrey W. Coy	4,294,542	454,271
John S. Ward	4,586,505	162,308
Joel R. Zullinger	4,610,805	138,009

The following Directors continued their term of office after the meeting:

Gregory A. Rosenberry, Glenn W. Snoke, Denver L. Tuckey, Peter C. Zimmerman, Anthony F. Ceddia, Andrea Pugh and Kenneth R. Shoemaker.

**Item 5 - Other Information**

None

**Item 6 - Exhibits**

- 3.1 Articles of Incorporation. Incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No. 333-131176.
- 3.2 By-laws. Incorporated by reference to Exhibit 3.2 of the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 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 of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No.333-131176.
  - (ii) By-laws of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 31.1 Rule 13a - 14(a)/15d-14(a) Certification (Chief Executive Officer) filed herewith
- 31.2 Rule 13a - 14(a)/15d-14(a) Certifications (Chief Financial Officer) filed herewith
- 32.1 Section 1350 Certifications (Chief Executive Officer) filed herewith
- 32.2 Section 1350 Certifications (Chief Financial Officer) filed herewith

**Table of Contents**

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/ Kenneth R. Shoemaker  
(Kenneth R. Shoemaker, President & CEO)  
(Duly Authorized Officer)

/s/ Bradley S. Everly  
(Bradley S. Everly, Senior Vice President & CFO)  
(Chief Financial Officer)

/s/ Robert B. Russell  
(Robert B. Russell, Controller)  
(Chief Accounting Officer)

Date: August 4, 2008

**Table of Contents**

ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

EXHIBIT INDEX

- 3.1 Articles of incorporation. Incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No.333-131176.
- 3.2 By-laws. Incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 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 of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No.333-131176.
  - ii. By-laws of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 31.1 Rule 13a - 14(a)/15d-14(a) Certification (Chief Executive Officer) filed herewith
- 31.2 Rule 13a - 14(a)/15d-14(a) Certifications (Chief Financial Officer) filed herewith
- 32.1 Section 1350 Certifications (Chief Executive Officer) filed herewith
- 32.2 Section 1350 Certifications (Chief Financial Officer) filed herewith