ORRSTOWN FINANCIAL SERVICES INC
Form 10-K
March 15, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended: December 31, 2009

or

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

Commission file number: 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania	**23-2530374**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
77 East King Street, P. O. Box 250, Shippensburg, Pennsylvania	**17257**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (717) 532-6114

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

Title of each class	**Name of Each Exchange on which Registered**
Common Stock, No Par Value	NASDAQ Stock Market LLC

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

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act.) Yes ¨ No x

Aggregate market value of the common stock held by non-affiliates computed by reference to the price at which the common equity was last sold on June 30, 2009 was $230,916,377.

Number of shares outstanding of the registrant s common stock as of March 11, 2010: 6,454,217.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2009 Annual Meeting of Security Holders are incorporated by reference in Part III of this Form 10-K.

ORRSTOWN FINANCIAL SERVICES, INC.

FORM 10-K

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PART I

ITEM 1 BUSINESS

Orrstown Financial Services, Inc. (the Corporation) is a financial holding company registered under the Gramm-Leach-Bliley Act. The executive offices of Orrstown Financial Services, Inc. are located at 77 East King Street, Shippensburg, Pennsylvania, 17257. Orrstown Financial Services, Inc. was organized on November 17, 1987, under the laws of the Commonwealth of Pennsylvania for the purpose of acquiring Orrstown Bank, Shippensburg, Pennsylvania, and such other banks and bank related activities as are permitted by law and desirable. Orrstown Bank is engaged in providing banking and bank related services in South Central Pennsylvania, principally Franklin, Perry and Cumberland Counties in Pennsylvania and in Washington County, Maryland. The twenty-one offices of Orrstown Bank are located in Shippensburg (2), Carlisle (4), Spring Run, Orrstown, Chambersburg (3), Greencastle, Mechanicsburg (2), Camp Hill, Newport (2), Duncannon, and New Bloomfield, Pennsylvania and Hagerstown, Maryland (2).

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

History and Acquisitions

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

From its inception in January 2000 to December 31, 2005, Pennbanks Insurance Company Cell P1 (Pennbanks) was a wholly-owned subsidiary of the Corporation. As of January 1, 2006, the Corporation divested the Pennbanks Insurance Company Cell P1 insurance book of business. The liabilities associated with the insurance business were assumed by American General under a contractual arrangement. Pennbanks was a reinsurer of credit, life, and disability insurance.

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

Business

Orrstown Financial Services, Inc. s primary activity consists of owning and supervising its subsidiary, Orrstown Bank (the Bank). The day-to-day management of the Bank is conducted by the subsidiary s officers. Orrstown Financial Services, Inc. derives a majority of its current income through dividends from Orrstown Bank. As of December 31, 2009, the Corporation had total assets of approximately $1.196 billion, total shareholders equity of approximately $111 million and total deposits of approximately $915 million.

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Orrstown Financial Services, Inc. has no employees. Its five officers are employees of its subsidiary bank. On December 31, 2009, Orrstown Bank had 249 full-time and 44 part-time employees.

The Bank is engaged in commercial banking and trust business as authorized by the Pennsylvania Banking Code of 1965. This involves accepting demand, time and savings deposits, and granting loans. The Bank grants commercial, residential, consumer and agribusiness customers in its market area of Franklin, Perry and Cumberland Counties of Pennsylvania and Washington County, Maryland. The concentrations of credit by type of loan are set forth on the face of the balance sheet filed herewith in Part II, Item 8, Financial Statements and Supplementary Data . The Bank maintains a diversified loan portfolio and evaluates each customer s credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon the extension of credit, is based on management s credit evaluation of the customer and collateral standards established in the Bank s lending policies and procedures.

Lending

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

Commercial Lending

A majority of the Company s loan assets are loans for business purpose. Approximately 74% of the loan portfolio is comprised of commercial loans. The Bank makes commercial real estate, equipment, working capital and other commercial purpose loans as required by the broad range of borrowers across the Bank s various markets. The average size loan in the Bank s commercial loan portfolio is approximately $240,000.00.

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

Approximately 45% of the Bank s commercial portfolio is owner occupied or non owner occupied commercial real estate loans including multi family. The typical loan in this type is secured by a commercial property with a maximum LTV of 75% of the appraised value of the property. The maximum term and amortization typically does not exceed 20 years. Interest rates charged on these loans are primarily fixed for a period of 3 to 7 years and then adjust to an index and spread after the fixed rate period. The average size of a loan in this type is approximately $361,000.

Approximately 38% of the Bank s commercial portfolio are loans for general commercial purpose and include permanent working capital, short term working capital, machinery and equipment financing. These types of loans can either be in the form of lines of credit or term loans. These loans are secured by the borrower s accounts receivable, inventory and machinery and equipment. In a majority of these loans, the collateral also includes the business real estate or the business owner s personal real estate or assets. The personal guarantee of the business owner is also be taken. In the case of term loans, the average term of a loan would be primarily driven by the use of the loan proceeds and the useful life of the collateral. Interest rates charged are either fixed or variable. If the interest rate is or will become variable at any point in the loans life, an interest rate floor is placed on the loan. The average size of a loan in this type is approximately $152,000.

The percentage allocations shown above split the loan portfolio based upon loan purpose as opposed to allocations based upon collateralization that appear in Management s Discussion and Analysis of Financial Condition and Results of Operation, Item 7 under the header Loan Portfolio and in the Financial Statements and Supplementary Data, Item 8 on the December 31, 2009 Consolidated Balance Sheets.

Consumer Lending

The Bank provides home equity loans, home equity lines of credit and other consumer loans through its branch network. A large majority of the consumer loans are secured by either a first or second lien position on the borrower s primary residential real estate. The Bank requires a LTV of no greater than 80% of the value of the real estate being taken as collateral. Underwriting standards typically require a borrower have a debt to income ratio of 38% or less.

Residential Lending

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

Loan Review

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

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

A new website is also slated for 2010 that will provide the platform for the new consumer loan and mortgage products and other enhancements to improve the customer experience. A customer relationship management (CRM) system will also be implemented which will enable our sales staff to more effectively meet all our customers needs. The new system will provide real time sales management tools and metrics to support the growth of all our lines of business.

Orrstown Financial Advisors (OFA)

Through its trust department, Orrstown Bank renders services as trustee, executor, administrator, guardian, managing agent, custodian, investment advisor, and other fiduciary activities authorized by law. OFA offers retail brokerage services through a third party broker/dealer arrangement with Financial Network Investment Corporation (FNIC).

Regulation and Supervision

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

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

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

Financial and Bank Holding Company Activities

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

Interstate Banking and Branching

As a bank holding company, the Corporation is required to obtain prior Federal Reserve Board approval before acquiring more than 5% of the voting shares, or substantially all of the assets, of a bank holding company, bank, or savings association. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal), subject to certain concentration limits and other requirements, bank holding companies such as the Corporation may acquire banks and bank holding companies located in any state. Riegle-Neal also permits banks to acquire branch offices outside their home states by merging with out-of-state banks, purchasing branches in other states, and establishing de novo branch offices in other states. The ability of banks to acquire branch offices is contingent, however, on the host state having adopted legislation opting in to those provisions of Riegle-Neal. In addition, the ability of a bank to merge with a bank located in another state is contingent on the host state not having adopted legislation opting out of that provision of Riegle-Neal. The Corporation has expanded its market south into Hagerstown, Maryland with its first branch opening in March 2006 and a second branch opening in September 2008.

Control Acquisitions

The Change in Bank Control Act prohibits a person or group of persons from acquiring control of a bank holding company, unless the Federal Reserve Board has been notified and has not objected to the transaction.

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Under a rebuttable presumption established by the Federal Reserve Board, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, such as the Corporation, would, under the circumstances set forth in the presumption, constitute acquisition of control of the bank holding company. In addition, a company is required to obtain the approval of the Federal Reserve Board under the Bank Holding Company Act before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of any class of outstanding voting stock of a bank holding company, or otherwise obtaining control or a controlling influence over that bank holding company.

Liability for Banking Subsidiaries

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

Capital Requirements

Information concerning the Corporation and its subsidiary with respect to capital requirements is incorporated by reference from Note 15, Regulatory Matters, of the Notes to Consolidated Financial Statements included under Item 8 of this report, and from the Capital Adequacy and Regulatory Matters section of the Management s Discussion and Analysis of Consolidated Financial Condition and Results of Operations, included under Item 7 of this report.

FDICIA

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and the regulations promulgated under FDICIA, among other things, established five capital categories for insured depository institutions well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized and requires federal bank regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements based on these categories. Unless a bank is well capitalized, it is subject to restrictions on its ability to offer brokered deposits and on certain other aspects of its operations. An undercapitalized bank must develop a capital restoration plan and its parent bank holding company must guarantee the bank s compliance with the plan up to the lesser of 5% of the bank s assets at the time it became undercapitalized and the amount needed to comply with the plan. As of December 31, 2009, the Bank was considered well capitalized based on the guidelines implemented by the bank s regulatory agencies.

Dividend Restrictions

The Corporation s funding for cash distributions to its shareholders is derived from a variety of sources, including cash and temporary investments. One of the principal sources of those funds is dividends received from its subsidiary, Orrstown Bank. Various federal and state laws limit the amount of dividends the Bank can pay to the Corporation without regulatory approval. In addition, federal bank regulatory agencies have authority to prohibit the Bank from engaging in an unsafe or unsound practice in conducting its business. The payment of dividends, depending upon the financial condition of the bank in question, could be deemed to constitute an unsafe or unsound practice. The ability of the Bank to pay dividends in the future is currently, and could be further, influenced by bank regulatory policies and capital guidelines. The Federal Reserve Board in 2009 notified all bank holding companies that dividends should be eliminated, deferred or significantly reduced if the bank holding company s net income for the past four quarters, net of dividends paid during that period, is not

sufficient to fully fund the dividends; the bank holding company s prospective rate of earnings retention is not consistent with the bank holding company s capital needs and overall, current and prospective financial conditions; or the bank holding company will not meet, or is in danger of meeting, its minimum regulatory capital adequacy ratios. Additional information concerning the Corporation and its banking subsidiary with respect to dividends is incorporated by reference from Note 15, Regulatory Matters , of the Notes to Consolidated Financial Statements included under Item 8 of this report, and the Capital Adequacy and Regulatory Matters section of Management s Discussion and Analysis of Consolidated Financial Condition and Results of Operations , included under Item 7 of this report.

Deposit or Preference Statute

In the liquidation or other resolution of an institution by any receiver, U.S. federal legislation provides that deposits and certain claims for administrative expenses and employee compensation against the insured depository institution would be afforded a priority over the general unsecured claims against that institution, including federal funds and letters of credit.

Other Federal Laws and Regulations

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

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

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

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

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

Sarbanes-Oxley Act of 2002

On July 30, 2002, the Sarbanes-Oxley Act of 2002 was enacted. The Sarbanes-Oxley Act represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. The Sarbanes-Oxley Act is applicable to all companies with equity securities registered or that file reports under the Securities Exchange Act of 1934. In particular, the Sarbanes-Oxley Act established: (i) new requirements for audit committees, including independence, expertise, and responsibilities; (ii) additional responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) new standards for auditors and regulation of audits; (iv) increased disclosure and reporting obligations for the reporting company and its directors and executive officers; and (v) new and increased civil and criminal penalties for violations of the securities laws. Many of the provisions were effective immediately while other provisions become effective over a period of time and are subject to rulemaking by the SEC. Because the Corporation s common stock is registered with the SEC, it is subject to this Act. As an accelerated filer as defined in Rule 12b-2 of the Securities Exchange Act of 1934, the Corporation was subject to section 404 of the Sarbanes-Oxley Act starting in the year ended December 31, 2004.

FDIC Insurance and Assessments

Deposit accounts in the Company s subsidiary bank are insured by the Federal Deposit Insurance Corporation. The Bank s deposits, therefore, are subject to FDIC deposit insurance. Deposits were generally

insured up to a maximum of $100,000 per separately insured depositor and up to a maximum of $250,000 for self-directed retirement accounts. The Emergency Economic Stabilization Act of 2008 increased the maximum deposit insurance amount on certain deposit accounts from $100,000 to $250,000 until December 31, 2013.

On February 15, 2006, federal legislation to reform federal deposit insurance was enacted. This new legislation required, among other things, that the FDIC adopt regulations for considering an increase in the insurance limits on all deposit accounts (including retirement accounts) every five years starting in 2011 based, in part, on inflation, and modifying the deposit fund s reserve ratio for a range between 1.15% and 1.50% of estimated insured deposits.

On November 2, 2006, the FDIC adopted final regulations establishing a risk-based assessment system that will enable the FDIC to more closely tie each financial institution s premiums to the risk it poses to the deposit insurance fund. Under the new risk-based assessment system, which became effective in the beginning of 2007, the FDIC will evaluate the risk of each financial institution based on three primary sources of information: (1) its supervisory rating, (2) its financial ratios, and (3) its long-term debt issuer rating, if the institution has one. The new rates for nearly all of the financial institution industry will vary between five and seven cents for every $100 of domestic deposits. At the same time, the FDIC also adopted final regulations designating the reserve ratio for the deposit insurance fund during 2007 at 1.25% of estimated insured deposits.

Effective March 31, 2006, the FDIC merged the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a single insurance fund called the Deposit Insurance Fund. As a result of the merger, the BIF and SAIF were abolished. The merger of the BIF and SAIF into the Deposit Insurance Fund does not affect the authority of the Financing Corporation (FICO) to impose and collect, with approval of the FDIC, assessments for anticipated payments, insurance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019.

On November 26, 2008, the FDIC issued the Temporary Liquidity Guarantee Program (TLG Program), effective October 14, 2008 for institutions opting into the program. The TLG Program consists of two components, Transaction Account Guarantee Program (TAG Program) and the Debt Guarantee Program (DGP). Orrstown Bank opted into the TAG Program. Under this program, through December 31, 2009, all noninterest-bearing transaction accounts and Now accounts, as defined by the final rule, are fully guaranteed by the FDIC for the entire amount in the account. Coverage under the TAG Program is in addition to and separate from the coverage available under the FDIC s general deposit insurance rules. Orrstown Bank and the Corporation opted out of the Debt Guarantee Program.

In 2009, the FDIC assessment for Orrstown Bank was $1,278,000, up from $296,000 during 2008. In addition, on November 17, 2009, the FDIC imposed a prepayment requirement on most insured depository institutions requiring that the organizations prepay estimated quarterly assessments for the fourth quarter of 2009 and for each quarter for 2010, 2011 and 2012 due to a negative balance in the Deposit Insurance Fund. $4,489,000 of future FDIC premiums were prepaid by Orrstown Bank at December 31, 2009. The actual assessments becoming due from Orrstown Bank on the last day of each such calendar quarter will be applied against the prepaid amount until the prepayment amount is exhausted. If the prepayment amount is not exhausted before June 30, 2012, any remaining balance will be returned to the Bank. The prepayment amount does not bear interest.

Government Actions and Legislation

The Emergency Economic Stabilization Act of 2008 (the EES Act), effective October 2008, allocated up to $700 billion towards purchasing and insuring assets held by financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. Pursuant to authority granted under the EES Act, the U.S. Treasury announced the Capital Purchase Program whereby the U.S. Treasury agreed to purchase senior

preferred shares from qualifying U.S. financial institutions. Each participating institution may sell to the U.S. Treasury an amount of senior preferred shares ranging from 1.0 percent to 3.0 percent of its September 30, 2008 risk-weighted assets. The preferred shares are generally nonvoting and pay an initial dividend rate of 5.0 percent per year for the first five years, increasing to 9.0 percent per year after year five. As part of the consideration for the shares, the U.S. Treasury requires the receipt of Warrants to acquire common stock from the participating institution having an aggregate market price equal to 15.0 percent of the amount of capital invested by the U.S. Treasury in the senior preferred shares, at an exercise price equal to the average trailing 20-trading day market price of the institution s common stock at the time of issuance. Participating institutions must agree to certain limitations on executive compensation, repurchases of junior preferred or common stock and increases in common stock dividend payments. The Corporation, after considerate analysis, chose not to participate in the Capital Purchase Program.

The government has also implemented the Homeowner Affordability and Stability Plan (HASP), a $75 billion federal program intended to support recovery in the housing market and ensure that eligible homeowners are able to continue to fulfill their mortgage obligations. HASP includes the following initiatives: (i) a refinance option for homeowners that are current in their mortgage payments and whose mortgages are owned by Fannie Mae or Freddie Mac; (ii) a homeowner stability initiative to prevent foreclosures and help eligible borrowers stay in their homes by offering loan modifications that reduce mortgage payments to more sustainable levels; and (iii) an increase in U.S. Treasury funding to Fannie Mae and Freddie Mac to allow them to lower mortgage rates. HASP also offers monetary incentives to mortgage holders for certain modifications of at-risk loans and would establish an insurance fund designed to reduce foreclosures.

Regulation of the financial services industry could undergo substantial changes in the near future. Legislation has been passed in the U.S. House of Representatives (the House Bill), and the U.S. Senate is expected to consider its version of the financial reform legislation (the Senate Bill) shortly. Such legislation would further increase regulation and oversight of the financial services industry and impose restrictions on the ability of firms within the industry to conduct business consistent with historical practices. For example, under the House Bill, a Consumer Financial Protection Agency would be established to regulate any person engaged in a financial activity in connection with a consumer financial product or service, including those that process financial services products or services. Although it is unclear at this time whether the Senate Bill would provide such an agency, it is expected that the Senate Bill would include some consumer protection measures. Federal and state regulatory agencies also consistently propose and adopt changes to their regulations or change the manner in which existing regulations are applied. We cannot predict the substance or impact of pending or future legislation or regulation, or the application thereof, although enactment of the proposed legislation could affect how Orrstown Financial Services, Inc. and Orrstown Bank operate and could significantly increase costs, impede the efficiency of internal business processes, or limit our ability to pursue business opportunities in an efficient manner, any of which could materially and adversely affect our business, financial condition and results of operation.

Future Legislation

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

NASDAQ Capital Market

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

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Forward Looking Statements

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

Competition

The Bank s principal market area consists of Franklin County, Perry County and Cumberland County, Pennsylvania, with a presence in Washington County, Maryland. It services a substantial number of depositors in this market area, with the greatest concentration within a radius of Chambersburg, Shippensburg, and Carlisle, Pennsylvania. As of June 30, 2009, the latest date for which information is available, our market share of deposits represented 14.08%, 17.40% and 9.48% of deposits in Franklin, Perry and Cumberland Counties, Pennsylvania, respectively, and 1.21% of deposits in Washington County, Maryland.

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

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

ITEM 1A RISK FACTORS

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

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

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

Since lending money is an essential part of our business, due to the current economic conditions, customers may be unable or unwilling to borrow money or repay funds already borrowed. The risk of non-payment is affected by credit risks of a particular customer, changes in economic conditions, the duration of the loan and, in the case of a collateralized loan, uncertainties as to the future value of the collateral and other factors. The potential effects of the current global financial crisis are difficult to forecast and mitigate. As a consequence, our operating results for a particular period are difficult to predict. The impact of this situation, together with concerns regarding the financial strength of financial institutions, has led to distress in credit markets and liquidity issues for financial institutions. Some financial institutions around the world have failed; others have

been forced to seek acquisition partners. The United States and other governments have taken unprecedented steps to try to stabilize the financial system, including investing in financial institutions. Our business and our financial condition and results of operations could be adversely affected by (1) continued or accelerated disruption and volatility in financial markets, (2) continued capital and liquidity concerns regarding financial institutions generally and our counterparties specifically, (3) limitations resulting from further governmental action in an effort to stabilize or provide additional regulation of the financial system, or (4) recessionary conditions that are deeper or last longer than currently anticipated.

We operate in a highly regulated environment and may be adversely affected by changes in laws or regulations.

We are subject to extensive regulation and supervision under federal and state laws and regulations. The requirements and limitations imposed by such laws and regulations limit the manner in which we conduct our business, undertake new investments and activities and obtain financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit our shareholders. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is within our control. There are currently several legislative proposals pending in Congress and proposed rule makings by the federal banking regulators which, if adopted as proposed, will impact the banking industry. On June 17, 2009, the U.S. Department of the Treasury released a financial regulatory reform plan that would, if enacted, represent the most sweeping reform of financial regulation and financial services in decades. These programs and proposals subject us and other financial institutions to additional restrictions, oversight and costs that may have an adverse impact on our business, financial condition, results of operations or the price of our common stock. If enacted, the Treasury Department s financial reform plan would substantially increase regulation of the financial services industry and impose restrictions on the operations and general ability of firms within the industry to conduct business consistent with historical practices. Federal and state regulatory agencies also frequently adopt changes to their regulations or change the manner in which existing regulations are applied or enforced. We cannot predict the substance or impact of pending or future legislation, regulation or the application thereof. Compliance with such current and potential regulation and scrutiny may significantly increase our costs, impede the efficiency of our internal business processes, require us to increase our regulatory capital and limit our ability to pursue business opportunities in an efficient manner.

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

There is no precise method of predicting loan losses. We can give no assurance that our allowance for loan losses is or will be sufficient to absorb actual loan losses. We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, that represents management s best estimate of probable incurred losses within the existing portfolio of loans. The level of the allowance reflects management s evaluation of, among other factors, the status of specific impaired loans, trends in historical loss experience, delinquency trends, credit concentrations and economic conditions within our market area. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan losses. Increases in nonperforming loans have a significant impact on our allowance for loan losses

In addition, bank regulatory agencies periodically review our allowance for loan losses and may require us to increase the provision for loan losses or to recognize further loan charge-offs, based on judgments that differ from those of management. If loan charge-offs in future periods exceed our allowance for loan losses, we will need to record additional provisions to increase our allowance for loan losses. Furthermore, growth in our loan

portfolio would generally lead to an increase in the provision for loan losses. Generally, increases in our allowance for loan losses will result in a decrease in net income and stockholders equity, and may have a material adverse effect on our financial condition, results of operations and cash flows.

Our allowance for loan losses was 1.26% of total loans and 259% of non-performing loans at December 31, 2009, compared to 0.87% of total loans and 2,094% of non-performing loans at December 31, 2008. Material additions to our allowance could materially decrease our net income. In addition, at December 31, 2009, we had 50 loan relationships, aggregating $307.5 million that were performing according to their original terms with outstanding balances that exceeded $3.0 million. However, the deterioration of one or more of these loans could result in a significant increase in our nonperforming loans and our provisions for loan losses, which would negatively impact our results of operations.

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

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

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

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

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

During 2008 and 2009, higher levels of bank failures have dramatically increased resolution costs of the Federal Deposit Insurance Corporation, or the FDIC, and depleted the deposit insurance fund. In addition, the FDIC and the U.S. Congress have taken action to increase federal deposit insurance coverage, placing additional stress on the deposit insurance fund.

In order to maintain a strong funding position and restore reserve ratios of the deposit insurance fund, the FDIC increased assessment rates of insured institutions uniformly by seven cents for every $100 of deposits beginning with the first quarter of 2009, with additional changes beginning April 1, 2009, which require riskier institutions to pay a larger share of premiums by factoring in rate adjustments based on secured liabilities and unsecured debt levels.

To further support the rebuilding of the deposit insurance fund, the FDIC imposed a special assessment on each insured institution, equal to five basis points of the institution s total assets minus Tier 1 capital as of September 30, 2009. For Orrstown Bank, this represented an aggregate charge of approximately $515,000. In

lieu of imposing an additional special assessment, the FDIC required all institutions to prepay their assessments for all of 2010, 2011 and 2012, which for us totaled $4.4 million. The FDIC has indicated that future special assessments are possible, although it has not determined the magnitude or timing of any future assessments.

We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures, we may be required to pay even higher FDIC premiums. Our expenses for the year ended December 31 2009 have been significantly and adversely affected by these increased premiums and the special assessment. These increases and assessment and any future increases in insurance premiums or additional special assessments may materially adversely affect our results of operations.

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

We are a holding company and depend on dividends, distributions and other payments from Orrstown Bank, our only subsidiary to fund dividend payments and to fund all payments on obligations. Orrstown Bank is subject to laws that restrict dividend payments or authorize regulatory bodies to block or reduce the flow of funds from it to us. Restrictions or regulatory action of that kind could impede access to funds that we need to make payments on our obligations, dividend payments or stock repurchases. In addition, our right to participate in a distribution of assets upon our subsidiary s liquidation or reorganization is subject to the prior claims of the subsidiary s creditors.

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

Our operations and the properties securing our loans are primarily in South Central Pennsylvania (principally Franklin, Perry and Cumberland Counties) and in Washington County, Maryland. As of December 31, 2009, managements estimates that more than 81% of deposits and 87% of loans came from its market area. Our operating results depend largely on economic and real estate valuations in these and surrounding areas. A further deterioration in the economic conditions in these market areas could materially adversely affect our operations and increase loan delinquencies, increase problem assets and foreclosures, increase claims and lawsuits, decrease the demand for our products and services and decrease the value of collateral securing loans, especially real estate, in turn reducing customers borrowing power, the value of assets associated with nonperforming loans and collateral coverage.

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

Our business strategy involves making loans secured by commercial real estate. These types of loans generally have higher risk-adjusted returns and shorter maturities than traditional one-to-four family residential mortgage loans. At December 31, 2009, our loans secured by commercial real estate totaled approximately $306 million, which represented 35% of total loans. Loans secured by commercial real estate properties are generally for larger amounts and may involve a greater degree of risk than one-to-four family residential mortgage loans. Payments on loans secured by these properties are often dependent on the income produced by the underlying properties which, in turn, depends on the successful operation and management of the properties. Accordingly, repayment of these loans is subject to adverse conditions in the real estate market or the local economy. In addition, many economists believe that deterioration in income producing commercial real estate is likely to worsen as vacancy rates continue to rise and absorption rates of existing square footage continue to decline. Because of the current general economic slowdown, these loans represent higher risk, could result in an increase in our total net-charge offs and could require us to increase our allowance for loan losses, which could have a material adverse effect on our financial condition or results of operations. While we seek to minimize these risks in a variety of ways, there can be no assurance that these measures will protect against credit-related losses.

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

Construction financing typically involves a higher degree of credit risk than financing on improved, owner-occupied real estate. Risk of loss on a construction loan is largely dependent upon the accuracy of the initial estimate of the property s value at completion of construction and the bid price and estimated cost (including interest) of construction. If the estimate of construction costs proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of the value proves to be inaccurate, we may be confronted, at or prior to the maturity of the loan, with a project whose value is insufficient to assure full repayment. When lending to builders, the cost of construction breakdown is provided by the builder, as well as supported by the appraisal. Although our underwriting criteria are designed to evaluate and minimize the risks of each construction loan, there can be no guarantee that these practices will safeguard against material delinquencies and losses to our operations. At December 31, 2009, we had loans of approximately $117 million, or 13% of total loans, outstanding to finance construction and land development. Construction and land development loans are dependent on the successful completion of the projects they finance, however, in many cases such construction and development projects in our primary market areas are not being completed in a timely manner, if at all.

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

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

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

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

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

In attracting business and consumer deposits, we face substantial competition from other insured depository institutions such as banks, savings institutions and credit unions, as well as institutions offering uninsured investment alternatives, including money market funds. Some of our competitors enjoy advantages, including greater financial resources and access to capital, stronger regulatory ratios, stronger asset quality and performance, more aggressive marketing campaigns, better brand recognition and more branch locations. These

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competitors may offer higher interest rates than we do, which could decrease the deposits that we attract or require us to increase our rates to retain existing deposits or attract new deposits. Increased deposit competition could materially adversely affect our ability to generate the funds necessary for lending operations. As a result, we may need to seek other sources of funds that may be more expensive to obtain and could increase our cost of funds.

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

In assessing the impairment of investment securities, we consider the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuers, and our intent and ability to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. Under current accounting standards, goodwill and certain other intangible assets with indeterminate lives are no longer amortized but, instead, are assessed for impairment periodically or when impairment indicators are present. Assessment of goodwill and such other intangible assets could result in circumstances where the applicable intangible asset is deemed to be impaired for accounting purposes. Under such circumstances, the intangible asset s impairment would be reflected as a charge to earnings in the period during which such impairment is identified. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The impact of each of these impairment matters could have a material adverse effect on our business, results of operations, and financial condition.

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

Our assets increased $595.0 million, or 98.9%, from $601.5 million at December 31, 2005, to $1.20 billion at December 31, 2009, primarily due to our acquisition of First National in 2006 and organic growth through increases in residential mortgage loans and commercial real estate loans funded by growth in deposits. Over the long term, we expect to continue to experience growth in the amount of our assets, the level of our deposits and the scale of our operations. However, achieving our growth targets requires us to successfully execute our business strategies, which include continuing to grow our loan portfolio thereby recognizing the value of our investments in personnel in that area. Our ability to successfully grow will also depend on the continued availability of loan opportunities that meet our stringent underwriting standards. In addition, we may consider the acquisition of other financial institutions and branches within or outside of our market area, the success of which will depend on a number of factors, including our ability to integrate the acquired branches into the current operations of the Corporation, our ability to limit the outflow of deposits held by customers of the acquired institution or branch locations, our ability to control the incremental increase in non-interest expense arising from any acquisition and our ability to retain and integrate the appropriate personnel of the acquired institution or branches. While we believe we have the resources and internal systems in place to successfully achieve and manage our future growth, there can be no assurance growth opportunities will be available or that we will successfully manage our growth. If we do not manage our growth effectively, we may not be able to achieve our business plan, and our business and prospects could be harmed.

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

Federal banking regulators require us and our banking subsidiaries to maintain adequate levels of capital to support our operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by our management and board of directors based on capital levels that they believe are necessary to support our business operations. At December 31, 2009, all three capital ratios for us and our banking subsidiary were above well capitalized levels under current bank regulatory guidelines. To be well capitalized, banking companies generally must maintain a tier 1 leverage ratio of at least 5%, a Tier 1 risk-based capital ratio of at least 6%, and a total risk-based capital ratio of at least

10%. However, our regulators may require us or our banking subsidiary to operate with higher capital levels. For example, regulators recently have required some banks to attain a Tier 1 leverage ratio of at least 8%, a Tier 1 risk-based capital ratio of at least 10%, and a total risk-based capital ratio of at least 12%.

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

We may be adversely affected by technological advances.

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

The soundness of other financial institutions could adversely affect us.

Our ability to engage in routine funding and other transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems, losses of depositor, creditor and counterparty confidence and could lead to losses or defaults by us or by other institutions. We could experience increases in deposits and assets as a result of other banks difficulties or failure, which would increase the capital we need to support such growth.

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

We own common stock of the Federal Home Loan Bank of Pittsburgh, or the FHLB, in order to qualify for membership in the Federal Home Loan Bank system, which enables us to borrow funds under the Federal Home Loan Bank advance program. The carrying value and fair market value of our FHLB common stock was approximately $6.8 million as of December 31, 2009.

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

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

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

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

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, referred to as Section 404, we are required to include in our Annual Reports on Form 10-K, our management s report on internal control over financial reporting. While we have reported no material weaknesses in the Form 10-K for the fiscal year ended December 31, 2009, we cannot guarantee that we will not have any material weaknesses reported in our management s report on internal control or by our independent registered public accounting firm in the future. Compliance with the requirements of Section 404 is expensive and time-consuming. If, in the future, we fail to complete this evaluation in a timely manner, or if our independent registered public accounting firm cannot timely attest to our evaluation, we could be subject to regulatory scrutiny and a loss of public confidence in our internal control over financial reporting. In addition, any failure to establish an effective system of disclosure controls and procedures could cause our current and potential shareholders and customers to lose confidence in our financial reporting and disclosure required under the Securities Exchange Act of 1934, which could adversely affect our business.

ITEM 1B UNRESOLVED STAFF COMMENTS

None

ITEM 2 PROPERTIES

Orrstown Bank owns buildings in Orrstown, Shippensburg (2), Carlisle (2), Spring Run, Chambersburg (3), Mechanicsburg (2), Newport (2), Duncannon, and New Bloomfield, Pennsylvania and in Hagerstown, Maryland. Offices of Orrstown Bank are located in each of these buildings.

The Bank also leases space for offices located in Greencastle, Carlisle (2) and Camp Hill, Pennsylvania and in Hagerstown, Maryland.

ITEM 3 LEGAL PROCEEDINGS

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

ITEM 4 REMOVED AND RESERVED

None

PART II

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

Market Information

Our common stock began trading on The NASDAQ Capital Market under the symbol ORRF as of April 28, 2009, and continues to be listed there as of the date hereof. Before such listing, our common stock was quoted on the OTC Bulletin Board (OTCBB). The OTCBB is a regulated quotation service that displays real-time quotes, last-sale prices and volume information in over-the-counter equity securities. Unlike The NASDAQ Capital Market, the OTCBB does not impose listing standards and does not provide automated trade executions. Historical trading in the Company s stock has not been extensive and such trades cannot be characterized as constituting an active trading market. At the close of business on March 8, 2010, there were approximately 3,108 shareholders of record.

The following table sets forth, for the fiscal periods indicated, the high and low sales prices or closing bid prices for our common stock for the two most recent fiscal years. The quotations for the periods in which our common stock traded on the OTCBB reflect inter-dealer prices, without retail mark-up, markdown or commission and may not represent actual transactions. Trading prices are based on published financial sources.

	2009			2008		
	Market Price		Quarterly	Market Price		Quarterly
Dividend(1)	High	Low	Dividend	High	Low	Dividend
First quarter	$ 29.25	$ 23.50	$ 0.22	$ 31.50	$ 29.50	$ 0.21
Second quarter	40.00	22.00	0.22	33.96	29.10	0.22
Third quarter	39.00	34.26	0.22	31.75	29.00	0.22
Fourth quarter	39.39	27.77	0.22	30.25	27.00	0.22
			$ 0.88			$ 0.87

The Corporation expects to continue its policy of paying regular cash dividends declared from time to time by the Board of Directors, although there is no assurance as to future dividends because they depend on future earnings, capital requirements, financial condition and other factors deemed relevant by the Board of Directors. See Note 15 in the Notes to Consolidated Financial Statements included in Item 8 for the year ended December 31, 2009 for restrictions on the payment of dividends.

Issuer Purchases of Equity Securities

The table below summarizes the Corporation s repurchase of common equity securities during the quarter ended December 31, 2009. The maximum number of shares that may yet be purchased under the plan is 52,110 shares at December 31, 2009.

	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)
10/1/09 through 10/31/09	5,883	$ 12.08	N/A	52,110
11/1/09 through 11/30/09			N/A	52,110
12/1/09 through 12/31/09			N/A	52,110

Total

(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 December 31, 2009, 97,890 shares have been purchased under the program.

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PERFORMANCE GRAPH

The following graph shows a five-year comparison of the cumulative total return on the Corporation s common stock as compared to other indexes: the SNL index of banks with assets between $1 billion and $5 billion, the S&P 500 Index, and the NASDAQ Composite index. Shareholder returns on the Corporation s common stock are based upon trades reported by the OTCBB for periods through April 27, 2009, and on the NASDAQ Stock Market after that date. The Corporation is not aware of all prices at which shares traded during periods in which quotes for the Corporation s common stock were reported on the OTCBB. The shareholder returns shown in the graph are not necessarily indicative of future performance.

Orrstown Financial Services, Inc.

	Period Ending					
Index	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**	**12/31/09**
Orrstown Financial Services, Inc.	100.00	81.99	88.74	78.40	72.62	96.61
SNL Bank $1B-$5B	100.00	98.29	113.74	82.85	68.72	49.26
S&P 500	100.00	104.91	121.48	128.16	80.74	102.11
NASDAQ Composite	100.00	101.37	111.03	121.92	72.49	104.31

In accordance with the rules of the SEC, this section captioned Performance Graph shall not be incorporated by reference into any of our future filings made under the Securities Exchange Act of 1934 or the Securities Act of 1933. The Performance Graph and its accompanying table is not deemed to be soliciting material or to be filed under the Exchange Act or the Securities Act.

Recent Sales of Unregistered Securities

The Corporation has not sold any securities within the past three years which were not registered under the Securities Act of 1933.

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ITEM 6 SELECTED FINANCIAL DATA

Selected Financial Data at or for the (Dollars in thousands)	Year Ended December 31, 2009	2008	2007	2006**	2005
Summary of Operations					
Interest income	**$ 53,070**	$ 52,313	$ 53,106	$ 44,788	$ 32,415
Interest expense	**16,500**	19,408	22,986	17,371	9,537
Net interest income	**36,570**	32,905	30,120	27,417	22,878
Provision for loan losses	**4,865**	1,450	750	390	144
Net interest income after provision for loan losses	**31,705**	31,455	29,370	27,027	22,734
Securities gains (losses)	**1,661**	(27)	58	41	(60)
Other operating income	**16,233**	15,444	13,248	11,042	9,119
Other operating expenses	**32,176**	28,287	24,921	21,628	17,397
Income before income taxes	**17,423**	18,585	17,755	16,482	14,396
Applicable income tax	**4,050**	5,482	5,197	4,850	4,409
Net income	**$ 13,373**	$ 13,103	$ 12,558	$ 11,632	$ 9,987
Per Common Share Data*					
Income before taxes	**$ 2.72**	$ 2.89	$ 2.76	$ 2.66	$ 2.54
Applicable income taxes	**0.63**	0.85	0.81	0.78	0.78
Net income	**2.09**	2.04	1.95	1.87	1.76
Diluted net income	**1.98**	1.94	1.86	1.79	1.69
Cash dividend paid	**0.88**	0.87	0.82	0.743	0.556
Book value at December 31	**17.21**	16.18	14.97	13.88	10.03
Tangible book value at December 31	**13.96**	12.87	11.64	10.53	9.69
Average shares outstanding basic	**6,406,106**	6,421,022	6,428,853	6,201,978	5,677,927
Average shares outstanding diluted	**6,740,492**	6,750,128	6,735,174	6,475,721	5,917,933
Stock Price Statistics*					
Close	**$ 34.88**	$ 27.00	$ 30.00	$ 34.81	$ 32.86
High	**40.00**	33.96	36.19	37.14	45.35
Low	**22.00**	27.00	28.00	30.29	32.81
Price earnings ratio at close (x)	**16.7**	13.2	15.4	18.6	18.7
Diluted price earnings ratio at close (x)	**17.6**	13.9	16.1	19.4	19.5
Price to book at close (x)	**2.0**	1.7	2.0	2.5	3.3
Price to tangible book at close (x)	**2.5**	2.1	2.6	3.3	3.4
Year-End Balance Sheet Data					
Total assets	**$ 1,196,432**	$ 1,051,783	$ 884,979	$ 809,031	$ 601,460
Total loans	**881,074**	820,468	701,964	618,827	460,386
Total investment securities	**204,309**	128,353	96,355	91,393	71,677
Deposits noninterest bearing	**90,676**	84,261	91,365	85,420	68,697
Deposits interest bearing	**824,494**	673,107	554,991	553,299	394,125
Total deposits	**915,170**	757,368	646,356	638,719	462,822

Repurchase agreements	**64,614**	63,407	55,580	40,953	36,138
Liabilities for borrowed money	**64,858**	118,887	78,453	33,190	40,306
Total shareholders equity	**110,886**	103,347	96,124	89,388	57,310
Trust assets under management market value	**414,000**	354,000	415,000	404,000	368,000

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Selected Financial Data at or for the (Dollars in thousands)	Year Ended December 31, 2009	2008	2007	2006**	2005
Performance Statistics					
Average equity / average assets	**9.55%**	10.45%	10.98%	10.66%	9.67%
Return on average equity	**12.48%**	13.20%	13.64%	15.10%	18.69%
Return on average tangible equity	**15.73%**	17.02%	18.02%	18.98%	19.28%
Return on average assets	**1.19%**	1.38%	1.50%	1.61%	1.81%
Return on average tangible assets	**1.23%**	1.43%	1.56%	1.66%	1.81%

* Per share amounts have been restated to reflect: a 5% stock dividend paid June 15, 2007 and a 5% stock dividend paid June 29, 2005.

** The First National Bank of Newport was acquired on May 1, 2006. Results above reflect First National s operations after May 1, 2006.

Supplemental Reporting of Non-GAAP-Based Financial Measures

Return on average tangible assets and return on average tangible equity is a non-GAAP-based financial measure calculated using non-GAAP-based amounts. The most directly comparable measure is return on average assets and return on average equity, which are calculated using GAAP-based amounts. The Company calculates the return on average tangible assets and equity by excluding the balance of intangible assets and their related amortization expense from the calculation of return on average assets and equity. Management uses 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 performance. In addition, this is consistent with the treatment by bank regulatory agencies, which exclude goodwill and other intangible assets from the calculation of risk-based capital ratios. A reconciliation of return on average assets and equity to the return on average tangible assets and equity, respectively, is set forth below.

(Dollars in thousands)	Year Ended December 31, 2009	2008	2007	2006	2005
Return on average assets (GAAP basis)	**1.19%**	1.38%	1.50%	1.61%	1.81%
Effect of excluding average intangible assets and related amortization	**0.04%**	0.05%	0.06%	0.05%	0.00%
Return on average tangible assets	**1.23%**	1.43%	1.56%	1.66%	1.81%
Return on average equity (GAAP basis)	**12.48%**	13.20%	13.64%	15.10%	18.69%
Effect of excluding average intangible assets and related amortization	**3.25%**	3.82%	4.38%	3.88%	0.59%
Return on average tangible equity	**15.73%**	17.02%	18.02%	18.98%	19.28%

Tangible book value 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. See reconciliation of book value per share to tangible book value per share below.

(Dollars in thousands)	Year Ended December 31, 2009	2008	2007	2006	2005
Common shareholder s equity	**$ 110,886**	$ 103,347	$ 96,124	$ 89,388	$ 57,310
Less: intangible assets	**$ 20,938**	$ 21,186	$ 21,368	$ 21,567	$ 1,935
Tangible common equity	**$ 89,948**	$ 82,161	$ 74,756	$ 67,821	$ 55,375
Book value per share	**$ 17.21**	$ 16.18	$ 14.97	$ 13.88	$ 10.03
Less: intangible assets per share	**$ 3.25**	$ 3.31	$ 3.33	$ 3.35	$ 0.34
Tangible book value per share	**$ 13.96**	$ 12.87	$ 11.64	$ 10.53	$ 9.69

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

Overview

The following is a discussion of our consolidated financial condition and results of operations for each of the three years ended December 31, 2009, 2008 and 2007. The following discussion and analysis should be read in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements presented in this report to assist in the evaluation of Orrstown Financial Services, Inc. s 2009 performance. 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-loc statements involve certain risks, uncertainties and other factors over which the Corporation has no direct control, actual results could differ materially from those contemplated in such statements. These factors include (but are not limited to) the following: general economic conditions, changes in interest rates, changes in the Corporation s cost of funds, changes in government monetary policy, changes in government regulation and taxation of financial institutions, changes in the rate of inflation, changes in technology, the intensification of competition within the Corporation s market area, and other similar factors. 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 Annual Report, see Important Factors Relating to Forward Looking Statements .

Corporate Profile and Significant Developments

Orrstown Financial Services, Inc. is a financial holding company headquartered in Shippensburg, Pennsylvania with consolidated assets of $1.196 billion at December 31, 2009. The consolidated financial information presented herein reflects the Corporation and its wholly-owned commercial bank subsidiary, Orrstown Bank.

Orrstown Bank, with total assets of $1.051 billion at December 31, 2009, is a Pennsylvania chartered commercial bank with 21 offices. Nineteen of those offices are located in Pennsylvania and two in Maryland. On May 21, 2006 the Corporation acquired The First National Bank of Newport, located in Perry County, Pennsylvania. On June 15, 2007 The First National Bank of Newport was merged into Orrstown Bank. Orrstown Bank s deposit services include a variety of checking, savings, time and money market deposits along with related debit card and merchant services. Lending services include commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Orrstown Financial Advisors, a division of Orrstown Bank, offers a diverse line of financial services to our customers, including, but not limited to, brokerage, mutual funds, trusts, estate planning, investments and insurance products. At December 31, 2009, approximately $414 million of assets under management were serviced by the Financial Advisors.

At the May 2008 annual shareholders meeting President and Chief Executive Officer, Kenneth R. Shoemaker announced his retirement effective after the May 5, 2009 annual shareholder s meeting. On February 13, 2009 it was announced that Thomas R. Quinn, Jr. had been selected to succeed Mr. Shoemaker effective May 5, 2009.

On October 29, 2007, Orrstown Bank purchased a facility to utilize as its Operations Center located at 2605 2695 Philadelphia Avenue, Chambersburg, Pennsylvania, in the North Pointe Business Center. During May 2008, this facility was completed. The loan operations, EFT department, deposit operations, information technology, human resources and other support staff moved into the renovated building. The reclamation and refurbishment of the largely unoccupied former strip shopping center has been positively recognized in the Chambersburg area.

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On September 2, 2008 Orrstown Bank opened its second office in Hagerstown, Maryland at 1020 Professional Court, off Eastern Boulevard. Growth in Hagerstown has been above expectations and justified a flagship office.

The Corporation achieved a milestone during 2008 s third quarter by surpassing $1 billion in assets.

Orrstown Financial Services, Inc. moved from the OTC Bulletin Board to The NASDAQ Capital Market during 2009. Trading began on The NASDAQ Capital Market under the symbol ORRF on April 28, 2009.

The Company joined the broad market Russell 3000® Index on June 26, 2009 when Russell Investments reconstituted its U.S. and global indexes. The Company is also part of the Russell 2000 Index, a subset of the Russell 3000 that measures the performance of companies ranked 1,001 3,000 by market capitalization.

Economic Climate

During 2008, the U.S. economy faced significant challenges resulting in an overall economic downturn. Poor economic conditions, which were initially evident within the residential housing market beginning in 2007, spread throughout most sectors of the economy in 2008. The economic malaise continued through 2009 and into the early stages of 2010. During 2009 interest rates held at the historically low levels that began in late 2008.

Despite the challenging economic conditions during 2009 and into 2010, the Corporation believes it is positioned to withstand these conditions through its strong capital and liquidity positions, high quality loan and debt securities portfolios and prudent management of credit and interest rate risk.

Results of Operations

For the year ended December 31, 2009, the Corporation recorded net income of $13,373,000, an increase of 2.06% over 2008 earnings of $13,103,000, which was a 4.3% increase over net income of $12,558,000 realized in 2007. Basic earnings per share have increased over the last three years from $1.95 in 2007 to $2.04 in 2008 and $2.09 in 2009.

The Corporation s earnings performance continues to be well above peer group averages as measured by various ratio analyses. Two widely recognized performance indicators are the return on average assets (ROA) and the return on average equity (ROE). The average publicly traded banking company and the average $1 billion to $5 billion in assets banking company generated ROAs of approximately 0.25% and 0.17%, respectively, during 2009 per SNL Financial, a provider of financial information for the banking industry. SNL Financial indicates that approximately 2.54% is the median 2009 ROE for our industry while $1 billion to $5 billion in assets banks returned approximately 1.65% on average. While the Corporation s rates of return have compacted somewhat from prior years, the peer performance of the industry have compacted more resulting in a rise in peer percentile rankings by the Corporation. Return on average tangible assets (ROTA) and return on average tangible equity (ROTE) ratios exclude intangibles from the balance sheet and related amortization and tax expense from net income. The Corporation has goodwill and intangibles from the acquisition of companies and purchased deposits. The following table compares the last three years performance ratios.

Performance Statistics	**2009**	**2008**	**2007**
Return on average assets	**1.19%**	**1.38%**	**1.50%**
Return on average tangible assets	**1.23%**	**1.43%**	**1.56%**
Return on average equity	**12.48%**	**13.20%**	**13.64%**
Return on average tangible equity	**15.73%**	**17.02%**	**18.02%**
Average equity / average assets	**9.55%**	**10.45%**	**10.98%**

Net Interest Income

Net interest income is the amount by which interest income on earning assets exceeds interest paid on interest bearing liabilities. The amount of net interest income is affected by changes in interest rates, account balances or volumes and the mix of earning assets and interest bearing liabilities. Net interest income is still the primary source of commercial bank profits despite a continued focus on noninterest income sources.

For the year ended December 31, 2009 net interest income, measured on a full tax equivalent basis, rose $3,941,000, or 12%, to $37,848,000 despite a decline in net interest margin from 3.93% in 2008 to 3.66%. Net interest income gains were fueled by growth with all attributable to volume factors rather than rate factors. Net interest margin compacted appreciably during the fourth quarter of 2008 given the Federal Reserve Bank s significant cuts to the federal funds rate. Those cuts served to lower the prime lending rate by similar amounts and the Corporation has approximately 31% of its assets tied to Wall Street Journal Prime. Actions taken by management at that time included the installation of floors on all new commercial loans, the placement of $60 million notional amount of prime for fixed interest rate swaps and the take down of $20 million of prime floating Federal Home Loan Bank advances. The Corporation was able to stabilize its net interest margin at 3.40% during the first quarter of 2009 and then increased it sequentially each quarter as the year advanced. Net interest margin generated quarterly for the second through fourth quarter of 2009 was 3.57%, 3.63% and 3.70% respectively. The sequential gains in net interest margin were achieved by a consistent lowering of the cost of funds. The overall cost of funds declined each month as we advanced through 2009. Loan demand during 2009 was lower than normal so more dollars were channeled to the debt securities portfolio where available yields were low given the overall rate environment. This decision helped result in the situation that any increases in net interest margin had to be achieved through a lower cost of funds.

The Corporation continued to grow at a brisk pace during 2009 with average earning assets increasing by $168.3 million, or 19.5% on an average daily basis. Approximately $94 million of that growth was realized in the loan portfolio with a similar amount realized in securities and short term investments. This differed from recent years when the majority of growth was realized in the loan portfolio. This served to increase our liquidity position as funding was more than sufficient during 2009. Deposits grew 20.9% during 2009 versus 2008 while loans increased 12.5% and investment securities grew 62.8%.

For the year ended December 31, 2008, net interest income measured on a full tax equivalent basis, rose $2,794,000, or 9% to $33,907,000 despite a decline in net interest margin from 4.08% to 3.93%. Net interest income gains were fueled primarily by loan growth.

Loan growth was robust during the fourth quarter 2008, exceeding expectations. This was fueled somewhat by the lowering rate environment as prime dropped 175 basis points during the fourth quarter. Approximately 31% of our balance sheet consists of variable rate loans. To compensate for the large portfolio of variable rate loans, the Bank acquired $50 million of rate swaps during the fourth quarter 2008. The swaps trade variable rate, at Wall Street Journal prime, for fixed rates at approximately 5.0%. This helped to stabilize the net interest margin. The rapid fourth quarter loan growth stressed our traditional funding sources, therefore, the Bank utilized the nontraditional sources of FHLB advances and brokered certificate of deposits. These buys were well within the confines of the Corporation s liquidity policy. These funds were acquired at a lower rate than the cost of traditional retail deposits, due to our strong IDC rating and the overall strength of Orrstown Bank.

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ANALYSIS OF NET INTEREST INCOME

Average Daily Balances and Interest Rates, Taxable Equivalent Basis

Taxable equivalent interest computed using a 35% tax rate in all three years.

	2009			2008			2007		
(Dollars in thousands)	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate %	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate %	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate %
Assets									
Interest Earning Assets:									
Federal funds sold & interest bearing bank balances	**$ 21,459**	**$ 68**	**0.32**	$ 10,356	$ 227	2.19	$ 11,618	$ 610	5.25
Taxable investment securities	**135,851**	**4,260**	**3.14**	76,413	2,862	3.75	64,323	2,931	4.56
Tax-exempt investment securities	**27,073**	**1,805**	**6.67**	23,679	1,692	7.15	27,005	1,901	7.04
Total investment securities	**162,924**	**6,065**	**3.72**	100,092	4,554	4.55	91,328	4,832	5.29
Taxable loans	**822,054**	**46,370**	**5.64**	738,552	47,362	6.41	646,707	47,720	7.38
Tax-exempt loans	**26,668**	**1,843**	**6.91**	15,780	1,172	7.43	12,437	937	7.53
Total Loans	**848,722**	**48,213**	**5.68**	754,332	48,534	6.43	659,144	48,657	7.38
Total interest-earning assets	**1,033,105**	**54,346**	**5.26**	864,780	53,315	6.17	762,090	54,099	7.10
Non-Interest Earning Assets:									
Cash and due from banks	**13,950**			13,857			14,767		
Bank premises and equipment	**30,382**			29,144			21,895		
Other assets	**51,973**			48,542			45,460		
Less allowance for loan losses	**(7,618)**			(6,421)			(5,632)		
Total	**$ 1,121,792**			$ 949,902			$ 838,580		
Liabilities and Shareholders Equity									
Interest Bearing Liabilities:									
Interest bearing demand deposits	**$ 307,968**	**3,171**	**1.03**	$ 251,547	$ 3,845	1.53	$ 203,718	$ 4,202	2.06
Savings deposits	**60,494**	**204**	**0.34**	61,881	618	1.00	73,718	1,440	1.95
Time deposits	**364,077**	**9,106**	**2.50**	279,127	9,558	3.42	283,343	13,007	4.59
Short term borrowings	**83,322**	**435**	**0.52**	67,175	1,248	1.86	50,305	2,295	4.56
Long term borrowings	**100,344**	**3,582**	**3.57**	94,737	4,139	4.37	42,415	2,042	4.81
Total interest bearing liabilities	**916,205**	**16,498**	**1.80**	754,467	19,408	2.57	653,499	22,986	3.52
Non-Interest Bearing Liabilities:									
Demand deposits	**89,797**			87,537			85,383		
Other	**8,652**			8,657			7,635		
Total Liabilities	**1,014,654**			850,661			746,517		
Shareholders Equity	**107,138**			99,241			92,063		
Total	**$ 1,121,792**		**1.60**	$ 949,902		2.24	$ 838,580		3.02

Net interest income / net interest spread	**$ 37,848**	**3.46%**	$ 33,907	3.60%	$ 31,113	3.58%
Net interest margin		**3.66%**		3.93%		4.08%

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CHANGES IN TAXABLE EQUIVALENT NET INTEREST INCOME

	2009 Versus 2008 Increase (Decrease) Due to Change in			2008 Versus 2007 Increase (Decrease) Due to Change in		
(Dollars in thousands)	Average Volume	Average Rate	Total Increase (Decrease)	Average Volume	Average Rate	Total Increase (Decrease)
Interest Income						
Loans (net of unearned discounts)	**$ 6,163**	**$ (6,484)**	**$ (321)**	$ 7,029	$ (7,152)	$ (123)
Taxable investment securities	**2,226**	**(828)**	**1,398**	551	(620)	(69)
Tax-exempt investment securities	**243**	**(130)**	**113**	(234)	25	(209)
Other short-term investments	**243**	**(402)**	**(159)**	(66)	(317)	(383)
Total interest income	**8,875**	**(7,844)**	**1,031**	7,280	(8,064)	(784)
Interest Expense						
Interest bearing demand deposits	**861**	**(1,535)**	**(674)**	987	(1,344)	(357)
Savings deposits	**(14)**	**(400)**	**(414)**	(231)	(591)	(822)
Time deposits	**2,909**	**(3,361)**	**(452)**	(194)	(3,255)	(3,449)
Short-term borrowings	**300**	**(1,113)**	**(813)**	770	(1,817)	(1,047)
Long-term borrowings	**245**	**(802)**	**(557)**	2,519	(422)	2,097
Total interest expense	**4,301**	**(7,211)**	**(2,910)**	3,851	(7,429)	(3,578)
Net Interest Income			**$ 3,941**			$ 2,794

TAX-EQUIVALENT NET INTEREST INCOME

	December 31,		
(Dollars in thousands)	2009	2008	2007
GAAP Financial Measurements:			
Interest income securities and other investment income	**$ 5,501**	$ 4,189	$ 4,777
Interest income loans	**47,569**	48,124	48,329
Interest expense deposits	**12,481**	14,021	18,649
Interest expense borrowings	**4,019**	5,387	4,337
Net interest income	**36,570**	32,905	30,120
Non-GAAP Financial Measurements:			
Add: tax benefit on tax-exempt investment securities	**$ 631**	$ 592	$ 665
Add: tax benefit on tax-exempt loans	**647**	410	328
Total tax benefit on tax-exempt interest income	**1,278**	1,002	993
Tax-equivalent net interest income	**$ 37,848**	$ 33,907	$ 31,113

Noninterest Income

The generation of noninterest income has consistently been a strength of the Corporation based upon peer comparisons. This trend continued in 2009 albeit by somewhat different means than prior years.

Total other income increased by $2,477,000, or 16.1% in 2009. Securities gains were up $1,688,000 and secondary mortgage market revenue increased $1,225,000, or 79.3%. The interest rate environment that existed during 2009 afforded the Corporation opportunities to take gains from the available for sale debt securities portfolio so those gains were strategically exercised at times to help support the increase in the loan loss provision. The secondary mortgage operations were expanded to take advantage of the refinancing boom that occurred during the year. Mortgage originators were added during 2009 and further increases are planned for 2010. Debit card revenue also increased $277,000, or 19.9% during 2009 as consumer habits continued to change and the popularity of the reward checking product, which requires a minimum number of debit card transactions to qualify for the highest interest rate, helped to fuel the increase.

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Gains in the aforementioned areas helped to offset declines in overdraft protection fees, trust department income and brokerage income. The difficult economic environment has caused many consumers to pull back on their personal spending and to become somewhat wary of investments that contain an element of risk.

The table that follows provides additional information regarding noninterest income changes over the past three years.

	Year Ended December 31,			% Change	
(Dollars in thousands)	**2009**	**2008**	**2007**	**2009-2008**	**2008-2007**
Other Income					
Debit card fees	**$ 1,671**	$ 1,394	$ 1,011	**19.9%**	37.9%
Overdraft protection fees	**3,655**	3,922	3,536	**-6.8%**	10.9%
Other service charges on deposit accounts	**1,579**	1,442	1,335	**9.5%**	8.0%
Secondary Mortgage Market revenue	**2,769**	1,544	979	**79.3%**	57.7%
Loan service charges and fees	**810**	951	626	**-14.8%**	51.9%
ATM fees	**540**	462	481	**16.9%**	-4.0%
Other service charges, commissions and fees	**107**	99	78	**8.1%**	26.9%
Trust department income	**2,645**	2,840	2,582	**-6.8%**	10.0%
Brokerage income	**1,327**	1,413	1,558	**-6.1%**	-9.3%
Cash surrender value income	**745**	683	682	**9.1%**	0.1%
Non-recurring revenue	**0**	0	219	**0.0%**	-100.0%
Other operating income	**385**	694	161	**-44.5%**	331.1%
Subtotal before securities transactions	**16,233**	15,444	13,248	**5.1%**	16.6%
Securities gains (losses)	**1,661**	(27)	58	**6251.9%**	-146.6%
Total other income	**$ 17,894**	$ 15,417	$ 13,306	**16.1%**	15.9%

Noninterest Expenses

Noninterest expenses rose $3,889,000, or 13.7% versus 2008 as the Corporation continued to expand. A new operations center in Chambersburg, PA and a new flagship branch in Hagerstown, MD were brought online during 2008 so a full twelve months of maintenance expense was realized during 2009, plus systems upgrades led to a 13.1% increase in occupancy and equipment expense. Employees were added to handle the aforementioned growth, average daily assets increased 18.1% for 2009 versus 2008, and incentive compensation for commissioned employees rose 12.3% during the year. Mortgage originators and asset management staff enjoyed a good production year in 2009. FDIC insurance expense rose $982,000, or 331%, from the $296,000 paid in 2008. This included a special assessment of $515,000. The increased FDIC insurance expense burdened the entire banking industry during 2009. Increased ATM expense of $75,000, or 45.7% in 2009 was offset by increased ATM income of $78,000 during the year. The bank offers a robust employee benefit package to all qualifying employees but cost increases were held to 2.0% due largely to savings derived through good performance in the health care consortium in which we participate. Given the 18.1% average daily asset growth, an increase of 13.7% in operating expenses was considered in line.

The table that follows provides additional information regarding noninterest expense changes over the past three years:

ANALYSES OF NONINTEREST EXPENSES

(Dollars in thousands)	Year Ended December 31, 2009	2008	2007	% Change 2009-2008	2008-2007
Other Expenses					
Salaries	**10,976**	9,950	9,367	**10.3%**	6.2%
Incentive compensation	**1,139**	1,014	895	**12.3%**	13.3%
Employee benefits	**4,990**	4,892	4,482	**2.0%**	9.1%
Occupancy and equipment	**4,806**	4,251	3,633	**13.1%**	17.0%
Data processing	**1,077**	999	888	**7.8%**	12.5%
ATM expense	**239**	164	194	**45.7%**	-15.5%
Telephone	**731**	679	498	**7.7%**	36.3%
Printing and supplies	**628**	688	621	**-8.7%**	10.8%
Postage	**337**	326	350	**3.4%**	-6.9%
Directors fees	**353**	385	404	**-8.3%**	-4.7%
Advertising	**541**	578	414	**-6.4%**	39.6%
PA capital stock & shares tax	**561**	566	552	**-0.9%**	2.5%
Contributions	**295**	357	377	**-17.4%**	-5.3%
Security impairment expense	**36**	84	0	**-57.1%**	100.0%
FDIC Insurance	**1,278**	296	113	**331.8%**	161.9%
Non-recurring expense	**0**	0	78	**0.0%**	-100.0%
Other operating expenses	**4,189**	3,058	2,055	**37.0%**	48.8%
Total operating expenses	**$ 32,176**	$ 28,287	$ 24,921	**13.7%**	13.5%
Noninterest inc / Noninterest exp	**55.6%**	54.5%	53.4%		

Federal Income Taxes

The Corporation s effective federal income tax rate for the year ended December 31, 2009 was 23.2% as compared to 29.5% in 2008 and 29.3% in 2007. The effective rate in 2009 was pushed down due to $620,000 of historic credits that flowed from the Newport Senior Housing project and $424,000 of low income housing credits that flowed from the four projects in which we hold limited partnership interests. Corporate income tax rates for 2010 are forecast higher than 2009 levels due to the fact that we will not have the $620,000 of historic tax credits available in 2010 plus the fact that we will be in the 38% marginal federal tax bracket during 2010. We have committed to investments in two additional low income housing projects but tax credits are unlikely to flow from those until 2011. We are actively seeking tax free investment opportunities. The Corporation was pushed into the 35% tax bracket during 2006 and remained in the 35% tax bracket through 2008. During 2009, taxable income for the Corporation will be at the 35% rate on average but marginally at the 38% rate.

Financial Condition

The quality of the Corporation s asset structure continues to be strong. 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.

Investment Securities

Orrstown has established investment policies and an asset management policy to assist in administering its investment portfolio. Decisions to purchase or sell these securities are based on economic conditions and

management s strategy to respond to changes in interest rates, liquidity, securitization of deposits and repurchase agreements and other factors while obtaining the maximum return on the investments. Under generally accepting accounting principles, the Corporation may segregate its investment portfolio into three categories: securities held to maturity , trading securities and securities available for sale . Management has classified the full securities portfolio as available for sale. Securities available for sale are to be accounted for at their current market value with unrealized gains and losses on such securities to be excluded from earnings and reported as a net amount in other comprehensive income.

The following table shows the maturities of investment securities at book value as of December 31, 2009, and weighted average yields of such securities. Yields are shown on a tax equivalent basis, assuming a 35% federal income tax rate.

INVESTMENT MATURITY SCHEDULE

(Dollars in thousands)	Within 1 year	After 1 year but within 5 years	After 5 years but within 10 years	After 10 years	Total	Average Maturity	Weighted Average Yield
U. S. Treasury and government agency securities	$ 2,509	$ 32,802	$ 79,085	$ 6,376	$ 120,772	6 yr. 4 mos.	2.98%
Obligations of states and political subdivisions	701	9,151	4,413	22,602	36,867	11 yr. 7 mos.	5.88%
Government Backed Residential Mortgage Securities	3,895	506	7,414	25,674	37,489	16 yr. 11 mos.	3.97%
Short term investments	3,660	2,728			6,388	1 yr. 5 mos.	1.24%
Total amortized cost	$ 10,765	$ 45,187	$ 90,912	$ 54,652	$ 201,516	9 yr. 3 mos.	3.64%
Percentage of total	5.34%	22.43%	45.11%	27.12%	100.00%		
Weighted average yield	2.76%	2.85%	3.34%	5.01%	3.61%		

(Dollars in thousands)	Outstanding Balances at December 31, 2009	2008	2007
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	$ 120,772	$ 58,246	$ 39,374
Debt securities issued by states and political subdivisions	36,867	23,226	24,782
Government residential mortgage-backed securities	37,489	36,330	23,276
Equity securities	1,894	2,021	2,307
Totals	$ 197,022	$ 119,823	$ 89,739
Short term investments	$ 6,388	$ 0	$ 0

Loan Portfolio

The Bank 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, consistent with past practice and policy.

The loan portfolio at December 31, 2009 has grown 7.4% year over year, from $820.5 million to $881.0 million. On an average daily balance, loans have grown 12.5%, from $754.3 million in 2008 to $848.7 million in 2009. Loans considered commercial in purpose continue to represent the largest component of the Bank s portfolio and the fastest growing. On an average daily basis commercial loans have grown from $528.9 million in 2008 to $620.7 million in 2009, which is a 17.4%, or $91.8 million increase. Mortgage loans have declined on an

average daily basis by $12.3 million as most loans generated were sold in the secondary market. Consumer loans have increased on an average daily basis by $15.0 million, or 14.0%.

The following table presents a breakdown of how loans are secured at the end of each of the last five years:

LOANS SECURED BY: **(Dollars in thousands)**	**2009**	**2008**	**2007**	**2006**	**2005**
Commercial, financial and agricultural	**$ 85,654**	$ 78,880	$ 55,698	$ 59,593	$ 50,104
Real estate Commercial	**305,703**	250,485	243,210	221,460	181,587
Real estate Construction	**117,156**	131,509	92,050	46,947	30,532
Real estate Mortgage	**363,839**	351,426	302,419	281,902	191,823
Consumer	**8,722**	8,168	8,587	8,925	6,340
Total loans	**$ 881,074**	$ 820,468	$ 701,964	$ 618,827	$ 460,386

Presented below are the approximate maturities of the loan portfolio (excluding real estate mortgages, installments, and credit cards) at December 31, 2009.

(Dollars in thousands)	**Under One Year**	**One to Five Years**	**Over Five Years**	**Total**
Commercial, financial and agricultural	$ 6,023	$ 12,908	$ 66,723	$ 85,654
Real estate Construction	28,117	39,687	49,352	117,156
Total loans	$ 34,140	$ 52,595	$ 116,075	$ 202,810

The following table presents the approximate amount of fixed rate loans and variable rate loans due as of December 31, 2009.

(Dollars in thousands)	**Fixed Rate Loans**	**Variable Rate Loans**
Due within one year	$ 13,585	$ 99,099
Due after one but within five years	38,280	48,340
Due after five years	97,027	584,743
Total loans	$ 148,892	$ 732,182

The variable rate loans shown above include semi-fixed loans that contractually will adjust with prime after the interest lock period which may be up to seven years. At December 31, 2009 there were approximately $274 million of such loans.

Deposit Products

On an average daily basis, total deposits grew 20.9% or $142.2 million over 2008. At December 31, 2009, total deposits grew to $915.1 million compared to $757.3 million at year end 2008, or a 20.8% increase.

Average daily time deposits grew by $84.95 million, or 30.4% due primarily to public funds growth, including school district deposits. Short maturity time deposits were used more in 2009 than in prior years due to the low rate environment and the steep yield curve. Brokered time deposits declined from $48.5 million at December 31, 2008 to $34.1 million at December 31, 2009. Interest bearing demand deposits grew $56.4 million, or 22.4%, on an average daily basis. The reward checking product was responsible for $30.3 million of that growth. The reward checking product is a higher rate interest bearing checking account that requires use of electronic statements and debit card usage. The cost savings and debit card cost revenue help offset the increased interest rate. Most transaction account rates were lowered during 2009.

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The average amounts of deposits are summarized below:

(Dollars in thousands)	Years Ended December 31, 2009	2008	2007
Demand deposits	**$ 89,797**	$ 87,537	$ 85,383
Interest bearing demand deposits	**307,968**	251,547	203,718
Savings deposits	**60,494**	61,881	73,718
Time deposits	**364,077**	279,127	283,343
Total deposits	**$ 822,336**	$ 680,092	$ 646,162

The following is a breakdown of maturities of time deposits of $100,000 or more as of December 31, 2009.

(Dollars in thousands)	Regular	Brokered	Total
Three months or less	$ 45,109	$	$ 45,109
Over three months through six months	31,122	9,055	40,177
Over six months through one year	31,852	18,083	49,935
Over one year	23,688	7,000	30,688
Total	$ 131,771	$ 34,138	$ 165,909

Short Term Borrowings

Information concerning the use of TAF funds is summarized as follows:

(Dollars in thousands)	2009	2008	2007
Balance at year end	**$ 33,000**	$ 0	$ 0
Average balance during the year	**20,244**	0	0
Average interest rate during the year	**0.25%**	0	0
Maximum month-end balance during the year	**33,000**	0	0
Collateral underlying the facility at year end			
Loans estimated fair value	**39,622**	0	0
Securities estimated fair value	**$ 11,014**	$ 0	$ 0

Federal funds purchased and securities sold under agreements to repurchase generally mature within one day from the transaction date. The Corporation requires US treasury and agency issues to be held as underlying securities for repurchase agreements.

Information concerning federal funds purchased and securities sold under agreements to repurchase is summarized as follows:

(Dollars in thousands)	2009	2008	2007
Balance at year end	**$ 64,614**	$ 63,407	$ 57,081
Average balance during the year	**60,241**	59,432	49,103
Average interest rate during the year	**0.57%**	1.69%	4.52%
Maximum month-end balance during the year	**74,293**	83,889	59,286
Securities underlying the agreements at year-end:			
Carrying value	**74,816**	81,528	60,201
Estimated fair value	**$ 74,877**	$ 82,625	$ 60,322

The use of short term borrowings increased during 2009 in order to take advantage of the low interest rate environment with the steep yield curve. The use of repurchase agreements followed customer demand and increased slightly during 2009. We decided to avail ourselves of the TAF funding opportunity and were able to carry over $20 million average daily balances at a cost of only 25 basis points. The TAF program, as we use it, will end by March 31, 2010.

Credit Risk Management

Allowance for Loan Losses

Historically, the Corporation has had an enviable record regarding its control of loan losses, but lending is a banking service that inherently contains elements of risk. The Bank s policies related to the allowance for loan losses are considered to be critical accounting policies 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 collectability of the loan portfolio, including the nature of the loan portfolio and loan growth, credit concentrations, trends in historical loss experience, specific impaired loans, and national and local 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 collectability 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 collectability 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, charge-offs and recoveries in total, overall portfolio quality, review of specific problem loans, recent examinations, 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 provision for loan losses amounted to $4,865,000, $1,450,000, and $750,000 for 2009, 2008 and 2007, respectively. These provisions compared to net charge-offs of $ 938,000, $451,000, and $129,000 for 2009, 2008 and 2007, respectively. The unallocated portion of the reserve was approximately 11.4% at December 31, 2009 and 14.0% at December 31, 2008. The reserve at December 31, 2009 represented 1.26% of loans outstanding, up from 0.87% at December 31, 2008.

In November of 2009, management undertook an expanded review of the Bank s commercial loan portfolio, in a proactive attempt to identify potential weaknesses and deterioration in the portfolio. This review was in addition to the normal loan review process conducted by our loan review officer and the Bank s Credit Administration Committee. A review team, which consisted of 3 employees and 2 contract employees, reviewed all commercial loan relationships with an aggregate committed exposure greater than or equal to $750,000. The review team focused on the global cash flow of the borrower, global debt service coverage ratios of the borrower, LTV ratios when collateral values decreased by 10% and 20%, borrower s liquidity and guarantor s overall cash flow and liquidity. The review covered a total of approximately $526,000,000 in outstanding loans and loan commitments. Following the review process, management increased the allowance by $3.1 million in order to better reflect the deterioration in local, regional and national economic conditions. All economic allocations were increased during 2009.

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 losses at this time.

In retrospect, the specific allocation in any particular category may prove excessive or inadequate and consequently may be reallocated in the future to reflect the then current conditions. Accordingly, the entire allowance is available to absorb losses in any category. The following is an allocation by loan categories of the allowance for loan losses for the last five years at December 31.

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ALLOCATION OF ALLOWANCE FOR LOAN LOSSES

(Dollars in thousands)	2009	2008	2007	2006	2005
Loans:					
Commercial, financial and agricultural	**$ 599**	$ 319	$ 1,227	$ 1,206	$ 558
Real estate Commercial	**3,250**	2,393	1,990	1,584	573
Real estate Construction	**2,567**	598	45	42	6
Real estate Mortgage	**3,293**	2,567	2,115	1,553	865
Consumer	**96**	265	30	13	44
Unallocated	**1,262**	998	734	1,122	2,382
Total	**$ 11,067**	$ 7,140	$ 6,141	$ 5,520	$ 4,428
Percentage of Loans to Total Loans					
Commercial, financial and agricultural	**10%**	10%	8%	10%	11%
Real estate Commercial	**35%**	30%	35%	36%	39%
Real estate Construction	**13%**	16%	13%	8%	7%
Real estate Mortgage	**41%**	43%	43%	45%	42%
Consumer	**1%**	1%	1%	1%	1%
Total	**100%**	100%	100%	100%	100%

Net charge-offs for the Bank s loan portfolio have historically been quite low when compared to industry standards, and represented 0.11% of average outstanding loans during 2009, 0.06% in 2008, and 0.02% in 2007. Net charge-offs to average loans for the industry averaged approximately .84% of loans during 2009, .32% in 2008 and ..11% in 2007, per SNL Financial. The $1-5 billion asset peer group averaged 0.16% of loans charged off in 2007 and 0.43% of loans in 2008, but 2009 charge offs increased to 1.14% of loans, per SNL Financial.

SUMMARY OF LOAN LOSS EXPERIENCE

	Year Ended December 31,				
(Dollars in thousands)	2009	2008	2007	2006	2005
Amount of loans outstanding at end of period	**$ 881,074**	$ 820,468	$ 701,964	$ 618,827	$ 460,386
Daily average loans outstanding	**$ 848,722**	$ 754,332	$ 659,144	$ 553,591	$ 421,728
Balance of allowance for possible loan losses at beginning of period	**$ 7, 140**	$ 6,141	$ 5,520	$ 4,428	$ 4,318
Loans charged off					
Commercial, financial and agricultural	**470**	2	8	12	0
Real estate Commercial	**0**	228	0	0	19
Real estate Construction	**0**	0	0	0	0
Real estate Mortgage	**416**	187	53	0	11
Consumer	**72**	80	120	85	52
Total loans charged off	**958**	497	181	97	82
Recoveries of loans previously charged off					
Commercial, financial and agricultural	**2**	0	3	50	0
Real estate Commercial	**1**	3	0	1	11
Real estate Construction	**0**	0	0	0	0
Real estate Mortgage	**6**	16	13	6	11
Consumer	**11**	27	36	22	26
Total recoveries	**20**	46	52	79	48
Net loans charged off (recovered)	**938**	451	129	18	34
Additions to allowance charged to expense	**4,865**	1,450	750	390	144
Additions established for acquired credit risk	**0**	0	0	720	0
Balance at end of period	**$ 11,067**	$ 7,140	$ 6,141	$ 5,520	$ 4,428
Ratio of net charge-offs to average loans outstanding	**0.11%**	0.06%	0.02%	0.00%	0.01%
Ratio of reserve to gross loans outstanding at December 31	**1.26%**	0.87%	0.87%	0.89%	0.96%

Risk Elements

Nonperforming assets are comprised of nonaccrual and restructured loans and other real estate owned (OREO) not including bank premises. OREO represents property acquired through foreclosure or settlements of loans and is carried at the lower of the principal amount of the loan outstanding at the time acquired or the estimated fair value of the property. The excess, if any, of the principal balance at the time acquired over the carrying amount is charged against the reserve for loan losses. Nonaccrual loans are loans for which interest income is not accrued due to concerns about the collectability of interest and/or principal. Restructured loans are loans whose terms have been renegotiated to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrower. Other credit risk elements include loans past due for 90 days or more. The Corporation s loan loss history has been much better than peer standards and analysis of the current credit risk position is favorable. The allowance for loan losses is ample given the current composition of the loan portfolio and adequately covers the credit risk management sees under present economic conditions. Management is prepared to make reserve adjustments that may become necessary as economic conditions continue to change.

Nonperforming loans, as represented by nonaccrual and renegotiated loans, were .48% of outstanding loans at December 31, 2009 and .05% at December 31, 2008. Loans 90 days or more past due and still accruing represented .70% and .75% of outstanding loans at December 31, 2009

and 2008, respectively.

Loans are placed on non-accrual status when a loan becomes past due for 90 days or more, except in cases where the loan is well secured and in the process of collection or is a consumer or mortgage loan secured by a 1-4 family residential property.

NONPERFORMING ASSETS

			December 31,		
(Dollars in thousands)	**2009**	**2008**	**2007**	**2006**	**2005**
Loans on nonaccrual (cash) basis	**$ 4,267**	$ 341	$ 118	$ 120	$ 52
Loans whose terms have been renegotiated to provide a reduction or deferral of interest or principal because of a deterioration in the financial position of the borrower	**0**	0	0	0	0
OREO	**1,065**	608	199	318	1,754
Total nonperforming loans and OREO	**$ 5,332**	$ 949	$ 317	$ 438	$ 1,806
Ratio of nonperforming assets to total loans and OREO	**0.60%**	0.12%	0.05%	0.07%	0.39%
Ratio of nonperforming assets to total assets	**0.44%**	0.09%	0.04%	0.05%	0.30%
OTHER CREDIT RISK ELEMENTS:					
Loans past due 90 or more days and still accruing	**$ 6,155**	$ 6,176	$ 3,586	$ 1,084	$ 411
Ratio of other credit risk elements to total loans and OREO	**0.70%**	0.75%	0.51%	0.18%	0.09%
Ratio of other credit risk elements to total assets	**0.51%**	0.59%	0.41%	0.13%	0.07%
Total nonperforming and other risk assets	**$ 11,487**	$ 7,125	$ 3,903	$ 1,522	$ 2,217
Ratio of total risk assets to total loans and OREO	**1.30%**	0.87%	0.56%	0.25%	0.48%
Ratio of total risk assets to total assets	**0.96%**	0.68%	0.44%	0.19%	0.37%

Nonaccrual loans in 2009 increased from $341,000 at December 31, 2008 to $4,267,000 at December 31, 2009. The nature of the increase was primarily due to three loan relationships that total $4,190,000 that were placed on non-accrual status in 2009. The three loans are secured by real estate and other assets. The Bank has specifically allocated, at December 31, 2009, $1,143,000 against these relationships for potential losses which might be incurred.

During January 2010 we were informed that a commercial credit aggregating approximately $5.0 million that was current and performing at December 31, 2009 was having problems and would become nonperforming during the first quarter of 2010. We have specifically allocated $2.0 million of the December 31, 2009 allowance for loan losses to this credit. This allocation is reflected in the accompanying financial statements at December 31, 2009. Subsequent to notification by the borrower, we have been pursuing a workout plan that we anticipate will result in the $2.0 million allocation being more than sufficient to cover the anticipated charge-off. Because we do not anticipate resolving the matter until second quarter 2010, nonperforming loans at March 31, 2010 may increase significantly.

Further discussion related to delinquent and non-accrual loans is included in Note 6 of the Consolidated Financial Statements which is included in Item 8.

Liquidity, Rate Sensitivity and Interest Rate Risk Analysis

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

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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.

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.

Our most liquid assets are cash and cash equivalents and interest-bearing deposits. The levels of these assets depend on our operating, financing, lending and investing activities during any given period. At December 31, 2009, cash and cash equivalents totaled $22 million. Securities classified as available-for-sale provide additional sources of liquidity, totaled $196 million at December 31, 2009. In addition, at December 31, 2009, we had the ability to borrow a total of approximately $425 million from the Federal Home Loan Bank of Pittsburgh, of which we had $64 million in advances and $11 million in letters of credit. On that date, we had no overnight advances outstanding.

At December 31, 2009, we had $174 million in loan commitments outstanding, which included $43 million in undisbursed loans, $57 million in unused home equity lines of credit and $74 million in commercial lines of credit. Certificates of deposit due within one year of December 31, 2009 totaled $293 million, or 71% of certificates of deposit. The large percentage of certificates of deposit that mature within one year reflects customers hesitancy to invest their funds for long periods in the current low interest rate environment. If these maturing deposits do not remain with us, we will be required to seek other sources of funds, including other certificates of deposit and lines of credit. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before December 31, 2010. We believe, however, based on past experience that a significant portion of our certificates of deposit will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

The Corporation is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Corporation is responsible for paying any dividends declared to its shareholders. The Corporation also has repurchased shares of its common stock. The Corporation s primary source of income is dividends received from the Bank. For restrictions on the Bank s ability to dividend funds to the Corporation, see Note 15 to the Consolidated Financial Statements in Item 8. At December 31, 2009, the Corporation had liquid assets of $897,000.

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 Corporation 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. The goal is to maintain a predominantly matched position with very few planned mismatches. Rate spreads will be sacrificed at times in order to enable the overall rate sensitivity position to stay within the guidelines called for by asset/liability management policy. Rate sensitivity is measured by monthly gap analyses, quarterly rate shocks, and periodic simulation. Investment and pricing decisions are made using both liquidity and sensitivity analyses as tools. The schedule that follows reflects the degree to which the Corporation can adjust its various portfolios to meet interest rate changes. Additionally, the Bank is a Federal Home Loan Bank (FHLB) member, and standard credit arrangements available to FHLB members provide increased liquidity.

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RATE SENSITIVITY ANALYSIS AT DECEMBER 31, 2009

	Interest Sensitivity Period				
(Dollars in thousands)	Within 3 Months	After 3 Within 6 Months	After 6 Within 12 Months	After 1 Year	Total
Rate Sensitive Assets (RSA)					
Loans	$ 356,625	$ 21,993	$ 57,072	$ 445,384	$ 881,074
Investment securities	15,977	20,327	20,282	147,722	204,308
Other earning assets	4,786	0	3,660	6,544	14,990
Total RSA	$ 377,388	$ 42,320	$ 81,014	$ 599,650	$ 1,100,372
Rate Sensitive Liabilities (RSL)					
Interest bearing deposits	$ 283,094	$ 62,585	$ 69,098	$ 409,716	$ 824,493
Short term borrowed funds	97,914	0	0	0	97,914
Long term borrowed funds	42,222	344	11,473	10,819	64,858
Total RSL	$ 423,230	$ 62,929	$ 80,571	$ 420,535	$ 987,265
Rate Sensitive GAP					
Period	$ (45,842)	$ (20,609)	$ 443	$ 179,115	$ 113,107
Cumulative	$ (45,842)	$ (66,451)	$ (66,008)	$ 113,107	
GAP as a Percent of Total Assets					
Period	-3.83%	-1.72%	0.04%	14.97%	
Cumulative	-3.83%	-5.55%	-5.52%	9.45%	
RSA/RSL cumulative	0.89%	0.86%	0.88%	1.11%	

The gap position is very closely balanced but slightly liability biased, or negative, on the short end at twelve months or less. The position is very closely balanced, though, so no strong bias exists. The cumulative RSA/RSL at December 31, 2009 is 0.89% at three months, 0.86% at six months and 0.88% at twelve months, so the Corporation is not at undue risk under any interest rate scenario. This indicates that the balance sheet is well positioned to be maintained in the current low rate environment and to react to any rate increases in the future. Many of the interest bearing deposits that are variable rate are subject to discretionary pricing so management retains flexibility with those funds which will enhance earnings in a rising rate environment. The majority of the loan portfolio is tied to prime, but the use of three to seven year rate locks as well as placing rate floors on any new loans helps to maintain the yield in a falling rate environment. Management will closely monitor the fiscal policies of our government and will react to any changes quickly in order to maintain a healthy earning asset / interest bearing liability balance.

Contractual Obligations

Contractual obligation payments of the Corporation as of December 31, 2009 are as follows:

(Dollars in thousands)	Less than 1 year	2 - 3 years	4 - 5 years	More than 5 years	Total
Long-term debt obligations	$ 29,336	$ 27,594	$ 2,659	$ 5,269	$ 64,858
Operating lease obligations	$ 260	291	225	657	1,433
Total	$ 29,596	$ 27,885	$ 2,884	$ 5,926	$ 66,291

Capital Adequacy and Regulatory Matters

The Corporation maintains a strong capital base which provides adequate resources to absorb both normal and unusual risks inherent to the banking business. Internal capital generation has been supported primarily by

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net income retained after the declaration of dividends and also through the exercise of options and employee stock purchases. Total shareholders equity rose $7.5 million during 2009, an increase of 7.3% over the balance at December 31, 2008. This followed growth of 7.5% during 2008 and 2007, respectively.

Unrealized securities gains decreased $1,037,000 during 2009, while unrealized derivative losses of $833,000 resulted from interest rate swaps. These are both components of comprehensive income as shown in Note 1 of Item 8 included in this report. Treasury stock purchases of $71,000 and issuances of $1,402,000 were completed during 2009. Other growth experienced during 2009 has been provided primarily by net income. Equity represented 9.27% of assets at December 31, 2009, which is down slightly from the 9.83% at December 31, 2008. The increasing earnings stream during this period has allowed the Corporation to increase cash dividends paid to shareholders. In 2009, cash dividends rose $48,000 or 0.9% over 2008 levels, while net income rose 2.1% during the same period. This followed a 6.0% increase in dividend payout for 2008 versus 2007. Dividends per share have moved from $0.82 to $0.87 to $0.88 for 2007 through 2009, respectively.

CAPITAL AND DIVIDEND RATIOS

(Dollars in thousands)	2009	2008	2007
At December 31:			
Shareholders equity	**$ 110,886**	$ 103,347	$ 96,124
Equity to asset ratio	**9.27%**	9.83%	10.86%
For the Year:			
Average assets	**$ 1,121,792**	$ 949,902	$ 838,580
Average shareholders equity	**107,138**	99,241	92,063
Net Income	**13,373**	13,103	12,558
Cash dividends paid	**5,636**	5,588	5,271
Equity to asset ratio	**9.55%**	10.45%	10.98%
Dividend payout ratio	**42.14%**	42.65%	41.97%
Return on average equity	**12.48%**	13.20%	13.64%
Return on average tangible equity	**15.73%**	17.02%	18.02%

	Orrstown Financial Services			Regulatory Requirements	
	2009	2008	2007	Minimum	Well Capitalized
Regulatory Capital Measures:					
Leverage ratio	**7.6%**	7.9%	8.6%	4.0%	5.0%
Tier I capital ratio	**10.1%**	10.0%	10.7%	4.0%	6.0%
Total (Tier I and Tier II) capital ratio	**11.3%**	10.9%	11.6%	8.0%	10.0%

The maintenance of a strong capital base, above regulatory risk based minimums and industry averages, has been an integral part of the Corporation s operating philosophy. Management foresees no problem in maintaining capital ratios in excess of regulatory requirements.

The Corporation and its banking subsidiary are subject to periodic examinations by the Federal Reserve Bank and the Pennsylvania Department of Banking. During 2009, a safety and soundness examination was conducted at Orrstown Bank. No comments were received from regulatory agencies which, if implemented, would have a material effect on Orrstown Financial Services, Inc. s liquidity, capital resources, or operations.

Future Impact of Recently Issued Accounting Standards

In April 2009, the Financial Accounting Standards Board (FASB) issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and

Identifying Transactions That Are Not Orderly, now codified as ASC Topic 820-10-65-4. This standard emphasizes that even if there has been a significant decrease in the volume and level of activity, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants. Topic 820-10-65-4 provides a number of factors to consider when evaluating whether there has been a significant decrease in the volume and level of activity for an asset or liability in relation to normal market activity. In addition, when transactions or quoted prices are not considered orderly, adjustments to those prices based on the weight of available information may be needed to determine the appropriate fair value. The standard also requires increased disclosures. This topic is effective for interim and annual reporting periods ending after June 15, 2009, and shall be applied prospectively. The Company adopted this topic 820-10-65-4 in the second quarter of 2009, but the adoption had no material impact on its consolidated financial statements.

In April 2009, the FASB issued guidance now codified as ASC Topic 825, Financial Instruments, which amended previous Topic 825 guidance to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies that were previously only required in annual financial statements. This guidance became effective for interim reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company adopted this topic in the second quarter of 2009.

In April 2009, the FASB issued guidance now codified as ASC Topic 320-10-35, Investments Debt and Equity Securities, Subsequent Measurements , which amends existing guidance for determining whether impairment is other-than-temporary for debt securities. The standard requires an entity to assess whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of these criteria is met, the entire difference between amortized cost and fair value is recognized in earnings. For securities that do not meet the aforementioned criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income. Additionally, the ASC Topic 320-10-35 expands and increases the frequency of existing disclosures about other-than-temporary impairments for debt and equity securities. This topic became effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company adopted this topic in the second quarter, but the adoption had no material impact on its consolidated financial statements.

In April 2009, the FASB issued Financial Statement Position (FSP) FAS 141(R)-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies (ASC 805 Business Combinations). FSP FAS 141(R)-1 amends and clarifies SFAS 141(R) to address application issues on initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. The FSP is effective for assets and liabilities arising from contingencies in business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company does not expect the adoption of FSP FAS 141(R)-1 to have a material impact on its consolidated financial statements.

In May 2009, the FASB issued guidance now codified as ASC Topic 855, Subsequent Events which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. ASC 855 sets forth (1) 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 or disclosure in the financial statements, (2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (3) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. This pronouncement became effective for the period ended June 30, 2009 and did not have a significant impact on the Company s consolidated financial statements.

In June 2009, the FASB issued ASC 105-10. (formerly Statement No. 168,) The FASB Accounting Standards Codification (Codification) and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162 . The guidance identifies the FASB Accounting Standards Codification (Codification) as the single source of authoritative U.S. Generally Accepted Accounting Principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. The Codification reorganizes all previous GAAP pronouncements into roughly 90 accounting topics and displays all topics using a consistent structure. All existing standards that were used to create the Codification have been superseded, replacing the previous references to specific Statements of Financial Accounting Standards (SFAS) with numbers used in the Codification s structural organization. The guidance is effective for interim and annual periods ending after September 15, 2009. After September 15, only one level of authoritative GAAP exists, other than guidance issued by the Securities and Exchange Commission (SEC). All other accounting literature excluded from the Codification is considered non-authoritative. The adoption of the Codification does not have a material impact on the Company s consolidated financial statements.

In June 2009, the FASB issued guidance now codified as ASC Topic 860, Transfers and Servicing, that defines the term participating interest to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. If the transfer does not meet those conditions, a transferor should account for the transfer as a sale only if it transfers an entire financial asset or a group of entire financial assets and surrenders control over the entire transferred asset(s) in accordance with the conditions in this topic. Under the revised standards guaranteed mortgage securitizations are removed to require those securitizations to be treated the same as any other transfer of financial assets within the scope of the topic. If such a transfer does not meet the requirements for sale accounting, the securitized mortgage loans should continue to be classified as loans in the transferor s statement of financial position. This topic requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor s beneficial interest and liabilities incurred as a result of a transfer of financial assets accounted for as a sale. The newly issued guidance under ASC Topic 860 is effective as of the beginning of each reporting entity s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. The Company does not expect that these revisions will have a material impact on the Company s consolidated financial statements.

In June 2009, the FASB issued guidance now codified as ASC Topic 810-10 Consolidation, to require an enterprise to perform an analysis to determine whether the enterprise s variable interest or interests give it a controlling financial interest in a variable interest entity. This analysis identifies the primary beneficiary of a variable interest entity as the enterprise that has both of the following characteristics: (1) The power to direct the activities of a variable interest entity that most significantly impact the entity s economic performance and (2) The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. Additionally, an enterprise is required to assess whether it has an implicit financial responsibility to ensure that a variable interest entity operates as designed when determining whether it has the power to direct the activities of the variable interest entity that most significantly impact the entity s economic performance. This revision of ASC Topic 810-10 is effective as of the beginning of each reporting entity s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. The Company does not expect that adoption of this guidance will have a material impact on the Company s consolidated financial statements.

In August 2009, the FASB issued Accounting Standards Update No. 2009-05 (ASU 2009-05), Fair Value Measurements and Disclosures (Topic 820) Measuring Liabilities at Fair Value. ASU 2009-05 amends Subtopic 820-10, Fair Value Measurements and Disclosures Overall, and provides clarification for the fair value measurement of liabilities. ASU 2009-05 is effective for the first reporting period including interim period beginning after issuance. The Company does not expect the adoption of ASU 2009-05 to have a material impact on its consolidated financial statements.

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In September 2009, the FASB issued Accounting Standards Update No. 2009-12 (ASU 2009-12), Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent). ASU 2009-12 provides guidance on estimating the fair value of alternative investments. ASU 2009-12 is effective for interim and annual periods ending after December 15, 2009. The Company does not expect the adoption of ASU 2009-12 to have a material impact on its consolidated financial statements.

In October 2009, the FASB issued Accounting Standards Update No. 2009-15 (ASU 2009-15), Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing. ASU 2009-15 amends Subtopic 470-20 to expand accounting and reporting guidance for own-share lending arrangements issued in contemplation of convertible debt issuance. ASU 2009-15 is effective for fiscal years beginning on or after December 15, 2009 and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. The Company does not expect the adoption of ASU 2009-15 to have a material impact on its consolidated financial statements.

Important Factors Relating to Forward Looking Statements

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

The Corporation undertakes no obligation to update any forward-looking statements. Actual results could differ materially from those anticipated in forward-looking statements and future results could differ materially from historical performance. In addition to factors mentioned elsewhere in this Report or previously disclosed in our SEC reports (accessible on the SEC s website at www.sec.gov or on our website at www.orrstown.com), the following factors, among others, could cause actual results to differ materially from forward-looking statements and future results could differ materially from historical performance:

- general political and economic conditions may be less favorable than expected;
- developments concerning credit quality in various corporate lending industry sectors as well as consumer and other types of credit, may result in an increase in the level of our provision for credit losses, nonperforming assets, net charge-offs and reserve for credit losses;
- customer borrowing, repayment, investment, and deposit practices generally may be less favorable than anticipated; and interest rate and currency fluctuations, equity and bond market fluctuations, and inflation may be greater than expected;
- the mix of interest rates and maturities of our interest earning assets and interest bearing liabilities (primarily loans and deposits) may be less favorable than expected;
- competitive product and pricing pressures among financial institutions within our markets may increase;
- legislative or regulatory developments, including changes in laws or regulations concerning taxes, banking, securities, capital requirements and risk-based capital guidelines, reserve methodologies, deposit insurance and other aspects of the financial services industry, may adversely affect the businesses in which we are engaged or our financial results;

legal and regulatory proceedings and related matters with respect to the financial services industry, including those directly involving the Corporation and its subsidiaries, could adversely affect the Corporation or the financial services industry generally;

pending and proposed changes in accounting rules, policies, practices, and procedures could adversely affect our financial results;

instruments and strategies used to manage exposure to various types of market and credit risk could be less effective than anticipated, and we may not be able to effectively mitigate our risk exposures in particular market environments or against particular types of risk;

terrorist activities or other hostilities, including the situation surrounding Iraq, may adversely affect the general economy, financial and capital markets, specific industries, and the Corporation; and

technological changes may be more difficult or expensive than anticipated.

ITEM 7A 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 Corporation 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. Interest-earning assets are substantially made up of loans and securities. Loans are priced by management with current market rates as guidelines while achieving a positive interest rate spread and limiting credit risk. A significant part of the loan portfolio is made up of variable rate loans and loans that will become variable after a fixed term and will reprice as market rates move. The Bank has entered into three (3) rate swap agreements two on November 24, 2008, and one on May 22, 2009, to better balance our market risk of variable vs. fixed rate loans. Securities are purchased using liquidity and maturity terms as guidelines to obtain a more matched position. The deposit base is a mix of transaction accounts and time deposits. Many of the interest bearing transaction accounts have discretionary pricing so great flexibility exists for deposit side price adjustments. Time deposits have set maturities as do short term and long term borrowings. Although deposit product cycles and growth are driven by the preferences of our customers, borrowings are structured with specific terms that, when aggregated with the terms for deposits and matched with interest-earning assets, mitigate our exposure to interest rate sensitivity. Rate sensitivity is measured by monthly gap analysis, quarterly rate shocks, and periodic simulation.

At December 31, 2009, the twelve month cumulative gap was a negative $66.0 million and the RSA/ RSL cumulative ratio was 0.88% which has increased from .87% since December 31, 2008. Further discussion related to the quantitative and qualitative disclosures about market risk is included under the heading of Liquidity, Rate Sensitivity and Interest Rate Risk Analysis in Item 7 of Management s Discussion and Analysis of Financial Condition and Results of Operations.

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ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

SUMMARY OF QUARTERLY FINANCIAL DATA

The unaudited quarterly results of operations for the years ended December 31, are as follows:

	2009				2008			
	Quarter Ended				Quarter Ended			
(Dollars in thousands)	**MAR**	**JUN**	**SEP**	**DEC**	**MAR**	**JUN**	**SEP**	**DEC**
Interest income	**$ 12,577**	**$ 13,142**	**$ 13,538**	**$ 13,813**	$ 13,388	$ 12,685	$ 13,098	$ 13,142
Interest expense	**4,555**	**4,330**	**4,059**	**3,556**	5,471	4,521	4,690	4,726
Net interest income	**8,022**	**8,812**	**9,479**	**10,257**	7,917	8,164	8,408	8,416
Provision for loan losses	**215**	**300**	**750**	**3,600**	158	257	257	778
Net interest income after provision for loan losses	**7,807**	**8,512**	**8,729**	**6,657**	7,759	7,907	8,151	7,638
Securities gains (losses)	**165**	**293**	**338**	**865**	49	(1)	(75)	0
Other income	**3,804**	**4,057**	**4,079**	**4,293**	3,562	4,145	3,820	3,917
Other expense	**7,677**	**8,344**	**8,039**	**8,116**	6,700	6,885	7,316	7,386
Income before income taxes	**4,099**	**4,518**	**5,107**	**3,699**	4,670	5,166	4,580	4,169
Applicable income taxes	**1,074**	**1,064**	**1,227**	**685**	1,420	1,563	1,417	1,082
Net income	**$ 3,025**	**$ 3,454**	**$ 3,880**	**$ 3,014**	$ 3,250	$ 3,603	$ 3,163	$ 3,087
Per Common Share Data								
Net income	**$ 0.47**	**$ 0.54**	**$ 0.61**	**$ 0.47**	$ 0.51	$ 0.56	$ 0.49	$ 0.48
Diluted net income	**0.45**	**0.51**	**0.58**	**0.44**	0.48	0.54	0.46	0.46
Dividends	**0.22**	**0.22**	**0.22**	**0.22**	0.21	0.22	0.22	0.22
Performance Statistics								
Return on average assets	**1.15%**	**1.26%**	**1.36%**	**1.01%**	1.45%	1.57%	1.31%	1.21%
Return on average tangible assets	**1.19%**	**1.30%**	**1.40%**	**1.04%**	1.50%	1.63%	1.36%	1.25%
Return on average equity	**11.84%**	**13.14%**	**14.33%**	**10.68%**	13.52%	14.69%	12.57%	12.10%
Return on average tangible equity	**15.08%**	**16.61%**	**18.01%**	**13.32%**	17.58%	18.94%	16.17%	15.50%
Average equity / avg. assets	**9.68%**	**9.58%**	**9.50%**	**9.45%**	10.73%	10.71%	10.43%	9.98%
Supplemental Reporting of Non-GAAP-Based Financial Measures								
Return on average assets (GAAP basis)	**1.15%**	**1.26%**	**1.36%**	**1.01%**	1.45%	1.57%	1.31%	1.21%
Effect of excluding average intangible assets and related amortization	**0.04%**	**0.04%**	**0.04%**	**0.03%**	0.05%	0.06%	0.05%	0.04%
Return on average tangible assets	**1.19%**	**1.30%**	**1.40%**	**1.04%**	1.50%	1.63%	1.36%	1.25%
Return on average equity (GAAP basis)	**11.84%**	**13.14%**	**14.33%**	**10.68%**	13.52%	14.69%	12.57%	12.10%
Effect of excluding average intangible assets and related amortization	**3.24%**	**3.47%**	**3.68%**	**2.64%**	4.06%	4.25%	3.60%	3.40%
Return on average tangible equity	**15.08%**	**16.61%**	**18.01%**	**13.32%**	17.58%	18.94%	16.17%	15.50%

Index to Financial Statements and Supplementary Data

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Management s Report on Internal Control

The management of Orrstown Financial Services, Inc. and its wholly-owned subsidiary has the responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting. Management maintains a comprehensive system of internal control to provide reasonable assurance of the proper authorization of transactions, the safeguarding of assets and the reliability of the financial records. The system of internal control provides for appropriate division of responsibility and is documented by written policies and procedures that are communicated to employees. Orrstown Financial Services, Inc. and its wholly-owned subsidiary maintains an internal auditing program, under the supervision of the Audit Committee of the Board of Directors, which independently assesses the effectiveness of the system of internal control and recommends possible improvements.

Under the supervision and with the participation of the Corporation s management, including its Chief Executive Officer and Chief Financial Officer, the Corporation has evaluated the effectiveness of its internal control over financial reporting as of December 31, 2009, using the *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, management has concluded that, at December 31, 2009, the Corporation s internal control over financial reporting is effective based on the criteria established in *Internal Control-Integrated Framework*.

The independent registered accounting firm, Smith Elliott Kearns & Company, LLC, has issued an audit report on the Corporation s internal control over financial reporting as of December 31, 2009. The accounting firm s audit report on internal control over financial reporting is included in this financial report.

/s/ Thomas R. Quinn, Jr.	/s/ Bradley S. Everly
Thomas R. Quinn, Jr.	**Bradley S. Everly**
President and Chief Executive Officer	**Senior Vice President and Chief Financial Officer**

March 15, 2010

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Orrstown Financial Services, Inc.

We have audited the accompanying consolidated balance sheets of Orrstown Financial Services, Inc. and its wholly-owned subsidiary as of December 31, 2009 and 2008, and the related consolidated statements of income, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2009. We also have audited Orrstown Financial Services, Inc. and its wholly-owned subsidiary s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The management of Orrstown Financial Services, Inc. and its wholly-owned subsidiary (the Corporation) is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control. Our responsibility is to express an opinion on these financial statements and an opinion on the Corporation s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Orrstown Financial Services, Inc. and its wholly-owned subsidiary as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, Orrstown Financial Services, Inc. and its wholly-owned subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

As described in Note 9 to the consolidated financial statements, the Corporation changed its method of accounting for split-dollar post retirement benefits in 2008 as required by accounting principles generally accepted in the United States of America.

/s/ Smith Elliott Kearns & Company, LLC
Smith Elliott Kearns & Company, LLC

Chambersburg, Pennsylvania

March 15, 2010

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Consolidated Balance Sheets

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

(Dollars in thousands)	At December 31, 2009	2008
Assets		
Cash and due from banks	**$ 13,940**	$ 12,871
Federal funds sold	**8,000**	13,933
Cash and cash equivalents	**21,940**	26,804
Short term investments	**6,388**	0
Interest bearing deposits with banks	**601**	409
Member stock, at cost which approximates market value	**8,056**	7,713
Securities available for sale	**196,253**	120,640
Loans		
Commercial, financial and agricultural	**85,654**	78,880
Real estate Commercial	**305,703**	250,485
Real estate Construction and land development	**117,156**	131,509
Real estate Mortgage	**363,839**	351,426
Consumer	**8,722**	8,168
	881,074	820,468
Less: Allowance for loan losses	**(11,067)**	(7,140)
Net Loans	**870,007**	813,328
Premises and equipment, net	**29,601**	31,050
Cash surrender value of life insurance	**21,204**	16,552
Goodwill and intangible assets	**20,938**	21,186
Accrued interest receivable	**4,605**	3,983
Other assets	**16,839**	10,118
Total assets	**$ 1,196,432**	$ 1,051,783
Liabilities and Shareholders Equity		
Deposits:		
Non-interest bearing	**$ 90,676**	$ 84,261
Interest bearing	**824,494**	673,107
Total deposits	**915,170**	757,368
Short-term borrowings	**97,914**	64,007
Long-term debt	**64,858**	118,287
Accrued interest and other liabilities	**7,604**	8,774
Total liabilities	**1,085,546**	948,436
Common stock, no par value $ .05205 stated value per share 50,000,000 shares authorized with 6,469,508 shares issued at December 31, 2009; 6,455,123 shares issued at December 31, 2008	**337**	336
Additional paid-in capital	**82,895**	82,555
Retained earnings	**28,857**	21,120

Accumulated other comprehensive income (loss)	**(501)**	1,369
Treasury stock common, at cost 26,313 shares in 2009; 69,457 shares in 2008	**(702)**	(2,033)
Total shareholders equity	**110,886**	103,347
Total liabilities and shareholders equity	**$ 1,196,432**	$ 1,051,783

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

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Consolidated Statements of Income

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

	Years Ended December 31,		
(Dollars in thousands)	**2009**	**2008**	**2007**
Interest and dividend income			
Interest and fees on loans	**$ 47,569**	$ 48,124	$ 48,329
Interest and dividends on investment securities			
U.S. Government and agency	**4,148**	2,589	2,545
Tax exempt	**1,172**	1,100	1,236
Other investment income	**181**	500	996
Total interest and dividend income	**53,070**	52,313	53,106
Interest expense			
Interest on deposits	**12,481**	14,021	18,649
Interest on short-term borrowings	**435**	1,248	2,295
Interest on long-term debt	**3,584**	4,139	2,042
Total interest expense	**16,500**	19,408	22,986
Net interest income	**36,570**	32,905	30,120
Provision for loan losses	**4,865**	1,450	750
Net interest income after provision for loan losses	**31,705**	31,455	29,370
Other income			
Service charges on deposit accounts	**6,905**	6,758	5,882
Other service charges, commissions and fees	**4,226**	3,056	2,164
Trust department income	**2,645**	2,840	2,582
Brokerage income	**1,327**	1,413	1,558
Non-recurring revenue	**0**	0	219
Other income	**1,130**	1,377	843
Investment securities gains (losses)	**1,661**	(27)	58
Total other income	**17,894**	15,417	13,306
Other expenses			
Salaries	**12,115**	10,964	10,262
Employee benefits	**4,990**	4,892	4,482
Occupancy and equipment	**4,806**	4,251	3,633
Non-recurring expense	**0**	0	78
Security impairment expense	**36**	84	0
Other operating expenses	**10,229**	8,096	6,466
Total other expenses	**32,176**	28,287	24,921
Income before income tax	**17,423**	18,585	17,755
Income tax expense	**4,050**	5,482	5,197

Net income	**$ 13,373**	$ 13,103	$ 12,558
Earnings per share			
Basic earnings per share	**$ 2.09**	$ 2.04	$ 1.95
Diluted earnings per share	**$ 1.98**	$ 1.94	$ 1.86
Dividends per share	**$ 0.88**	$ 0.87	$ 0.82

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

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Consolidated Statements of Changes in Shareholders Equity

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

	Years Ended December 31, 2009, 2008 and 2007					
(Dollars in thousands)	**Common Stock**	**Additional Paid-In Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income**	**Treasury Stock**	**Total Shareholders Equity**
Balance, December 31, 2006	320	72,023	16,934	507	(396)	89,388
Net income	0	0	12,558	0	0	12,558
Net unrealized securities gains	0	0	0	60	0	60
Comprehensive income						12,618
Cash dividends ($.82 per share)	0	0	(5,271)	0	0	(5,271)
Stock dividends issued	16	10,314	(10,330)	0	0	0
Cash paid in lieu of fractional stock dividends	0	0	(23)	0	0	(23)
Stock-based compensation plans:						
Compensation expense	0	161	0	0	0	161
Issuance of stock	0	39	0	0	0	39
Purchase of treasury stock (27,964 shares)	0	0	0	0	(937)	(937)
Issuance of treasury stock (5,355 shares)	0	(49)	0	0	198	149
Balance, December 31, 2007	336	82,488	13,868	567	(1,135)	96,124
Net income	0	0	13,103	0	0	13,103
Net unrealized gains on derivatives	0	0	0	831	0	831
Net unrealized securities losses	0	0	0	(29)	0	(29)
Comprehensive income						13,905
Cash dividends ($.87 per share)	0	0	(5,588)	0	0	(5,588)
Post retirement split dollar life insurance	0	0	(263)	0	0	(263)
Stock-based compensation plans:						
Compensation expense	0	123	0	0	0	123
Issuance of stock	0	39	0	0	0	39
Purchase of treasury stock (49,294 shares)	0	0	0	0	(1,376)	(1,376)
Issuance of treasury stock (13,140 shares)	0	(95)	0	0	478	383
Balance, December 31, 2008	$ 336	$ 82,555	$ 21,120	$ 1,369	($ 2,033)	$ 103,347
Net income	**0**	**0**	**13,373**	**0**	**0**	**13,373**
Net unrealized losses on derivatives	**0**	**0**	**0**	**(833)**	**0**	**(833)**
Net unrealized securities losses	**0**	**0**	**0**	**(1,037)**	**0**	**(1,037)**
Comprehensive income						**11,503**
Cash dividends ($.88 per share)	**0**	**0**	**(5,636)**	**0**	**0**	**(5,636)**
Post retirement split dollar life insurance	**0**	**0**	**0**	**0**	**0**	**0**
Stock-based compensation plans:						

Compensation expense	**0**	**117**	**0**	**0**	**0**	**117**
Issuance of stock	**1**	**295**	**0**	**0**	**0**	**296**
Purchase of treasury stock (5,883 shares)	**0**	**0**	**0**	**0**	**(71)**	**(71)**
Issuance of treasury stock (49,027 shares)	**0**	**(72)**	**0**	**0**	**1,402**	**1,330**
Balance, December 31, 2009	**$ 337**	**$ 82,895**	**$ 28,857**	**$ (501)**	**($ 702)**	**$ 110,886**

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

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Consolidated Statements of Cash Flows

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

	Years Ended December 31,		
(Dollars in thousands)	**2009**	**2008**	**2007**
Cash flows from operating activities			
Net income	**$ 13,373**	$ 13,103	$ 12,558
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**3,755**	2,295	1,836
Provision for loan losses	**4,865**	1,450	750
Stock based compensation	**117**	123	161
Net gain on disposal of other real estate owned	**(9)**	(11)	(14)
Net (gain) loss on disposal of bank premises and equipment	**24**	(344)	4
Net (gain) on sale of investment in affiliate	**0**	0	(219)
Deferred income taxes	**(916)**	(667)	(482)
Investment securities (gains) losses	**(1,661)**	27	(58)
Security impairment loss	**36**	84	0
Increase in cash surrender value of life insurance	**(932)**	(485)	(494)
Increase in accrued interest receivable	**(622)**	(493)	(211)
Increase (decrease) in accrued interest payable	**(125)**	(7)	61
Other, net	**(5,588)**	(834)	677
Net cash provided by operating activities	**12,317**	14,241	14,569
Cash flows from investing activities			
Net (increase) decrease in interest bearing deposits with banks and short term investments	**(6,580)**	(178)	664
Sales of available for sale securities	**76,444**	1,860	1,547
Maturities of available for sale securities	**74,366**	93,772	41,441
Proceeds from divesting of affiliates	**0**	0	551
Purchases of available for sale securities			