ORRSTOWN FINANCIAL SERVICES INC
Form 10-Q
November 08, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10 Q

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

For the quarterly period ended September 30, 2012

or

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

For the transition period from to

Commission file number: 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.

(Exact Name of Registrant as Specified in its Charter)

Pennsylvania	**23-2530374**
(State or Other Jurisdiction of	**(I.R.S. Employer**
Incorporation or Organization)	**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

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 Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

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

Number of shares outstanding of the registrant s Common Stock as of November 1, 2012: 8,079,462.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated Balance Sheets

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

(Dollars in thousands, Except per Share Data)	**(Unaudited) September 30, 2012**	(Audited)* December 31, 2011
Assets		
Cash and due from banks	**$ 13,960**	$ 19,630
Federal funds sold	**0**	0
Cash and cash equivalents	**13,960**	19,630
Interest bearing deposits with banks	**93,644**	90,039
Restricted investments in bank stock	**10,615**	11,758
Securities available for sale	**291,649**	310,365
Loans held for sale	**8,049**	2,553
Loans	**803,738**	965,440
Less: Allowance for loan losses	**(36,700)**	(43,715)
Net Loans	**775,087**	924,278
Premises and equipment, net	**26,929**	27,183
Cash surrender value of life insurance	**24,797**	24,147
Goodwill and intangible assets	**884**	1,041
Accrued interest receivable	**3,696**	4,548
Other assets	**28,058**	31,108
Total assets	**$ 1,269,319**	$ 1,444,097
Liabilities		
Deposits:		
Non-interest bearing	**$ 113,115**	$ 111,930
Interest bearing	**1,007,348**	1,104,972
Total deposits	**1,120,463**	1,216,902
Short-term borrowings	**12,066**	35,013
Long-term debt	**37,808**	53,798
Accrued interest and other liabilities	**11,662**	10,187
Total liabilities	**1,181,999**	1,315,900
Shareholders Equity		
Preferred Stock, $1.25 par value per share; 500,000 shares authorized; no shares issued or outstanding	**0**	0
Common stock, no par value - $ 0.05205 stated value per share 50,000,000 shares authorized; 8,066,091 and 8,055,787 shares issued; 8,065,279 and 8,054,975 shares outstanding	**420**	419
Additional paid - in capital	**122,616**	122,514

Retained earnings (accumulated deficit)	**(38,289)**	1,195
Accumulated other comprehensive income	**2,593**	4,089
Treasury stock - common, 812 shares, at cost	**(20)**	(20)
Total shareholders equity	**87,320**	128,197
Total liabilities and shareholders equity	**$ 1,269,319**	$ 1,444,097

* The consolidated balance sheet at December 31, 2011 has been derived from audited financial statements at that date.
The Notes to Consolidated Financial Statements are an integral part of these statements.

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Consolidated Statements of Operations

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

(Dollars in thousands, Except per Share Data)	**Three Months Ended September 30, 2012**	Three Months Ended September 30, 2011	**Nine Months Ended September 30, 2012**	Nine Months Ended September 30, 2011
Interest and dividend income				
Interest and fees on loans	**$ 9,567**	$ 12,406	**$ 30,717**	$ 37,224
Interest and dividends on investment securities				
Taxable	**768**	2,287	**3,105**	6,746
Tax-exempt	**325**	756	**1,413**	2,296
Short-term investments	**71**	42	**214**	87
Total interest and dividend income	**10,731**	15,491	**35,449**	46,353
Interest expense				
Interest on deposits	**1,519**	2,322	**5,359**	7,206
Interest on short-term borrowings	**20**	68	**113**	286
Interest on long-term debt	**163**	276	**560**	838
Total interest expense	**1,702**	2,666	**6,032**	8,330
Net interest income	**9,029**	12,825	**29,417**	38,023
Provision for loan losses	**5,100**	7,900	**47,300**	32,325
Net interest income after provision for loan losses	**3,929**	4,925	**(17,883)**	5,698
Noninterest income				
Service charges on deposit accounts	**1,564**	1,674	**4,626**	4,804
Other service charges, commissions and fees	**368**	323	**966**	1,020
Trust department income	**1,096**	1,046	**3,348**	3,092
Brokerage income	**364**	372	**1,148**	1,260
Mortgage banking activities	**931**	927	**2,143**	2,259
Earnings on life insurance	**251**	256	**749**	836
Merchant processing revenue	**149**	1,310	**149**	1,850
Other income	**159**	692	**145**	916
Investment securities gains (losses)	**(2)**	2,351	**4,824**	3,199
Total noninterest income	**4,880**	8,951	**18,098**	19,236
Noninterest expense				
Salaries and employee benefits	**4,874**	4,690	**14,508**	13,698
Occupancy expense	**491**	477	**1,518**	1,516
Furniture and equipment	**754**	672	**2,159**	2,045
Data processing	**171**	375	**434**	1,036
Telephone	**137**	141	**479**	482
Advertising and bank promotions	**434**	276	**1,115**	830
FDIC Insurance	**788**	690	**2,019**	2,002
Professional services	**729**	1,125	**2,281**	1,993
Taxes other than income	**231**	226	**695**	636
Collection expense	**593**	359	**1,890**	690
OREO Expense	**230**	235	**706**	313
Intangible asset amortization	**52**	52	**157**	157

Other operating expenses		**1,649**		1,509		**4,788**		4,590
Total noninterest expenses		**11,133**		10,827		**32,749**		29,988
Income (loss) before income tax (benefit)		**(2,324)**		3,049		**(32,534)**		(5,054)
Income tax expense (benefit)		**19,028**		(1,265)		**6,950**		(2,572)
Net income (loss)	**$**	**(21,352)**	$	4,314	**$**	**(39,484)**	$	(2,482)
Per share information:								
Basic earnings (loss) per share	**$**	**(2.65)**	$	0.54	**$**	**(4.90)**	$	(0.31)
Diluted earnings (loss) per share		**(2.65)**		0.54		**(4.90)**		(0.31)
Dividends per share		**0.00**		0.23		**0.00**		0.69

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

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Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

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

	Three Months Ended		**Nine Months Ended**	
(Dollars in thousands)	**September 30, 2012**	**September 30, 2011**	**September 30, 2012**	**September 30, 2011**
Net income (loss)	**$ (21,352)**	$ 4,314	**$ (39,484)**	$ (2,482)
Other comprehensive income (loss), net of tax:				
Unrealized holding gains (losses) on securities available for sale arising during the period	**1,603**	7,479	**2,522**	13,132
Reclassification adjustment for (gains) losses realized in net income (loss)	**2**	(2,351)	**(4,824)**	(3,199)
Net unrealized gains (losses)	**1,605**	5,128	**(2,302)**	9,933
Tax effect	**(562)**	(1,795)	**806**	(3,477)
	1,043	3,333	**(1,496)**	6,456
Unrealized holding gains (losses) in fair value of derivatives used for cash flow hedges	**0**	2	**0**	(127)
Reclassification adjustment for (gains) realized in net income	**0**	(673)	**0**	(791)
Net unrealized gains (losses)	**0**	(671)	**0**	(918)
Tax effect	**0**	235	**0**	322
	0	(436)	**0**	(596)
Total other comprehensive income (loss), net of tax and reclassification adjustments	**1,043**	2,897	**(1,496)**	5,860
Total comprehensive income (loss)	**$ (20,309)**	$ 7,211	**$ (40,980)**	$ 3,378

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

	Nine Months Ended September 30, 2012 and 2011					
(Dollars in thousands, except per share data)	**Common Stock**	**Additional Paid-In Capital**	**Retained Earnings (Accumulated Deficit)**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total Shareholders Equity**
Balance, January 1, 2011	$ 416	$ 121,508	$ 38,680	($ 88)	($ 32)	$ 160,484
Net income (loss)	0	0	(2,482)	0	0	(2,482)
Total other comprehensive income, net of taxes	0	0	0	5,860	0	5,860
Cash dividends ($0.69 per share)	0	0	(5,522)	0	0	(5,522)
Stock-based compensation plans:						
Issuance of stock	1	507	0	0	0	508
Issuance of stock through dividend reinvestment plan	2	328	0	0	0	330
Purchase of treasury stock (2,232 shares)	0	0	0	0	(54)	(54)
Issuance of treasury stock (2,719 shares)	0	(19)	0	0	66	47
Balance, September 30, 2011	$ 419	$ 122,324	$ 30,676	$ 5,772	($ 20)	$ 159,171
Balance, January 1, 2012	**$ 419**	**$ 122,514**	**$ 1,195**	**$ 4,089**	**($ 20)**	**$ 128,197**
Net income (loss)	**0**	**0**	**(39,484)**	**0**	**0**	**(39,484)**
Total other comprehensive income (loss), net of taxes	**0**	**0**	**0**	**(1,496)**	**0**	**(1,496)**
Stock-based compensation plans:						
Issuance of stock (8,879 shares)	**1**	**68**	**0**	**0**	**0**	**69**
Compensation expense	**0**	**23**	**0**	**0**	**0**	**23**
Issuance of stock through dividend reinvestment plan (1,407 shares)	**0**	**11**	**0**	**0**	**0**	**11**
Balance, September 30, 2012	**$ 420**	**$ 122,616**	**($ 38,289)**	**$ 2,593**	**($ 20)**	**$ 87,320**

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

(Dollars in Thousands, Except per Share Data)	**Nine Months Ended September 30, 2012**	**Nine Months Ended September 30, 2011**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	**$ (39,484)**	$ (2,482)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of premiums on securities available for sale	**5,251**	4,045
Depreciation and amortization	**1,963**	2,055
Provision for loan losses	**47,300**	32,325
Net change in loans held for sale	**(5,496)**	(4,777)
Net (gain) loss on disposal of other real estate owned	**8**	(30)
Writedown of other real estate owned	**436**	350
Net gain on disposal of bank premises and equipment	**0**	2
Deferred income taxes, including valuation allowance	**20,384**	(5,827)
Investment securities gains	**(4,824)**	(3,199)
Gain on sale of rate swap	**0**	(791)
Earnings on cash surrender value of life insurance	**(650)**	(754)
Decrease in accrued interest receivable	**852**	543
(Decrease) in accrued interest payable	**(483)**	(106)
Other, net	**(14,423)**	(568)
Net cash provided by operating activities	**10,834**	20,786
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (increase) in interest bearing deposits with banks and short term investments	**(3,605)**	(61,993)
Sales of available for sale securities	**94,099**	102,665
Maturities, repayments and calls of available for sale securities	**59,889**	42,674
Purchases of available for sale securities	**(138,000)**	(58,588)
Net change in restricted investments in bank stocks	**1,143**	(959)
Net (increase) decrease in loans	**84,403**	(49,647)
Proceeds from sale of loans	**19,702**	0
Investment in limited partnerships	**0**	(254)
Purchases of bank premises and equipment	**(1,245)**	(895)
Proceeds from disposal of other real estate owned	**2,383**	388
Proceeds from sale of rate swap	**0**	911
Purchases of bank owned life insurance	**0**	(500)
Net cash provided (used) by investing activities	**118,769**	(26,198)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase (decrease) in deposits	**(96,439)**	98,510
Net decrease in short term purchased funds	**(22,947)**	(60,316)
Payments on long-term debt	**(15,990)**	(31,058)
Dividends paid	**0**	(5,522)
Proceeds from issuance of common stock	**103**	838
Purchase of treasury stock	**0**	(54)
Net proceeds from issuance of treasury stock	**0**	47
Net cash provided (used) by financing activities	**(135,273)**	2,445

Net decrease in cash and cash equivalents	**(5,670)**	(2,967)
Cash and cash equivalents at beginning of period	**19,630**	19,200
Cash and cash equivalents at end of period	**$ 13,960**	$ 16,233
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	**$ 6,515**	$ 8,436
Income taxes	**1,267**	3,657
Supplemental schedule of noncash investing activities:		
Other real estate acquired in settlement of loans	**$ 3,237**	$ 2,239

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

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Notes to Consolidated Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Basis of Presentation The unaudited financial statements of the Company and its subsidiary are presented for the three and nine months ended September 30, 2012 and 2011 and have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. However, unaudited information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, considered necessary for a fair presentation of the financial position, results of operations and cash flows for the interim period. Information presented at December 31, 2011 is condensed from audited year-end financial statements. For further information, refer to the audited consolidated financial statements and footnotes thereto, included in the Annual Report on Form 10-K for the year ended December 31, 2011.

All significant intercompany transactions and accounts have been eliminated. Operating results for the three and nine months ended September 30, 2012, are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

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

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

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

Subsequent Events - GAAP establishes standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The subsequent events principle sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements,

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identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and specifies the disclosures that should be made about events or transactions that occur after the balance sheet date. In preparing these financial statements, the Company evaluated the events and transactions that occurred after September 30, 2012, through the date these financial statements were filed with the Securities and Exchange Commission (the Commission).

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

The types of securities the Company invests in are included in Note 2, Securities Available for Sale and the type of lending the Company engages in are included in Note 3, Loans Receivable and Allowance for Loan Losses.

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

Restricted Investments in Bank Stocks - Restricted investment in bank stocks, which represents required investments in the common stock of correspondent banks, is carried at cost as of September 30, 2012 and December 31, 2011, and consists of common stock of the Federal Reserve Bank of Philadelphia, Atlantic Central Bankers Bank and the Federal Home Loan Bank (FHLB) of Pittsburgh stocks.

Management evaluates the restricted investment in bank stocks for impairment in accordance with Accounting Standard Codification (ASC) Topic 942, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others.* Management s determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the correspondent bank as compared to the capital stock amount for the correspondent bank and the length of time this situation has persisted, (2) commitments by the correspondent bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of the correspondent bank, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the correspondent bank.

Management believes no impairment charge is necessary related to the restricted investment in bank stocks as of September 30, 2012. However, security impairment analysis is completed quarterly and the determination that no impairment had occurred as of September 30, 2012 is no assurance that impairment may not occur in the future.

Interest-Bearing Deposits in Banks - Interest bearing deposits in banks are due on demand or mature within one year and are carried at cost.

Securities - Certain debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. As of September 30, 2012 and December 31, 2011 the Company had no held to maturity or trading securities. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

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The Company follows the accounting guidance related to recognition and presentation of other-than-temporary impairment (FASB ASC 320-10). This guidance specifies that (*a*) if a company does not have the intent to sell a debt security prior to recovery and (*b*) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held-to-maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment should be amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

The Company had no debt securities it deemed to be other than temporarily impaired at September 30, 2012 and December 31, 2011.

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

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

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

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

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and amortized as a yield adjustment over the respective term of the loan.

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

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

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

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

Loans Serviced - The Bank administers secondary market mortgage programs available through the FHLB of Pittsburgh and the Federal National Mortgage Association and offers residential mortgage products and services to customers. The Bank originates single-family residential mortgage loans for immediate sale in the secondary market, and retains the servicing of those loans. At September 30, 2012 and December 31, 2011 the balance of loans serviced for others was $316,088,000 and $299,998,000.

Transfers of Financial Assets - Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Foreclosed Real Estate - Real estate properties acquired through, or in lieu of, loan foreclosure are initially recorded at the lower of carrying value or fair value less estimated costs to sell the underlying collateral. Capitalized costs include accrued interest and any costs that significantly improve the value of the properties. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of its carrying amount or fair value less estimated costs to sell. Foreclosed real estate totaled $2,575,000 and $2,165,000 as of September 30, 2012 and December 31, 2011 and is included in other assets.

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

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

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management s judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized. The Company recognizes interest and penalties, if any, on income taxes as a component of income tax expense.

Treasury Stock - Common stock shares repurchased are recorded as treasury stock at cost.

Earnings Per Share - Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect the additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate solely to outstanding stock options.

Treasury shares are not deemed outstanding for earnings per share calculations.

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

The component of accumulated other comprehensive income, net of taxes, at September 30, 2012 and December 31, 2011 consisted of unrealized gains on securities available for sale and totaled $2,593,000 and $4,089,000.

Fair Value of Financial Instruments - Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

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

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

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* The ASU requires certain disclosures about transfers between Level 1 and Level 2 of the fair value hierarchy, sensitivity of fair value measurements categorized within Level 3 of the fair value hierarchy, and categorization by level of items that are reported at cost but are required to be disclosed at fair value. The disclosures are to be applied prospectively in the first interim and annual periods beginning after December 15, 2011. The adoption of this standard did not have a material impact on the Company s consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05,* which defers certain provisions of ASU 2011-05, *Presentation of Comprehensive Income*. One of ASU 2011-05 s provisions requires entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented (for both interim and annual financial statements). Accordingly, this requirement is indefinitely deferred by ASU 2011-12 and will be further deliberated by the FASB at a future date. ASUs 2011-05 and 2011-12 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and should be applied retrospectively for all periods presented in the financial statements. The Company adopted the provisions of this guidance which are incorporated in these consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*. The ASU requires new disclosures regarding the nature of an entity s rights of setoff and related arrangements associated with its financial instruments and derivative instruments. The new disclosures are designed to make GAAP financial statements more comparable to those prepared under International Financial Reporting Standards. The new disclosures entail presenting information about both gross and net exposures. The new disclosure requirements are effective for annual reporting periods beginning on or after January 1, 2013, and interim periods therein; retrospective application is required. The Company has not yet completed its evaluation of this ASU; however, since the provisions of ASU 2011-11 are disclosure-related, the Company s adoption of this ASU is not expected to have an impact to its financial condition or results of operations.

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NOTE 2. SECURITIES AVAILABLE FOR SALE

At September 30, 2012 and December 31, 2011, the investment securities portfolio was comprised exclusively of securities classified as available for sale , resulting in investment securities being carried at fair value. The amortized cost and fair values of investment securities available for sale at September 30, 2012 and December 31, 2011 were:

(Dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2012				
U.S. Treasury	**$ 25,995**	**$ 12**	**$ 0**	**$ 26,007**
U.S. Government Sponsored Enterprises (GSE)	**45,063**	**450**	**5**	**45,508**
States and political subdivisions	**35,788**	**1,553**	**4**	**37,337**
GSE residential mortgage-backed securities	**180,763**	**2,018**	**53**	**182,728**
Total debt securities	**287,609**	**4,033**	**62**	**291,580**
Equity securities	**50**	**19**	**0**	**69**
Totals	**$ 287,659**	**$ 4,052**	**$ 62**	**$ 291,649**
December 31, 2011				
U.S. Government Sponsored Enterprises (GSE)	$ 41,563	$ 2,081	$ 22	$ 43,622
States and political subdivisions	75,232	2,852	33	78,051
GSE residential mortgage-backed securities	186,018	1,783	217	187,584
Total debt securities	302,813	6,716	272	309,257
Equity securities	1,260	41	193	1,108
Totals	$ 304,073	$ 6,757	$ 465	$ 310,365

The following table shows gross unrealized losses and fair value of the Company s available for sale securities that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2012 and December 31, 2011:

	Less Than 12 Months		12 Months or More		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2012						
U.S. Government Sponsored Enterprises (GSE)	**$ 2,199**	**$ 5**	**$ 0**	**$ 0**	**$ 2,199**	**$ 5**
States and political subdivisions	**889**	**4**	**0**	**0**	**889**	**4**
GSE residential mortgage-backed securities	**9,841**	**20**	**3,421**	**33**	**13,262**	**53**
Total temporarily impaired securities	**$ 12,929**	**$ 29**	**$ 3,421**	**$ 33**	**$ 16,350**	**$ 62**
December 31, 2011						
U.S. Government Sponsored Enterprises (GSE)	$ 8,685	$ 22	$ 0	$ 0	$ 8,685	$ 22
States and political subdivisions	0	0	1,467	33	1,467	33
GSE residential mortgage-backed securities	45,019	217	0	0	45,019	217
Total debt securities	53,704	239	1,467	33	55,171	272
Equity securities	751	193	0	0	751	193
Total temporarily impaired securities	$ 54,455	$ 432	$ 1,467	$ 33	$ 55,922	$ 465

The Company had 7 securities and 35 securities at September 30, 2012 and December 31, 2011 in which the amortized cost exceeds their values, as discussed below.

U.S. Treasuries and Government Sponsored Enterprises (GSE). Six GSE securities, including mortgage-backed securities, have amortized costs which exceed their fair values, all but one of which are in the less than 12 months category at September 30, 2012. At December 31, 2011, the Company had 15 GSE securities with unrealized losses, all of which were in the less than 12 months category. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2012 or at December 31, 2011.

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State and Political Subdivisions. One state and political subdivision security had an amortized cost which exceeded its fair value for less than 12 months at September 30, 2012. At December 31, 2011, two state and political subdivision securities had unrealized losses, both of which were greater than 12 months. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. Management considers the investment rating, the state of the issuer of the security and other credit support in determining whether the security is other-than-temporarily impaired. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2012 or at December 31, 2011.

Equity Securities. Zero equity securities have cost which exceeds their fair value, at September 30, 2012. At December 31, 2011, 18 equity securities had unrealized losses, all of which had unrealized losses for less than 12 months. These securities are among various industries, including financial, industrial, consumer, energy, health care and a large cap fund, In considering whether the equity securities are other-than-temporarily impaired, management reviews the severity and duration of decline in fair value, research reports, analysts recommendations, credit rating changes, news stories and other relevant information. Management believes the equity securities are not other-than-temporarily impaired and will equal or exceed our cost basis within a reasonable period of time. Since these companies are considered viable and carry the possibility of price appreciation in the future, impairments are considered temporary. The Company recorded no other than temporary impairment expense on equity securities for the three or nine months ended September 30, 2012 and 2011.

The amortized cost and fair values of securities available for sale at September 30, 2012 by contractual maturity are shown below. Contractual maturities will differ from expected maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale	
(Dollars in thousands)	**Amortized Cost**	**Fair Value**
Due in one year or less	**$ 7,760**	**$ 7,818**
Due after one year through five years	**56,816**	**56,971**
Due after five years through ten years	**25,567**	**26,337**
Due after ten years	**16,703**	**17,726**
GSE residential mortgage-backed securities	**180,763**	**182,728**
Total debt securities	**287,609**	**291,580**
Equity securities	**50**	**69**
	$ 287,659	**$ 291,649**

Gross gains on the sales of securities were $20,000 and $2,373,000 for the quarters ended September 30, 2012 and 2011. Gross losses on the sales of securities available for sale were $22,000 and $22,000 for the quarters ended September 30, 2012 and 2011. Gross gains on the sales of securities were $4,986,000 and $3,294,000 for the nine months ended September 30, 2012 and 2011. Gross losses on the sales of securities were $162,000 and $95,000 for the nine months ended September 30, 2012 and 2011.

Securities with a fair value of $272,643,000 and $283,501,000 at September 30, 2012 and December 31, 2011 were pledged to secure public funds and for other purposes as required or permitted by law.

NOTE 3. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

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

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

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

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

Acquisition and development loans consist of 1-4 family residential construction and commercial and land development loans. The risk of loss on these loans is largely dependent on the Company s ability to assess the property s value at the completion of the project, which should exceed the property s construction costs. During the construction phase, a number of factors could potentially negatively impact the collateral value, including cost overruns, delays in completing the project, competition, and real estate market conditions which may change based on the supply of similar properties in the area. In the event the collateral value at the completion of the project is not sufficient to cover the outstanding loan balance, the Company must rely upon other repayment sources, including the guarantors of the project or other collateral securing the loan.

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

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

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

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

The loan portfolio, excluding residential loans held for sale, broken out by classes, as of September 30, 2012 and December 31, 2011 was as follows:

(Dollars in thousands)	**September 30, 2012**	**December 31, 2011**
Commercial real estate:		
Owner-occupied	**$ 162,246**	$ 199,646
Non-owner occupied	**146,527**	141,037
Multi-family	**29,512**	27,327
Acquisition and development:		
1-4 family residential construction	**4,409**	7,098
Commercial and land development	**42,920**	77,564
Commercial and industrial	**199,662**	277,900
Residential mortgage:		
First lien	**114,166**	104,327
Home equity - term	**14,717**	37,513
Home equity - Lines of credit	**82,274**	80,951
Installment and other loans	**7,305**	12,077
	$ 803,738	$ 965,440

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

The Bank has a loan review policy and program which is designed to reduce and control risk in the lending function. The Credit Administration Committee, comprised of members of the Board, is charged with the overall credit quality and risk exposure of the Company s loan portfolio. This includes the monitoring of the lending activities of all Bank personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The loan review program provides the Bank with an internal (through an outsourced third party beginning in 2011), independent review of the Bank s loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession or death of the borrower occurs, which heightens awareness as to a possible credit event.

Loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $1,000,000. Loan review documentation is submitted to the Credit Administration Committee quarterly with a formal review and rating as presented by independent loan review personnel. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed by the Credit Administration Committee on a quarterly basis, with reaffirmation of the rating as recommended by the Bank s Problem Loan Committee or independent loan review personnel. In addition to the policy and procedure guidelines noted above, the Company expanded its review coverage during the last three quarters of 2011 in light of softness in overall economic conditions and deterioration of underlying collateral securing lending relationships. As a result, all commercial real estate, construction and development loans, and commercial loans in excess of $500,000, representing over 75% coverage of these portfolios, have been reviewed. The Company will continue with this expanded review throughout 2012.

The following summarizes the Bank s ratings based on its internal risk rating system as of September 30, 2012 and December 31, 2011:

(Dollars in thousands)	**Pass**	**Special Mention**	**Non-Impaired Substandard**	**Impaired Substandard**	**Doubtful**	**Total**
September 30, 2012						
Commercial real estate:						
Owner-occupied	**$ 130,756**	**$ 12,846**	**$ 9,671**	**$ 8,785**	**$ 188**	**$ 162,246**
Non-owner occupied	**105,472**	**11,805**	**14,860**	**14,390**	**0**	**146,527**
Multi-family	**17,685**	**7,657**	**1,951**	**2,219**	**0**	**29,512**
Acquisition and development:						
1-4 family residential construction	**1,871**	**434**	**0**	**1,386**	**718**	**4,409**
Commercial and land development	**15,602**	**8,420**	**5,228**	**13,053**	**617**	**42,920**
Commercial and industrial	**157,319**	**18,813**	**8,867**	**12,902**	**1,761**	**199,662**
Residential mortgage:						
First lien	**105,599**	**2,478**	**1,999**	**4,090**	**0**	**114,166**
Home equity - term	**14,375**	**55**	**238**	**49**	**0**	**14,717**
Home equity - Lines of credit	**78,779**	**1,272**	**1,495**	**529**	**199**	**82,274**
Installment and other loans	**7,277**	**14**	**6**	**8**	**0**	**7,305**
	$ 634,735	**$ 63,794**	**$ 44,315**	**$ 57,411**	**$ 3,483**	**$ 803,738**
December 31, 2011						
Commercial real estate:						
Owner-occupied	$ 161,695	$ 19,820	$ 8,321	$ 8,828	$ 982	$ 199,646
Non-owner occupied	93,379	19,689	7,785	16,661	3,523	141,037
Multi-family	14,896	7,581	1,387	1,328	2,135	27,327
Acquisition and development:						
1-4 family residential construction	3,361	724	831	2,182	0	7,098
Commercial and land development	28,513	16,274	13,713	19,064	0	77,564
Commercial and industrial	190,675	19,859	14,232	50,047	3,087	277,900
Residential mortgage:						
First lien	102,398	0	596	1,333	0	104,327
Home equity - term	36,290	0	638	585	0	37,513
Home equity - Lines of credit	80,881	0	70	0	0	80,951
Installment and other loans	12,075	0	2	0	0	12,077
	$ 724,163	$ 83,947	$ 47,575	$ 100,028	$ 9,727	$ 965,440

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

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

As of September 30, 2012 and December 31, 2011, nearly all of the Company s impaired loans extent of impairment was measured based on the estimated fair value of the collateral securing the credit, except for certain troubled debt restructurings not in nonaccrual status. By definition, troubled debt restructurings are considered impaired. For real estate loans, collateral generally consists of commercial real estate, but in the case of commercial and industrial loans, it would also consist of accounts receivable, inventory, equipment or other business assets. Commercial and industrial loans may also have real estate collateral.

At the time a real estate-secured loan is deemed impaired, management determines whether an updated certified appraisal of the real estate is necessary to assist in determining the extent of an impairment reserve, if any. The decision for requiring an updated appraisal takes into consideration the age of the most recent appraisal, the loan-to-value ratio based on the original certified appraisal, the Company s recent experience and knowledge of market conditions, recent list prices or broker opinions, the condition of the property, and environmental factors. If market conditions have changed significantly from the date of the most recent appraisal, an updated appraisal will be obtained. As of October 1, 2011, the Company amended its policy, which now requires annual updated appraisals for criticized loans in excess of $250,000. In many cases the as is value provided in the appraisal is used as the fair value of the collateral in determining impairment, unless circumstances, such as subsequent improvements, approvals, or other circumstances dictate that another value provided by the appraiser is more appropriate.

Generally impaired loans secured by real estate were measured at fair value using certified real estate appraisals that had been completed within the last year. Appraised values are further discounted for estimated costs to sell the property and other selling considerations to arrive at the property s fair value. In those situations in which it is determined an updated appraisal is not required for loans individually evaluated for impairment, fair values are based on one or a combination of the following approaches. In those situations in which a combination of approaches is considered, the one that carries the most consideration will be the one management believes is warranted. The approaches are as follows:

Original appraisal - if the original appraisal provides a strong loan-to-value (generally 70% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the Credit Administration staff that there has not been a significant deterioration in the collateral value, the original certified appraised value may be used. Discounts as deemed appropriate for selling costs are factored into the appraised value in arriving at fair value.

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

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

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The Company distinguishes Substandard loans on both an impaired and non-impaired basis, as it places less emphasis on a loan s classification, and increased reliance on whether the loan was performing in accordance with the contractual terms. Substandard classification does not automatically meet the definition of impaired . A Substandard credit is one that is inadequately protected by current sound worth or paying capacity of the obligor or the collateral pledged, if any. Extensions of credit so classified have well-defined weaknesses which may jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of Substandard credits, does not have to exist in individual extensions of credit classified Substandard. As a result, the Company revised its methodology in its evaluation of certain accruing commercial real estate, acquisition and development and commercial and industrial loans rated Substandard to be collectively evaluated for impairment as opposed to evaluating these loans individually for impairment. Although we believe these loans have well defined weaknesses and meet the definition of Substandard , they are generally performing and management has concluded that it is likely it will be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement.

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

The following summarizes impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required as of September 30, 2012 and December 31, 2011. In the first quarter of 2012, the Company began to more aggressively charge off specific reserve allocations on impaired loans rather than to carry related allowances. At December 31, 2011, specific reserves related to anticipated closing costs, additional market discounts on appraisal values and specific reserves identified during periods subsequent to the balance sheet. Allowances established at September 30, 2012 generally pertain to those credits in which an updated appraisal is pending, and the partial charge-off will be recorded when received.

	Impaired Loans with a Specific Allowance			Impaired Loans with No Specific Allowance	
(Dollars in thousands)	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)	Related Allowance	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)
September 30, 2012					
Commercial real estate:					
Owner-occupied	**$ 0**	**$ 0**	**$ 0**	**$ 8,973**	**$ 10,821**
Non-owner occupied	**1,266**	**1,266**	**333**	**13,124**	**18,642**
Multi-family	**0**	**0**	**0**	**2,219**	**2,767**
Acquisition and development:					
1-4 family residential construction	**718**	**725**	**413**	**1,386**	**3,896**
Commercial and land development	**617**	**624**	**363**	**13,053**	**28,085**
Commercial and industrial	**1,852**	**1,866**	**1,089**	**12,811**	**17,086**
Residential mortgage:					
First lien	**450**	**450**	**4**	**3,640**	**3,880**
Home equity - term	**0**	**0**	**0**	**49**	**162**
Home equity - lines of credit	**199**	**199**	**60**	**529**	**529**
Consumer	**0**	**0**	**0**	**8**	**8**
	$ 5,102	**$ 5,130**	**$ 2,262**	**$ 55,792**	**$ 85,876**
December 31, 2011					
Commercial real estate:					
Owner-occupied	$ 5,016	$ 5,200	$ 1,762	$ 4,794	$ 4,838
Non-owner occupied	16,682	20,472	6,876	3,502	4,071
Multi-family	3,129	5,117	1,213	334	334
Acquisition and development:					
1-4 family residential construction	2,182	3,715	926		
Commercial and land development	10,657	13,899	4,369	8,407	9,712
Commercial and industrial	46,685	47,256	14,591	6,449	6,551

Residential mortgage:					
First lien	1,122	1,122	9	211	211
Home equity - term	41	41	42	544	709
Home equity - lines of credit	0	0	0	0	0
Consumer	0	0	0	0	0
	$ 85,514	$ 96,822	$ 29,788	$ 24,241	$ 26,426

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The following summarizes the average recorded investment in impaired loans and related interest income recognized on loans deemed impaired as of September 30:

	Three Months Ended September 30,			
	2012		2011	
(Dollars in thousands)	Average Impaired Balance	Interest Income Recognized	Average Impaired Balance	Interest Income Recognized
Commercial real estate:				
Owner-occupied	**$ 8,499**	$ 48	$ 5,500	$ 38
Non-owner occupied	**14,928**	37	5,376	90
Multi-family	**1,203**	120	3,423	14
Acquisition and development:				
1-4 family residential construction	**2,049**	21	131	1
Commercial and land development	**13,608**	100	9,109	36
Commercial and industrial	**15,799**	73	33,171	351
Residential mortgage:				
First lien	**3,459**	41	463	17
Home equity - term	**46**	1	710	6
Home equity lines of credit	**383**	17	0	0
Installment and other loans	**6**	1	0	0
Total	**$ 59,980**	$ 459	$ 57,883	$ 553

	Nine months Ended September 30,			
	2012		2011	
(Dollars in thousands)	Average Impaired Balance	Interest Income Recognized	Average Impaired Balance	Interest Income Recognized
Commercial real estate:				
Owner-occupied	**$ 9,864**	$ 92	$ 3,210	$ 236
Non-owner occupied	**17,099**	397	3,479	335
Multi-family	**2,008**	120	1,734	207
Acquisition and development:				
1-4 family residential construction	**1,881**	23	65	3
Commercial and land development	**14,863**	287	4,554	244
Commercial and industrial	**30,320**	299	21,936	1,093
Residential mortgage:				
First lien	**2,184**	68	466	23
Home equity - term	**311**	3	710	10
Home equity lines of credit	**191**	17	0	0
Installment and other loans	**3**	2	0	0
Total	**$ 78,724**	$ 1,308	$ 36,154	$ 2,151

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The following presents impaired loans that are troubled debt restructurings, as well as the number of loans modified as of September 30, 2012 and December 31, 2011:

	Troubled Debt Restructurings At Period End		New Troubled Debt Restructurings Nine Months Ended September 30, 2012	
(Dollars in thousands)	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
September 30, 2012				
Accruing:				
Commercial real estate:				
Non-owner occupied	**2**	**$ 1,995**	**0**	**$ 0**
Multi-family	**0**	**0**	**0**	**0**
Commercial and industrial	**2**	**330**	0	0
Residential mortgage:				
First lien	**2**	**752**	**1**	**301**
Home equity - lines of credit	**1**	**36**	**1**	**36**
	7	**3,113**	**2**	**337**
Nonaccruing:				
Owner-occupied	**2**	**689**	**0**	**0**
Non-owner occupied	**1**	**193**	**0**	**0**
Acquisition and development:				
Commercial and land development	**3**	**1,159**	**0**	**0**
Commercial and industrial	**7**	**3,160**	**1**	**197**
	13	**5,201**	**1**	**197**
	20	**$ 8,314**	**3**	**$ 534**

	Troubled Debt Restructurings At Period End		New Troubled Debt Restructurings Year Ended December 31, 2011	
(Dollars in thousands)	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
December 31, 2011				
Accruing:				
Commercial real estate:				
Owner-occupied	1	$ 924	1	$ 924
Nonowner occupied	2	2,039	2	2,039
Acquisition and development:				
Commercial and land development	2	1,061	2	1,061
Commercial and industrial	10	23,434	10	23,434
Residential mortgage:				
First lien	1	459	0	0
	16	27,917	15	27,458
Nonaccruing:				
Commercial real estate:				
Owner-occupied	1	54	1	54
Non-owner occupied	1	221	1	221

Acquisition and development:				
Commercial and land development	3	3,179	3	3,179
Commercial and industrial	10	5,648	10	5,648
Residential mortgage:				
Home equity term	1	544	0	0
	16	9,646	15	9,102
	32	$ 37,563	30	$ 36,560

The loans presented above were considered troubled debt restructurings as the result of the Company agreeing to below market interest rates for the risk of the transaction, allowing the loan to remain on interest only status, or for residential mortgage loans, agreeing to a temporary reduction in interest rates for periods not exceeding 12 months in order to assist the borrowers to improve cash flows during such periods.

Troubled debt restructurings included in nonaccrual status at September 30, 2012 were designated as such either due to the borrower defaulting on the modified terms within the past twelve months, or management s determination the borrower would not be able to continue to meet debt service requirements for a sustainable period of time or where newly restructured debts had not yet reached a minimum of 6 months of performance according to modifications. As of September 30, 2012, 13 loans totaling $5,201,000 were in default of their restructured terms.

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No additional commitments have been made to borrowers whose loans are considered troubled debt restructurings.

Management further monitors the performance and credit quality of the loan portfolio by analyzing the length of time a portfolio is past due, by aggregating loans based on its delinquencies. The following table presents the classes of the loan portfolio summarized by aging categories of performing loans and nonaccrual loans as of September 30, 2012 and December 31, 2011:

		Days Past Due					
	Current	30-59	60-89	90+ (still accruing)	Total Past Due	Non-Accrual	Total Loans
September 30, 2012							
Commercial real estate:							
Owner-occupied	**$ 152,154**	**$ 922**	**$ 0**	**$ 197**	**$ 1,119**	**$ 8,973**	**$ 162,246**
Non-owner occupied	**134,132**	**0**	**0**	**0**	**0**	**12,395**	**146,527**
Multi-family	**27,293**	**0**	**0**	**0**	**0**	**2,219**	**29,512**
Acquisition and development:							
1-4 family residential construction	**2,305**	**0**	**0**	**0**	**0**	**2,104**	**4,409**
Commercial and land development	**27,186**	**976**	**931**	**157**	**2,064**	**13,670**	**42,920**
Commercial and industrial	**184,330**	**224**	**206**	**569**	**999**	**14,333**	**199,662**
Residential mortgage:							
First lien	**109,102**	**1,342**	**384**	**0**	**1,726**	**3,338**	**114,166**
Home equity - term	**14,490**	**178**	**0**	**0**	**178**	**49**	**14,717**
Home equity - Lines of credit	**81,485**	**98**	**0**	**0**	**98**	**691**	**82,274**
Installment and other loans	**7,122**	**174**	**1**	**0**	**175**	**8**	**7,305**
	$ 739,599	**$ 3,914**	**$ 1,522**	**$ 923**	**$ 6,359**	**$ 57,780**	**$ 803,738**
December 31, 2011							
Commercial real estate:							
Owner-occupied	$ 188,679	$ 2,135	$ 0	$ 0	$ 2,135	$ 8,832	$ 199,646
Non-owner occupied	122,816	75	0	0	75	18,146	141,037
Multi-family	23,864	0	0	0	0	3,463	27,327
Acquisition and development:							
1-4 family residential construction	4,916	0	0	0	0	2,182	7,098
Commercial and land development	59,121	440	0	0	440	18,003	77,564
Commercial and industrial	246,696	1,341	15	0	1,356	29,848	277,900
Residential mortgage:							
First lien	100,215	1,637	547	0	2,184	1,928	104,327
Home equity - term	35,998	283	9	0	292	1,223	37,513
Home equity - Lines of credit	80,783	98	0	0	98	70	80,951
Installment and other loans	11,932	141	2	0	143	2	12,077
	$ 875,020	$ 6,150	$ 573	$ 0	$ 6,723	$ 83,697	$ 965,440

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

For each loan class presented above, general allowances are provided for loans that are collectively evaluated for impairment, which is based on quantitative factors, principally historical loss trends for the respective loan class, adjusted for qualitative factors. Effective December 31, 2011, the historical loss factor was based on average charge-offs for the last eight quarters and applied to the entire pool of loans, excluding those loans evaluated for impairment under ASC 310-10-35. In addition, an additional adjustment to the historical loss factors is made to account for delinquency and other potential risk not elsewhere defined within the Allowance for Loan and Lease Loss methodology. The refinement to the methodology was made as management determined that the most recent eight quarters loss history as adjusted based on other portfolio analysis and applied to an entire pool of loans is a better reflection of the

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losses inherent on non-impaired loans within the portfolio. In making this determination, management considered current economic and real estate conditions, trends in historical charge-off percentages at the Company as well as peers.

In addition to the changes mentioned under ASC 450-20, the Company refined its methodology under ASC 310-10-35 in the manner in which partial charge offs are calculated. Based on management s assessment and in compliance with regulatory guidance, the Company will generally incur partial charge offs in total by the amount a loan s carrying value exceeds its fair value, less discount for market conditions and costs to dispose, eliminating the need for specific reserves. This will be accomplished by charging the loan off to a level below the fair market value, or appraisal value, of collateral less costs to sell. This method will result in the loan being carried at the fair market value of collateral, less any discount determined necessary based on current market conditions, less costs to dispose of the asset. In direct correlation with this change in methodology, the historical loss rates have been elevated when compared to prior periods which does affect the reserves held under ASC 450-20. Management believes this is a more conservative method for calculating the allowance for loan losses.

In addition to the quantitative analysis, additional reserves are allocated on loans collectively evaluated for impairment based on additional qualitative factors. The qualitative factors used by management to adjust the historical loss percentage to the anticipated loss allocation, which range from 0 8 basis points per factor, include:

Nature and Volume of Loans Loan growth in the current and subsequent quarters based on the Bank s targeted growth and strategic plan, coupled with the types of loans booked based on risk management and credit culture, and number of exceptions to loan policy; supervisory loan to value exceptions etc.

Concentrations of Credit and Changes within Credit Concentrations Factors considered including the Bank s overall portfolio makeup and managements evaluation relating to concentration risk management and the inherent risk associated with the concentrations identified.

Experience, Ability and Depth of Management/Lending staff Factors considered include the years experience of senior and middle management and the lending and loan review staff and turnover of the staff.

Other External Factors (Economic, Legal, Competition, Regulatory etc.) Ratios and factors considered include trends in the consumer price index (CPI); unemployment rates; housing price index; housing statistics compared to the prior year; bankruptcy rates; regulatory and legal environment risks and competition.

Activity in the allowance for loan losses for three months ended September 30, 2012 and 2011 is as follows:

(Dollars in thousands)	**Commercial Real Estate**	**Acquisition and Development**	**Commercial and Industrial**	**Residential Mortgage**	**Installment and Other**	**Unallocated**	**Total**
September 30, 2012							
Balance, beginning of period	**$ 15,204**	**$ 6,803**	**$ 11,334**	**$ 887**	**$ 69**	**$ 1,938**	**$ 36,235**
Provision for loan losses	**222**	**5,020**	**(171)**	**169**	**58**	**(198)**	**5,100**
Charge-offs	**(482)**	**(4,139)**	**(369)**	**(109)**	**(46)**	**0**	**(5,145)**
Recoveries	**258**	**13**	**233**	**4**	**2**	**0**	**510**
Balance, end of period	**$ 15,202**	**$ 7,697**	**$ 11,027**	**$ 951**	**$ 83**	**$ 1,740**	**$ 36,700**

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(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Installment and Other	Unallocated	Total
September 30, 2011							
Balance, beginning of period	$ 7,244	$ 5,026	$ 11,132	$ 2,150	$ 97	$ 1,563	$ 27,212
Provision for loan losses	5,466	3,084	(531)	(178)	38	21	7,900
Charge-offs	(4,179)	(2,707)	(2,466)	(64)	(23)	0	(9,439)
Recoveries	0	0	0	1	3	0	4
Balance, end of period	$ 8,531	$ 5,403	$ 8,135	$ 1,909	$ 115	$ 1,584	$ 25,677

Activity in the allowance for loan losses for nine months ended September 30, 2012 and 2011 is as follows:

(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Installment and Other	Unallocated	Total
September 30, 2012							
Balance, beginning of period	**$ 13,864**	**$ 9,708**	**$ 17,569**	**$ 933**	**$ 75**	**$ 1,566**	**$ 43,715**
Provision for loan losses	**21,994**	**11,419**	**13,216**	**384**	**113**	**174**	**47,300**
Charge-offs	**(22,328)**	**(14,116)**	**(20,183)**	**(381)**	**(115)**	**0**	**(57,123)**
Recoveries	**1,672**	**686**	**425**	**15**	**10**	**0**	**2,808**
Balance, end of period	**$ 15,202**	**$ 7,697**	**$ 11,027**	**$ 951**	**$ 83**	**$ 1,740**	**$ 36,700**
September 30, 2011							
Balance, beginning of period	$ 5,324	$ 1,767	$ 6,795	$ 1,863	$ 106	$ 165	$ 16,020
Provision for loan losses	8,632	8,918	13,069	249	38	1,419	32,325
Charge-offs	(5,433)	(5,282)	(11,729)	(204)	(47)	0	(22,695)
Recoveries	8	0	0	1	18	0	27
Balance, end of period	$ 8,531	$ 5,403	$ 8,135	$ 1,909	$ 115	$ 1,584	$ 25,677

The following summarizes the ending loan balance individually evaluated for impairment based upon loan segment, as well as the related allowance for loan loss allocation for each at September 30, 2012 and December 31, 2011:

(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Residential Mortgage	Installment and Other	Unallocated	Total
September 30, 2012							
Loans allocated by:							
Individually evaluated for impairment	**$ 25,582**	**$ 15,774**	**$ 14,663**	**$ 4,867**	**$ 8**	**$ 0**	**$ 60,894**
Collectively evaluated for impairment	**312,703**	**31,555**	**184,999**	**206,290**	**7,297**	**0**	**742,844**
	$ 338,285	**$ 47,329**	**$ 199,662**	**$ 211,157**	**$ 7,305**	**$ 0**	**$ 803,738**
Allowance for loan losses allocated by:							
Individually evaluated for impairment	**$ 333**	**$ 776**	**$ 1,089**	**$ 64**	**$ 0**	**$ 0**	**$ 2,262**
Collectively evaluated for impairment	**14,869**	**6,921**	**9,938**	**887**	**83**	**1,740**	**34,438**
	$ 15,202	**$ 7,697**	**$ 11,027**	**$ 951**	**$ 83**	**$ 1,740**	**$ 36,700**

December 31, 2011							
Loans allocated by:							
Individually evaluated for impairment	$ 33,457	$ 21,246	$ 53,134	$ 1,918	$ 0	$ 0	$ 109,755
Collectively evaluated for impairment	334,553	63,416	224,766	220,873	12,077	0	855,685
	$ 368,010	$ 84,662	$ 277,900	$ 222,791	$ 12,077	$ 0	$ 965,440
Allowance for loan losses allocated by:							
Individually evaluated for impairment	$ 9,851	$ 5,295	$ 14,591	$ 51	$ 0	$ 0	$ 29,788
Collectively evaluated for impairment	4,013	4,413	2,978	882	75	1,566	13,927
	$ 13,864	$ 9,708	$ 17,569	$ 933	$ 75	$ 1,566	$ 43,715

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NOTE 4. INCOME TAXES

The Company files income tax returns in the U. S. federal jurisdiction and the Commonwealth of Pennsylvania. The Bank also files an income tax return in the State of Maryland. The Company is no longer subject to U. S. federal or state income tax examination by tax authorities for years before 2009.

Included in the balance sheet at September 30, 2012 and December 31, 2011, are tax positions related to loan charge-offs for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the tax authority to an earlier period.

The components of income tax expense for the three and nine months ended September 30, 2012 and 2011 are summarized as follows:

(Dollars in thousands)	**Three Months Ended September 30, 2012**	**Three Months Ended September 30, 2011**	**Nine Months Ended September 30, 2012**	**Nine Months Ended September 30, 2011**
Current year provision:				
Federal	**$ (3,894)**	$ 722	**$ (13,388)**	$ 3,087
State	**0**	46	**(46)**	167
Deferred tax benefit	**3,050**	(2,033)	**512**	(5,826)
Valuation allowance on deferred taxes	**19,872**	0	**19,872**	0
Net income tax expense (benefit)	**$ 19,028**	$ (1,265)	**$ 6,950**	$ (2,572)

The components of the net deferred tax asset (liability), included in other assets or liabilities, are as follows:

(Dollars in thousands)	**September 30, 2012**	December 31, 2011
Deferred tax assets:		
Allowance for loan losses	**$ 16,470**	$ 19,517
Deferred compensation	**456**	443
Retirement plans and salary continuation	**1,440**	1,336
Stock compensation	**184**	176
Off balance sheet reserves	**324**	387
Nonaccrual loan interest	**333**	508
Low income housing credit carry forward	**357**	0
Net operating loss carry forward	**2,202**	0
Other	**211**	406
Total deferred tax assets	**21,977**	22,773
Valuation allowance	**(19,872)**	0
	2,105	22,773
Deferred tax liabilities:		
Depreciation	**1,243**	1,408
Net unrealized gains on securities available for sale	**1,396**	2,202
Purchase accounting adjustments	**595**	659
Other	**267**	322
Total deferred tax liabilities	**3,501**	4,591

Net deferred tax asset (liability)	**$ (1,396)**	$ 18,182

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. Management considers taxes paid in prior years, projected future taxable income and available tax planning strategies, and other factors in making this assessment. Based upon the level of historical taxable income, projections for future taxable income over the periods and other available evidence, management believed it was not more likely than not that the net deferred tax asset would be realized at September 30, 2012. Accordingly, a valuation allowance for the net amount of the deferred tax assets, or $19,872,000, which represented future deductible temporary differences on our tax returns, was established at September 30, 2012, compared to no valuation allowance at December 31, 2011. Primary factors contributing to this determination at September 30, 2012 included full carryback of 2012 s taxable loss to the prior two years taxable income, cumulative losses over the past 36 months, and continued uncertainty in economic recovery.

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As of September 30, 2012, the Company had federal net operating loss carry forwards of approximately $6,300,000, which will expire if unused, by the end of 2032. The Company also has federal tax credit carry forwards of $357,000 which will expire if unused by 2032.

NOTE 5. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITY

As of December 31, 2010, the Company had two interest rate swap agreements related to fixed rate loans. The Company used these interest rate swaps to reduce interest rate risks and to manage interest income. By entering into these agreements, the Company converted floating rate assets into fixed rate assets. These interest rate swap agreements were considered cash flow hedge derivative instruments that qualified for hedge accounting. A portion of the amount was included in other comprehensive income and was reclassified from other comprehensive income to the appropriate income statement line item as net settlements occurred.

During the nine months ended September 30, 2011, the Company sold its interest rate swaps and recognized a $791,000 in gains on the sales, which was included as ineffective, once it no longer qualified as a hedge. For the three months ended September 30, 2011, $673,000 in gains were recognized on the gain on sale. As of September 30, 2011, there were no interest rate swaps remaining.

A roll forward of the unrealized gains (losses) on the derivatives, and the effects on the Company s statements of operation for the three and nine months ended September 30, 2011 was as follows:

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Unrealized gains on derivatives in cash flow from hedging relationship, beginning of period	$ 671	$ 918
Amount of gain recognized in other comprehensive income on derivative for effective portion of cash flow hedge	28	159
Amount of gain reclassified from accumulated other comprehensive income into interest income	(26)	(261)
Amount of gain recognized as noninterest income for the ineffective portion of the cash flow hedge	(673)	(816)
Unrealized gains on derivatives in cash flow from hedging relationship, end of period	$ 0	$ 0

NOTE 6. SHAREHOLDERS EQUITY AND REGULATORY CAPITAL

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

Quantitative measures established by regulators to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (as set forth in the following table) of total and Tier 1 capital (as defined in regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Management believes that, as of September 30, 2012 and December 31, 2011 the Company and the Bank meet all capital adequacy requirements to which they are subject.

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As of September 30, 2012, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank s category. The Company and the Bank s actual capital ratios as of September 30, 2012 and December 31, 2011 are also presented in the table.

	Actual		Minimum Capital Requirement		Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions	
(Dollars in thousands)	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
September 30, 2012						
Total capital to risk weighted assets						
Orrstown Financial Services, Inc.	**$ 95,022**	**10.9%**	**$ 69,464**	**8.0%**	**n/a**	**n/a**
Orrstown Bank	**92,452**	**10.7%**	**69,437**	**8.0%**	**$ 86,796**	**10.0%**
Tier 1 capital to risk weighted assets						
Orrstown Financial Services, Inc.	**83,838**	**9.7%**	**34,732**	**4.0%**	**n/a**	**n/a**
Orrstown Bank	**81,272**	**9.4%**	**34,718**	**4.0%**	**52,078**	**6.0%**
Tier 1 capital to average assets						
Orrstown Financial Services, Inc.	**83,838**	**6.4%**	**52,221**	**4.0%**	**n/a**	**n/a**
Orrstown Bank	**81,272**	**6.2%**	**52,224**	**4.0%**	**65,280**	**5.0%**
December 31, 2011						
Total capital to risk weighted assets						
Orrstown Financial Services, Inc.	$ 134,621	13.0%	$ 83,090	8.0%	n/a	n/a
Orrstown Bank	127,529	12.3%	82,899	8.0%	$ 103,624	10.0%
Tier 1 capital to risk weighted assets						
Orrstown Financial Services, Inc.	121,249	11.7%	41,545	4.0%	n/a	n/a
Orrstown Bank	114,187	11.0%	41,450	4.0%	62,175	6.0%
Tier 1 capital to average assets						
Orrstown Financial Services, Inc.	121,249	8.2%	58,851	4.0%	n/a	n/a
Orrstown Bank	114,187	7.8%	58,682	4.0%	73,352	5.0%

NOTE 7. EARNINGS PER SHARE

Earnings per share for the three and nine months ended September 30, 2012 and September 30, 2011 were as follows:

(In thousands, except per share data)	Three Months Ended September 30,		Nine months Ended September 30,	
	2012	**2011**	**2012**	**2011**
Net income (loss)	**$ (21,352)**	$ 4,314	$ (39,484)	$ ($2,482)
Weighted average shares outstanding	**8,065**	8,027	8,062	8,005
Impact of common stock equivalents	**0**	0	0	13
Weighted average shares outstanding (diluted)	**8,065**	8,027	8,062	8,018
Per share information:				
Basic earnings (loss) per share	**$ (2.65)**	$ 0.54	$ (4.90)	$ (0.31)
Diluted earnings (loss) per share	**(2.65)**	0.54	(4.90)	(0.31)

Stock options for 305,000 and 43,000 shares of common stock were not considered in computing diluted earnings per share for the three months ended September 30, 2012 and 2011, and stock options for 305,000 and 307,000 shares of common stock were not considered for the nine months ended September 30, 2012 and 2011 as they were anti-dilutive.

NOTE 8. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financial needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

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The Company s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit and financial guarantees written is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

	Contract or Notional Amount	
(Dollars in thousands)	**September 30, 2012**	**December 31, 2011**
Commitments to fund:		
Revolving, open ended home equity loans	**$ 77,365**	$ 80,197
1-4 family residential construction loans	**926**	2,021
Commercial real estate, construction and land development loans	**836**	31,788
Commercial, industrial and other loans	**48,218**	91,530
Standby letters of credit	**14,740**	25,751

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer s credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management s credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, equipment, residential real estate, and income-producing commercial properties.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Company holds collateral supporting those commitments when deemed necessary by management. The current amount of liability, as of September 30, 2012 and December 31, 2011, for guarantees under standby letters of credit issued was not material.

The Company currently maintains a reserve in other liabilities totaling $927,000 and $782,000 at September 30, 2012 and December 31, 2011 for off-balance sheet credit exposures that currently are not funded, based on historical loss experience of the related loan class. For the three months ended September 30, 2012 and 2011, $76,000 and $0 was charged to other noninterest expense for this exposure, and for the nine months ended September 30, 2012 and 2011, the amount expensed was $145,000 and $250,000.

The Company has sold loans to the Federal Home Loan Bank of Chicago as part of its Mortgage Partnership Finance Program (MPF Program). Under the terms of the MPF Program, there is limited recourse back to the Company for loans that do not perform in accordance with the terms of the loan agreement. Each loan that is sold under the program is credit enhanced such that the individual loan s rating is raised to AA, as determined by the Federal Home Loan Bank of Chicago. The sum of total loans sold under the MPF Program was $132,735,000, with limited recourse back to the Company on these loans of $8,420,000. Many of the loans sold under the MPF Program have primary mortgage insurance, which reduces the Company s overall exposure.

NOTE 9. FAIR VALUE DISCLOSURES

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

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

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

Securities

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

The Company had no fair value liabilities at September 30, 2012 and December 31, 2011. A summary of assets at September 30, 2012 and December 31, 2011, measured at estimated fair value on a recurring basis was as follows:

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
September 30, 2012				
Securities available for sale:				
U.S. Treasury	**$ 0**	**$ 26,007**	**$ 0**	**$ 26,007**
U.S. Government Sponsored Enterprises (GSE)	**0**	**45,508**	**0**	**45,508**
States and political subdivisions	**0**	**37,337**	**0**	**37,337**
GSE residential mortgage-backed securities	**0**	**182,728**	**0**	**182,728**
Total debt securities	**0**	**291,580**	**0**	**291,580**
Equity securities:				
Financial services	**0**	**69**	**0**	**69**
Total equity securities	**0**	**69**	**0**	**69**
Total securities	**$ 0**	**$ 291,649**	**$ 0**	**$ 291,649**

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
December 31, 2011				
Securities available for sale:				
U.S. Government Sponsored Enterprises (GSE)	$ 0	$ 43,622	$ 0	$ 43,622
States and political subdivisions	0	78,051	0	78,051
GSE residential mortgage-backed securities	0	187,584	0	187,584

Total debt securities	0	309,257	0	309,257
Equity securities:				
Diversified	37	0	0	37
Energy	141	0	0	141
Financial services	166	70	0	236
Industrials	150	0	0	150
Technology	221	0	0	221
Other	323	0	0	323
Total equity securities	1,038	70	0	1,108
Total securities	$ 1,038	$ 309,327	$ 0	$ 310,365

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Certain financial assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

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

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due, according to the contractual terms of the loan agreement, will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loan, less estimated costs to sell. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The value of the real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction, or if management adjusts the appraisal value, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal, if deemed significant, or the net book value on the applicable business financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans with an allocation to the allowance for loan losses are measured at fair value on a nonrecurring basis; however not all impaired loans have an allocation to the allowance for loan losses. Any fair value adjustments are recorded in the period incurred as a provision for loan losses on the consolidated statement of income. Specific allocations to the allowance for loan losses were $2,262,000 and $29,788,000 at September 30, 2012 and December 31, 2011.

Foreclosed Real Estate

Other real estate property acquired through foreclosure is initially recorded at the fair value of the property at the transfer date less estimated selling cost. Subsequently, other real estate owned is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. Specific charges to value the real estate owned at the lower of cost or fair value on properties held at September 30, 2012 and December 31, 2011 were $506,000 and $365,000.

Mortgage Servicing Rights

The fair value of mortgage servicing rights is estimated to be equal to its carrying value, unless the quarterly valuation model calculates the present value of the estimated net servicing income as less than its carrying value, in which case a lower of cost or fair value charge is taken. As of September 30, 2012 and December 31, 2011, a $621,000 and $284,000 lower of cost or fair value reserve existed on the mortgage servicing rights portfolio.

A summary of assets at September 30, 2012 and December 31, 2011 measured at fair value on a nonrecurring basis is as follows:

(Dollars in Thousands)	**Level 1**	**Level 2**	**Level 3**	**Total Fair Value Measurements**
September 30, 2012				
Impaired loans, net	**$ 0**	**$ 0**	**$ 53,374**	**$ 53,374**
Foreclosed real estate	**0**	**0**	**1,018**	**1,018**
Mortgage servicing rights	**0**	**0**	**2,142**	**2,142**
December 31, 2011				
Impaired loans, net	$ 0	$ 0	$ 55,726	$ 55,726
Foreclosed real estate	0	0	1,378	1,378
Mortgage servicing rights	0	0	2,253	2,253

The following table presents additional qualitative information about assets measured on a nonrecurring basis and for which the Company has utilized Level 3 inputs to determine fair value:

	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range
September 30, 2012				
Impaired loans	**$ 53,374**	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity	0% -30% discount
			Management adjustments for liquidation expenses	5% -10% discount
Foreclosed real estate	**1,018**	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity	0% -30% discount
			Management adjustments for liquidation expenses	5% -10% discount
Mortgage servicing rights	**2,142**	Discounted cash flows	Remaining term	4.0 years
			Discount rate	10.70%

Fair values of financial instruments

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

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

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

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

Loans Held for Sale

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

Loans Receivable

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

Restricted Investment in Bank Stock

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

Deposit Liabilities

The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate, fixed-term money

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market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposits and IRAs are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market to a schedule of aggregated expected maturities on time deposits.

Short-Term Borrowings

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

Long-Term Debt

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

Accrued Interest

The carrying amounts of accrued interest approximate their fair values.

Off-Balance-Sheet Instruments

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

The estimated fair values of the Company s financial statements were as follows at September 30, 2012 and December 31, 2011:

(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
September 30, 2012:					
Financial Assets					
Cash and due from banks	**$ 13,960**	**$ 13,960**	**$ 13,960**	**$ 0**	**$ 0**
Interest bearing deposits with banks	**93,644**	**93,644**	**93,644**	**0**	**0**
Restricted investments in bank stock	**10,615**	**10,615**	**0**	**0**	**10,615**
Securities available for sale	**291,649**	**291,649**	**0**	**291,649**	**0**
Loans held for sale	**8,049**	**8,049**	**0**	**8,049**	**0**
Loans, net of allowance for loan losses	**767,038**	**770,544**	**0**	**0**	**770,544**
Accrued interest receivable	**3,696**	**3,696**	**0**	**0**	**3,696**
Mortgage servicing rights	**2,142**	**2,142**	**0**	**0**	**2,142**
Financial Liabilities					
Deposits	**1,120,463**	**1,125,180**	**0**	**1,125,180**	**0**
Short-term borrowings	**12,066**	**12,066**	**0**	**12,066**	**0**
Long-term debt	**37,808**	**39,126**	**0**	**39,126**	**0**
Accrued interest payable	**424**	**424**	**0**	**424**	**0**
Off-balance sheet instruments	**0**	**0**	**0**	**0**	**0**
December 31, 2011:					
Financial Assets					
Cash and due from banks	$ 19,630	$ 19,630			
Interest bearing deposits with banks	90,039	90,039			
Restricted investments in bank stock	11,758	11,758			
Securities available for sale	310,365	310,365			
Loans held for sale	2,553	2,553			
Loans, net of allowance for loan losses	921,725	925,923			

Accrued interest receivable	4,548	4,548
Mortgage servicing rights	2,253	2,253
Financial Liabilities		
Deposits	$ 1,216,902	$ 1,222,058
Short-term borrowings	35,013	35,013
Long-term debt	53,798	54,998
Accrued interest payable	907	907
Off-balance sheet instruments	0	0

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

Orrstown Financial Services, Inc. (the Company) is a financial holding company with a wholly-owned bank subsidiary, Orrstown Bank (the Bank). The following is a discussion of our consolidated financial condition at September 30, 2012 and results of operations for the three and nine months ended September 30, 2012. Throughout this discussion, the yield on earning assets is stated on a fully taxable-equivalent basis and balances represent average daily balances unless otherwise stated. The discussion and analysis should be read in conjunction with our Condensed Consolidated Financial Statements (Unaudited) and Notes thereto presented elsewhere in this report. Certain prior period amounts, presented in this discussion and analysis, have been reclassified to conform to current period classifications.

Certain statements appearing herein which are not historical in nature are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements refer to a future period or periods, reflecting management s current views as to likely future developments, and use words like may, will, expect, estimate, anticipate or similar terms. Because forward-looking statements involve certain risks, uncertainties and other factors over which the Company has no direct control, actual results could differ materially from those contemplated in such statements. These factors include (but are not limited to) the following: general economic conditions, changes in interest rates, changes in the Company s cost of funds, changes in government monetary policy, changes in government regulation and taxation of financial institutions, including changes resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act and related regulations, changes in the rate of inflation, changes in technology, our ability to attract skilled personnel and retain key members of our senior management team, the intensification of competition within the Company s market area, the outcome of litigation against the Company and other similar factors. For a discussion of these forward-looking statements and important factors that could cause results to differ materially from the forward-looking statements contained in this Report, see Management s Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors contained in our Annual Report on Form 10-K for the year ended December 31, 2011 and contained in our Quarterly Reports for the quarters ended March 31, 2012, June 30, 2012 and this Report.

Critical Accounting Policies

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP) and follow general practices within the financial services industry in which it operates. Management, in order to prepare the Company s consolidated financial statements, is required to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the balance sheet date through the date the financial statements are filed with the SEC. As this information changes, the consolidated financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources.

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

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

The Company recognizes deferred tax assets and liab