ORRSTOWN FINANCIAL SERVICES INC
Form 10-Q
November 08, 2013
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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, 2013

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, 2013: 8,106,444.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated Balance Sheets (Unaudited)

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

(Dollars in thousands, except per share data)	**September 30, 2013**	December 31, 2012 *
Assets		
Cash and due from banks	**$ 17,502**	$ 16,933
Interest bearing deposits with banks	**52,874**	133,755
Cash and cash equivalents	**70,376**	150,688
Restricted investments in bank stock	**8,037**	9,804
Securities available for sale	**384,522**	301,970
Loans held for sale	**1,648**	7,862
Loans	**683,642**	703,739
Less: Allowance for loan losses	**(21,252)**	(23,166)
Net Loans	**664,038**	688,435
Premises and equipment, net	**26,375**	26,782
Cash surrender value of life insurance	**25,635**	25,030
Intangible assets	**674**	832
Accrued interest receivable	**3,380**	3,188
Other assets	**29,441**	25,939
Total assets	**1,212,478**	$ 1,232,668
Liabilities		
Deposits:		
Non-interest bearing	**$ 118,181**	$ 121,090
Interest bearing	**916,752**	963,949
Total deposits	**1,034,933**	1,085,039
Short-term borrowings	**25,320**	9,650
Long-term debt	**16,431**	37,470
Accrued interest and other liabilities	**46,156**	12,815
Total liabilities	**1,122,840**	1,144,974

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; 8,107,255 and 8,080,411 shares issued; 8,106,444 and 8,079,599 shares outstanding	**422**	421
Additional paid in capital	**123,100**	122,724
Retained earnings (accumulated deficit)	**(30,182)**	(37,259)
Accumulated other comprehensive income (loss)	**(3,682)**	1,828
Treasury stock common, 811 and 812 shares, at cost	**(20)**	(20)
Total shareholders equity	**89,638**	87,694
Total liabilities and shareholders equity	**$ 1,212,478**	$ 1,232,668

* The consolidated balance sheet at December 31, 2012 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 (Unaudited)

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

(Dollars in thousands, except per share data)	**Three Months Ended September 30, 2013**	Three Months Ended September 30, 2012	**Nine Months Ended September 30, 2013**	Nine Months Ended September 30, 2012
Interest and dividend income				
Interest and fees on loans	**$ 7,739**	$ 9,567	**$ 23,803**	$ 30,717
Interest and dividends on investment securities				
Taxable	**904**	768	**2,716**	3,105
Tax-exempt	**298**	325	**784**	1,413
Short-term investments	**41**	71	**152**	214
Total interest and dividend income	**8,982**	10,731	**27,455**	35,449
Interest expense				
Interest on deposits	**1,073**	1,519	**3,436**	5,359
Interest on short-term borrowings	**19**	20	**33**	113
Interest on long-term debt	**124**	163	**412**	560
Total interest expense	**1,216**	1,702	**3,881**	6,032
Net interest income	**7,766**	9,029	**23,574**	29,417
Provision for loan losses	**0**	5,100	**(1,400)**	47,300
Net interest income after provision for loan losses	**7,766**	3,929	**24,974**	(17,883)
Noninterest income				
Service charges on deposit accounts	**1,448**	1,564	**4,307**	4,626
Other service charges, commissions and fees	**283**	368	**789**	966
Trust department income	**1,273**	1,096	**3,551**	3,348
Brokerage income	**426**	364	**1,502**	1,148
Mortgage banking activities	**727**	931	**2,584**	2,143
Earnings on life insurance	**241**	251	**721**	749
Other income (loss)	**44**	308	**(38)**	294
Investment securities gains (losses)	**157**	(2)	**279**	4,824
Total noninterest income	**4,599**	4,880	**13,695**	18,098
Noninterest expense				
Salaries and employee benefits	**5,584**	4,874	**16,717**	14,508
Occupancy expense	**486**	491	**1,521**	1,518
Furniture and equipment	**900**	754	**2,528**	2,159
Data processing	**106**	171	**369**	434
Telephone	**108**	137	**301**	479

Advertising and bank promotions		**231**		434		**716**		1,115
FDIC Insurance		**647**		788		**1,938**		2,019
Professional services		**463**		729		**1,801**		2,281
Collection problem loan		**184**		593		**565**		1,890
Real estate owned expenses		**55**		230		**115**		706
Taxes other than income		**222**		231		**710**		695
Intangible asset amortization		**52**		52		**157**		157
Other operating expenses		**1,499**		1,649		**4,375**		4,788
Total noninterest expenses		**10,537**		11,133		**31,813**		32,749
Income (loss) before income tax (benefit)		**1,828**		(2,324)		**6,856**		(32,534)
Income tax expense (benefit)		**(281)**		19,028		**(221)**		6,950
Net income (loss)	**$**	**2,109**	$	(21,352)	**$**	**7,077**	$	(39,484)
Per share information:								
Basic earnings (loss) per share	**$**	**0.26**	$	(2.65)	**$**	**0.87**	$	(4.90)
Diluted earnings (loss) per share		**0.26**		(2.65)		**0.87**		(4.90)
Dividends per share		**0.00**		0.00		**0.00**		0.00
Average shares and common stock equivalents outstanding		**8,091,172**		8,065,268		**8,088,876**		8,061,682

The Notes to the 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, 2013**	September 30, 2012	**September 30, 2013**	September 30, 2012
Net income (loss)	**$ 2,109**	$ (21,352)	**$ 7,077**	$ (39,484)
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on securities available for sale arising during the period	**(688)**	1,603	**(8,198)**	2,522
Reclassification adjustment for (gains) losses realized in net income	**(157)**	2	**(279)**	(4,824)
Net unrealized gains (losses)	**(845)**	1,605	**(8,477)**	(2,302)
Tax effect	**296**	(562)	**2,967**	806
Total other comprehensive loss, net of tax and reclassification adjustments	**(549)**	1,043	**(5,510)**	(1,496)
Total comprehensive income (loss)	**$ 1,560**	$ (20,309)	**$ 1,567**	$ (40,980)

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

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Consolidated Statements of Changes in Shareholders Equity (Unaudited)

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

	Nine Months Ended September 30, 2013 and 2012					
(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, 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
Balance, January 1, 2013	**$ 421**	**$ 122,724**	**$ (37,259)**	**$ 1,828**	**$ (20)**	**$ 87,694**
Net income	**0**	**0**	**7,077**	**0**	**0**	**7,077**
Total other comprehensive income (loss), net of taxes	**0**	**0**	**0**	**(5,510)**	**0**	**(5,510)**
Stock-based compensation plans:						
Issuance of stock (26,610 shares, including 1 treasury)	1	373	0	0	0	374
Issuance of stock through dividend reinvestment plan (235 shares)	**0**	**3**	**0**	**0**	**0**	**3**
Balance, September 30, 2013	**$ 422**	**$ 123,100**	**$ (30,182)**	**$ (3,682)**	**$ (20)**	**$ 89,638**

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

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Consolidated Statements of Cash Flows (Unaudited)

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

(Dollars in thousands)	**Nine Months Ended September 30, 2013**	**Nine Months Ended September 30, 2012**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	**$ 7,077**	$ (39,484)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of premiums on securities available for sale	**5,996**	5,251
Depreciation and amortization	**2,076**	1,963
Provision for loan losses	**(1,400)**	47,300
Stock based compensation	**125**	0
Net change in loans held for sale	**6,214**	(5,496)
Net loss on disposal of other real estate owned	**144**	8
Writedown of other real estate owned	**29**	436
Deferred income taxes, including valuation allowance adjustments	**0**	20,384
Investment securities gains	**(279)**	(4,824)
Earnings on cash surrender value of life insurance	**(605)**	(650)
(Increase) decrease in accrued interest receivable	**(118)**	852
Increase in accrued interest payable and other liabilities	**(253)**	2,280
Other, net	**(2,695)**	(17,186)
Net cash provided by operating activities	**16,311**	10,834
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of available for sale securities	**25,519**	94,099
Maturities, repayments and calls of available for sale securities	**68,080**	59,889
Purchases of available for sale securities	**(155,841)**	(138,000)
Net change in restricted investments in bank stocks	**1,767**	1,143
Net decrease in loans	**19,214**	84,403
Proceeds from sale of loans	**0**	19,702
Purchases of bank premises and equipment	**(1,218)**	(1,245)
Proceeds from disposal of other real estate owned	**1,079**	2,383
Net cash provided (used) by investing activities	**(41,400)**	122,374
CASH FLOWS FROM FINANCING ACTIVITIES		
Net decrease in deposits	**(50,106)**	(96,439)
Net increase (decrease) in short term purchased funds	**15,670**	(22,947)
Payments on long-term debt	**(21,039)**	(15,990)
Net proceeds from issuance of common stock	**252**	103
Net cash used by financing activities	**(55,223)**	(135,273)

Net decrease in cash and cash equivalents		**(80,312)**		(2,065)
Cash and cash equivalents at beginning of period		**150,688**		109,669
Cash and cash equivalents at end of period	**$**	**70,376**	$	107,604
Supplemental disclosures of cash flow information:				
Cash paid during the period for:				
Interest	**$**	**3,974**	$	6,515
Income taxes		**0**		1,267
Supplemental schedule of noncash investing activities:				
Other real estate acquired in settlement of loans	**$**	**341**	$	3,237
Security purchases not yet settled		**34,578**		0

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 bank holding company (that has elected status as a financial holding company with the Board of Governors of the Federal Reserve System) whose primary activity consists of supervising its wholly-owned subsidiary, Orrstown Bank (the Bank). The Company operates through its office in Shippensburg, Pennsylvania. The Bank provides services through its network of 21 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 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, 2013 and 2012 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, 2012 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, 2012. The consolidated financial statements include the accounts of the Company and the Bank. Operating results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. All significant intercompany transactions and accounts have been eliminated.

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, and the valuation allowance required on its deferred tax assets. 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.

The Company has established a full valuation allowance on its net deferred tax assets at September 30, 2013, based on the Company s previous taxable losses, projections for future taxable income, and other available evidence, in which management determined it was more likely than not that some portion of the asset would not be realized. Management may need to modify its judgment in this regard from one quarter to the next, and should improvement occur in operating performance, the need for a full valuation allowance may be reduced or eliminated.

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, 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, 2013, through the date these financial statements were filed with the Securities and Exchange Commission (the Commission).

Concentration of Credit Risk The Company grants 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 types 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, federal funds sold and interest bearing deposits due on demand, all of which have original maturities of 90 days or less.

Restricted Investments in Bank Stocks Restricted investments in bank stocks, which represents required investments in the common stock of correspondent banks, is carried at cost as of September 30, 2013 and December 31, 2012, 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, 2013. However, security impairment analysis is completed quarterly and the determination that no impairment had occurred as of September 30, 2013 is no assurance that impairment may not occur in the future.

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, 2013 and December 31, 2012 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 and approximate the level yield method. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Company follows the accounting guidance related to recognition and presentation of other-than-temporary impairment (FASB ASC 820-10). 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 that 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, 2013 and December 31, 2012.

The Company s securities are exposed to various risks, such as interest rate risk, market risk, 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.

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

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

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 generally retains the servicing of those loans. At September 30, 2013 and December 31, 2012 the balance of loans serviced for others was $324,613,000 and $329,360,000.

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.

Premises and Equipment Buildings, improvements, equipment, furniture and fixtures are carried at cost less accumulated depreciation and amortization. Land is carried at cost. Depreciation and amortization has been provided generally on the straight-line method and is computed over the estimated useful lives of the various assets as follows: buildings and improvements 10 to 40 years; equipment, furniture and fixtures 3 to 15 years; and computer software 3 to 5 years. Repairs and maintenance are charged to operations as incurred, while major additions and improvements are capitalized. Gain or loss on retirement or disposal of individual assets is recorded as income or expense in the period of retirement or disposal.

Mortgage Servicing Rights The estimated fair value of mortgage servicing rights (MSRs) related to loans sold and serviced by the Company is recorded as an asset upon the sale of such loan. MSRs are amortized as a reduction to servicing income over the estimated lives of the underlying loans. MSRs are evaluated periodically for impairment, by comparing the carrying amount to estimated fair value. Fair value is determined periodically through a discounted cash flows valuation performed by a third party. Significant inputs to the valuation include expected servicing income, net of expense, the discount rate and the expected life of the underlying loans. To the extent the amortized cost of the MSRs exceeds their estimated fair values, a valuation allowance is established for such impairment through a charge against servicing income on the consolidated statement of income. If the Company determines, based on subsequent valuations, that impairment no longer exists or is reduced, the valuation allowance is reduced through a credit to earnings.

Foreclosed Real Estate Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value less estimated costs to sell the underlying collateral. Capitalized costs include 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 carrying amount or fair value less estimated costs to sell. Foreclosed real estate totaled $965,000 and $1,876,000 as of September 30, 2013 and December 31, 2012 and is included in other assets.

Securities Sold Under Agreements to Repurchase (Repurchase Agreements) The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities which are included in short-term borrowings. Under these agreements, the Company may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, these repurchase agreements are accounted for as collateralized financing arrangements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Company s consolidated statements of condition, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. In other words, there is no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Company does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements.

The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Company be in default (e.g., fails to make an interest payment to the counterparty). For the repurchase agreements, the collateral is held by the Company in a segregated custodial account under a third party agreement.

Stock Compensation Plans The Company has a stock compensation plan that covers 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 is calculated and recognized over the employee s 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 basis 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.

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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 is limited to unrealized gains (losses) on securities available for sale for all years presented.

The component of accumulated other comprehensive income, net of taxes, at September 30, 2013 and December 31, 2012 consisted of unrealized gains (losses) on securities available for sale and totaled ($3,682,000) and $1,828,000.

Fair Value of Financial Instruments Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 8. 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 December 2011, the Financial Accounting Standard Board (the FASB) issued Accounting Standards Update (ASU) No. 2011-11, Disclosures *About Offsetting Assets and Liabilities*. The new disclosure requirements mandate that entities disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position as well as instruments and transactions subject to an agreement similar to a master netting arrangement. ASU No. 2011-11 also requires disclosure of collateral received and posted in connection with master netting agreements or similar arrangements. In January 2013, the FASB issued ASU No. 2013-01, *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. The provisions of ASU No. 2013-01 limit the scope of the new balance sheet offsetting disclosures to the following financial instruments, to the extent they are offset in the financial statements or subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in the statement of financial position: (1) derivative financial instruments; (2) repurchase agreements and reverse repurchase agreements; and (3) securities borrowing and securities lending transactions. The Company adopted the provisions of ASU No. 2011-11 and ASU No. 2013-01 effective January 1, 2013. As the provisions of ASU No. 2011-11 and ASU No. 2013-01 only impacted the disclosure requirements related to the offsetting of assets and liabilities and information about instruments and transactions eligible for offset in the statement of financial position, the adoption had no impact on the Company s consolidated statements of operations and financial condition.

In February 2013, the FASB issued ASU No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, to improve the transparency of reporting these reclassifications. ASU No. 2013-02 does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements. ASU No. 2013-02 requires an entity to disaggregate the total change of each component of other comprehensive income (e.g., unrealized gains or losses on available-for-sale investment securities) and separately present reclassification adjustments and current period other comprehensive income. The provisions of ASU No. 2013-02 also require that entities present either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source (e.g., unrealized gains or losses on available-for-sale investment securities) and the income statement line item affected by the reclassification (e.g., realized gains (losses) on sales of investment securities). If a component is not required to be reclassified to net income in its entirety (e.g., amortization of defined benefit plan items), entities would instead cross reference to the related note to the financial statements for additional information (e.g., pension footnote). The Company adopted the provisions of ASU No. 2013-02 effective January 1, 2013. As the Company s only item of accumulated other comprehensive income is unrealized gains or losses on securities available for sale, the adoption of this standard had no impact on our Consolidated Financial Statements.

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NOTE 2. SECURITIES AVAILABLE FOR SALE

At September 30, 2013 and December 31, 2012, 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, 2013 and December 31, 2012 were:

(Dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2013				
U.S Treasury	**$ 25,998**	**$ 29**	**$ 0**	**$ 26,027**
U.S. Government Agencies	**26,657**	**17**	**271**	**26,403**
U.S. Government Sponsored Enterprises (GSE)	**40,136**	**43**	**647**	**39,532**
States and political subdivisions	**70,972**	**462**	**3,489**	**67,945**
GSE residential mortgage-backed securities	**185,385**	**1,097**	**822**	**185,660**
GSE commercial mortgage-backed securities	**40,989**	**0**	**2,103**	**38,886**
Total debt securities	**390,137**	**1,648**	**7,332**	**384,453**
Equity securities	**50**	**19**	**0**	**69**
Totals	**$ 390,187**	**$ 1,667**	**$ 7,332**	**$ 384,522**
December 31, 2012				
U.S. Treasury	$ 25,996	$ 14	$ 0	$ 26,010
U.S. Government Sponsored Enterprises (GSE)	44,331	431	0	44,762
States and political subdivisions	37,324	1,588	3	38,909
GSE residential mortgage-backed securities	160,118	1,014	333	160,799
GSE commercial mortgage-backed securities	31,339	143	61	31,421
Total debt securities	299,108	3,190	397	301,901
Equity securities	50	19	0	69
Totals	$ 299,158	$ 3,209	$ 397	$ 301,970

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, 2013 and December 31, 2012:

	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, 2013						
U.S. Government Agencies	**$ 20,671**	**$ 271**	**$ 0**	**$ 0**	**$ 20,671**	**$ 271**

U.S. Government Sponsored Enterprises (GSE)	**12,139**	**647**	**0**	**0**	**12,139**	**647**
States and political subdivisions	**47,042**	**3,489**	**0**	**0**	**47,042**	**3,489**
GSE residential mortgage-backed securities	**80,371**	**821**	**769**	**1**	**81,140**	**822**
GSE commercial mortgage-backed securities	**38,886**	**2,103**	**0**	**0**	**38,886**	**2,103**
Total temporarily impaired securities	**$ 199,109**	**$ 7,331**	**$ 769**	**$ 1**	**$ 199,878**	**$ 7,332**
December 31, 2012						
States and political subdivisions	$ 885	$ 3	$ 0	$ 0	$ 885	$ 3
GSE residential mortgage-backed securities	64,952	312	2,657	21	67,609	333
GSE commercial mortgage-backed securities	20,396	61	0	0	20,396	61
Total temporarily impaired securities	$ 86,233	$ 376	$ 2,657	$ 21	$ 88,890	$ 397

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The Company had 73 securities and 27 securities at September 30, 2013 and December 31, 2012 in which the amortized cost exceeds their values, as discussed below.

U.S. Agencies and Government Sponsored Enterprises (GSE). 46 U.S. Agencies and 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, 2013. At December 31, 2012, the Company had 26 GSE securities with amortized costs which exceed their fair values, all but one of which was 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 basis 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 basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2013 or at December 31, 2012.

State and Political Subdivisions. 27 state and political subdivision securities had amortized costs which exceeded their fair value for less than 12 months at September 30, 2013. At December 31, 2012, one state and political subdivision security had an unrealized loss, which was less 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 basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2013 or at December 31, 2012.

The amortized cost and fair values of securities available for sale at September 30, 2013 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	**$ 54,013**	$ 54,089
Due after one year through five years	**380**	380
Due after five years through ten years	**25,534**	24,713
Due after ten years	**83,836**	80,725
GSE residential mortgage-backed securities	**185,385**	185,660
GSE commercial mortgage-backed securities	**40,989**	38,886
Total debt securities	**390,137**	384,453
Equity securities	**50**	69
	$ 390,187	$ 384,522

Gross gains on sales of securities were $160,000 and $20,000 for the three months ended September 30, 2013 and 2012. Gross losses on sales of securities were $3,000 and $22,000 for the three months ended September 30, 2013 and 2012. Gross gains on the sales of securities were $419,000 and $4,986,000 for the nine months ended September 30, 2013 and 2012. Gross losses on securities available for sale were $140,000 and $162,000 for the nine months ended September 30, 2013 and 2012.

Securities with a fair value of $280,309,000 and $258,024,000 at September 30, 2013 and December 31, 2012 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.

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 and non-owner occupied residential loans present a different credit risk to the Company than owner-occupied commercial real estate loans, 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 hinders the ability of the borrower to meet debt service requirements, and may result in lower collateral values. The Company generally recognizes that 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 significant number 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 typical. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

Municipal loans consist of extensions of credit to municipalities and school districts within the Company s market area. These loans generally present a lower risk than commercial and industrial loans, as they are generally secured by the municipality s full taxing authority, by revenue obligations, or by its ability to raise assessments on its customers for a specific utility.

The Company originates loans to its retail customers, including fixed-rate and adjustable first lien mortgage loans with the underlying 1-4 family owner-occupied residential property securing the loan. 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 43%.

Installment and other loans credit risk are mitigated through conservative underwriting standards, including the evaluation of the credit worthiness of the borrower through 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 typically present a greater risk to the Company than 1-4 family residential loans.

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The loan portfolio, excluding residential loans held for sale, broken out by classes, as of September 30, 2013 and December 31, 2012 was as follows:

(Dollars in thousands)	**September 30, 2013**	**December 31, 2012**
Commercial real estate:		
Owner-occupied	**$ 111,304**	$ 144,290
Non-owner occupied	**144,092**	120,930
Multi-family	**19,656**	21,745
Non-owner occupied residential	**59,384**	66,381
Acquisition and development:		
1-4 family residential construction	**1,725**	2,850
Commercial and land development	**23,487**	30,375
Commercial and industrial	**34,218**	39,340
Municipal	**63,291**	68,018
Residential mortgage:		
First lien	**124,488**	108,601
Home equity term	**19,204**	14,747
Home equity Lines of credit	**76,422**	79,448
Installment and other loans	**6,371**	7,014
	$ 683,642	$ 703,739

In order to monitor ongoing risk associated with its loan portfolio and specific loans within the segments, management uses an internal grading system. The first several rating categories, representing the lowest risk to the Bank, are combined and given a Pass rating. Management generally follows regulatory definitions in assigning criticized ratings to loans, including special mention, substandard, doubtful or loss. 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 classified rating. 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 identify and mitigate risk in the lending function. The Credit Administration Committee, comprised of executive officers and loan department personnel, was charged with the oversight of overall credit quality and risk exposure of the Company s loan portfolio. Effective December 31, 2012, the Credit Administration Committee became a subcommittee of the Enterprise Risk Management (ERM) Committee. From that date forward, the ERM Committee is responsible for oversight of overall credit quality and risk exposure. 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 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 ERM Committee no less than quarterly with a formal review and confirmation of risk 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 ERM Committee on a quarterly basis, with reaffirmation of the rating as approved by the Bank s Loan Work Out Committee or loan review staff.

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The following tables summarize the Bank s ratings based on its internal risk rating system as of September 30, 2013 and December 31, 2012:

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
September 30, 2013						
Commercial real estate:						
Owner-occupied	**$ 90,511**	**$ 4,481**	**$ 11,731**	**$ 4,105**	**$ 476**	**$ 111,304**
Non-owner occupied	**115,859**	**4,763**	**17,782**	**5,688**	**0**	**144,092**
Multi-family	**15,918**	**2,161**	**1,242**	**335**	**0**	**19,656**
Non-owner occupied residential	**46,574**	**3,281**	**5,255**	**4,274**	**0**	**59,384**
Acquisition and development:						
1-4 family residential construction	**1,382**	**0**	**0**	**343**	**0**	**1,725**
Commercial and land development	**13,906**	**1,159**	**5,886**	**2,536**	**0**	**23,487**
Commercial and industrial	**29,323**	**2,004**	**1,048**	**1,843**	**0**	**34,218**
Municipal	**63,291**	**0**	**0**	**0**	**0**	**63,291**
Residential mortgage:						
First lien	**121,860**	**0**	**299**	**2,281**	**48**	**124,488**
Home equity term	**19,154**	**0**	**0**	**37**	**13**	**19,204**
Home equity Lines of credit	**76,289**	**0**	**10**	**88**	**35**	**76,422**
Installment and other loans	**6,371**	**0**	**0**	**0**	**0**	**6,371**
	$ 600,438	**$ 17,849**	**$ 43,253**	**$ 21,530**	**$ 572**	**$ 683,642**

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
December 31, 2012						
Commercial real estate:						
Owner-occupied	$ 121,333	$ 11,917	$ 8,623	$ 2,229	$ 188	$ 144,290
Non-owner occupied	95,876	7,351	14,241	3,462	0	120,930
Multi-family	17,205	3,936	585	19	0	21,745
Non-owner occupied residential	45,468	12,199	3,346	5,368	0	66,381
Acquisition and development:						
1-4 family residential construction	1,608	333	0	198	711	2,850
Commercial and land development	14,793	8,937	2,836	3,208	601	30,375
Commercial and industrial	33,380	3,713	429	566	1,252	39,340
Municipal	68,018	0	0	0	0	68,018
Residential mortgage:						
First lien	101,390	3,026	1,604	2,581	0	108,601
Home equity term	14,403	52	235	57	0	14,747
Home equity Lines of credit	76,418	1,073	1,365	592	0	79,448
Installment and other loans	6,998	11	3	2	0	7,014

	$ 596,890	$ 52,548	$ 33,267	$ 18,282	$ 2,752	$ 703,739

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 on 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.

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 may continue to have an impairment reserve on it after the partial charge-off, if factors warrant.

As of September 30, 2013 and December 31, 2012, nearly all of the Company s impaired loans extent of impairment was measured based on the estimated fair value of the collateral securing the loan, except for troubled debt restructurings. By definition, troubled debt restructurings are considered impaired. All restructured loans impairment was determined based on discounted cash flows for those loans classified as troubled debt restructurings but that are accruing interest. 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.

According to policy, updated appraisals are required annually for classified loans in excess of $250,000. The as is value provided in the appraisal is often used as the fair value of the collateral in determining impairment, unless circumstances, such as subsequent improvements, approvals, or other circumstances dictate that another value provided by the appraiser is more appropriate.

Generally, impaired loans secured by real estate were measured at fair value using certified real estate appraisals that had been completed within the last year. Appraised values are further discounted for estimated costs to sell the property and other selling considerations to arrive at the 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 factor that carries the most consideration will be the one management believes is warranted. The approaches are as follows:

Original appraisal if the original appraisal provides a strong loan-to-value ratio (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 used to validate collateral values derived from other approaches.

Collateral on certain impaired loans is not limited to real estate, and may consist 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.

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 loan is one that is inadequately protected by current sound worth, paying capacity of the obligor or the collateral pledged, if any. Extensions of credit so classified have well-defined weaknesses which may jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard loans, does not have to exist in individual extensions of credit classified substandard. As a result, the Company s methodology includes an 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.

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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 tables summarize 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, 2013 and December 31, 2012. Allowances established at September 30, 2013 and December 31, 2012 generally pertain to those loans in which loan forbearance agreements were in the process of being negotiated or updated appraisals were pending, and the partial charge-off will be recorded when final information is 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, 2013					
Commercial real estate:					
Owner-occupied	**$ 476**	**$ 942**	**$ 476**	**$ 4,105**	**$ 4,607**
Non-owner occupied	**0**	**0**	**0**	**5,688**	**6,218**
Multi-family	**0**	**0**	**0**	**335**	**420**
Non-owner occupied residential	**0**	**0**	**0**	**4,274**	**4,550**
Acquisition and development:					
1-4 family residential construction	**0**	**0**	**0**	**343**	**371**
Commercial and land development	**0**	**0**	**0**	**2,536**	**3,170**
Commercial and industrial	**0**	**0**	**0**	**1,843**	**1,953**
Residential mortgage:					
First lien	**48**	**48**	**48**	**2,281**	**2,425**
Home equity term	**50**	**51**	**49**	**0**	**0**
Home equity Lines of credit	**123**	**124**	**105**	**0**	**0**
Installment and other loans	**0**	**0**	**0**	**0**	**0**
	$ 697	**$ 1,165**	**$ 678**	**$ 21,405**	**$ 23,714**

	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)
December 31, 2012					
Commercial real estate:					
Owner-occupied	$ 0	$ 0	$ 0	$ 2,417	$ 2,680
Non-owner occupied	1,257	1,257	329	2,205	5,487

Multi-family	0	0	0	19	198
Non-owner occupied residential	204	204	46	5,164	6,510
Acquisition and development:					
1-4 family residential construction	711	725	9	198	202
Commercial and land development	0	0	0	3,809	8,556
Commercial and industrial	1,373	1,402	928	445	445
Residential mortgage:					
First lien	0	0	0	2,581	2,784
Home equity term	0	0	0	57	75
Home equity lines of credit	0	0	0	592	597
Installment and other loans	0	0	0	2	2
	$ 3,545	$ 3,588	$ 1,312	$ 17,489	$ 27,536

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The following tables summarize the average recorded investment in impaired loans and related interest income recognized on loans deemed to be impaired for the three and nine months ended September 30, 2013 and 2012:

	Three Months Ended September 30,			
	2013		**2012**	
(Dollars in thousands)	**Average Impaired Balance**	**Interest Income Recognized**	Average Impaired Balance	Interest Income Recognized
Commercial real estate:				
Owner-occupied	**$ 4,249**	**$ 41**	$ 8,499	$ 48
Non-owner occupied	**3,980**	**50**	14,928	37
Multi-family	**168**	**16**	1,203	120
Non-owner occupied residential	**5,108**	**45**	12,440	57
Acquisition and development:				
1-4 family residential construction	**345**	**0**	2,049	21
Commercial and land development	**2,613**	**0**	13,608	100
Commercial and industrial	**1,875**	**0**	3.359	16
Residential mortgage:				
First lien	**2,421**	**29**	3,459	41
Home equity term	**47**	**2**	46	1
Home equity lines of credit	**116**	**4**	383	17
Installment and other loans	**1**	**0**	6	1
	$ 20,923	**$ 187**	$ 59,980	$ 459

	Nine Months Ended September 30,			
	2013		**2012**	
(Dollars in thousands)	**Average Impaired Balance**	**Interest Income Recognized**	Average Impaired Balance	Interest Income Recognized
Commercial real estate:				
Owner-occupied	**$ 3,270**	**$ 99**	$ 9,864	$ 92
Non-owner occupied	**3,605**	**86**	17,099	397
Multi-family	**89**	**16**	2,008	120
Non-owner occupied residential	**4,875**	**60**	26,905	266
Acquisition and development:				
1-4 family residential construction	**602**	**0**	1,881	23
Commercial and land development	**2,967**	**2**	14,863	287
Commercial and industrial	**1,724**	**65**	2,748	27
Residential mortgage:				
First lien	**2,528**	**31**	2,730	73
Home equity term	**47**	**2**	181	2
Home equity lines of credit	**336**	**4**	436	19
Installment and other loans	**1**	**0**	9	2

	$	**20,044**	**$**	**365**	$	78,724	$	1,308

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The following table presents impaired loans that are troubled debt restructurings, with the recorded investment as of September 30, 2013 and December 31, 2012.

	September 30, 2013		December 31, 2012	
(Dollars in thousands)	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Accruing:				
Commercial real estate:				
Owner Occupied	**2**	**$ 150**	0	$ 0
Non-owner occupied	**3**	**4,165**	2	1,981
Non-owner occupied residential	**0**	**0**	1	204
Acquisition and development:				
Commercial and land development	**1**	**520**	0	0
Commercial and industrial	**0**	**0**	1	122
Residential mortgage:				
First lien	**1**	**454**	2	749
Home equity lines of credit	**0**	**0**	1	36
Total accruing	**7**	**5,289**	7	3,092
Nonaccruing:				
Commercial real estate:				
Owner-occupied	**0**	**0**	1	7
Non-owner occupied	**1**	**713**	0	0
Non-owner occupied residential	**1**	**196**	4	1,209
Commercial and industrial	**1**	**114**	0	0
Residential mortgage:				
First lien	**1**	**283**	0	0
	4	**1,306**	5	1,216
	11	**$ 6,595**	12	$ 4,308

The following table presents restructured loans, included in nonaccrual status, that were modified as troubled debt restructurings within the previous 12 months and for which there was a payment default during the three and nine months ended September 30, 2013 and 2012.

	September 30, 2013		September 30, 2012	
(Dollars in thousands)	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Three Months Ended:				
Commercial real estate:				
Non-owner occupied	**0**	**$ 0**	1	$ 193

Nine Months Ended:						
Commercial real estate:						
Owner-occupied	**0**	**$**	**0**	1	$	6
Non-owner occupied	**0**		**0**	1		193
Non-owner occupied residential	**0**		**0**	5		1,269
Acquisition and development:						
Commercial and land development	**0**		**0**	2		772
	0	**$**	**0**	9	$	2,240

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The following table presents the number of loans modified with the recorded investment representing both their pre-modification and post-modification investment balances for the three and nine months ended September 30, 2013 and 2012:

	September 30, 2013		September 30, 2012	
(Dollars in thousands)	**Number of Contracts**	**Recorded Investment**	Number of Contracts	Recorded Investment
Three Months Ended:				
Commercial real estate:				
Owner-occupied	**2**	**$ 150**	0	$ 0
Non-owner occupied	**2**	**3,457**	0	0
	4	**$ 3,607**	0	$ 0
Nine Months Ended:				
Commercial real estate:				
Owner-occupied	**2**	**$ 150**	0	$ 0
Non-owner occupied	**2**	**3,457**	0	0
Acquisition and development:				
Commercial and land development	**1**	**524**	0	0
Commercial and industrial	**0**	**0**	1	203
Residential mortgage:				
First lien	**0**	**0**	1	299
Home equity lines of credit	**0**	**0**	1	37
	5	**$ 4,131**	3	$ 539

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, 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. For troubled debt restructurings in default of their modified terms, impairment is determined on a collateral dependent approach.

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

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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 loans in the portfolio summarized by aging categories of performing loans and nonaccrual loans as of September 30, 2013 and December 31, 2012:

	Days Past Due						
(Dollars in thousands)	Current	30-59	60-89	90+ (still accruing)	Total Past Due	Non-Accrual	Total Loans
September 30, 2013							
Commercial real estate:							
Owner-occupied	**$ 106,279**	**$ 594**	**$ 0**	**$ 0**	**$ 594**	**$ 4,431**	**$ 111,304**
Non-owner occupied	**142,569**	**0**	**0**	**0**	**0**	**1,523**	**144,092**
Multi-family	**19,321**	**0**	**0**	**0**	**0**	**335**	**19,656**
Non-owner occupied residential	**55,026**	**84**	**0**	**0**	**84**	**4,274**	**59,384**
Acquisition and development:							
1-4 family residential construction	**1,382**	**0**	**0**	**0**	**0**	**343**	**1,725**
Commercial and land development	**21,250**	**193**	**8**	**20**	**221**	**2,016**	**23,487**
Commercial and industrial	**31,500**	**875**	**0**	**0**	**875**	**1,843**	**34,218**
Municipal	**63,291**	**0**	**0**	**0**	**0**	**0**	**63,291**
Residential mortgage:							
First lien	**120,955**	**1,124**	**534**	**0**	**1,658**	**1,875**	**124,488**
Home equity term	**18,933**	**160**	**61**	**0**	**221**	**50**	**19,204**
Home equity Lines of credit	**75,962**	**288**	**49**	**0**	**337**	**123**	**76,422**
Installment and other loans	**6,284**	**50**	**37**	**0**	**87**	**0**	**6,371**
	$ 662,752	**$ 3,368**	**$ 689**	**$ 20**	**$ 4,077**	**$ 16,813**	**$ 683,642**

	Days Past Due						
(Dollars in thousands)	**Current**	**30-59**	**60-89**	**90+ (still accruing)**	**Total Past Due**	**Non-Accrual**	**Total Loans**
December 31, 2012							
Commercial real estate:							
Owner-occupied	$ 141,833	$ 40	$ 0	$ 0	$ 40	$ 2,417	$ 144,290
Non-owner occupied	119,320	129	0	0	129	1,481	120,930
Multi-family	21,726	0	0	0	0	19	21,745
Non-owner occupied residential	60,890	122	205	0	327	5,164	66,381
Acquisition and development:							
1-4 family residential construction	1,770	0	171	0	171	909	2,850
Commercial and land development	26,054	511	1	0	512	3,809	30,375
Commercial and industrial	37,348	296	0	0	296	1,696	39,340
Municipal	68,018	0	0	0	0	0	68,018
Residential mortgage:							
First lien	104,933	1,565	270	0	1,835	1,833	108,601
Home equity term	14,609	81	0	0	81	57	14,747

Home equity Lines of credit	78,880	0	12	0	12	556	79,448
Installment and other loans	6,837	161	14	0	175	2	7,014
	$ 682,218	$ 2,905	$ 673	$ 0	$ 3,578	$ 17,943	$ 703,739

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The Company maintains the allowance for loan losses at a level believed adequate by management to absorb losses inherent in the portfolio. The allowance 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 includes the specific credit evaluation of impaired loans as discussed above, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC Section 310-10-35 for loans individually identified as impaired, and ASC Subtopic 450-20 for loans collectively evaluated for impairment, and other bank regulatory guidance.

In connection with its quarterly evaluation of the adequacy of the allowance for loan losses, management continually reviews its methodology to determine if it continues to properly address the risk in the loan portfolio. 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. In response to the improved risk profile within the loan portfolio at December 31, 2012, the look back period for historical losses was extended to 12 quarters, weighted one-half for the most recent four quarters, and one quarter for each of the two previous four quarter periods in order to appropriately capture the loss history in the loan segment. Again, management considered current economic and real estate conditions, the trends in historical charge-off percentages that resulted from applying partial charge-offs to impaired loans, and the impact of distressed loan sales during the year. Based on management s assessment and in compliance with regulatory guidance, the Company began recording partial charge offs on collateral dependent loans in the first quarter of 2012, eliminating the need for specific reserves on collateral dependent loans. Although both methods are acceptable under ASC 310, the revised method is more consistent with regulatory directives and was implemented by the Company resulting in increased charge-offs during 2012.

In addition to the quantitative analysis, adjustments to the reserve requirements are allocated to loans collectively evaluated for impairment based on additional qualitative factors. As of September 30, 2013 and December 31, 2012, the qualitative factors used by management to adjust the historical loss percentage to the anticipated loss allocation, which may range from a minus 150 basis points to a positive 150 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, number of exceptions to loan policy, and supervisory loan to value exceptions, etc.

Concentrations of Credit and Changes within Credit Concentrations Factors considered include the composition of the Bank s overall portfolio and management s evaluation related to concentration risk management and the inherent risk associated with the concentrations identified.

Underwriting Standards and Recovery Practices Factors considered include changes to underwriting standards and perceived impact on anticipated losses, trends in the number of exceptions to loan policy; supervisory loan to value exceptions; and administration of loan recovery practices.

Delinquency Trends Factors considered include the delinquency percentages noted in the portfolio relative to economic conditions, severity of the delinquencies, and whether the ratios are trending upwards or downwards.

Classified Loans Trends Factors considered include the internal loan ratings of the portfolio, the severity of the ratings, whether the loan segment s ratings show a more favorable or less favorable trend, and underlying market conditions and its impact on the collateral values securing the loans.

Experience, Ability and Depth of Management/Lending staff Factors considered include the years experience of senior and middle management and the lending staff and turnover of the staff, and instances of repeat criticisms of ratings.

Quality of Loan Review Factors include the years of experience of the loan review staff, in-house versus outsourced provider of review, turnover of staff and the perceived quality of their work in relation to other external information.

National and Local Economic Conditions 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.

Prior to December 31, 2012, qualitative factors were also utilized in the determination of loans collectively evaluated for impairment, but consisted of only five factors, which are included in the eight factors listed above, with anticipated loss allocations that ranged from 0-8 basis points. It was determined that the qualitative adjustments would be expanded to the current range of minus 150 basis points to a positive 150 basis points, as the prior range of 0-8 basis points was deemed to be too restrictive and did not adequately address the credit improvement in the remaining loan portfolio.

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Activity in the allowance for loan losses for the three months ended September 30, 2013 and 2012 was as follows:

(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial Commercial and Industrial	Municipal	Total	Residential Mortgage	Consumer Installment and Other	Total	Unallocated	Total
September 30, 2013										
Balance, beginning of period	**$ 11,288**	**$ 1,946**	**$ 875**	**$ 254**	**$ 14,363**	**$ 3,796**	**$ 134**	**$ 3,930**	**$ 1,805**	**$ 20,098**
Provision for loan losses	**3,495**	**(1,117)**	**(2,651)**	**(12)**	**(285)**	**2**	**11**	**13**	**272**	**0**
Charge-offs	**(1,767)**	**(2)**	**0**	**0**	**(1,769)**	**0**	**(46)**	**(46)**	**0**	**(1,815)**
Recoveries	**45**	**267**	**2,530**	**0**	**2,842**	**100**	**27**	**127**	**0**	**2,969**
Balance, end of period	**$ 13,061**	**$ 1,094**	**$ 754**	**$ 242**	**$ 15,151**	**$ 3,898**	**$ 126**	**$ 4,024**	**$ 2,077**	**$ 21,252**
September 30, 2012										
Balance, beginning of period	$ 23,521	$ 6,803	$ 2,005	$ 1,012	$ 33,341	$ 887	$ 69	$ 956	$ 1,938	$ 36,235
Provision for loan losses	584	5,020	250	(783)	5,071	169	58	227	(198)	5,100
Charge-offs	(782)	(4,139)	(69)	0	(4,990)	(109)	(46)	(155)	0	(5,145)
Recoveries	483	13	8	0	504	4	2	6	0	510
Balance, end of period	$ 23,806	$ 7,697	$ 2,194	$ 229	$ 33,926	$ 951	$ 83	$ 1,034	$ 1,740	$ 36,700

Activity in the allowance for loan losses for the nine months ended September 30, 2013 and 2012 is as follows:

(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial Commercial and Industrial	Municipal	Total	Residential Mortgage	Consumer Installment and Other	Total	Unallocated	Total
September 30, 2013										
Balance, beginning of period	**$ 13,719**	**$ 3,502**	**$ 1,635**	**$ 223**	**$ 19,079**	**$ 2,275**	**$ 85**	**$ 2,360**	**$ 1,727**	**$ 23,166**
Provision for loan losses	**3,653**	**(3,943)**	**(3,309)**	**19**	**(3,580)**	**1,750**	**80**	**1,830**	**350**	**(1,400)**
Charge-offs	**(4,444)**	**(146)**	**(114)**	**0**	**(4,704)**	**(263)**	**(92)**	**(355)**	**0**	**(5,059)**
Recoveries	**133**	**1,681**	**2,542**	**0**	**4,356**	**136**	**53**	**189**	**0**	**4,545**
Balance, end of period	**$ 13,061**	**$ 1,094**	**$ 754**	**$ 242**	**$ 15,151**	**$ 3,898**	**$ 126**	**$ 4,024**	**$ 2,077**	**$ 21,252**
September 30, 2012										
	$ 29,559	$ 9,708	$ 1,085	$ 789	$ 41,141	$ 933	$ 75	$ 1,008	$ 1,566	$ 43,715

Balance, beginning of period										
Provision for loan losses	33,464	11,419	2,306	(560)	46,629	384	113	497	174	47,300
Charge-offs	(41,222)	(14,116)	(1,289)	0	(56,627)	(381)	(115)	(496)	0	(57,123)
Recoveries	2,005	686	92	0	2,783	15	10	25	0	2,808
Balance, end of period	$ 23,806	$ 7,697	$ 2,194	$ 229	$ 33,926	$ 951	$ 83	$ 1,034	$ 1,740	$ 36,700

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The following tables summarize 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, 2013 and December 31, 2012:

(Dollars in thousands)	**Commercial Real Estate**	**Acquisition and Development**	**Commercial and Industrial**	**Municipal**	**Residential Mortgage**	**Installment and Other**	**Unallocated**	**Total**
September 30, 2013								
Loans allocated by:								
Individually evaluated for impairment	**$ 14,878**	**$ 2,879**	**$ 1,843**	**$ 0**	**$ 2,502**	**$ 0**	**$ 0**	**$ 22,102**
Collectively evaluated for impairment	**319,558**	**22,333**	**32,375**	**63,291**	**217,612**	**6,371**	**0**	**661,540**
	$ 334,436	**$ 25,212**	**$ 34,218**	**$ 63,291**	**$ 220,114**	**$ 6,371**	**$ 0**	**$ 683,642**
Allowance for loan losses allocated by:								
Individually evaluated for impairment	**$ 476**	**$ 0**	**$ 0**	**$ 0**	**$ 202**	**$ 0**	**$ 0**	**$ 678**
Collectively evaluated for impairment	**12,585**	**1,094**	**754**	**242**	**3,696**	**126**	**2,077**	**20,574**
	$ 13,061	**$ 1,094**	**$ 754**	**$ 242**	**$ 3,898**	**$ 126**	**$ 2,077**	**$ 21,252**
December 31, 2012								
Loans allocated by:								
Individually evaluated for impairment	$ 11,266	$ 4,718	$ 1,818	$ 0	$ 3,230	$ 2	$ 0	$ 21,034
Collectively evaluated for impairment	342,080	28,507	37,522	68,018	199,566	7,012	0	682,705
	$ 353,346	$ 33,225	$ 39,340	$ 68,018	$ 202,796	$ 7,014	$ 0	$ 703,739
Allowance for loan losses allocated by:								
Individually evaluated for impairment	$ 375	$ 9	$ 928	$ 0	$ 0	$ 0	$ 0	$ 1,312
Collectively evaluated for impairment	13,344	3,493	707	223	2,275	85	1,727	21,854
	$ 13,719	$ 3,502	$ 1,635	$ 223	$ 2,275	$ 85	$ 1,727	$ 23,166

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, 2013 and December 31, 2012, 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, 2013 and 2012 are summarized as follows:

(Dollars in thousands)	**Three months ended September 30, 2013**	**Three months ended September 30, 2012**	**Nine months ended September 30, 2013**	**Nine months ended September 30, 2012**
Current year provision (benefit):				
Federal	**$ 0**	$ (3,894)	**$ 60**	$ (13,388)
State	**(281)**	0	**(281)**	(46)
Deferred tax expense (benefit)	**532**	3,050	**1,320**	512
Valuation allowance on deferred taxes	**(532)**	19,872	**(1,320)**	19,872
Net income tax expense (benefit)	**$ (281)**	$ 19,028	**$ (221)**	$ 6,950

The provision for income taxes includes $55,000 and ($1,000) of applicable income tax expense (benefit) related to net securities gains (losses) for the three months ended September 30, 2013 and 2012. The provision for income taxes includes $98,000 and $1,688,000 of applicable income tax expense related to net securities gains for the nine months ended September 30, 2013 and 2012.

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

(Dollars in thousands)	**September 30, 2013**	December 31, 2012
Deferred tax assets:		
Allowance for loan losses	**$ 7,762**	$ 9,672
Deferred compensation	**480**	477
Retirement plans and salary continuation	**1,558**	1,473
Stock compensation	**189**	184
Off balance sheet reserves	**214**	231
Nonaccrual loan interest	**263**	228
Net unrealized losses on securities available for sale	**1,983**	0
Goodwill	**191**	214
Low income housing credit carryforward	**832**	806
Alternative minimum tax credit carryforward	**60**	0
Charitable contribution carryforward	**232**	391
Net operating loss carryforward	**9,156**	8,466
Other	**179**	237
Total deferred tax assets	**23,099**	22,379
Valuation allowance	**(18,915)**	(20,235)
	4,184	2,144
Deferred tax liabilities:		
Depreciation	**1,107**	1,232
Net unrealized gains on securities available for sale	**0**	984
Purchase accounting adjustments	**515**	575
Other	**579**	337
Total deferred tax liabilities	**2,201**	3,128
Net deferred asset (liability)	**$ 1,983**	$ (984)

As of September 30, 2013, the Company has charitable contribution, low-income housing, and net operating loss carryforwards that expire through 2018, 2032 and 2032, respectively.

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, 2013 and December 31, 2012.

Accordingly, a full valuation allowance for the net amount of the deferred tax assets, which represented future deductible temporary differences on our tax returns, was established at September 30, 2013 and December 31, 2012. Primary factors contributing to this determination at September 30, 2013 and December 31, 2012 included:

The Company has exhausted all of its carryback availability to 2010 2011, as we had recognized current federal income tax receivable which fully offset 2010 and 2011 s taxable income.

As of September 30, 2013 and December 31, 2012, the Company was in a three-year cumulative loss position, representing significant negative evidence against the realizability of the deferred tax asset, and we do not expect to be out of a cumulative loss position over the next few quarters.

The entire balance of the deferred tax asset is disallowed for purposes of calculating regulatory capital ratios as of September 30, 2013 and December 31, 2012.

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Given the current uncertainty of the economy and in the event economic and real estate conditions decline, additional losses may result in our loan portfolio above those already provided for. As a result, we have placed less weight on our current forecast of earnings until the point where we demonstrate sustainable earnings for the realization of the deferred tax asset.

NOTE 5. 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, as of September 30, 2013 and December 31, 2012, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of September 30, 2013, 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, 2013 and December 31, 2012 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, 2013						
Total capital to risk weighted assets						
Orrstown Financial Services, Inc.	**$ 102,017**	**14.1%**	**$ 58,012**	**8.0%**	**n/a**	**n/a**
Orrstown Bank	**100,067**	**13.8%**	**57,966**	**8.0%**	**$ 72,458**	**10.0%**
Tier 1 capital to risk weighted assets						
Orrstown Financial Services, Inc.	**92,796**	**12.8%**	**29,006**	**4.0%**	**n/a**	**n/a**
Orrstown Bank	**90,853**	**12.5%**	**28,983**	**4.0%**	**43,475**	**6.0%**
Tier 1 capital to average assets						
Orrstown Financial Services, Inc.	**92,796**	**7.9%**	**47,137**	**4.0%**	**n/a**	**n/a**

Orrstown Bank	**90,853**	**7.7%**	**47,169**	**4.0%**	**58,961**	**5.0%**
December 31, 2012						
Total capital to risk weighted assets						
Orrstown Financial Services, Inc.	$ 94,928	12.2%	$ 62,438	8.0%	n/a	n/a
Orrstown Bank	92,466	11.9%	62,418	8.0%	$ 78,023	10.0%
Tier 1 capital to risk weighted assets						
Orrstown Financial Services, Inc.	84,999	10.9%	31,219	4.0%	n/a	n/a
Orrstown Bank	82,540	10.6%	31,209	4.0%	46,814	6.0%
Tier 1 capital to average assets						
Orrstown Financial Services, Inc.	84,999	6.8%	49,840	4.0%	n/a	n/a
Orrstown Bank	82,540	6.6%	49,873	4.0%	62,341	5.0%

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NOTE 6. EARNINGS PER SHARE

Earnings per share for the three and nine months ended September 30, 2013 and 2012 were as follows:

(In thousands, except per share data)	**Three Months Ended September 30, 2013**	**2012**	**Nine Months Ended September 30, 2013**	**2012**
Net income (loss)	**$ 2,109**	$ (21,352)	**$ 7,077**	$ (39,484)
Weighted average shares outstanding (basic)	**8,091**	8,065	**8,089**	8,062
Impact of common stock equivalents	**0**	0	**0**	0
Weighted average shares outstanding (diluted)	**8,091**	8,065	**8,089**	8,062
Per share information:				
Basic earnings per share	**$ 0.26**	$ (2.65)	**$ 0.87**	$ (4.90)
Diluted earnings per share	**0.26**	(2.65)	**0.87**	(4.90)

Stock options for 207,000 and 305,000 shares of common stock were not considered in computing diluted earnings per share for the three months ended September 30, 2013 and 2012 as their exercise would have been antidilutive as the exercise price exceeded the average market value. Stock options for 230,000 and 305,000 shares of common stock were not considered in computing diluted earnings per share for the nine months ended September 30, 2013 and 2012 as their exercise would have been antidilutive as the exercise price exceeded the average market value.

NOTE 7. 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.

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.

(Dollars in thousands)	**Contract or Notional Amount September 30, 2013**	**December 31, 2012**
Commitments to fund:		
Revolving, open ended home equity loans	**$ 83,582**	$ 77,674

1-4 family residential construction loans	**1,910**	1,002
Commercial real estate, construction and land development loans	**10,320**	1,021
Commercial, industrial and other loans	**35,857**	60,250
Standby letters of credit	**6,226**	11,551

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, 2013 and December 31, 2012, for guarantees under standby letters of credit issued was not material.

The Company currently maintains a reserve in other liabilities totaling $513,000 and $583,000 at September 30, 2013 and December 31, 2012 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, 2013 and 2012, $76,000 was charged to other noninterest expense for this exposure and for the nine months ended September 30, 2013 and 2012, the amount expensed was ($70,000) and $145,000.

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 $64,504,000 and $115,630,000 at September 30, 2013 and December 31, 2012, with limited recourse back to the Company on these loans of $8,379,000 and $8,420,000 at these dates. Many of the loans sold under the MPF Program have primary mortgage insurance, which reduces the Company s overall exposure. The Company is in the process of foreclosing on loans sold under the MPF program or recovering amounts previously charged off, with a resulting charge (credit) of $76,000 and ($101,000) for the three months ended September 30, 2013 and 2012, and $20,000 and ($4,000) for the nine months ended September 30, 2013 and 2012. These amounts, charged to other noninterest expenses represent an estimate of the Company s loss under its recourse exposure.

NOTE 8. FAIR VALUE DISCLOSURES

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.

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

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

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

Securities

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

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The Company had no fair value liabilities at September 30, 2013 and December 31, 2012. A summary of assets at September 30, 2013 and December 31, 2012, 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, 2013				
Securities available for sale:				
U.S. Treasury	**$ 0**	**$ 26,027**	**$ 0**	**26,027**
U.S. Government Agencies	**0**	**26,403**	**0**	**26,403**
U.S. Government Sponsored Enterprises (GSE)	**0**	**39,532**	**0**	**39,532**
States and political subdivisions	**0**	**67,945**	**0**	**67,945**
GSE residential mortgage-backed securities	**0**	**185,660**	**0**	**185,660**
GSE commercial mortgage-backed securities	**0**	**38,886**	**0**	**38,886**
Total debt securities	**0**	**384,453**	**0**	**384,453**
Equity securities financial services	**0**	**69**	**0**	**69**
Total securities	**$ 0**	**$ 384,522**	**$ 0**	**$ 384,522**

(Dollars in Thousands)	**Level 1**	**Level 2**	**Level 3**	**Total Fair Value Measurements**
December 31, 2012				
Securities available for sale:				
U.S. Treasury	$ 0	$ 26,010	$ 0	$ 26,010
U.S. Government Sponsored Enterprises (GSE)	0	44,762	0	44,762
States and political subdivisions	0	38,909	0	38,909
GSE residential mortgage-backed securities	0	160,799	0	160,799
GSE commercial mortgage-backed securities	0	31,421	0	31,421
Total debt securities	0	301,901	0	301,901
Equity securities financial services	0	69	0	69
Total securities	$ 0	$ 301,970	$ 0	$ 301,970

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 statements of operations. Specific allocations to the allowance for loan losses or cumulative partial charge-offs were $2,562,000 and $10,843,000 at September 30, 2013 and December 31, 2012.

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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 cumulative charges to value the real estate owned at the lower of cost or fair value on properties held at September 30, 2013 and December 31, 2012 were $412,000 and $581,000.

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, 2013 and December 31, 2012, a $0 and $644,000 lower of cost or fair value reserve existed on the mortgage servicing rights portfolio.

A summary of assets at September 30, 2013 and December 31, 2012 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, 2013				
Impaired loans, net	**$ 0**	**$ 0**	**$ 4,692**	**$ 4,692**
Foreclosed real estate	**0**	**0**	**659**	**659**
December 31, 2012				
Impaired loans, net	$ 0	$ 0	$ 10,675	$ 10,675
Foreclosed real estate	0	0	1,101	1,101
Mortgage servicing rights	0	0	2,296	2,296

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:

(Dollars in thousands)	**Fair Value Estimate**	**Valuation Techniques**	**Unobservable Input**	**Range**
September 30, 2013				
Impaired loans	**$ 4,692**	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	**659**	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity	0%-30% discount
				5%-25% discount

			Management adjustments for liquidation expenses	
December 31, 2012				
Impaired loans	$ 10,675	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	1,101	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	2,296	Discounted cash flows	Remaining term	4.0 years
			Discount rate	10.70%

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Fair values of financial instruments

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 and Interest Bearing Deposits with Banks

The carrying amounts of cash and due from banks and interest bearing deposits with banks 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 market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit 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.

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The estimated fair values of the Company s financial statements were as follows at September 30, 2013 and December 31, 2012:

(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
September 30, 2013:					
Financial Assets					
Cash and due from banks	**$ 17,502**	**$ 17,502**	**$ 17,502**	**$ 0**	**$ 0**
Interest bearing deposits with banks	**52,874**	**52,874**	**52,874**	**0**	**0**
Restricted investments in bank stock	**8,037**	**8,037**	**0**	**0**	**8,037**
Securities available for sale	**384,522**	**384,522**	**0**	**384,522**	**0**
Loans held for sale	**1,648**	**1,648**	**0**	**1,648**	**0**
Loans, net of allowance for loan losses	**662,390**	**669,446**	**0**	**0**	**669,446**
Accrued interest receivable	**3,380**	**3,380**	**0**	**0**	**3,380**
Mortgage servicing rights	**2,844**	**3,162**	**0**	**0**	**3,162**
Financial Liabilities					
Deposits	**1,034,933**	**1,037,181**	**0**	**1,037,181**	**0**
Short-term borrowings	**25,320**	**25,320**	**0**	**25,320**	**0**
Long-term debt	**16,431**	**17,096**	**0**	**17,096**	**0**
Accrued interest payable	**331**	**331**	**0**	**331**	**0**
Off-balance sheet instruments	**0**	**0**	**0**	**0**	**0**
December 31, 2012:					
Financial Assets					
Cash and due from banks	$ 16,933	$ 16,933	$ 16,933	$ 0	$ 0
Interest bearing deposits with banks	133,755	133,755	133,755	0	0
Restricted investments in bank stock	9,804	9,804	0	0	9,804
Securities available for sale	301,970	301,970	0	301,970	0
Loans held for sale	7,862	7,862	0	7,862	0
Loans, net of allowance for loan losses	680,573	681,414	0	0	681,414
Accrued interest receivable	3,188	3,188	0	0	3,188
Mortgage servicing rights	2,296	2,296	0	0	2,296
Financial Liabilities					
Deposits	$ 1,085,039	$ 1,089,344	0	$ 1,089,344	0
Short-term borrowings	9,650	9,650	0	9,650	0
Long-term debt	37,470	38,676	0	38,676	0
Accrued interest payable	424	424	0	424	0
Off-balance sheet instruments	0	0	0	0	0

NOTE 9. CONTINGENCIES

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

On May 25, 2012, Southeastern Pennsylvania Transportation Authority (SEPTA) filed a putative class action complaint in the United States District Court for the Middle District of Pennsylvania against the Company, the Bank and certain current and former directors and executive officers (collectively, the Defendants). The complaint alleges, among other things, that (i) in connection with the Company s Registration Statement on Form S-3 dated February 23, 2010 and its Prospectus Supplement dated March 23, 2010, and (ii) during the purported class period of March 24, 2010 through October 27, 2011, the Company issued materially false and misleading statements regarding the Company s lending practices and financial results, including misleading statements concerning the stringent nature of the Bank s credit practices and underwriting standards, the quality of its loan portfolio, and the intended use of the proceeds from the Company s March 2010 public offering of common stock. The complaint asserts claims under Sections 11, 12(a) and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and seeks class certification, unspecified money damages, interest, costs, fees and equitable or injunctive relief. Under the Private Securities Litigation Reform Act of 1995 (PSLRA), motions for appointment of Lead Plaintiff in this case were due by July 24, 2012. SEPTA was the sole movant and the Court appointed SEPTA Lead Plaintiff on August 20, 2012.

Pursuant to the PSLRA and the Court s September 27, 2012 Order, SEPTA was given until October 26, 2012 to file an amended complaint and the Defendants until December 7, 2012 to file a motion to dismiss the amended complaint. SEPTA s opposition to the Defendant s motion to dismiss was originally due January 11, 2013. Under the PSLRA, discovery and all other proceedings in the case are stayed pending the Court s ruling on the motion to dismiss. The September 27, 2012 Order specified that if the motion to dismiss were denied, the Court would schedule a conference to address discovery and the filing of a motion for class certification. On October 26, 2012, SEPTA filed an unopposed motion for enlargement of time to file its amended complaint in order to permit the parties and new defendants to be named in the amended complaint time to discuss plaintiff s claims and defendants defenses. On October 26, 2012, the Court granted SEPTA s motion, mooting its September 27, 2012 scheduling Order, and requiring SEPTA to file its amended complaint on or before January 16, 2013 or otherwise advise the Court of circumstances that require a further enlargement of time. On January 14, 2013, the Court granted SEPTA s second unopposed motion for enlargement of time to file an amended complaint on or before March 22, 2013.

On March 4, 2013, SEPTA filed an amended complaint. The amended complaint expands the list of defendants in the action to include the Company s independent registered public accounting firm and the underwriters of the Company s March 2010 public offering of common stock. In addition, among other things, the amended complaint extends the purported 1934 Exchange Act class period from March 15, 2010 through April 5, 2012.

Pursuant to the Court s March 28, 2013 Second Scheduling Order, on May 28, 2013 all defendants filed their motions to dismiss the amended complaint, and on July 22, 2013 SEPTA filed its omnibus opposition to all of the defendants motions to dismiss. On August 23, 2013, all defendants filed reply briefs in further support of their motions to dismiss. The Second Scheduling Order stays all discovery in the case pending the outcome of the motions to dismiss, and informs the parties that a telephonic conference to address discovery and the filing of SEPTA s motion for class certification will be scheduled after the Court s ruling on the motions to dismiss.

The matter is currently progressing through the legal process. The Defendants believe that the allegations in the complaint are without merit, and intend to defend vigorously against those claims.

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

The Company is a bank holding company, with the Bank as its wholly-owned subsidiary. At September 30, 2013, the Company had total assets of $1,212,478,000, total liabilities of $1,122,840,000 and total shareholders equity of $89,638,000. Currently, the U.S. economy appears to be slowly recovering from one of its longest and most severe economic recessions in recent history. The economic recovery has been slower than anticipated, but signs of growth that began to appear in the fourth quarter of 2012 have continued into 2013, which helped the Company generate net income of $2,109,000 for the third quarter of 2013 compared to a net loss of $21,352,000 for the same period in 2012. However, the continued uncertainty with the economy, together with the challenging regulatory environment, will continue to affect the Company and the markets in which it does business, and may impact the Company s results in the future. American households are being affected by higher social security and payroll taxes and higher fuel costs, all of which affect household spending and may slow economic growth. During the past several months, mortgage interest rates have risen, leading to a reduction in the number of customers refinancing their residential mortgages which contributed to the lower revenues. Despite decreased refinancing activity, the higher interest rate environment has positively impacted the fair value of the mortgage servicing rights.

Caution About Forward Looking Statements

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. Forward-looking statements are statements that include projections, predictions, expectations, or beliefs about events or results or otherwise are not statements of historical facts, including, but not limited to, statements related to new business development, new loan opportunities, growth in the balance sheet and fee based revenue lines of business, reducing risk assets, and mitigating losses in the future. Actual results and trends could differ materially from those set forth in such statements and there can be no assurances that we will achieve the desired level of new business development and new loans, growth in the balance sheet and fee based revenue lines of business, continue to reduce risk assets or mitigate losses in the future. Factors that could cause actual results to differ from those expressed or implied by the forward looking statements include, but are not limited to, the following: ineffectiveness of the Company s business strategy due to changes in current or future market conditions; the effects of competition, including industry consolidation and development of competing financial products and services; changes in laws and regulations, including the Dodd-Frank Wall Street Reform and Consumer Protection Act; interest rate movements; changes in credit quality; inability to raise capital under favorable conditions, volatilities in the securities markets; deteriorating economic conditions, and other risks and uncertainties, including those detailed in the Company s Form 10-K for the fiscal year ended December 31, 2012, and the Form 10-Qs for the quarters ended March 31, 2013 and June 30, 2013 and in this Form 10-Q under the sections titled Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations and in other filings made with the Securities and Exchange Commission. The statements are valid only as of the date hereof and the Company disclaims any obligation to update this information.

The following is a discussion of our consolidated financial condition at September 30, 2013 and results of operations for the three and nine months ended September 30, 2013 and 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.

Critical Accounting Policies

The Company s consolidated financial statements are prepared in accordance with 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.

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 liabilities for the future effects of temporary differences and tax credits. Enacted tax rates are applied to cumulative temporary differences based on expected taxable income in the periods in which the deferred tax asset or liability is anticipated to be realized. Future tax rate changes could occur that would require the recognition of income or expense in the statement of operations in the period in which they are enacted. Deferred tax assets must be reduced by a valuation allowance if in management s judgment it is more likely than not that some portion of the asset will not be realized. Management may need to modify its judgment in this regard from one period to another should a material change occur in the business environment, tax legislation, or in any other business factor that could impair the Company s ability to benefit from the asset in the future. Based upon the Company s prior cumulative taxable losses, projections for future taxable income and other available evidence, management determined that there was not sufficient positive evidence to outweigh the cumulative loss, and concluded it was not more likely than not that the net deferred tax asset would be realized. Accordingly, a full valuation allowance was recorded at September 30, 2013 and December 31, 2012. Management will continue to update its analysis quarterly, and after a period of sustainable taxable income, the valuation allowance may be reversed in part or in total.

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

RESULTS OF OPERATIONS

QUARTER ENDED SEPTEMBER 30, 2013 COMPARED TO QUARTER ENDED SEPTEMBER 30, 2012

Summary

The Company recorded net income of $2,109,000 for the third quarter of 2013 compared to a net loss of $21,352,000 for the same period in 2012. Basic and diluted earnings (loss) per share for the third quarter of 2013 were $0.26, compared to ($2.65) for the third quarter of 2012. Third quarter earnings were positively impacted by no provision for loan losses, compared to provision expense of $5,100,000 for the same period in 2012. Also negatively impacting the results of operations for the three months ended September 30, 2012, was a full valuation allowance charge the Company recorded on its net deferred tax asset of $19,872,000. Net interest income of $7,766,000 was $1,263,000 less for the three months ended September 30, 2013 than in the same period in 2012, due primarily to a decrease in net earning assets.

Net Interest Income

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

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

The Analysis of Net Interest Income table below presents net interest income on a fully taxable equivalent basis, net interest spread and net interest margin for the quarters ended September 30, 2013 and 2012.

For the three months ended September 30, 2013, net interest income measured on a fully tax equivalent basis decreased $1,339,000 to $8,235,000 from $9,574,000 in the corresponding period in 2012. The primary reason for the decrease in net interest income was a decrease in average earning assets from $1,229,190,000 for the third quarter of 2012 to $1,103,545,000 for the same period in 2013, and a decline in net interest margin from 3.10% for the three months ended September 30, 2012 to 2.96% for the three months ended September 30, 2013.

Interest income earned on loans decreased $1,889,000 from $9,937,000 for the quarter ended September 30, 2012 to $8,048,000 for the same period in 2013. The primary reason for the decline was a decrease in the average balance of loans from $827,553,000 for the third quarter of 2012 to $676,849,000 for the same period in 2013 primarily due to the loan sale which took place in the fourth quarter of 2012, combined with scheduled amortization of loans. In addition, the average tax-equivalent rate earned on loans declined from 4.78% for the three months ended September 30, 2012 to 4.72% for the same period in 2013.

Securities interest income for the three months ended September 30, 2013 was $1,362,000, an increase of $94,000 compared to $1,268,000 for the same period in 2012. Although the average balance on securities has increased from $295,578,000 in the third quarter of 2012 to $365,015,000 for the same period in 2013, the volume increase was not sufficient to offset the decrease in rates earned on securities, which declined from a tax equivalent yield of 1.71% for the three months ended September 30, 2012 to 1.48% in the same period in 2013. The low interest rate environment in the first half of 2013 resulted in increased refinancing activity and accelerated prepayments on mortgage backed securities, many of which have premiums associated with them. As prepayments accelerated, the amortization of the premiums also increased, which reduced the yields earned on the securities. Further, the proceeds from the sales or maturities of securities have been reinvested at lower interest rates, also negatively impacting the yield earned on securities.

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Interest expense on deposits and borrowings for the three months ended September 30, 2013 was $1,216,000, a decrease of $486,000, from $1,702,000 for the same period in 2012. The average balance of interest bearing liabilities decreased 10.5% from $1,067,133,000 for the three months ended September 30, 2012 to $955,640,000 for the same period in 2013. In addition, the Company s cost of funds on interest bearing liabilities has declined to 0.50% for the quarter ended September 30, 2013 from 0.63% for the same period in 2012. The interest rate environment has allowed the Company to lower the rates offered on its demand deposits, including interest bearing demand, money market and savings in 2013 compared to 2012, and as time deposits mature, it has also been able to replace the funds at slightly lower rates.

The Company s net interest spread of 2.89% declined 13 basis points in the quarter ended September 30, 2013 as compared to the same period in 2012. Net interest margin for the quarter ended September 30, 2013 was 2.96%, a 14 basis point decline from 3.10%, for the quarter ended September 30, 2012.

The table that follows shows average balances and interest yields on a fully taxable equivalent basis (FTE) for the quarters ended September 30, 2013 and 2012:

Analysis of Net Interest Income

	September 30, 2013			September 30, 2012		
(Dollars in thousands)	**Average Balance**	**Tax Equivalent Interest**	**Tax Equivalent Rate**	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate
Assets						
Federal funds sold & interest bearing bank balances	**$ 61,681**	**$ 41**	**0.26%**	$ 106,059	$ 71	0.27%
Securities	**365,015**	**1,362**	**1.48**	295,578	1,268	1.71
Loans	**676,849**	**8,048**	**4.72**	827,553	9,937	4.78
Total interest-earning assets	**1,103,545**	**9,451**	**3.40**	1,229,190	11,276	3.65
Other assets	**75,406**			77,234		
Total	**$ 1,178,951**			$ 1,306,424		
Liabilities and Shareholders Equity						
Interest bearing demand deposits	**$ 481,533**	**$ 171**	**0.14**	$ 495,095	$ 248	0.20
Savings deposits	**80,731**	**50**	**0.25**	73,757	31	0.17
Time deposits	**340,271**	**852**	**0.99**	439,628	1,240	1.12
Short term borrowings	**27,124**	**19**	**0.28**	20,647	20	0.39
Long term debt	**25,981**	**124**	**1.89**	38,006	163	1.71
Total interest bearing liabilities	**955,640**	**1,216**	**0.50**	1,067,133	1,702	0.63
Non-interest bearing demand deposits	**125,907**			122,050		

Other	**10,320**			10,611		
Total Liabilities	**1,091,867**			1,199,794		
Shareholders Equity	**87,084**			106,630		
Total	**$ 1,178,951**		**0.44%**	$ 1,306,424		0.55%
Net interest income (FTE)/ net interest spread		**8,235**	**2.89%**		9,574	3.02%
Net interest margin			**2.96%**			3.10%
Tax-equivalent adjustment		**(469)**			(545)	
Net interest income		**$ 7,766**			$ 9,029	

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

Provision for Loan Losses

The Company recorded no provision for loan losses for the three months ended September 30, 2013, compared to a provision of $5,100,000 for the same period in 2012. No provision was required for the third quarter of 2013, as net recoveries of $1,154,000 recorded during the period were sufficient to cover the additional reserve required that has resulted from the change in the volume and quality of the Company s loan portfolio.

See further discussion in the Allowance for Loan Losses section.

Noninterest Income

Noninterest income, excluding securities gains, totaled $4,442,000 for the three months ended September 30, 2013, compared to $4,882,000 for the same period in 2012. Several factors led to the lower revenues for the three months ended September 30, 2013 compared to the same period in 2012, including the following:

The Company recorded a gain on the sale of its merchant service business of $149,000 for the three months ended September 30, 2012, with no similar benefit recorded in the same period in 2013.

Mortgage banking revenue for the quarter ended September 30, 2013 was $727,000, a $204,000, or 21.9%, decrease from the 2012 quarter s total of $931,000. During the past several months, mortgage interest rates have risen, leading to a reduction in the number of customers refinancing their residential mortgages which contributed to the lower revenues. Despite decreased refinancing activity, the higher interest rate environment has positively impacted the fair value of the mortgage servicing rights, which allowed for the recovery of $280,000 of the impairment reserve in the third quarter of 2013, compared to an additional charge of $88,000 in the third quarter of 2012. As of September 30, 2013, the Company no longer has an impairment reserve, and similar reversal of reserves is not expected in future quarters.

The Company has experienced a decline in other service charges consistent with the downward trends in loans and deposit balances.

Partially offsetting the unfavorable variances were the revenues generated by Orrstown Financial Advisors, which generates trust and brokerage income. Orrstown Financial Advisors recorded revenues of $1,699,000 for the quarter ended September 30, 2013, an increase of 16.4% over the $1,460,000 recorded in the same period in 2012.

Security gains (losses) totaled $157,000 for the three months ended September 30, 2013, compared to ($2,000) for the same period in 2012.

Noninterest Expenses

Noninterest expenses amounted to $10,537,000 for the three months ended September 30, 2013 compared to $11,133,000 for the corresponding prior year period, a decrease of 5.4%. Several factors led to the net favorable variance, including the following.

Salaries and employee benefits totaled $5,584,000 for the three months ended September 30, 2013, compared to $4,874,000 for the three months ended September 30, 2012, an increase of $710,000. A large component of the difference pertains to an increase in the Company s number of full-time equivalents, which has increased as enhancements are made to our enterprise risk management area and less reliance is placed on outside consultants.

In 2013, the Company began making increased investments in technology in order to enhance our enterprise risk management practices, and to provide our customers with a better customer experience when utilizing our automated delivery channels. As a result, the Company has seen an increase in furniture and equipment expense, which increased from $754,000 for the three months ended September 30, 2012 to $900,000 for the same period in 2013.

Advertising and bank promotions expense decreased $203,000 to $231,000 for the three months ended September 30, 2013 from $434,000 for the same period in 2012. This reduction in expense relates to the timing of promotions and contributions, which were more heavily weighted in the third quarter of 2012 than the third quarter 2013. It is anticipated that contributions will be higher in the fourth quarter of 2013 than for the same period in 2012 and the third quarter of 2013.

FDIC insurance expense decreased from $788,000 for the three months ended September 30, 2012 to $647,000 for the same period in 2013. The decrease is the result of the reduction in the Bank s assets and deposits.

Professional service fees, including loan review assistance, legal fees and accounting expenses, have decreased $266,000 to $463,000 in the third quarter of 2013 from $729,000 in the same period in 2012. During the third quarter of 2013, the Company has been able to reduce its reliance on outside consultants which is the primary reason for the favorable variance.

Asset quality related costs, including collection and problem loan and real estate owned expenses, were $239,000 for the three months ended September 30, 2013, a $584,000 reduction from $823,000 for the same period in 2012. Significant reductions in nonperforming assets led to the 71.0% reduction in asset quality related costs.

In order to better understand how noninterest expenses increased in relation to related increases in revenue, operating expense levels are often measured in the financial services industry by the efficiency ratio, which expresses non-interest expense, as a percentage of tax-equivalent net interest income and noninterest income. As a result of the decline in net interest income, partially offset by a slight decrease in noninterest expense, the Company s efficiency ratio was 82.4% for the three months ended September 30, 2013, compared to 75.1% for the same period in 2012.

Income Tax Expense

Income tax expense (benefit) totaled ($281,000) for the three months ended September 30, 2013, on pre-tax income of $1,828,000, compared to income tax expense of $19,028,000 on pre-tax-loss of 2,324,000 recorded for the three months ended September 30, 2012.

During the third quarter of 2012, an evaluation was completed on the net deferred tax asset that existed at that time, which principally resulted from credit and credit related losses and expenses that the company experienced. As a result of the taxable losses that were generated during 2012, and our inability to fully offset the tax to the two preceding carryback years allowed by tax regulation, our net deferred tax asset was dependent on tax planning strategies and future taxable income. Based on forecasted taxable income at that time, combined with limited tax planning strategies, we were not able to conclude that the deferred tax asset would more likely than not be realized in its entirety, and as such, a valuation allowance was established for the full amount beginning in the third quarter of 2012 and resulted in a charge of $19,872,000. An updated evaluation was completed at September 30, 2013, and we continue to believe that the valuation allowance is appropriate. The net benefit recorded during the three months ended September 30, 2013 pertains to a state income tax refund.

NINE MONTHS ENDED SEPTEMBER 30, 2013 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2012

Summary

The Company recorded net income of $7,077,000 for the nine months ended September 30, 2013 compared to a net loss of $39,484,000 for the same period in 2012. Basic and diluted earnings (loss) per share for the nine months ended September 30, 2013 were $0.87, compared to ($4.90) for the nine months ended September 30, 2012. Year-to-date earnings were positively impacted by a negative provision for loan losses of $1,400,000 for the nine months ended September 30, 2013, compared to a provision expense of $47,300,000 in the same period in 2012. In the third quarter of 2012, the Company recorded a full valuation allowance charge on its net deferred tax asset of $19,872,000, which negatively impacted results of operations for the nine months ended September 30, 2012.

Net Interest Income

The Analysis of Net Interest Income table below presents net interest income on a fully taxable equivalent basis, net interest spread and net interest margin for the nine months ended September 30, 2013 and 2012.

For the nine months ended September 30, 2013, net interest income measured on a fully tax equivalent basis decreased $6,287,000 to $24,910,000 from $31,197,000 in the corresponding period in 2012. The primary reason for the decrease in net interest income was a decrease in average earning assets from $1,318,006,000 for the nine months ended 2012 to $1,119,588,000 for the same period in 2013. Compression in net interest margin from 3.16% for the nine months ended September 30, 2012 to 2.98% for the same period in 2013 also contributed to the decline.

Interest income earned on loans decreased from $31,736,000 for the nine months ended September 30, 2012 to $24,717,000 for the same period in 2013, a $7,019,000 decline. The primary reason for the decline was that the average balance of loans decreased from $887,111,000 for the nine months ended September 30, 2012 to $682,143,000 for the same period in 2013 due largely to the two loan sales which took place in 2012, additional management work out efforts and scheduled amortization of loans. Partially offsetting the volume variance was an increase in rates earned on loans from 4.78% in 2012 to 4.84% in 2013, as the Company has been able to reduce its non-accrual loan balance.

Securities interest income also declined in 2013 and totaled $3,922,000 for the nine months ended September 30, 2013, a decrease of $1,357,000, compared to $5,279,000 for the same period in 2012. Although the average balance of securities has increased from $322,369,000 for the nine months ended September 30, 2012 to $359,338,000 for the same period in 2013, the volume increase was not enough to offset the decrease in rates earned on securities, which declined from a tax equivalent yield of 2.19% for the nine months ended September 30, 2012 to 1.46% in the same period in 2013. The low interest rate environment has resulted in increased refinancing activity and accelerated prepayments on mortgage backed securities, many of which have premiums associated with them. Furthermore, the proceeds from the sales or maturities of securities have been reinvested at lower interest rates, also negatively impacting the yield earned on securities.

Interest expense on deposits and borrowings for the nine months ended September 30, 2013 was $3,881,000, a decrease of $2,151,000, from $6,032,000 for the same period in 2012. The average balance of interest bearing liabilities decreased 14.9% from $1,144,952,000 for the nine months ended September 30, 2012 to $974,414 for the same period in 2013. In addition, the Company s cost of funds on interest bearing liabilities has declined to 0.53% for the nine months ended September 30, 2013 from 0.70% for the same period in 2012. The interest rate environment has allowed the Company to lower the rates offered on its demand deposits, including interest bearing demand, money market and savings in 2013 compared to 2012, and as time deposits mature, it has also been able to replace the funds at slightly lower rates.

The Company s net interest spread of 2.91% declined 16 basis points in the nine months ended September 30, 2013 as compared to the same period in 2012. Net interest margin for the nine months ended September 30, 2013 was 2.98%, an 18 basis point decline from 3.16% for the nine months ended September 30, 2012. Management anticipates continued pressure on the net interest margin in future quarters, as compared to the prior year, as rates earned on loans and securities will continue to pay off or mature, and be reinvested at lower interest rates. However, management anticipates margin to expand on a quarter over quarter basis, as some of the current liquidity is invested in loans which yield a higher interest rate than short-term investments.

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The table that follows shows average balances and interest yields on a fully taxable equivalent basis (FTE) for the nine months ended September 30, 2013 and 2012:

Analysis of Net Interest Income

	September 30, 2013			September 30, 2012		
(Dollars in thousands)	**Average Balance**	**Tax Equivalent Interest**	**Tax Equivalent Rate**	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate
Assets						
Federal funds sold & interest bearing bank balances	**$ 78,107**	**$ 152**	**0.26%**	$ 108,526	$ 214	0.26%
Securities	**359,338**	**3,922**	**1.46**	322,369	5,279	2.19
Loans	**682,143**	**24,717**	**4.84**	887,111	31,736	4.78
Total interest-earning assets	**1,119,588**	**28,791**	**3.44**	1,318,006	37,229	3.77
Other assets	**72,855**			70,605		
Total	**$ 1,192,443**			$ 1,388,611		
Liabilities and Shareholders Equity						
Interest bearing demand deposits	**$ 481,462**	**$ 593**	**0.16**	$ 517,094	$ 1,008	0.26
Savings deposits	**78,393**	**99**	**0.17**	74,236	93	0.17
Time deposits	**363,455**	**2,744**	**1.01**	471,006	4,258	1.21
Short term borrowings	**18,151**	**33**	**0.24**	37,058	113	0.41
Long term debt	**32,953**	**412**	**1.67**	45,558	560	1.64
Total interest bearing liabilities	**974,414**	**3,881**	**0.53**	1,144,952	6,032	0.70
Non-interest bearing demand deposits	**119,236**			116,194		
Other	**10,940**			9,914		
Total Liabilities	**1,104,590**			1,271,060		
Shareholders Equity	**87,853**			117,551		
Total	**$ 1,192,443**		**0.46%**	$ 1,388,611		0.61%
Net interest income (FTE)/ net interest spread		**24,910**	**2.91%**		31,197	3.07%
Net interest margin			**2.98%**			3.16%
Tax-equivalent adjustment		**(1,336)**			(1,780)	

Net interest income	**$ 23,574**	$ 29,417

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

Provision for Loan Losses

The Company recorded a negative provision for loan losses, or a reversal of amounts previously provided, of $1,400,000 for the nine months ended September 30, 2013, compared to expense of $47,300,000 for the same period in 2012. During the second quarter of 2013, the Company received payments on classified loans with partial charge-offs recorded. As payments received during the quarter exceeded the carrying value of these loans, the excess was included in recoveries of loan amounts previously charged off, and was taken into income through a negative provision. Favorable charge-off history during the nine months ended September 30, 2013 combined with improvements in average levels of impaired loans has resulted in no additional provision for loan losses being required during the period, as the reserve balance at the beginning of 2013 was sufficient to absorb net charge-offs. In the same period in 2012, the provision for loan losses was significantly higher, as the Company was still working through its classified assets in an aggressive manner in order to improve its overall asset quality and balance sheet.

See further discussion in the Allowance for Loan Losses section.

Noninterest Income

Noninterest income, excluding securities gains, totaled $13,416,000 for the nine months ended September 30, 2013, compared to $13,274,000 for the same period in 2012. The following contributed to the net increase in noninterest income:

Trust department and brokerage income, in total, increased $557,000, or 12.4%, to $5,053,000 for the nine months ended September 30, 2013 compared to the same period in 2012. Favorable market conditions and the Company s ability to promote new products and attract accounts and customers contributed to the increase.

Mortgage banking activities revenue for the nine months ended September 30, 2013 was $2,584,000, a $441,000 increase from $2,143,000 in the same period in 2012. Despite recent increases in interest rates which have negatively impacted mortgage banking revenues in the third quarter of 2013, income was favorably influenced by a low interest rate environment in the early part of 2013, allowing for favorable market conditions. As rates have risen, however, refinancing volume has declined, slowing down the payment speed on loans serviced for others. This slower prepayment speed favorably impacted the fair value of our mortgage servicing rights, and allowed the Company to recover $644,000 of its impairment reserve during the nine months ended September 30, 2013, compared to an additional charge of $338,000 for the same period in 2012.

Offsetting the favorable variances above, a decline in deposit and other service charges was experienced consistent with the downward trends in loans and deposit balances.

The decrease in other income (loss) was principally due to an increase in losses on the sale of other real estate owned of $136,000 for the nine months ended September 30, 2013 compared to the same period in 2012, combined with a $149,000 gain on the sale of our merchant service business recorded in the nine months ended September 30, 2012, with no similar gain recorded in 2013.

Securities gains totaled $279,000 for the nine months ended September 30, 2013 compared to $4,824,000 for the same period in 2012. In 2013, asset/liability management strategies and interest rate conditions resulted in a limited number of sales of securities. Strategic considerations and interest rate conditions, as well as a desire to maintain capital levels, factored into the extent and timing of securities gains in the nine months ended September 30, 2012.

Noninterest Expenses

Noninterest expenses amounted to $31,813,000 for the nine months ended September 30, 2013 compared to $32,749,000 for the corresponding prior year period. The following factors contributed to this net decrease in noninterest expense.

Salaries and employee benefits totaled $16,717,000 for the nine months ended September 30, 2013, compared to $14,508,000 for the same period in 2012, an increase of $2,209,000. A large component of the increase pertains to an increase in the Company s number of full-time equivalents, which has increased as we enhance our enterprise risk management area, place less reliance on outside consultants, and enhance our technology and delivery channels to meet the changing needs of our customers. An additional factor contributing to the increase in salaries and benefit expense was the restoration of certain incentive based employee benefits as a result of the Company s return to profitability, which totaled $365,000 for the nine months ended September 30, 2013, with no similar expenses recorded in the same period in 2012.

In 2013, the Company began making increased investments in technology in order to enhance our enterprise risk management practices, and to provide our customers with a better customer experience when utilizing our automated delivery channels. As a result, the Company has seen an increase in furniture and equipment expense, which increased from $2,159,000 for the nine months ended September 30, 2012 to $2,528,000 for the same period in 2013.

Advertising and bank promotions expense decreased $399,000 to $716,000 for the nine months ended September 30, 2013 from $1,115,000 for the same period in 2012. This reduction in expense relates to the timing of promotions and charitable contributions, which were more heavily weighted in the nine months ended September 30, 2012 than in the same period in 2013.

FDIC insurance expense decreased $81,000 to $1,938,000 for the nine months ended September 30, 2013 compared to $2,019,000 for the same period in 2012. A reduction in the Bank s assets and deposits offset an increase in the quarterly deposit insurance assessment rate that went into effect in the second quarter of 2012 and resulted from an increased risk rating.

Professional service fees, including loan review assistance, legal fees and accounting expenses, have decreased $480,000 to $1,801,000 in the nine months ended September 30, 2013 from $2,281,000 in the same period in 2012. During the nine months ended September 30, 2013, the Company has been able to reduce consulting fees over the same period in 2012.

Asset quality related costs, including collection and problem loan and real estate owned expenses, were $680,000 for the nine months ended September 30, 2013, a $1,916,000 reduction from the same period in 2012. Significant reductions in nonperforming assets led to the 73.8% reduction in asset quality related costs.

As a result of the decline in net interest income, partially offset by a slight decrease in noninterest expense, the Company s efficiency ratio for the nine months ended September 30, 2013 increased to 82.0% compared to 71.7% for the same period in 2012.

Income Tax Expense

Income tax expense (benefit) totaled ($221,000) for the nine months ended September 30, 2013, on pre-tax income of $6,856,000, compared to income tax expense of $6,950,000 recorded on pre-tax loss of $32,534,000 for the nine months ended September 30, 2012. During the third quarter of 2012, an evaluation was completed on the net deferred tax asset that existed at that time, which principally resulted from credit and credit related losses and expenses that the Company experienced. As a result of the taxable losses that were generated during 2012, and our inability to fully offset the tax to the two preceding carryback years allowed by tax regulation, our net deferred tax asset was dependent on tax planning strategies and future taxable income. Based on forecasted taxable income in the near future, combined with limited tax planning strategies, we were not able to conclude that the deferred tax asset would more likely than not be realized in its entirety, and as such, a full valuation allowance of $19,872,000 was established in the third quarter of 2012. An updated evaluation was completed at September 30, 2013, and we continue to believe that the valuation allowance is appropriate. The net benefit recorded during the first nine months of 2013 pertains to a state income tax refund, offset by estimated federal alternative minimum tax.

FINANCIAL CONDITION

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

Securities Available for Sale

The Company utilizes securities available for sale as a tool for managing interest rate risk, enhancing income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings. As of September 30, 2013, securities available for sale were $384,522,000, an increase of $82,552, 000, or 27.3%, from December 31, 2012 s balance of $301,970,000. The growth in the portfolio is the result of investing the Company s excess liquidity in the securities available for sale portfolio, as loan balances have declined and securities return a better yield than overnight funds. Many of the securities have monthly cash flows or short maturities, which will provide cash flow to fund loan growth as the loan pipeline expands. Included in the September 30, 2013 available for sale security balance is $34,578,000 of securities purchased as of quarter end, that have not yet settled and for which a corresponding liability is included in other liabilities.

Loan Portfolio

The Company offers various products to meet the credit needs of our borrowers, principally consisting of commercial real estate loans, commercial and industrial loans, and retail loans consisting of loans secured by residential properties, and to a lesser extent, installment loans. No loans are extended to non-domestic borrowers or governments.

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. See Note 3, Loans Receivable and Allowance for Loan Losses, in the Notes to the Consolidated Financial Statements for a detailed description of the Company s loan classes and differing levels of credit risk associated with each class, which information is incorporated herein by reference.

The loan portfolio, excluding residential loans held for sale, broken out by classes as of September 30, 2013 and December 31, 2012 is as follows:

(Dollars in thousands)	**September 30, 2013**	December 31, 2012
Commercial real estate:		
Owner-occupied	**$ 111,304**	$ 144,290
Non-owner occupied	**144,092**	120,930
Multi-family	**19,656**	21,745
Non-owner occupied residential	**59,384**	66,381
Acquisition and development:		
1-4 family residential construction	**1,725**	2,850
Commercial and land development	**23,487**	30,375
Commercial and industrial	**34,218**	39,340
Municipal	**63,291**	68,018
Residential mortgage:		
First lien	**124,488**	108,601
Home equity term	**19,204**	14,747
Home equity lines of credit	**76,422**	79,448
Installment and other loans	**6,371**	7,014
	$ 683,642	$ 703,739

The loan portfolio at September 30, 2013 was $683,642,000 compared to $703,739,000 at December 31, 2012. On a year-to-date basis, the loan repayments have outpaced loan originations by approximately $20,097,000. In the past three months, however, the loan balance increased $10,887,000 from the June 30, 2013 balance, or 6.4% on an annualized basis. The growth in loans was the result of investment in new people and markets, as well as broadening relationships with current customers.

Asset Quality

Risk Elements

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

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

Nonperforming assets include nonaccrual and restructured loans and foreclosed real estate. In addition, loans past due 90 days or more and still accruing are also deemed to be risk assets. For all loan classes, the accrual of interest income ceases when principal or interest is past due 90 days or more and collateral is inadequate to cover principal and interest or immediately if, in the opinion of 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 generally reversed and charged against interest income, unless fully collateralized. Subsequent payments received are either applied to the outstanding principal balance or recorded as interest income, depending on management s assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan classes, when all the principal and interest amounts contractually due are brought current, the loans have performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contract terms of the loan.

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,

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or below market rates. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual troubled debt restructurings are restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for six months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. Troubled debt restructurings are evaluated individually for impairment if they have been restructured during the most recent calendar year, or if they are not performing according to their modified terms.

The following table presents the Company s risk elements, including information concerning the aggregate balances of nonaccrual, restructured loans still accruing, loans past due 90 days or more, and foreclosed real estate as of September 30, 2013, June 30, 2013, December 31, 2012 and September 30, 2012. Relevant asset quality ratios are also presented.

(Dollars in thousands)	**September 30, 2013**	June 30, 2013	December 31, 2012	September 30, 2012
Risk elements:				
Nonaccrual loans (cash basis)	**$ 16,813**	$ 18,047	$ 17,943	$ 57,780
Other real estate (OREO)	**965**	1,072	1,876	2,575
Total nonperforming assets	**17,778**	19,119	19,819	60,355
Restructured loans still accruing	**5,289**	1,691	3,092	3,113
Loans past due 90 or more days and still accruing	**20**	0	0	923
Total risk assets	**$ 23,087**	$ 20,810	$ 22,911	$ 64,391
Loans 30-89 days past due	**$ 4,059**	$ 3,223	$ 3,578	$ 5,435
Ratio of:				
Total nonperforming loans to loans	**2.46%**	2.68%	2.55%	7.19%
Total nonpeforming assets to assets	**1.47%**	1.60%	1.61%	4.75%
Total nonpeforming assets to total loans and OREO	**2.60%**	2.84%	2.81%	7.49%
Total risk assets to total loans and OREO	**3.37%**	3.09%	3.25%	7.99%
Total risk assets to total assets	**1.90%**	1.75%	1.86%	5.07%
Allowance for loan losses to total loans	**3.11%**	2.99%	3.29%	4.57%
Allowance for loan losses to nonperforming loans	**126.40%**	111.36%	129.11%	63.52%
Allowance for loan losses to nonperforming loans and restructured loans still accruing	**96.15%**	101.82%	110.13%	60.27%

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A further breakdown of impaired loans at September 30, 2013 and December 31, 2012 is as follows:

(Dollars in thousands)	**September 30, 2013** Nonaccrual Loans	Restructured Loans Still Accruing	Total	December 31, 2012 Nonaccrual Loans	Restructured Loans Still Accruing	Total
Commercial real estate:						
Owner occupied	**$ 4,431**	**$ 150**	**$ 4,581**	$ 2,417	0	$ 2,417
Non-owner occupied	**1,523**	**4,165**	**5,688**	1,481	1,981	3,462
Multi-family	**335**	**0**	**335**	19	0	19
Non-owner occupied residential	**4,274**	**0**	**4,274**	5,164	204	5,368
Acquisition and development						
1-4 family residential construction	**343**	**0**	**343**	909	0	909
Commercial and land development	**2,016**	**520**	**2,536**	3,809	0	3,809
Commercial and industrial	**1,843**	**0**	**1,843**	1,696	122	1,818
Residential mortgage:						
First lien	**1,875**	**454**	**2,329**	1,833	749	2,582
Home equity term	**50**	**0**	**50**	57	0	57
Home equity lines of credit	**123**	**0**	**123**	556	36	592
Installment and other loans	**0**	**0**	**0**	2	0	2
	$ 16,813	**$ 5,289**	**$ 22,102**	$ 17,943	$ 3,092	$ 21,035

During the third quarter of 2013, the Company continued to actively identify and monitor nonperforming assets and other risk assets, and has acted to address remaining credit quality issues. Risk assets, defined as nonaccrual loans, restructured and loans past due 90 days or more and still accruing, and real estate owned was, $23,087,000 at September 30, 2013, which was a 0.8% increase from December 31, 2012 s balance of $22,911,000 and a 10.9% increase from the June 30, 2013 balance of $20,810,000. Risk assets have shown a 64.1% reduction from $64,391,000 at September 30, 2012. The Company has been able to reduce its level of risk assets from the highs that were recorded in 2012, and current levels are more consistent with historical levels. During the third quarter of 2013, the primary reason for the increase in risk assets from June 30, 2013 is due to an increase of $3,598,000 in restructured loans still accruing and is primarily related to one relationship totaling $3,607,000 that was restructured during the quarter, and discussed more thoroughly below.

The allowance for loan losses totaled $21,252,000 at September 30, 2013, a decrease of $1,914,000 from $23,166,000 at December 31, 2012, principally due to net charge-offs of $514,000 during the nine month period, combined with the negative provision for loan losses of $1,400,000 recorded in the second quarter of 2013 as discussed in the Provision for Loan Losses section. Despite the negative provision for loan losses and the net charge-offs recorded during 2013, the allowance for loan losses to total loans ratio was 3.11% at September, 30, 2013, and the allowance to loan losses coverage ratio of nonaccrual loans and restructured loans still accruing was 96.2%.

A priority of the Company is to continue to work through its nonaccrual loans and other risk elements, in an attempt to reduce the levels of these underperforming assets and to recover amounts previously charged off, if possible. As new information is learned about borrowers or updated appraisals on real estate with lower fair values are obtained, the Company may continue to experience additional impaired loans.

On a year to date basis, recoveries of $5,145,000 have been credited to the allowance for loan losses, with two large recoveries contributing $3,889,000 of the total. In the second quarter of 2013, the Company recorded a large recovery of $1,407,000 on a previously charged off relationship due to successful loan monitoring and workout solutions. Although recoveries of this magnitude are difficult to predict, any additional recoveries that the Company receives will be used to replenish the allowance for loan losses. Future negative provisions could result if it is determined the reserve is adequate at the time of recovery, as was done in the second quarter of 2013.

As of September 30, 2013, the Company had approximately 49 lending relationships that had loans that were considered impaired, and included in the impaired loan balance of $22,102,000. Of these relationships, five have outstanding book balances in excess of $1,000,000 totaling $12,749,000, or 58% of the total impaired loan balance. In connection with the determination of the impairment associated with these five relationships, four were determined to be collateral dependent and had either partial charge-offs or reserves established on them totaling $648,000. The Company takes partial charge-offs on collateral dependent loans whose carrying value exceeded their estimated fair value, as determined by the most recent appraisal adjusted for current (within the quarter) conditions, less costs to dispose. ASC 310 impairment reserves remain in those situations in which updated appraisals are pending, and represent management s estimate of potential loss.

In the third quarter of 2013, the Company classified a relationship with a borrower in the food service and entertainment industry as impaired, based on restructuring negotiations with the borrower. Management expects the notes to continue to perform under the restructured terms and considers the loan adequately supported by the collateral securing the note, allowing for the remaining notes to remain in accruing status. The nearly $4,000,000 balance has been classified as impaired, as by definition, troubled debt restructurings are impaired. After evaluation of the relationship, in accordance with impairment guidance, it was determined no reserve was required.

In the second quarter of 2013, the Company deemed a relationship with a book balance of nearly $2,886,000 to be impaired, and moved the related loans to nonaccrual status. The relationship consists of several notes secured by multi-family rental properties and food services establishments. The borrower began to experience financial difficulties due to increased competition in the market area. The Company is still in the early stages of determining the fair value of the collateral securing the related loans, but has initially established an ASC 310 reserve on this relationship totaling approximately 3.6% of the outstanding loan balances.

An impaired relationship had a book balance of approximately $2,160,000 at September 30, 2013. The borrower is a wholesaler that supplies inventory to the commercial construction industry. As a result of the deterioration in real estate conditions, the borrower s business has been negatively impacted; leading management to conclude that it will be unable to continue to service its debt requirements. The relationship also includes financing for a residence. Based on recently obtained appraisals and impairment charges, partial charge-offs representing 1.7% of the outstanding September 30, 2013 legal loan balances have been taken on this relationship. During the quarter ended September 30, 2013, a payment was received and a loan with a general ledger balance of $522,000 was paid off. Extensions of credit to this borrower with subordinate lien positions have been fully charged off. The borrower has filed for bankruptcy, and the Company is working with legal counsel to liquidate the collateral.

An additional relationship that the Company has determined to be impaired at September 30, 2013 is with a real estate developer who also actively leases residential properties. This relationship consists of separate loans with total outstanding book balances of $2,153,000, secured by different parcels of land or residential structures. Recent appraisals on the collateral securing the outstanding loans resulted in the relationship being placed in nonaccrual status, as the softening of real estate prices and rental prices, and the lengthening of absorption periods resulted in it being classified and evaluated as a collateral dependent impaired loan. To date, partial charge-offs or specific reserves of approximately 23.5% of the outstanding loan balances have been taken. The Company is actively working with the borrower to reduce its outstanding loan balances, and has resulted in a reduction of the loan balances of over $900,000 during 2013.

A fifth relationship that includes impaired loans and had a balance of approximately $1,943,000 is with a borrower that purchased a large parcel of land in the Company s market area. The loan is current with respect to the interest only payment requirements. Since there have been no sales to date, and several extension requests, the loan was placed in nonaccrual status. Due to the guarantee of this debt by several municipal authorities, combined with a strong loan to value ratio, no partial charge-offs or specific reserves have been established on this loan as of September 30, 2013.

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During the quarter ended September 30, 2013, a relationship with a balance of $1,750,000 at June 30, 2013 was paid off, and resulted in a recovery of amounts previously charged off of $24,000.

The Company has another 44 relationships with borrowers that include loans that are individually evaluated for impairment, and has taken a similar approach with these relationships as it has with those mentioned above in determining the extent of full or partial charge-offs that were required, or ASC 310 reserves that may be needed. The determination of the Company s charge-offs or impairment reserve determination properly included an evaluation of the outstanding loan balance, and the related collateral securing the credit. Through a combination of collateral securing the loans and partial charge-offs taken to date totaling $1,825,000, the Company believes that it has adequately provided for the potential losses that it may incur on these relationships as of September 30, 2013. However, over time, additional information may become known that could result in increased reserve allocations or, alternatively, it may be deemed that the reserve allocations exceed those that are needed.

Credit Risk Management

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level believed adequate by management to absorb losses inherent in the portfolio. The allowance 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, 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.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management s periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. See Note 3, Loans Receivable and Allowance for Loan Losses in the Notes to the Consolidated Financial Statements for a description of the methodology for establishing the allowance and provision for loan losses and related procedures in establishing the appropriate level of reserve, which information is incorporated herein by reference.

Activity in the allowance for loan losses for the three months ended September 30, 2013 and 2012 is as follows:

(Dollars in thousands)	**Commercial Real Estate**	**Acquisition and Development**	**Commercial Commercial and Industrial**	**Municipal**	**Total**	**Residential Mortgage**	**Consumer Installment and Other**	**Total**	**Unallocated**	**Total**
September 30, 2013										
Balance, beginning of period	**$ 11,288**	**$ 1,946**	**$ 875**	**$ 254**	**$ 14,363**	**$ 3,796**	**$ 134**	**$ 3,390**	**$ 1,805**	**$ 20,098**
Provision for loan losses	**3,495**	**(1,117)**	**(2,651)**	**(12)**	**(285)**	**2**	**11**	**13**	**272**	**0**
Charge-offs	**(1,767)**	**(2)**	**0**	**0**	**(1,769)**	**0**	**(46)**	**(46)**	**0**	**(1,815)**

Recoveries	**45**	**267**	**2,530**	**0**	**2,842**	**100**	**27**	**127**	**0**	**2,969**
Balance, end of period	**$ 13,061**	**$ 1,094**	**$ 754**	**$ 242**	**$ 15,151**	**$ 3,898**	**$ 126**	**$ 4,024**	**$ 2,077**	**$ 21,252**
September 30, 2012										
Balance, beginning of period	$ 23,521	$ 6,803	$ 2,005	$ 1,012	$ 33,341	$ 887	$ 69	$ 956	$ 1,938	$ 36,235
Provision for loan losses	584	5,020	250	(783)	5,071	169	58	227	(198)	5,100
Charge-offs	(782)	(4,139)	(69)	0	(4,990)	(109)	(46)	(155)	0	(5,145)
Recoveries	483	13	8	0	504	4	2	6	0	510
Balance, end of period	$ 23,806	$ 7,697	$ 2,194	$ 229	$ 33,926	$ 951	$ 83	$ 1,034	$ 1,740	$ 36,700

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Activity in the allowance for loan losses for the nine months ended September 30, 2013 and 2012 is as follows:

	Commercial					Consumer				
(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Total	Residential Mortgage	Installment and Other	Total	Unallocated	Total
September 30, 2013										
Balance, beginning of period	**$ 13,719**	**$ 3,502**	**$ 1,635**	**$ 223**	**$ 19,079**	**$ 2,275**	**$ 85**	**$ 2,360**	**$ 1,727**	**$ 23,166**
Provision for loan losses	**3,653**	**(3,943)**	**(3,309)**	**19**	**(3,580)**	**1,750**	**80**	**1,830**	**350**	**(1,400)**
Charge-offs	**(4,444)**	**(146)**	**(114)**	**0**	**(4,704)**	**(263)**	**(92)**	**(355)**	**0**	**(5,059)**
Recoveries	**133**	**1,681**	**2,542**	**0**	**4,356**	**136**	**53**	**189**	**0**	**4,545**
Balance, end of period	**$ 13,061**	**$ 1,094**	**$ 754**	**$ 242**	**$ 15,151**	**$ 3,898**	**$ 126**	**$ 4,024**	**$ 2,077**	**$ 21,252**
September 30, 2012										
Balance, beginning of period	$ 29,559	$ 9,708	$ 1,085	$ 789	$ 41,141	$ 933	$ 75	$ 1,008	$ 1,566	$ 43,715
Provision for loan losses	33,464	11,419	2,306	(560)	46,629	384	113	497	174	47,300
Charge-offs	(41,222)	(14,116)	(1,289)	0	(56,627)	(381)	(115)	(496)	0	(57,123)
Recoveries	2,005	686	92	0	2,783	15	10	25	0	2,808
Balance, end of period	$ 23,806	$ 7,697	$ 2,194	$ 229	$ 33,926	$ 951	$ 83	$ 1,034	$ 1,740	$ 36,700

The allowance for loan losses totaled $21,252,000 at September 30, 2013, a $1,944,000 decline from December 31, 2012. As of September 30, 2013, the allowance for loan losses to total loans was 3.11% compared to 3.29% as of December 31, 2012, and the allowance for loan losses to nonaccrual loans and restructured loans still accruing was 110.13% at December 31, 2012 compared to 96.15% at September 30, 2013.

A summary of relevant asset quality ratios for the three and nine months ended September 30, 2013 and 2012 are as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	**September 30, 2013**	September 30, 2012
Ratio of annualized net charge-offs (recoveries) to average loans outstanding	**(0.68)%**	2.23%	**0.10%**	8.18%
Provision for loan losses to net charge-offs	**0.00%**	110.03%	**(272.37)%**	87.08%

Net charge-offs (recoveries) were ($1,154,000) and $514,000 for the three and nine months ended September 30, 2013, compared to $4,635,000 and $54,315,000 for the same period in 2012. The lower levels of charge-offs in 2013 significantly decreased the annualized ratio of charge-offs to average loans outstanding and reduced the provision for loan losses to charge-off ratio. The elevated charge-offs for the quarter ended September 30, 2012 significantly increased the annualized charge-offs to average loans outstanding ratio during that period, and was the result of the Company changing its approach to partial charge-offs on impaired loans, versus reserving them as was general practice prior to this quarter. The majority of the charge-offs remain in the non owner-occupied commercial real estate, owner-occupied commercial real estate and commercial and land development loan portfolios.

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The following tables summarize the ending loan balance individually or collectively evaluated for impairment based upon loan type, as well as the allowance for loan loss allocation for each at September 30, 2013 and December 31, 2012.

(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Residential Mortgage	Installment and Other	Unallocated	Total
September 30, 2013								
Loans allocated by:								
Individually evaluated for impairment	**$ 14,878**	**$ 2,879**	**$ 1,843**	**$ 0**	**$ 2,502**	**$ 0**	**$ 0**	**$ 22,102**
Collectively evaluated for impairment	**319,558**	**22,333**	**32,375**	**63,291**	**217,612**	**6,371**	**0**	**661,540**
	$ 334,436	**$ 25,212**	**$ 34,218**	**$ 63,291**	**$ 220,114**	**$ 6,371**	**$ 0**	**$ 683,642**
Allowance for loan losses allocated by:								
Individually evaluated for impairment	**$ 476**	**$ 0**	**$ 0**	**$ 0**	**$ 202**	**$ 0**	**$ 0**	**$ 678**
Collectively evaluated for impairment	**12,585**	**1,094**	**754**	**242**	**3,696**	**126**	**2,077**	**20,574**
	$ 13,061	**$ 1,094**	**$ 754**	**$ 242**	**$ 3,898**	**$ 126**	**$ 2,077**	**$ 21,252**
December 31, 2012								
Loans allocated by:								
Individually evaluated for impairment	$ 11,266	$ 4,718	$ 1,818	$ 0	$ 3,230	$ 2	$ 0	$ 21,034
Collectively evaluated for impairment	342,080	28,507	37,522	68,018	199,566	7,012	0	682,705
	$ 353,346	$ 33,225	$ 39,340	$ 68,018	$ 202,796	$ 7,014	$ 0	$ 703,739
Allowance for loan losses allocated by:								
Individually evaluated for impairment	$ 375	$ 9	$ 928	$ 0	$ 0	$ 0	$ 0	$ 1,312
Collectively evaluated for impairment	13,344	3,493	707	223	2,275	85	1,727	21,854
	$ 13,719	$ 3,502	$ 1,635	$ 223	$ 2,275	$ 85	$ 1,727	$ 23,166

The allowance for loan losses allocations presented above represent the reserve allocations on loan balances outstanding at September 30, 2013 and December 31, 2012. In addition to the reserve allocations on impaired loans noted above at September 30, 2013, 15 loans, with outstanding general ledger principal balances of $4,472,000 have had cumulative partial charge-offs to the allowance for loan losses recorded totaling $2,368,000. As updated appraisals were received on collateral dependent loans, partial charge-offs were taken in prior periods to the extent the loans principal balances exceeded their fair values.

Management believes the allocation of the allowance for loan losses between the various loan segments adequately reflects the inherent risk in each portfolio, and is based on the methodology previously discussed. Management routinely reviews its methodology, and may make revisions in order to enhance its analysis, and improves the accuracy of quantifying losses presently inherent in the portfolio. Management charges actual loan losses to the reserve and bases the provision for loan losses on the overall analysis taking the methodology into account. To the extent recoveries of loans previously charged off occur, or improvements in charge-off percentages are experienced, future quarters may include a reversal of the allowance level, or a negative provision for loan losses.

A large component of the reserve for the last two years has been allocated to the commercial real estate segment, which is consistent with this segment having the largest amount of impaired loans at both September 30, 2013 and December 31, 2012.

The unallocated portion of the allowance for loan losses reflects estimated inherent losses within the portfolio that have not been detected. This reserve results due to risk of error in the specific and general reserve allocation, other potential exposure in the loan portfolio, variances in management s assessment of national and local economic conditions and other factors management believes appropriate at the time. The unallocated portion of the allowance increased from $1,727,000 at December 31, 2012 to $2,077,000 at September 30, 2013 and represents 9.8% of the entire allowance for loan losses balance at September 30, 2013, compared to 7.5% at December 31, 2012.

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

Capital Adequacy and Regulatory Matters

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

Total shareholders equity increased $1,944,000 from $87,694,000 at December 31, 2012 to $89,638,000 at September 30, 2013. The primary reason for the net increase in shareholders equity was the $7,077,000 net income for the nine months ended September 30, 2013, offset by a decline in the unrealized gains on securities available for sale, net of tax, of $5,510,000. As of September 30, 2013, accumulated other comprehensive loss of $3,682,000 was primarily the result of the rise in interest rates during the year, resulting in unrealized losses on the available for sale securities portfolio.

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

Capital Adequacy. In the determination of Tier 1 and Total risk based capital, generally accumulated other comprehensive income (loss) is excluded from capital, as are intangible assets, a portion of mortgage servicing rights and deferred tax assets that is dependent on future taxable income greater than one year from the reporting date. As of September 30, 2013 and December 31, 2012, the Company provided a full valuation allowance on its deferred tax asset, which reduced the deferred tax asset, excluding other comprehensive income items, to zero.

The allowance for credit losses, including the allowance for loan losses and reserve for off-balance sheet credit commitments, is included as Tier 2 capital to the extent it does not exceed 1.25% of risk weighted assets. The amount that exceeds 1.25% of risk weighted assets, is disallowed as Tier 2 capital, but also reduces the Company s risk weighted assets. As of September 30, 2013 and December 31, 2012, $12,544,000 and $13,820,000 of the allowance for credit losses was excluded from Tier 2 capital.

Regulatory Capital. As of September 30, 2013 the Bank was considered well capitalized under applicable banking regulations. The Company s and the Bank s capital ratios as of September 30, 2013 compared to the minimum to be considered well capitalized under prompt corrective action provisions were as follows:

	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, 2013						
Total capital to risk weighted assets						
Orrstown Financial Services, Inc.	**$ 102,017**	**14.1%**	**$ 58,012**	**8.0%**	**n/a**	**n/a**
Orrstown Bank	**100,067**	**13.8%**	**57,966**	**8.0%**	**$ 72,458**	**10.0%**
Tier 1 capital to risk weighted assets						
Orrstown Financial Services, Inc.	**92,796**	**12.8%**	**29,006**	**4.0%**	**n/a**	**n/a**
Orrstown Bank	**90,853**	**12.5%**	**28,983**	**4.0%**	**43,475**	**6.0%**
Tier 1 capital to average assets						
Orrstown Financial Services, Inc.	**92,796**	**7.9%**	**47,137**	**4.0%**	**n/a**	**n/a**
Orrstown Bank	**90,853**	**7.7%**	**47,169**	**4.0%**	**58,961**	**5.0%**

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The Company and the Bank have been able to increase their capital ratios from December 31, 2012 levels due to net income earned for the first nine months of 2013, combined with a lowering of its risk weighted assets due to a shift in asset composition, and a reduction in off-balance sheet exposures and related credit equivalent factors.

As noted above, the Bank s capital ratios exceed those to be considered well capitalized under applicable banking regulations. The Company routinely evaluates its capital levels in light of its risk profile to assess its capital needs. In March 2012, the Company and the Bank entered into a Written Agreement with the Federal Reserve Bank of Philadelphia and the Bank entered into a Consent Order with the Pennsylvania Department of Banking. In accordance therewith, the Bank has filed a confidential Capital Plan with each of those banking regulators.

In October 2011, the Company announced it had discontinued its quarterly dividend, which was the result of regulatory guidance from the Federal Reserve. Due to the regulatory restrictions included in the Written Agreement and the Consent Order with the respective regulators, the Company is restricted from paying any dividends or repurchasing any stock without prior regulatory approval. Accordingly, there can be no assurance that the Company will be permitted to pay a cash dividend or conduct any stock repurchases in the near future.

Basel III Capital Rules. In July 2013, the Company and Bank s primary federal regulator, the Federal Reserve, approved final rules (the Basel III Capital Rules) establishing a new comprehensive capital framework for U.S. banking organizations, including community banks, which also incorporate provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including the Company and Bank, compared to existing U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions regulatory capital ratios, addresses risk weights and other issues affecting the denominator in banking institutions regulatory capital ratios and replace the current risk-weighting approach. The Basel III Capital Rules are effective for the Company and Bank on January 1, 2015 (subject to a phase-in period).

The Basel III Capital Rules, among other things, (i) introduce a new capital measure called Common Equity Tier 1 (CET1), (ii) specify that Tier 1 capital consist of CET1 and Additional Tier 1 capital instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments from capital as compared to existing regulations.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and Bank to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) may face constraints on dividends, equity repurchases and discretionary bonuses to executive officers based on the amount of the shortfall.

Under the Basel III Capital Rules, the initial minimum capital ratios as of January 1, 2015 will be as follows:

4.5% CET1 to risk-weighted assets;

6.0% Tier 1 capital to risk-weighted assets; and

8.0% Total capital to risk-weighted assets.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Under current capital standards, the effects of accumulated other comprehensive income items included in capital are excluded for the purposes of determining regulatory capital ratios. Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive items are not excluded; however the Company and Bank, may make a one-time permanent election to continue to exclude these items. The Company and Bank are still evaluating the benefits and limitations of making this election, and have not yet concluded if they will take advantage of the election.

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Implementation of the deductions and other adjustments to CET1 will begin on January 1, 2015 and will be phased-in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter until fully phased-in at January 1, 2018). The implementation of the capital conservation buffer will begin on January 1, 2016 at the 0.625% level and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

With respect to the Bank, the Basel III Capital Rules also revise the prompt corrective action regulations pursuant to Section 38 of the Federal Deposit Insurance Act, by (i) introducing a CET1 ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category (other than critically undercapitalized), with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the current 6%), and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3% leverage ratio and still be adequately capitalized. The Basel III Capital Rules do not change the total risk-based capital requirement for any prompt corrective action category.

The Basel III Capital Rules prescribe a standardized approach for risk weightings that expand the risk-weighting categories from the current four categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories. Significant changes to current rules that will impact the Company s determination of risk-weighted assets include, among other things:

- Applying a 150% risk weight for certain high volatility commercial real estate acquisition, development and construction loans, compared to 100% risk weight currently in place;

- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due or in nonaccrual status, compared to 100% risk weight currently in place; and

- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, compared to 0% currently in place.

Management is currently evaluating the impact that the Basel III Capital Rules, on a fully phased-in basis, will have on our capital levels. Management anticipates that it will be in compliance with the phased in rules.

Liquidity

Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Our primary sources of funds consist of deposit inflows, loan repayments, maturities and sales of investment securities and borrowings from the FHLB. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Interest rate sensitivity management requires the maintenance of an appropriate balance between interest sensitive assets and liabilities. Management, through its ALCO process, attempts to manage the level of repricing and maturity mismatch so that fluctuations in net interest income is maintained within policy limits in current and expected market conditions. The Company has consistently followed a strategy of pricing assets and liabilities according to prevailing market rates. Rate spreads will be sacrificed at times in order to enable the sensitivity position to stay within the guidelines called for by asset/liability management policy. Investment and pricing decisions are made using both liquidity and sensitivity analyses as tools. Rate sensitivity is measured by monthly gap analysis, quarterly rate shocks, and periodic simulation.

The Company s Risk Sensitive Assets (RSA) to Risk Sensitive Liabilities (RSL) ratio at September 30, 2013 decreased from December 31, 2012, and is more liability sensitive than at year end. The primary reason for the decrease in the RSA/RSL ratio for each cumulative period presented is due to investing greater liquidity in securities available for sale, and less in interest-bearing deposits in banks in order to capture greater yield.

The following gap summary demonstrates the shift in RSA/RSL (cumulative) position since year end:

	Within 6 Months	Within 12 Months	Within 24 Months	Within 36 Months
September 30, 2013	**0.84**	**0.86**	**0.92**	**1.05**
June 30, 2013	0.79	0.86	0.92	1.06
March 31, 2013	0.84	0.92	0.95	1.09
December 31, 2012	0.99	0.94	1.02	1.09

Management closely monitors the fiscal and monetary policies of our government and acts in anticipation of changes in order to maintain a healthy earning asset interest bearing liabilities balance.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

The Company s Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company s disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of September 30, 2013. Based on such evaluation, such officers have concluded that the Company s disclosure controls and procedures were designed and functioning effectively, as of September 30, 2013, to provide reasonable assurance that the information required to be disclosed by the Company in reports filed under the Securities Exchange Act of 1934, as amended, is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and (ii) accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.

(b) Changes in Internal Control Over Financial Reporting

No change in the Company s internal control over financial reporting occurred during the quarter ended September 30, 2013 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1 Legal Proceedings

The nature of Orrstown Financial Services, Inc. s business generates a certain amount of litigation involving matters arising out of the ordinary course of business. Except as described in Note 9, Contingencies to the Notes to the Consolidated Financial Statements, which information is incorporated herein by reference, in the opinion of management, there are no legal proceedings that might have a material effect on the results of operations, liquidity, or the financial position of the Company at this time.

Item 1A Risk Factors

There have been no material changes from the risk factors as disclosed in the Annual Report on Form 10-K for the year ended December 31, 2012.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

For the quarter ended September 30, 2013, there were no repurchases of common equity securities by the Company under the announced Stock Repurchase Plan. In connection with the formal written agreements entered into with the Federal Reserve Bank of Philadelphia and the Pennsylvania Department of Banking, the Company s Stock Repurchase Plan has been suspended, and the Company does not expect to repurchase shares in the foreseeable future.

The Company did not sell any unregistered securities during the quarter ended September 30, 2013.

Item 3 Defaults Upon Senior Securities

Not applicable

Item 4 Mine Safety Disclosures

Not applicable

Item 5 Other Information

None

Item 6 Exhibits

3.1	Articles of Incorporation as amended, incorporated by reference to Exhibit 3.1 of the Registrant s Report on Form 8-K filed on January 29, 2010.
3.2	By-laws as amended, incorporated by reference to Exhibit 3.1 to the Registrant s Report on Form 8-K filed March 1, 2013.
4.1	Specimen Common Stock Certificate, incorporated by reference to the Registrant s Registration Statement on Form S-3 filed February 8, 2010 (File No. 333-164780).
31.1	Rule 13a 14(a)/15d-14(a) Certification (Principal Executive Officer)
31.2	Rule 13a 14(a)/15d-14(a) Certifications (Principal Financial Officer)
32.1	Section 1350 Certifications (Principal Executive Officer)
32.2	Section 1350 Certifications (Principal Financial Officer)
101.LAB	XBRL Taxonomy Extension Label Linkbase *
101.PRE	XBRL Taxonomy Extension Presentation Linkbase *
101.INS	XBRL Instance Document *
101.SCH	XBRL Taxonomy Extension Schema *
101.CAL	XBRL Taxonomy Extension Calculation Linkbase *
101.DEF	XBRL Taxonomy Extension Definition Linkbase *

* Attached as Exhibit 101 to this Form 10-Q are documents formatted in XBRL (Extensive Business Reporting Language).

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SIGNATURES

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

/s/ Thomas R. Quinn, Jr.
Thomas R. Quinn, Jr.
President and CEO
(Principal Executive Officer)

/s/ David P. Boyle
David P. Boyle
Executive Vice President and CFO
(Principal Financial Officer)

Date: November 8, 2013

ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

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101.DEF	XBRL Taxonomy Extension Definition Linkbase *

All other exhibits for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

* Attached as Exhibits 101 to this Form 10-Q are documents formatted in XBRL (Extensive Business Reporting Language).