

ORRSTOWN FINANCIAL SERVICES INC

Form 10-Q

November 08, 2012

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10 Q**

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

**For the quarterly period ended September 30, 2012**

**or**

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

**For the transition period from to**

**Commission file number: 001-34292**

**ORRSTOWN FINANCIAL SERVICES, INC.**

**(Exact Name of Registrant as Specified in its Charter)**

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**Pennsylvania**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**23-2530374**  
(I.R.S. Employer  
Identification No.)

**77 East King Street, P. O. Box 250, Shippensburg, Pennsylvania**  
(Address of Principal Executive Offices)

**17257**  
(Zip Code)

**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 ☒ No ☐

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 ☒

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 ☒

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

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

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

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

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

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

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

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

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

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

**Table of Contents****Consolidated Statements of Comprehensive Income (Loss) (Unaudited)****ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY**

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

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

**Table of Contents****Consolidated Statements of Changes in Shareholders' Equity****ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY****Nine Months Ended September 30, 2012 and 2011**

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

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

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### Consolidated Statements of Cash Flows

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

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

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|                                                                                                |           |           |
|------------------------------------------------------------------------------------------------|-----------|-----------|
| Net decrease in cash and cash equivalents                                                      | (5,670)   | (2,967)   |
| Cash and cash equivalents at beginning of period                                               | 19,630    | 19,200    |
| Cash and cash equivalents at end of period                                                     | \$ 13,960 | \$ 16,233 |
| <b>Supplemental disclosures of cash flow information:</b>                                      |           |           |
| Cash paid during the period for:                                                               |           |           |
| Interest                                                                                       | \$ 6,515  | \$ 8,436  |
| Income taxes                                                                                   | 1,267     | 3,657     |
| <b>Supplemental schedule of noncash investing activities:</b>                                  |           |           |
| Other real estate acquired in settlement of loans                                              | \$ 3,237  | \$ 2,239  |
| <i>The Notes to Consolidated Financial Statements are an integral part of these statements</i> |           |           |

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### **Notes to Consolidated Financial Statements**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

*Income Taxes* - The Company accounts for Income Taxes in accordance with income tax accounting guidance (FASB ASC 740, *Income Taxes*). The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable

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income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

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

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

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

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

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

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

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

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

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

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

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

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

**Table of Contents****NOTE 2. SECURITIES AVAILABLE FOR SALE**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of \$1,000,000. Loan review documentation is submitted to the Credit Administration Committee quarterly with a formal review and rating as presented by independent loan review personnel. In addition,

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

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

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

Classified loans may also be evaluated for impairment. For commercial real estate, acquisition and development and commercial and industrial loans, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Generally, loans that are more than 90 days past due are deemed impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed, to determine if the loan should be placed in nonaccrual status. Nonaccrual loans in the commercial and commercial real estate portfolios are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and

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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

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may include updated appraisals. The updated fair values will be incorporated into the impairment analysis as of the next reporting period. In the event an updated appraisal that requires a higher impairment reserve is received after a reporting period, but prior to the issuance of the financial statements, an evaluation is made as to the significance of the difference and whether the amounts need to be reflected in the financial statements not yet issued.

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

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

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

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

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

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

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

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

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

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

|                                     | Impaired Loans with a Specific Allowance |                   |                 | Impaired Loans with No Specific Allowance |                   |
|-------------------------------------|------------------------------------------|-------------------|-----------------|-------------------------------------------|-------------------|
|                                     | Recorded                                 | Unpaid            |                 | Recorded                                  | Unpaid            |
|                                     | Investment                               | Principal Balance | Related         | Investment                                | Principal Balance |
|                                     | (Book Balance)                           | (Legal Balance)   | Allowance       | (Book Balance)                            | (Legal Balance)   |
| <i>(Dollars in thousands)</i>       |                                          |                   |                 |                                           |                   |
| <b>September 30, 2012</b>           |                                          |                   |                 |                                           |                   |
| Commercial real estate:             |                                          |                   |                 |                                           |                   |
| Owner-occupied                      | \$ 0                                     | \$ 0              | \$ 0            | \$ 8,973                                  | \$ 10,821         |
| Non-owner occupied                  | 1,266                                    | 1,266             | 333             | 13,124                                    | 18,642            |
| Multi-family                        | 0                                        | 0                 | 0               | 2,219                                     | 2,767             |
| Acquisition and development:        |                                          |                   |                 |                                           |                   |
| 1-4 family residential construction | 718                                      | 725               | 413             | 1,386                                     | 3,896             |
| Commercial and land development     | 617                                      | 624               | 363             | 13,053                                    | 28,085            |
| Commercial and industrial           | 1,852                                    | 1,866             | 1,089           | 12,811                                    | 17,086            |
| Residential mortgage:               |                                          |                   |                 |                                           |                   |
| First lien                          | 450                                      | 450               | 4               | 3,640                                     | 3,880             |
| Home equity - term                  | 0                                        | 0                 | 0               | 49                                        | 162               |
| Home equity - lines of credit       | 199                                      | 199               | 60              | 529                                       | 529               |
| Consumer                            | 0                                        | 0                 | 0               | 8                                         | 8                 |
|                                     | <b>\$ 5,102</b>                          | <b>\$ 5,130</b>   | <b>\$ 2,262</b> | <b>\$ 55,792</b>                          | <b>\$ 85,876</b>  |

**December 31, 2011**

|                                     |          |          |          |          |          |
|-------------------------------------|----------|----------|----------|----------|----------|
| Commercial real estate:             |          |          |          |          |          |
| Owner-occupied                      | \$ 5,016 | \$ 5,200 | \$ 1,762 | \$ 4,794 | \$ 4,838 |
| Non-owner occupied                  | 16,682   | 20,472   | 6,876    | 3,502    | 4,071    |
| Multi-family                        | 3,129    | 5,117    | 1,213    | 334      | 334      |
| Acquisition and development:        |          |          |          |          |          |
| 1-4 family residential construction | 2,182    | 3,715    | 926      |          |          |
| Commercial and land development     | 10,657   | 13,899   | 4,369    | 8,407    | 9,712    |
| Commercial and industrial           | 46,685   | 47,256   | 14,591   | 6,449    | 6,551    |

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

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

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

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

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

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

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

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## Acquisition and development:

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

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

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

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

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

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

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

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

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methodology was made as management determined that the most recent eight quarters loss history as adjusted based on other portfolio analysis and applied to an entire pool of loans is a better reflection of the

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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**December 31, 2011**

Loans allocated by:

|                                       |            |           |            |            |           |      |            |
|---------------------------------------|------------|-----------|------------|------------|-----------|------|------------|
| Individually evaluated for impairment | \$ 33,457  | \$ 21,246 | \$ 53,134  | \$ 1,918   | \$ 0      | \$ 0 | \$ 109,755 |
| Collectively evaluated for impairment | 334,553    | 63,416    | 224,766    | 220,873    | 12,077    | 0    | 855,685    |
|                                       | \$ 368,010 | \$ 84,662 | \$ 277,900 | \$ 222,791 | \$ 12,077 | \$ 0 | \$ 965,440 |

Allowance for loan losses allocated by:

|                                       |           |          |           |        |       |          |           |
|---------------------------------------|-----------|----------|-----------|--------|-------|----------|-----------|
| Individually evaluated for impairment | \$ 9,851  | \$ 5,295 | \$ 14,591 | \$ 51  | \$ 0  | \$ 0     | \$ 29,788 |
| Collectively evaluated for impairment | 4,013     | 4,413    | 2,978     | 882    | 75    | 1,566    | 13,927    |
|                                       | \$ 13,864 | \$ 9,708 | \$ 17,569 | \$ 933 | \$ 75 | \$ 1,566 | \$ 43,715 |

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### NOTE 4. INCOME TAXES

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

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

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

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

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

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

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|                                    |    |         |    |        |
|------------------------------------|----|---------|----|--------|
| Net deferred tax asset (liability) | \$ | (1,396) | \$ | 18,182 |
|------------------------------------|----|---------|----|--------|

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

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

**NOTE 5. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITY**

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

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

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

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

**NOTE 6. SHAREHOLDERS' EQUITY AND REGULATORY CAPITAL**

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

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

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

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

**NOTE 7. EARNINGS PER SHARE**

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

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

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

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

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

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

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

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

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

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

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

**NOTE 9. FAIR VALUE DISCLOSURES**

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

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

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

**Securities**

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

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

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

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

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

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

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

**Impaired Loans**

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

**Foreclosed Real Estate**

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

**Mortgage Servicing Rights**

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

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

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

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

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

**Fair values of financial instruments**

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

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

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

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

**Loans Held for Sale**

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

**Loans Receivable**

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

**Restricted Investment in Bank Stock**

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

Deposit Liabilities

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

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

**Short-Term Borrowings**

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

**Long-Term Debt**

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

**Accrued Interest**

The carrying amounts of accrued interest approximate their fair values.

**Off-Balance-Sheet Instruments**

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

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

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

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

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

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

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

### **Critical Accounting Policies**

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

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

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

The Company recognizes deferred tax assets and liabilities for the future effects of temporary differences and tax credits. Enacted tax rates are applied to cumulative temporary differences based on expected taxable income in the periods in which the deferred tax asset or liability is anticipated to be realized. Future tax rate changes could occur that would require the recognition of income or expense in the statement of operations in the period in which they are enacted. Deferred tax assets must be reduced by a valuation allowance if in management's judgment it is more likely than not that some portion of the asset will not be realized. Management may need to modify their judgments in this regard from one period to another should a material change occur in the business environment, tax legislation, or in any other business factor that could impair the Company's ability to benefit from the asset in the future. Based upon the Company's continued taxable losses, projections for future taxable income and other available evidence, management believed it was not more likely than not that the net deferred tax asset would be realized at September 30, 2012, and accordingly, recorded a full valuation allowance of \$19,872,000 at September 30, 2012.

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

**SUMMARY OF FINANCIAL RESULTS**

The Company recorded a net loss of \$21,352,000 for the third quarter of 2012 compared to net income of \$4,314,000 for the same period in 2011. Basic and diluted earnings (loss) per share (EPS) for the third quarter of 2012 were \$(2.65), compared to \$0.54 for the third quarter of 2011. On a year-to-date basis, the net loss recorded for the period was \$39,484,000 for 2012, compared to a net loss of \$2,482,000 for the same period in 2011. Basic and diluted earnings (loss) per share totaled \$(4.90) for the nine months ended September 30, 2012 compared to \$(0.31) for the same period in 2011.

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

|                                   | Three Months Ended |                | Nine Months Ended |                |
|-----------------------------------|--------------------|----------------|-------------------|----------------|
|                                   | September, 30,     | September, 30, | September, 30,    | September, 30, |
|                                   | 2012               | 2011           | 2012              | 2011           |
| Return on average assets          | (6.50)%            | 1.11%          | (3.80)%           | (0.22)%        |
| Return on average tangible assets | (6.50)%            | 1.13%          | (3.80)%           | (0.21)%        |
| Return on average equity          | (79.60)%           | 10.82%         | (44.87)%          | (2.06)%        |
| Return on average tangible equity | (80.22)%           | 12.54%         | (45.12)%          | (2.27)%        |
| Average equity / average assets   | 8.16%              | 10.22%         | 8.47%             | 10.50%         |

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

Return on average tangible assets and return on average tangible equity are non-GAAP-based financial measures calculated using non-GAAP-based amounts. The most directly comparable measure is return on average assets and return on average equity, which are calculated using GAAP-based amounts. The Company calculates the return on average tangible assets and equity by excluding the balance of

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intangible assets and their related amortization expense, net of tax, from the calculation of return on average assets and equity. Management uses the return on average tangible assets and equity to assess the Company's core operating results and believes that this is a better measure of our operating performance as it is based on the Company's tangible assets and capital. We believe that excluding the impact of purchase accounting adjustments allows for a meaningful comparison with the Company's peers; particularly those that may not have acquired other companies. Lastly, the exclusion of goodwill and other intangible assets is consistent with the treatment by bank regulatory agencies on the calculation of risk-based capital ratios, which excludes these amounts. However, these non-GAAP financial measures are supplemental and are not a substitute for an analysis based on GAAP measures. A reconciliation of return on average assets and equity to the return on average tangible assets and equity, is set forth below.

|                                                                                    | September 30, 2012 | September 30, 2011 |
|------------------------------------------------------------------------------------|--------------------|--------------------|
| <b>For Quarter Ended:</b>                                                          |                    |                    |
| Return on Average Assets (GAAP basis)                                              | (6.50)%            | 1.11%              |
| Effect of excluding average intangible assets and related amortization, net of tax | 0.00%              | 0.02%              |
| Return on Average Tangible Assets                                                  | (6.50)%            | 1.13%              |
| Return on Average Equity (GAAP basis)                                              | (79.60)%           | 10.82%             |
| Effect of excluding average intangible assets and related amortization, net of tax | (0.62)%            | 1.72%              |
| Return on Average Tangible Equity                                                  | (80.22)%           | 12.54%             |

|                                                                                    | September 30, 2012 | September 30, 2011 |
|------------------------------------------------------------------------------------|--------------------|--------------------|
| <b>For Nine Months Ended:</b>                                                      |                    |                    |
| Return on Average Assets (GAAP basis)                                              | (3.80)%            | (0.22)%            |
| Effect of excluding average intangible assets and related amortization, net of tax | 0.00%              | 0.01%              |
| Return on Average Tangible Assets                                                  | (3.80)%            | (0.21)%            |
| Return on Average Equity (GAAP basis)                                              | (44.87)%           | (2.06)%            |
| Effect of excluding average intangible assets and related amortization, net of tax | (0.25)%            | (0.21)%            |
| Return on Average Tangible Equity                                                  | (45.12)%           | (2.27)%            |

|                                                      | September 30, 2012 | December 31, 2011 |
|------------------------------------------------------|--------------------|-------------------|
| <i>(Dollars in thousands, except per share data)</i> |                    |                   |
| Common shareholders' equity                          | \$ 87,320          | \$ 128,197        |
| Less: Intangible assets                              | 884                | 1,041             |
| Tangible common equity                               | \$ 86,436          | \$ 127,156        |
| Total assets                                         | \$ 1,269,319       | \$ 1,444,097      |
| Less: Intangible assets                              | 884                | 1,041             |
| Tangible assets                                      | \$ 1,268,435       | \$ 1,443,056      |

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Tangible book value per share is computed by dividing shares outstanding into tangible common equity. Management uses tangible book value per share because it believes such ratio is useful in understanding the Company's capital position and ratios. A reconciliation of book value per share to tangible book value per share is as follows:

|                                      | September 30, 2012 | December 31, 2011 |
|--------------------------------------|--------------------|-------------------|
| Book value per share                 | \$ 10.83           | \$ 15.92          |
| Less: Intangible assets per share    | 0.11               | 0.13              |
| <b>Tangible book value per share</b> | <b>\$ 10.72</b>    | <b>\$ 15.79</b>   |

Tax equivalent net interest income is derived from GAAP interest income and net interest income using an assumed tax rate of 35%. We believe the presentation of net interest income on a tax-equivalent basis ensures comparability of net interest income arising from both taxable and tax-exempt sources and is consistent with industry practice. The following reconciles net interest income on a fully taxable equivalent basis:

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| <i>(Dollars in thousands)</i>             | September 30,<br>2012 | September 30,<br>2011 |
|-------------------------------------------|-----------------------|-----------------------|
| <b>For Quarter Ended:</b>                 |                       |                       |
| Net interest income                       | \$ 9,029              | \$ 12,825             |
| Effect of tax exempt income               | 545                   | 720                   |
| Net interest income, tax equivalent basis | \$ 9,574              | \$ 13,545             |
| <b>For Nine Months Ended:</b>             |                       |                       |
| Net interest income                       | \$ 29,417             | \$ 38,023             |
| Effect of tax exempt income               | 1,780                 | 2,122                 |
| Net interest income, tax equivalent basis | \$ 31,197             | \$ 40,145             |

**RESULTS OF OPERATIONS****QUARTER ENDED SEPTEMBER 30, 2012 COMPARED TO QUARTER ENDED****SEPTEMBER 30, 2011****Net Interest Income**

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

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

The Average Balances and Interest Rates 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, 2012 and 2011.

For the three months ended September 30, 2012, net interest income measured on a fully tax equivalent basis decreased \$3,971,000 to \$9,574,000 from \$13,545,000 in the corresponding period in 2011. The primary reason for the decrease in net interest income was a decrease in average earning assets from \$1,460,536,000 for the third quarter of 2011 to \$1,229,190,000 for the same period in 2012. In addition, net interest margin decreased by 56 basis points, from 3.66% for the three months ended September 30, 2011 to 3.10% for the same period in 2012. The net interest spread for the three months ended September 30, 2012 was 3.02%, compared to 3.54% for the same period in 2011.

Interest income earned on loans decreased from \$12,719,000 for the quarter ended September 30, 2011 to \$9,937,000 for the same period in 2012, a \$2,782,000 decline. Several factors have contributed to the decline. First, the average balance of impaired loans, which generally are in nonaccrual status, increased from \$57,883,000 for the third quarter of 2011 to \$59,980,000 for the same period in 2012. Additionally, the Company settled two floating for fixed rate interest rate swaps last year, and therefore there was no interest income from the swaps to enhance 2012's yield. As a result of these two factors, combined with generally lower interest rates, the yield on loans declined from 4.97% for the third quarter of 2011 to 4.78% for the third quarter of 2012. In addition to lower yields, the average volume of loans declined from \$1,002,964,000 for the three months ended September 30, 2011 to \$827,553,000 for the same period in 2012. The Company has temporarily curbed its loan growth in order to address and enhance credit administration and underwriting processes and procedures.

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Securities interest income also declined in 2012 and totaled \$1,268,000 for the quarter ended September 30, 2012, a decrease of \$2,182,000, compared to \$3,450,000 for the same period in 2011. The average balance on securities has declined from \$408,951,000 in the third quarter of 2011 to \$295,578,000 for the same period in 2012, and is a reason for the decrease in securities interest income. As a result of the recent regulatory climate related to nontraditional funding sources, management anticipates that it will not utilize brokered deposits to the extent it has in the past, and as such, as the brokered deposits matured, security proceeds were used to fund the payoff. In addition, the low interest rate environment has resulted in increased refinancing activity. This refinancing has resulted in accelerated prepayments on mortgage backed securities, many of which have premiums associated with them. As the prepayments have accelerated, the amortization of the premiums has been faster than in the past, which has placed pressure on 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. The yields earned on securities were 1.71% for the third quarter of 2012, a 167 basis point decline as compared to 3.38% for the third quarter of 2011.

Interest expense on deposits and borrowings for the three months ended September 30, 2012 was \$1,702,000, a decrease of \$964,000, from the \$2,666,000 expensed in the same period in 2011. The Company's cost of funds on interest bearing liabilities has declined from 0.84% for the quarter ended September 30, 2011 to 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 2012 compared to 2011, and as time deposits and long-term debt mature, it has also been able to replace the funds at slightly lower rates.

The Company's net interest spread of 3.02% declined 52 basis points in the quarter ended September 30, 2012 as compared to the same period in 2011. Net interest margin for the quarter ended September 30, 2012 was 3.10%, a 56 basis point decline from 3.66% for the quarter ended September 30, 2011. Management anticipates continued pressure on the net interest margin in future quarters as the level of nonaccrual loans will continue to impact rates earned on loans and securities will continue to pay off or mature, and be reinvested at lower interest rates.

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

**Average Balances and Interest Rates**

|                                                        | September 30, 2012 |                               |                           | Three Months Ended<br>September 30, 2011 |                               |                           |
|--------------------------------------------------------|--------------------|-------------------------------|---------------------------|------------------------------------------|-------------------------------|---------------------------|
|                                                        | Average<br>Balance | Tax<br>Equivalent<br>Interest | Tax<br>Equivalent<br>Rate | Average<br>Balance                       | Tax<br>Equivalent<br>Interest | Tax<br>Equivalent<br>Rate |
| <i>(Dollars in thousands)</i>                          |                    |                               |                           |                                          |                               |                           |
| <b>Assets</b>                                          |                    |                               |                           |                                          |                               |                           |
| Federal funds sold & interest bearing bank<br>balances | \$ 106,059         | 71                            | 0.27%                     | \$ 46,621                                | \$ 42                         | 0.34%                     |
| Securities                                             | 295,578            | 1,268                         | 1.71                      | 408,951                                  | 3,450                         | 3.38                      |
| Loans                                                  | 827,553            | 9,937                         | 4.78                      | 1,002,964                                | 12,719                        | 4.97                      |
| Total interest-earning assets                          | 1,229,190          | 11,276                        | 3.65                      | 1,460,536                                | 16,211                        | 4.38                      |
| Other assets                                           | 77,234             |                               |                           | 87,511                                   |                               |                           |
| Total                                                  | \$ 1,306,424       |                               |                           | \$ 1,548,047                             |                               |                           |
| <b>Liabilities and Shareholders' Equity</b>            |                    |                               |                           |                                          |                               |                           |
| Interest bearing demand deposits                       | \$ 495,095         | 248                           | 0.20                      | \$ 503,972                               | \$ 415                        | 0.33                      |
| Savings deposits                                       | 73,757             | 31                            | 0.17                      | 72,845                                   | 36                            | 0.20                      |
| Time deposits                                          | 439,628            | 1,240                         | 1.12                      | 585,030                                  | 1,871                         | 1.27                      |
| Short term borrowings                                  | 20,647             | 20                            | 0.39                      | 53,015                                   | 68                            | 0.51                      |
| Long term debt                                         | 38,006             | 163                           | 1.71                      | 43,192                                   | 276                           | 2.55                      |
| Total interest bearing liabilities                     | 1,067,133          | 1,702                         | 0.63                      | 1,258,054                                | 2,666                         | 0.84                      |
| Non-interest bearing demand Deposits                   | 122,050            |                               |                           | 121,749                                  |                               |                           |
| Other                                                  | 10,611             |                               |                           | 10,094                                   |                               |                           |
| Total Liabilities                                      | 1,199,794          |                               |                           | 1,389,897                                |                               |                           |
| Shareholders' Equity                                   | 106,630            |                               |                           | 158,150                                  |                               |                           |
| Total                                                  | \$ 1,306,424       |                               | 0.55%                     | \$ 1,548,047                             |                               | 0.72%                     |
| Net interest income (FTE)/ net interest spread         |                    | 9,574                         | 3.02%                     |                                          | 13,545                        | 3.54%                     |
| Net interest margin                                    |                    |                               | 3.10%                     |                                          |                               | 3.66%                     |
| Tax-equivalent adjustment                              |                    | (545)                         |                           |                                          | (720)                         |                           |
| Net interest income                                    |                    | \$ 9,029                      |                           |                                          | \$ 12,825                     |                           |

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**

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The provision for loan losses for the three months ended September 30, 2012 totaled \$5,100,000, a decrease from the third quarter of 2011's provision of \$7,900,000. As further discussed in the Allowance for Loan Losses section, the 2012 provision levels were impacted by several factors. During the third quarter of 2012, the Company's risk elements, impaired loans, and net loan charge-offs continued to trend favorably. Total risk assets remained relatively constant when compared to June 30, 2012, increasing \$1,031,000, or 1.6%, to \$64,391,000. When compared to December 31, 2011, risk assets have decreased \$49,388,000 or 43.4%. Impaired loans also remained relatively constant when compared to June 30, 2012, increasing \$1,835,000 or 3.1% to \$60,894,000. When compared to December 31, 2011, impaired loans have decreased \$48,861,000, or 44.5%. During the third quarter of 2012, net loan charge-offs totaled \$4,635,000, which is a decrease of \$10,286,000 or 68.9% when compared to the second quarter of 2012. When compared to the third quarter of 2011, net loan charge-offs have decreased \$4,800,000 or 50.9%. Over the past four quarters ended June 30, 2012, the Company has experienced less favorable credit metrics overall, resulting in increased provisioning for loan losses during this period. As a result of the increased provision over the past four quarters accompanied with the reduced loan charge-offs, continued overall loan contraction, and relatively flat risk assets on a linked quarter basis, the Company did not require as large of a provision for loan loss when compared to the quarter ended September 30, 2011.

See further discussion in the Allowance for Loan Losses section.

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### **Noninterest Income**

Noninterest income, excluding securities gains, totaled \$4,882,000 for the three months ended September 30, 2012, compared to \$6,600,000 for the same period in 2011. The net decline in revenues can be attributed to several factors, including the following:

The Company sold its merchant service business in 2011, which had accounted for a \$1,161,000 decrease in income for the third quarter of 2012 when compared to the same period in 2011.

Consistent with a trend noted in 2011, the Company has experienced a decline in overdraft charges, as consumers are spending less, and less likely to overdraw their account. This change in consumer behavior is the primary reason that service charges on deposit accounts declined from \$1,674,000 for the three months ended September 30, 2011 to \$1,564,000 for the same period in 2012.

Trust department and brokerage income, in total, increased \$42,000, or 3.0%, to \$1,460,000 for the three months ended September 30, 2012 compared to the same period in 2011 despite a volatile market. The Company has been able to attract new accounts and customers which contributed to the increase.

Mortgage banking activities revenue for the quarter ended September 30, 2012 was \$931,000, a \$4,000 increase from the 2011 quarter's total of \$927,000. The low interest rate environment has positively impacted loan origination volume, as refinancing activity has increased. However, the increase in revenues has been negatively impacted through acceleration of mortgage servicing rights amortization on loans sold with servicing retained.

The Company sold an interest rate swap during the third quarter of 2011 resulting in a gain of \$673,000 to other income. No such gain was recorded during the third quarter of 2012.

Securities gains (losses) totaled (\$2,000) for the three months ended September 30, 2012 compared to \$2,351,000 for the same period in 2011. Asset/liability management strategies, interest rate conditions, as well as maintaining capital levels factored into the decision to sell securities that resulted in elevated levels of security gains in the third quarter of 2011.

### **Noninterest Expenses**

Noninterest expenses amounted to \$11,133,000 for the three months ended September 30, 2012 compared to \$10,827,000 for the corresponding prior year period. Asset quality and regulatory matters have contributed significantly to the increase in noninterest expenses, including the following:

Salaries and employee benefits totaled \$4,874,000 for the three months ended September 30, 2012, compared to \$4,690,000 for the three months ended September 30, 2011, an increase of \$184,000. The increase in salaries and employee benefits is largely the result of the establishment of the Company's Special Assets Group to assist in working through troubled assets, as well as an increase in personnel in the Credit Administration Department. During the upcoming quarters, we expect that our salaries and employee benefit charges will exceed the prior years, as we expect to recruit and add additional talent to the Company's executive and management ranks.

Collection and problem loan expenses totaled \$593,000 for the three months ended September 30, 2012, compared to \$359,000 for the three months ended September 30, 2011, an increase of \$234,000. In order to properly monitor its impaired loans, the Company updates appraisals on its collateral and incurs legal expenses as it develops work out plans. Increased appraisal activity and legal expenses have led to the increased charges.

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Advertising and bank promotions expense increased \$158,000 from \$276,000 for the three months ended September 30, 2011 to \$434,000 for the same period in 2012 as a result of contributions to the Educational Improvement Tax Credit program made during the quarter. During 2011, these contributions were made during the fourth quarter.

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FDIC Insurance expense increased \$98,000 to \$788,000 for the three months ended September 30, 2012. This increase is the result of an increased risk rating and associated increased depository insurance rate, which has been slightly offset by a reduction in net assets of the Bank.

Professional service fees, including loan review assistance, legal fees and accounting expenses, have decreased \$396,000 from \$1,125,000 in the third quarter of 2011 to \$729,000 in the same period in 2012.

As noted in the Noninterest Income section, the Company sold its merchant services business in 2011. Data processing expenses of \$231,000 were incurred in the three months ended September 30, 2011 pertaining to these revenues with no corresponding charges in 2012.

Other noninterest expenses increased \$140,000 from \$1,509,000 for the three months ended September 30, 2011 to \$1,649,000 for the three months ended September 30, 2012.

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. The Company's efficiency ratio was 75.07% for the three months ended September 30, 2012, compared to 52.36% for the same period in 2011. The increase in the ratio is the result of increases in noninterest expenses combined with declining net interest income. As the Company continues to address its asset quality issues and regulatory concerns, it anticipates the efficiency ratio will remain elevated in comparison to historical results.

### **Income Tax Expense**

The Company recorded a deferred tax asset valuation allowance of \$19,872,000 offset by an income tax benefit of \$844,000 for a total income tax expense of \$19,028,000 for the quarter ended September 30, 2012, compared to a \$1,265,000 tax benefit for the same period in 2011. A meaningful comparison of income tax expense to levels of pre-tax income is its effective tax rate, which exceeds the 35% federal statutory rate primarily due to tax-exempt loan and security income, life insurance earnings and tax credits associated with low-income housing and historic projects, offset by certain non-deductible expenses and state income taxes.

Excluding the deferred tax asset valuation allowance charge, the Company's effective tax rate was 36.3% for the quarter ended September 30, 2012, compared to (41.5%) for the corresponding prior year period. The higher tax rate in 2012 compared to 2011 is due to assumptions used in calculating the 2011 tax provision, in which a lower effective tax rate was estimated for the year, in accordance with interim financial reporting guidance outlined in ASC 740-270-25.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers taxes paid in prior years, projected future taxable income and available tax planning strategies, and other factors in making this assessment. Based upon the level of historical taxable income, projections for future taxable income over the periods and other available evidence, management believed it was not more likely than not that the net deferred tax asset would be realized at September 30, 2012. Accordingly, a valuation allowance for the net amount of the deferred tax assets, or \$19,872,000, which represented future deductible temporary differences on our tax returns, was established at September 30, 2012, compared to no valuation allowance at December 31, 2011.

**Table of Contents****NINE MONTHS ENDED SEPTEMBER 30, 2012 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2011****Net Interest Income**

For the nine months ended September 30, 2012, net interest income measured on a fully tax equivalent basis decreased \$8,948,000 to \$31,197,000 from \$40,145,000 in the corresponding period in 2011. A reason for the decrease in net interest income was a decrease in average earning assets from \$1,443,171,000 for the first nine months of 2011 to \$1,318,006,000 for the same period in 2012. In addition, net interest margin decreased by 53 basis points, from 3.69% for the nine months ended September 30, 2011 to 3.16% for the same period in 2012. The net interest spread for the nine months ended September 30, 2012 was 3.07%, compared to 3.57% for the same period in 2011.

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

**Average Balances and Interest Rates**

|                                                     | September 30, 2012 |                         |                     | September 30, 2011 |                         |                     |
|-----------------------------------------------------|--------------------|-------------------------|---------------------|--------------------|-------------------------|---------------------|
|                                                     | Average Balance    | Tax Equivalent Interest | Tax Equivalent Rate | Average Balance    | Tax Equivalent Interest | Tax Equivalent Rate |
| <i>(Dollars in thousands)</i>                       |                    |                         |                     |                    |                         |                     |
| <b>Assets</b>                                       |                    |                         |                     |                    |                         |                     |
| Federal funds sold & interest bearing bank balances | \$ 108,526         | \$ 214                  | 0.26%               | \$ 32,184          | \$ 87                   | 0.36%               |
| Securities                                          | 322,369            | 5,279                   | 2.19                | 413,483            | 10,277                  | 3.32                |
| Loans                                               | 887,111            | 31,736                  | 4.78                | 997,504            | 38,111                  | 5.06                |
| Total interest-earning assets                       | 1,318,006          | 37,229                  | 3.77                | 1,443,171          | 48,475                  | 4.46                |
| Other assets                                        | 70,605             |                         |                     | 89,389             |                         |                     |
| Total                                               | \$ 1,388,611       |                         |                     | \$ 1,532,560       |                         |                     |
| <b>Liabilities and Shareholders' Equity</b>         |                    |                         |                     |                    |                         |                     |
| Interest bearing demand deposits                    | \$ 517,094         | \$ 1,008                | 0.26                | \$ 463,737         | \$ 1,280                | 0.37                |
| Savings deposits                                    | 74,236             | 93                      | 0.17                | 70,784             | 110                     | 0.21                |
| Time deposits                                       | 471,006            | 4,258                   | 1.21                | 593,612            | 5,816                   | 1.31                |
| Short term borrowings                               | 37,058             | 113                     | 0.41                | 73,882             | 286                     | 0.52                |
| Long term debt                                      | 45,558             | 560                     | 1.64                | 46,027             | 838                     | 2.43                |
| Total interest bearing liabilities                  | 1,144,952          | 6,032                   | 0.70                | 1,248,042          | 8,330                   | 0.89                |
| Non-interest bearing demand deposits                | 116,194            |                         |                     | 113,662            |                         |                     |
| Other                                               | 9,914              |                         |                     | 9,901              |                         |                     |
| Total Liabilities                                   | 1,271,060          |                         |                     | 1,371,605          |                         |                     |
| Shareholders' Equity                                | 117,551            |                         |                     | 160,955            |                         |                     |
| Total                                               | \$ 1,388,611       |                         | 0.61%               | \$ 1,532,560       |                         | 0.77%               |
| Net interest income (FTE)/ net interest spread      |                    | 31,197                  | 3.07%               |                    | \$ 40,145               | 3.57%               |
| Net interest margin                                 |                    |                         | 3.16%               |                    |                         | 3.69%               |
| Tax-equivalent adjustment                           |                    | (1,780)                 |                     |                    | (2,122)                 |                     |

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|                     |           |           |
|---------------------|-----------|-----------|
| Net interest income | \$ 29,417 | \$ 38,023 |
|---------------------|-----------|-----------|

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.

Interest income earned on loans decreased from \$38,111,000 for the nine months ended September 30, 2011 to \$31,736,000 in 2012, a \$6,375,000 decline. Several factors have contributed to the decline. First, the average balance of impaired loans, which generally are in nonaccrual status, increased from \$36,154,000 for the first nine months of 2011 to \$78,724,000 for the corresponding period in 2012. Additionally, the Company settled two floating for fixed rate interest rate swaps last year, and therefore there was no interest income from the swaps to enhance 2012's yield compared to \$261,000 included in

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interest income in 2011. As a result of these factors, combined with generally lower interest rates, the yield on loans declined from 5.06% for the first nine months of 2011 to 4.78% for the first nine months of 2012. In addition to lower yields, the average volume of loans declined from \$997,504,000 for the nine months ended September 30, 2011 to \$887,111,000 for the same period in 2012. The Company has temporarily curbed its loan growth in order to address and enhance credit administration and underwriting processes and procedures.

Securities interest income also declined in 2012 and totaled \$5,279,000 for the nine months ended September 30, 2012, a decrease of \$4,998,000 compared to \$10,277,000 for the same period in 2011. The average balance on securities has declined significantly, from \$413,483,000 in the first nine months of 2011 to \$322,369,000 for the same period in 2012, and is a reason for the decrease in securities interest income. As a result of the recent regulatory climate related to nontraditional funding sources, management anticipates it will not utilize brokered deposits to the extent it has in the past, and as such, as the brokered deposits matured, securities proceeds were used to fund the payoff. In addition, the low interest rate environment has resulted in increased refinancing activity. This refinancing has resulted in accelerated prepayments on mortgage backed securities, many of which have premiums associated with them. As the prepayments have accelerated, the amortization of the premium has been faster than in the past, which has placed pressure on 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. The yields earned on securities were 2.19% for the first nine months of 2012, a 113 basis point decline from the same period in 2011.

Interest expense on deposits and borrowings for the nine months ended September 30, 2012 was \$6,032,000, a decrease of \$2,298,000, from the \$8,330,000 expensed in the same period in 2011. The Company's cost of funds on interest bearing liabilities has declined from 0.89 % for the nine months ended September 30, 2011 to 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 accounts in 2012 compared to 2011, and as time deposits and long-term debt mature, it has been able to replace the funds with slightly lower rates as well.

The Company's net interest spread of 3.07% has declined by 50 basis points for the nine months ended September 30, 2012 compared to the same period in 2011. Net interest margin of 3.16% has declined 53 basis points for the nine months ended September 30, 2012 compared to the same period in 2011. Management anticipates continued pressure on the net interest margin in future quarters as the level of nonaccrual loans will continue to impact rates earned on loans and securities that will continue to pay off or mature, and be reinvested at lower interest rates.

### **Provision for Loan Losses**

The provision for loan losses for the nine months ended September 30, 2012 totaled \$47,300,000, compared to the first nine months of 2011's provision of \$32,325,000. As further discussed in the Allowance for Loan Losses section, the Company downgraded some credits, including \$76,600,000 which moved to nonaccrual status during the first nine months of 2012, and were generally evaluated for impairment based on a collateral dependent approach. As real estate conditions remain soft, additional provisioning was required for these newly impaired loans. In addition, the Company sold classified loans with a book value of \$28,598,000 for \$19,702,000, resulting in an additional charge of \$8,896,000. These loans were sold in order to reduce our classified assets and the effort and resources required to work out these problem loans. As a result of the combination of these factors, the Company's net charge offs during the nine months ended September 30, 2012 totaled \$54,315,000, as generally all specific reserves provided on impaired loans were charged against the allowance for loan losses during the first nine months. This elevated level of charge offs significantly increased our two-year average historical loss factors, leading to additional general reserves required on non-criticized loans.

See further discussion in the Allowance for Loan Losses section.

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### **Noninterest Income**

Noninterest income, excluding securities gains, totaled \$13,274,000 for the nine months ended September 30, 2012, compared to \$16,037,000 for the same period in 2011. The net decline in revenues can be attributed to a number of factors, including the following:

The Company sold its merchant service business in 2011, which had accounted for a \$1,701,000 decrease in income for the nine months of 2012 when compared to the same period in 2011.

Trust department and brokerage income increased \$144,000, to \$4,496,000 for the nine months ended September 30, 2012 compared to 2011 as a result of the number of accounts under management by the Company increasing.

Mortgage banking activities revenue for the nine months ended September 30, 2012 was \$2,143,000, a \$116,000 decline from \$2,259,000 for the first nine months of 2011. Although the low interest rate environment has positively impacted loan origination volume and related income, this rate environment negatively impacted the mortgage servicing rights on loans sold with servicing retained. For the nine months ended September 30, 2012, the Company recorded a lower of cost or fair value reserve of \$338,000 compared to the recovery of \$200,000 of the reserve in 2011, a fluctuation of \$538,000.

The Company recorded a \$791,000 gain on the settlement of an interest rate swap in the first nine months of 2011 which was included in other income (loss), with no corresponding revenues in the same period for 2012. In connection with the Company's asset liability management, it was determined these swaps would be settled as the gain represented much of the interest that would be earned over the remaining life of the swap, and the settlement would protect earnings in the event of rising interest rates.

Consistent with a trend noted in 2011, the Company has experienced a decline in overdraft charges, as consumers are spending less, and less likely to overdraw their account. This change in consumer behavior is the primary reason that service charges on deposit accounts declined from \$4,804,000 for the nine months ended September 30, 2011 to \$4,626,000 for the same period in 2012. Securities gains totaled \$4,824,000 for the nine months ended September 30, 2012 compared to \$3,199,000 for the same period in 2011. Asset/liability management strategies, interest rate conditions, as well as maintaining capital levels factored into the decision to take elevated levels of security gains in the first nine months of 2012.

### **Noninterest Expenses**

Noninterest expenses amounted to \$32,749,000 for the nine months ended September 30, 2012 compared to \$29,988,000 for the corresponding prior year period. Asset quality and regulatory matters have contributed significantly to the increase in noninterest expenses, including the following:

Salaries and employee benefits totaled \$14,508,000 for the nine months ended September 30, 2012, compared to \$13,698,000 for the nine months ended September 30, 2011, an increase of \$810,000. The increase in salaries and employee benefits is the result of the establishment of the Company's Special Assets Group to assist in working through troubled assets, as well as an increase in personnel in the Credit Administration Department. During the upcoming quarters, we expect that our salaries and employee benefit charges will exceed the prior years, as we expect to recruit and add additional skilled personnel to the Company's executive and management ranks.

Collection and problem loan expenses totaled \$1,890,000 for the nine months ended September 30, 2012, compared to \$690,000 for the nine months ended September 30, 2011, an increase of \$1,200,000. In order to properly monitor its impaired loans, the Company updates appraisals on its collateral and incurs legal expenses as it develops work out plans.

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Real estate owned expenses, which includes regular maintenance and upkeep expenses as well as write-downs of properties to fair value less costs to dispose, increased \$393,000 in the first nine months of 2012 compared to the same period in 2011, from \$313,000 in 2011 to \$706,000 in 2012. This increase is consistent with the higher number of properties that the Company owns and is managing, as well as continued softness in the real estate market, which led to further write-downs of properties.

Professional service fees, including loan review assistance, legal fees and accounting expenses, have increased \$288,000 from \$1,993,000 in the first nine months of 2011 to \$2,281,000 in the same period in 2012. The increased complexity of the organization, as well as complying with regulatory orders received in the first quarter of 2012 have led to additional assistance required from professional service providers. The increases in these expense categories demonstrate the Company's efforts to address the issues it currently faces in a diligent and expedient manner.

Advertising and bank promotions totaled \$1,115,000 for the nine months ended September 30, 2012, an increase of \$285,000 over the corresponding period in 2011. In light of recent events, the Company has developed a successful advertising campaign focused on our commitment to customer service and the community, which has led to higher expenses than those incurred in the prior year.

As noted in the Noninterest Income section, the Company sold its merchant services business in 2011. Data processing expenses of \$695,000 were incurred in the nine months ended September 30, 2011 pertaining to these revenues with no corresponding charges in 2012.

The increase in other operating expenses which totaled \$4,788,000 for the nine months ended September 30, 2012 compared to \$4,590,000 for the same period in 2011, was principally due to an increase in fraud losses associated with customer accounts, consistent with industry trends.

The remainder of the increase in other expenses is primarily the result of the growth experienced by the Company, and the development of new products and increased investments in technology.

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. The Company's efficiency ratio was 71.71% for the nine months ended September 30, 2012, compared to 52.59% for the same period in 2011. The increase in the ratio is the result of increases in noninterest expenses combined with declining net interest income. As the Company continues to address its asset quality issues and regulatory concerns, it anticipates the efficiency ratio will remain elevated in comparison to prior year's results.

## **Income Tax Expense**

The Company recorded a deferred tax asset valuation allowance of \$19,872,000 offset by an income tax benefit of \$12,922,000 for a total income tax expense of \$6,950,000 for the nine months ended September 30, 2012, compared to a \$2,572,000 tax benefit for the same period in 2011. A meaningful comparison of income tax expense to levels of pre-tax income is its effective tax rate, which is less than the 35% federal statutory rate, primarily due to tax-exempt loan and security income, life insurance earnings and tax credits associated with low-income housing and historic projects, offset by certain non-deductible expenses and state income taxes.

Excluding the deferred tax asset valuation allowance charge, the Company's effective tax rate was 39.7% for the nine months ended September 30, 2012, compared to 50.9% for the corresponding prior year period.

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

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those temporary differences become deductible. Management considers taxes paid in prior years, projected future taxable income and available tax planning strategies, and other factors in making this assessment. Based upon the level of historical taxable income, projections for future taxable income over the periods and other available evidence, management believed it was not more likely than not that the net deferred tax asset would be realized at September 30, 2012. Accordingly, a valuation allowance for the net amount of the deferred tax assets, or \$19,872,000, which represented future deductible temporary differences on our tax returns, was established at September 30, 2012, compared to no valuation allowance at December 31, 2011.

## **FINANCIAL CONDITION**

Assets decreased \$174,778,000 to \$1,269,319,000 at September 30, 2012 from December 31, 2011. This decrease resulted primarily from a decrease in securities available for sale and a decrease in our loan portfolio. The Company has implemented a strategy designed to slow loan growth and reduce its risk weighted asset levels in order to maintain capital ratios at levels that exceed well capitalized limits.

### **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, 2012, securities available for sale were \$291,649,000, a decrease of \$18,716,000, or 6% from December 31, 2011's balance of \$310,365,000. The state and municipal security portfolio has declined from 25.1% of the total portfolio at December 31, 2011 to 12.8% at September 30, 2012, as many of the revenue bonds were sold during the nine months ended September 30, 2012, and reinvested in U.S. Treasury securities. Both the decline in the securities portfolio and the shift of investment types, are consistent with Company's strategy to reduce its risk weighted assets.

### **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.

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

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

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

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

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

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

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

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

The loan portfolio at September 30, 2012 of \$803,738,000 decreased \$161,702,000 from \$965,440,000 at December 31, 2011. The bulk of the decrease was a result of elevated charge off levels experienced in the commercial loan portfolio during the first nine months of 2012, primarily in the commercial and industrial, owner-occupied and commercial and land development portfolios. In addition, the Company has continued to curb its new loan originations in order to focus on current portfolio analysis and maintenance and to enhance credit administration and underwriting processes and procedures. Given the softness in the economy within the Company's footprint, management feels this is a prudent course of action in order to rehabilitate its loan portfolio. Also, for longer term interest rate risk considerations, the Company continues to sell its longer term residential mortgage loans, as it is not willing to take on the interest rate risk in this environment.

During the first quarter of 2012, the Company reviewed its term home equity loan portfolio, and re-designated certain of these loans as first lien residential mortgages. First lien and home equity term loans totaled \$128,883,000 at September 30, 2012, a 9% decrease from \$141,840,000 at December 31, 2011.

As a result of the low interest rate environment, the Company has experienced early pay-offs of portfolio loans.

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

Nonperforming assets include nonaccrual and restructured loans and foreclosed real estate. In addition, loans past due 90 days or more and still accruing are also deemed to be a risk asset. For all loan classes, the accrual of interest income generally 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

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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.

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

The following table presents the Company's risk elements, including information concerning the aggregate balances of nonaccrual, restructured, loans past due 90 days or more, and foreclosed real estate as of September 30, 2012, December 31, 2011 and September 30, 2011. Relevant asset quality ratios are also presented.

| <i>(Dollars in Thousands)</i>                                                 | September 30,<br>2012 | December 31,<br>2011 | September 30,<br>2011 |
|-------------------------------------------------------------------------------|-----------------------|----------------------|-----------------------|
| Nonaccrual loans (cash basis)                                                 | \$ 57,780             | \$ 83,697            | \$ 31,174             |
| Other real estate (OREO)                                                      | 2,575                 | 2,165                | 2,754                 |
| <b>Total nonperforming assets</b>                                             | <b>60,355</b>         | <b>85,862</b>        | <b>33,928</b>         |
| Restructured loans still accruing                                             | 3,113                 | 27,917               | 37,175                |
| Loans past due 90 days or more and still accruing                             | 923                   | 0                    | 2,956                 |
| <b>Total risk assets</b>                                                      | <b>\$ 64,391</b>      | <b>\$ 113,779</b>    | <b>\$ 74,059</b>      |
| <b>Loans 30-89 days past due</b>                                              | <b>\$ 5,435</b>       | <b>\$ 6,723</b>      | <b>\$ 21,365</b>      |
| Asset quality ratios:                                                         |                       |                      |                       |
| Total nonaccrual loans to loans                                               | 7.19%                 | 8.67%                | 3.15%                 |
| Total nonperforming assets to assets                                          | 4.75%                 | 5.95%                | 2.24%                 |
| Total nonperforming assets to total loans and OREO                            | 7.49%                 | 8.87%                | 3.42%                 |
| Total risk assets to total loans and OREO                                     | 7.99%                 | 11.76%               | 7.47%                 |
| Total risk assets to total assets                                             | 5.07%                 | 7.88%                | 4.88%                 |
| Allowance for loan losses to total loans                                      | 4.57%                 | 4.53%                | 2.60%                 |
| Allowance for loan losses to nonaccrual loans                                 | 63.52%                | 52.23%               | 82.37%                |
| Allowance for loan losses to nonaccrual and restructured loans still accruing | 60.27%                | 39.17%               | 37.57%                |

A further breakdown of nonaccrual loans as of September 30, 2012 and December 31, 2011 is as follows:

| <i>(Dollars in Thousands)</i>       | Nonaccrual Loans   |                   |
|-------------------------------------|--------------------|-------------------|
|                                     | September 30, 2012 | December 31, 2011 |
| Commercial real estate:             |                    |                   |
| Owner-occupied                      | \$ 8,973           | \$ 8,832          |
| Non-owner occupied                  | 12,395             | 18,146            |
| Multi-family                        | 2,219              | 3,463             |
| Acquisition and development:        |                    |                   |
| 1-4 family residential construction | 2,104              | 2,182             |
| Commercial and land development     | 13,670             | 18,003            |
| Commercial and industrial           | 14,333             | 29,848            |
| Residential mortgage:               |                    |                   |
| First lien                          | 3,338              | 1,928             |
| Home equity                         | 740                | 1,293             |
| Installment and other loans         | 8                  | 2                 |
|                                     | <b>\$ 57,780</b>   | <b>\$ 83,697</b>  |

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During the second quarter of 2011, the Company began to experience deterioration in asset quality as a result of the continued softness in economic conditions and collateral values. During 2012, the Company has continued to actively identify and monitor nonperforming assets and other risk assets, and has acted aggressively to address the deteriorating 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, declined from \$113,779,000 at December 31, 2011 to \$64,391,000 at September 30, 2012, an improvement of \$49,388,000.

The risk element that showed the greatest percentage decline was restructured loans still accruing, which totaled \$3,113,000 at September 30, 2012, a \$24,804,000, or 88.8% decline from December 31, 2011. During the first nine months of 2012, the Company received payments/payoffs on restructured loans totaling \$4,357,000, and charged-off \$1,484,000 in connection with loan workouts. Additionally, \$19,300,000 of restructured loans migrated to nonaccrual status either due to missed payments or the Company's determination that the borrowers would not be able to keep their payments current for a sustainable period of time.

Offsetting these declines was \$337,000 in loans restructured during the period.

Nonaccrual loans at September 30, 2012 totaled \$57,780,000, a decrease of \$25,917,000 from December 31, 2011's balance of \$83,697,000. The Company's focus on asset quality restoration, including loan workouts, additional information gathered from borrowers or additional structural enhancements, and sales of non-performing assets to third parties has driven this significant reduction over year end 2011. This net decrease in nonaccrual loans for the nine months ended September 30, 2012 was the result of \$55,092,000 in loans charged off, \$39,689,000 in proceeds received from loan sales and pay downs, \$5,029,000 of loans returned to accrual status, and \$2,656,000 of loans foreclosed on and transferred to real estate owned, offset by \$76,550,000 being moved to nonaccrual status during the period, including \$19,300,000 previously classified as restructured loans.

The allowance for loan losses totaled \$36,700,000 at September 30, 2012, a \$7,015,000 decrease from December 31, 2011. As of September 30, 2012, the allowance for loan losses to total loans was 4.57%, a slight increase from 4.53% at December 31, 2011. In addition, the allowance for loan losses to nonaccrual loans and restructured loans still accruing increased to 60.27% at September 30, 2012 from 39.17% at December 31, 2011. The increase in the coverage ratios reflect lower levels of risk assets, particularly the significant decrease in non-performing assets discussed above.

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. 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. Through increased human resources allocated to credit related issues, the Company believes it can continue to mitigate its risk of loss, and to reduce its level of nonaccrual and classified loans.

As of September 30, 2012, the Company has approximately 71 lending relationships that are included in the nonaccrual loan balance of \$57,780,000. Of these relationships, eight have outstanding book balances in excess of \$3,000,000, totaling \$29,975,000, or 52% of the total nonaccrual balance. In connection with the determination of the impairment associated with these collateral dependent relationships, partial charge-offs on 70 relationships totaling \$32,326,000 were taken on the related outstanding loans, balances, and another \$2,262,000 of ASC 310 impairment reserves were recorded on the balances at September 30, 2012. The \$2,262,000 in impairment reserves is in contrast to \$15,607,000 in impairment reserves on nonaccrual loans at December 31, 2011. In 2012, the Company began taking 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. Prior to 2012, the fair value that was used was based on the most recent appraised value of the loans, and any additional discounts determined to be appropriate based on current (within the quarter) conditions, plus costs to dispose, were separately reserved for and not included in the partial charge-off. As a result of this more conservative approach, the accumulated partial charge-offs as of September 30, 2012 increased over December 31, 2011. ASC 310 impairment reserves remain in those situations in which updated appraisals are pending, and represent management's estimate of potential loss.

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The largest relationship that the Company has in nonaccrual status at September 30, 2012 is with a real estate developer who also actively leases residential properties and operates trailer parks. This relationship consists of separate notes with total outstanding book balances of \$5,609,000, and different parcels of land or residential structures securing the outstanding loan balances. Recent appraisals on the collateral securing the outstanding notes received during the fourth quarter of 2011 and through the third quarter of 2012 resulted in the relationship being placed in nonaccrual status, as the softening of real estate prices as well as 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 of approximately 49% of the outstanding loan balances were taken. The Company is actively working with the customer in reducing its outstanding loan balances.

A second significant nonaccrual relationship with outstanding book balances of \$4,590,000 at September 30, 2012 is to a motel operator that has experienced declining occupancy rates, which has impacted the collateral value of the motels securing the outstanding notes. All loans are current as to scheduled payments, however, the performance of the motels has resulted in management placing the notes in nonaccrual status, and taking a partial charge-off of 32% of the outstanding legal balances. The impairment charge was determined based on appraisals received in the first quarter of 2012.

A third nonaccrual loan relationship is one with outstanding loan book balances of \$3,708,000 at September 30, 2012, which is with a real estate developer and builder with multiple subdivisions in the Company's southern market area. The softness in the real estate market has resulted in longer absorption periods of the lots for sale, delays in commencing new phases of the subdivisions, and lower sales prices. Upon receipt of updated appraised values on the collateral in the second half of 2011, the Company moved the relationship to nonaccrual status. To date, cumulative partial charge-offs on the loans outstanding total 59%. The borrower has declared bankruptcy and we are currently working through the bankruptcy proceedings in order to remedy our delinquent loans.

The Company has exposure to another land developer and lessor of residential properties whose loans are current as to scheduled interest and principal payments. The outstanding book balance of the relationship at September 30, 2012 is \$3,250,000, after partial charge-offs totaling 11% of the outstanding legal balance. Appraisals have been obtained within the past year on all properties and were used in determining the extent of impairment and related partial charge-off. Despite all loans being current, the relationship was placed on nonaccrual status due to global cash flow not being sufficient to cover all principal and interest payments, as the largest loan, representing 71% of the relationship's balance, is land that is not producing revenue, and it is not anticipated that a potential buyer will be identified in the near future.

A fourth significant relationship that is in nonaccrual status at September 30, 2012 is to a lessor of real estate properties who also owns several service industry enterprises. As of September 30, 2012, the outstanding book balances of the loans comprising this relationship total \$3,284,000, which includes partial charge-offs of approximately 6% of the outstanding legal balance. In determining the relationships impairment, appraisals were obtained within the past year, and only two of the notes had collateral that was not sufficient to cover the outstanding loan balances. Charge-offs were taken on the loans in order to have the remaining loan balances line up with the values determined under a collateral dependent impairment model. Several of the loans are delinquent less than 90 days, however the entire relationship is in nonaccrual status as one loan is greater than 90 days past due and the cash flows of the Company and related enterprises is not sufficient to meet debt service requirements.

Another significant relationship in nonaccrual status is to a hotel operator in the Company's southern market, with an outstanding loan balance of approximately \$3,184,000. Despite being current as to scheduled loan payments, the loan is on nonaccrual status due to the structure of the required principal and interest payments. The loan is adequately secured by the related real estate, with an appraisal obtained in the past twelve months, and as such, no impairment charge has been taken to date.

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One additional relationship has a book balance of \$3,135,000 at September 30, 2012 to a wholesaler that supplies inventory to the commercial construction industry. As a result of deterioration in real estate conditions, the borrower's business has been negatively impacted, and has resulted in management concluding that it will be unable to continue to service its debt requirements. The relationship also includes financing for a residence in a resort area. The Company has received appraisals in the fourth quarter of 2011 which has resulted in impairment charges being taken on the relationship, and has resulted in partial charge-offs representing 40% of the outstanding September 30, 2012 loan balance. The borrower has filed bankruptcy, and the Company is working with legal counsel to liquidate the collateral.

One final relationship with a book balance in excess of \$3,000,000 is to a contractor whose business has been negatively impacted by the slow residential construction market. As a result of the deterioration in real estate conditions, volumes have been lowered which has had a negative impact on the borrower's cash flow and it was determined the borrower would not be able to continue its debt service requirements. The Company is still in the process of determining the fair value of the collateral securing the related loans, and has established a preliminary ASC 310 reserve on this relationship totaling approximately 51% of the outstanding loan balances of \$3,215,000.

The Company has approximately 63 additional relationships with borrowers with loans that are individually evaluated for impairment, and has taken a similar approach to 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.

The Company believes through partial charge-offs taken to date totaling \$29,500,000, the combination of the collateral securing the loans and the reserves allocated for these nonaccrual and restructured loans totaling \$2,262,000, that it has adequately provided for the potential losses that it may incur on these relationships as of September 30, 2012. 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 that which is needed.

As noted previously, in the second quarter of 2012, the Company was able to sell 65 notes with an aggregate carrying balance of \$28,598,000, consisting of seven relationships, to a third party. Upon the sale, an additional charge-off of \$8,896,000 was taken to reflect the sales proceeds received. The sale of these notes allowed the Company to reduce its nonaccrual loan balances.

The Company's foreclosed real estate balance of \$2,575,000 at September 30, 2012 is a slight increase from \$2,165,000 at December 31, 2011. As of September 30, 2012, nine properties were owned by the Company, seven of which were commercial properties and totaled \$2,037,000, and the remaining two consisted of residential properties and totaled \$538,000. The largest commercial property is three acres of commercially zone real estate located near a major interstate with a carrying value of \$672,000. A second commercial property with a carrying value of \$271,000 was originally purchased by the Company for future expansion purposes. During 2011, it was determined that this property was no longer in the Company's strategic plans, and as such, the Company re-designated the property as held for sale. The largest residential property has a carrying balance of \$475,000 at September 30, 2012 and is being carried at a value lower than its list price. The remaining properties have carrying values less than \$276,000 and are also carried at the lower of cost or fair value, less costs to dispose.

As of September 30, 2012, the Company believes the value of foreclosed assets represents their fair values, but if the real estate market continues to remain soft, additional charges may be needed. Additionally, as the Company works through some of its problem loans, management anticipates that the foreclosed real estate balances may grow.

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### **Credit Risk Management**

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

The Company's charge-offs have increased significantly in the past year, reflective of sluggish economic and real estate conditions. The Company maintains the allowance for loan losses at a level believed to be 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 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.

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.

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

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

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

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

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

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

| <i>(Dollars in thousands)</i>       | Pass              | Special<br>Mention | Non-Impaired<br>Substandard | Impaired<br>Substandard | Doubtful        | Total             |
|-------------------------------------|-------------------|--------------------|-----------------------------|-------------------------|-----------------|-------------------|
| <b>September 30, 2012</b>           |                   |                    |                             |                         |                 |                   |
| Commercial real estate:             |                   |                    |                             |                         |                 |                   |
| Owner-occupied                      | \$ 130,756        | \$ 12,846          | \$ 9,671                    | \$ 8,785                | \$ 188          | \$ 162,246        |
| Non-owner occupied                  | 105,472           | 11,805             | 14,860                      | 14,390                  | 0               | 146,527           |
| Multi-family                        | 17,685            | 7,657              | 1,951                       | 2,219                   | 0               | 29,512            |
| Acquisition and development:        |                   |                    |                             |                         |                 |                   |
| 1-4 family residential construction | 1,871             | 434                | 0                           | 1,386                   | 718             | 4,409             |
| Commercial and land development     | 15,602            | 8,420              | 5,228                       | 13,053                  | 617             | 42,920            |
| Commercial and industrial           | 157,319           | 18,813             | 8,867                       | 12,902                  | 1,761           | 199,662           |
| Residential mortgage:               |                   |                    |                             |                         |                 |                   |
| First lien                          | 105,599           | 2,478              | 1,999                       | 4,090                   | 0               | 114,166           |
| Home equity - term                  | 14,375            | 55                 | 238                         | 49                      | 0               | 14,717            |
| Home equity - Lines of credit       | 78,779            | 1,272              | 1,495                       | 529                     | 199             | 82,274            |
| Installment and other loans         | 7,277             | 14                 | 6                           | 8                       | 0               | 7,305             |
|                                     | <b>\$ 634,735</b> | <b>\$ 63,794</b>   | <b>\$ 44,315</b>            | <b>\$ 57,411</b>        | <b>\$ 3,483</b> | <b>\$ 803,738</b> |

| <i>(Dollars in thousands)</i>       | Pass              | Special<br>Mention | Non-Impaired<br>Substandard | Impaired<br>Substandard | Doubtful        | Total             |
|-------------------------------------|-------------------|--------------------|-----------------------------|-------------------------|-----------------|-------------------|
| <b>December 31, 2011</b>            |                   |                    |                             |                         |                 |                   |
| Commercial real estate:             |                   |                    |                             |                         |                 |                   |
| Owner-occupied                      | \$ 161,695        | \$ 19,820          | \$ 8,321                    | \$ 8,828                | \$ 982          | \$ 199,646        |
| Non-owner occupied                  | 93,379            | 19,689             | 7,785                       | 16,661                  | 3,523           | 141,037           |
| Multi-family                        | 14,896            | 7,581              | 1,387                       | 1,328                   | 2,135           | 27,327            |
| Acquisition and development:        |                   |                    |                             |                         |                 |                   |
| 1-4 family residential construction | 3,361             | 724                | 831                         | 2,182                   | 0               | 7,098             |
| Commercial and land development     | 28,513            | 16,274             | 13,713                      | 19,064                  | 0               | 77,564            |
| Commercial and industrial           | 190,675           | 19,859             | 14,232                      | 50,047                  | 3,087           | 277,900           |
| Residential mortgage:               |                   |                    |                             |                         |                 |                   |
| First lien                          | 102,398           | 0                  | 596                         | 1,333                   | 0               | 104,327           |
| Home equity - term                  | 36,290            | 0                  | 638                         | 585                     | 0               | 37,513            |
| Home equity - Lines of credit       | 80,881            | 0                  | 70                          | 0                       | 0               | 80,951            |
| Installment and other loans         | 12,075            | 0                  | 2                           | 0                       | 0               | 12,077            |
|                                     | <b>\$ 724,163</b> | <b>\$ 83,947</b>   | <b>\$ 47,575</b>            | <b>\$ 100,028</b>       | <b>\$ 9,727</b> | <b>\$ 965,440</b> |

Potential problem loans are defined as performing loans, which have characteristics that cause management to have some doubt as to the ability of the borrower to perform under present loan repayment terms and which may result in the reporting of these loans as non-performing loans in the future. Generally, management feels that Substandard loans that are currently performing and not considered impaired, result in some doubt as to the borrower's ability to continue to perform under the terms of the loan, and represent potential problem loans. Additionally, the Special Mention classification is intended to be a temporary classification, and is reflective of 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. Special Mention loans represent an elevated risk, but their weakness does not yet justify a more severe, or classified rating. These loans require follow-up by lenders on the information that may cause the potential weakness, and once resolved, the loan classification may be downgraded to Substandard, or alternatively, could be upgraded to Pass. As a result, these loans may become potential problem loans if conditions worsen and they are subsequently downgraded.

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

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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

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more than 90 days past due are assigned a Substandard rating. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed to determine if the loan should be placed in nonaccrual status. Nonaccrual loans in the commercial and commercial real estate portfolios are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates on fair values are obtained, which may include updated appraisals. The updated fair values will be incorporated into the impairment analysis as of the next reporting period. In the event an updated appraisal that requires a higher impairment reserve is received after a reporting period, but prior to the issuance of the financial statements, an evaluation is made as to the significance of the difference and whether the amounts need to be reflected in the financial statements not yet issued.

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

As of September 30, 2012, nearly all of the Company's impaired loans' extent of impairment was measured based on the estimated fair value of the collateral securing the credit, except for certain troubled debt restructurings. 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.

At the time a real-estate-secured loan is deemed impaired, management determines whether an updated certified appraisal of the real estate is necessary to assist in determining the extent of an impairment reserve, if any. The decision for requiring an updated appraisal takes into consideration the age of the most recent appraisal, the loan-to-value ratio based on the original certified appraisal, the Company's recent experience and knowledge of market conditions, recent list prices or broker opinions, the condition of the property, and environmental factors. If market conditions have changed significantly from the date of the most recent appraisal, an updated appraisal will be obtained. Updated appraisals are required for criticized loans in excess of \$250,000 on at least an annual basis. 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 one that carries the most consideration will be the one management believes is warranted. The approaches are as follows:

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

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

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

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

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

The following summarizes impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required as of September 30, 2012 and December 31, 2011:

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

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|                                 |        |        |        |       |       |
|---------------------------------|--------|--------|--------|-------|-------|
| Commercial and land development | 10,657 | 13,899 | 4,369  | 8,407 | 9,712 |
| Commercial and industrial       | 46,685 | 47,256 | 14,591 | 6,449 | 6,551 |
| Residential mortgage:           |        |        |        |       |       |
| First lien                      | 1,122  | 1,122  | 9      | 211   | 211   |
| Home equity - term              | 41     | 41     | 42     | 544   | 709   |
| Home equity - lines of credit   | 0      | 0      | 0      | 0     | 0     |
| Consumer                        | 0      | 0      | 0      | 0     | 0     |

|           |    |        |    |        |    |        |    |        |
|-----------|----|--------|----|--------|----|--------|----|--------|
| \$ 85,514 | \$ | 96,822 | \$ | 29,788 | \$ | 24,241 | \$ | 26,426 |
|-----------|----|--------|----|--------|----|--------|----|--------|

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The difference between the recorded investment (book balance) and the unpaid principal balance (legal balance) generally results from partial charge-offs taken on loans and payments applied entirely to principal on those loans placed on nonaccrual status. As noted above, the book balance of impaired loans at September 30, 2012 totaled \$60,894,000 whereas the legal balance, or the amount the customer contractually owes the Company, totaled \$91,006,000 indicating that amounts totaling \$30,112,000 were either partially charged-off or had interest payments applied to principal.

The following presents impaired loans that are troubled debt restructurings as of September 30, 2012 and December 31, 2011.

|                                     | Troubled Debt Restructurings |                     | New Troubled Debt Restructurings     |                     |
|-------------------------------------|------------------------------|---------------------|--------------------------------------|---------------------|
|                                     | At Period End                |                     | Nine Months Ended September 30, 2012 |                     |
|                                     | Number of Contracts          | Recorded Investment | Number of Contracts                  | Recorded Investment |
| <i>(Dollars in thousands)</i>       |                              |                     |                                      |                     |
| <b>September 30, 2012</b>           |                              |                     |                                      |                     |
| Accruing:                           |                              |                     |                                      |                     |
| Commercial real estate:             |                              |                     |                                      |                     |
| Owner-occupied                      | 0                            | \$ 0                | 0                                    | \$ 0                |
| Non-owner occupied                  | 2                            | 1,995               | 0                                    | 0                   |
| Multi-family                        | 0                            | 0                   | 0                                    | 0                   |
| Acquisition and development:        |                              |                     |                                      |                     |
| 1-4 family residential construction | 0                            | 0                   | 0                                    | 0                   |
| Commercial and land development     | 0                            | 0                   | 0                                    | 0                   |
| Commercial and industrial           | 2                            | 330                 | 0                                    | 0                   |
| Residential mortgage:               |                              |                     |                                      |                     |
| First lien                          | 2                            | 752                 | 1                                    | 301                 |
| Home equity - term                  | 1                            | 36                  | 1                                    | 36                  |
|                                     | 7                            | 3,113               | 2                                    | 337                 |
| Nonaccruing:                        |                              |                     |                                      |                     |
| Commercial real estate:             |                              |                     |                                      |                     |
| Owner-occupied                      | 2                            | 689                 | 0                                    | 0                   |
| Non-owner occupied                  | 1                            | 193                 | 0                                    | 0                   |
| Multi-family                        | 0                            | 0                   | 0                                    | 0                   |
| Acquisition and development:        |                              |                     |                                      |                     |
| 1-4 family residential construction | 0                            | 0                   | 0                                    | 0                   |
| Commercial and land development     | 3                            | 1,159               | 0                                    | 0                   |
| Commercial and industrial           | 7                            | 3,160               | 1                                    | 197                 |
| Residential mortgage:               |                              |                     |                                      |                     |
| First lien                          | 0                            | 0                   | 0                                    | 0                   |
| Home equity - term                  | 0                            | 0                   | 0                                    | 0                   |
|                                     | 13                           | 5,201               | 1                                    | 197                 |
|                                     | 20                           | \$ 8,314            | 3                                    | \$ 534              |
| <b>December 31, 2011</b>            |                              |                     |                                      |                     |
| Accruing:                           |                              |                     |                                      |                     |
| Commercial real estate:             |                              |                     |                                      |                     |
| Owner-occupied                      | 1                            | \$ 924              | 1                                    | \$ 924              |
| Nonowner occupied                   | 2                            | 2,039               | 2                                    | 2,039               |
| Acquisition and development:        |                              |                     |                                      |                     |
| 1-4 family residential construction | 0                            | 0                   | 0                                    | 0                   |
| Commercial and land development     | 2                            | 1,061               | 2                                    | 1,061               |

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|                                 |    |           |    |           |
|---------------------------------|----|-----------|----|-----------|
| Commercial and industrial       | 10 | 23,434    | 10 | 23,434    |
| Residential mortgage:           |    |           |    |           |
| First lien                      | 1  | 459       | 0  | 0         |
|                                 | 16 | 27,917    | 15 | 27,458    |
| Nonaccruing:                    |    |           |    |           |
| Commercial real estate:         |    |           |    |           |
| Owner-occupied                  | 1  | 54        | 1  | 54        |
| Non-owner occupied              | 1  | 221       | 1  | 221       |
| Acquisition and development:    |    |           |    |           |
| Commercial and land development | 3  | 3,179     | 3  | 3,179     |
| Commercial and industrial       | 10 | 5,648     | 10 | 5,648     |
| Residential mortgage:           |    |           |    |           |
| First lien                      | 1  | 544       | 0  | 0         |
|                                 | 16 | 9,646     | 15 | 9,102     |
|                                 | 32 | \$ 37,563 | 30 | \$ 36,560 |

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

The following summarizes the average recorded investment in impaired loans and related interest income recognized, on loans deemed impaired at September 30, 2012 on a cash basis, and interest income earned but not recognized for the three and nine months ended September 30, 2012 and 2011:

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

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

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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, 2012 and December 31, 2011.

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

For each loan class presented above, general allowances are provided for loans that are collectively evaluated for impairment, which are based on quantitative factors, principally historical loss trends for the respective loan class, adjusted for qualitative factors. Effective December 31, 2011, the historical loss factor was based on average charge-offs for the last eight quarters and applied to the entire pool of loans, excluding those loans evaluated for impairment under ASC 310-10-35. In addition, an additional adjustment to the historical loss factors is made to account for delinquency and other potential risk not elsewhere defined within the Allowance for Loan and Lease Loss methodology. The refinement to the methodology was made as management determined that the most recent eight quarters loss history, as adjusted based on other portfolio analysis and applied to an entire pool of loans, is a better reflection of the losses inherent on non-impaired loans within the portfolio. In making this determination, management considered current economic and real estate conditions, trends in historical charge-off percentages at the Company as well as peers, and feedback from regulators.

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In addition to the changes mentioned under ASC 450-20, the Company refined its methodology under ASC 310-10-35 in the manner in which partial charge offs are calculated. Based on management's assessment and in compliance with regulatory guidance, the Company will generally incur partial charge-offs in the amount that a loan's carrying value exceeds its fair value, less discount for market conditions and costs to dispose, eliminating the need for specific reserves. This will be accomplished by charging the loan off to a level below the fair market value, or appraisal value, of collateral less costs to sell. This method will result in the loan being carried at the fair market value of collateral, less any discount determined necessary based on current market conditions, less costs to dispose of the asset.

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In direct correlation with this change in methodology, the historical loss rates have been elevated when compared to prior periods which does affect the reserves held under ASC 450-20. Management believes this is a more conservative method in calculating the allowance for loan losses.

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

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

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

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

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

A summary of the activity in the allowance for loan losses for the three months ended September 30, 2012 and 2011 is as follows:

|                               | Commercial<br>Real<br>Estate | Acquisition<br>and Development | Commercial<br>and Industrial | Residential<br>Mortgage | Installment<br>and<br>Other | Unallocated | Total     |
|-------------------------------|------------------------------|--------------------------------|------------------------------|-------------------------|-----------------------------|-------------|-----------|
| <i>(Dollars in thousands)</i> |                              |                                |                              |                         |                             |             |           |
| <b>September 30, 2012</b>     |                              |                                |                              |                         |                             |             |           |
| Balance, beginning of period  | \$ 15,204                    | \$ 6,803                       | \$ 11,334                    | \$ 877                  | \$ 69                       | \$ 1,938    | \$ 36,235 |
| Provision for loan losses     | 222                          | 5,020                          | (171)                        | 169                     | 58                          | (198)       | 5,100     |
| Charge-offs                   | (482)                        | (4,139)                        | (369)                        | (109)                   | (46)                        | 0           | (5,145)   |
| Recoveries                    | 258                          | 13                             | 233                          | 4                       | 2                           | 0           | 510       |
| Balance, end of period        | \$ 15,202                    | \$ 7,697                       | \$ 11,027                    | \$ 951                  | \$ 83                       | \$ 1,740    | \$ 36,700 |
| <b>September 30, 2011</b>     |                              |                                |                              |                         |                             |             |           |
| Balance, beginning of period  | \$ 7,244                     | \$ 5,026                       | \$ 11,132                    | \$ 2,150                | \$ 97                       | \$ 1,563    | \$ 27,212 |
| Provision for loan losses     | 5,466                        | 3,084                          | (531)                        | (178)                   | 38                          | 21          | 7,900     |
| Charge-offs                   | (4,179)                      | (2,707)                        | (2,466)                      | (64)                    | (23)                        | 0           | (9,439)   |
| Recoveries                    | 0                            | 0                              | 0                            | 1                       | 3                           | 0           | 4         |
| Balance, end of period        | \$ 8,531                     | \$ 5,403                       | \$ 8,135                     | \$ 1,909                | \$ 115                      | \$ 1,584    | \$ 25,677 |

A summary of the activity in the allowance for loan losses for nine months ended September 30, 2012 and 2011 is as follows:

|                               | Commercial<br>Real<br>Estate | Acquisition<br>and Development | Commercial<br>and Industrial | Residential<br>Mortgage | Installment<br>and<br>Other | Unallocated | Total     |
|-------------------------------|------------------------------|--------------------------------|------------------------------|-------------------------|-----------------------------|-------------|-----------|
| <i>(Dollars in thousands)</i> |                              |                                |                              |                         |                             |             |           |
| <b>September 30, 2012</b>     |                              |                                |                              |                         |                             |             |           |
| Balance, beginning of period  | \$ 13,864                    | \$ 9,708                       | \$ 17,569                    | \$ 933                  | \$ 75                       | \$ 1,566    | \$ 43,715 |

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|                           |                 |          |                 |              |              |            |                 |
|---------------------------|-----------------|----------|-----------------|--------------|--------------|------------|-----------------|
| Provision for loan losses | <b>21,994</b>   | 11,419   | <b>13,216</b>   | <b>384</b>   | <b>113</b>   | <b>174</b> | <b>47,300</b>   |
| Charge-offs               | <b>(22,328)</b> | (14,116) | <b>(20,183)</b> | <b>(381)</b> | <b>(115)</b> | <b>0</b>   | <b>(57,123)</b> |
| Recoveries                | <b>1,672</b>    | 686      | <b>425</b>      | <b>15</b>    | <b>10</b>    | <b>0</b>   | <b>2,808</b>    |

|                        |                  |          |                  |               |              |                 |                  |
|------------------------|------------------|----------|------------------|---------------|--------------|-----------------|------------------|
| Balance, end of period | <b>\$ 15,202</b> | \$ 7,697 | <b>\$ 11,027</b> | <b>\$ 951</b> | <b>\$ 83</b> | <b>\$ 1,740</b> | <b>\$ 36,700</b> |
|------------------------|------------------|----------|------------------|---------------|--------------|-----------------|------------------|

September 30, 2011

|                              |          |          |          |          |        |        |           |
|------------------------------|----------|----------|----------|----------|--------|--------|-----------|
| Balance, beginning of period | \$ 5,324 | \$ 1,767 | \$ 6,795 | \$ 1,863 | \$ 106 | \$ 165 | \$ 16,020 |
| Provision for loan losses    | 8,632    | 8,918    | 13,069   | 249      | 38     | 1,419  | 32,325    |
| Charge-offs                  | (5,433)  | (5,282)  | (11,729) | (204)    | (47)   | 0      | (22,695)  |
| Recoveries                   | 8        | 0        | 0        | 1        | 18     | 0      | 27        |

|                        |                 |          |                 |                 |               |                 |                  |
|------------------------|-----------------|----------|-----------------|-----------------|---------------|-----------------|------------------|
| Balance, end of period | <b>\$ 8,531</b> | \$ 5,403 | <b>\$ 8,135</b> | <b>\$ 1,909</b> | <b>\$ 115</b> | <b>\$ 1,584</b> | <b>\$ 25,677</b> |
|------------------------|-----------------|----------|-----------------|-----------------|---------------|-----------------|------------------|

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The allowance for loan losses totaled \$36,700,000 at September 30, 2012, a \$7,015,000 decline from December 31, 2011. As of September 30, 2012, the allowance for loan losses to total loans was 4.57% compared to 4.53% as of December 31, 2011, and the allowance for loan losses to nonaccrual loans and restructured loans still accruing improved from 39.17% at December 31, 2011 to 60.27% at September 30, 2012. The increase in the coverage ratio of nonaccrual and restructured loans reflects lower levels of risk assets, particularly the significant decrease in non-performing assets discussed above. As of December 31, 2011, the reserves specifically allocated on impaired loans totaled \$29,788,000 on \$109,755,000 of loans deemed impaired. The Company has taken partial charge-offs on nearly all impaired loans at September 30, 2012, so that the loan balances reflect the loans fair value, less anticipated closing costs. As such, impaired loans generally no longer had specific reserves allocated to them, as the anticipated loss has already been recorded as a charge-off. At September 30, 2012, the reserves specifically allocated on impaired loans totaled \$2,262,000 on \$60,894,000 of loans meeting the impaired definition.

A summary of relevant asset quality ratios for the three and nine months ended September 30, 2012 and 2011 are as follows:

|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | Three Months Ended    |                       | Nine months Ended     |                       |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              | September 30,<br>2012 | September 30,<br>2011 | September 30,<br>2012 | September 30,<br>2011 |
| Ratio of net charge-offs to average loans outstanding                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | 2.23%                 | 3.73%                 | 8.18%                 | 3.04%                 |
| Provision for loan losses to net charge-offs                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 | 110.03%               | 83.73%                | 87.08%                | 142.60%               |
| Net charge-offs were \$54,300,000 for the nine months ended September 30, 2012, compared to \$22,700,000 for the same period in 2011, and the provision for loan losses to net charge-offs was 87.08% for the nine months ended September 30, 2012 compared to 142.60 % for the same period in 2011. The elevated levels of charge-offs in the first nine months of 2012 significantly increased the annualized ratio of charge-offs to average loans outstanding and reduced the provision for loan losses to charge-off ratio in 2012. 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. |                       |                       |                       |                       |

The following summarizes 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, 2012 and December 31, 2011.

| (Dollars in thousands)                  | Commercial<br>Real Estate | Acquisition<br>and Development | Commercial<br>and Industrial | Residential<br>Mortgage | Installment<br>and Other | Unallocated | Total      |
|-----------------------------------------|---------------------------|--------------------------------|------------------------------|-------------------------|--------------------------|-------------|------------|
| <b>September 30, 2012</b>               |                           |                                |                              |                         |                          |             |            |
| Loans allocated by:                     |                           |                                |                              |                         |                          |             |            |
| Individually evaluated for impairment   | \$ 25,582                 | \$ 15,774                      | \$ 14,663                    | \$ 4,867                | \$ 8                     | \$ 0        | \$ 60,894  |
| Collectively evaluated for impairment   | 312,703                   | 31,555                         | 184,999                      | 206,290                 | 7,297                    | 0           | 742,844    |
|                                         | \$ 338,285                | \$ 47,329                      | \$ 199,662                   | \$ 211,157              | \$ 7,305                 | \$ 0        | \$ 803,738 |
| Allowance for loan losses allocated by: |                           |                                |                              |                         |                          |             |            |
| Individually evaluated for impairment   | \$ 333                    | \$ 776                         | \$ 1,089                     | \$ 64                   | \$ 0                     | \$ 0        | \$ 2,262   |
| Collectively evaluated for impairment   | 14,869                    | 6,921                          | 9,938                        | 887                     | 83                       | 1,740       | 34,438     |
|                                         | \$ 15,202                 | \$ 7,697                       | \$ 11,027                    | \$ 951                  | \$ 83                    | \$ 1,740    | \$ 36,700  |
| <b>December 31, 2011</b>                |                           |                                |                              |                         |                          |             |            |
| Loans allocated by:                     |                           |                                |                              |                         |                          |             |            |
| Individually evaluated for impairment   | \$ 33,457                 | \$ 21,246                      | \$ 53,134                    | \$ 1,918                | \$ 0                     | \$ 0        | \$ 109,755 |
| Collectively evaluated for impairment   | 334,553                   | 63,416                         | 224,766                      | 220,873                 | 12,077                   | 0           | 855,685    |
|                                         | \$ 368,010                | \$ 84,662                      | \$ 277,900                   | \$ 222,791              | \$ 12,077                | \$ 0        | \$ 965,440 |
| Allowance for loan losses allocated by: |                           |                                |                              |                         |                          |             |            |
| Individually evaluated for impairment   | \$ 9,851                  | \$ 5,295                       | \$ 14,591                    | \$ 51                   | \$ 0                     | \$ 0        | \$ 29,788  |
| Collectively evaluated for impairment   | 4,013                     | 4,413                          | 2,978                        | 822                     | 75                       | 1,566       | 13,927     |

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\$ 13,864 \$ 9,708 \$ 17,569 \$ 933 \$ 75 \$ 1,566 \$ 43,715

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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. As previously noted, management re-evaluates and makes certain modifications to its methodology in establishing a reserve to better account for risks inherent in the different segments of the portfolio, particularly in light of increased charge-offs, with differences between the different loan segments. Management believes these periodic enhancements to the allowance for loan losses methodology 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.

The acquisition and development and commercial and industrial loan segments' reserve allocations at September 30, 2012 declined from the December 31, 2011 balance due to the extensive partial charge-offs taken in each portfolio. The increase in the commercial real estate loan segment is the direct result of the significant partial charge-offs taken to date during 2012, which has caused the Company's historical loss factors to increase and led to higher general reserve allocations on the non-impaired loans.

The unallocated portion of the allowance for loan losses reflects estimated inherent losses within the portfolio that have not been detected. This reserve is due to the 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 \$1,566,000 at December 31, 2011 to \$1,740,000 at September 30, 2012. The unallocated portion of the reserve represents 4.7% of the entire allowance for loan losses at September 30, 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**

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

Total shareholders' equity decreased \$40,877,000 from \$128,197,000 at December 31, 2011 to \$87,320,000 at September 30, 2012. The primary reason for the decline was the \$39,484,000 net loss posted for the nine months ended September 30, 2012 combined with unrealized losses on securities, net of tax of \$1,496,000.

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.

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 are dependent on future taxable income greater than one year from the reporting

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date. As of December 31, 2011, \$1,441,000 of the Company's deferred tax asset had been disallowed for Tier 1 and Total risk based capital. As of September 30, 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 valuation allowance of \$19,872,000 negatively impacted Tier 1 and total risk based capital and was the primary reason capital ratios declined from June 30, 2012. June 30, 2012's total capital, Tier 1 capital, and Tier 1 leverage ratios on a consolidated basis were 11.7%, 10.4%, and 6.7%, respectively compared to 10.9%, 9.7%, and 6.4%, respectively at September 30, 2012.

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, 2012 and December 31, 2011, \$26,447,000 and \$31,174,000 of the allowance for credit losses was excluded from Tier 2 capital. The lower disallowed amount was the result of the elevated charge-offs during the quarter which essentially eliminated specific reserves on impaired loans.

As of September 30, 2012 and December 31, 2011, the Bank met the ratios required to be considered well capitalized under applicable banking regulations. The Company's and the Bank's capital ratios as of September 30, 2012 and December 31, 2011 were as follows:

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

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 Capital Plan with each of those banking regulators.

In 2009, the Federal Reserve Board notified all bank holding companies that dividends should be eliminated, deferred or reduced if the bank holding company's net income for the past four quarters, net of dividends paid, is not sufficient to fully fund the dividends; the bank holding company's prospective rate of earnings retention is not consistent with the bank holding company's capital need and overall current and prospective financial conditions, or the bank holding company will not meet, or is in danger of not meeting its minimum regulatory capital adequacy ratios. In October 2011, the Company announced it had

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discontinued its quarterly dividend, which was the result of regulatory guidance from the Federal Reserve indicating that the Company's dividend application would not be approved. 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 we will be permitted to pay a cash dividend or conduct any stock repurchases in the near future.

**Liquidity**

The primary function of asset/liability management is to assure adequate liquidity and sensitivity to changing interest rates. Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Our primary sources of funds consist of deposit inflows, loan repayments, maturities and sales of investment securities and borrowings from the Federal Home Loan Bank of Pittsburgh (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.

In the second quarter of 2012, the FHLB notified that Bank that all borrowings from the FHLB must be secured with acceptable collateral, consisting principally of eligible loans and securities. The FHLB takes delivery of the collateral to further protect their risk of loss.

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

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

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

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

The Company's Risk Sensitive Assets (RSA) to Risk Sensitive Liabilities (RSL) ratio has decreased since December 31, 2011, and is less asset sensitive than at year end. The primary reason for the decrease in the RSA/RSL ratio for each cumulative period presented is due to management's evaluation of its interest bearing deposit accounts, and their perceived rate sensitivity in this low interest rate environment. As of September 30, 2012, it was determined that three quarters of interest bearing deposits would be classified to reprice in the 0-3 month time horizon, versus one quarter as of December 31, 2011. The principle reason for this change in methodology is due to the large amount of municipal checking accounts as we have experienced increased bid situations due to the low interest rate environment.

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

|                    | Within 3 Months | Within 6 Months | Within 12 Months | Within 36 Months |
|--------------------|-----------------|-----------------|------------------|------------------|
| September 30, 2012 | 1.08            | 1.03            | 0.96             | 1.14             |
| December 31, 2011  | 1.58            | 1.31            | 1.21             | 1.39             |

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Management will closely monitor the Federal Reserve's monetary policies and will react to any changes quickly in order to maintain a balanced earning assets to interest bearing liabilities ratio.

### **Item 4. Controls and Procedures**

(a) Evaluation of disclosure controls and procedures:

The Company's Principal Executive Officer and Principal Financial Officer (the "Certifying Officers") have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2012. Based on such evaluation, such officers have concluded that, as of September 30, 2012, the Company's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Company (including its consolidated subsidiary) required to be included in the Company's periodic filings under the Exchange Act as it pertains to the consolidated financial statements and internal controls over financial reporting.

The Company's management and Certifying Officers consider the evaluations and conclusions regarding: i) the effectiveness of the Company's disclosure controls and procedures; and ii) any material weakness in internal controls over financial reporting as separate and distinct processes.

As of December 31, 2011, the Company's Principal Executive Officer and Principal Financial Officer concluded that disclosure controls and procedures were not effective, and also concluded that a material weakness existed pertaining to our internal controls over financial reporting as it related to loan ratings and their impact on the allowance for loan losses. The effectiveness of our disclosure control conclusion was based on final testing conducted by management and our external auditors that took place after December 31, 2011 but prior to the filing of the Company's Annual Report on Form 10-K.

Throughout 2012, the following controls have been put in place by the Company in order to enhance our ability to evaluate the effectiveness of the Company's disclosure controls, and in particular, those disclosure controls relating to loan ratings and the allowance for loan losses. These steps included:

Repetition in conducting of internal control procedures developed during the end of 2011 relating to enhanced underwriting, credit administration and problem loan identification procedures, and ongoing refinement of the flow through of the results of these processes through to the allowance for loan losses calculation;

Contracted a third party service provider specializing in corporate governance matters to review existing policies and procedures pertaining to credit administration, finance and other banking areas to determine if additional gaps in internal controls were noted;

As a result of the gap analysis, the Company enhanced the training of lending, credit administration and special assets staff on the new policies and procedures, including the timing of when information is required to be completed and reviewed as part of the disclosure process. These policies included enhanced lending policy as it pertains to problem loans management, and procedures and expectations concerning disclosures;

Conducted routine meetings with certain members of middle and senior management to discuss the progress that the Bank was making in improving its control structure pertaining to loan ratings and the allowance for loan losses calculation;

Contracted a second third party internal audit firm to review internal audit programs, workpapers and reports of our primary third party internal audit firm with the intention of enhancing quality control over the work completed;

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Met with the Audit Committee Chairperson routinely between Audit Committee meetings to provide an update on the enhancements to processes and procedures to remediate our material weakness. The frequency of both formal and informal discussions with the Audit Committee Chairperson have increased; and

Hired additional members of our Special Assets Group and Credit Administration departments, whose primary functions are the timeliness and accuracy of information from the lending and lending administration groups to the allowance for loan loss model. We also implemented other personnel changes to allow for more effective and timely reporting of loan rating changes and review of the allowance for loan losses calculation. Further, our outsourced internal audit department completed out-of-scope audit procedures, which consisted of reviewing the allowance for loan losses calculation against the underlying data, for the first three quarters of 2012.

Our increased awareness of the material weakness and the ineffectiveness of our disclosure controls and procedures at December 31, 2011 and our efforts to remediate these issues resulted in an improved communication process among management, key staff members, members of the Audit Committee, and third party service providers, which we believe greatly enhanced the quality and effectiveness of these discussions and conclusions of the Disclosure Committee. At each quarter end during 2012, prior to and during our scheduled Disclosure Committee meetings, lengthy and substantive discussions were held as to the Company's progress in remediating the material weakness. Based upon information gathered, the Disclosure Committee noted that the material weakness in internal controls over financial reporting remained at March 31, 2012, June 30, 2012 and September 30, 2012. Based on the measures discussed and the effectiveness of the controls put in place since the end of 2011, the Certifying Officers noted that the processes relating to disclosure controls and procedures were significantly enhanced since December 31, 2011, which allowed them to conclude that the disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Company required to be included the Company's periodic filings under the Exchange Act as it pertains the consolidated financial statements and internal control over financial reporting.

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

In the Company's Annual Report on Form 10-K for the year ended December 31, 2011, management noted that the Company had not fully remediated its material weakness in its internal control over financing reporting relating to loan ratings and its impact on the allowance for loan losses. This material weakness remains at September 30, 2012. The Company continues to make progress on the remedial action, as disclosed in section (a) above.

As of September 30, 2012, the Company continues to implement and test the remediation procedures outlined above. Except as described above, there have been no further changes to the Company's internal control over financial reporting that occurred since the beginning of the quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal controls 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 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, Orrstown ). 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 Orrstown until December 7, 2012 to file a motion to dismiss the amended complaint. SEPTA's opposition to Orrstown's motion to dismiss was originally due January 11, 2013, and Orrstown's reply brief in further support of its motion to dismiss was originally due on January 25, 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, mooted 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. If and when SEPTA's amended complaint is filed, the Court will issue an order for a scheduling conference to set deadlines for the filing and briefing of the Company's motion to dismiss.

In a related development, the Board of Directors of Orrstown Financial Services, Inc. received a letter dated October 12, 2012 from a law firm purportedly writing on behalf of a shareholder demanding that the Board investigate, institute litigation and take all other necessary remedial measures to prevent a recurrence of the Board's and the Company's officers' [alleged] breaches of fiduciary duties from March 24, 2010 to March 23, 2012 (the Demand Letter ). The Demand Letter threatens to take whatever action its law firm authors deem in the best interest of the Company and its shareholders, including litigation against Orrstown, unless the Board of Directors agrees to pursue the investigation, litigation, or remedial steps demanded in the Demand Letter. Notably, the allegations and averments contained in the Demand Letter are based upon the allegations made by SEPTA in its purported class-action complaint against Orrstown. The Board is reviewing the Demand Letter and will exercise its business judgment regarding proper disposition of and response to the claims made in the Demand Letter.

Orrstown believes that the allegations in SEPTA's complaint are without merit, and intends to defend vigorously against those claims.

#### **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, 2011 and Quarterly Report on Form 10-Q for the quarter ended March 31, 2012 and June 30, 2012 with the exception that the risk factor entitled *We have a significant deferred tax asset and cannot assure you that it will be fully realized.* is hereby deleted and the risk factor entitled *Our inability to use a short form registration statement on Form S-3 may affect our short-term ability to access the capital markets, if needed.* is replaced with the following risk factor:

***Our inability to use a short form registration statement on Form S-3 may affect our short-term ability to access the capital markets, if needed.***

A registration statement on Form S-3 permits an eligible issuer to incorporate by reference its past and future filings and reports made under the Exchange Act. In addition, Form S-3 enables eligible issuers to conduct primary offerings off the shelf under Rule 415 of the Securities Act. The

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shelf registration process under Form S-3 combined with the ability to incorporate information by reference on a forward basis, allows issuers to avoid additional delays and interruptions in the offering process and to access the capital markets in a more expeditious and efficient manner than raising capital in a standard offering on Form S-1. One of the thresholds for Form S-3 eligibility is for an issuer to have a market capitalization held by the public (a public float ) of \$75 million or more. If an issuer meets this public float threshold, it is eligible to offer and sell the maximum amount of securities registered pursuant to its registration statement on Form S-3. However, if an issuer fails to meet this threshold, the amount of securities it may offer and sell pursuant to the Form S-3 is limited. Due to fluctuations in our stock price, our public float may be less than \$75 million, which may limit our ability to raise capital through use of a registration statement on Form S-3. As a result, if we would like to raise capital in the capital markets during a period

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of time that that our use of Form S-3 is limited or otherwise precluded, we may experience delays. Any such delay may result in offering terms that may not be advantageous to us or may cause us not to obtain capital in a timely fashion to execute our business strategies.

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

For the quarter ended September 30, 2012, 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, 2012.

### **Item 3 Defaults upon Senior Securities**

Not applicable

### **Item 4 Mine Safety Disclosures**

Not applicable

### **Item 5 Other Information**

None

### **Item 6 Exhibits**

|         |                                                                         |
|---------|-------------------------------------------------------------------------|
| 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 *                           |

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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, 2012

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ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

EXHIBIT INDEX

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 \*

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), Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.