

ORRSTOWN FINANCIAL SERVICES INC

Form 10-Q

August 09, 2006

[Table of Contents](#)

---

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

---

**FORM 10 - Q**

---

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

For the quarterly period ended June 30, 2006

Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 33-18888

---

**ORRSTOWN FINANCIAL SERVICES, INC.**

(Exact name of registrant as specified in its charter)

---

Commonwealth of Pennsylvania  
(State or other jurisdiction of

incorporation or organization)

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

Identification No.)

77 East King Street, P.O. Box 250, Shippensburg, Pennsylvania

17257

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

(Address of principal executive offices)

(Zip Code)

(717) 532-6114

(Registrant's telephone number, including area code)

---

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

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ☐ NO ☒

As of June 30, 2006, 6,134,268 shares of common stock, no par value, of the registrant were outstanding.

---

**Table of Contents**

ORRSTOWN FINANCIAL SERVICES, INC.

INDEX

	<b>Page</b>
<b>Part I - <u>FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements (unaudited)</u>	
<u>Condensed consolidated balance sheets - June 30, 2006 and December 31, 2005</u>	3
<u>Condensed consolidated statements of income - Three months ended June 30, 2006 and 2005</u>	4
<u>Condensed consolidated statements of income - Six months ended June 30, 2006 and 2005</u>	5
<u>Condensed consolidated statements of comprehensive income - Three months &amp; six months ended June 30, 2006 and 2005</u>	6
<u>Condensed consolidated statements of cash flows - Six months ended June 30, 2006 and 2005</u>	7
<u>Notes to condensed consolidated financial statements</u>	8 -11
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12 -18
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	18
Item 4. <u>Controls and Procedures</u>	18
<b>PART II - <u>OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	19
Item 1A. <u>Risk Factors</u>	19
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	19
Item 3. <u>Defaults upon Senior Securities</u>	20
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	20
Item 5. <u>Other Information</u>	20
Item 6. <u>Exhibits</u>	20
<u>SIGNATURES</u>	21
<u>EXHIBIT INDEX</u>	22

**Table of Contents**

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited) June 30, 2006	(Audited) * December 31, 2005
<b>(Dollars in Thousands)</b>		
<b>ASSETS</b>		
Cash and due from banks	\$ 21,784	\$ 11,901
Federal funds sold	17,103	23,430
Cash and cash equivalents	38,887	35,331
Interest bearing deposits with banks	940	3,445
Member stock, at cost which approximates market value	2,425	2,669
Securities available for sale	93,249	69,008
Loans	575,816	460,386
Allowance for loan losses	(5,177)	(4,428)
Net Loans	570,639	455,958
Premises and equipment, net	17,349	13,636
Accrued interest receivable	2,739	2,169
Intangible Assets	21,692	2,070
Cash surrender value of life insurance	15,249	7,787
Other assets	4,770	9,387
Total assets	\$ 767,939	\$ 601,460
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits:		
Non-interest bearing	\$ 85,689	\$ 68,697
Interest bearing	533,013	394,125
Total deposits	618,702	462,822
Short term borrowings	36,000	36,138
Long term debt	23,247	40,306
Accrued interest payable	758	550
Other liabilities	4,186	4,334
Total liabilities	682,893	544,150
Common stock, no par value - \$ .05205 stated value per share; 50,000,000 shares authorized; 6,134,268 and 5,439,227 shares issued		
	320	283
Additional paid - in capital	72,038	46,876
Retained earnings	13,401	9,964
Accumulated other comprehensive income	(345)	187
Treasury stock, 10,025 and 25 shares, at cost	(368)	0

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

Total shareholders' equity	85,046	57,310
Total liabilities and shareholders' equity	\$ 767,939	\$ 601,460

---

\* Condensed from audited financial statements

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

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Three Months Ended June	
	2006	2005
<b>(Dollars in Thousands)</b>		
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 9,656	\$ 6,851
Interest and dividends on investment securities	939	856
Interest on short term investments	250	98
<b>Total interest income</b>	<b>10,845</b>	<b>7,805</b>
<b>INTEREST EXPENSE</b>		
Interest on deposits	3,244	1,698
Interest on short-term borrowings	435	154
Interest on long-term debt	301	357
<b>Total interest expense</b>	<b>3,980</b>	<b>2,209</b>
<b>Net interest income</b>	<b>6,865</b>	<b>5,596</b>
Provision for loan losses	36	24
<b>Net interest income after provision for loan losses</b>	<b>6,829</b>	<b>5,572</b>
<b>OTHER INCOME</b>		
Service charges on deposits	1,146	984
Other service charges	666	371
Trust department income	626	569
Brokerage income	340	276
Other income	166	107
Securities gains / (losses)	10	0
<b>Total other income</b>	<b>2,954</b>	<b>2,307</b>
<b>OTHER EXPENSES</b>		
Salaries and employee benefits	3,288	2,275
Occupancy and equipment	828	633
Data processing	248	188
Advertising	122	66
Other operating expenses	864	982
<b>Total other expense</b>	<b>5,350</b>	<b>4,144</b>
<b>Income before income tax</b>	<b>4,433</b>	<b>3,735</b>
Income tax expenses	1,287	1,175
<b>Net income</b>	<b>\$ 3,146</b>	<b>\$ 2,560</b>
<b>PER SHARE DATA</b>		
Earnings per share		

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

Basic earnings per share	\$ 0.53	\$ 0.48
Weighted average number of shares outstanding	5,910,128	5,401,641
Diluted earnings per share	\$ 0.51	\$ 0.45
Weighted average number of shares outstanding	6,158,671	5,612,715
Dividends per share	\$ 0.20	\$ 0.14

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

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Six Months Ended June	
	2006	2005
<b>(Dollars in Thousands)</b>		
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 17,773	\$ 13,112
Interest and dividends on investment securities	1,690	1,770
Interest on short term investments	462	142
Total interest income	19,925	15,024
<b>INTEREST EXPENSE</b>		
Interest on deposits	5,698	3,190
Interest on short-term borrowings	763	263
Interest on long-term debt	725	717
Total interest expense	7,186	4,170
Net interest income	12,739	10,854
Provision for loan losses	72	48
Net interest income after provision for loan losses	12,667	10,806
<b>OTHER INCOME</b>		
Service charges on deposits	2,073	1,791
Other service charges	1,018	641
Trust department income	1,174	1,106
Brokerage income	653	473
Other income	311	199
Securities gains / (losses)	12	(2)
Total other income	5,241	4,208
<b>OTHER EXPENSES</b>		
Salaries and employee benefits	6,004	4,475
Occupancy and equipment	1,570	1,272
Data processing	432	329
Advertising	199	161
Other operating expenses	1,693	1,934
Total other expense	9,898	8,171
Income before income tax	8,010	6,843
Income tax expenses	2,366	2,112
Net income	\$ 5,644	\$ 4,731
<b>PER SHARE DATA</b>		
Earnings per share		



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

Basic earnings per share	\$ 0.99	\$ 0.88
Weighted average number of shares outstanding	5,676,038	5,396,428
Diluted earnings per share	\$ 0.95	\$ 0.84
Weighted average number of shares outstanding	5,922,316	5,605,520
Dividends per share	\$ 0.38	\$ 0.2733

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

**Table of Contents**

ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	<b>Three Months Ended</b>	
	<b>June</b>	<b>June</b>
<b>(Dollars in Thousands)</b>	<b>2006</b>	<b>2005</b>
<b>COMPREHENSIVE INCOME</b>		
Net Income	\$ 3,146	\$ 2,560
Other comprehensive income, net of tax		
Unrealized gain (loss) on investment securities available for sale	(376)	420
<b>Comprehensive Income</b>	<b>\$ 2,770</b>	<b>\$ 2,980</b>

	<b>Six Months Ended</b>	
	<b>June</b>	<b>June</b>
<b>(Dollars in Thousands)</b>	<b>2006</b>	<b>2005</b>
<b>COMPREHENSIVE INCOME</b>		
Net Income	\$ 5,644	\$ 4,731
Other comprehensive income, net of tax		
Unrealized (loss) on investment securities available for sale	(532)	(153)
<b>Comprehensive Income</b>	<b>\$ 5,112</b>	<b>\$ 4,578</b>

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

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Six Months Ended June	
	2006	2005
<b>(Dollars in Thousands)</b>		
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 5,644	\$ 4,731
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	708	586
Provision for loan losses	72	48
Other, net	(597)	(263)
<b>Net cash provided by operating activities</b>	<b>5,827</b>	<b>5,102</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net decrease in interest bearing deposits with banks	2,680	(2)
Purchases of available for sale securities	(783)	(6,406)
Sales and maturities of available for sale securities	4,764	6,875
Net (increase) in loans	(42,777)	(35,001)
Purchases of bank premises and equipment	(1,908)	(487)
Purchase price of shares exchanged for cash	(8,882)	0
Cash acquired in acquisition	13,031	0
Other, net	640	503
<b>Net cash (used) by investing activities</b>	<b>(33,235)</b>	<b>(34,518)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	50,378	48,083
Dividends paid	(2,208)	(1,476)
Proceeds from issuance of common stock	135	741
Purchase of treasury stock	(368)	0
Net change in short-term borrowings	(138)	8,859
Repayment of long-term borrowings	(17,059)	(1,682)
Other, net	224	(19)
<b>Net cash provided by financing activities</b>	<b>30,964</b>	<b>54,506</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>3,556</b>	<b>25,090</b>
Cash and cash equivalents at beginning of period	35,331	19,849
<b>Cash and cash equivalents at end of period</b>	<b>\$ 38,887</b>	<b>\$ 44,939</b>
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ 6,978	\$ 4,134
Income Taxes	2,525	1,900
Supplemental schedule of noncash investing and financing activities:		
Unrealized (loss) on investments available for sale (net of deferred taxes of \$(274) and \$ (78) at June 30, 2006 and 2005, respectively)	(532)	(153)
The accompanying notes are an integral part of these condensed financial statements.		



## **Table of Contents**

ORRSTOWN FINANCIAL SERVICES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

June 30, 2006

Note 1: Summary of Significant Accounting Policies

Basis of Presentation

The unaudited financial statements of Orrstown Financial Services, Inc. and its subsidiaries (the Corporation or Orrstown) are presented at and for the three and six months ended June 30, 2006 and 2005 and have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. However, unaudited information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the interim period. Information presented at December 31, 2005 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, 2005.

Operating

Orrstown Financial Services, Inc. is a financial holding company including its wholly-owned subsidiaries, Orrstown Bank, the First National Bank of Newport (First National) and Pennbanks Insurance Company Cell P1 (Cell P1). All significant intercompany transactions and accounts have been eliminated.

The Corporation has been in the process of divesting the Pennbanks Insurance Company Cell P1 insurance book of business. As of January 1, 2006 the liabilities associated with the insurance business were assumed by American General under a contractual arrangement. Cell P1 had investments in debt and equity securities. As of June 30, 2006, the equity security portfolio has been sold and only debt securities remain.

Operating results for the three and six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

Cash Flows

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

Federal Income Taxes

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

Investment Securities

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

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

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

**Table of Contents**

The Corporation has classified all investment securities as available for sale. At December 31, 2005, fair value exceeded amortized cost by \$284,000 and at June 30, 2006 amortized cost exceeded fair value by \$523,000. In shareholders' equity, the balance of accumulated other comprehensive income decreased to \$(345,000) from \$187,000 at December 31, 2005.

**Stock-Based Compensation**

The Corporation maintains two stock-based compensation plans. These plans provide for the granting of stock options to the Corporation's employees and directors. The Corporation has historically accounted for the plans using the intrinsic-value method under the recognition and measurement principles of APB Opinion No. 25 and related Interpretations. In December 2004, the FASB issued a final FAS Statement No. 123R, Share-Based Payment, which requires financial statement recognition of compensation cost for stock options and other stock-based awards. As of January 1, 2006, the Corporation has adopted the modified prospective method. This requires the recognition of compensation expense for the unvested portion of existing awards and new grants, but does not require a restatement of prior periods. All options that have been awarded in prior years were fully vested when granted and did not require any amounts to be expensed.

As a result of adopting Statement 123R on June 30, 2006, the Corporation's income before taxes and net income for the six months ended June 30, 2006, are \$223,926 and \$145,552 lower, respectively, than if it had continued to account for share-based compensation under Opinion 25. Basic and diluted earnings per share for the six months ended June 30, 2006 are \$.03 and \$.03 lower, respectively, than if the company had continued to account for share-based compensation under Opinion 25. Options have an exercise price equal to the fair market value as established by the average of the daily high bid and daily low offer quotations for the shares reported in the OTC Bulletin Board service during the ten trading days immediately preceding the date of purchase. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model.

**Earnings per share of common stock**

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect the addition of an incremental number of shares added as a result of converting common stock equivalents. All per share amounts have been restated for stock splits and stock dividends that occurred prior to the issuance of the financial statements, including a 5% stock dividend paid June 2005. A reconciliation of the weighted average shares outstanding used to calculate basic net income per share and diluted net income per share follows. There is no adjustment to net income to arrive at diluted net income per share.

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 2006</b>	<b>June 2005</b>	<b>June 2006</b>	<b>June 2005</b>
Net Income	\$ 3,146	\$ 2,560	\$ 5,644	\$ 4,731
Weighted average shares outstanding (basic)	5,910	5,402	5,676	5,396
Impact of common stock equivalents	249	211	246	210
Weighted average shares outstanding (diluted)	6,159	5,613	5,922	5,606
Per share information:				
Basic earnings per share	\$ 0.53	\$ 0.48	\$ 0.99	\$ 0.88
Diluted earnings per share	\$ 0.51	\$ 0.45	\$ 0.95	\$ 0.84
Note 2: Other Commitments				

In the normal course of business, the banks make various commitments and incur certain contingent liabilities which are not reflected in the accompanying financial statements. These commitments include various guarantees and commitments to extend credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Corporation's subsidiary banks evaluate each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. Standby letters of credit and financial guarantees written are conditional commitments to guarantee the performance of a customer to a third party. Those guarantees are





## Table of Contents

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. Each bank holds collateral supporting those commitments when deemed necessary by management. As of June 30, 2006, \$18,734,000 of performance standby letters of credit have been issued. The Corporation does not anticipate any losses as a result of these transactions.

### Note 3: Allowance for loan losses:

An allowance has been established for the acquired credit risk of the loan portfolio less any amounts attributable to loans with credit quality issues acquired in the May 1, 2006 acquisition of the First National Bank of Newport.

(Dollars in Thousands)	Three Months Ended		Six Months Ended	
	June 2006	June 2005	June 2006	June 2005
Balance at beginning of period	\$ 4,449	\$ 4,338	\$ 4,428	\$ 4,318
Provision for loan losses	36	24	72	48
Net loans charged-off	(28)	(13)	(43)	(17)
Additions established for acquired credit risk	720		720	
Balance at end of period	\$ 5,177	\$ 4,349	\$ 5,177	\$ 4,349

### Note 4: Acquisition

On May 1, 2006, Orrstown Financial Services, Inc. completed the acquisition of The First National Bank of Newport, a \$120 million national banking institution with four banking offices in Perry County, Pennsylvania. First National operates as a wholly owned subsidiary of Orrstown Financial Services, Inc. under the name The First National Bank of Newport .

Under the terms of the agreement, each share of First National common stock outstanding at the time of the transaction was exchanged for 1.75 shares of Orrstown common stock and \$22.20 in cash. The purchase price for share exchanged for common stock was \$35.49 with 400,000 shares of First National common stock outstanding.

The following table summarizes the preliminary purchase price allocation based on estimated fair values of the assets acquired and liabilities assumed at the date of acquisition (in thousands).

<b>Assets</b>	
Cash and cash equivalents	13,031
Investments securities	29,398
Net Loans	71,976
Core deposit intangible	1,665
Other assets	5,828
<b>Total identifiable assets</b>	<b>\$ 121,898</b>
<b>Liabilities</b>	
Total deposits	105,502
Short term borrowings	
Long term borrowings	
Other liabilities	547
<b>Total liabilities</b>	<b>\$ 106,049</b>

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

Merger related expenses of \$286,000 were paid in the second quarter of 2006 and entered into goodwill and deferred taxes. \$146,000 of fixed asset costs incurred in connection with the conversion and updating the Corporation's core operating system has been paid in the second quarter of 2006. The bulk of conversion related costs have been incurred during the second quarter. Less significant expenses for other items may be recognized in future quarters.

## Table of Contents

Orrstown Financial Services, Inc. used the purchase method of accounting to record the acquisition transaction with First National. The \$18,160,000 of goodwill in connection with the acquisition is calculated below. The goodwill recorded was allocated to First National as all of the assets and liabilities acquired were related to the banking subsidiary.

Orrstown Financial Services, Inc common stock issued	699,949	
Average purchase price per Orrstown common shares	\$ 35.49	
		\$ 24,841
Cash price paid at \$22.20 per share plus 51 fractional shares		8,882
Merger costs		286
Total purchase price		34,009
Net assets acquired:		
First National's shareholders' equity	13,648	
Adjustments to reflect assets acquired at fair value:		
Investments		
Loans	329	
Bank premises	1,189	
Core deposit intangible	1,665	
Deferred tax assets	(1,165)	
Adjustments to reflect liabilities acquired at fair value:		
Time deposits	183	
		15,849
Goodwill resulting from merger		\$ 18,160

The following pro forma combined results of operations for the six months ended June 30, 2006 and June 30, 2005 gives effect to the merger as if the merger had been completed on January 1, 2006 and January 1, 2005, respectively. The pro forma information shows the combination of First National's historical results into Orrstown Financial services, Inc. results of operations under the purchase method of accounting. While certain adjustments have been made for the estimated impact of purchase accounting adjustments, the pro forma results of operations is presented for illustrative purposes only and does not indicate the financial results of the combined company had the companies actually been combined at the beginning of the period presented.

### Pro forma

	Six Months Ended	
	June 2006	June 2005
(Dollars in Thousands, except per share data)		
Net interest income	14,237	13,070
Other income	5,426	4,765
Net income	5,896	5,518
Earnings per share	0.96	0.91

## Table of Contents

### PART I - FINANCIAL INFORMATION

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

##### OVERVIEW

The following is a discussion of our consolidated financial condition at June 30, 2006 and results of operations for the three and six months ended June 30, 2006 and three and six months ended June 30, 2005. Throughout this discussion, the yield on earning assets is stated on a fully taxable-equivalent basis and balances represent average daily balances unless otherwise stated.

Some statements and information may contain forward-looking statements. The following factors, among others, could cause actual results to differ materially from forward-looking statements include: general political and economic conditions, unforeseen changes in the general interest rate environment, developments concerning credit quality in various corporate lending industry sectors, legislative or regulatory developments, legal proceedings, pending and proposed changes in accounting rules, policies, practices, and procedures. Each of these factors could affect estimates and assumptions used to produce forward looking statements causing actual results to differ materially from those anticipated. Future results could also differ materially from historical performance.

##### Critical Accounting Policies

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

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

##### SUMMARY OF FINANCIAL RESULTS

Orrstown Financial Services, Inc. recorded net income of \$3,146,000 for the second quarter of 2006 compared to \$2,560,000 for the same period in 2005, representing an increase of \$586,000 or 22.9%. Basic earnings per share increased \$0.05 to \$0.53 in the recent quarter from the \$0.48 earned during the second quarter of 2005. Diluted earnings per share for the second quarter were \$0.51 versus \$0.45 last year.

Net income for the first six months of 2006 was \$5,644,000 compared to \$4,731,000 for the same period in 2005, representing an increase of \$913,000 or 19.3%. First National contributed \$302,000 of net income during its two months of inclusion. Basic earnings per share for the first half of 2006 increased to \$.99, up from the \$.88 per share realized during the six months ended June 30, 2005. All per share amounts have been restated to reflect the 5% stock dividend paid to shareholders on June 29, 2005.

The following statistics compare 2006's second quarter and year-to-date performance to that of 2005:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June</b>	<b>June</b>	<b>June</b>	<b>June</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Return on average assets	1.79%	1.90%	1.74%	1.80%
Return on average tangible assets	1.83%	1.90%	1.77%	1.80%
Return on average equity	16.54%	19.73%	16.97%	18.61%
Return on average tangible equity	20.55%	20.27%	19.42%	19.13%
Average equity / Average assets	10.81%	9.61%	10.27%	9.67%



**Table of Contents****RESULTS OF OPERATIONS**Quarter ended June 30, 2006 compared to Quarter ended June 30, 2005**Net Interest Income**

Net interest income for the second quarter of 2006 was \$6,865,000 representing a growth of \$1,269,000, or 22.7% over the \$5,596,000 realized during the second quarter last year. First National contributed \$745,000 to net interest income during its two months of operations. On a fully taxable equivalent basis (FTE), net interest income for the second quarter of 2006 and 2005 were \$7,122,000 and \$5,770,000, respectively.

**Interest income FTE**

FTE interest income totaled \$11,102,000 for the second quarter of 2006 versus \$7,979,000 for the same period last year, a difference of \$3,123,000 or 39.1%. The rate on earning assets rose from 6.24% during the second quarter 2005 to 6.85% during the same quarter this year. Increases in the prime lending rate and the federal funds rate during 2005 and continuing through the first six months of 2006 have increased the earnings yield of the Corporation. Total earning assets grew \$135.8 million or 26.7% from \$508.5 million on average for the second quarter of 2005 to \$644.3 million during the second quarter 2006. Approximately 15.1% of this growth is due to the acquisition of First National, resulting in approximately 11.6% of organic growth throughout the Corporation. Commercial loans have continued to be the largest area of growth. Since most of these loans are variable in nature, this has enabled interest income to grow given the rising rate environment.

**Interest expense**

Interest expense increased \$1,771,000 or 80.2%, to \$3,980,000. Interest bearing liabilities increased to \$545.0 million from \$421.4 million or 29.3%. Approximately 15.6% of this growth is due to the acquisition of First National, resulting in approximately 13.7% of organic growth in interest bearing liabilities. Savings accounts continued to increase in volume but have slowed down compared to past quarters, while interest bearing demand deposits are decreasing in volume in the rising rate environment. Time deposits grew 74.9% or \$99.5 million from \$132.9 to \$232.4 or approximately 49.6% excluding time deposits acquired from First National. Short term borrowings have increased by \$15.4 million due to a seasonal increase in repurchase agreements. Total long term borrowings have decreased by \$7.2 million due to pay downs and maturities. First National did not have any borrowings at the time of the acquisition.

Interest rates on liabilities have risen due to the rising rate environment in which we are operating. Time deposit open accounts and a prime savings account are tied to the prime lending rate, so costs have increased over the past twelve months. As a result of the cost of funds increasing at a faster pace than earning assets, the funds flow mentioned above, and the addition of First National at slightly tighter margin, the interest spread decreased from 4.14% to 3.92% and the interest margin decreased from 4.50% during second quarter 2005 to 4.38% during second quarter 2006.

The table that follows states rates on a fully taxable equivalent basis (FTE) and demonstrates the aforementioned effects:

	Three Months Ended					
	Average Balance	June 2006 Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	June 2005 Tax Equivalent Interest	Tax Equivalent Rate
<b>(Dollars in thousands)</b>						
<b>Interest Earning Assets:</b>						
Federal funds sold & interest bearing bank balances	\$ 19,972	\$ 250	5.02%	\$ 13,256	\$ 98	2.97%
Investment securities	88,076	1,103	5.03%	81,302	1,009	4.99%
Total loans	536,255	9,749	7.22%	413,928	6,872	6.60%
<b>Total interest-earning assets</b>	<b>644,303</b>	<b>11,102</b>	<b>6.85%</b>	<b>508,486</b>	<b>7,979</b>	<b>6.24%</b>
<b>Interest Bearing Liabilities:</b>						
Interest bearing demand deposits	\$ 156,500	\$ 399	1.02%	\$ 169,013	\$ 423	1.00%
Savings deposits	90,530	520	2.30%	62,155	265	1.71%
Time deposits	232,429	2,325	4.01%	132,910	1,010	3.05%

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

Short term borrowings	38,201	435	4.57%	22,770	154	2.71%
Long term borrowings	27,393	301	4.41%	34,567	357	4.14%
Total interest bearing liabilities	545,053	3,980	2.93%	421,415	2,209	2.10%
Net interest income / net interest spread	\$ 7,122		3.92%	\$ 5,770		4.14%
Net interest margin			4.38%			4.50%

## **Table of Contents**

### **Non-Interest Income**

Total non-interest income, excluding securities gains, increased \$637,000, or 27.6%, from \$2,307,000 to \$2,944,000. There were no net securities gains (losses) in the second quarter 2005 compared to the \$10,000 of gains taken in the second quarter of 2006. Significant increases were realized in the secondary mortgage program, asset management fees, debit card utilization and the overdraft protection program. Service charges on deposits increased 16.5% or \$162,000 with \$122,000 of the growth due to the overdraft protection program. Fees from debit cards and merchant accounts added another \$54,000. Other service charges increased by \$295,000. The success of the secondary mortgage program contributed greatly to this growth in other service charges. Property and casualty insurance increased by \$70,000 while credit life and disability insurance fell due to the sale of Cell P1's book of business as of January 1, 2006. Asset management fees added significantly to the growth as trust fees increased by \$57,000 or 10.0% and brokerage fees increased \$64,000 or 23.2%. Life insurance income increased \$69,000 due to the acquisition of First National's bank owned life insurance and an additional investment of \$4.5 million in single premium life insurance policies.

### **Non-Interest Expense**

Other expenses rose from \$4,144,000 during the second quarter 2005 to \$5,350,000 during the second quarter of 2006, an increase of \$1,206,000, or 29.1%. The \$1,013,000 advance in salaries and benefits, including stock option expense of \$198,000, was the largest contributor to the overall increase in non interest expense. The addition of two months salary and benefit expense of First National's employees, annual salary increases of previously employed staff, new staff growth and rising health care costs contributed to the increase.

Occupancy and equipment expense rose \$195,000, or 30.8%, over the prior year. Expense related to premises and equipment increased with the addition of Orrstown Bank's fifteenth branch on March 30, 2006 in Hagerstown, Maryland, a full service replacement branch opening in Greencastle, Pennsylvania on June 12, 2006, and the four branches acquired with First National in Perry County, Pennsylvania. Data processing expense increased by \$60,000 or 31.9%, and advertising expense rose 84.8% or \$56,000. All other operating expenses decreased by \$118,000. Deferred loan costs decreased by \$384,000 while printing and supplies increased \$41,000, public relations increased \$35,000, amortization expense increased \$29,000 and OREO expense increased \$21,000. The Corporation's overhead efficiency ratio increased slightly to 52.45% for the current quarter versus the second quarter 2005 ratio of 51.05%. The increase in the overhead efficiency ratio, due to the increase in non interest expense, was kept to a minimum by a combination of the rapidly growing net interest income and increases in noninterest income.

### **Six months ended June 30, 2006 compared to Six months ended June 30, 2005**

### **Net Interest Income**

Net interest income for the first six months of 2006 was \$12,739,000 representing a growth of \$1,885,000, or 17.4% over the \$10,854,000 realized during the same period last year. On a fully taxable equivalent basis (FTE), net interest income for the first six months of 2006 and 2005 was \$13,201,000 and \$11,223,000, respectively.

### **Interest income FTE**

Interest income totaled \$20,387,000 for the first six months of 2006 versus \$15,393,000 for the same period last year. The steady increase in the prime lending rate and federal funds sold rate during the past year and continuing on into this year, have contributed to the growth of the Corporation's earning asset yield along with the 20.7% growth in the volume of total earning assets. Approximately 7.8% of the growth to average earning assets for the six month period was contributed by First National balances. The Bank's earning asset yield increased 60 basis points from the prior year's 6.17% to 6.77% for the first six months of 2006. Total securities decreased by \$3.1 million primarily as a result of payments in the mortgage backed securities portfolio. The total loan portfolio increased by \$96.9 million or 23.9% over the same period last year. Approximately 6.3% of this growth was due to the acquisition of First National. Mortgage loan balances remained steady while consumer loans increased by 18.5% or \$10.4 million. The majority of the growth continues to be in the commercial loan portfolio which increased from \$257.6 million to \$333.6 or 29.5%. The volume growth in earning assets and increases in the prime lending rate, have increased the total interest income by \$4,994,000 or 32.4% versus the first six months of 2005.

### **Interest expense**

Total interest expense increased \$3,016,000 from \$4,170,000 to \$7,186,000 or 72.3% over the first six months of 2005. Interest bearing demand deposits have decreased over the first six months of 2005 by \$24.7 million; the Corporation has increased its non-interest demand deposits by \$10.9 million in the same period. The rising interest rate environment has caused some disintermediation of NOW account balances. Balances in savings deposits have grown by 70.1% or \$35.6 million due primarily to the popularity of a prime based savings product introduced in January 2005. Time deposits balances have increased by \$71.1 million due in large part to increases in time deposit rates. Approximately 12.6% of the



growth in savings deposits, and 12.8% of the growth in time deposits was due to the acquisition of First National.

**Table of Contents**

Short term borrowings have increased in volume due to normal fluctuations in repurchase agreements at this time of the year. Maturity and amortization of long term debt has decreased balances by \$1.4 million over 2005.

As a result of balance shifts to higher paying savings and certificate of deposit products at a faster rate than earning asset yields, along with the addition of First National with a slightly tighter spread, the interest spread decreased from 4.14% to 3.92% and the interest margin decreased from 4.49% during the first six months of 2005 to 4.36% during the first six months of 2006.

The table that follows states rates on a fully taxable equivalent basis (FTE) and demonstrates the aforementioned effects:

	Six Months Ended			June 2005		
	Average Balance	June 2006 Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	June 2005 Tax Equivalent Interest	Tax Equivalent Rate
<b>(Dollars in thousands)</b>						
<b>Interest Earning Assets:</b>						
Federal funds sold & interest bearing bank balances	\$ 19,619	\$ 462	4.75%	\$ 10,258	\$ 142	2.79%
Investment securities	79,578	1,993	5.04%	82,678	2,092	5.08%
Total loans	501,551	17,932	7.13%	404,691	13,159	6.49%
<b>Total interest-earning assets</b>	<b>600,748</b>	<b>20,387</b>	<b>6.77%</b>	<b>497,627</b>	<b>15,393</b>	<b>6.17%</b>
<b>Interest Bearing Liabilities:</b>						
Interest bearing demand deposits	\$ 148,220	\$ 726	0.99%	\$ 172,895	\$ 877	1.02%
Savings deposits	86,469	1,017	2.37%	50,848	365	1.45%
Time deposits	203,509	3,955	3.92%	132,416	1,948	2.97%
Short term borrowings	35,520	763	4.27%	21,111	263	2.48%
Long term borrowings	33,615	725	4.29%	35,026	717	4.07%
<b>Total interest bearing liabilities</b>	<b>507,333</b>	<b>7,186</b>	<b>2.86%</b>	<b>412,296</b>	<b>4,170</b>	<b>2.04%</b>
<b>Net interest income / net interest spread</b>		<b>\$ 13,201</b>	<b>3.92%</b>		<b>\$ 11,223</b>	<b>4.14%</b>
<b>Net interest margin</b>			<b>4.36%</b>			<b>4.49%</b>
<b>Non-Interest Income</b>						

Other income, excluding securities gains, increased \$1,019,000, or 24.2%, from \$4,210,000 to \$5,229,000. Securities gains (losses) increased from \$2,000 of net losses in 2005 to \$12,000 of net gains in 2006. Service charges on deposits increased 15.7% or \$282,000. The overdraft protection program increased \$186,000, while debit card fees added \$67,000 and merchant account service charges added \$44,000. Other service charges increased by \$377,000. The success of the secondary mortgage program was a material contributor adding \$198,000. ATM fees increased by \$51,000 and other loan fees generated an additional \$35,000 versus the prior year. This broad growth across almost all areas simply reflects the growth of the Corporation.

The asset management area continued to grow during 2006, increasing income by \$68,000 while brokerage income increased \$180,000 or 38.1% over the first six months of 2005. Trust assets under management reached \$390 million at June 30, 2006.

**Non-Interest Expense**

Other expenses rose from \$8,171,000 during the first six months of 2005 to \$9,898,000 during the same period of 2006, an increase of \$1,727,000, or 21.1%. Salaries increased \$766,000 due somewhat in part to the acquisition of First National and normal overall growth throughout the Corporation. Benefit expense grew by \$764,000 including \$198,000 of employee options expense in June. Profit sharing expense grew by \$89,000 and other increases in benefits were primarily due to the cost of employee insurance plans.

Occupancy and equipment expense rose \$298,000, or 23.4%. Depreciation expense contributed \$68,000 of the increase along with increases in real estate taxes and maintenance agreements and rent expense. Data processing expense increased \$103,000 or 31.3% over 2005, while advertising increased by \$38,000. Other operating expenses decreased by \$241,000 or 12.5%, including the deferral of loan origination costs. Printing and supplies expense grew by \$56,000 while consulting expense increased by \$62,000 and amortization expense increased \$30,000.

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

given the amortization of intangibles for the First National acquisition. Secondary market mortgage expense increased \$24,000, OREO expense grew \$81,000 and the non-employee director stock option expense added an additional \$26,000 to non interest expense in April.

**Table of Contents**

The overhead efficiency ratio remained almost even, increasing to 52.89% for the first six months of 2006 compared to the 52.68% last year, despite increases in net interest income and non-interest income. The acquisition of First National altered the ratio slightly. The achievement of an efficiency ratio below 60% is quite admirable for a banking company with less than \$1 billion of assets.

**INCOME TAX EXPENSE**

Income tax expense increased \$112,000, or 9.5%, during the second quarter of 2006 versus the second quarter of 2005. For the first six months of 2006 the income tax expense rose \$254,000 or 12.0% over the same period 2005. The marginal federal income tax bracket is 35% for all periods presented. Effective income tax rates were as follows:

	<b>Three Months Ended</b>		<b>Six months Ended</b>	
	<b>June</b>	<b>June</b>	<b>June</b>	<b>June</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Effective income tax rate	29.0%	31.5%	29.5%	30.9%

The addition of First National's low income housing credits helped to reduce the effective tax rate.

**PROVISION AND ALLOWANCE FOR LOAN LOSSES**

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

The provision for loan losses amounted to \$36,000 and \$24,000 for the second quarter of 2006 and 2005, respectively. These provisions compared to net charge-offs of \$28,000 during the second quarter 2006 and \$13,000 during the same period last year. The provision for loan losses increased by \$12,000 while loans increased by \$122.3 million or 29.6% on an average daily basis for the current quarter.

For the first six months of 2006 the provision for loan losses was \$72,000 compared to \$48,000 taken in the first half of 2005. The year to date net charge-offs for 2006 were \$43,000 compared to \$17,000 of net charge-offs for the same period 2005. An addition of \$720,000 was established for the provision of the loans acquired with First National Bank of Newport, representing 0.9% of their loans at June 30, 2006. This is in line with the reserve to loan ratio for the entire Corporation of 0.9% at June 30, 2006.

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June</b>	<b>June</b>	<b>June</b>	<b>June</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>(Dollars in Thousands)</b>				
Balance at beginning of period	\$ 4,449	\$ 4,338	\$ 4,428	\$ 4,318
Provision for loan losses	36	24	72	48
Recoveries	7	11	13	15
Loan charge-offs	(35)	(24)	(56)	(32)
Additions established for acquired credit risk	720	0	720	0
Balance at end of period	\$ 5,177	\$ 4,349	\$ 5,177	\$ 4,349

**Table of Contents****NONPERFORMING ASSETS / RISK ELEMENTS**

Nonperforming assets at June 30, are as follows:

<b>(Dollars in Thousands)</b>	<b>2006</b>	<b>2005</b>
Loans on nonaccrual (cash) basis	\$ 302	\$ 188
Loans whose terms have been renegotiated	0	0
OREO	950	0
 Total nonperforming loans and OREO	 1,252	 188
 Loans past due 90 or more days and still accruing	 674	 3,078
 Total nonperforming and other risk assets	 \$ 1,926	 \$ 3,266
 Ratio of total risk assets to total loans and OREO	 0.33%	 0.77%
Ratio of total risk assets to total assets	0.25%	0.57%
Any loans classified for regulatory purposes as loss, doubtful, substandard or special mention that have not been disclosed under Item III of Industry Guide 3 do not represent or result from trends or uncertainties which management reasonably expects will materially impact future operating results, liquidity or capital resources.		

**CAPITAL**

Orrstown Financial Services, Inc. is a financial holding company and, as such, must maintain a well capitalized status in its bank subsidiary. Management foresees no problem in maintaining capital ratios well in excess of regulatory minimums. A comparison of Orrstown Financial Services, Inc.'s capital ratios to regulatory minimum requirements at June 30, 2006 are as follows:

	<b>Orrstown Financial Services, Inc.</b>	<b>Regulatory Minimum</b>	<b>Regulatory Well Capitalized Minimum</b>
Leverage Ratio	9.24%	4%	5%
Risk Based Capital Ratios:			
Tier I Capital Ratio	10.97%	4%	6%
Total (Tier I & II) Capital Ratio (core capital plus allowance for loan losses)	11.90%	8%	10%

At May 1, 2006 Orrstown Financial Services, Inc. issued 699,949 shares to complete the acquisition of First National, resulting in an additional \$24.8 million in shareholders' equity. The purchase price assigned to shares issued was based on the average closing prices of Orrstown's common stock 2-days before and 2 days after the announcement date between Orrstown and First National. All other growth experienced during 2006 has been supported by capital growth in the form of retained earnings. Equity represented 11.07% of assets at June 30, 2006 which is up from 9.53% at December 31, 2005. The equity to asset ratio was enhanced with the addition of the well capitalized First National along with the included purchase accounting adjustments.

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

**LIQUIDITY**

The primary function of asset/liability management is to assure adequate liquidity while minimizing interest rate risk. Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Sources of liquidity include investment securities, loan and lease income and payments, and increases in customer's deposit accounts. Additionally, the Bank is a Federal Home Loan Bank (FHLB)

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

member, and standard credit arrangements available to FHLB members provide increased liquidity. Funds provided from financing activities and operating activities were the primary source of liquidity for the first six months of 2006. The net increase of organic

## **Table of Contents**

growth in deposits of \$50,378,000 was channeled into loan growth of \$42,705,000 from December 31, 2005 to June 30, 2006 not including funds and loans acquired by First National at May 1, 2006. First National improved the liquidity of the Corporation by adding \$33,000,000 of deposits in excess of their loans and another \$13,031,000 of cash and cash equivalents.

### **PART I - FINANCIAL INFORMATION**

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

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

Interest rate sensitivity management requires the maintenance of an appropriate balance between interest sensitive assets and liabilities. Interest bearing assets and liabilities that are maturing or repricing should be adequately balanced to avoid fluctuating net interest margins and to enhance consistent growth of net interest income through periods of changing interest rates. The Corporation has consistently followed a strategy of pricing assets and liabilities according to prevailing market rates while largely matching maturities, within the guidelines of sound marketing and competitive practices. Rate sensitivity is measured by monthly gap analysis, quarterly rate shocks, and periodic simulation. At June 30, 2006, the cumulative gap was a negative \$9,918,000 and the RSA/ RSL cumulative ratio was .97% which has decreased from the 1.14% since December 31, 2005. The gap position is slightly negative at this 12 month point. The interest spread and interest margin may continue to fall in a rising rate environment but the balance sheet should be positioned adequately to avoid material earnings damage if rates do not rise or start to fall. The deposit base is a mix of discretionarily priced transaction accounts, including non interest checking, but savings deposits, time deposits and repurchase agreements have all increased in volume at higher interest rates.

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

##### **(a) Evaluation of disclosure controls and procedures:**

The Corporation's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Corporation's disclosure controls and procedures (as such term is defined in Rules 13a-14(c) under the Securities Exchange Act of 1934, as amended) as of June 30, 2006. Based on such evaluation, such officers have concluded that, as of June 30, 2006, the Corporation's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Corporation (including its consolidated subsidiaries) required to be included in the Corporation's periodic filings under the Exchange Act.

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

There have not been any significant changes in the Corporation's internal control over financial reporting or in other factors that could significantly affect such control during the second quarter of 2006.

**Table of Contents****PART II - OTHER INFORMATION****Item 1 - Legal Proceedings**

The nature of Orrstown Financial Services, Inc.'s business generates a certain amount of litigation involving matters arising out of the ordinary course of business. In the opinion of management, there are no legal proceedings that might have a material effect on the results of operations, liquidity, or the financial position of Orrstown at this time.

**Item 1A - Risk Factors**

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

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

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

The table below summarizes the Company's repurchase of common equity securities during the quarter ended June 30, 2006:

	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)</b>	<b>Maximum Number of Shares that may Yet be Purchased Under the Plans or Programs (1)</b>
4/1/06 through 4/30/06		\$		150,000
5/1/06 through 5/31/06				150,000
6/1/06 through 6/30/06	10,000	36.75	N/A	140,000
Total	10,000	\$ 36.75		

- (1) On April 27, 2006, Orrstown Financial Services, Inc. announced a Stock Repurchase Plan approving the purchase of up to 150,000 shares as conditions allow. The plan may be suspended at any time without prior notice and has no prescribed time limit in which to fill the authorized repurchase amount. As of June 30, 2006 ten thousand shares have been purchased under the program. Orrstown did not sell any unregistered securities.



**Table of Contents**

Item 3 - Defaults upon Senior Securities

Not applicable

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

The Annual Meeting of Orrstown Financial Services, Inc. was held on May 2, 2006. The only matter that was voted on by security holders was the election of three directors to Class C for three year terms expiring in 2009. Incumbent directors, Anthony F. Ceddia, Andrea Pugh and Kenneth R. Shoemaker, were re-elected at the Annual Meeting.

Item 5 - Other Information

None

Item 6 Exhibits

- 3.1 Articles of Incorporation. Incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No. 333-131176.
- 3.2 By-laws. Incorporated by reference to Exhibit 3.2 of the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 4 Instruments defining the rights of security holders including indentures. The rights of the holders of Registrant's common stock are contained in:
  - (i) Articles of Incorporation of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No. 333-131176.
  - (ii) By-laws of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 31.1 Rule 13a - 14(a)/15d-14(a) Certification (Chief Executive Officer) filed herewith
- 31.2 Rule 13a - 14(a)/15d-14(a) Certifications (Chief Financial Officer) filed herewith
- 32.1 Section 1350 Certifications (Chief Executive Officer) filed herewith
- 32.2 Section 1350 Certifications (Chief Financial Officer) filed herewith

**Table of Contents**

SIGNATURES

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

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

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

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

Date: August 7, 2006

**Table of Contents**

ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

EXHIBIT INDEX

- 3.1 Articles of incorporation. Incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No.333-131176.
- 3.2 By-laws. Incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 4 Instruments defining the rights of security holders including indentures. The rights of the holders of Registrant's common stock are contained in:
  - (i) Articles of Incorporation of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No.333-131176.
  - (ii) By-laws of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 31.1 Rule 13a - 14(a)/15d-14(a) Certification (Chief Executive Officer) filed herewith
- 31.2 Rule 13a - 14(a)/15d-14(a) Certifications (Chief Financial Officer) filed herewith
- 32.1 Section 1350 Certifications (Chief Executive Officer) filed herewith
- 32.2 Section 1350 Certifications (Chief Financial Officer) filed herewith