ORRSTOWN FINANCIAL SERVICES INC
Form 10-Q
August 05, 2010
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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, 2010

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)

Commonwealth of Pennsylvania	**23-2530374**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

77 East King Street, P.O. Box 250, Shippensburg, Pennsylvania	**17257**
(Address of principal executive offices)	**(Zip Code)**

(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 filled 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 x NO ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES ¨ 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 definition of large accelerated filer, accelerated filer: and smaller reporting company in Rule 12b 2 of the Exchange Act. (Check one):

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell Corporation (as defined in Rule 12b 2 of the Exchange Act). YES ¨ NO x

As of June 30, 2010, 7,970,559 shares of common stock, no par value, of the registrant were outstanding.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)	**(Unaudited) June 30, 2010**	**(Audited) * December 31, 2009**
ASSETS		
Cash and due from banks	$ 17,838	$ 13,940
Federal funds sold	20,705	8,000
Cash and cash equivalents	38,543	21,940
Short-term investments	6,247	6,388
Interest bearing deposits with banks	0	601
Member stock, at cost which approximates market value	8,056	8,056
Securities available for sale	327,907	196,253
Loans	898,128	881,074
Allowance for loan losses	(14,582)	(11,067)
Net Loans	883,546	870,007
Premises and equipment, net	28,566	29,601
Goodwill and intangible assets	20,808	20,938
Cash surrender value of life insurance	22,312	21,204
Accrued interest receivable	4,762	4,605
Other assets	18,009	16,839
Total assets	$ 1,358,756	$ 1,196,432
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Non-interest bearing	$ 102,725	$ 90,676
Interest bearing	986,825	824,494
Total deposits	1,089,550	915,170
Short-term borrowings	45,367	97,914
Long-term debt	57,132	64,858
Accrued interest payable	899	1,040
Other liabilities	7,905	6,564
Total liabilities	1,200,853	1,085,546
Common stock, no par value - $ .05205 stated value per share; 50,000,000 shares authorized; 7,972,398 and 6,469,508 shares issued	415	337
Additional paid-in capital	120,814	82,895
Retained earnings	32,999	28,857
Accumulated other comprehensive income (loss)	3,728	(501)

Treasury stock, 1,839 and 26,313 shares, at cost	(53)	(702)
Total shareholders equity	157,903	110,886
Total liabilities and shareholders equity	$ 1,358,756	$ 1,196,432

* Condensed from audited financial statements

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

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ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Dollars in Thousands)	Three Months Ended June 2010	June 2009
INTEREST INCOME		
Interest and fees on loans	$ 12,205	$ 11,787
Interest and dividends on investment securities	2,298	1,342
Interest on short-term investments	33	13
Total interest income	14,536	13,142
INTEREST EXPENSE		
Interest on deposits	2,747	3,265
Interest on short-term borrowings	81	96
Interest on long-term debt	408	969
Total interest expense	3,236	4,330
Net interest income	11,300	8,812
Provision for loan losses	5,000	300
Net interest income after provision for loan losses	6,300	8,512
OTHER INCOME		
Service charges on deposits	1,881	1,750
Other service charges	1,451	1,130
Trust department income	834	637
Brokerage income	440	350
Other income	1,301	190
Securities gains	1,781	293
Total other income	7,688	4,350
OTHER EXPENSES		
Salaries and employee benefits	4,716	4,268
Occupancy and equipment	1,186	1,176
Data processing	309	283
Advertising	100	113
Other operating expense	2,413	2,504
Total other expense	8,724	8,344
Income before income taxes	5,264	4,518
Income tax expense	1,360	1,064
Net income	$ 3,904	$ 3,454

PER SHARE DATA				
Basic earnings per share	$	0.49	$	0.54
Diluted earnings per share	$	0.47	$	0.51
Dividends per share	$	0.22	$	0.22

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

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ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Six Months Ended	
(Dollars in Thousands)	**June 2010**	**June 2009**
INTEREST INCOME		
Interest and fees on loans	$ 24,044	$ 23,202
Interest and dividends on investment securities	4,212	2,484
Interest on short term investments	63	33
Total interest income	28,319	25,719
INTEREST EXPENSE		
Interest on deposits	5,427	6,656
Interest on short-term borrowings	245	181
Interest on long-term debt	850	2,048
Total interest expense	6,522	8,885
Net interest income	21,797	16,834
Provision for loan losses	6,420	515
Net interest income after provision for loan losses	15,377	16,319
OTHER INCOME		
Service charges on deposits	3,577	3,261
Other service charges	2,330	2,177
Trust department income	1,530	1,286
Brokerage income	838	635
Other income	1,707	502
Securities gains	2,179	458
Total other income	12,161	8,319
OTHER EXPENSES		
Salaries and employee benefits	9,548	8,539
Occupancy and equipment	2,389	2,390
Data processing	603	530
Advertising	191	226
Security impairment expense	0	36
Other operating expense	4,779	4,300
Total other expense	17,510	16,021
Income before income taxes	10,028	8,617
Income tax expense	2,718	2,138
Net income	$ 7,310	$ 6,479

PER SHARE DATA				
Basic earnings per share	$	1.01	$	1.01
Diluted earnings per share	$	0.97	$	0.96
Dividends per share	$	0.44	$	0.44

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

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ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY (UNAUDITED)

	Six Months Ended June 30, 2010 and 2009					
(Dollars in thousands)	**Common Stock**	**Additional Paid-In Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total Shareholders Equity**
Beginning Balance, January 1, 2009	$ 336	$ 82,555	$ 21,120	$ 1,369	($ 2,033)	$ 103,347
Comprehensive income						
Net income	0	0	6,479	0	0	6,479
Net unrealized securities gains	0	0	0	170	0	170
Net unrealized losses on derivatives	0	0	0	(1,086)	0	(1,086)
Comprehensive income						5,563
Cash dividends ($.44 per share)	0	0	(2,811)	0	0	(2,811)
Stock-based compensation plans:						
Compensation expense	0	24	0	0	0	24
Issuance of stock	1	240	0	0	0	241
Issuance of treasury stock (3,042 shares)	0	(42)	0	0	103	61
Balance, June 30, 2009	$ 337	$ 82,777	$ 24,788	$ 453	($ 1,930)	$ 106,425
Beginning Balance, January 1, 2010	$ 337	$ 82,895	$ 28,857	($ 501)	($ 702)	$ 110,886
Comprehensive income						
Net income	0	0	7,310	0	0	7,310
Net unrealized securities gains	0	0	0	3,594	0	3,594
Net unrealized gains on derivatives	0	0	0	635	0	635
Comprehensive income						11,539
Cash dividends ($.44 per share)	0	0	(3,168)	0	0	(3,168)
Stock-based compensation plans:						
Compensation expense	0	27	0	0	0	27
Issuance of stock	0	150	0	0	0	150
Issuance of stock through dividend reinvestment plan	1	331	0	0	0	332
Issuance of treasury stock (24,474 shares)	0	(62)	0	0	649	587
Issuance of common stock (1,481,481 shares)	77	37,473	0	0	0	37,550
Balance, June 30, 2010	$ 415	$ 120,814	$ 32,999	$ 3,728	($ 53)	$ 157,903

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

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

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	Three Months Ended	
(Dollars in Thousands)	**June 2010**	**June 2009**
COMPREHENSIVE INCOME		
Net Income	$ 3,904	$ 3,454
Other comprehensive income, net of tax		
Unrealized gain on investment securities available for sale	2,913	7
Unrealized gain (loss) on rate swaps	231	(1,059)
Comprehensive Income	$ 7,048	$ 2,402

	Six Months Ended	
(Dollars in Thousands)	**June 2010**	**June 2009**
COMPREHENSIVE INCOME		
Net Income	$ 7,310	$ 6,479
Other comprehensive income, net of tax		
Unrealized gain on investment securities available for sale	3,594	170
Unrealized gain (loss) on rate swaps	635	(1,086)
Comprehensive Income	$ 11,539	$ 5,563

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

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ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Six Months Ended	
(Dollars in Thousands)	**June 2010**	**June 2009**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 7,310	$ 6,479
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,431	1,714
Provision for loan losses	6,420	515
Net loss on disposal of other real estate owned	16	9
Net (gain) on disposal of bank premises and equipment	(119)	0
Net (gain) on sale of rate swap	(778)	0
Investment securities (gains)	(2,179)	(458)
Securities impairment loss	0	36
Other, net	(1,732)	(2,000)
Net cash provided by operating activities	11,369	6,295
CASH FLOWS FROM INVESTING ACTIVITIES		
Net decrease (increase) in interest bearing deposits with banks and short term investments	742	(268)
Purchases of available for sale securities	(307,424)	(98,703)
Sales and maturities of available for sale securities	182,432	54,844
Proceeds from disposal of other real estate owned	225	417
Proceeds from disposal of bank premises and equipment	373	0
Proceeds from sale of rate swap	868	0
Net (increase) in loans	(20,398)	(26,011)
Purchases of bank premises and equipment	(317)	(201)
Other, net	(825)	(1,199)
Net cash (used) by investing activities	(144,324)	(71,121)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	174,380	51,754
Dividends paid	(3,168)	(2,811)
Net proceeds from issuance of common stock	38,032	241
Net proceeds from issuance of treasury stock	587	61
Net change in short-term borrowings	(52,547)	20,392
Repayment of long-term borrowings	(7,726)	(13,220)
Net cash provided by financing activities	149,558	56,417
Net increase (decrease) in cash and cash equivalents	16,603	(8,409)
Cash and cash equivalents at beginning of period	21,940	26,804
Cash and cash equivalents at end of period	$ 38,543	$ 18,395
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		

Interest	$ 6,663	$ 8,728
Income Taxes	3,400	1,575
Supplemental schedule of noncash investing and financing activities:		
Unrealized gain on investments available for sale (net of deferred taxes of $1,935 and $92 at June 30, 2010 and 2009, respectively)	3,594	170
Unrealized gain (loss) on rate swaps (net of deferred taxes of $342 and ($585) at June 30, 2010 and 2009, respectively)	635	(1,086)
Other real estate acquired in settlement of loans	439	764

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

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ORRSTOWN FINANCIAL SERVICES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

June 30, 2010

Note 1: Summary of Significant Accounting Policies

Basis of Presentation

The unaudited financial statements of Orrstown Financial Services, Inc. (the Corporation) and its subsidiary are presented at and for the three and six months ended June 30, 2010 and 2009 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, 2009 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, 2009.

Operating

Orrstown Financial Services, Inc. is a financial holding company including its wholly-owned subsidiary, Orrstown Bank. All significant intercompany transactions and accounts have been eliminated. Operating results for the three and six months ended June 30, 2010, are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 Corporation s allowance for losses on loans and foreclosed real estate. Such agencies may require the Corporation 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.

Cash Flows

For purposes of the Statements of Cash Flows, cash and cash equivalents include Cash and due from banks and Federal funds sold. 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 and tax free loans.

Investment Securities

Under generally accepted accounting principles, the Corporation may segregate their investment portfolio into three specific categories: securities held to maturity , trading securities and securities available for sale . Securities held to maturity are to be accounted for at their amortized cost; securities classified as trading securities are to be accounted

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for at their current market value with unrealized gains and losses on such securities included in current period earnings; and securities classified as available for sale are to be accounted for at their current market value with unrealized gains and losses on such securities to be excluded from earnings and reported as a net amount in other comprehensive income.

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.

The Corporation has classified all of its investment securities as available for sale . Short-term investments consist of certificates of deposits with banks.

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 holding gains and losses, net of tax, on securities available for sale are reported as a net amount in a separate component (accumulated other comprehensive income) of shareholders equity until realized. Other-than-temporary impairment (OTTI) loss is recognized in earnings through the income statement in the period in which OTTI loss is taken, except for the non-credit component of OTTI losses on debt securities, which are recognized in other comprehensive income. Purchase premiums and discounts are recognized in interest income over the terms of the securities using the interest method over the period to maturity.

The Corporation s investments 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 financial statements.

Stock-Based Compensation

The Corporation maintains two stock-based compensation plans. These plans provide for the granting of stock options to the Corporation s directors and the Bank s employees. Generally accepted accounting principles, Share-Based Payment requires financial statement recognition of compensation cost for stock options and other stock-based awards. Both of the Corporation s stock-based compensation plans are fully vested when granted and, therefore, are expensed 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. A reconciliation of the weighted average shares outstanding used to calculate basic net income per share and diluted net income per share follows.

Earnings per share for the three and six months ended June 30 have been computed as follows:

(In Thousands, except per share data)	**Three Months Ended June 2010**	**Three Months Ended June 2009**	**Six Months Ended June 2010**	**Six Months Ended June 2009**
Net Income	$ 3,904	$ 3,454	$ 7,310	$ 6,479
Weighted average shares outstanding (basic)	7,962	6,392	7,233	6,389
Impact of common stock equivalents	308	338	315	337
Weighted average shares outstanding (diluted)	8,270	6,730	7,548	6,726
Per share information:				
Basic earnings per share	$ 0.49	$ 0.54	$ 1.01	$ 1.01

Diluted earnings per share	$ 0.47	$ 0.51	$ 0.97	$ 0.96

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Derivative Instruments and Hedging Activities

Generally accepted accounting principles require that all derivatives be recognized in the Consolidated Financial Statements at their fair values. On the dates that derivative contracts are entered into, the Corporation designates derivatives as (a) hedges of fair values of recognized assets or liabilities or of unrecognized firm commitments (fair-value hedges); (b) hedges of forecasted transactions or variable cash flows to be received or paid in conjunction with recognized assets or liabilities (cash-flow hedges) or (c) instruments that are held for trading or non-hedging purposes (trading or economic-hedging instruments). For a derivative treated as a fair-value hedge, the effective portion of a change in fair value is recorded as an adjustment to the hedged item. The ineffective portion of the fair-value hedge is recognized in current period earnings. Upon termination of a fair-value hedge of a debt instrument, the resulting gain or loss is amortized to earnings through the maturity date of the debt instrument. For a derivative treated as a cash flow hedge, the ineffective portion of changes in fair value is reported in current period earnings. The effective portion of the cash flow hedge is recorded as an adjustment to the hedged item through other comprehensive income. For a derivative treated as a trading or economic hedging instrument, changes in fair value are reported in current period earnings. Fair values are determined based upon quoted market prices and mathematical models using current and historical data.

The Corporation formally assesses, both at the hedges inception, and on an on-going basis, whether derivatives used in hedging transactions have been highly effective in offsetting changes in fair values or cash flows of hedged items and whether those derivatives are expected to remain highly effective in subsequent periods. The Corporation discontinues hedge accounting when (a) it determines that a derivative is no longer effective in offsetting changes in fair value or cash flows of a hedged item; (b) the derivative expires or is sold, terminated or exercised; (c) probability exists that the forecasted transaction will no longer occur or (d) management determines that designating the derivative as a hedging instrument is no longer appropriate. In all cases in which hedge accounting is discontinued and a derivative remains outstanding, the Corporation will carry the derivative at fair value in the Consolidated Financial Statements, recognizing changes in fair value in current period income in the statement of income.

The Corporation follows generally accepted accounting principles, Disclosures about Derivative Instruments and Hedging Activities , which includes the disclosure requirements for derivative instruments and hedging activities to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows.

The Bank entered into three (3) rate swap agreements - two on November 24, 2008, and one on May 22, 2009 - related to fixed rate loans. The Bank uses interest rate swaps to reduce interest rate risks and to manage interest income. By entering into these agreements, the Bank converts floating rate assets into fixed rate assets, or alternatively, converts fixed rate assets into floating rate assets. Interest differentials paid or received under the swap agreements are reflected as adjustments to interest income. These interest rate swap agreements are considered cash flow hedge derivative instruments that qualify for hedge accounting. The notional amounts of the interest rate swaps are not exchanged and do not represent exposure to credit loss. In the event of default by a counter party, the risk in these transactions is the cost of replacing the agreements at current market rates. During the second quarter, the Bank sold one of the rate swaps and received $868,000 as total proceeds from the sale. The Bank recognized a $778,000 gain on the sale of the rate swap that is included in other income on the three and six months ended consolidated statements of income.

The effects of derivative instruments on the Financial Statements for June 30, 2010 and December 31, 2009, are as follows:

Asset Derivatives at dates shown:

(Dollars in thousands)			**June 30, 2010**		
Derivatives designated as hedging instruments	**Notional/ Contract Amount**	**Estimated Net Fair Value**	**Estimated Net Fair Value**	**Expiration Date**	**Fixed Rate**
Interest rate swap - 5 year cash flow	$ 20,000	$ 773	other assets	11/26/2013	5.28%
Interest rate swap - 4 year cash flow	10,000	201	other assets	5/27/2013	4.54%
	$ 30,000	**$ 974**			**5.03%**

(Dollars in thousands)	**December 31, 2009**	
Derivatives designated as hedging instruments		**Fixed Rate**

	Notional/ Contract Amount	Fair Value Balance Sheet Location	Estimated Net Fair Value	Expiration Date	
Interest rate swap - 4 year cash flow	$ 30,000	$ 225	other assets	11/26/2012	4.97%
Interest rate swap - 5 year cash flow	20,000	39	other assets	11/26/2013	5.28%
Interest rate swap - 4 year cash flow	10,000	(146)	other assets	5/27/2013	4.54%
	$ 60,000	**$ 118**			**5.00%**

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For three months ended June 30, 2010 and June 30, 2009

(Dollars in thousands)

Derivatives in cash flow hedging relationships	Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)		Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion)	Amount of Gain (Loss) Recognized in Income on Derivative (Ineffective Portion)	
	2010	2009		2010	2009
Interest rate swap - 4 year cash flow	$ (406)	(675)	Other income	$ (22)	(18)
Interest rate swap - 5 year cash flow	535	(693)	Other income	11	(10)
Interest rate swap - 4 year cash flow	228	(261)	Other income	0	0
	$ 357	**(1,629)**		**$ (11)**	**(28)**

For six months ended June 30, 2010 and June 30, 2009

(Dollars in thousands)

Derivatives in cash flow hedging relationships	Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion)		Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion)	Amount of Gain (Loss) Recognized in Income on Derivative (Ineffective Portion)	
	2010	2009		2010	2009
Interest rate swap - 4 year cash flow	$ (152)	(660)	Other income	$ (5)	(1)
Interest rate swap - 5 year cash flow	781	(750)	Other income	22	0
Interest rate swap - 4 year cash flow	348	(261)	Other income	0	0
	$ 977	**(1,671)**		**$ 17**	**(1)**

Under the terms of the agreement, the Bank pays interest monthly at the rate equivalent to Wall Street Journal prime and receives interest income monthly at the fixed rate shown above.

Recent Accounting Pronouncements

In June 2009, the FASB issued new guidance relating to the accounting for transfers of financial assets. The new guidance, which was issued as SFAS No. 166, Accounting for Transfers of Financial Assets, an amendment to SFAS No. 140 , was adopted into Codification in December 2009 through the issuance of Accounting Standards Updated (ASU) 2009-16. The new standard provides guidance to improve the relevance, representational faithfulness, and comparability of the information that an entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor s continuing involvement, if any, in transferred financial assets. The adoption of the new guidance did not have a material impact on the Corporation s consolidated financial statements.

In June 2009, the FASB issued new guidance relating to the variable interest entities. The new guidance, which was issued as SFAS No. 167, Amendments to FASB Interpretation No. 46(R), was adopted into Codification in December 2009. The objective of the guidance is to improve financial reporting by enterprises involved with variable interest entities and to provide more relevant and reliable information to users of financial statements. SFAS No. 167 is effective as of January 1, 2010. The adoption of the new guidance did not have a material impact on the Corporation s consolidated financial statements.

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

In January 2010, the FASB issued ASU 2010-04, *Accounting for Various Topics Technical Corrections to SEC Paragraphs*. ASU 2010-04 makes technical corrections to existing SEC guidance including the following topics: accounting for subsequent investments, termination of an interest rate swap, issuance of financial statements - subsequent events, use of residential method to value acquired assets other than goodwill, adjustments in assets and

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liabilities for holding gains and losses, and selections of discount rate used for measuring defined benefit obligation. The adoption of the new guidance did not have a material impact on the Corporation s consolidated financial statements.

In January 2010, the FASB issued Accounting Standards Update No. 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers disclosures about postretirement benefit plan assets. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Corporation s consolidated financial statements.

In February 2010, the FASB issued Accounting Standards Update No. 2010-08, Technical Corrections to Various Topics. ASU 2010-08 clarifies guidance on embedded derivatives and hedging. ASU 2010-08 is effective for interim and annual periods beginning after December 15, 2009. The adoption of the new guidance did not have a material impact on the Corporation s consolidated financial statements.

In February 2010, the FASB issued Accounting Standards Update No. 2010-09, Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements. ASU 2010-09 addresses both the interaction of the requirements of Topic 855 with the SEC s reporting requirements and the intended breadth of the reissuance disclosures provisions related to subsequent events. An entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. ASU 2010-09 is effective immediately. The adoption of the new guidance did not have a material impact on the Company s consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. The new disclosure guidance will significantly expand the existing requirements and will lead to greater transparency into a Corporation s exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period will become effective for both interim and annual reporting periods ending at December 31, 2010. Specific items regarding activity that occurred before the issuance of the ASU, such as the allowance rollforward and modification disclosures, will be required for periods beginning after December 31, 2010. The Corporation is currently assessing the impact that ASU 2010-20 will have on its consolidated financial statements.

Note 2: Other Commitments

In the normal course of business, the Bank makes various commitments and incurs 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 bank evaluates 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 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 Bank holds collateral supporting those commitments when deemed necessary by management. As June 30, 2010, $31,735,000 of performance standby letters of credit have been issued. The Corporation does not anticipate any losses as a result of these transactions.

Note 3: Fair Value Measurements

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.

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

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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 Corporation 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 Corporation s securities are classified as available for sale.

Interest Rate Swaps

Cash flow interest rate swaps are classified within Level 2 with fair values determined by quoted market prices and mathematical models using current and historical data.

The Corporation had no fair value liabilities at June 30, 2010 or December 31, 2009. A summary of assets at June 30, 2010 and December 31, 2009, measured at estimated fair value on a recurring basis were as follows:

June 30, 2010

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
Securities available for sale:				
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	$ 0	$ 123,707	$ 0	$ 123,707
Debt securities issued by states and political subdivisions	0	58,710	0	58,710
Government residential mortgage-backed securities	0	143,279	0	143,279
Total debt securities	$ 0	$ 325,696	$ 0	$ 325,696
Equity securities	1,957	254	0	2,211
Total securities	$ 1,957	$ 325,950	$ 0	$ 327,907
Interest rate swaps	0	974	0	974
Total assets	$ 1,957	$ 326,924	$ 0	$ 328,881

December 31, 2009

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
Securities available for sale:				
Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies	$ 0	$ 119,416	$ 0	$ 119,416
Debt securities issued by states and political subdivisions	0	37,384	0	37,384
Government residential mortgage-backed securities	0	37,872	0	37,872

Total debt securities	$ 0	$ 94,672	$ 0	$ 194,672
Equity securities	1,334	247	0	1,581
Total securities	$ 1,334	$ 194,919	$ 0	$ 196,253
Interest rate swaps	0	118	0	118
Total assets	$ 1,334	$ 195,037	$ 0	$ 196,371

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with accounting principles generally accepted in the United States. 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.

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

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 (Level 2). As such, the Corporation records any fair value adjustments on a nonrecurring basis. At June 30, 2010 and December 31, 2009, loans held for sale were included in total loans on the balance sheet and were recorded at cost, which approximates their fair value.

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 Corporation using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is older than two years, 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 receivables 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. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statement of income. Specific allocations to the allowance for loan losses were $4,783,000 and $4,801,000 at June 30, 2010 and December 31, 2009, respectively.

Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at the lower of cost or fair value less cost to sell. There were no OREO write-downs for the quarter ended June 30, 2010.

Goodwill and Intangible Assets

Goodwill is valued at the fair value of the assets and liabilities at the time of purchase. Intangible assets are valued based on the purchase price agreed to at the time of purchase.

A summary of assets at June 30, 2010 and December 31, 2009 measured at fair value on a nonrecurring basis is as follows:

June 30, 2010

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
Impaired loans, net	$ 0	$ 0	$ 10,620	$ 10,620
OREO	0	1,265	0	1,265
Loans held for sale	0	4,174	0	4,174

December 31, 2009

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
Impaired loans, net	$ 0	$ 0	$ 10,702	$ 10,702
OREO	0	1,065	0	1,065
Loans held for sale	0	594	0	594

Fair values of financial instruments

The corporation 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 Corporation.

The following methods and assumptions were used by the Corporation in estimating fair values of financial instruments as disclosed herein:

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

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

Securities Available for Sale

Fair values for investment securities are based on quoted market prices.

Interest Rate Swaps

Fair values for cash flow interest rate swaps are determined by quoted market prices and mathematical models using current and historical data.

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 for loans with similar terms to borrowers of similar credit quality. Fair values for impaired loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Restricted Bank Stock

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

Deposit Liabilities

The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposits and IRA s are estimated using a discounted cash flow calculation that applies interest rates currently being offered 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 Corporation s current incremental borrowing rates for similar types of borrowing arrangements.

Long-Term Borrowings

The fair value of the Corporation s fixed rate long-term borrowings is estimated using a discounted cash flow analysis based on the Corporation 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 Corporation generally does not charge commitment fees. Fees for standby letters of credit and other off-balance-sheet instruments are not significant.

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The estimated fair values of the Corporation s financial statements were as follows at June 30, 2010 and December 31, 2009:

	June 30, 2010		December 31, 2009	
(Dollars in thousands)	**Carrying Amount**	**Fair Value**	**Carrying Amount**	**Fair Value**
Financial Assets				
Cash, due from banks, interest bearing deposits with banks and short-term investments	$ 24,085	$ 24,085	$ 20,929	$ 20,929
Federal funds sold	20,705	20,705	8,000	8,000
Securities available for sale	327,907	327,907	196,253	196,253
Restricted bank stocks	8,056	8,056	8,056	8,056
Interest rate swaps	974	974	118	118
Loans	898,128		881,074	
Allowance for loan losses	(14,582)		(11,067)	
Net loans	883,546			