ORRSTOWN FINANCIAL SERVICES INC
Form 10-Q
August 08, 2008
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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, 2008

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	**23-2530374 .**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer 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 is a 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 x 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 x

As of June 30, 2008, 6,425,040 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, 2008**	**(Audited) * December 31, 2007**
ASSETS		
Cash and due from banks	$ 20,973	$ 17,625
Federal funds sold	3,949	808
Cash and cash equivalents	24,922	18,433
Interest bearing deposits with banks	286	231
Member stock, at cost which approximates market value	6,737	5,751
Securities available for sale	82,169	90,604
Loans	752,697	701,964
Allowance for loan losses	(6,429)	(6,141)
Net Loans	746,268	695,823
Premises and equipment, net	29,828	25,980
Goodwill and intangible assets	21,261	21,368
Cash surrender value of life insurance	16,348	16,067
Accrued interest receivable	3,442	3,490
Other assets	8,258	7,232
Total assets	$ 939,519	$ 884,979
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Non-interest bearing	$ 87,844	$ 91,365
Interest bearing	589,292	554,991
Total deposits	677,136	646,356
Short term borrowings	65,327	58,130
Long term debt	88,038	75,903
Accrued interest payable	1,026	1,172
Other liabilities	8,301	7,294
Total liabilities	839,828	788,855
Common stock, no par value - $.05205 stated value per share; 50,000,000 shares authorized; 6,452,845 and 6,452,845 shares issued	336	336
Additional paid - in capital	82,419	82,488
Retained earnings	17,698	13,868
Accumulated other comprehensive income	146	567
Treasury stock, 27,805 and 33,303 shares, at cost	(908)	(1,135)
Total shareholders equity	99,691	96,124

Total liabilities and shareholders equity	$ 939,519	$ 884,979

* 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 2008	June 2007
INTEREST INCOME		
Interest and fees on loans	$ 11,726	$ 11,857
Interest and dividends on investment securities	905	974
Interest on short term investments	54	189
Total interest income	12,685	13,020
INTEREST EXPENSE		
Interest on deposits	3,299	4,665
Interest on short-term borrowings	239	580
Interest on long-term debt	983	415
Total interest expense	4,521	5,660
Net interest income	8,164	7,360
Provision for loan losses	257	90
Net interest income after provision for loan losses	7,907	7,270
OTHER INCOME		
Service charges on deposits	1,718	1,393
Other service charges	1,119	554
Trust department income	713	648
Brokerage income	377	383
Other income	218	176
Non-recurring revenue	0	219
Securities gains / (losses)	(1)	16
Total other income	4,144	3,389
OTHER EXPENSES		
Salaries and employee benefits	3,811	3,588
Occupancy and equipment	1,072	898
Data processing	247	194
Advertising	145	108
Non-recurring expense	0	78
Other operating expense	1,610	1,259
Total other expense	6,885	6,125
Income before income taxes	5,166	4,534
Income tax expense	1,563	1,314
Net income	$ 3,603	$ 3,220

PER SHARE DATA

Basic earnings per share	$	0.56	$	0.50
Diluted earnings per share	$	0.54	$	0.48
Dividends per share	$	0.22	$	0.20

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)

	Six Months Ended	
(Dollars in Thousands)	**June 2008**	**June 2007**
INTEREST INCOME		
Interest and fees on loans	$ 23,971	$ 23,198
Interest and dividends on investment securities	1,923	1,980
Interest on short term investments	179	401
Total interest income	26,073	25,579
INTEREST EXPENSE		
Interest on deposits	7,384	9,168
Interest on short-term borrowings	650	1,080
Interest on long-term debt	1,958	811
Total interest expense	9,992	11,059
Net interest income	16,081	14,520
Provision for loan losses	415	150
Net interest income after provision for loan losses	15,666	14,370
OTHER INCOME		
Service charges on deposits	3,253	2,621
Other service charges	1,827	1,040
Trust department income	1,423	1,258
Brokerage income	756	739
Other income	448	367
Non-recurring revenue	0	219
Securities gains	48	70
Total other income	7,755	6,314
OTHER EXPENSES		
Salaries and employee benefits	7,828	7,292
Occupancy and equipment	2,029	1,795
Data processing	478	418
Advertising	243	186
Non-recurring expense	0	78
Other operating expense	3,007	2,325
Total other expense	13,585	12,094
Income before income taxes	9,836	8,590
Income tax expense	2,983	2,507
Net income	$ 6,853	$ 6,083

PER SHARE DATA

Basic earnings per share	$ 1.07	$ 0.95
Diluted earnings per share	$ 1.02	$ 0.90
Dividends per share	$ 0.43	$ 0.40

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)

(Dollars in thousands)	**Common Stock**	**Additional Paid-In Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income**	**Treasury Stock**	**Total Shareholders Equity**
	Six Months Ended June 30, 2008 and 2007					
Beginning Balance, January 1, 2007	$ 320	$ 72,023	$ 16,934	$ 507	($ 396)	$ 89,388
Comprehensive income						
Net income	0	0	6,083	0	0	6,083
Change in unrealized gain on investment securities available for sale, net of tax	0	0	0	(488)	0	(488)
Total comprehensive income						5,595
Cash dividends ($.40 per share)	0	0	(2,573)	0	0	(2,573)
Stock dividends issued	16	10,314	(10,330)	0	0	0
Cash paid in lieu of fractional stock dividends	0	0	(23)	0	0	(23)
Stock-based compensation plans:						
Compensation expense	0	18	0	0	0	18
Issuance of stock	0	15	0	0	0	15
Purchase of treasury stock (17,000 shares)	0	0	0	0	(589)	(589)
Issuance of treasury stock (1,978 shares)	0	(14)	0	0	73	59
Balance, June 30, 2007	$ 336	$ 82,356	$ 10,091	$ 19	($ 912)	$ 91,890
Beginning Balance, January 1, 2008	$ 336	$ 82,488	$ 13,868	$ 567	($ 1,135)	$ 96,124
Comprehensive income						
Net income	0	0	6,853	0	0	6,853
Change in unrealized gain on investment securities available for sale, net of tax	0	0	0	(421)	0	(421)
Total comprehensive income						6,432
Cash dividends ($.43 per share)	0	0	(2,760)	0	0	(2,760)
Split dollar post retirement plan	0	0	(263)	0	0	(263)
Stock-based compensation plans:						
Compensation expense	0	(8)	0	0	0	(8)
Purchase of treasury stock (3,962 shares)	0	0	0	0	(123)	(123)
Issuance of treasury stock (9,460 shares)	0	(61)	0	0	350	289
Balance, June 30, 2008	$ 336	$ 82,419	$ 17,698	$ 146	($ 908)	$ 99,691

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 COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in Thousands)	**Three Months Ended June 2008**	**Three Months Ended June 2007**
COMPREHENSIVE INCOME		
Net Income	$ 3,603	$ 3,220
Other comprehensive income, net of tax		
Unrealized (loss) on investment securities available for sale	(788)	(535)
Comprehensive Income	$ 2,815	$ 2,685

(Dollars in Thousands)	**Six Months Ended June 2008**	**Six Months Ended June 2007**
COMPREHENSIVE INCOME		
Net Income	$ 6,853	$ 6,083
Other comprehensive income, net of tax		
Unrealized (loss) on investment securities available for sale	(421)	(488)
Comprehensive Income	$ 6,432	$ 5,595

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 2008**	**June 2007**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 6,853	$ 6,083
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,028	937
Provision for loan losses	415	150
Other, net	(601)	(1,829)
Net cash provided by operating activities	7,695	5,341
CASH FLOWS FROM INVESTING ACTIVITIES		
Net (increase) decrease in interest bearing deposits with banks	(55)	348
Purchases of available for sale securities	(25,791)	(4,109)
Sales and maturities of available for sale securities	33,631	11,178
Purchase of intangible assets	18	51
Net (increase) in loans	(50,860)	(34,443)
Purchases of bank premises and equipment	(4,680)	(2,861)
Other, net	(986)	(542)
Net cash (used) by investing activities	(48,723)	(30,378)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	30,780	15,042
Dividends paid	(2,760)	(2,573)
Net proceeds from issuance of common stock	0	1
Purchase of treasury stock	(123)	(589)
Net proceeds from issuance of treasury stock	288	73
Net change in short-term borrowings	7,197	6,746
Proceeds from long-term borrowings	13,000	4,000
Repayment of long-term borrowings	(865)	(7,958)
Other, net	0	(23)
Net cash provided by financing activities	47,517	14,719
Net increase (decrease) in cash and cash equivalents	6,489	(10,318)
Cash and cash equivalents at beginning of period	18,433	39,134
Cash and cash equivalents at end of period	$ 24,922	$ 28,816
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 10,138	$ 11,241
Income Taxes	3,025	2,725
Supplemental schedule of noncash investing and financing activities:		
Unrealized (loss) on investments available for sale (net of deferred taxes of $(222) and $(263) at June 30, 2008 and 2007, respectively)	(421)	(488)

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, 2008

Note 1: Summary of Significant Accounting Policies

Basis of Presentation

The unaudited financial statements of Orrstown Financial Services, Inc. (the Company) and its subsidiary are presented at and for the three and six months ended June 30, 2008 and 2007 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, 2007 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, 2007.

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, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

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 Company 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

Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company 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.

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 Company s results of operations.

The Company has classified all investment securities as available for sale . At December 31, 2007, fair value exceeded amortized cost by $865,000 and at June 30, 2008 fair value exceeded amortized cost by $223,000. In shareholders equity, the balance of accumulated other comprehensive income decreased to $146,000 at June 30, 2008 from $567,000 at December 31, 2007.

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Stock-Based Compensation

The Company maintains two stock-based compensation plans. These plans provide for the granting of stock options to the Company s directors and the Bank s employees. FAS Statement No 123R, Share-Based Payment requires financial statement recognition of compensation cost for stock options and other stock-based awards. Both of the Company 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:

	Three Months Ended		Six Months Ended	
(In Thousands, except per share data)	**June 2008**	**June 2007**	**June 2008**	**June 2007**
Net Income	$ 3,603	$ 3,220	$ 6,853	$ 6,083
Weighted average shares outstanding (basic)	6,422	6,431	6,421	6,434
Impact of common stock equivalents	318	291	321	289
Weighted average shares outstanding (diluted)	6,740	6,722	6,742	6,723
Per share information:				
Basic earnings per share	$ 0.56	$ 0.50	$ 1.07	$ 0.95
Diluted earnings per share	$ 0.54	$ 0.48	$ 1.02	$ 0.90

Change in Accounting Principle

In September of 2006, the Emerging Issues Task Force of the FASB (EITF) issued EITF 06-04. This pronouncement affects the recording of post retirement costs of insurance of bank owned life insurance policies in instances where the Company has promised a continuation of life insurance coverage to persons post retirement. EITF 06-04 requires that a liability equal to the present value of the cost of post retirement insurance be recorded during the insured employees term of service. The terms of this pronouncement require the initial recording of this liability with a corresponding adjustment to retained earnings to reflect the implementation of the pronouncement. This EITF became effective for fiscal years beginning after December 15, 2007. The effect of this change on January 1, 2008 was a reduction in retained earnings and an increase in accrued benefit liabilities of $263,000.

Recent Accounting Pronouncements

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), Business Combinations (SFAS 141 (R)). The Statement replaces SFAS No. 141, Business Combinations . This statement retains the fundamental requirements of SFAS 141 that the acquisition method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity s first year annual reporting period that begins after December 15, 2008. The Company does not expect the implementation of SFAS 141(R) to have a material impact on its financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Noncontrolling Interest in Consolidated Financial Statements an Amendment of ARB No. 51 (SFAS 160). The Standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interest in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity s first fiscal year that begins after December 15, 2008, with early adoption permitted. The Company does not expect the implementation of SFAS 160 to have a material impact on its financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related

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hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company does not expect the implementation of SFAS 161 to have a material impact on its 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 Company 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 of June 30, 2008, $26,354,000 of performance standby letters of credit have been issued. The Company does not anticipate any losses as a result of these transactions.

Note 3: Fair Value Measurements

SFAS 157, *Fair Value Measurements*, (SFAS 157) defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, establishes a three-level valuation hierarchy for disclosure of fair value measurement and expands disclosures requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The definition of fair value is clarified by SFAS No. 157 to be the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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

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

Securities

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

Loans Held for Sale

Loans held for sale which is required to be measured at the lower of cost or fair value. Under SFAS No 157, market value is to represent fair value. Management obtains quotes or bids on all or part of these loans directly from the purchasing financial institutions. Premiums received or to be received on the quotes or bids are indicative of the fact that cost is lower than fair value. At June 30, 2008, loans held for sale were included in total loans on the balance sheet and were recorded at cost.

Impaired Loans

SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, Accounting by Creditors for Impairment of a Loan, including impaired loans measured at an observable market price (if available), or at the fair value of the loan s collateral (if the loan is collateral dependent). Fair value of the loan s collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of SFAS No. 157.

The Company had no estimated fair value liabilities at June 30, 2008. A summary of assets at June 30, 2008 measured at estimated fair value on a recurring basis were as follows:

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
Securities available for sale	$ 1,283	$ 80,886	$ 0	$ 82,169

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PART I - FINANCIAL INFORMATION

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

Orrstown Financial Services, Inc. (the Company) is a financial holding company with a wholly-owned bank subsidiary, Orrstown Bank. The following is a discussion of our consolidated financial condition at June 30, 2008 and results of operations for the three and six months ended June 30, 2008 and three and six months ended June 30, 2007. 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. Factors that could cause actual results to differ materially from forward-looking statements include, but are not limited to: 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, and pending or 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 $3,603,000 for the second quarter of 2008 compared to $3,220,000 for the same period in 2007, representing an increase of $383,000 or 11.9%. Basic earnings per share (EPS) increased $0.06 to $0.56 in the recent quarter from the $0.50 earned during the second quarter of 2007. Diluted earnings per share for the second quarter were $0.54 versus $0.48 last year.

Net income for the first six months of 2008 was $6,853,000 compared to $6,083,000 for the same period in 2007, representing an increase of $770,000 or 12.7%. Basic earnings per share for the first half of 2008 increased by $0.12 to $1.07 from the $0.95 earned for the same period in 2007. Diluted earnings per share for the first six months were $1.02 versus $0.90 last year.

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

The following statistics compare the second quarter and year-to-date performance of 2008 to that of 2007:

	Three Months Ended		Six Months Ended	
	June 2008	June 2007	June 2008	June 2007
Return on average assets	1.57%	1.57%	1.51%	1.51%

Return on average tangible assets	1.63%	1.63%	1.57%	1.57%
Return on average equity	14.69%	14.16%	14.11%	13.56%
Return on average tangible equity	18.94%	18.75%	18.27%	18.04%
Average equity / Average assets	10.71%	11.07%	10.72%	11.10%

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RESULTS OF OPERATIONS

Quarter ended June 30, 2008 compared to Quarter ended June 30, 2007

Net interest income for the second quarter of 2008 was $8,164,000 representing a growth of $804,000, or 10.9% over the $7,360,000 realized during the second quarter last year. On a fully taxable equivalent basis (FTE), net interest income for the second quarter of 2008 and 2007 was $8,394,000 and $7,612,000, respectively.

The table that follows states rates on a fully taxable equivalent basis (FTE):