ORRSTOWN FINANCIAL SERVICES INC
Form 10-Q
May 08, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10 – Q

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

For the quarterly period ended March 31, 2015

or

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

For the transition period from to

Commission file number: 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.
(Exact Name of Registrant as Specified in its Charter)

Pennsylvania	23-2530374
(State or Other Jurisdiction of 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)

Registrant’s Telephone Number, Including Area Code: (717) 532-6114

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “accelerated filer,” “large accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act.). Yes ¨ No x

Number of shares outstanding of the registrant’s Common Stock as of May 4, 2015: 8,295,111.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements
Consolidated Balance Sheets (Unaudited)
ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY

(Dollars in thousands, except per share data)	March 31, 2015	December 31, 2014
Assets		
Cash and due from banks	$21,182	$18,174
Interest bearing deposits with banks	11,856	13,235
Cash and cash equivalents	33,038	31,409
Restricted investments in bank stock	7,678	8,350
Securities available for sale	349,827	376,199
Loans held for sale	5,177	3,159
Loans	727,753	704,946
Less: Allowance for loan losses	(14,461)	(14,747)
Net loans	713,292	690,199
Premises and equipment, net	24,325	24,800
Cash surrender value of life insurance	26,829	26,645
Intangible assets	363	414
Accrued interest receivable	3,049	3,097
Other assets	25,842	26,171
Total assets	$1,189,420	$1,190,443
Liabilities		
Deposits:		
Non-interest bearing	$129,593	$116,302
Interest bearing	816,163	833,402
Total deposits	945,756	949,704
Short-term borrowings	75,272	86,742
Long-term debt	24,734	14,812
Accrued interest and other liabilities	11,804	11,920
Total liabilities	1,057,566	1,063,178
Shareholders’ Equity		
Preferred Stock, $1.25 par value per share; 500,000 shares authorized; no shares issued or outstanding	0	0
Common stock, no par value—$0.05205 stated value per share 50,000,000 shares authorized; 8,295,922 and 8,264,554 shares issued; 8,295,111 and 8,263,743 shares outstanding	430	430
Additional paid - in capital	123,573	123,392
Retained earnings	4,349	1,887
Accumulated other comprehensive income	3,522	1,576
Treasury stock—common, 811 shares, at cost	(20)	(20)
Total shareholders’ equity	131,854	127,265
Total liabilities and shareholders’ equity	$1,189,420	$1,190,443

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

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Consolidated Statements of Income (Unaudited)
ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY

(Dollars in thousands, except per share data)	Three Months Ended March 31, 2015	March 31, 2014
Interest and dividend income		
Interest and fees on loans	$7,327	$7,441
Interest and dividends on investment securities		
Taxable	1,820	1,918
Tax-exempt	55	234
Short-term investments	26	8
Total interest and dividend income	9,228	9,601
Interest expense		
Interest on deposits	777	956
Interest on short-term borrowings	60	33
Interest on long-term debt	76	96
Total interest expense	913	1,085
Net interest income	8,315	8,516
Provision for loan losses	0	0
Net interest income after provision for loan losses	8,315	8,516
Noninterest income		
Service charges on deposit accounts	1,193	1,269
Other service charges, commissions and fees	173	188
Trust department income	1,247	1,208
Brokerage income	437	448
Mortgage banking activities	520	459
Earnings on life insurance	229	234
Other income	40	35
Investment securities gains	1,529	597
Total noninterest income	5,368	4,438
Noninterest expenses		
Salaries and employee benefits	5,900	5,812
Occupancy expense	624	635
Furniture and equipment	743	836
Data processing	467	381
Automated teller and interchange fees	206	180
Advertising and bank promotions	245	425
FDIC insurance	246	464
Professional services	512	628
Collection and problem loan	96	159
Real estate owned expenses	25	27
Taxes other than income	226	158
Intangible asset amortization	51	52
Other operating expenses	1,165	1,219
Total noninterest expenses	10,506	10,976
Income before income taxes	3,177	1,978
Income tax expense	715	0
Net income	$2,462	$1,978
Per share information:		

Basic earnings per share	$0.30	$0.24
Diluted earnings per share	0.30	0.24
Dividends per share	0.00	0.00

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

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

(Dollars in thousands)	Three Months Ended March 31, 2015	March 31, 2014
Net income	$2,462	$1,978
Other comprehensive income, net of tax:		
Unrealized gains on securities available for sale arising during the period	4,523	4,868
Reclassification adjustment for gains realized in net income	(1,529)	(597)
Net unrealized gains	2,994	4,271
Tax effect	(1,048)	(1,495)
Total other comprehensive income, net of tax and reclassification adjustments	1,946	2,776
Total comprehensive income	$4,408	$4,754

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

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Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY

Three Months Ended March 31, 2015 and 2014

(Dollars in thousands, except per share data)	Common Stock	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance, January 1, 2014	$422	$123,105	$(27,255)	$ (4,813)	$(20)	$91,439
Net income	0	0	1,978	0	0	1,978
Total other comprehensive income, net of taxes	0	0	0	2,776	0	2,776
Stock-based compensation plans:						
Issuance of stock (3,348 shares), including compensation expense of $12	0	59	0	0	0	59
Issuance of stock through dividend reinvestment plan (7 shares)	0	0	0	0	0	0
Balance, March 31, 2014	$422	$123,164	$(25,277)	$ (2,037)	$(20)	$96,252
Balance, January 1, 2015	$430	$123,392	$1,887	$ 1,576	$(20)	$127,265
Net income	0	0	2,462	0	0	2,462
Total other comprehensive income, net of taxes	0	0	0	1,946	0	1,946
Stock-based compensation plans:						
Issuance of stock (31,358 shares), including compensation expense of $134	0	181	0	0	0	181
Issuance of stock through dividend reinvestment plan (10 shares)	0	0	0	0	0	0
Balance, March 31, 2015	$430	$123,573	$4,349	$ 3,522	$(20)	$131,854

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

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Consolidated Statements of Cash Flows (Unaudited)
ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY

(Dollars in thousands)	Three Months Ended March 31, 2015	March 31, 2014
Cash flows from operating activities		
Net income	$2,462	$1,978
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums on securities available for sale	1,534	1,358
Depreciation and amortization	741	765
Stock based compensation	134	12
Net change in loans held for sale	(2,018)	(716)
Net gain on disposal of other real estate owned	(7)	0
Net loss on disposal of premises and equipment	0	46
Deferred income taxes, including valuation allowance	726	0
Investment securities gains	(1,529)	(597)
Earnings on cash surrender value of life insurance	(229)	(234)
Decrease in accrued interest receivable	48	116
Increase (decrease) in accrued interest payable and other liabilities	(116)	1,196
Other, net	(986)	80
Net cash provided by operating activities	760	4,004
Cash flows from investing activities		
Proceeds from sales of available for sale securities	41,382	67,567
Maturities, repayments and calls of available for sale securities	7,838	11,205
Purchases of available for sale securities	(19,859)	(87,383)
Net redemptions of restricted investments in bank stocks	672	907
Net increase in loans	(23,842)	(4,346)
Purchases of bank premises and equipment	(126)	(649)
Proceeds from disposal of other real estate owned	253	0
Net cash provided by (used in) investing activities	6,318	(12,699)
Cash flows from financing activities		
Net increase (decrease) in deposits	(3,948)	2,015
Net decrease in short term purchased funds	(11,470)	(10,211)
Proceeds from long-term debt	20,000	10,000
Payments on long-term debt	(10,078)	(359)
Dividends paid	0	0
Net proceeds from issuance of common stock	47	47
Net cash provided by (used in) financing activities	(5,449)	1,492
Net increase (decrease) in cash and cash equivalents	1,629	(7,203)
Cash and cash equivalents at beginning of period	31,409	37,560
Cash and cash equivalents at end of period	$33,038	$30,357
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$923	$1,079
Income taxes	0	0
Supplemental schedule of noncash investing activities:		
Other real estate acquired in settlement of loans	$745	$1,625
Security purchases not yet settled	0	12,751

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

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Notes to Consolidated Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations – Orrstown Financial Services, Inc. (the "Company") is a bank holding company (that has elected status as a financial holding company with the Board of Governors of the Federal Reserve System (the "FRB")) whose primary activity consists of supervising its wholly-owned subsidiary, Orrstown Bank (the "Bank"). The Company operates through its office in Shippensburg, Pennsylvania. The Bank provides services through its network of 22 offices in Cumberland, Franklin, Lancaster, and Perry Counties of Pennsylvania and in Washington County, Maryland. The Bank engages in lending services for commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Deposit services include checking, savings, time, and money market deposits. The Bank also provides investment and brokerage services through its Orrstown Financial Advisors division. The Company and the Bank are subject to the regulation of certain federal and state agencies and undergo periodic examinations by such regulatory authorities.

Basis of Presentation – The unaudited consolidated financial statements of the Company and its subsidiary are presented for the three months ended March 31, 2015 and 2014 and have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. However, unaudited information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, considered necessary for a fair presentation of the financial position, results of operations and cash flows for the interim period. Information presented at December 31, 2014 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, 2014. The consolidated financial statements include the accounts of the Company and the Bank. Operating results for the three months ended March 31, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. All significant intercompany transactions and accounts have been eliminated.

Use of Estimates – The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and actual results could differ.

Subsequent Events – GAAP establishes standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The subsequent events principle sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements, identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and specifies the disclosures that should be made about events or transactions that occur after the balance sheet date.

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

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

Cash and Cash Equivalents – For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash, balances due from banks, federal funds sold and interest bearing deposits due on demand, all of which have original maturities of 90 days or less. Net cash flows are reported for customer loan and deposit transactions, loans held for sale and redemption (purchases) of restricted investments in bank stocks.

Restricted Investments in Bank Stocks – Restricted investments in bank stocks, which represents required investments in the common stock of correspondent banks, is carried at cost as of March 31, 2015 and December 31, 2014, and consists of common stock of the Federal Reserve Bank of Philadelphia ("Federal Reserve Bank"), Atlantic Community Bankers Bank and the Federal Home Loan Bank of Pittsburgh ("FHLB") stocks.

Management evaluates the restricted investment in bank stocks for impairment in accordance with Accounting Standard Codification (ASC) Topic 942, Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or

Finance the Activities of Others. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the correspondent bank as compared to the capital stock amount for the correspondent bank and the length of time this situation has persisted, (2) commitments by the correspondent bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of the correspondent bank, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the correspondent bank.

Management believes no impairment charge is necessary related to the restricted investments in bank stocks as of March 31, 2015. However, security impairment analysis is completed quarterly and the determination that no impairment had occurred as of March 31, 2015 is no assurance that impairment may not occur in the future.

Securities – Certain debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. "Trading" securities are recorded at fair value with changes in fair value included in earnings. As of March 31, 2015 and December 31, 2014, the Company had no held to maturity or trading securities. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities and approximate the level yield method. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

The Company had no debt securities it deemed to be other than temporarily impaired at March 31, 2015 and December 31, 2014.

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

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

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

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

respective term of the loan.

For all classes of loans, the accrual of interest income on loans, including impaired loans, ceases when principal or interest is past due 90 days or more or immediately if, in the opinion of management, full collection is unlikely. Interest will continue to accrue on loans past due 90 days or more if the collateral is adequate to cover principal and interest, and the loan is in the process of collection. Interest accrued, but not collected, as of the date of placement on nonaccrual status, is reversed and charged against current interest income, unless fully collateralized. Subsequent payments received are either applied to the

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outstanding principal balance or recorded as interest income, depending upon management's assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan classes, when all the principal and interest amounts contractually due are brought current, the loan has performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contractual terms of the loan.

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

Allowance for Loan Losses – The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

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

See Note 3, "Loans Receivable and Allowance for Loan Losses," for additional details.

Loans Serviced – The Bank administers secondary market mortgage programs available through the FHLB and the Federal National Mortgage Association and offers residential mortgage products and services to customers. The Bank originates single-family residential mortgage loans for immediate sale in the secondary market, and retains the servicing of those loans. At March 31, 2015 and December 31, 2014, the balance of loans serviced for others was $311,920,000 and $315,239,000.

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

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

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

earnings.

Foreclosed Real Estate – Real estate properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less estimated costs to sell the underlying collateral. Capitalized costs include any costs that significantly improve the value of the properties. After foreclosure, valuations are periodically performed by management and

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the real estate is carried at the lower of carrying amount or fair value less estimated costs to sell. Foreclosed real estate totaled $1,431,000 and $932,000 as of March 31, 2015 and December 31, 2014 and is included in other assets.
Securities Sold Under Agreements to Repurchase ("Repurchase Agreements") – The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities which are included in short-term borrowings. Under these agreements, the Company may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, these Repurchase Agreements are accounted for as collateralized financing arrangements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Company's consolidated balance sheet, while the securities underlying the Repurchase Agreements remain in the respective investment securities asset accounts. In other words, there is no offsetting or netting of the investment securities assets with the Repurchase Agreement liabilities. In addition, as the Company does not enter into reverse Repurchase Agreements, there is no such offsetting to be done with the Repurchase Agreements.
The right of setoff for a Repurchase Agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the Repurchase Agreement should the Company be in default (e.g., fails to make an interest payment to the counterparty). For the Repurchase Agreements, the collateral is held by the Company in a segregated custodial account under a third party agreement.
Advertising – The Company follows the policy of charging costs of advertising to expense as incurred. Advertising expense was $112,000 and $233,000 for the three months ended March 31, 2015 and 2014.
Stock Compensation Plans – The Company has stock compensation plans that cover employees and non-employee directors. Stock compensation accounting guidance (FASB ASC 718, Compensation – Stock Compensation) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost is measured based on the grant date fair value of the stock award, including a Black-Scholes model for stock options. Compensation cost for all stock awards is calculated and recognized over the employees' service period, generally defined as the vesting period.
Income Taxes – The Company accounts for income taxes in accordance with income tax accounting guidance (FASB ASC 740, Income Taxes). The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.
Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized. The Company recognizes interest and penalties, if any, on income taxes as a component of income tax expense.
Treasury Stock – Common stock shares repurchased are recorded as treasury stock at cost.
Earnings Per Share – Basic earnings per share represent net income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Restricted stock awards are included in weighted average common shares outstanding as they are earned. Diluted earnings per share reflect the additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential

common shares that may be issued by the Company related solely to outstanding stock options and restricted stock awards.

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

Comprehensive Income – Comprehensive income consists of net income and other comprehensive income. Other comprehensive income is limited to unrealized gains on securities available for sale for all years presented.

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The component of accumulated other comprehensive income, net of taxes, at March 31, 2015 and December 31, 2014 consisted of unrealized gains on securities available for sale and totaled $3,522,000 and $1,576,000.
Fair Value of Financial Instruments – Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 9. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.
Segment Reporting – The Company only operates in one significant segment – Community Banking. The Company's non-banking activities are insignificant to the consolidated financial statements.
Reclassification – Certain amounts in the 2014 consolidated financial statements have been reclassified to conform to the 2015 presentation.
Recent Accounting Pronouncements – In January 2014, the Financial Accounting Standards Board ("FASB") issued ASU 2014-1, Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. ASU 2014-1 permits reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in ASU 2014-1 should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those pre-existing investments. ASU 2014-1 is effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. The Company anticipates it will use the proportional amortization in future projects it enters into. However the existing projects did not qualify for this approach, and as such, the adoption of this ASU did not have a significant impact on the Company's financial statements.
In January 2014, the FASB issued ASU 2014-4, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. ASU 2014-4 clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. ASU 2014-4 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in ASU 2014-4 using either a modified retrospective transition method or a prospective transition method. The adoption of ASU 2014-4 did not have a significant impact on the Company's operating results or financial condition.
In May 2014, the FASB issued ASU 2014-9, Revenue from Contracts with Customers (Topic 606). ASU 2014-9, creates a new topic, Topic 606, to provide guidance on revenue recognition for entities that enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additional disclosures are required to provide quantitative and qualitative information regarding the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. ASU 2014-9 is effective for annual reporting periods, and interim reporting periods within those annual periods, beginning after December 15, 2016. Early adoption is not permitted. Management is currently evaluating the impact of the adoption of this guidance on the Company's financial statements.

In June 2014, the FASB issued ASU 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. ASU 2014-11 changes the accounting for repurchase-to-maturity transactions and linked repurchase financings to secured borrowing accounting, which is consistent with the accounting for other repurchase agreements. The pronouncement also requires two new disclosures. The first disclosure requires an entity to disclose information on transfers accounted for as sales in transactions that are economically similar to repurchase agreements. The second disclosure provides increased transparency about the types of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. ASU 2014-11 is effective for public business entities for annual periods, and

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interim periods within those annual periods, beginning after December 15, 2014. The adoption of this ASU did not have a significant impact on the Company's operating results or financial condition.
In August 2014, FASB issued ASU 2014-14, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure. ASU 2014-14 amends existing guidance related to the classification of certain government-guaranteed mortgage loans, including those guaranteed by the FHA and the VA, upon foreclosure. It requires that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if the following conditions are met: 1) The loan has a government guarantee that is not separable from the loan before the foreclosure; 2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim; and 3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance, including principal and interest, expected to be recovered from the guarantor. These amendments are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted if the amendments under ASU 2014-04, have been adopted. The amendments may be applied using a prospective transition method in which a reporting entity applies the guidance to foreclosures that occur after the date of adoption, or a modified retrospective transition using a cumulative-effect adjustment (through a reclassification to separate other receivable) as of the beginning of the annual period of adoption. Prior periods should not be adjusted. A reporting entity must apply the same method of transition as elected under ASU 2014-04. The Company's adoption of this standard on January 1, 2015 did not have a significant impact on the Company's operating results or financial condition.

NOTE 2. SECURITIES AVAILABLE FOR SALE

At March 31, 2015 and December 31, 2014, the investment securities portfolio was comprised exclusively of securities classified as "available for sale," resulting in investment securities being carried at fair value. The amortized cost and fair values of investment securities available for sale at March 31, 2015 and December 31, 2014 were:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2015				
U.S. Government Agencies	$ 28,282	$ 97	$ 29	$ 28,350
States and political subdivisions	57,826	1,046	393	58,479
U.S. Government Sponsored Enterprises (GSE) residential mortgage-backed securities	158,610	2,599	0	161,209
GSE residential collateralized mortgage obligations (CMOs)	30,071	492	85	30,478
GSE commercial CMOs	69,570	1,742	69	71,243
Total debt securities	344,359	5,976	576	349,759
Equity securities	50	18	0	68
Totals	$ 344,409	$ 5,994	$ 576	$ 349,827
December 31, 2014				
U.S. Government Agencies	$ 23,910	$ 71	$ 23	$ 23,958
States and political subdivisions	52,578	819	996	52,401
GSE residential mortgage-backed securities	174,220	1,573	197	175,596
GSE residential CMOs	57,976	857	128	58,705
GSE commercial CMOs	65,041	1,017	586	65,472
Total debt securities	373,725	4,337	1,930	376,132
Equity securities	50	17	0	67
Totals	$ 373,775	$ 4,354	$ 1,930	$ 376,199

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The following table shows gross unrealized losses and fair value of the Company's available for sale securities that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position at March 31, 2015 and December 31, 2014:

	Less Than 12 Months		12 Months or More		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2015						
U.S. Government Agencies	$10,726	$26	$3,546	$3	$14,272	$29
States and political subdivisions	8,834	22	14,426	371	23,260	393
GSE residential collateralized mortgage obligations (CMOs)	3,321	29	5,449	56	8,770	85
GSE commercial CMOs	24,638	69	0	0	24,638	69
Total temporarily impaired securities	$47,519	$146	$23,421	$430	$70,940	$576
December 31, 2014						
U.S. Government Agencies	$0	$0	$9,012	$23	$9,012	$23
States and political subdivisions	0	0	35,833	996	35,833	996
GSE residential mortgage-backed securities	65,474	197	0	0	65,474	197
GSE residential CMOs	11,930	128	0	0	11,930	128
GSE commercial CMOs	0	0	29,969	586	29,969	586
Total temporarily impaired securities	$77,404	$325	$74,814	$1,605	$152,218	$1,930

The Company had 23 securities and 37 securities at March 31, 2015 and December 31, 2014 in which the amortized cost exceed their values, as discussed below.

U.S. Agencies and Government Sponsored Enterprises (GSE). Thirteen U.S. Agencies and GSE securities, including mortgage-backed securities and collateralized mortgage obligations, have amortized costs which exceed their fair values, 8 of which are in the less than 12 months category at March 31, 2015. At December 31, 2014, the Company had 21 U.S. Government Agencies and GSE securities, including mortgage-backed and collateralized mortgage obligations with unrealized losses, 13 GSE securities have amortized costs which exceed their fair values for less than 12 months, and eight have amortized costs which exceed their fair values for more than 12 months. These unrealized losses have been caused by a rise in interest rates or widening of spreads from the time the securities were purchased. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the par value basis of the investments. Because the Company did not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2015 or at December 31, 2014.

State and Political Subdivisions. Ten state and political subdivision securities have amortized costs which exceeded their fair values, 5 of which are in the less than 12 months category at March 31, 2015. At December 31, 2014, 16 state and political subdivision securities have an amortized cost which exceeds their fair value for more than 12 months. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. Management considers the investment rating, the state of the issuer of the security and other credit support in determining whether the security is other-than-temporarily impaired. Because the Company did not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2015 or at December 31, 2014.

The amortized cost and fair values of securities available for sale at March 31, 2015 by contractual maturity are shown below. Contractual maturities will differ from expected maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	Available for Sale Amortized Cost	Fair Value
Due in one year or less	$0	$0
Due after one year through five years	875	918
Due after five years through ten years	37,787	38,272
Due after ten years	47,446	47,639
Mortgage-backed securities and collateralized mortgage obligations	258,251	262,930
Total debt securities	344,359	349,759
Equity securities	50	68
	$344,409	$349,827

Gross gains on the sales of securities were $1,553,000 and $646,000 for the three months ended March 31, 2015 and 2014. Gross losses on securities available for sale were $24,000 and $49,000 for the three months ended March 31, 2015 and 2014.

Securities with a fair value of $244,614,000 and $261,034,000 at March 31, 2015 and December 31, 2014 were pledged to secure public funds and for other purposes as required or permitted by law.

NOTE 3. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

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

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

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

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

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

Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest rated borrowers, the majority of these loans are secured by the borrower’s accounts receivable, inventory and machinery and equipment. In a significant number of these loans, the collateral also includes the business, real estate or the business

owner’s personal real estate or assets. Commercial and industrial loans present credit exposure to the Company, as they are more susceptible to risk of loss during a downturn in the economy, as borrowers may have greater difficulty in meeting their debt service requirements and

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the value of the collateral may decline. The Company attempts to mitigate this risk through its underwriting standards, including evaluating the credit worthiness of the borrower and to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and meetings with the borrowers are typical. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.
Municipal loans consist of extensions of credit to municipalities and school districts within the Company's market area. These loans generally present a lower risk than commercial and industrial loans, as they are generally secured by the municipality's full taxing authority, by revenue obligations, or by its ability to raise assessments on its customers for a specific utility.
The Company originates loans to its retail customers, including fixed-rate and adjustable first lien mortgage loans with the underlying 1-4 family owner-occupied residential property securing the loan. The Company's risk exposure is minimized in these types of loans through the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and underwriting standards which limit the loan-to-value ratio to generally no more than 80% upon loan origination, unless the borrower obtains private mortgage insurance.
Home equity loans, including term loans and lines of credit, present a slightly higher risk to the Company than 1-4 family first liens, as these loans can be first or second liens on 1-4 family owner occupied residential property, but can have loan-to-value ratios of no greater than 90% of the value of the real estate taken as collateral. The credit worthiness of the borrower is considered including credit scores and debt-to-income ratios, which generally cannot exceed 43%.
Installment and other loans' credit risk are mitigated through conservative underwriting standards, including the evaluation of the credit worthiness of the borrower through credit scores and debt-to-income ratios, and if secured, the collateral value of the assets. As these loans can be unsecured or secured by assets the value of which may depreciate quickly or may fluctuate, they typically present a greater risk to the Company than 1-4 family residential loans.
The loan portfolio, excluding residential loans held for sale, broken out by classes, as of March 31, 2015 and December 31, 2014 was as follows:

(Dollars in thousands)	March 31, 2015	December 31, 2014
Commercial real estate:		
Owner-occupied	$111,399	$100,859
Non-owner occupied	150,921	144,301
Multi-family	28,943	27,531
Non-owner occupied residential	48,806	49,315
Acquisition and development:		
1-4 family residential construction	5,883	5,924
Commercial and land development	26,239	24,237
Commercial and industrial	48,742	48,995
Municipal	60,661	61,191
Residential mortgage:		
First lien	125,752	126,491
Home equity - term	19,912	20,845
Home equity - lines of credit	94,623	89,366
Installment and other loans	5,872	5,891
	$727,753	$704,946

In order to monitor ongoing risk associated with its loan portfolio and specific loans within the segments, management uses an internal grading system. The first several rating categories, representing the lowest risk to the Bank, are combined and given a "Pass" rating. Management generally follows regulatory definitions in assigning criticized ratings to loans, including special mention, substandard, doubtful or loss. The "Special Mention" category includes loans that have potential weaknesses that may, if not monitored or corrected, weaken the asset or inadequately protect the Bank's position at some future date. These assets pose elevated risk, but their weakness does not yet justify a more severe, or

classified rating. “Substandard” loans are classified as they have a well-defined weakness, or weaknesses that jeopardize liquidation of the debt. These loans are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. “Substandard”

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loans include loans that management has determined not to be impaired, as well as loans considered to be impaired. A "Doubtful" loan has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification of loss is deferred. "Loss" assets are considered uncollectible, as the underlying borrowers are often in bankruptcy, have suspended debt repayments, or have ceased business operations. Once a loan is classified as "Loss," there is little prospect of collecting the loan's principal or interest and it is generally written off.
The Bank has a loan review policy and program which is designed to identify and manage risk in the lending function. The Enterprise Risk Management ("ERM") Committee, comprised of senior officers and credit department personnel, is charged with the oversight of overall credit quality and risk exposure of the Bank's loan portfolio. This includes the monitoring of the lending activities of all Bank personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The loan review program provides the Bank with an independent review of the Bank's loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in the "Pass" categories unless a specific action, such as extended delinquencies, bankruptcy, repossession or death of the borrower occurs, which heightens awareness as to a possible credit event.
Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $1,000,000, which includes confirmation of risk rating by the Credit Administration department. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed by the ERM Committee on a quarterly basis, with reaffirmation of the rating as approved by the Bank's Problem Loan Committee.

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The following summarizes the Bank’s ratings based on its internal risk rating system as of March 31, 2015 and December 31, 2014:

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
March 31, 2015						
Commercial real estate:						
Owner-occupied	$100,189	$2,529	$ 5,457	$3,224	$0	$111,399
Non-owner occupied	128,162	13,700	7,424	414	1,221	150,921
Multi-family	25,547	1,367	1,308	721	0	28,943
Non-owner occupied residential	43,174	2,870	1,800	962	0	48,806
Acquisition and development:						
1-4 family residential construction	5,883	0	0	0	0	5,883
Commercial and land development	24,352	230	1,319	338	0	26,239
Commercial and industrial	43,679	958	1,889	2,216	0	48,742
Municipal	60,661	0	0	0	0	60,661
Residential mortgage:						
First lien	120,619	0	0	5,133	0	125,752
Home equity - term	19,751	0	0	161	0	19,912
Home equity - lines of credit	93,272	654	127	570	0	94,623
Installment and other loans	5,848	0	0	24	0	5,872
	$671,137	$22,308	$ 19,324	$13,763	$1,221	$727,753
December 31, 2014						
Commercial real estate:						
Owner-occupied	$89,815	$2,686	$ 5,070	$3,288	$0	$100,859
Non-owner occupied	120,829	20,661	1,131	1,680	0	144,301
Multi-family	24,803	1,086	1,322	320	0	27,531
Non-owner occupied residential	43,020	2,968	1,827	1,500	0	49,315
Acquisition and development:						
1-4 family residential construction	5,924	0	0	0	0	5,924
Commercial and land development	22,261	233	1,333	410	0	24,237
Commercial and industrial	43,794	850	1,914	2,437	0	48,995
Municipal	61,191	0	0	0	0	61,191
Residential mortgage:						
First lien	121,160	9	0	5,290	32	126,491
Home equity - term	20,775	0	0	70	0	20,845
Home equity - lines of credit	88,164	630	93	479	0	89,366
Installment and other loans	5,865	0	0	26	0	5,891
	$647,601	$29,123	$ 12,690	$15,500	$32	$704,946

Classified loans may also be evaluated for impairment. For commercial real estate, acquisition and development and commercial and industrial loans, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Generally, loans that are more than 90 days past due are deemed impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances

surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed to determine if the loan should be placed on nonaccrual status. Nonaccrual loans in the commercial and

commercial real estate portfolios and any TDRs are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates on fair values are obtained, which may include updated appraisals. The updated fair values are incorporated into the impairment analysis as of the next reporting period.

Loan charge-offs, which may include partial charge-offs, are taken on an impaired loan that is collateral dependent if the loan's carrying balance exceeds its collateral's appraised value; the loan has been identified as uncollectible; and it is deemed to be a confirmed loss. Typically, impaired loans with a charge-off or partial charge-off will continue to be considered impaired, unless the note is split into two, and management expects the performing note to continue to perform and is adequately secured. The second, or non-performing note, would be charged-off. Generally, an impaired loan with a partial charge-off may continue to have an impairment reserve on it after the partial charge-off, if factors warrant.

As of March 31, 2015 and December 31, 2014, nearly all of the Company's impaired loans' extent of impairment was measured based on the estimated fair value of the collateral securing the loan, except for TDRs. By definition, TDRs are considered impaired. All restructured loan impairments were determined based on discounted cash flows for those loans classified as TDRs but that are still accruing interest. For real estate loans, collateral generally consists of commercial real estate, but in the case of commercial and industrial loans, it would also consist of accounts receivable, inventory, equipment or other business assets. Commercial and industrial loans may also have real estate collateral.

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

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

- Original appraisal – if the original appraisal provides a strong loan-to-value ratio (generally 70% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the Credit Administration staff that there has not been a significant deterioration in the collateral value, the original certified appraised value may be used. Discounts as deemed appropriate for selling costs are factored into the appraised value in arriving at fair value.
- Discounted cash flows – in limited cases, discounted cash flows may be used on projects in which the collateral is liquidated to reduce the borrowings outstanding, and is used to validate collateral values derived from other approaches.

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

The Company distinguishes substandard loans on both an impaired and non-impaired basis, as it places less emphasis on a loan's classification, and increased reliance on whether the loan was performing in accordance with the contractual terms. "Substandard" classification does not automatically meet the definition of "impaired." A substandard loan is one that is inadequately protected by the current sound worth, paying capacity of the obligor or the collateral pledged, if any. Extensions of credit so classified have well-defined weaknesses which may jeopardize the liquidation

of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard loans, does not have to exist in individual extensions of credit classified as substandard. As a result, the Company's methodology includes an evaluation of certain accruing commercial real estate, acquisition and development and commercial and industrial loans rated "Substandard" to be collectively evaluated for impairment as opposed to evaluating these loans individually for impairment. Although we believe these loans have well defined weaknesses and meet the definition of "Substandard," they are generally performing and management has concluded

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that it is likely it will be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement.

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

The following table summarizes impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required as of March 31, 2015 and December 31, 2014. The recorded investment in loans excludes accrued interest receivable due to insignificance. Allowances established generally pertain to those loans in which loan forbearance agreements were in the process of being negotiated or updated appraisals were pending, and the partial charge-off will be recorded when final information is received.

	Impaired Loans with a Specific Allowance			Impaired Loans with No Specific Allowance	
(Dollars in thousands)	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)	Related Allowance	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)
March 31, 2015					
Commercial real estate:					
Owner-occupied	$0	$ 0	$0	$ 3,224	$ 4,548
Non-owner occupied	1,221	1,326	487	415	2,073
Multi-family	408	408	166	313	352
Non-owner occupied residential	0	0	0	962	1,276
Acquisition and development:					
Commercial and land development	0	0	0	338	1,024
Commercial and industrial	0	0	0	2,216	2,307
Residential mortgage:					
First lien	1,241	1,289	142	3,892	4,379
Home equity - term	0	0	0	160	163
Home equity - lines of credit	0	0	0	570	772
Installment and other loans	12	12	12	12	36
	$2,882	$ 3,035	$807	$ 12,102	$ 16,930
December 31, 2014					
Commercial real estate:					
Owner-occupied	$0	$ 0	$0	$ 3,288	$ 4,558
Non-owner occupied	0	0	0	1,680	3,420
Multi-family	0	0	0	320	356
Non-owner occupied residential	198	203	2	1,302	1,570
Acquisition and development:					
Commercial and land development	0	0	0	410	1,077
Commercial and industrial	0	0	0	2,437	2,500
Residential mortgage:					
First lien	982	982	149	4,340	4,968
Home equity - term	0	0	0	70	71
Home equity - lines of credit	24	40	24	455	655
Installment and other loans	13	13	13	13	36
	$1,217	$ 1,238	$188	$ 14,315	$ 19,211

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The following table summarizes the average recorded investment in impaired loans and related interest income recognized on loans deemed impaired, generally on a cash basis, for the three months ended March 31, 2015 and 2014:

(Dollars in thousands)	2015 Average Impaired Balance	Interest Income Recognized	2014 Average Impaired Balance	Interest Income Recognized
Commercial real estate:				
Owner-occupied	$3,159	$0	$4,249	$10
Non-owner occupied	1,658	0	7,049	4
Multi-family	521	0	371	1
Non-owner occupied residential	1,303	0	3,300	8
Acquisition and development:				
Commercial and land development	392	2	2,288	2
Commercial and industrial	2,346	0	2,088	3
Residential mortgage:				
First lien	5,241	9	3,364	1
Home equity - term	93	0	108	0
Home equity - lines of credit	512	0	121	0
Installment and other loans	25	0	0	0
	$15,250	$11	$22,938	$29

The following table presents impaired loans that are TDRs, with the recorded investment as of March 31, 2015 and December 31, 2014.

(Dollars in thousands)	March 31, 2015 Number of Contracts	Recorded Investment	December 31, 2014 Number of Contracts	Recorded Investment
Accruing:				
Acquisition and development:				
Commercial and land development	1	$287	1	$287
Residential mortgage:				
First lien	8	809	8	813
	9	1,096	9	1,100
Nonaccruing:				
Residential mortgage:				
First lien	14	1,652	13	1,715
Installment and other loans	1	12	1	13
	15	1,664	14	1,728
	24	$2,760	23	$2,828

The loans presented above were considered TDRs as the result of the Company agreeing to below market interest rates for the risk of the transaction, allowing the loan to remain on interest only status, or a reduction in interest rates, in order to give the borrowers an opportunity to improve their cash flows. For TDRs in default of their modified terms, impairment is generally determined on a collateral-dependent approach, except for accruing residential mortgage TDRs, which are generally on the discounted cash flow approach.

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The following table presents the number of loans modified, and their pre-modification and post-modification investment balances for the three months ended March 31, 2015 and 2014:

(Dollars in thousands)	2015			2014		
	Number of Contracts	Pre-Modification Recorded Investment	Post Modification Recorded Investment	Number of Contracts	Pre-Modification Recorded Investment	Post Modification Recorded Investment
Three Months Ended March 31,						
Residential mortgage:						
First lien	1	$59	$59	0	$0	$0
	1	$59	$59	0	$0	$0

The following table presents restructured loans, included in nonaccrual status, that were modified as TDRs within the previous 12 months and for which there was a payment default during the three months ended March 31, 2015 and 2014:

(Dollars in thousands)	2015		2014	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Three Months Ended March 31,				
Residential mortgage:				
First lien	5	$323	0	$0
	5	$323	0	$0

No additional commitments have been made to borrowers whose loans are considered TDRs.

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Management further monitors the performance and credit quality of the loan portfolio by analyzing the average length of time a portfolio is past due, by aggregating loans based on its delinquencies. The following table presents the classes of the loan portfolio summarized by aging categories of performing loans and nonaccrual loans as of March 31, 2015 and December 31, 2014:

		Days Past Due					
	Current	30-59	60-89	90+ (still accruing)	Total Past Due	Non-Accrual	Total Loans
March 31, 2015							
Commercial real estate:							
Owner-occupied	$108,175	$0	$0	$0	$0	$3,224	$111,399
Non-owner occupied	149,212	73	0	0	73	1,636	150,921
Multi-family	28,222	0	0	0	0	721	28,943
Non-owner occupied residential	47,799	0	45	0	45	962	48,806
Acquisition and development:							
1-4 family residential construction	5,883	0	0	0	0	0	5,883
Commercial and land development	26,158	30	0	0	30	51	26,239
Commercial and industrial	46,526	0	0	0	0	2,216	48,742
Municipal	60,661	0	0	0	0	0	60,661
Residential mortgage:							
First lien	120,451	930	47	0	977	4,324	125,752
Home equity - term	19,543	209	0	0	209	160	19,912
Home equity - lines of credit	93,769	284	0	0	284	570	94,623
Installment and other loans	5,835	13	0	0	13	24	5,872
	$712,234	$1,539	$92	$0	$1,631	$13,888	$727,753
December 31, 2014							
Commercial real estate:							
Owner-occupied	$97,571	$0	$0	$0	$0	$3,288	$100,859
Non-owner occupied	142,621	0	0	0	0	1,680	144,301
Multi-family	27,211	0	0	0	0	320	27,531
Non-owner occupied residential	47,706	109	0	0	109	1,500	49,315
Acquisition and development:							
1-4 family residential construction	5,924	0	0	0	0	0	5,924
Commercial and land development	24,114	0	0	0	0	123	24,237
Commercial and industrial	46,558	0	0	0	0	2,437	48,995
Municipal	61,191	0	0	0	0	0	61,191
Residential mortgage:							
First lien	120,806	776	400	0	1,176	4,509	126,491
Home equity - term	20,640	135	0	0	135	70	20,845
Home equity - lines of credit	88,745	142	0	0	142	479	89,366
Installment and other loans	5,815	41	9	0	50	26	5,891
	$688,902	$1,203	$409	$0	$1,612	$14,432	$704,946

The Company maintains the allowance for loan losses at a level believed to be adequate by management to absorb losses inherent in the portfolio. The allowance is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the allowance for loan losses utilizing a defined

methodology, which

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considers specific credit evaluation of impaired loans as discussed above, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC Section 310-10-35 for loans individually identified as impaired, and ASC Subtopic 450-20 for loans collectively evaluated for impairment, and other bank regulatory guidance.

In connection with its quarterly evaluation of the adequacy of the allowance for loan losses, management continually reviews its methodology to determine if it continues to properly address the risk in the loan portfolio. For each loan class presented above, general allowances are provided for loans that are collectively evaluated for impairment, which is based on quantitative factors, principally historical loss trends for the respective loan class, adjusted for qualitative factors. In addition, an adjustment to the historical loss factors is made to account for delinquency and other potential risk not elsewhere defined within the Allowance for Loan and Lease Loss methodology.

The look-back period for historical losses is 12 quarters, weighted one-half for the most recent four quarters, and one quarter for each of the two previous four quarter periods in order to appropriately capture the loss history in the loan segment. Management considers current economic and real estate conditions, and the trends in historical charge-off percentages that resulted from applying partial charge-offs to impaired loans, and the impact of distressed loan sales during the year in determining the look back period.

In addition to the quantitative analysis, adjustments to the reserve requirements are allocated on loans collectively evaluated for impairment based on additional qualitative factors. As of March 31, 2015 and December 31, 2014, the qualitative factors used by management to adjust the historical loss percentage to the anticipated loss allocation, which may range from a minus 150 basis points to a positive 150 basis points per factor, include:

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

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

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

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

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

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

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

National and Local Economic Conditions – Ratios and factors considered include trends in the consumer price index (CPI), unemployment rates, housing price index, housing statistics compared to the prior year, bankruptcy rates, regulatory and legal environment risks and competition.

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Activity in the allowance for loan losses for the three months ended March 31, 2015 and 2014 is as follows:

	Commercial					Consumer				
(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Total	Residential Mortgage	Installment and Other	Total	Unallocated	Total
March 31, 2015										
Balance, beginning of period	$9,462	$697	$806	$183	$11,148	$2,262	$119	$2,381	$1,218	$14,747
Provision for loan losses	(63)	(87)	(137)	(62)	(349)	494	15	509	(160)	0
Charge-offs	(66)	(22)	(26)	0	(114)	(201)	(20)	(221)	0	(335)
Recoveries	13	0	22	0	35	12	2	14	0	49
Balance, end of period	$9,346	$588	$665	$121	$10,720	$2,567	$116	$2,683	$1,058	$14,461
March 31, 2014										
Balance, beginning of period	$13,215	$670	$864	$244	$14,993	$3,780	$124	$3,904	$2,068	$20,965
Provision for loan losses	738	(196)	60	0	602	(481)	44	(437)	(165)	0
Charge-offs	(259)	0	(9)	0	(268)	(193)	(67)	(260)	0	(528)
Recoveries	25	0	4	0	29	6	25	31	0	60
Balance, end of period	$13,719	$474	$919	$244	$15,356	$3,112	$126	$3,238	$1,903	$20,497

The following table summarizes the ending loan balance individually evaluated for impairment based upon loan segment, as well as the related allowance for loan losses allocation for each at March 31, 2015 and December 31, 2014:

	Commercial					Consumer				
(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Total	Residential Mortgage	Installment and Other	Total	Unallocated	Total
March 31, 2015										
Loans allocated by:										
Individually evaluated for impairment	$6,542	$338	$2,216	$0	$9,096	$5,864	$24	$5,888	$0	$14,984
Collectively evaluated for impairment	333,527	31,784	46,526	60,661	472,498	234,423	5,848	240,271	0	712,769
	$340,069	$32,122	$48,742	$60,661	$481,594	$240,287	$5,872	$246,159	$0	$727,753
Allowance for loan losses allocated by:										
Individually evaluated for impairment	$653	$0	$0	$0	$653	$142	$12	$154	$0	$807
Collectively evaluated for impairment	8,693	588	665	121	10,067	2,425	104	2,529	1,058	13,654
	$9,346	$588	$665	$121	$10,720	$2,567	$116	$2,683	$1,058	$14,461
December 31, 2014										
Loans allocated by:										
Individually evaluated for impairment	$6,788	$410	$2,437	$0	$9,635	$5,871	$26	$5,897	$0	$15,532
	315,218	29,751	46,558	61,191	452,718	230,831	5,865	236,696	0	689,414

Collectively evaluated for impairment	$322,006	$30,161	$48,995	$61,191	$462,353	$236,702	$5,891	$242,593	$0	$704,946
Allowance for loan losses allocated by:										
Individually evaluated for impairment	$2	$0	$0	$0	$2	$173	$13	$186	$0	$188
Collectively evaluated for impairment	9,460	697	806	183	11,146	2,089	106	2,195	1,218	14,559
	$9,462	$697	$806	$183	$11,148	$2,262	$119	$2,381	$1,218	$14,747

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NOTE 4. INCOME TAXES

The Company files income tax returns in the U.S. federal jurisdiction and the Commonwealth of Pennsylvania. The Bank also files an income tax return in the State of Maryland. The Company is generally no longer subject to U.S. federal, state or local income tax examination by tax authorities for years before 2011.

The components of income tax expense for the three months ended March 31, 2015 and 2014 are summarized as follows:

	Three months ended March 31,	
(Dollars in thousands)	2015	2014
Current year provision:		
Federal	$(15)	$0
State	4	0
	(11)	0
Deferred tax expense		
Federal	720	253
State	6	2
	726	255
Change in valuation allowance on deferred taxes	0	(255)
Net federal income tax expense (benefit)	$715	$0

The provision for income taxes includes $535,000 and $209,000 of applicable income tax expense related to net security gains for the three months ended March 31, 2015 and 2014.

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

(Dollars in thousands)	March 31, 2015	December 31, 2014
Deferred tax assets:		
Allowance for loan losses	$5,284	$5,424
Deferred compensation	530	528
Retirement plans and salary continuation	1,724	1,695
Share-based compensation	147	102
Off balance sheet reserves	195	205
Nonaccrual loan interest	351	210
Goodwill	146	154
Bonus Accrual	210	396
Low income housing credit carryforward	1,405	1,322
Alternative minimum tax credit carryforward	1,331	1,291
Charitable contribution carryforward	188	209
Net operating loss carryforward	5,829	6,606
Other	228	237
Total deferred tax assets	17,568	18,379
Deferred tax liabilities:		
Depreciation	888	955
Net unrealized gains on securities available for sale	1,896	848
Mortgage servicing rights	606	606
Purchase accounting adjustments	402	421
Other	175	174
Total deferred tax liabilities	3,967	3,004
Net deferred tax asset	$13,601	$15,375

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The provision for income taxes differs from that computed by applying statutory rates to income before income taxes primarily due to the effects of tax-exempt income, non-deductible expenses and tax credits.

As of March 31, 2015, the Company has charitable contribution, low-income housing, and net operating loss carryforwards that expire through 2020, 2035 and 2032, respectively.

In assessing whether or not some or all of our deferred tax asset is more likely than not to be realized in the future, management considers all positive and negative evidence, including projected future taxable income, tax planning strategies and recent financial operating results. Based upon our evaluation of both positive and negative evidence, a full valuation on the net deferred tax assets was established as of September 30, 2012. Specifically, it was felt at that time that the negative evidence, which included recent cumulative history of operating losses, deterioration in asset quality and resulting impact on profitability, and that we had exhausted our carryback availability, outweighed the positive evidence, and the reserve was established.

Each subsequent quarter-end, the Company continued to weigh both positive and negative evidence and re-analyzed its position that a valuation allowance was required. At December 31, 2014, management noted the Company’s profitable operations over the past nine quarters, improvements in asset quality, strengthened capital position, reduced regulatory risk, as well as improvement in economic conditions. Based on this analysis, management determined that a full valuation allowance was no longer necessary, and the full amount of the valuation allowance was recaptured as of December 31, 2014. The ultimate realization of deferred tax assets is dependent upon existence, or generation, of taxable income in the periods when those temporary differences and net operating loss and credit carryforwards are deductible. Management considered projected future taxable income, length of time needed for carryforwards to reverse, available tax planning strategies, and other factors in making its assessment that it was more likely than not the net deferred tax assets would be realized, and recaptured the full valuation allowance at December 31, 2014. As a result of the recapture of the valuation allowance at December 31, 2014, the Company began recording income tax expense.

NOTE 5. SHARE-BASED COMPENSATION PLANS

The Company maintains share-based compensation plans, the purpose of which are to provide officers, employees, and non-employee members of the Board of Directors of the Company and the Bank, with additional incentive to further the success of the Company. In May 2011, the shareholders of the Company approved the 2011 Orrstown Financial Services, Inc. Incentive Stock Plan (the “Plan”). Under the Plan, 381,920 shares of the common stock of the Company were reserved to be issued. As of March 31, 2015, 195,394 shares were available to be issued under the Plan.

Incentive awards under the Plan may consist of grants of incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, deferred stock units and performance shares. All employees of the Company and its present or future subsidiaries, and members of the Board of Directors of the Company or any subsidiary of the Company, are eligible to participate in the Plan. The Plan allows for the Compensation Committee of the Board of Directors to determine the type of incentive to be awarded, its term, manner of exercise, vesting of awards and restrictions on shares. Generally, awards are nonqualified under the IRS code, unless the awards are deemed to be incentive awards to employees, at the Compensation Committee’s discretion.

A roll forward of the Company’s nonvested restricted shares for the three months ended March 31, 2015 is presented below:

	Shares	Weighted Average Grant Date Fair Value
Nonvested shares, beginning of year	155,500	$15.52
Granted	28,394	17.20
Nonvested shares, at period end	183,894	$15.78

For the three months ended March 31, 2015 and 2014, $131,000 and $4,000 was recognized as expense on the restricted stock awards, with tax benefits recorded of $46,000 and $1,000 for the respective periods. As of March 31, 2015 and December 31, 2014, the unrecognized compensation expense related to the stock awards were $2,322,000

and $1,982,000. The unrecognized compensation expense is expected to be recognized over a weighted-average period of 4.0 years.

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A roll forward of the Company's outstanding stock options for the three months ended March 31, 2015 is presented below:

	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	148,193	$31.18
Forfeited	(18,413)	31.73
Expired	0	0.00
Options outstanding and exercisable, at year end	129,780	$31.10

The exercise price of each option equals the market price of the Company's stock on the date of grant and an option's maximum term is ten years. All options are fully vested upon issuance. Information pertaining to options outstanding and exercisable at March 31, 2015 is as follows:

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
$21.14 - $24.99	37,024	5.18	$21.46
$25.00 - $29.99	2,792	5.00	25.76
$30.00 - $34.99	39,620	2.51	31.28
$35.00 - $39.99	25,145	2.08	36.57
$40.00 - $40.14	25,199	0.22	40.14
$21.14 - $40.14	129,780	2.80	$31.10

The options outstanding and exercisable had no intrinsic value at March 31, 2015 and December 31, 2014 as each exercise price exceeded the market value.

The Company also maintains an employee stock purchase plan, in order to provide employees of the Company and its subsidiaries an opportunity to purchase stock of the Company. Under the employee stock purchase plan, eligible employees may purchase shares in an amount that does not exceed 10% of their annual salary, up to the IRS limit, at the lower of 95% (85% prior to August 31, 2014) of the fair market value of the shares on the semi-annual offering date, or related purchase date. The Company reserved 350,000 shares of its common stock, after making adjustments for stock dividends and a stock split, to be issued under the employee stock purchase plan. As of March 31, 2015, 195,679 shares were available to be issued under the employee stock purchase plan. Employees purchased 2,964 and 3,348 shares at a weighted average price of $15.74 and $13.92 for the three months ended March 31, 2015 and 2014. Compensation expense recognized on the employee stock purchase plan totaled $3,000 and $8,000 for the three months ended March 31, 2015 and 2014.

The Company uses a combination of issuing new shares or treasury shares to meet stock compensation exercises depending on market conditions.

NOTE 6. SHAREHOLDERS' EQUITY AND REGULATORY CAPITAL

On January 8, 2013, the Company filed a shelf registration statement on Form S-3 with the Securities and Exchange Commission (the "Commission") that provides for the issuance of up to an aggregate of $80,000,000 worth of common stock, preferred stock, and warrants. To date, the Company has not issued any securities under this shelf registration statement.

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific guidelines that

involve quantitative measures of assets, liabilities and certain

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off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Although applicable to the Bank, prompt corrective action provisions are not applicable to bank holding companies, including financial holding companies.

Quantitative measures established by regulators to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (as set forth in the following table) of total and Tier 1 capital (as defined in regulations) to risk-weighted assets (as defined), common equity Tier 1 capital (as defined) to risk weighted assets, and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of March 31, 2015 and December 31, 2014, the Company and the Bank meet all capital adequacy requirements to which they are subject.

Effective January 1, 2015, the Company and Bank became subject to the final rules previously approved by the FRB establishing a new comprehensive capital framework for U.S. banking organizations, including community banks (the "Basel III Capital Rules"), which substantially revised the risk-based capital requirements in comparison to the existing U.S. risk-based capital rules which were in effect through December 31, 2014. The Basel III Capital Rules, among other things, (i) introduced a new capital measure called “Common Equity Tier 1” (“CET1”), (ii) increased the minimum requirements for Tier 1 Capital ratio as well as the minimum to be considered well capitalized under prompt corrective action; (iii) and introduced the "capital conservation buffer”, designed to absorb losses during periods of economic stress. Institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer may face constraints on dividends, equity repurchases and discretionary bonuses to executive officers based on the amount of the shortfall. The implementation of the capital conservation buffer will begin on January 1, 2016 at the 0.625% level and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

As of March 31, 2015, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, Common Equity Tier 1, and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank’s category.

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The Company and the Bank’s actual capital ratios as of March 31, 2015, under the new Basel III Capital Rules, and December 31, 2014, under the previous U.S. risk based capital rules, are also presented in the table.

	Actual			Minimum Capital Requirement			Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions		
(Dollars in thousands)	Amount	Ratio		Amount	Ratio		Amount	Ratio	
March 31, 2015									
Total capital to risk weighted assets									
Orrstown Financial Services, Inc.	$135,008	16.8	%	$64,192	8.0	%	n/a	n/a	
Orrstown Bank	132,893	16.6	%	64,161	8.0	%	$ 80,202	10.0	%
Tier 1 capital to risk weighted assets									
Orrstown Financial Services, Inc.	124,847	15.6	%	48,144	6.0	%	n/a	n/a	
Orrstown Bank	122,748	15.3	%	48,121	6.0	%	64,161	8.0	%
CET1 to risk weighted assets									
Orrstown Financial Services, Inc.	124,847	15.6	%	36,108	4.5	%	n/a	n/a	
Orrstown Bank	122,748	15.3	%	36,091	4.5	%	52,131	6.5	%
Tier 1 capital to average assets									
Orrstown Financial Services, Inc.	124,847	10.6	%	47,110	4.0	%	n/a	n/a	
Orrstown Bank	122,748	10.4	%	47,169	4.0	%	58,961	5.0	%
December 31, 2014									
Total capital to risk weighted assets									
Orrstown Financial Services, Inc.	$119,713	16.8	%	$56,859	8.0	%	n/a	n/a	
Orrstown Bank	118,540	16.7	%	56,835	8.0	%	$ 71,043	10.0	%
Tier 1 capital to risk weighted assets									
Orrstown Financial Services, Inc.	110,750	15.6	%	28,429	4.0	%	n/a	n/a	
Orrstown Bank	109,581	15.4	%	28,417	4.0	%	42,626	6.0	%
Tier 1 capital to average assets									
Orrstown Financial Services, Inc.	110,750	9.5	%	46,496	4.0	%	n/a	n/a	
Orrstown Bank	109,581	9.4	%	46,518	4.0	%	58,148	5.0	%

On April 2, 2015, the Federal Reserve Bank of Philadelphia terminated the Written Agreement that it originally entered into with the Company and the Bank on March 22, 2012, thereby terminating all of its enforcement actions against the Company and the Bank. On February 6, 2015, the Bank was released from the Memorandum of Understanding by and between the Bank and the Pennsylvania Department of Banking and Securities ("PDB"), thereby terminating all of the PDB's enforcement actions against the Bank.

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NOTE 7. EARNINGS PER SHARE

Earnings per share for the three months ended March 31, 2015 and 2014 were as follows:

(Dollars in thousands, except per share data)	Three Months Ended March 31, 2015	2014
Net income	$2,462	$1,978
Weighted average shares outstanding (basic)	8,110	8,108
Impact of common stock equivalents	24	0
Weighted average shares outstanding (diluted)	8,134	8,108
Per share information:		
Basic earnings per share	$0.30	$0.24
Diluted earnings per share	0.30	0.24

Stock options amounting to 130,000 and 206,000 shares of common stock were not considered in computing diluted earnings per share for the three months ended March 31, 2015 and 2014 as their exercise would have been antidilutive as the exercise price exceeded the average market value.

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

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

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

	Contract or Notional Amount	
(Dollars in thousands)	March 31, 2015	December 31, 2014
Commitments to fund:		
Revolving, open ended home equity loans	$105,791	$100,897
1-4 family residential construction loans	4,751	2,463
Commercial real estate, construction and land development loans	13,432	11,682
Commercial, industrial and other loans	68,508	71,483
Standby letters of credit	6,888	7,309

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

Standby letters of credit and financial guarantees written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private

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borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Company holds collateral supporting those commitments when deemed necessary by management. The current amount of liability, as of March 31, 2015 and December 31, 2014, for guarantees under standby letters of credit issued was not material.

The Company currently maintains a reserve in other liabilities totaling $417,000 and $485,000 at March 31, 2015 and December 31, 2014 for off-balance sheet credit exposures that currently are not funded, based on historical loss experience of the related loan class. For the three months ended March 31, 2015 and 2014, the amount expensed (recovered) was $(68,000) and $(70,000).

The Company has sold loans to the Federal Home Loan Bank of Chicago as part of its Mortgage Partnership Finance Program ("MPF Program"). Under the terms of the MPF Program, there is limited recourse back to the Company for loans that do not perform in accordance with the terms of the loan agreement. Each loan that is sold under the program is "credit enhanced" such that the individual loan's rating is raised to "AA," as determined by the Federal Home Loan Bank of Chicago. The sum of total loans sold under the MPF Program with limited recourse was $49,189,000 and $51,773,000 at March 31, 2015 and December 31, 2014, with limited recourse back to the Company on these loans of $8,379,000 at these dates. Many of the loans sold under the MPF Program have primary mortgage insurance, which reduces the Company's overall exposure. The Company is in the process of foreclosing on loans sold under the MPF Program or recovering amounts previously charged off, with a resulting net charge of $40,000 and $17,000 for the three months ended March 31, 2015 and 2014. These amounts, charged to other expenses represent an estimate of the Company's loss under its recourse exposure.

NOTE 9. FAIR VALUE DISCLOSURES

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

Fair value measurements under GAAP 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 valuation techniques that employ unobservable inputs (Level 3). If the inputs used to measure the assets or liabilities fall within different levels of the hierarchy, the classification is based on the lowest level input that is significant to the fair value measurement of the asset or liability. Classification of assets and liabilities within the hierarchy considers the markets in which the assets and liabilities are traded and the reliability and transparency of the assumptions used to determine fair value.

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

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

Securities

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, securities are classified within Level 2 and fair values are estimated

by using pricing models, quoted prices of securities with similar characteristics or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation,

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securities are classified within Level 3 of the valuation hierarchy. All of the Company's securities are classified as available for sale.

The Company had no fair value liabilities measured on a recurring basis at March 31, 2015 and December 31, 2014. A summary of assets at March 31, 2015 and December 31, 2014, measured at estimated fair value on a recurring basis was as follows:

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
March 31, 2015				
Securities available for sale:				
U.S. Government Agencies	$0	$28,350	$0	$28,350
States and political subdivisions	0	58,479	0	58,479
U.S. Government Sponsored enterprises (GSE) residential mortgage-backed securities	0	161,209	0	161,209
GSE residential collateralized mortgage obligations (CMOs)	0	30,478	0	30,478
GSE commercial CMOs	0	71,243	0	71,243
Total debt securities	0	349,759	0	349,759
Equity securities - financial services	0	68	0	68
Total securities	$0	$349,827	$0	$349,827
	Level 1	Level 2	Level 3	Total Fair Value Measurements
December 31, 2014				
Securities available for sale:				
U.S. Government Agencies	$0	$23,958	$0	$23,958
States and political subdivisions	0	52,401	0	52,401
GSE residential mortgage-backed securities	0	175,596	0	175,596
GSE residential collateralized mortgage obligations (CMOs)	0	58,705	0	58,705
GSE commercial CMOs	0	65,472	0	65,472
Total debt securities	0	376,132	0	376,132
Equity securities - financial services	0	67	0	67
Total securities	$0	$376,199	$0	$376,199

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

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

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due, according to the contractual terms of the loan agreement, will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loan, less estimated costs to sell. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The value of the real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction, or if management adjusts the appraisal value, then the fair value is considered Level 3. The value of business equipment is

based upon an outside appraisal, if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for

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inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans with an allocation to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statements of income. Specific allocations to the allowance for loan losses or partial charge-offs were $4,935,000 and $4,413,000 at March 31, 2015 and December 31, 2014.

Foreclosed Real Estate

Other real estate property acquired through foreclosure is initially recorded at the fair value of the property at the transfer date less estimated selling cost. Subsequently, other real estate owned is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. Cumulative specific charges to value the real estate owned at the lower of cost or fair value on properties held at March 31, 2015 and December 31, 2014 were $551,000 and $581,000.

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

(Dollars in thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range
March 31, 2015				
Impaired loans	$5,250	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity	0%-30% discount
			Management adjustments for liquidation expenses	5%-10% discount
Foreclosed real estate	540	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity	0%-30% discount
			Management adjustments for liquidation expenses	5%-25% discount
December 31, 2014				
Impaired loans	$4,859	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity	0%-30% discount
			Management adjustments for liquidation expenses	5%-10% discount
Foreclosed real estate	786	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity	0%-5% discount
			Management adjustments for liquidation expenses	6%-18% discount

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A summary of assets at March 31, 2015 and December 31, 2014, measured at estimated fair value on a nonrecurring basis was as follows:

(Dollars in thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
March 31, 2015				
Commercial real estate:				
Owner-occupied	$0	$0	$1,152	$1,152
Non-owner occupied	0	0	919	919
Multi-family	0	0	332	332
Non-owner occupied residential	0	0	535	535
Acquisition and development:				
Commercial and land development	0	0	44	44
Commercial and industrial	0	0	29	29
Residential mortgage:				
First lien	0	0	2,000	2,000
Home equity - Lines of credit	0	0	227	227
Installment and other loans	0	0	12	12
Impaired loans, net	$0	$0	$5,250	$5,250
Foreclosed real estate				
Residential	$0	$0	$217	$217
Commercial and land development	0	0	323	323
Total foreclosed real estate	$0	$0	$540	$540
December 31, 2014				
Commercial real estate:				
Owner-occupied	$0	$0	$1,228	$1,228
Non-owner occupied	0	0	192	192
Multi-family	0	0	92	92
Non-owner occupied residential	0	0	937	937
Acquisition and development:				
Commercial and land development	0	0	117	117
Commercial and industrial	0	0	29	29
Residential mortgage:				
First lien	0	0	2,022	2,022
Home equity - Lines of credit	0	0	229	229
Installment and other loans	0	0	13	13
Impaired loans, net	$0	$0	$4,859	$4,859
Foreclosed real estate				
Residential	$0	$0	$217	$217
Commercial and land development	0	0	569	569
Total foreclosed real estate	$0	$0	$786	$786

Fair values of financial instruments

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

Cash and Due from Banks and Interest Bearing Deposits with Banks

The carrying amounts of cash and due from banks and interest bearing deposits with banks approximate their fair value.

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Loans Held for Sale

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

Loans Receivable

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

Restricted Investment in Bank Stock

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

Mortgage Servicing Rights

The fair value of mortgage servicing rights is estimated based on a valuation model that calculates the present value of estimated future net servicing income.

Deposits

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, money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposits and IRAs are estimated using a discounted cash flow calculation based on the Company's incremental borrowing rates for similar maturities.

Short-Term Borrowings

Fair values of the Company's short-term borrowings are estimated using discounted cash flow analyses based on the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

Long-Term Debt

The fair value of the Company’s fixed rate long-term borrowings is estimated using a discounted cash flow analysis based on the Company’s current incremental borrowing rate for similar types of borrowing arrangements.

Accrued Interest

The carrying amounts of accrued interest receivable and payable approximate their fair values.

Off-Balance-Sheet Instruments

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

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The estimated fair values of the Company’s financial instruments were as follows at March 31, 2015 and December 31, 2014:

(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
March 31, 2015					
Financial Assets					
Cash and due from banks	$21,182	$21,182	$21,182	$0	$0
Interest bearing deposits with banks	11,856	11,856	11,856	0	0
Restricted investments in bank stock	7,678	n/a	n/a	n/a	n/a
Securities available for sale	349,827	349,827	0	349,827	0
Loans held for sale	5,177	5,299	0	5,299	0
Loans, net of allowance for loan losses	713,292	721,120	0	0	721,120
Accrued interest receivable	3,049	3,049	0	1,393	1,656
Mortgage servicing rights	2,637	2,696	0	0	2,696
Financial Liabilities					
Deposits	945,756	947,318	0	947,318	0
Short-term borrowings	75,272	75,272	0	75,272	0
Long-term debt	24,734	25,572	0	25,572	0
Accrued interest payable	263	263	0	263	0
Off-balance sheet instruments	0	0	0	0	0
December 31, 2014					
Financial Assets					
Cash and due from banks	$18,174	$18,174	$18,174	$0	$0
Interest bearing deposits with banks	13,235	13,235	13,235	0	0
Restricted investments in bank stock	8,350	n/a	n/a	n/a	n/a
Securities available for sale	376,199	376,199	0	376,199	0
Loans held for sale	3,159	3,249	0	3,249	0
Loans, net of allowance for loan losses	690,199	697,506	0	0	697,506
Accrued interest receivable	3,097	3,097	0	1,593	1,504
Mortgage servicing rights	2,684	2,785	0	0	2,785
Financial Liabilities					
Deposits	949,704	950,667	0	950,667	0
Short-term borrowings	86,742	86,742	0	86,742	0
Long-term debt	14,812	15,610	0	15,610	0
Accrued interest payable	273	273	0	273	0
Off-balance sheet instruments	0	0	0	0	0

NOTE 10. CONTINGENCIES

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

On May 25, 2012, Southeastern Pennsylvania Transportation Authority (“SEPTA”) filed a putative class action complaint in the United States District Court for the Middle District of Pennsylvania against the Company, the Bank and certain current and former directors and executive officers (collectively, the “Defendants”). The complaint alleges, among other things, that (i) in connection with the Company’s Registration Statement on Form S-3 dated February 23, 2010 and its Prospectus Supplement dated March 23, 2010, and (ii) during the purported class period of March 24, 2010 through October 27, 2011, the

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Company issued materially false and misleading statements regarding the Company's lending practices and financial results, including misleading statements concerning the stringent nature of the Bank's credit practices and underwriting standards, the quality of its loan portfolio, and the intended use of the proceeds from the Company's March 2010 public offering of common stock. The complaint asserts claims under Sections 11, 12(a) and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and seeks class certification, unspecified money damages, interest, costs, fees and equitable or injunctive relief. Under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), motions for appointment of Lead Plaintiff in this case were due by July 24, 2012. SEPTA was the sole movant and the Court appointed SEPTA Lead Plaintiff on August 20, 2012.

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

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

Pursuant to the Court's March 28, 2013 Second Scheduling Order, on May 28, 2013 all defendants filed their motions to dismiss the amended complaint, and on July 22, 2013 SEPTA filed its "omnibus" opposition to all of the defendants' motions to dismiss. On August 23, 2013, all defendants filed reply briefs in further support of their motions to dismiss. On December 5, 2013, the Court ordered oral argument on the Orrstown Defendants' motion to dismiss the amended complaint to be heard on February 7, 2014. Oral argument on the pending motions to dismiss SEPTA's amended complaint was held on April 29, 2014.

On April 10, 2015, pursuant to Court order, all parties filed supplemental briefs addressing the impact of the United States Supreme Court's March 24, 2015 decision in Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund on defendants' motions to dismiss the amended complaint. The Court's ruling on the motions to dismiss is pending.

The Second Scheduling Order stays all discovery in the case pending the outcome of the motions to dismiss, and informs the parties that, if required, a telephonic conference to address discovery and the filing of SEPTA's motion for class certification will be scheduled after the Court's ruling on the motions to dismiss.

The matter is currently progressing through the legal process. The Orrstown Defendants believe that the allegations in the amended complaint are without merit and intend to defend themselves vigorously against those claims. Considering that no ruling has been made on the motions to dismiss, discovery in the proceeding remains stayed and class certification has not been granted, it is not possible to estimate reasonably possible losses, or even a range of reasonably possible losses, at this time in connection with SEPTA's putative class action complaint.

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

Overview

The Company, headquartered in Shippensburg, Pennsylvania, is a one bank holding company that has elected status as a financial holding company. The consolidated financial information presented herein reflects the Company and its wholly-owned subsidiary, Orrstown Bank. At March 31, 2015, the Company had total assets of $1,189,420,000, total

liabilities of $1,057,566,000 and total shareholders' equity of $131,854,000.
The U.S. economy is in its fifth year of recovery from one of its longest and most severe economic recessions in recent history. The strength of the recovery has been modest by historical standards, with GDP growth struggling to sustain momentum above 2.0%. Unemployment had been slow to decline until 2014, when the country experienced its best employment growth in over a decade. While the economic outlook finally appears strong enough that the FRB is expected to

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begin raising interest rates in 2015, most of the rest of the world's economies appear to be in a recession or experiencing decelerating growth. As a result, the dollar has strengthened significantly and commodity prices have fallen precipitously.

Caution About Forward Looking Statements

Certain statements appearing herein which are not historical in nature are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. In addition, the Company may make other written and oral communications, from time to time, that contain such statements. Such forward-looking statements refer to a future period or periods, reflecting management's current beliefs as to likely future developments, and use words like "may," "will," "expect," "estimate," "anticipate" or similar terms. Forward-looking statements are statements that include projections, predictions, expectations, or beliefs about events or results or otherwise are not statements of historical facts, including, but not limited to, statements related to new business development, new loan opportunities, growth in the balance sheet and fee based revenue lines of business, reducing risk assets, and mitigating losses in the future. Actual results and trends could differ materially from those set forth in such statements and there can be no assurances that we will achieve the desired level of new business development and new loans, growth in the balance sheet and fee based revenue lines of business, continue to reduce risk assets or mitigate losses in the future. Factors that could cause actual results to differ from those expressed or implied by the forward looking statements include, but are not limited to, the following: ineffectiveness of the Company's business strategy due to changes in current or future market conditions; the effects of competition, including industry consolidation and development of competing financial products and services; changes in laws and regulations, including the Dodd-Frank Wall Street Reform and Consumer Protection Act; interest rate movements; changes in credit quality; inability to raise capital under favorable conditions, volatilities in the securities markets; deteriorating economic conditions, and other risks and uncertainties, including those detailed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014, and this Quarterly Report on Form 10-Q under the sections titled "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in other filings made with the Commission. The statements are valid only as of the date hereof and the Company disclaims any obligation to update this information.

The following is a discussion of our consolidated financial condition at March 31, 2015 and results of operations for the three months ended March 31, 2015 and 2014. Throughout this discussion, the yield on earning assets is stated on a fully taxable-equivalent basis and balances represent average daily balances unless otherwise stated. The discussion and analysis should be read in conjunction with our Consolidated Financial Statements (Unaudited) and Notes thereto presented elsewhere in this report. Certain prior period amounts, presented in this discussion and analysis, have been reclassified to conform to current period classifications.

Critical Accounting Policies

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

The most significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes, provide information on how significant assets and liabilities are valued in the financial statements and how those

values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, the Company has identified the adequacy of the allowance for loan losses and accounting for income taxes as critical accounting policies.

The allowance for loan losses represents management's estimate of probable incurred credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on

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impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheet.

The Company recognizes deferred tax assets and liabilities for the future effects of temporary differences and tax credits. Enacted tax rates are applied to cumulative temporary differences based on expected taxable income in the periods in which the deferred tax asset or liability is anticipated to be realized. Future tax rate changes could occur that would require the recognition of income or expense in the statement of operations in the period in which they are enacted. Deferred tax assets must be reduced by a valuation allowance if in management's judgment it is "more likely than not" that some portion of the asset will not be realized. Management may need to modify its judgment in this regard, from one period to another, should a material change occur in the business environment, tax legislation, or in any other business factor that could impair the Company's ability to benefit from the asset in the future. Based upon the Company's prior cumulative taxable losses, projections for future taxable income and other available evidence, management determined that there was not sufficient positive evidence to outweigh the cumulative loss, and concluded it was not more likely than not that the net deferred tax asset would be realized for the quarters ended September 30, 2012 through September 30, 2014. Accordingly, a full valuation allowance was recorded for each of these quarters. However, at December 31, 2014, management noted the Company's profitable operations over the past nine quarters, improvement in asset quality, strengthened capital position, reduced regulatory risk, as well as improvement in economic conditions. Based on this analysis, management determined that a full valuation allowance was no longer necessary, and the full amount was recaptured as of December 31, 2014. The ultimate realization of deferred tax assets is dependent upon existence, or generation, of taxable income in the periods when those temporary differences and net operating loss and credit carryforwards are deductible. Management considered projected future taxable income, length of time needed for carryforwards to reverse, available tax planning strategies, and other factors in making its assessment that it was more likely than not the net deferred taxes would be realized, and recaptured the full valuation allowance at December 31, 2014.

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

RESULTS OF OPERATIONS

QUARTER ENDED MARCH 31, 2015 COMPARED TO QUARTER ENDED MARCH 31, 2014

Summary

The Company recorded net income of $2,462,000 for the first quarter of 2015 compared to net income of $1,978,000 for the same period in 2014. Basic and diluted earnings per share (EPS) for the first quarter of 2015 were $0.30, compared to $0.24 for the first quarter of 2014. Net interest income of $8,315,000 was $201,000 lower for the three months ended March 31, 2015 than in the same period of 2014. Despite higher average balances in loans during the first quarter of 2015 as compared to the same period of 2014, the impact of the flattening yield curve in which short term interest rates rose but longer term interest rates declined, negatively impacted our net interest margin. Maturing loans and securities were reinvested at lower rates; however, lowering rates on our deposits to the same extent was not feasible. Net income for the three months ended March 31, 2015 benefited from higher levels of gains on sales of securities, which were $932,000 higher than in the same period in the prior year. In addition, results continue to be aided by the absence of a provision for loan losses for the three months ended March 31, 2015 and 2014.

Net Interest Income

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

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

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liabilities, and stockholders' equity, the net interest margin exceeds the net interest spread, as these funding sources are non-interest bearing.

For the three months ended March 31, 2015, net interest income measured on a fully tax equivalent basis decreased $323,000 to $8,619,000 from $8,942,000 in the corresponding period in 2014. The primary reason for the decrease in net interest income was a decrease in the average rates on interest earning assets, only partially offset by a lower cost of funds on interest bearing liabilities.

Interest income earned on loans decreased from $7,741,000 for the quarter ended March 31, 2014 to $7,601,000 for the same period in 2015, a $140,000 decline. The primary reason for the decline was a decrease in the average rate earned from 4.67% in the quarter ended March 31, 2014 to 4.32% in the same period in 2015, offset by an increase in the average balance of loans from $672,364,000 for the first quarter of 2014 to $713,330,000 for the same period in 2015. A combination of loans with higher rates paying off and new loans made at lower rates due to competitive market conditions have led to the lower interest rates earned on loans.

Securities interest income decreased $373,000 to $1,905,000 for the quarter ended March 31, 2015, from $2,278,000 for the same period in 2014. The primary reason for the decline is the average balance of securities has decreased from $412,963,000 in the first quarter of 2014 to $356,635,000 for the same period in 2015. The decrease in the average balance of securities is the result of sales and pay downs on securities available for sale used to fund loan growth. Also, as securities mature or pay off, the funds are reinvested at lower rates which resulted in a decrease in tax equivalent yield from 2.24% for the three months ended March 31, 2014 to 2.17% in the same period in 2015. Included in interest income for the three months ended March 31, 2015 is a $161,000 special dividend declared by the Federal Home Loan Bank of Pittsburgh that favorably impacted the yield on securities by six basis points.

Interest expense on deposits and borrowings for the three months ended March 31, 2015 was $913,000, a decrease of $172,000, from $1,085,000 in the same period in 2014. The Company's cost of funds on interest bearing liabilities declined to 0.40% for the quarter ended March 31, 2015 from 0.47% for the same period in 2014. The interest rate environment has allowed the Company to obtain long-term debt at lower rates, and as time deposits mature, the Company has also been able to replace the funds at slightly lower rates.

The Company's net interest spread of 3.12% decreased 11 basis points in the quarter ended March 31, 2015 as compared to the same period in 2014. Net interest margin for the quarter ended March 31, 2015 was 3.18%, a 12 basis point decrease from 3.30% for the quarter ended March 31, 2014.

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The table below presents net interest income on a fully taxable equivalent basis (FTE), net interest spread and net interest margin for the quarters ended March 31, 2015 and 2014.

(Dollars in thousands)	March 31, 2015 Average Balance	Tax Equivalent Interest	Tax Equivalent Rate	March 31, 2014 Average Balance	Tax Equivalent Interest	Tax Equivalent Rate
Assets						
Federal funds sold & interest bearing bank balances	$29,569	$26	0.36 %	$12,902	$ 8	0.25 %
Securities	356,635	1,905	2.17	412,963	2,278	2.24
Loans	713,330	7,601	4.32	672,364	7,741	4.67
Total interest-earning assets	1,099,534	9,532	3.52	1,098,229	10,027	3.70
Other assets	81,698			60,978		
Total	$1,181,232			$1,159,207		
Liabilities and Shareholders' Equity						
Interest bearing demand deposits	$504,387	$220	0.18	$478,369	$ 186	0.16
Savings deposits	87,665	34	0.16	80,399	33	0.17
Time deposits	235,049	523	0.90	310,693	737	0.96
Short term borrowings	78,370	60	0.31	50,719	33	0.26
Long term debt	16,112	76	1.91	17,928	96	2.17
Total interest bearing liabilities	921,583	913	0.40	938,108	1,085	0.47
Non-interest bearing demand deposits	118,866			116,211		
Other	11,166			10,949		
Total Liabilities	1,051,615			1,065,268		
Shareholders' Equity	129,617			93,939		
Total	$1,181,232			$1,159,207		
Net interest income (FTE)/net interest spread		8,619	3.12 %		8,942	3.23 %
Net interest margin			3.18 %			3.30 %
Tax-equivalent adjustment		(304)			(426)	
Net interest income		$8,315			$ 8,516	

NOTES: Yields and interest income on tax-exempt assets have been computed on a fully taxable equivalent basis assuming a 35% tax rate.

For yield calculation purposes, nonaccruing loans are included in the average loan balance.

Provision for Loan Losses

The Company recorded no provision for loan losses for the three months ended March 31, 2015 and 2014. In determining the required provision for loan losses, both quantitative and qualitative factors are considered in the determination of the adequacy of the allowance for loan losses, as noted in the "Asset Quality" section. For both periods presented, the favorable historical charge-off data combined with relatively stable economic and market conditions has resulted in the determination that no additional provision for loan losses was required to offset net charge-offs, additional reserves needed on impaired loans, or for loan growth experienced during the periods. See further discussion in the "Allowance for Loan Losses" section.

Noninterest Income

Noninterest income, excluding securities gains, totaled $3,839,000 for the three months ended March 31, 2015, compared to $3,841,000 for the same period in 2014. While noninterest income was nearly identical between the two periods, the components of noninterest income, excluding securities gains, varied during the first quarter of 2015 compared to the same period in 2014, as noted below.

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- The Company continues to experience declines in service charges on deposits and other services charges from $1,269,000 for the three months ended March 31, 2014 to $1,193,000 for the same period in 2015. This 6.0% decline reflects trends noted in more conservative consumer spending behavior, particularly insufficient funds charges, as customers have increased real time access as to their funds availability through the internet and phone.
- Orrstown Financial Advisors revenues, which includes trust and estate fees and brokerage income, totaled $1,684,000 for the three months ended March 31, 2015 compared to $1,656,000 for the three months ended March 31, 2014, an increase of $28,000. New account generation and stable market conditions led to the increase in trust department income.
- Mortgage banking activities generated revenue of $520,000 for the three months ended March 31, 2015, a $61,000, or 13.3% increase over the same period in 2014. Favorable real estate and interest rate conditions led to the increase in mortgage banking activities.

Securities gains totaled $1,529,000 for the three months ended March 31, 2015, compared to $597,000 for the same period in 2014. For both periods, asset/liability management strategies and interest rate conditions resulted in gains on sales of securities, as market conditions presented opportunities to realize earnings on securities through gains, while funding loan growth.

Noninterest Expenses

Noninterest expenses amounted to $10,506,000 for the three months ended March 31, 2015, compared to $10,976,000 for the corresponding prior year period, a decrease of 4.3%. The improvement in the expense base is the result of improved asset quality, related impact on operating performance and a reduction in discretionary spending.

- Salaries and employee benefits increased $88,000, or 1.5% to $5,900,000 for the three months ended March 31, 2015 compared to the same period in 2014.
- Furniture and equipment expense of $743,000 for the three months ended March 31, 2015 represented a decrease of $93,000 from $836,000 for the same period in 2014. The decrease was due principally to losses on disposal of equipment in the 2014 period of $46,000 for assets that were retired early and lower depreciation charges.
- Data processing costs of $467,000 for the three months ended March 31, 2015 represents an increase of $86,000, or 22.6%, from $381,000 for the same period in 2014, due to higher volumes and costs associated with more sophisticated product and service offerings.
- Advertising and bank promotions expense totaled $245,000 for the three months ended March 31, 2015, a $180,000, or 42.4%, decrease from $425,000 for the same period in 2014, as the Company’s brand promotion spending was concentrated in the first quarter of 2014. Bank promotion spending in 2015 has returned to more historically consistent levels.
- FDIC insurance premiums produced the greatest dollar and percentage decline, and totaled $246,000 for the three months ended March 31, 2015, compared to $464,000 for the same period in 2014, a decline of $218,000, or 47.0%. This decline in FDIC insurance premiums was primarily due to a decrease in the assessment rate as the Company’s risk profile continued to improve.
- Collection and problem loan expense decreased $63,000, or 39.6%, to $96,000 for the three months ended March 31, 2015, as compared to the same period in 2014, and reflects improvement in the level of classified loans between the two periods. Similarly, professional services expense declined from $628,000 for the three months ended March 31, 2014 to $512,000 for the same period in 2015, as less assistance was needed from external parties.
- Taxes other than income totaled $226,000 for the three months ended March 31, 2015, a $68,000 increase over the same period in 2014 as Pennsylvania’s Bank Shares tax is based on shareholders’ equity at the beginning of the year. A combination of 2014’s earnings and unrealized gains on securities, net of tax, resulted in the increase in this equity-based tax.

The Company’s efficiency ratio declined slightly for the three months ended March 31, 2015 to 83.8% compared to 85.2% for the same period in 2014. The improvement in the ratio was primarily the result of the decrease in noninterest expense exceeding the decline in net interest income and noninterest income. The efficiency ratio expresses noninterest expense as a percentage of tax equivalent net interest income and noninterest income, excluding securities gains, intangible asset amortization and other real estate income and expenses.

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Income Tax Expense

Income tax expense totaled $715,000 for the three months ended March 31, 2015, for an effective tax rate of 22.5% compared to no income tax expense for the same period in 2014.

As of December 31, 2014, the Company recaptured its entire valuation allowance on deferred tax assets which had previously been established. It was determined that with significant improvements in asset quality, strengthened capital ratios, and nine quarters of profitability, combined with improving market and economic conditions, maintaining a valuation allowance was no longer required. As a result of the reversal of the valuation allowance in the fourth quarter of 2014, income tax expense resulted in 2015, whereas no provision for income taxes was required in the first quarter of 2014.

FINANCIAL CONDITION

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

Securities Available for Sale

The Company utilizes securities available for sale as a tool for managing interest rate risk, enhancing income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings. As of March 31, 2015, securities available for sale were $349,827,000, a decrease of $26,372,000, from December 31, 2014's balance of $376,199,000. Many of the securities have monthly cash flows which will provide cash flow to fund loan growth as the loan pipeline expands.

Loan Portfolio

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

The risks associated with lending activities differ among the various loan classes, and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans, and general economic conditions. All of these factors may adversely impact the borrower's ability to repay its loans, and impact the associated collateral. See Note 3, "Loans Receivable and Allowance for Loan Losses," in the Notes to the Consolidated Financial Statements for a detailed description of the Company's loan classes and differing levels of credit risk associated with each class, which information is incorporated herein by reference.

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The loan portfolio, excluding residential loans held for sale, broken out by classes as of March 31, 2015 and December 31, 2014 is as follows:

(Dollars in thousands)	March 31, 2015	December 31, 2014
Commercial real estate:		
Owner-occupied	$111,399	$100,859
Non-owner occupied	150,921	144,301
Multi-family	28,943	27,531
Non-owner occupied residential	48,806	49,315
Acquisition and development:		
1-4 family residential construction	5,883	5,924
Commercial and land development	26,239	24,237
Commercial and industrial	48,742	48,995
Municipal	60,661	61,191
Residential mortgage:		
First lien	125,752	126,491
Home equity - term	19,912	20,845
Home equity - lines of credit	94,623	89,366
Installment and other loans	5,872	5,891
	$727,753	$704,946

The loan portfolio at March 31, 2015 of $727,753,000 reflected an increase of $22,807,000, or 3.2%, from $704,946,000 at December 31, 2014. Growth was achieved principally in the commercial real estate and residential mortgage loan segments, as our sales and marketing efforts have been concentrated in these areas. Competition for new business opportunities remains strong, which may temper loan growth in future quarters.

Asset Quality

Risk Elements

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

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

Nonperforming assets include nonaccrual loans and foreclosed real estate. In addition, restructured loans still accruing and loans past due 90 days or more and still accruing are also deemed to be risk assets. For all loan classes, the accrual of interest income ceases when principal or interest is past due 90 days or more and collateral is inadequate to cover principal and interest or immediately if, in the opinion of management, full collection is unlikely. Interest will continue to accrue on loans past due 90 days or more if the collateral is adequate to cover principal and interest, and the loan is in the process of collection. Interest accrued, but not collected, as of the date of placement on nonaccrual status, is generally reversed and charged against interest income, unless fully collateralized. Subsequent payments received are either applied to the outstanding principal balance or recorded as interest income, depending on management’s assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan classes, when all the principal and interest amounts contractually due are brought current, the loans have performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contract terms of the loan.

Loans, the terms of which are modified, are classified as TDRs if a concession was granted, for legal or economic reasons, related to a debtor’s financial difficulties. Concessions granted under a TDR typically involve a temporary

deferral of

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scheduled loan payments, an extension of a loan's stated maturity date, temporary reduction in interest rates, or below market rates. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual TDRs are restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for six months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. TDRs are evaluated individually for impairment if they have been restructured during the most recent calendar year, or if they are not performing according to their modified terms.
The following table presents the Company's risk elements, including information concerning the aggregate balances of nonaccrual, restructured loans still accruing, loans past due 90 days or more, and foreclosed real estate as of March 31, 2015, December 31, 2014 and March 31, 2014. Relevant asset quality ratios are also presented.

(Dollars in thousands)	March 31, 2015		December 31, 2014		March 31, 2014	
Nonaccrual loans (cash basis)	$13,888		$14,432		$14,606	
Other real estate (OREO)	1,431		932		2,612	
Total nonperforming assets	15,319		15,364		17,218	
Restructured loans still accruing	1,096		1,100		5,487	
Loans past due 90 days or more and still accruing	0		0		497	
Total risk assets	$16,415		$16,464		$23,202	
Loans 30-89 days past due	$1,631		$1,612		$2,902	
Asset quality ratios:						
Nonaccrual loans to loans	1.91	%	2.05	%	2.17	%
Nonperforming assets to assets	1.29	%	1.29	%	1.44	%
Total nonperforming assets to total loans and OREO	2.10	%	2.18	%	2.55	%
Total risk assets to total loans and OREO	2.25	%	2.33	%	3.43	%
Total risk assets to total assets	1.38	%	1.38	%	1.94	%
Allowance for loan losses to total loans	1.99	%	2.09	%	3.04	%
Allowance for loan losses to nonaccrual loans	104.13	%	102.18	%	140.33	%
Allowance for loan losses to nonaccrual and restructured loans still accruing	96.51	%	94.95	%	102.01	%

Risk assets totaled $16,415,000 at March 31, 2015, which was a decrease of $49,000, or 0.3%, from the balance at December 31, 2014 of $16,464,000, and a decrease of $6,787,000, or 29.3% from March 31, 2014. Loans on nonaccrual status declined from $14,432,000 at December 31, 2014 to $13,888,000 at March 31, 2015, principally due to foreclosures that took place during the period, that resulted in a corresponding increase in other real estate owned. The Company continues to actively address its classified and impaired loans.

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A further breakdown of impaired loans at March 31, 2015 and December 31, 2014 is as follows:

(Dollars in thousands)	March 31, 2015			December 31, 2014		
	Nonaccrual Loans	Restructured Loans Still Accruing	Total	Nonaccrual Loans	Restructured Loans Still Accruing	Total
Commercial real estate:						
Owner occupied	$3,224	$0	$3,224	$3,288	$0	$3,288
Non-owner occupied	1,636	0	1,636	1,680	0	1,680
Multi-family	721	0	721	320	0	320
Non-owner occupied residential	962	0	962	1,500	0	1,500
Acquisition and development						
Commercial and land development	51	287	338	123	287	410
Commercial and industrial	2,216	0	2,216	2,437	0	2,437
Residential mortgage:						
First lien	4,324	809	5,133	4,509	813	5,322
Home equity - term	160	0	160	70	0	70
Home equity - lines of credit	570	0	570	479	0	479
Installment and other loans	24	0	24	26	0	26
	$13,888	$1,096	$14,984	$14,432	$1,100	$15,532

As of March 31, 2015, the Company had 92 lending relationships with loans that were considered impaired, and were included in the impaired loan balance of $14,984,000, compared to 94 lending relationships with an impaired loan balance of $15,532,000 at December 31, 2014. The exposure to these borrowers with impaired loans is summarized in the following table, along with the partial charge-offs taken to date and the specific reserves established on the relationships at March 31, 2015 and December 31, 2014.

(Dollars in thousands)	# of Relationships	Recorded Investment	Partial Charge-offs to Date	Specific Reserves at Period End
March 31, 2015				
Relationships greater than $1,000,000	2	$ 3,434	$ 0	$ 487
Relationships greater than $500,000 but less than $1,000,000	2	1,040	0	0
Relationships greater than $250,000 but less than $500,000	11	3,503	742	185
Relationships less than $250,000	77	7,007	3,386	135
	92	$ 14,984	$ 4,128	$ 807
December 31, 2014				
Relationships greater than $1,000,000	2	$ 3,687	$ 0	$ 0
Relationships greater than $500,000 but less than $1,000,000	2	1,156	0	0
Relationships greater than $250,000 but less than $500,000	11	3,558	804	0
Relationships less than $250,000	79	7,131	3,421	188
	94	$ 15,532	$ 4,225	$ 188

The Company takes partial charge-offs on collateral dependent loans whose carrying value exceeded their estimated fair value, as determined by the most recent appraisal adjusted for current (within the quarter) conditions, less costs to dispose. ASC 310 impairment reserves remain in those situations in which updated appraisals are pending, and represent management’s estimate of potential loss, or on restructured loans that are still accruing, and the impairment is based on discounted cash flows.

Of the relationships deemed to be impaired at March 31, 2015, two had an outstanding book balance in excess of $1,000,000, totaling $3,434,000. Seventy-seven of the relationships, or nearly 84% of the total number of impaired

relationships, have recorded balances less than $250,000, which reduces the likelihood of a large loss on one particular loan.
The Company's largest impaired relationship at March 31, 2015 had an outstanding balance in excess of $2,200,000 and was to a commercial business. The loans associated with this relationship were paid in full in April 2015, with no loss to the Company.

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The second relationship, with an impaired loan balance exceeding $1,000,000, was to a commercial lessor with an outstanding balance of $1,225,000. The decision to initially move the loan to nonaccrual status was made despite the loan being current as to both principal and interest, as a result of declining cash flows of the borrower and the potential for further reduction in cash available to service debt in the near future. During the three months ended March 31, 2015, a specific reserve of $487,000 was established on the loan, as the value of the real estate collateral securing the property has deteriorated, and the reserve established represents an estimate as to the collateral's fair value, less costs to dispose. An updated appraisal has been ordered, and once received, a charge-off for the amount that the loan's carrying value exceeds the fair value of the collateral, less costs to dispose, will be recorded.

In its individual loan impairment analysis, the Company determines the extent of any full or partial charge-offs that may be required, or any ASC 310 reserves that may be needed. The determination of the Company’s charge-offs or impairment reserve determination included an evaluation of the outstanding loan balance, and the related collateral securing the credit. Through a combination of collateral securing the loans and partial charge-offs taken to date, the Company believes that it has adequately provided for the potential losses that it may incur on these relationships as of March 31, 2015. However, over time, additional information may become known that could result in increased reserve allocations or, alternatively, it may be deemed that the reserve allocations exceed those that are needed.

The Company’s foreclosed real estate balance of $1,431,000 consists of 17 properties owned by the Company, seven of which were commercial properties and totaled $784,000, and 10 residential properties that totaled $647,000. The largest commercial property with a carrying value of $254,000 was land originally purchased by the Company for future expansion purposes. During 2011, it was determined that this property was no longer in the Company’s strategic plans, and as such, the Company re-designated the property as held for sale. A second commercial property is land divided into three parcels with a carrying value of $221,000. The remaining properties have carrying values less than $125,000 and are also carried at the lower of cost or fair value, less costs to dispose.

As of March 31, 2015, the Company believes the value of foreclosed assets represents their fair values, but if the real estate market remains challenging, additional charges may be needed.

Credit Risk Management

Allowance for Loan Losses

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

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

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The following tables summarize the Bank's ratings based on its internal risk rating system as of March 31, 2015 and December 31, 2014:

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
March 31, 2015						
Commercial real estate:						
Owner-occupied	$100,189	$2,529	$ 5,457	$3,224	$0	$111,399
Non-owner occupied	128,162	13,700	7,424	414	1,221	150,921
Multi-family	25,547	1,367	1,308	721	0	28,943
Non-owner occupied residential	43,174	2,870	1,800	962	0	48,806
Acquisition and development:						
1-4 family residential construction	5,883	0	0	0	0	5,883
Commercial and land development	24,352	230	1,319	338	0	26,239
Commercial and industrial	43,679	958	1,889	2,216	0	48,742
Municipal	60,661	0	0	0	0	60,661
Residential mortgage:						
First lien	120,619	0	0	5,133	0	125,752
Home equity - term	19,751	0	0	161	0	19,912
Home equity - lines of credit	93,272	654	127	570	0	94,623
Installment and other loans	5,848	0	0	24	0	5,872
	$671,137	$22,308	$ 19,324	$13,763	$1,221	$727,753
December 31, 2014						
Commercial real estate:						
Owner-occupied	$89,815	$2,686	$ 5,070	$3,288	$0	$100,859
Non-owner occupied	120,829	20,661	1,131	1,680	0	144,301
Multi-family	24,803	1,086	1,322	320	0	27,531
Non-owner occupied residential	43,020	2,968	1,827	1,500	0	49,315
Acquisition and development:						
1-4 family residential construction	5,924	0	0	0	0	5,924
Commercial and land development	22,261	233	1,333	410	0	24,237
Commercial and industrial	43,794	850	1,914	2,437	0	48,995
Municipal	61,191	0	0	0	0	61,191
Residential mortgage:						
First lien	121,160	9	0	5,290	32	126,491
Home equity - term	20,775	0	0	70	0	20,845
Home equity - lines of credit	88,164	630	93	479	0	89,366
Installment and other loans	5,865	0	0	26	0	5,891
	$647,601	$29,123	$ 12,690	$15,500	$32	$704,946

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

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Activity in the allowance for loan losses for the three months ended March 31, 2015 and 2014 is as follows:

(Dollars in thousands)	Commercial Commercial Real Estate	Commercial Acquisition and Development	Commercial Commercial and Industrial	Commercial Municipal	Commercial Total	Consumer Residential Mortgage	Consumer Installment and Other	Consumer Total	Unallocated	Total
March 31, 2015										
Balance, beginning of period	$9,462	$ 697	$ 806	$ 183	$11,148	$2,262	$ 119	$2,381	$ 1,218	$14,747
Provision for loan losses	(63)	(87)	(137)	(62)	(349)	494	15	509	(160)	0
Charge-offs	(66)	(22)	(26)	0	(114)	(201)	(20)	(221)	0	(335)
Recoveries	13	0	22	0	35	12	2	14	0	49
Balance, end of period	$9,346	$ 588	$ 665	$ 121	$10,720	$2,567	$ 116	$2,683	$ 1,058	$14,461
March 31, 2014										
Balance, beginning of period	$13,215	$ 670	$ 864	$ 244	$14,993	$3,780	$ 124	$3,904	$ 2,068	$20,965
Provision for loan losses	738	(196)	60	0	602	(481)	44	(437)	(165)	0
Charge-offs	(259)	0	(9)	0	(268)	(193)	(67)	(260)	0	(528)
Recoveries	25	0	4	0	29	6	25	31	0	60
Balance, end of period	$13,719	$ 474	$ 919	$ 244	$15,356	$3,112	$ 126	$3,238	$ 1,903	$20,497

The allowance for loan losses totaled $14,461,000 at March 31, 2015, a decrease of $286,000 from $14,747,000 at December 31, 2014, due to a net charge-offs, of $286,000 during the period. Despite the reduction in the allowance for loan losses balance from December 31, 2014, allowance coverage metrics remain strong, with the allowance for total loans ratio at 1.99% at March 31, 2015, and the allowance for loan losses to nonaccrual loans coverage ratio at 104.13%.
Net charge-offs were $286,000 for the three months ended March 31, 2015, compared to $468,000 for the same period in 2014, resulting in a ratio of annualized net charge-offs to average loans outstanding of 0.16% and 0.28%, respectively. For both periods presented, the favorable historical charge-off data combined with relatively stable economic and market conditions has resulted in the determination that no additional provision for loan losses was required to offset net charge-offs, additional reserves needed on impaired loans, or for loan growth experienced during the periods.

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The following summarizes the ending loan balance individually or collectively evaluated for impairment based upon loan type, as well as the allowance for loan losses allocation for each at March 31, 2015 and December 31, 2014.

(Dollars in thousands)	Commercial					Consumer				
	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Total	Residential Mortgage	Installment and Other	Total	Unallocated	Total
March 31, 2015										
Loans allocated by:										
Individually evaluated for impairment	$ 6,542	$ 338	$ 2,216	$ 0	$ 9,096	$ 5,864	$ 24	$ 5,888	$ 0	$ 14,984
Collectively evaluated for impairment	333,527	31,784	46,526	60,661	472,498	234,423	5,848	240,271	0	712,769
	$ 340,069	$ 32,122	$ 48,742	$ 60,661	$ 481,594	$ 240,287	$ 5,872	$ 246,159	$ 0	$ 727,753
Allowance for loan losses allocated by:										
Individually evaluated for impairment	$ 653	$ 0	$ 0	$ 0	$ 653	$ 142	$ 12	$ 154	$ 0	$ 807
Collectively evaluated for impairment	8,693	588	665	121	10,067	2,425	104	2,529	1,058	13,654
	$ 9,346	$ 588	$ 665	$ 121	$ 10,720	$ 2,567	$ 116	$ 2,683	$ 1,058	$ 14,461
December 31, 2014										
Loans allocated by:										
Individually evaluated for impairment	$ 6,788	$ 410	$ 2,437	$ 0	$ 9,635	$ 5,871	$ 26	$ 5,897	$ 0	$ 15,532
Collectively evaluated for impairment	315,218	29,751	46,558	61,191	452,718	230,831	5,865	236,696	0	689,414
	$ 322,006	$ 30,161	$ 48,995	$ 61,191	$ 462,353	$ 236,702	$ 5,891	$ 242,593	$ 0	$ 704,946
Allowance for loan losses allocated by:										
Individually evaluated for impairment	$ 2	$ 0	$ 0	$ 0	$ 2	$ 173	$ 13	$ 186	$ 0	$ 188
Collectively evaluated for	9,460	697	806	183	11,146	2,089	106	2,195	1,218	14,559

impairment									
$9,462	$ 697	$ 806	$ 183	$ 11,148	$ 2,262	$ 119	$ 2,381	$ 1,218	$ 14,747

The allowance for loan losses allocations presented above represent the reserve allocations on loan balances outstanding at March 31, 2015 and December 31, 2014. In addition to the reserve allocations on impaired loans noted above, 28 loans, with aggregate outstanding general ledger principal balances of $3,428,000, have had cumulative partial charge-offs to the allowance for loan losses recorded totaling $4,128,000 at March 31, 2015. As updated appraisals were received on collateral dependent loans, partial charge-offs were taken to the extent the loans' principal balance exceeded their fair value.

Management believes the allocation of the allowance for loan losses between the various loan segments adequately reflects the probable incurred credit losses in each portfolio, and is based on the methodology outlined in "Note 3 – Loans Receivable and Allowance for Loan Losses" included in the Notes to the Consolidated Financial Statements. Management re-evaluates and makes certain enhancements to its methodology used to establish a reserve to better reflect the risks inherent in the different segments of the portfolio, particularly in light of changes in levels of charge-offs, with noticeable differences between the different loan segments. Management believes these enhancements to the allowance for loan losses methodology improve the accuracy of quantifying losses presently inherent in the portfolio. Management charges actual loan losses to the reserve and bases the provision for loan losses on the overall analysis taking the methodology into account.

The unallocated portion of the allowance for loan losses reflects estimated inherent losses within the portfolio that have not been detected. This reserve results due to risk of error in the specific and general reserve allocation, other potential exposure in the loan portfolio, variances in management's assessment of national and local economic conditions and other factors management believes appropriate at the time. The unallocated portion of the allowance has decreased from $1,218,000 at December 31, 2014 to $1,058,000 at March 31, 2015 and represents 7.3% of the entire allowance for loan losses balance at March 31, 2015.

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

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Deposits

Total deposits were $945,756,000 at March 31, 2015, a decrease of $3,948,000, or 0.4%, from $949,704,000 at December 31, 2014. Despite the decrease in total deposits, there was a shift to non-interest bearing deposits, which grew by $13,291,000, or 11.4%. A decrease was experienced in time deposits, which are interest rate sensitive, and the Company allowed them to runoff and replace the funding with cheaper alternatives.

Capital Adequacy and Regulatory Matters

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

Total shareholders' equity increased $4,589,000 from $127,265,000 at December 31, 2014 to $131,854,000 at March 31, 2015. The primary reason for the increase in shareholders' equity was the $2,462,000 net income retained for the three months ended March 31, 2015, combined with a $1,946,000 increase in accumulated other comprehensive income, net of taxes.

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

Quantitative measures established by regulators to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (as set forth in the following table) of total and Tier 1 capital (as defined in regulations) to risk-weighted assets (as defined), common equity Tier 1 capital (as defined) to risk weighted assets, and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of March 31, 2015 and December 31, 2014, the Company and the Bank meet all capital adequacy requirements to which they are subject.

Effective January 1, 2015, the Company and the Bank became subject to the Basel III Capital Rules, which substantially revised the risk-based capital requirements in comparison to the existing U.S. risk-based capital rules which were in effect through December 31, 2014. The Basel III Capital Rules, among other things, (i) introduced a new capital measure called "Common Equity Tier 1" ("CET1"), (ii) increased the minimum requirements for Tier 1 Capital ratio as well as the minimum to be considered well capitalized under prompt corrective action; (iii) and introduced the 'capital conservation buffer", designed to absorb losses during periods of economic stress. Institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer may face constraints on dividends, equity repurchases and discretionary bonuses to executive officers based on the amount of the shortfall.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Under current capital standards, the effects of accumulated other comprehensive income items included in capital are excluded for the purposes of determining regulatory capital ratios. Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive items are no longer excluded; except for unrealized gains or losses on securities available for sale since the Company and Bank made the one-time permanent election to continue to exclude these items.

Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and will be phased-in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter until fully phased-in at January 1, 2018). The implementation of the capital conservation buffer will begin on January 1, 2016 at the

0.625% level and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

As of March 31, 2015, $3,219,000 of the Company's deferred tax asset was disallowed for Tier 1 capital purposes pertaining to tax attribute deferred tax assets, including net operating loss carryforwards, net of a portion of deferred tax liabilities, subject to Basel III transition rules.

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

- Greater restrictions on the amount of deferred tax assets that can be included in CET1 capital with assets relating to net operating loss and credit carry forwards being excluded, and a 10% - 15% limitation on deferred tax assets arising from temporary differences that cannot be realized through net operating loss carry backs.
- Applying a 150% risk weight for certain high volatility commercial real estate acquisition, development and construction loans, compared to 100% risk weight previously in place;
- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due or in nonaccrual status, compared to 100% risk weight previously in place; and
- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, compared to 0% previously in place.

The allowance for credit losses, including the allowance for loan losses and reserve for off-balance sheet credit commitments, is included as Tier 2 capital to the extent it does not exceed 1.25% of risk weighted assets. The amount that exceeds 1.25% of risk weighted assets, is disallowed as Tier 2 capital, but also reduces the Company's risk weighted assets. As of March 31, 2015, $4,729,000 of the allowance for credit losses was excluded from Tier 2 capital.

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Regulatory Capital. As of March 31, 2015 and December 31, 2014, the Bank was considered well capitalized under applicable banking regulations. The Company's and the Bank's capital ratios as of March 31, 2015 and December 31, 2014 were as follows:

	Actual			Minimum Capital Requirement			Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions		
(Dollars in thousands)	Amount	Ratio		Amount	Ratio		Amount	Ratio	
March 31, 2015									
Total capital to risk weighted assets									
Orrstown Financial Services, Inc.	$135,008	16.8	%	$64,192	8.0	%	n/a	n/a	
Orrstown Bank	132,893	16.6	%	64,161	8.0	%	$80,202	10.0	%
Tier 1 capital to risk weighted assets									
Orrstown Financial Services, Inc.	124,847	15.6	%	48,144	6.0	%	n/a	n/a	
Orrstown Bank	122,748	15.3	%	48,121	6.0	%	64,161	8.0	%
CET1 to risk weighted assets									
Orrstown Financial Services, Inc.	124,847	15.6	%	36,108	4.5	%	n/a	n/a	
Orrstown Bank	122,748	15.3	%	36,091	4.5	%	52,131	6.5	%
Tier 1 capital to average assets									
Orrstown Financial Services, Inc.	124,847	10.6	%	47,110	4.0	%	n/a	n/a	
Orrstown Bank	122,748	10.4	%	47,169	4.0	%	58,961	5.0	%
December 31, 2014									
Total capital to risk weighted assets									
Orrstown Financial Services, Inc.	$119,713	16.8	%	$56,859	8.0	%	n/a	n/a	
Orrstown Bank	118,540	16.7	%	56,835	8.0	%	$71,043	10.0	%
Tier 1 capital to risk weighted assets									
Orrstown Financial Services, Inc.	110,750	15.6	%	28,429	4.0	%	n/a	n/a	
Orrstown Bank	109,581	15.4	%	28,417	4.0	%	42,626	6.0	%
Tier 1 capital to average assets									
Orrstown Financial Services, Inc.	110,750	9.5	%	46,496	4.0	%	n/a	n/a	
Orrstown Bank	109,581	9.4	%	46,518	4.0	%	58,148	5.0	%

As noted above, the Bank's capital ratios exceed the regulatory minimums to be considered well capitalized under applicable banking regulations. The Company routinely evaluates its capital levels in light of its risk profile to assess its capital needs.

On January 8, 2013, the Company filed a shelf registration statement on Form S-3 with the Commission, covering up to an aggregate of $80,000,000 worth of common stock, preferred stock, and warrants. To date, the Company has not issued any of the securities registered under this shelf registration statement.

In October 2011, the Company announced it had discontinued its quarterly dividend, which was the result of regulatory guidance from the Federal Reserve Bank. Under the Written Agreement entered into with the Federal Reserve Bank in March 2012, the Company was restricted from paying any dividends or repurchasing any stock without prior regulatory approval. The Written Agreement was terminated by the Federal Reserve Bank on April 1, 2015. On April 22, 2015, the Company declared a dividend of $0.07 per common share, payable May 21, 2015 to shareholders of record as of May 8, 2015.

Liquidity

The primary function of asset/liability management is to ensure adequate liquidity and manage the Company's sensitivity to changing interest rates. Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Our primary sources of funds consist of deposit inflows, loan

repayments, maturities and sales of investment securities, the sale of mortgage loans and borrowings from the Federal Home Loan Bank of Pittsburgh. While maturities and

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scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is defined as the exposure to interest rate risk, foreign currency exchange rate risk, commodity price risk, and other relevant market rate or price risks. For domestic banks, including the Company, the majority of market risk is related to interest rate risk. Interest rate sensitivity management requires the maintenance of an appropriate balance between reward, in the form of net interest margin, and risk as measured by the amount of earnings and value at risk.

Interest Rate Risk

Interest rate risk is the exposure to fluctuations in the Company's future earnings (earnings at risk) and value (value at risk) resulting from changes in interest rates. This exposure results from differences between the amounts of interest earning assets and interest bearing liabilities that reprice within a specified time period as a result of scheduled maturities, scheduled and unscheduled repayments, the propensity of borrowers and depositors to react to changes in their economic interests, and security and contractual interest rate changes.

Management, through its asset/liability management process, attempts to manage the level of repricing and maturity mismatch so that fluctuations in net interest income is maintained within policy limits across a range of market conditions while satisfying liquidity and capital requirements. Management recognizes that a certain amount of interest rate risk is inherent, appropriate and necessary to ensure the Company's profitability. Thus, the goal of interest rate risk management is to evaluate the amount of reward for taking risk and adjusting both the size and composition of the balance sheet relative to the level of reward available for taking risk.

Management endeavors to control the exposure to changes in interest rates by understanding, reviewing and making decisions based on its risk position. The Company primarily uses the securities portfolio, FHLB advances, and brokered deposits to manage its interest rate risk position. Additionally, pricing, promotion and product development activities are directed in an effort to emphasize the loan and deposit term or repricing characteristics that best meet current interest rate risk objectives. At present, there is no use of hedging instruments.

The asset/liability committee operates under management policies defining guidelines and limits on the level of risk. These policies are approved by the Board of Directors.

The Company uses simulation analysis to assess earnings at risk and net present value analysis to assess value at risk. These methods allow management to regularly monitor both the direction and magnitude of the Company's interest rate risk exposure. These modeling techniques involve assumptions and estimates that inherently cannot be measured with complete precision. Key assumptions in the analyses include maturity and repricing characteristics of assets and liabilities, prepayments on amortizing assets, non-maturity deposit sensitivity, and loan and deposit pricing. These assumptions are inherently uncertain due to the timing, magnitude and frequency of rate changes and changes in market conditions and management strategies, among other factors. However, the analyses are useful in quantifying risk and provide a relative gauge of the Company's interest rate risk position over time.

Earnings at Risk

Simulation analysis evaluates the effect of upward and downward changes in market interest rates on future net interest income. The analysis involves changing the interest rates used in determining net interest income over the next twelve months. The resulting percentage change in net interest income in various rate scenarios is an indication of the Company's short-term interest rate risk. The analysis assumes recent trends in new loan and deposit volumes will continue while the amount of investment securities remains constant. Additional assumptions are applied to modify volumes and pricing under the various rate scenarios. These include prepayment assumptions on mortgage assets, sensitivity of non-maturity deposit rates, and other factors deemed significant.

The simulation analysis results are presented in Table 7a. These results, as of March 31, 2015, indicate that the Company would expect net interest income to decrease over the next twelve months by 2.4% assuming a downward shock in market interest rates of 1.00%, and to decrease by 3.8% assuming an upward shock of 2.00%. This profile

reflects an acceptable short-

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term interest rate risk position. However, a decrease in interest rates of 1.00% would create an environment in which deposit rates could not practically decline further, thus decreasing net interest income.

Earnings at risk simulations for December 31, 2014, exhibited greater sensitivity to rising and declining interest rates.

Value at Risk

The net present value analysis provides information on the risk inherent in the balance sheet that might not be taken into account in the simulation analysis due to the short time horizon used in that analysis. The net present value of the balance sheet is defined as the discounted present value of expected asset cash flows minus the discounted present value of the expected liability cash flows. The analysis involves changing the interest rates used in determining the expected cash flows and in discounting the cash flows. The resulting percentage change in net present value in various rate scenarios is an indication of the longer term repricing risk and options embedded in the balance sheet.

The net present value analysis results are presented in Table 7b. These results, as of March 31, 2015, indicate that the net present value would increase 1.0% assuming a downward shift in market interest rates of 1.00% and decrease 3.1% if interest rates shifted up 2.00% in the same manner.

Table 7a - Earnings at Risk

	% Change in Net Interest Income	
Change in Market Interest Rates	March 31, 2015	December 31, 2014
(100)	(2.4%)	(1.5%)
200	(3.8%)	(6.1%)

Table 7b - Value at Risk

	% Change in Net Interest Income	
Change in Market Interest Rates	March 31, 2015	December 31, 2014
(100)	1.0%	2.2%
200	(3.1%)	(6.8%)

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

The Company’s Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company’s disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of March 31, 2015. Based on such evaluation, such officers have concluded that the Company’s disclosure controls and procedures were designed and functioning effectively, as of March 31, 2015, to provide reasonable assurance that the information required to be disclosed by the Company in reports filed under the Securities Exchange Act of 1934, as amended, is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and (ii) accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure.

(b) Changes in Internal Control Over Financial Reporting

No change in the Company’s internal control over financial reporting occurred during the fiscal quarter ended March 31, 2015, that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1 – Legal Proceedings

The nature of Orrstown Financial Services, Inc.’s business generates a certain amount of litigation involving matters arising out of the ordinary course of business. Except as described in Note 10, “Contingencies” to the Notes to the Consolidated Financial Statements, which information is incorporated herein by reference, in the opinion of management, there are no material pending legal proceedings that are expected to have a material effect on the results of operations, liquidity, or the financial position of the Company at this time.

Item 1A – Risk Factors

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There have been no material changes from the risk factors as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2014, with the exception of the following revisions.
The risk factors entitled, "The Company is subject to restrictions and conditions of a formal agreement issued by the Federal Reserve Bank of Philadelphia. Failure to comply with this formal agreement could result in additional enforcement action against us, including the imposition of monetary penalties" and "The Company may not be able to pay any cash dividends or conduct any stock repurchases for the foreseeable future" are no longer applicable as a result of the release from the Written Order with the Federal Reserve Bank of Philadelphia on April 2, 2015.
In addition, the risk factor entitled, "The Company is a holding company dependent for liquidity on payments from the Bank, its sole subsidiary, which is subject to restrictions" is replaced with the following:
The Company is a holding company dependent for liquidity on payments from the Bank, its sole subsidiary, which is subject to restrictions.
The Company is a holding company and depends on dividends, distributions and other payments from the Bank to fund dividend payments, if permitted, and to fund all payments on obligations. The Bank is subject to laws that restrict dividend payments or authorize regulatory bodies to block or reduce the flow of funds from it to us. In addition, our right to participate in a distribution of assets upon the Bank's liquidation or reorganization is subject to the prior claims of the Bank's creditors.

Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds
For the quarter ended March 31, 2015, there were no repurchases of common equity securities by the Company under the announced Stock Repurchase Plan due to, among other reasons, the restriction on stock repurchases imposed by the Written Agreement with the Federal Reserve Bank. However, with the termination of the Written Agreement by the Federal Reserve Bank, the restriction on stock repurchases by the Company has been removed.
The Company did not sell any unregistered securities during the quarter ended March 31, 2015.

Item 3 – Defaults Upon Senior Securities
Not applicable

Item 4 – Mine Safety Disclosures
Not applicable

Item 5 – Other Information
None

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Item 6 – Exhibits

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

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

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SIGNATURES

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

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

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

Date: May 8, 2015

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ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES
EXHIBIT INDEX

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

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