

ORRSTOWN FINANCIAL SERVICES INC  
Form 10-Q  
August 05, 2016  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10 – Q

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

For the quarterly period ended June 30, 2016

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 (I.R.S. Employer  
Incorporation or Organization) Identification No.)  
77 East King Street, P. O. Box 250, Shippensburg, Pennsylvania 17257  
(Address of Principal Executive Offices) (Zip Code)  
Registrant’s Telephone Number, Including Area Code: (717) 532-6114

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

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

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

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

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

Number of shares outstanding of the registrant’s Common Stock as of July 29, 2016: 8,280,866.

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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)   | June 30,<br>2016 | December 31,<br>2015 |
|---|------------------|----------------------|
| Assets  |                  |                      |
| Cash and due from banks   | \$12,940         | \$ 11,412            |
| Interest bearing deposits with banks  | 50,709           | 16,928               |
| Cash and cash equivalents   | 63,649           | 28,340               |
| Restricted investments in bank stocks   | 5,780            | 8,720                |
| Securities available for sale   | 324,540          | 394,124              |
| Loans held for sale   | 6,627            | 5,917                |
| Loans   | 831,933          | 781,713              |
| Less: Allowance for loan losses   | (13,440)         | (13,568)             |
| Net loans   | 818,493          | 768,145              |
| Premises and equipment, net   | 31,379           | 23,960               |
| Cash surrender value of life insurance  | 31,653           | 31,224               |
| Intangible assets   | 132              | 207                  |
| Accrued interest receivable   | 3,759            | 3,845                |
| Other assets  | 25,341           | 28,334               |
| Total assets  | \$1,311,353      | \$ 1,292,816         |
| Liabilities   |                  |                      |
| Deposits:   |                  |                      |
| Non-interest bearing  | \$147,680        | \$ 131,390           |
| Interest bearing  | 940,289          | 900,777              |
| Total deposits  | 1,087,969        | 1,032,167            |
| Short-term borrowings   | 43,393           | 89,156               |
| Long-term debt  | 24,331           | 24,495               |
| Accrued interest and other liabilities  | 14,621           | 13,937               |
| Total liabilities   | 1,170,314        | 1,159,755            |
| 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; 8,357,941 and 8,320,479 shares issued; 8,276,866 and 8,272,591 shares outstanding | 437              | 435                  |
| Additional paid - in capital  | 124,807          | 124,317              |
| Retained earnings   | 9,787            | 7,939                |
| Accumulated other comprehensive income  | 7,421            | 1,199                |
| Treasury stock—common, 81,075 and 47,888 shares, at cost  | (1,413)          | (829)                |
| Total shareholders' equity  | 141,039          | 133,061              |
| Total liabilities and shareholders' equity  | \$1,311,353      | \$ 1,292,816         |

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

|   | Three Months |          | Six Months |          |
|---|--------------|----------|------------|----------|
|   | Ended        |          | Ended      |          |
| (Dollars in thousands, except per share data)       | June 30,     | June 30, | June 30,   | June 30, |
|   | 2016         | 2015     | 2016       | 2015     |
| Interest and dividend income                        |              |          |            |          |
| Interest and fees on loans                          | \$8,384      | \$ 7,749 | \$16,375   | \$15,076 |
| Interest and dividends on investment securities     |              |          |            |          |
| Taxable   | 1,368        | 1,660    | 2,832      | 3,480    |
| Tax-exempt  | 441          | 142      | 882        | 197      |
| Short-term investments                              | 79           | 17       | 144        | 43       |
| Total interest and dividend income                  | 10,272       | 9,568    | 20,233     | 18,796   |
| Interest expense                                    |              |          |            |          |
| Interest on deposits                                | 1,191        | 780      | 2,330      | 1,557    |
| Interest on short-term borrowings                   | 25           | 81       | 91         | 141      |
| Interest on long-term debt                          | 105          | 109      | 211        | 185      |
| Total interest expense                              | 1,321        | 970      | 2,632      | 1,883    |
| Net interest income                                 | 8,951        | 8,598    | 17,601     | 16,913   |
| Provision for loan losses                           | 0            | 0        | 0          | 0        |
| Net interest income after provision for loan losses | 8,951        | 8,598    | 17,601     | 16,913   |
| Noninterest income                                  |              |          |            |          |
| Service charges on deposit accounts                 | 1,372        | 1,299    | 2,675      | 2,492    |
| Other service charges, commissions and fees         | 289          | 265      | 449        | 438      |
| Trust department income                             | 1,188        | 1,198    | 2,524      | 2,445    |
| Brokerage income                                    | 577          | 548      | 1,026      | 985      |
| Mortgage banking activities                         | 727          | 793      | 1,369      | 1,313    |
| Earnings on life insurance                          | 270          | 233      | 538        | 462      |
| Other income  | 114          | 194      | 201        | 234      |
| Investment securities gains                         | 0            | 353      | 1,420      | 1,882    |
| Total noninterest income                            | 4,537        | 4,883    | 10,202     | 10,251   |
| Noninterest expenses                                |              |          |            |          |
| Salaries and employee benefits                      | 6,312        | 6,158    | 12,495     | 12,058   |
| Occupancy expense                                   | 592          | 562      | 1,118      | 1,186    |
| Furniture and equipment                             | 748          | 763      | 1,534      | 1,506    |
| Data processing                                     | 519          | 526      | 1,154      | 1,037    |
| Telephone and communication                         | 190          | 171      | 366        | 361      |
| Automated teller and interchange fees               | 237          | 215      | 398        | 421      |
| Advertising and bank promotions                     | 355          | 324      | 811        | 569      |
| FDIC insurance                                      | 223          | 184      | 455        | 430      |
| Legal fees  | 225          | 476      | 406        | 689      |
| Other professional services                         | 345          | 344      | 684        | 643      |
| Directors compensation                              | 257          | 170      | 488        | 327      |
| Collection and problem loan                         | 96           | 102      | 148        | 198      |
| Real estate owned expenses                          | 58           | 49       | 101        | 74       |
| Taxes other than income                             | 253          | 226      | 408        | 452      |
| Intangible asset amortization                       | 24           | 54       | 75         | 105      |
| Legal reserve                                       | 1,000        | 0        | 1,000      | 0        |
| Other operating expenses                            | 1,124        | 1,334    | 2,038      | 2,108    |

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|                            |        |          |         |         |
|----------------------------|--------|----------|---------|---------|
| Total noninterest expenses | 12,558 | 11,658   | 23,679  | 22,164  |
| Income before income taxes | 930    | 1,823    | 4,124   | 5,000   |
| Income tax expense         | 252    | 321      | 866     | 1,036   |
| Net income                 | \$678  | \$ 1,502 | \$3,258 | \$3,964 |
| Per share information:     |        |          |         |         |
| Basic earnings per share   | \$0.08 | \$ 0.19  | \$0.40  | \$0.49  |
| Diluted earnings per share | 0.08   | 0.18     | 0.40    | 0.49    |
| Dividends per share        | 0.09   | 0.07     | 0.17    | 0.07    |

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

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

| (Dollars in thousands)   | Three Months Ended |                  | Six Months Ended |                  |
|--|--------------------|------------------|------------------|------------------|
|  | June 30,<br>2016   | June 30,<br>2015 | June 30,<br>2016 | June 30,<br>2015 |
| Net income   | \$ 678             | \$ 1,502         | \$3,258          | \$3,964          |
| Other comprehensive income, net of tax:  |                    |                  |                  |                  |
| Unrealized gains (losses) on securities available for sale arising during the period | 4,596              | (3,918 )         | 10,992           | 605              |
| Reclassification adjustment for gains realized in net income                         | 0                  | (353 )           | (1,420 )         | (1,882 )         |
| Net unrealized gains (losses)  | 4,596              | (4,271 )         | 9,572            | (1,277 )         |
| Tax effect   | (1,609 )           | 1,494            | (3,350 )         | 446              |
| Total other comprehensive income (loss), net of tax and reclassification adjustments | 2,987              | (2,777 )         | 6,222            | (831 )           |
| Total comprehensive income (loss)  | \$ 3,665           | \$ (1,275 )      | \$9,480          | \$3,133          |

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



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

| (Dollars in thousands, except per share data)                                    | Six Months Ended June 30, 2016 and 2015 |                            |                   |  |                | Total Shareholders' Equity |
|--|---|----------------------------|-------------------|--|----------------|----------------------------|
|  | Common Stock                            | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock |                            |
| Balance, January 1, 2015   | \$430                                   | \$123,392                  | \$1,887           | \$1,576                                | \$(20)         | \$127,265                  |
| Net income   | 0                                       | 0                          | 3,964             | 0                                      | 0              | 3,964                      |
| Total other comprehensive income (loss), net of taxes                            | 0                                       | 0                          | 0                 | (831)                                  | 0              | (831)                      |
| Cash dividends (\$0.07 per share)  | 0                                       | 0                          | (579)             | 0                                      | 0              | (579)                      |
| Stock-based compensation plans:  |   |                            |                   |  |                |                            |
| Issuance of stock (55,417 shares), including compensation expense of \$291       | 6                                       | 347                        | 0                 | 0                                      | 0              | 353                        |
| Issuance of stock through dividend reinvestment plan (5,239 shares)              | 0                                       | 90                         | 0                 | 0                                      | 0              | 90                         |
| Balance, June 30, 2015   | \$436                                   | \$123,829                  | \$5,272           | \$745                                  | \$(20)         | \$130,262                  |
| Balance, January 1, 2016   | \$435                                   | \$124,317                  | \$7,939           | \$1,199                                | \$(829)        | \$133,061                  |
| Net income   | 0                                       | 0                          | 3,258             | 0                                      | 0              | 3,258                      |
| Total other comprehensive income, net of taxes                                   | 0                                       | 0                          | 0                 | 6,222                                  | 0              | 6,222                      |
| Cash dividends (\$0.17 per share)  | 0                                       | 0                          | (1,410)           | 0                                      | 0              | (1,410)                    |
| Stock-based compensation plans:  |   |                            |                   |  |                |                            |
| Issuance of stock (37,462 shares), including compensation expense of \$496       | 2                                       | 494                        | 0                 | 0                                      | 0              | 496                        |
| Issuance of treasury stock (2,461 shares), including compensation expense of \$3 | 0                                       | (4)                        | 0                 | 0                                      | 47             | 43                         |
| Acquisition of treasury stock (35,648 shares)                                    | 0                                       | 0                          | 0                 | 0                                      | (631)          | (631)                      |
| Balance, June 30, 2016   | \$437                                   | \$124,807                  | \$9,787           | \$7,421                                | \$(1,413)      | \$141,039                  |

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)  | Six Months Ended |                  |
|---|------------------|------------------|
|   | June 30,<br>2016 | June 30,<br>2015 |
| Cash flows from operating activities  |                  |                  |
| Net income  | \$3,258          | \$3,964          |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| Amortization of premiums on securities available for sale                         | 2,577            | 3,027            |
| Depreciation and amortization   | 1,458            | 1,463            |
| Provision for loan losses   | 0                | 0                |
| Stock-based compensation  | 499              | 291              |
| Gain on sales of loans originated for sale  | (1,164 )         | (1,099 )         |
| Mortgage loans originated for sale  | (44,052 )        | (41,052 )        |
| Proceeds from sales of loans originated for sale                                  | 44,237           | 40,987           |
| Net gain on disposal of other real estate owned                                   | (92 )            | (173 )           |
| Writedown of other real estate owned  | 95               | 0                |
| Net loss on disposal of premises and equipment                                    | 46               | 0                |
| Deferred income taxes   | 743              | 987              |
| Investment securities gains   | (1,420 )         | (1,882 )         |
| Earnings on cash surrender value of life insurance                                | (538 )           | (462 )           |
| Decrease (increase) in accrued interest receivable                                | 86               | (262 )           |
| Increase (decrease) in accrued interest payable and other liabilities             | 684              | (184 )           |
| Other, net  | (1,045 )         | (688 )           |
| Net cash provided by operating activities   | 5,372            | 4,917            |
| Cash flows from investing activities  |                  |                  |
| Proceeds from sales of available for sale securities                              | 64,743           | 60,594           |
| Maturities, repayments and calls of available for sale securities                 | 13,258           | 16,712           |
| Purchases of available for sale securities  | 0                | (79,965 )        |
| Net (investment) redemptions of restricted investments in bank stocks             | 2,940            | (849 )           |
| Net increase in loans   | (50,762 )        | (48,288 )        |
| Purchases of bank premises and equipment  | (8,585 )         | (683 )           |
| Improvements to other real estate owned   | (39 )            | 0                |
| Proceeds from disposal of other real estate owned                                 | 508              | 847              |
| Net cash provided by (used in) investing activities                               | 22,063           | (51,632 )        |
| Cash flows from financing activities  |                  |                  |
| Net increase in deposits  | 55,802           | 13,150           |
| Net (decrease) increase in short term borrowings                                  | (45,763 )        | 16,534           |
| Proceeds from long-term debt  | 0                | 20,000           |
| Payments on long-term debt  | (164 )           | (10,157 )        |
| Dividends paid  | (1,410 )         | (579 )           |
| Net proceeds from issuance of common stock  | 0                | 152              |
| Acquisition of treasury stock   | (631 )           | 0                |
| Issuance of treasury stock  | 40               | 0                |
| Net cash provided by financing activities   | 7,874            | 39,100           |
| Net increase (decrease) in cash and cash equivalents                              | 35,309           | (7,615 )         |
| Cash and cash equivalents at beginning of period                                  | 28,340           | 31,409           |
| Cash and cash equivalents at end of period  | \$63,649         | \$23,794         |
| Supplemental disclosures of cash flow information:                                |                  |                  |

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Cash paid during the period for:

|              |         |         |
|--------------|---------|---------|
| Interest     | \$2,620 | \$1,898 |
| Income taxes | 450     | 0       |

Supplemental schedule of noncash investing activities:

|   |       |       |
|---|-------|-------|
| Other real estate acquired in settlement of loans | \$414 | \$804 |
|---|-------|-------|

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 26 offices in Berks, Cumberland, Dauphin, Franklin, Lancaster, and Perry Counties of Pennsylvania and in Washington County, Maryland. The Bank engages in lending services for commercial, residential, commercial mortgages, construction, municipal, 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 condensed consolidated financial statements of the Company and its subsidiary are presented for the three and six months ended June 30, 2016 and 2015 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, 2015 is condensed from audited year-end financial statements. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes thereto, included in the Annual Report on Form 10-K for the year ended December 31, 2015. The consolidated financial statements include the accounts of the Company and the Bank. Operating results for the three and six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. 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 generally grants commercial, residential, construction, municipal, and various forms of consumer lending 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, and short-term borrowings.

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 June 30, 2016 and December 31, 2015, 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”).

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

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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 June 30, 2016. However, security impairment analysis is completed quarterly and the determination that no impairment had occurred as of June 30, 2016 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 June 30, 2016 and December 31, 2015, 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 June 30, 2016 or December 31, 2015.

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

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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 in connection with the modification, for legal or economic reasons, related to the 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, a 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 on a quarterly basis including monitoring of performance 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.

**Loan Commitments and Related Financial Instruments** – Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

**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 June 30, 2016 and December 31, 2015, the balance of loans serviced for others was \$322,576,000 and \$317,793,000.

**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.

**Cash Surrender Value of Life Insurance** – The Company has purchased life insurance policies on certain employees. Company owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

**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.



Intangible Assets – Intangible assets represent purchased assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights. The Company’s intangible assets have finite lives and are amortized, on a straight line basis, over their estimated lives, generally 10 years for deposit premiums and 15 years for customer lists.

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**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. The balance of mortgage servicing rights was \$2,698,000 and \$2,672,000 as of June 30, 2016 and December 31, 2015, and is included in other assets.

**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 the real estate is carried at the lower of carrying amount or fair value less estimated costs to sell. Foreclosed real estate totaled \$651,000 and \$710,000 as of June 30, 2016 and December 31, 2015 and is included in other assets.

**Investments in Real Estate Partnerships** – The Company currently has a 99% limited partner interest in several real estate partnerships in central Pennsylvania. These investments are affordable housing projects which entitle the Company to tax deductions and credits that expire through 2025. The Company accounts for its investments in affordable housing projects under the proportional amortization method when the criteria are met, which is limited to one investment entered into in 2015. Investments prior to 2015 did not meet the criteria, and are accounted for under the equity method of accounting. The recorded investment in these real estate partnerships, included in other assets in the balance sheet, totaled \$5,187,000 and \$5,450,000 as of June 30, 2016 and December 31, 2015, of which \$2,098,000 and \$2,205,000 are accounted for under the proportional amortization method, respectively.

Losses accounted for under the equity method of \$89,000 and \$99,000 were recorded for the three months ended June 30, 2016 and 2015, and \$178,000 and \$184,000 for the six months ended June 30, 2016 and 2015, and are included in other noninterest income. Losses on the investments accounted for under the proportional amortization method of \$53,000 for the three months ended June 30, 2016, and \$86,000 for the six months ended June 30, 2016, net of federal income tax benefit, is netted against income tax expense. The Company recognized federal tax credits from the projects totaling \$184,000 and \$119,000 during the three months ended June 30, 2016 and 2015, and \$368,000, and \$238,000 during the six months ended June 30, 2016 and 2015, which is included in income tax expense.

**Advertising** – The Company follows the policy of charging costs of advertising to expense as incurred. Advertising expense was \$202,000 and \$144,000 for the three months ended June 30, 2016 and 2015, and \$353,000 and \$256,000 for the six months ended June 30, 2016 and 2015.

**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 Repurchase 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. Repurchase agreements are secured by U.S. Government Sponsored Enterprises mortgage-backed securities and mature overnight.

Stock Compensation Plans – The Company has stock compensation plans that cover employees and non-employee directors. Stock compensation accounting guidance (Financial Accounting Standards Board ("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

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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.

**Loss Contingencies** – Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

**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. The component of accumulated other comprehensive income, net of taxes, at June 30, 2016 and December 31, 2015 consisted of unrealized gains on securities available for sale and totaled \$7,421,000 and \$1,199,000.

**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 2015 consolidated financial statements have been reclassified to conform to the 2016 presentation. Reclassifications had no effect on prior year net income or shareholders' equity.

**Recent Accounting Pronouncements** – In May 2014, the FASB issued ASU 2014-9, Revenue from Contracts with Customers (Topic 606). ASU 2014-9, as amended, 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. These amendments are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted only as of annual reporting periods beginning after December 15, 2016,

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including interim reporting periods within that period. The Company is evaluating the impact of this standard on its financial position and results of operations.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The update provides updated accounting and reporting requirements for both public and non-public entities. The most significant provisions that will impact the Company are: 1) equity securities available for sale will be measured at fair value, with the changes in fair value recognized in the income statement; 2) the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments at amortized cost on the balance sheet has been eliminated; 3) a provision to permit the utilization of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; 4) a requirement for separate presentation of both financial assets and liabilities by measurement category and form of financial asset on the balance sheet or accompanying notes to the financial statements. The update will be effective for interim and annual periods beginning after December 15, 2017, using a cumulative-effect adjustment to the balance sheet as of the beginning of the year of adoption. Early adoption is not permitted. The Company is evaluating the impact of this standard on its financial position and results of operations. In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The update provides updated accounting and reporting requirements, which, among other things, requires lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. The Company anticipates that the impact on the balance sheet will result in an increase in assets and liabilities for its right of use assets and related lease liabilities for those leases that are outstanding at the date of adoption, however, it does not anticipate it will have a material impact on its results of operations. We are currently evaluating the other effects of adoption of this new standard on our financial position, including regulatory capital.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation: Improvements to Employee Share-Based Payment Accounting (Topic 718). The update will require recognition of the income tax effects of share-based awards in the income statement when the awards vest or are settled, eliminating the additional paid-in-capital pools. The guidance will be effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company does not anticipate this update will have a material impact on its financial position or results of operations.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The amendments in this update replace the existing incurred loss impairment methodology in current GAAP with an expected loss impairment methodology, which considers a broader range of reasonable and supportable information to support credit loss estimates, including historical loss experience, current conditions and reasonable and foreseeable forecasts. ASU No. 2016-13 also requires enhanced and greater disclosure pertaining to significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of the Company's financial instrument portfolio, including loans and securities. These amendments are effective for annual reporting periods beginning after December 15, 2019, including interim periods within that reporting period, with earlier adoption permitted as of one year earlier. The Company is currently evaluating the impact of the significance of this amendment, and the impact it will have on its financial position, results of operations, and regulatory capital ratios.



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## NOTE 2. SECURITIES AVAILABLE FOR SALE

At June 30, 2016 and December 31, 2015, 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 June 30, 2016 and December 31, 2015 were:

| (Dollars in thousands)   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--|----------------|------------------------|-------------------------|------------|
| June 30, 2016  |                |                        |                         |            |
| U.S. Government Agencies   | \$ 43,330      | \$ 199                 | \$ 135                  | \$43,394   |
| States and political subdivisions  | 123,818        | 8,478                  | 113                     | 132,183    |
| U.S. Government Sponsored Enterprises (GSE) residential mortgage-backed securities | 126,213        | 2,662                  | 0                       | 128,875    |
| GSE residential collateralized mortgage obligations (CMOs)                         | 12,363         | 383                    | 9                       | 12,737     |
| Private label CMOs   | 7,349          | 0                      | 73                      | 7,276      |
| Total debt securities  | 313,073        | 11,722                 | 330                     | 324,465    |
| Equity securities  | 50             | 25                     | 0                       | 75         |
| Totals   | \$ 313,123     | \$ 11,747              | \$ 330                  | \$324,540  |
| December 31, 2015  |                |                        |                         |            |
| U.S. Government Agencies   | \$ 47,209      | \$ 200                 | \$ 182                  | \$47,227   |
| States and political subdivisions  | 124,421        | 2,483                  | 943                     | 125,961    |
| GSE residential mortgage-backed securities   | 132,389        | 229                    | 269                     | 132,349    |
| GSE residential CMOs   | 15,668         | 215                    | 40                      | 15,843     |
| GSE commercial CMOs  | 63,598         | 735                    | 563                     | 63,770     |
| Private label CMOs   | 8,944          | 0                      | 43                      | 8,901      |
| Total debt securities  | 392,229        | 3,862                  | 2,040                   | 394,051    |
| Equity securities  | 50             | 23                     | 0                       | 73         |
| Totals   | \$ 392,279     | \$ 3,885               | \$ 2,040                | \$394,124  |



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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 June 30, 2016 and December 31, 2015:

| (Dollars in thousands)                                     | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| June 30, 2016  |                     |                   |                   |                   |            |                   |
| U.S. Government Agencies                                   | \$5,261             | \$ 22             | \$15,098          | \$ 113            | \$20,359   | \$ 135            |
| States and political subdivisions                          | 0                   | 0                 | 5,553             | 113               | 5,553      | 113               |
| GSE residential collateralized mortgage obligations (CMOs) | 0                   | 0                 | 798               | 9                 | 798        | 9                 |
| Private label CMOs   | 7,276               | 73                | 0                 | 0                 | 7,276      | 73                |
| Total temporarily impaired securities                      | \$12,537            | \$ 95             | \$21,449          | \$ 235            | \$33,986   | \$ 330            |
| December 31, 2015  |                     |                   |                   |                   |            |                   |
| U.S. Government Agencies                                   | \$27,640            | \$ 182            | \$0               | \$ 0              | \$27,640   | \$ 182            |
| States and political subdivisions                          | 30,252              | 373               | 14,139            | 570               | 44,391     | 943               |
| GSE residential mortgage-backed securities                 | 82,911              | 269               | 0                 | 0                 | 82,911     | 269               |
| GSE residential CMOs                                       | 0                   | 0                 | 4,237             | 40                | 4,237      | 40                |
| GSE commercial CMOs  | 33,606              | 563               | 0                 | 0                 | 33,606     | 563               |
| Private label CMOs   | 8,901               | 43                | 0                 | 0                 | 8,901      | 43                |
| Total temporarily impaired securities                      | \$183,310           | \$ 1,430          | \$18,376          | \$ 610            | \$201,686  | \$ 2,040          |

The Company had 10 securities and 53 securities at June 30, 2016 and December 31, 2015 in which the amortized cost exceed their values, as discussed below.

U.S. Agencies and Government Sponsored Enterprises (GSE). Six U.S. Agencies and GSE securities, including mortgage-backed securities and collateralized mortgage obligations, have amortized costs which exceed their fair values, two of which are in the less than 12 months category, and four had amortized costs which exceed their fair value for more than 12 months at June 30, 2016. At December 31, 2015, the Company had 29 U.S. Government Agencies and GSE securities, including mortgage-backed and collateralized mortgage obligations with unrealized losses of which 25 GSE securities have had amortized costs which exceeded their fair values for less than 12 months, and four have had 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 does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2016 or at December 31, 2015.

State and Political Subdivisions. One state and political subdivision security had an amortized cost which exceeded its fair value in the more than 12 months category at June 30, 2016. At December 31, 2015, 21 state and political subdivision securities have an amortized cost which exceeded their fair value, 16 of which are in the less than 12 months category, and five are in the more than 12 months category. These unrealized losses have been caused by a rise in interest rates or a widening of spreads 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 June 30, 2016 or at December 31, 2015.

Private Label. Three private label collateralized mortgage obligations have unrealized losses, all of which were in the less than 12 months category at June 30, 2016. At December 31, 2015, three private label securities have an amortized cost which exceeded their fair value for less than 12 months. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be

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maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2016 or at December 31, 2015.

The amortized cost and fair values of securities available for sale at June 30, 2016 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<br>Amortized Cost | Fair Value |
|--|--------------------------------------|------------|
| Due in one year or less  | \$0                                  | \$0        |
| Due after one year through five years                              | 3,221                                | 3,397      |
| Due after five years through ten years                             | 70,993                               | 75,677     |
| Due after ten years  | 92,934                               | 96,503     |
| Mortgage-backed securities and collateralized mortgage obligations | 145,925                              | 148,888    |
| Total debt securities  | 313,073                              | 324,465    |
| Equity securities  | 50                                   | 75         |
|  | \$313,123                            | \$324,540  |

Gross gains on the sales of securities were \$0 and \$353,000 for the three months ended June 30, 2016 and 2015.

Gross gains on the sales of securities were \$1,468,000 and \$1,906,000 for the six months ended June 30, 2016 and 2015. Gross losses on securities available for sale were \$48,000 and \$24,000 for the six months ended June 30, 2016 and 2015.

Securities with a fair value of \$278,202,000 and \$250,397,000 at June 30, 2016 and December 31, 2015 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 for the 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.

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

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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 for 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 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 rate 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 generally 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 prudent 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 class, as of June 30, 2016 and December 31, 2015 was as follows:

| (Dollars in thousands)              | June 30,<br>2016 | December<br>31, 2015 |
|-------------------------------------|------------------|----------------------|
| Commercial real estate:             |                  |                      |
| Owner-occupied                      | \$ 106,649       | \$ 103,578           |
| Non-owner occupied                  | 190,558          | 145,401              |
| Multi-family                        | 38,957           | 35,109               |
| Non-owner occupied residential      | 56,100           | 54,175               |
| Acquisition and development:        |                  |                      |
| 1-4 family residential construction | 6,714            | 9,364                |
| Commercial and land development     | 24,748           | 41,339               |
| Commercial and industrial           | 82,616           | 73,625               |
| Municipal                           | 61,568           | 57,511               |
| Residential mortgage:               |                  |                      |
| First lien                          | 129,577          | 126,022              |

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|                               |           |           |
|-------------------------------|-----------|-----------|
| Home equity - term            | 16,216    | 17,337    |
| Home equity - lines of credit | 110,908   | 110,731   |
| Installment and other loans   | 7,322     | 7,521     |
|                               | \$831,933 | \$781,713 |

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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” 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 executive officers and loan 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.

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The following summarizes the Bank's ratings based on its internal risk rating system as of June 30, 2016 and December 31, 2015:

| (Dollars in thousands)              | Pass       | Special<br>Mention | Non-Impaired<br>Substandard | Impaired -<br>Substandard | Doubtful | Total      |
|-------------------------------------|------------|--------------------|-----------------------------|---------------------------|----------|------------|
| June 30, 2016                       |            |                    |                             |                           |          |            |
| Commercial real estate:             |            |                    |                             |                           |          |            |
| Owner-occupied                      | \$ 101,005 | \$ 1,719           | \$ 2,098                    | \$ 1,827                  | \$ 0     | \$ 106,649 |
| Non-owner occupied                  | 167,320    | 16,031             | 152                         | 7,055                     | 0        | 190,558    |
| Multi-family                        | 36,190     | 1,298              | 1,253                       | 216                       | 0        | 38,957     |
| Non-owner occupied residential      | 53,132     | 1,224              | 1,184                       | 560                       | 0        | 56,100     |
| Acquisition and development:        |            |                    |                             |                           |          |            |
| 1-4 family residential construction | 6,432      | 0                  | 282                         | 0                         | 0        | 6,714      |
| Commercial and land development     | 23,986     | 107                | 653                         | 2                         | 0        | 24,748     |
| Commercial and industrial           | 81,480     | 627                | 35                          | 347                       | 127      | 82,616     |
| Municipal                           | 61,568     | 0                  | 0                           | 0                         | 0        | 61,568     |
| Residential mortgage:               |            |                    |                             |                           |          |            |
| First lien                          | 125,155    | 0                  | 0                           | 4,391                     | 31       | 129,577    |
| Home equity - term                  | 16,120     | 0                  | 0                           | 96                        | 0        | 16,216     |
| Home equity - lines of credit       | 110,271    | 248                | 52                          | 337                       | 0        | 110,908    |
| Installment and other loans         | 7,312      | 0                  | 0                           | 10                        | 0        | 7,322      |
|                                     | \$ 789,971 | \$ 21,254          | \$ 5,709                    | \$ 14,841                 | \$ 158   | \$ 831,933 |
| December 31, 2015                   |            |                    |                             |                           |          |            |
| Commercial real estate:             |            |                    |                             |                           |          |            |
| Owner-occupied                      | \$ 96,715  | \$ 1,124           | \$ 3,630                    | \$ 2,109                  | \$ 0     | \$ 103,578 |
| Non-owner occupied                  | 125,043    | 12,394             | 108                         | 7,856                     | 0        | 145,401    |
| Multi-family                        | 31,957     | 1,779              | 1,140                       | 233                       | 0        | 35,109     |
| Non-owner occupied residential      | 50,601     | 1,305              | 1,374                       | 895                       | 0        | 54,175     |
| Acquisition and development:        |            |                    |                             |                           |          |            |
| 1-4 family residential construction | 9,364      | 0                  | 0                           | 0                         | 0        | 9,364      |
| Commercial and land development     | 40,181     | 219                | 934                         | 5                         | 0        | 41,339     |
| Commercial and industrial           | 70,967     | 1,380              | 544                         | 734                       | 0        | 73,625     |
| Municipal                           | 57,511     | 0                  | 0                           | 0                         | 0        | 57,511     |
| Residential mortgage:               |            |                    |                             |                           |          |            |
| First lien                          | 121,214    | 0                  | 0                           | 4,808                     | 0        | 126,022    |
| Home equity - term                  | 17,234     | 0                  | 0                           | 103                       | 0        | 17,337     |
| Home equity - lines of credit       | 109,731    | 230                | 180                         | 590                       | 0        | 110,731    |
| Installment and other loans         | 7,504      | 0                  | 0                           | 17                        | 0        | 7,521      |
|                                     | \$ 738,022 | \$ 18,431          | \$ 7,910                    | \$ 17,350                 | \$ 0     | \$ 781,713 |

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

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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 June 30, 2016 and December 31, 2015, nearly all of the Company's impaired loans' extent of impairment were 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 and 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 generally required every 18 months 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 18 months. 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. A "Substandard" classification does not automatically meet the definition of "impaired." A "Substandard" loan is one that is inadequately protected by the current sound worth and 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 June 30, 2016 and December 31, 2015. The recorded investment in loans excludes accrued interest receivable due to insignificance. Related 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.

| (Dollars in thousands)          | Impaired Loans with a Specific Allowance |  |                   | Impaired Loans with No Specific Allowance |  |
|---------------------------------|--|--|-------------------|---|--|
|                                 | Recorded Investment (Book Balance)       | Unpaid Principal Balance (Legal Balance) | Related Allowance | Recorded Investment (Book Balance)        | Unpaid Principal Balance (Legal Balance) |
| June 30, 2016                   |  |  |                   |   |  |
| Commercial real estate:         |  |  |                   |   |  |
| Owner-occupied                  | \$0                                      | \$ 0                                     | \$ 0              | \$ 1,827                                  | \$ 3,158                                 |
| Non-owner occupied              | 0  | 0  | 0                 | 7,055                                     | 7,929                                    |
| Multi-family                    | 0  | 0  | 0                 | 216                                       | 376                                      |
| Non-owner occupied residential  | 0  | 0  | 0                 | 560                                       | 798                                      |
| Acquisition and development:    |  |  |                   |   |  |
| Commercial and land development | 0  | 0  | 0                 | 2   | 17                                       |
| Commercial and industrial       | 127                                      | 127                                      | 126               | 347                                       | 395                                      |
| Residential mortgage:           |  |  |                   |   |  |
| First lien                      | 751                                      | 758                                      | 106               | 3,671                                     | 4,456                                    |
| Home equity - term              | 0  | 0  | 0                 | 96  | 105                                      |
| Home equity - lines of credit   | 0  | 0  | 0                 | 337                                       | 434                                      |
| Installment and other loans     | 2  | 3  | 2                 | 8   | 35                                       |
|                                 | \$880                                    | \$ 888                                   | \$ 234            | \$ 14,119                                 | \$ 17,703                                |
| December 31, 2015               |  |  |                   |   |  |
| Commercial real estate:         |  |  |                   |   |  |
| Owner-occupied                  | \$0                                      | \$ 0                                     | \$ 0              | \$ 2,109                                  | \$ 3,344                                 |
| Non-owner occupied              | 0  | 0  | 0                 | 7,856                                     | 8,600                                    |
| Multi-family                    | 0  | 0  | 0                 | 233                                       | 385                                      |
| Non-owner occupied residential  | 0  | 0  | 0                 | 895                                       | 1,211                                    |
| Acquisition and development:    |  |  |                   |   |  |
| Commercial and land development | 0  | 0  | 0                 | 5   | 19                                       |
| Commercial and industrial       | 0  | 0  | 0                 | 734                                       | 780                                      |
| Residential mortgage:           |  |  |                   |   |  |
| First lien                      | 1,952                                    | 1,984                                    | 271               | 2,856                                     | 3,369                                    |
| Home equity - term              | 0  | 0  | 0                 | 103                                       | 110                                      |
| Home equity - lines of credit   | 22                                       | 23                                       | 10                | 568                                       | 688                                      |
| Installment and other loans     | 8  | 9  | 8                 | 9   | 35                                       |
|                                 | \$1,982                                  | \$ 2,016                                 | \$ 289            | \$ 15,368                                 | \$ 18,541                                |



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The following tables summarize the average recorded investment in impaired loans and related interest income recognized on loans deemed impaired, generally on a cash basis, for the three and six months ended June 30, 2016 and 2015:

| (Dollars in thousands)          | Three Months Ended June 30, |                  |                  |                  |
|---------------------------------|-----------------------------|------------------|------------------|------------------|
|                                 | 2016                        |                  | 2015             |                  |
|                                 | Average Interest            | Average Interest | Average Interest | Average Interest |
|                                 | Impaired Income             | Impaired Income  | Impaired Income  | Impaired Income  |
|                                 | Balance                     | Recognized       | Balance          | Recognized       |
| Commercial real estate:         |                             |                  |                  |                  |
| Owner-occupied                  | \$1,954                     | \$ 0             | \$2,793          | \$ 0             |
| Non-owner occupied              | 7,251                       | 0                | 1,403            | 0                |
| Multi-family                    | 221                         | 0                | 537              | 0                |
| Non-owner occupied residential  | 699                         | 0                | 919              | 0                |
| Acquisition and development:    |                             |                  |                  |                  |
| Commercial and land development | 3                           | 0                | 313              | 3                |
| Commercial and industrial       | 514                         | 0                | 978              | 0                |
| Residential mortgage:           |                             |                  |                  |                  |
| First lien                      | 4,618                       | 8                | 4,856            | 9                |
| Home equity - term              | 98                          | 0                | 164              | 0                |
| Home equity - lines of credit   | 499                         | 0                | 587              | 0                |
| Installment and other loans     | 14                          | 0                | 22               | 0                |
|                                 | \$15,871                    | \$ 8             | \$12,572         | \$ 12            |

| (Dollars in thousands)          | Six Months Ended June 30, |                  |                  |                  |
|---------------------------------|---------------------------|------------------|------------------|------------------|
|                                 | 2016                      |                  | 2015             |                  |
|                                 | Average Interest          | Average Interest | Average Interest | Average Interest |
|                                 | Impaired Income           | Impaired Income  | Impaired Income  | Impaired Income  |
|                                 | Balance                   | Recognized       | Balance          | Recognized       |
| Commercial real estate:         |                           |                  |                  |                  |
| Owner-occupied                  | \$2,012                   | \$ 0             | \$2,941          | \$ 0             |
| Non-owner occupied              | 7,511                     | 0                | 1,515            | 0                |
| Multi-family                    | 225                       | 0                | 502              | 0                |
| Non-owner occupied residential  | 787                       | 0                | 1,132            | 0                |
| Acquisition and development:    |                           |                  |                  |                  |
| Commercial and land development | 4                         | 0                | 354              | 5                |
| Commercial and industrial       | 619                       | 0                | 1,583            | 0                |
| Residential mortgage:           |                           |                  |                  |                  |
| First lien                      | 4,697                     | 17               | 5,037            | 18               |
| Home equity - term              | 100                       | 0                | 124              | 0                |
| Home equity - lines of credit   | 544                       | 0                | 546              | 0                |
| Installment and other loans     | 16                        | 0                | 24               | 0                |
|                                 | \$16,515                  | \$ 17            | \$13,758         | \$ 23            |

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The following table presents impaired loans that are TDRs, with the recorded investment as of June 30, 2016 and December 31, 2015.

| (Dollars in thousands)      | June 30, 2016       |                     | December 31, 2015   |                     |
|-----------------------------|---------------------|---------------------|---------------------|---------------------|
|                             | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |
| Accruing:                   |                     |                     |                     |                     |
| Residential mortgage:       |                     |                     |                     |                     |
| First lien                  | 8                   | \$ 907              | 8                   | \$ 793              |
|                             | 8                   | 907                 | 8                   | 793                 |
| Nonaccruing:                |                     |                     |                     |                     |
| Residential mortgage:       |                     |                     |                     |                     |
| First lien                  | 12                  | 1,106               | 12                  | 1,153               |
| Installment and other loans | 1                   | 8                   | 1                   | 10                  |
|                             | 13                  | 1,114               | 13                  | 1,163               |
|                             | 21                  | \$ 2,021            | 21                  | \$ 1,956            |

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 agreeing to a reduction in interest rates, in order to give the borrowers an opportunity to improve their cash flows. For TDRs in default of their original 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.

The following table presents the number of loans modified, and their pre-modification and post-modification investment balances for the three and six months ended June 30, 2016 and 2015:

| (Dollars in thousands)      | 2016                |                     | 2015                |                     |       |       |
|-----------------------------|---------------------|---------------------|---------------------|---------------------|-------|-------|
|                             | Pre-Modification    | Post Modification   | Pre-Modification    | Post Modification   |       |       |
|                             | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |       |       |
| Three Months Ended June 30, |                     |                     |                     |                     |       |       |
| Residential mortgage:       |                     |                     |                     |                     |       |       |
| First lien                  | 0                   | \$ 0                | \$ 0                | 0                   | \$ 0  | \$ 0  |
| Installment and other loans | 0                   | 0                   | 0                   | 0                   | 0     | 0     |
|                             | 0                   | \$ 0                | \$ 0                | 0                   | \$ 0  | \$ 0  |
| Six Months Ended June 30,   |                     |                     |                     |                     |       |       |
| Residential mortgage:       |                     |                     |                     |                     |       |       |
| First lien                  | 1                   | \$ 257              | \$ 257              | 1                   | \$ 59 | \$ 59 |
| Installment and other loans | 0                   | 0                   | 0                   | 0                   | 0     | 0     |
|                             | 1                   | \$ 257              | \$ 257              | 1                   | \$ 59 | \$ 59 |

Certain loans modified during a period may no longer be outstanding at the end of the period if the loan was paid off. The following table presents restructured loans, included in nonaccrual loans, that were modified as TDRs within the previous 12 months and for which there was a payment default during the three and six months ended June 30, 2016 and 2015:

| (Dollars in thousands)      | 2016                |                     | 2015                |                     |
|-----------------------------|---------------------|---------------------|---------------------|---------------------|
|                             | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |
| Three Months Ended June 30, |                     |                     |                     |                     |
| Residential mortgage:       |                     |                     |                     |                     |
| First lien                  | 0                   | \$ 0                | 3                   | \$ 249              |
|                             | 0                   | \$ 0                | 3                   | \$ 249              |

Six Months Ended June 30,

Residential mortgage:

|            |   |    |   |   |    |     |
|------------|---|----|---|---|----|-----|
| First lien | 0 | \$ | 0 | 4 | \$ | 308 |
|            | 0 | \$ | 0 | 4 | \$ | 308 |

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

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 June 30, 2016 and December 31, 2015:

| (Dollars in thousands)              | Days Past Due |          |        |                         | Total<br>Past Due | Non-<br>Accrual | Total<br>Loans |
|-------------------------------------|---------------|----------|--------|-------------------------|-------------------|-----------------|----------------|
|                                     | Current       | 30-59    | 60-89  | 90+<br>(still accruing) |                   |                 |                |
| June 30, 2016                       |               |          |        |                         |                   |                 |                |
| Commercial real estate:             |               |          |        |                         |                   |                 |                |
| Owner-occupied                      | \$ 104,822    | \$ 0     | \$ 0   | \$ 0                    | \$ 0              | \$ 1,827        | \$ 106,649     |
| Non-owner occupied                  | 183,503       | 0        | 0      | 0                       | 0                 | 7,055           | 190,558        |
| Multi-family                        | 38,741        | 0        | 0      | 0                       | 0                 | 216             | 38,957         |
| Non-owner occupied residential      | 55,501        | 39       | 0      | 0                       | 39                | 560             | 56,100         |
| Acquisition and development:        |               |          |        |                         |                   |                 |                |
| 1-4 family residential construction | 6,432         | 0        | 282    | 0                       | 282               | 0               | 6,714          |
| Commercial and land development     | 24,746        | 0        | 0      | 0                       | 0                 | 2               | 24,748         |
| Commercial and industrial           | 82,142        | 0        | 0      | 0                       | 0                 | 474             | 82,616         |
| Municipal                           | 61,568        | 0        | 0      | 0                       | 0                 | 0               | 61,568         |
| Residential mortgage:               |               |          |        |                         |                   |                 |                |
| First lien                          | 125,561       | 468      | 33     | 0                       | 501               | 3,515           | 129,577        |
| Home equity - term                  | 16,112        | 8        | 0      | 0                       | 8                 | 96              | 16,216         |
| Home equity - lines of credit       | 110,363       | 203      | 5      | 0                       | 208               | 337             | 110,908        |
| Installment and other loans         | 7,299         | 13       | 0      | 0                       | 13                | 10              | 7,322          |
|                                     | \$ 816,790    | \$ 731   | \$ 320 | \$ 0                    | \$ 1,051          | \$ 14,092       | \$ 831,933     |
| December 31, 2015                   |               |          |        |                         |                   |                 |                |
| Commercial real estate:             |               |          |        |                         |                   |                 |                |
| Owner-occupied                      | \$ 101,395    | \$ 74    | \$ 0   | \$ 0                    | \$ 74             | \$ 2,109        | \$ 103,578     |
| Non-owner occupied                  | 137,545       | 0        | 0      | 0                       | 0                 | 7,856           | 145,401        |
| Multi-family                        | 34,876        | 0        | 0      | 0                       | 0                 | 233             | 35,109         |
| Non-owner occupied residential      | 53,280        | 0        | 0      | 0                       | 0                 | 895             | 54,175         |
| Acquisition and development:        |               |          |        |                         |                   |                 |                |
| 1-4 family residential construction | 9,364         | 0        | 0      | 0                       | 0                 | 0               | 9,364          |
| Commercial and land development     | 41,236        | 0        | 98     | 0                       | 98                | 5               | 41,339         |
| Commercial and industrial           | 72,846        | 24       | 21     | 0                       | 45                | 734             | 73,625         |
| Municipal                           | 57,511        | 0        | 0      | 0                       | 0                 | 0               | 57,511         |
| Residential mortgage:               |               |          |        |                         |                   |                 |                |
| First lien                          | 120,119       | 1,844    | 44     | 0                       | 1,888             | 4,015           | 126,022        |
| Home equity - term                  | 17,200        | 34       | 0      | 0                       | 34                | 103             | 17,337         |
| Home equity - lines of credit       | 109,740       | 286      | 91     | 24                      | 401               | 590             | 110,731        |
| Installment and other loans         | 7,488         | 16       | 0      | 0                       | 16                | 17              | 7,521          |
|                                     | \$ 762,600    | \$ 2,278 | \$ 254 | \$ 24                   | \$ 2,556          | \$ 16,557       | \$ 781,713     |

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The Company maintains the allowance for loan losses at a level believed to be 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 as discussed above, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC Subtopic 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 are 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.

Prior to December 31, 2015, the look back period for historical losses was 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. Effective December 31, 2015, the Company extended the look back period to 16 quarters which will increase to 20 quarters through December 31, 2016. The extended period was on a prospective basis, more heavily weighted to the most recent four quarters. The look back period was extended as it was determined that a longer look back period is more consistent with the duration of an economic cycle. Management considers current economic, business, 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 June 30, 2016 and December 31, 2015, 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 June 30, 2016 and 2015 was as follows:

| (Dollars in thousands)       | Commercial             |                             |                           |           |          | Consumer             |                       |         | Unallocated | Total    |
|------------------------------|------------------------|-----------------------------|---------------------------|-----------|----------|----------------------|-----------------------|---------|-------------|----------|
|                              | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Municipal | Total    | Residential Mortgage | Installment and Other | Total   |             |          |
| June 30, 2016                |                        |                             |                           |           |          |                      |                       |         |             |          |
| Balance, beginning of period | \$7,996                | \$ 739                      | \$ 1,030                  | \$ 62     | \$9,827  | \$2,677              | \$ 179                | \$2,856 | \$ 664      | \$13,347 |
| Provision for loan losses    | (12 )                  | (152 )                      | 112                       | (1 )      | (53 )    | 66                   | 26                    | 92      | (39 )       | 0        |
| Charge-offs                  | (26 )                  | 0                           | 0                         | 0         | (26 )    | (80 )                | (48 )                 | (128 )  | 0           | (154 )   |
| Recoveries                   | 175                    | 0                           | 6                         | 0         | 181      | 43                   | 23                    | 66      | 0           | 247      |
| Balance, end of period       | \$8,133                | \$ 587                      | \$ 1,148                  | \$ 61     | \$9,929  | \$2,706              | \$ 180                | \$2,886 | \$ 625      | \$13,440 |
| June 30, 2015                |                        |                             |                           |           |          |                      |                       |         |             |          |
| Balance, beginning of period | \$9,346                | \$ 588                      | \$ 665                    | \$ 121    | \$10,720 | \$2,567              | \$ 116                | \$2,683 | \$1,058     | \$14,461 |
| Provision for loan losses    | (750 )                 | 132                         | 188                       | (2 )      | (432 )   | 479                  | 74                    | 553     | (121 )      | 0        |
| Charge-offs                  | (475 )                 | 0                           | (24 )                     | 0         | (499 )   | (151 )               | (9 )                  | (160 )  | 0           | (659 )   |
| Recoveries                   | 11                     | 0                           | 15                        | 0         | 26       | 23                   | 1                     | 24      | 0           | 50       |
| Balance, end of period       | \$8,132                | \$ 720                      | \$ 844                    | \$ 119    | \$9,815  | \$2,918              | \$ 182                | \$3,100 | \$ 937      | \$13,852 |

Activity in the allowance for loan losses for the six months ended June 30, 2016 and 2015 was as follows:

| (Dollars in thousands)       | Commercial             |                             |                           |           |          | Consumer             |                       |         | Unallocated | Total    |
|------------------------------|------------------------|-----------------------------|---------------------------|-----------|----------|----------------------|-----------------------|---------|-------------|----------|
|                              | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Municipal | Total    | Residential Mortgage | Installment and Other | Total   |             |          |
| June 30, 2016                |                        |                             |                           |           |          |                      |                       |         |             |          |
| Balance, beginning of period | \$7,883                | \$ 850                      | \$ 1,012                  | \$ 58     | \$9,803  | \$2,870              | \$ 121                | \$2,991 | \$ 774      | \$13,568 |
| Provision for loan losses    | 21                     | (263 )                      | 149                       | 3         | (90 )    | 111                  | 128                   | 239     | (149 )      | 0        |
| Charge-offs                  | (26 )                  | 0                           | (21 )                     | 0         | (47 )    | (324 )               | (112 )                | (436 )  | 0           | (483 )   |
| Recoveries                   | 255                    | 0                           | 8                         | 0         | 263      | 49                   | 43                    | 92      | 0           | 355      |
| Balance, end of period       | \$8,133                | \$ 587                      | \$ 1,148                  | \$ 61     | \$9,929  | \$2,706              | \$ 180                | \$2,886 | \$ 625      | \$13,440 |
| June 30, 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    | (813 )                 | 45                          | 51                        | (64 )     | (781 )   | 973                  | 89                    | 1,062   | (281 )      | 0        |
| Charge-offs                  | (541 )                 | (22 )                       | (50 )                     | 0         | (613 )   | (352 )               | (29 )                 | (381 )  | 0           | (994 )   |
| Recoveries                   | 24                     | 0                           | 37                        | 0         | 61       | 35                   | 3                     | 38      | 0           | 99       |
| Balance, end of period       | \$8,132                | \$ 720                      | \$ 844                    | \$ 119    | \$9,815  | \$2,918              | \$ 182                | \$3,100 | \$ 937      | \$13,852 |

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The following table summarizes the ending loan balances individually evaluated for impairment based upon loan segment, as well as the related allowance for loan losses allocation for each at June 30, 2016 and December 31, 2015:

| (Dollars in thousands)                  | Commercial             |                             |                           |           | Total     | Consumer             |                       |           | Unallocated | Total     |
|---|------------------------|-----------------------------|---------------------------|-----------|-----------|----------------------|-----------------------|-----------|-------------|-----------|
|   | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Municipal |           | Residential Mortgage | Installment and Other | Total     |             |           |
| June 30, 2016                           |                        |                             |                           |           |           |                      |                       |           |             |           |
| Loans allocated by:                     |                        |                             |                           |           |           |                      |                       |           |             |           |
| Individually evaluated for impairment   | \$9,658                | \$2                         | \$474                     | \$0       | \$10,134  | \$4,855              | \$10                  | \$4,865   | \$0         | \$14,999  |
| Collectively evaluated for impairment   | 382,606                | 31,460                      | 82,142                    | 61,568    | 557,776   | 251,846              | 7,312                 | 259,158   | 0           | 816,934   |
|   | \$392,264              | \$31,462                    | \$82,616                  | \$61,568  | \$567,910 | \$256,701            | \$7,322               | \$264,023 | \$0         | \$831,933 |
| Allowance for loan losses allocated by: |                        |                             |                           |           |           |                      |                       |           |             |           |
| Individually evaluated for impairment   | \$0                    | \$0                         | \$126                     | \$0       | \$126     | \$106                | \$2                   | \$108     | \$0         | \$234     |
| Collectively evaluated for impairment   | 8,133                  | 587                         | 1,022                     | 61        | 9,803     | 2,600                | 178                   | 2,778     | 625         | 13,206    |
|   | \$8,133                | \$587                       | \$1,148                   | \$61      | \$9,929   | \$2,706              | \$180                 | \$2,886   | \$625       | \$13,440  |
| December 31, 2015                       |                        |                             |                           |           |           |                      |                       |           |             |           |
| Loans allocated by:                     |                        |                             |                           |           |           |                      |                       |           |             |           |
| Individually evaluated for impairment   | \$11,093               | \$5                         | \$734                     | \$0       | \$11,832  | \$5,501              | \$17                  | \$5,518   | \$0         | \$17,350  |
| Collectively evaluated for impairment   | 327,170                | 50,698                      | 72,891                    | 57,511    | 508,270   | 248,589              | 7,504                 | 256,093   | 0           | 764,363   |
|   | \$338,263              | \$50,703                    | \$73,625                  | \$57,511  | \$520,102 | \$254,090            | \$7,521               | \$261,611 | \$0         | \$781,713 |
| Allowance for loan losses allocated by: |                        |                             |                           |           |           |                      |                       |           |             |           |
| Individually evaluated for impairment   | \$0                    | \$0                         | \$0                       | \$0       | \$0       | \$281                | \$8                   | \$289     | \$0         | \$289     |
| Collectively evaluated for impairment   | 7,883                  | 850                         | 1,012                     | 58        | 9,803     | 2,589                | 113                   | 2,702     | 774         | 13,279    |
|   | \$7,883                | \$850                       | \$1,012                   | \$58      | \$9,803   | \$2,870              | \$121                 | \$2,991   | \$774       | \$13,568  |

**NOTE 4. INCOME TAXES**

The Company files income tax returns in the U.S. federal jurisdiction and the Commonwealth of Pennsylvania. The Bank also files an income tax return in the State of Maryland. The Company is no longer subject to U.S. federal, state or local income tax examination by tax authorities for years before 2012.

The components of income tax expense for the three and six months ended June 30, 2016 and 2015 are summarized as follows:

| (Dollars in thousands)            | Three months ended June 30, |      | Six months ended June 30, |      |
|-----------------------------------|-----------------------------|------|---------------------------|------|
|                                   | 2016                        | 2015 | 2016                      | 2015 |
| Current year provision (benefit): |                             |      |                           |      |
| Federal                           | \$238                       | \$56 | \$126                     | \$41 |
| State                             | (1 )                        | 4    | (3 )                      | 8    |

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|                        |       |       |       |         |
|------------------------|-------|-------|-------|---------|
|                        | 237   | 60    | 123   | 49      |
| Deferred tax expense   |       |       |       |         |
| Federal                | 10    | 257   | 732   | 977     |
| State                  | 5     | 4     | 11    | 10      |
|                        | 15    | 261   | 743   | 987     |
| Net income tax expense | \$252 | \$321 | \$866 | \$1,036 |

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The provision for income taxes includes zero and \$123,000 of applicable income tax expense related to net security gains for the three months ended June 30, 2016 and 2015. The provision for income taxes includes \$497,000 and \$659,000 of applicable income tax expense related to net securities gains for the six months ended June 30, 2016 and 2015.

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

| (Dollars in thousands)                                | June 30, December 31, |           |
|---|-----------------------|-----------|
|   | 2016                  | 2015      |
| Deferred tax assets:                                  |                       |           |
| Allowance for loan losses                             | \$5,084               | \$ 5,111  |
| Deferred compensation                                 | 544                   | 547       |
| Retirement plans and salary continuation              | 1,905                 | 1,824     |
| Share-based compensation                              | 439                   | 343       |
| Off balance sheet reserves                            | 275                   | 218       |
| Nonaccrual loan interest                              | 369                   | 246       |
| Goodwill  | 109                   | 124       |
| Bonus accrual   | 117                   | 359       |
| Low income housing credit carryforward                | 1,818                 | 1,652     |
| Alternative minimum tax credit carryforward           | 2,462                 | 2,195     |
| Charitable contribution carryforward                  | 69                    | 211       |
| Net operating loss carryforward                       | 3,193                 | 4,431     |
| Other   | 272                   | 182       |
| Total deferred tax assets                             | 16,656                | 17,443    |
| Deferred tax liabilities:                             |                       |           |
| Depreciation  | 744                   | 815       |
| Net unrealized gains on securities available for sale | 3,996                 | 646       |
| Mortgage servicing rights                             | 711                   | 669       |
| Purchase accounting adjustments                       | 329                   | 352       |
| Other   | 189                   | 181       |
| Total deferred tax liabilities                        | 5,969                 | 2,663     |
| Net deferred tax asset                                | \$10,687              | \$ 14,780 |

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 June 30, 2016, the Company had charitable contribution, low-income housing, and net operating loss carryforwards that expire through 2019, 2036 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. 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 that no valuation allowance was required at June 30, 2016 or December 31, 2015.

**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 June 30, 2016, 141,945 shares were available to be issued under the Plan.





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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 six months ended June 30, 2016 is presented below:

|                                     | Shares    | Weighted<br>Average<br>Grant<br>Date Fair<br>Value |
|-------------------------------------|-----------|--|
| Nonvested shares, beginning of year | 197,381   | \$ 16.17   |
| Granted                             | 41,045    | 17.77  |
| Forfeited                           | (3,583 )  | 16.91  |
| Vested                              | (12,500 ) | 15.97  |
| Nonvested shares, at period end     | 222,343   | \$ 16.46   |

For the three months ended June 30, 2016 and 2015, \$259,000 and \$157,000 was recognized as expense on the restricted stock awards, with tax benefits recorded of \$91,000 and \$55,000 for the respective periods. For the six months ended June 30, 2016 and 2015, \$496,000 and \$288,000 was recognized as expense on the restricted stock awards, with tax benefits recorded of \$174,000 and \$101,000 for the respective periods. As of June 30, 2016 and December 31, 2015, the unrecognized compensation expense related to the stock awards were \$2,409,000 and \$2,293,000. The unrecognized compensation expense at June 30, 2016 is expected to be recognized over a weighted-average period of 2.7 years.

A roll forward of the Company's outstanding stock options for the six months ended June 30, 2016 is presented below:

|  | Shares    | Weighted<br>Average<br>Exercise<br>Price |
|--|-----------|--|
| Outstanding at beginning of year                   | 101,460   | \$ 28.72                                 |
| Forfeited  | (2,525 )  | 26.15                                    |
| Expired  | (18,265 ) | 35.11                                    |
| Options outstanding and exercisable, at period end | 80,670    | \$ 27.35                                 |

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 June 30, 2016 is as follows:

| Range of Exercise Prices | Number<br>Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted<br>Average<br>Exercise<br>Price |
|--------------------------|-----------------------|---|--|
| \$21.14 - \$24.99        | 35,299                | 3.90  | \$ 21.47                                 |
| \$25.00 - \$29.99        | 2,792                 | 3.76  | 25.76                                    |
| \$30.00 - \$34.99        | 35,231                | 1.43  | 31.34                                    |
| \$35.00 - \$37.59        | 7,348                 | 3.06  | 37.08                                    |

\$21.14 - \$37.59

80,670

2.74

\$ 27.35

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The options outstanding and exercisable had no intrinsic value at June 30, 2016 and December 31, 2015 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% 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 June 30, 2016, 189,877 shares were available to be issued under the employee stock purchase plan. Employees purchased 0 and 0 shares at a weighted average price of \$0.00 and \$0.00 for the three months ended June 30, 2016 and 2015. For the six months ended June 30, 2016 and 2015, employees purchased 2,461 and 2,964 shares at a weighted average price of \$16.57 and \$15.74. Compensation expense recognized on the employee stock purchase plan totaled \$0 and \$0 for the three months ended June 30, 2016 and 2015. For the six months ended June 30, 2016 and 2015, compensation expense recognized on the employee stock purchase plan totaled \$3,000 and \$3,000.

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 19, 2016, the Company filed a shelf registration statement on Form S-3 with the Securities and Exchange Commission (the "Commission") that provides for up to an aggregate of \$100,000,000, through the sale of common stock, preferred stock, warrants, debt securities, and units. To date, the Company has not issued any securities under this shelf registration.

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. 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 June 30, 2016 and December 31, 2015, 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 final rules 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 previously existing U.S. risk-based capital rules. 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 levels 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 are subject to 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 began on January 1, 2016 at the 0.625% level and will 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 June 30, 2016, 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 June 30, 2016 and December 31, 2015, are also presented in the table.

| (Dollars in thousands)                 | Actual     |       | Minimum Capital Requirement |       | Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions |       |   |
|--|------------|-------|-----------------------------|-------|--|-------|---|
|  | Amount     | Ratio | Amount                      | Ratio | Amount   | Ratio |   |
| June 30, 2016                          |            |       |                             |       |  |       |   |
| Total capital to risk weighted assets  |            |       |                             |       |  |       |   |
| Orrstown Financial Services, Inc.      | \$ 137,860 | 15.2% | \$ 72,496                   | 8.0 % | n/a  | n/a   |   |
| Orrstown Bank                          | 123,567    | 13.7% | 72,412                      | 8.0 % | \$ 90,515  | 10.0  | % |
| Tier 1 capital to risk weighted assets |            |       |                             |       |  |       |   |
| Orrstown Financial Services, Inc.      | 126,463    | 14.0% | 54,372                      | 6.0 % | n/a  | n/a   |   |
| Orrstown Bank                          | 112,182    | 12.4% | 54,309                      | 6.0 % | 72,412   | 8.0   | % |
| CET1 to risk weighted assets           |            |       |                             |       |  |       |   |
| Orrstown Financial Services, Inc.      | 126,463    | 14.0% | 40,779                      | 4.5 % | n/a  | n/a   |   |
| Orrstown Bank                          | 112,182    | 12.4% | 40,732                      | 4.5 % | 58,835   | 6.5   | % |
| Tier 1 capital to average assets       |            |       |                             |       |  |       |   |
| Orrstown Financial Services, Inc.      | 126,463    | 9.8 % | 51,868                      | 4.0 % | n/a  | n/a   |   |
| Orrstown Bank                          | 112,182    | 8.6 % | 51,881                      | 4.0 % | 64,851   | 5.0   | % |
| December 31, 2015                      |            |       |                             |       |  |       |   |
| Total capital to risk weighted assets  |            |       |                             |       |  |       |   |
| Orrstown Financial Services, Inc.      | \$ 134,562 | 15.8% | \$ 68,078                   | 8.0 % | n/a  | n/a   |   |
| Orrstown Bank                          | 118,671    | 14.0% | 68,027                      | 8.0 % | \$ 85,034  | 10.0  | % |
| Tier 1 capital to risk weighted assets |            |       |                             |       |  |       |   |
| Orrstown Financial Services, Inc.      | 123,825    | 14.6% | 51,058                      | 6.0 % | n/a  | n/a   |   |
| Orrstown Bank                          | 107,942    | 12.7% | 51,021                      | 6.0 % | 68,027   | 8.0   | % |
| CET1 to risk weighted assets           |            |       |                             |       |  |       |   |
| Orrstown Financial Services, Inc.      | 123,825    | 14.6% | 38,294                      | 4.5 % | n/a  | n/a   |   |
| Orrstown Bank                          | 107,942    | 12.7% | 38,265                      | 4.5 % | 55,272   | 6.5   | % |
| Tier 1 capital to average assets       |            |       |                             |       |  |       |   |
| Orrstown Financial Services, Inc.      | 123,825    | 9.8 % | 50,684                      | 4.0 % | n/a  | n/a   |   |
| Orrstown Bank                          | 107,942    | 8.5 % | 50,695                      | 4.0 % | 63,368   | 5.0   | % |

On September 14, 2015, the Board of Directors of the Company authorized a stock repurchase program under which the Company may repurchase up to 5% of the Company's outstanding shares of common stock, or approximately 416,000 shares, in the open market, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Securities Exchange Act of 1934, as amended. The extent to which the Company repurchases its shares, and the timing of such repurchases, will depend upon a variety of factors, including market conditions, regulatory requirements and other corporate considerations, as determined by management. Purchases may be made from time to time on open market or privately negotiated transactions. The repurchase program may be suspended or discontinued at any time. As of June 30, 2016, 82,725 shares had been repurchased under the program at a total cost of \$1,438,000, or \$17.38 per share.

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## NOTE 7. EARNINGS PER SHARE

Earnings per share for the three and six months ended June 30, 2016 and 2015 were as follows:

| (Dollars in thousands, except per share data) | Three Months<br>Ended June<br>30, |         | Six Months<br>Ended June 30, |         |
|---|-----------------------------------|---------|------------------------------|---------|
|   | 2016                              | 2015    | 2016                         | 2015    |
| Net income                                    | \$678                             | \$1,502 | \$3,258                      | \$3,964 |
| Weighted average shares outstanding (basic)   | 8,053                             | 8,115   | 8,062                        | 8,112   |
| Impact of common stock equivalents            | 83                                | 23      | 76                           | 24      |
| Weighted average shares outstanding (diluted) | 8,136                             | 8,138   | 8,138                        | 8,136   |
| Per share information:                        |                                   |         |                              |         |
| Basic earnings per share                      | \$0.08                            | \$0.19  | \$0.40                       | \$0.49  |
| Diluted earnings per share                    | 0.08                              | 0.18    | 0.40                         | 0.49    |

Stock options amounting to 96,000 and 128,000 shares of common stock were not considered in computing diluted earnings per share for the three months ended June 30, 2016 and 2015 as their exercise would have been antidilutive as the exercise price exceeded the average market value. Stock options amounting to 101,000 and 129,000 shares of common stock were not considered in computing diluted earnings per share for the six months ended June 30, 2016 and 2015 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 and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

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.

| (Dollars in thousands)  | Contract or Notional Amount |                      |
|---|-----------------------------|----------------------|
|   | June 30, 2016               | December 31,<br>2015 |
| Commitments to fund:  |                             |                      |
| Revolving, open ended home equity loans                         | \$ 119,024                  | \$ 110,473           |
| 1-4 family residential construction loans                       | 8,162                       | 6,153                |
| Commercial real estate, construction and land development loans | 43,206                      | 14,174               |
| Commercial, industrial and other loans                          | 110,246                     | 84,480               |
| Standby letters of credit                                       | 7,607                       | 6,510                |

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.

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Standby letters of credit and financial guarantees written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Company holds collateral supporting those commitments when deemed necessary by management. The current amount of liability, as of June 30, 2016 and December 31, 2015, for guarantees under standby letters of credit issued was not material.

The Company currently maintains a reserve in other liabilities totaling \$771,000 and \$472,000 at June 30, 2016 and December 31, 2015 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 June 30, 2016 and 2015, \$252,000 and \$83,000 was expensed through noninterest expense for this exposure and for the six months ended June 30, 2016 and 2015, the amount expensed was \$299,000 and \$15,000.

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 \$40,319,000 and \$44,124,000 at June 30, 2016 and December 31, 2015, with limited recourse back to the Company on these loans of \$8,199,000 and \$8,230,000 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 (recovery) of \$(59,000) and \$30,000 for the three months ended June 30, 2016 and 2015, and of \$(112,000) and \$70,000 for the six months ended June 30, 2016 and 2015. 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:





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## Securities

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

The Company had no fair value liabilities measured on a recurring basis at June 30, 2016 and December 31, 2015. A summary of assets at June 30, 2016 and December 31, 2015, measured at estimated fair value on a recurring basis was as follows:

| (Dollars in Thousands)   | Level<br>1 | Level 2   | Level<br>3 | Total Fair<br>Value<br>Measurements |
|--|------------|-----------|------------|-------------------------------------|
| June 30, 2016  |            |           |            |                                     |
| Securities available for sale:   |            |           |            |                                     |
| U.S. Government Agencies   | \$ 0       | \$43,394  | \$ 0       | \$ 43,394                           |
| States and political subdivisions  | 0          | 132,183   | 0          | 132,183                             |
| U.S. Government Sponsored enterprises (GSE) residential mortgage-backed securities | 0          | 128,875   | 0          | 128,875                             |
| GSE residential collateralized mortgage obligations (CMOs)                         | 0          | 12,737    | 0          | 12,737                              |
| Private label CMOs   | 0          | 7,276     | 0          | 7,276                               |
| Total debt securities  | 0          | 324,465   | 0          | 324,465                             |
| Equity securities - financial services   | 0          | 75        | 0          | 75                                  |
| Total securities   | \$ 0       | \$324,540 | \$ 0       | \$ 324,540                          |
| December 31, 2015  |            |           |            |                                     |
| Securities available for sale:   |            |           |            |                                     |
| U.S. Government Agencies   | \$ 0       | \$47,227  | \$ 0       | \$ 47,227                           |
| States and political subdivisions  | 0          | 125,961   | 0          | 125,961                             |
| GSE residential mortgage-backed securities   | 0          | 132,349   | 0          | 132,349                             |
| GSE residential collateralized mortgage obligations (CMOs)                         | 0          | 15,843    | 0          | 15,843                              |
| GSE commercial CMOs  | 0          | 63,770    | 0          | 63,770                              |
| Private label CMOs   | 0          | 8,901     | 0          | 8,901                               |
| Total debt securities  | 0          | 394,051   | 0          | 394,051                             |
| Equity securities - financial services   | 0          | 73        | 0          | 73                                  |
| Total securities   | \$ 0       | \$394,124 | \$ 0       | \$ 394,124                          |

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:

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## Impaired Loans

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, or discounted cash flows based on a market rate of interest for performing TDRs. For collateral dependent loans, fair value is measured based on the value of the collateral securing the loan, less estimated costs to sell. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The value of the real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction, or if management adjusts the appraisal value, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal, if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). For discounted cash flow impairment measurement on residential mortgage loans, the Company discounts cash flows on a particular credit, utilizing a market rate of interest that adequately reflects the terms and conditions of the note, and the credit risk associated with it. 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 \$2,242,000 and \$2,246,000 at June 30, 2016 and December 31, 2015. Changes in the fair value of impaired loans for those still held at June 30, considered in the determination as to the provision for loan losses, totaled \$183,000 and \$42,000 for the three months ended June 30, 2016 and 2015, and \$162,000 and \$845,000 for the six months ended June 30, 2016 and 2015.

## Foreclosed Real Estate

Other real estate property acquired through foreclosure is initially recorded at the fair value of the property at the transfer date less estimated selling cost. Subsequently, other real estate owned is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. Specific charges to value the real estate owned at the lower of cost or fair value on properties held at June 30, 2016 and December 31, 2015 were \$200,000 and \$129,000. Changes in the fair value of foreclosed real estate for those still held at June 30, charged to real estate expenses, totaled \$44,000 and zero for the three months ended June 30, 2016 and 2015, and totaled \$95,000 and zero for the six months ended June 30, 2016 and 2015.

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              |
|------------------------|---------------------|-------------------------|--|--------------------|
| June 30, 2016          |                     |                         |  |                    |
| Impaired loans         | \$ 4,427            | Appraisal of collateral | Management adjustments on appraisals for property type and recent activity | 0% - 68% discount  |
|                        |                     |                         | Management adjustments for liquidation expenses                            | 0% - 45% discount  |
| Foreclosed real estate | 204                 | Appraisal of collateral | Management adjustments on appraisals for property type and recent activity | 25% - 53% discount |
|                        |                     |                         | Management adjustments for liquidation expenses                            | 7% - 8% discount   |
| December 31, 2015      |                     |                         |  |                    |
| Impaired loans         | \$ 4,757            | Appraisal of collateral | Management adjustments on appraisals for property type and recent activity | 0% - 70% discount  |
|                        |                     |                         | Management adjustments for liquidation expenses                            | 6% - 44% discount  |
| Foreclosed real estate | 175                 | Appraisal of collateral | Management adjustments on appraisals for property type and recent activity | 10% - 20% discount |
|                        |                     |                         | Management adjustments for liquidation expenses                            | 5% - 6% discount   |



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A summary of assets at June 30, 2016 and December 31, 2015, measured at estimated fair value on a nonrecurring basis was as follows:

| (Dollars in thousands)          | Level 1 | Level 2 | Level 3 | Total<br>Fair Value<br>Measurements |
|---------------------------------|---------|---------|---------|-------------------------------------|
| June 30, 2016                   |         |         |         |                                     |
| Impaired Loans                  |         |         |         |                                     |
| Commercial real estate:         |         |         |         |                                     |
| Owner-occupied                  | \$ 0    | \$ 0    | \$942   | \$ 942                              |
| Non-owner occupied              | 0       | 0       | 736     | 736                                 |
| Multi-family                    | 0       | 0       | 216     | 216                                 |
| Non-owner occupied residential  | 0       | 0       | 442     | 442                                 |
| Acquisition and development:    |         |         |         |                                     |
| Commercial and land development | 0       | 0       | 2       | 2                                   |
| Residential mortgage:           |         |         |         |                                     |
| First lien                      | 0       | 0       | 1,928   | 1,928                               |
| Home equity - lines of credit   | 0       | 0       | 153     | 153                                 |
| Installment and other loans     | 0       | 0       | 8       | 8                                   |
| Impaired loans, net             | \$ 0    | \$ 0    | \$4,427 | \$ 4,427                            |
| Foreclosed real estate          |         |         |         |                                     |
| Residential                     | \$ 0    | \$ 0    | \$173   | \$ 173                              |
| Commercial and land development | 0       | 0       | 31      | 31                                  |
| Total foreclosed real estate    | \$ 0    | \$ 0    | \$204   | \$ 204                              |
| December 31, 2015               |         |         |         |                                     |
| Impaired Loans                  |         |         |         |                                     |
| Commercial real estate:         |         |         |         |                                     |
| Owner-occupied                  | \$ 0    | \$ 0    | \$881   | \$ 881                              |
| Non-owner occupied              | 0       | 0       | 736     | 736                                 |
| Multi-family                    | 0       | 0       | 233     | 233                                 |
| Non-owner occupied residential  | 0       | 0       | 570     | 570                                 |
| Acquisition and development:    |         |         |         |                                     |
| Commercial and land development | 0       | 0       | 5       | 5                                   |
| Residential mortgage:           |         |         |         |                                     |
| First lien                      | 0       | 0       | 2,094   | 2,094                               |
| Home equity - lines of credit   | 0       | 0       | 229     | 229                                 |
| Installment and other loans     | 0       | 0       | 9       | 9                                   |
| Impaired loans, net             | \$ 0    | \$ 0    | \$4,757 | \$ 4,757                            |
| Foreclosed real estate          |         |         |         |                                     |
| Residential                     | \$ 0    | \$ 0    | \$101   | \$ 101                              |
| Commercial and land development | 0       | 0       | 74      | 74                                  |
| Total foreclosed real estate    | \$ 0    | \$ 0    | \$175   | \$ 175                              |

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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.

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.

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

Short-Term Borrowings

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

Long-Term Debt

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

Accrued Interest

The carrying amounts of accrued interest 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 June 30, 2016 and December 31, 2015:

| (Dollars in thousands)                  | Carrying Amount | Fair Value | Level 1  | Level 2   | Level 3 |
|---|-----------------|------------|----------|-----------|---------|
| June 30, 2016                           |                 |            |          |           |         |
| Financial Assets                        |                 |            |          |           |         |
| Cash and due from banks                 | \$ 12,940       | \$ 12,940  | \$12,940 | \$ 0      | \$ 0    |
| Interest bearing deposits with banks    | 50,709          | 50,709     | 50,709   | 0         | 0       |
| Restricted investments in bank stocks   | 5,780           | n/a        | n/a      | n/a       | n/a     |
| Securities available for sale           | 324,540         | 324,540    | 0        | 324,540   | 0       |
| Loans held for sale                     | 6,627           | 6,808      | 0        | 6,808     | 0       |
| Loans, net of allowance for loan losses | 818,493         | 837,477    | 0        | 0         | 837,477 |
| Accrued interest receivable             | 3,759           | 3,759      | 0        | 2,087     | 1,672   |
| Financial Liabilities                   |                 |            |          |           |         |
| Deposits                                | 1,087,969       | 1,096,309  | 0        | 1,096,309 | 0       |
| Short-term borrowings                   | 43,393          | 43,393     | 0        | 43,393    | 0       |
| Long-term debt                          | 24,331          | 25,282     | 0        | 25,282    | 0       |
| Accrued interest payable                | 378             | 378        | 0        | 378       | 0       |
| Off-balance sheet instruments           | 0               | 0          | 0        | 0         | 0       |
| December 31, 2015                       |                 |            |          |           |         |
| Financial Assets                        |                 |            |          |           |         |
| Cash and due from banks                 | \$ 11,412       | \$ 11,412  | \$11,412 | \$ 0      | \$ 0    |
| Interest bearing deposits with banks    | 16,928          | 16,928     | 16,928   | 0         | 0       |
| Restricted investments in bank stocks   | 8,720           | n/a        | n/a      | n/a       | n/a     |
| Securities available for sale           | 394,124         | 394,124    | 0        | 394,124   | 0       |
| Loans held for sale                     | 5,917           | 6,045      | 0        | 6,045     | 0       |
| Loans, net of allowance for loan losses | 768,145         | 776,067    | 0        | 0         | 776,067 |
| Accrued interest receivable             | 3,845           | 3,845      | 0        | 2,257     | 1,588   |
| Financial Liabilities                   |                 |            |          |           |         |
| Deposits                                | 1,032,167       | 1,032,265  | 0        | 1,032,265 | 0       |
| Short-term borrowings                   | 89,156          | 89,156     | 0        | 89,156    | 0       |
| Long-term debt                          | 24,495          | 25,357     | 0        | 25,357    | 0       |
| Accrued interest payable                | 366             | 366        | 0        | 366       | 0       |
| Off-balance sheet instruments           | 0               | 0          | 0        | 0         | 0       |

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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.

The Company, the Bank and certain current and former directors and executive officers (collectively, "Orrstown Defendants") are defendants in a putative class action filed by Southeastern Pennsylvania Transportation Authority ("SEPTA") on May 25, 2012, in the United States District Court for the Middle District of Pennsylvania. In a later amended complaint, the list of defendants was expanded to include the Company's then independent registered public accounting firm and the underwriters of the Company's March 2010 public offering of common stock. The complaint, as amended, 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 15, 2010 through April 5, 2012, the Company issued materially false and misleading statements regarding the Company's lending practices and financial results, including misleading statements concerning the stringent nature of the Bank's credit practices and underwriting standards, the quality of its loan portfolio, and the intended use of the proceeds from the Company's March 2010 public offering of common stock. The complaint asserts claims under Sections 11, 12(a) and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and seeks class certification, unspecified money damages, interest, costs, fees and equitable or injunctive relief.

On June 22, 2015, the Court dismissed without prejudice SEPTA's amended complaint against all defendants, finding that SEPTA failed to state a claim under either the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended. The Court ordered that, within 30 days, SEPTA either seek leave to amend its amended complaint, accompanied by the proposed amendment, or file a notice of its intention to stand on the amended complaint.

On July 22, 2015, SEPTA filed a motion for leave to amend under Local Rule 15.1, as allowed by the Court's ruling on June 22, 2015. Many of the allegations of the proposed second amended complaint are essentially the same or similar to the allegations of the dismissed amended complaint. The proposed second amended complaint also alleges that the Orrstown Defendants did not publicly disclose certain alleged failures of internal controls over loan underwriting, risk management, and financial reporting during the period 2009 to 2012, in violation of the federal securities laws. On February 8, 2016, the Court granted SEPTA's motion for leave to amend and SEPTA filed its second amended complaint that same day.

On February 25, 2016, the Court issued a scheduling Order directing: all defendants to file any motions to dismiss by March 18, 2016; SEPTA to file an omnibus opposition to defendants' motions to dismiss by April 8, 2016; and all defendants to file reply briefs in support of their motions to dismiss by April 22, 2016. Defendants timely filed their motions to dismiss the second amended complaint and the parties filed their briefs in accordance with the Court-ordered schedule. The February 25, 2016 Order stays all discovery and other deadlines in the case (including the filing of SEPTA's motion for class certification) pending the outcome of the motions to dismiss.

The Company believes that the allegations of SEPTA's second amended complaint are without merit and intends to vigorously defend itself against those claims. Given the litigation is still in the pleading stage, it is not possible at this time to estimate reasonably possible losses, or even a range of reasonably possible losses, in connection with the litigation.

SEPTA's Second Amended Complaint disclosed the existence of a confidential, non-public, fact-finding inquiry regarding the Company being conducted by the Securities and Exchange Commission ("Commission"). The Company has been cooperating fully with the investigation but has not yet reached any definitive agreement with the Commission regarding a resolution. Accordingly, there can be no assurances that the outcome of the investigation will not have a material adverse effect on the Company's financial condition or results of operations.

The Company has established a reserve of \$1,000,000 for outstanding legal matters.

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 June 30, 2016, the Company had total assets of \$1,311,353,000, total liabilities of \$1,170,314,000 and total shareholders' equity of \$141,039,000.

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The U.S. economy is in its seventh 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 continues to decline, however it remains to be seen if this will continue. Corporate profitability for publicly traded companies has been declining for a few quarters and historically this has led to cutbacks in business investment and employment. In addition, most of the rest of the world's economies appear to be in a recession or experiencing decelerating growth which has resulted in volatile markets. Although the dollar strengthened significantly in 2014 and 2015, the dollar weakened somewhat in the first half of 2016. This has led to a mild increase in commodity prices. The Federal Reserve paused their plans to tighten monetary policy due to the increased uncertainty.

### 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, 2015, the Company's Quarterly Reports on Form 10-Q for the quarter ended March 31, 2016, 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 June 30, 2016 and results of operations for the three and six months ended June 30, 2016 and 2015. 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

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

The Company recognizes deferred tax assets and liabilities for the future effects of temporary differences and tax credits. Enacted tax rates are applied to cumulative temporary differences based on expected taxable income in the periods in which the deferred tax asset or liability is anticipated to be realized. Future tax rate changes could occur that would require the recognition of income or expense in the statement of operations in the period in which they are enacted. Deferred tax assets must be reduced by a valuation allowance if in management's judgment it is "more likely than not" that some portion of the asset will not be realized. Management may need to modify 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. 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.

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 JUNE 30, 2016 COMPARED TO QUARTER ENDED JUNE 30, 2015

#### Summary

The Company recorded net income of \$678,000 for the second quarter of 2016 compared to net income of \$1,502,000 for the same period in 2015. Diluted earnings per share amounted to \$0.08 for the three months ended June 30, 2016, compared to \$0.18 for the same period in 2015. The results of operations for the three months ended June 30, 2016 were negatively impacted by the establishment of a \$1,000,000 reserve for outstanding legal matters. Net interest income totaled \$8,951,000 for the three months June 30, 2016, a 4.1% increase compared to the same period in 2015. Net interest margin on a fully tax-equivalent basis was 3.15% for the three months ended June 30, 2016 compared to 3.18% for the same period in 2015. Despite higher average balances in loans in 2016 as compared to 2015 and a 25 basis point ("bp") increase in the prime lending rate between the two years, the flattening yield curve negatively affected the Company's net interest margin for the period.

There was no provision for loan losses recorded for the three months ended June 30, 2016 and 2015.

Securities gains were \$0 for the three months ended June 30, 2016, a decrease of \$353,000 from the same period in the prior year.

#### 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 federal funds sold. Interest bearing liabilities include deposits and borrowed funds. To compare the tax-exempt yields to taxable yields, amounts are adjusted to pretax equivalents based on a 35% federal corporate tax rate.

Net interest income is affected by changes in interest rates, volumes of interest-earning assets and interest-bearing liabilities and the composition of those assets and liabilities. The "net interest spread" and "net interest margin" 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

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of net interest income to average earning assets. Through the use of non-interest bearing demand deposits and shareholders' equity, the net interest margin exceeds the net interest spread, as these funding sources are non-interest bearing.

For the three months ended June 30, 2016, net interest income measured on a fully tax equivalent basis increased \$510,000, or 5.7%, to \$9,456,000 from \$8,946,000 in the corresponding period in 2015. A primary reason for the increase in net interest income is a 6.8% increase in interest earning assets offset partially by increased funding costs. Interest income earned on loans increased from \$8,021,000 for the quarter ended June 30, 2015 to \$8,652,000 for the same period in 2016, a \$631,000 increase. The reason for the increase was an increase in the average balance of loans from \$744,542,000 for the second quarter of 2015 to \$824,004,000 for the same period in 2016, partially offset by a decrease in the average rate earned from 4.32% in the quarter ended June 30, 2015 to 4.22% in the same period in 2016. 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 decrease in lower average interest rates earned on loans.

Securities interest income increased \$168,000 to \$2,046,000 for the quarter ended June 30, 2016, from \$1,878,000 for the same period in 2015. Despite lower average balances, the reason for the increase is the result of the average tax equivalent yields on securities increasing from 2.04% for the three months ended June 30, 2015 to 2.49% for the corresponding period in the current year. The increase in yields has resulted from a higher composition of tax free securities, and the higher tax-equivalent yields associated with them. 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. The Company has not purchased any new securities in 2016.

Interest expense on deposits and borrowings for the three months ended June 30, 2016 was \$1,321,000, an increase of \$351,000, from \$970,000 in the same period in 2015. Our ability to attract new deposits in all categories, but in particular, time deposits, resulted in an increase in average interest-bearing deposits. The Company's cost of funds on interest-bearing liabilities increased to 0.53% for the quarter ended June 30, 2016 from 0.42% for the same period in 2015. The higher rate paid was primarily for intermediate term brokered deposits that were acquired in the latter half of 2015 to protect the bank's earnings from a rising rate environment. Additionally, the cost of interest bearing liabilities is influenced by changes in short-term interest rates.

The Company's net interest spread of 3.07% decreased 3 basis points in the quarter ended June 30, 2016 as compared to the same period in 2015. Net interest margin was 3.15% for the quarter ended June 30, 2016, a 3 basis point decrease from 3.18% for the quarter ended June 30, 2015. Despite higher average balances in loans during the three months ended June 30, 2016 as compared to 2015, the effect of a flattening yield curve negatively impacted the Company's net interest margin for the period. Maturing loans were reinvested at lower rates due to competitive market conditions. The increase on securities yields helped increase the average yield earned on interest earning assets for the three months ended June 30, 2016 as compared to 2015, however, it was not enough to offset increased funding costs.

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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 June 30, 2016 and 2015.

| (Dollars in thousands)                              | June 30, 2016   |                         |                     | June 30, 2015   |                         |                     |
|---|-----------------|-------------------------|---------------------|-----------------|-------------------------|---------------------|
|   | Average Balance | Tax Equivalent Interest | Tax Equivalent Rate | Average Balance | Tax Equivalent Interest | Tax Equivalent Rate |
| <b>Assets</b>                                       |                 |                         |                     |                 |                         |                     |
| Federal funds sold & interest bearing bank balances | \$50,491        | \$ 79                   | 0.63 %              | \$14,429        | \$ 17                   | 0.47 %              |
| Securities  | 330,973         | 2,046                   | 2.49                | 369,368         | 1,878                   | 2.04                |
| Loans   | 824,004         | 8,652                   | 4.22                | 744,542         | 8,021                   | 4.32                |
| Total interest-earning assets                       | 1,205,468       | 10,777                  | 3.60                | 1,128,339       | 9,916                   | 3.52                |
| Other assets  | 98,376          |                         |                     | 82,987          |                         |                     |
| Total   | \$1,303,844     |                         |                     | \$1,211,326     |                         |                     |
| <b>Liabilities and Shareholders' Equity</b>         |                 |                         |                     |                 |                         |                     |
| Interest bearing demand deposits                    | \$542,075       | \$ 282                  | 0.21                | \$502,182       | \$ 225                  | 0.18                |
| Savings deposits                                    | 91,341          | 36                      | 0.16                | 84,366          | 34                      | 0.16                |
| Time deposits                                       | 300,244         | 873                     | 1.17                | 230,937         | 521                     | 0.90                |
| Short term borrowings                               | 47,810          | 25                      | 0.21                | 94,953          | 81                      | 0.34                |
| Long term debt                                      | 24,378          | 105                     | 1.73                | 24,700          | 109                     | 1.77                |
| Total interest bearing liabilities                  | 1,005,848       | 1,321                   | 0.53                | 937,138         | 970                     | 0.42                |
| Non-interest bearing demand deposits                | 146,233         |                         |                     | 132,063         |                         |                     |
| Other   | 13,364          |                         |                     | 10,617          |                         |                     |
| Total Liabilities                                   | 1,165,445       |                         |                     | 1,079,818       |                         |                     |
| Shareholders' Equity                                | 138,399         |                         |                     | 131,508         |                         |                     |
| Total   | \$1,303,844     |                         |                     | \$1,211,326     |                         |                     |
| Net interest income (FTE)/net interest spread       |                 | 9,456                   | 3.07 %              |                 | 8,946                   | 3.10 %              |
| Net interest margin                                 |                 |                         | 3.15 %              |                 |                         | 3.18 %              |
| Tax-equivalent adjustment                           |                 | (505 )                  |                     |                 | (348 )                  |                     |
| Net interest income                                 |                 | \$ 8,951                |                     |                 | \$ 8,598                |                     |

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 during the three months ended June 30, 2016 and 2015. In calculating 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. For both periods presented, favorable historical charge-off data combined with stable economic and market conditions has resulted in the determination that no additional provision for loan losses was required to offset net charge-offs, nor were additional reserves needed for loan growth experienced during the periods.

See further discussion in the "Allowance for Loan Losses" section.

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Noninterest Income

Noninterest income, excluding securities gains, totaled \$4,537,000 for the three months ended June 30, 2016, compared to \$4,530,000 earned in the same period in 2015. Despite consistent income levels, the components of noninterest income varied during the three months ended June 30, 2016 compared to the same period in 2015, as noted below.

- Service charges on deposit accounts totaled \$1,372,000 for the three months ended June 30, 2016, compared to \$1,299,000 for the same period in 2015, with the increase due principally to revenues generated from new product offerings and higher interchange fees associated with increased usage by our customers.

Mortgage banking activities generated revenue of \$727,000 for the three months ended June 30, 2016, which was approximately 8.3% lower than the same period in 2015, due to the Company maintaining a portion of the mortgage production for its loan portfolio.

Earnings on life insurance totaled \$270,000 for the three months ended June 30, 2016, an increase of \$37,000, or 15.9%, over the same period in 2015, due principally to additional life insurance purchased in 2016 to fund a new compensation arrangement.

Other income of \$114,000 for the three months ended June 30, 2016 was \$80,000, or 41.2%, lower than for the same period in 2015 due principally to a reduced level of gains on the sale of other real estate, which totaled \$49,000 for the second quarter of 2016, compared to \$166,000 in the second quarter of 2015.

Securities gains totaled \$0 for the three months ended June 30, 2016, compared to \$353,000 for the same period in 2015. Asset/liability management strategies and interest rate conditions resulted in gains on sales of securities for the three months ended June 30, 2015, as market conditions presented opportunities to accelerate earnings on securities through gains, while also meeting funding requirements of anticipated lending activity.

Noninterest Expenses

Noninterest expenses totaled \$12,558,000 for the three months ended June 30, 2016, compared to \$11,658,000 for the corresponding prior year period, an increase of 7.7%. The following factors contributed to the net decrease in noninterest expense.

Salaries and employee benefits totaled \$6,312,000 for the three months ended June 30, 2016 compared to \$6,158,000 for the same period in 2015. Excluding the impact of severance costs of \$63,000 and \$360,000 for the three months ended June 30, 2016 and 2015, salaries and benefits increased 7.8% for the three months ended June 30, 2016, compared to 2015. The higher expenses in 2016 were due to merit increases, additional employees, higher costs associated with supplemental executive compensation and additional share-based awards granted in 2016, with incremental expense on top of previous awards that have not fully vested.

FDIC insurance increased from \$184,000 for the three months ended June 30, 2016 to \$223,000 for the same period in 2016, an increase of 21.2%. The increase in expense is attributable to the growth the Company has experienced, as the assessment is based on the Bank's assets less tangible equity.

Legal fees totaled \$225,000 for the three months ended June 30, 2016, a decrease of \$251,000 from \$476,000 for the same period in 2015. In the second quarter of 2015, the Company had higher than normal legal expenses as it attended to legal matters, including the outstanding litigation against the Company and the ongoing confidential investigation with the Securities and Exchange Commission, which began in the second quarter of 2015. Although both matters are ongoing, the professional services associated with them in 2016 have been less than the heightened levels in 2015. There can be no assurances that future legal fees will remain lower than 2015 amounts.

Directors' compensation totaled \$257,000 for the three months ended June 30, 2016, a 51.1% increase over \$170,000 for the same period in 2015. The increase is principally attributable to two new directors added in 2016, and related compensation paid to them for their services. The remainder of the increase is attributable to directors' compensation that resulted from the issuance of restricted stock, in which there was only one month of expense in the three months ended June 30, 2015 as the stock was awarded at the end of May, 2015. The corresponding period in 2016 had two months of expense for the 2015 award, and two months of expense for the 2016 award that occurred at the beginning of May 2016. Both awards have a one year vesting period.





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Taxes, other than income, increased \$27,000 from \$226,000 for the three months ended June 30, 2015 to \$253,000 for the three months ended June 30, 2016. The increase is attributable to higher capital, which is used in the assessment of the Pennsylvania Bank Shares Tax liability.

During the second quarter of 2016, a reserve of \$1,000,000 was established for outstanding legal matters which increased noninterest expense.

Other operating expenses of \$1,124,000 for the three months ended June 30, 2016 represented a \$210,000 decrease over the \$1,334,000 expensed in the corresponding period in 2015. Included in this category are losses associated with loans sold on the secondary market for credit enhancements that the Company provided to the investor. The charge to earnings for credit enhancement losses totaled \$209,000 for the three months ended June 30, 2015, compared to a recovery of expenses of \$45,000 for the corresponding period in 2015.

The Company's efficiency ratio improved for the three months ended June 30, 2016 to 82.3% compared to 86.8% for the same period in 2015. The improvement in the ratio was primarily the result of the increases in net interest income coupled with noninterest income as well as a decrease in noninterest expense. The efficiency ratio expresses noninterest expense as a percentage of tax equivalent net interest income and noninterest income, excluding securities gains, intangible asset amortization, other real estate income and expenses and the legal reserve established in 2016.

**Income Tax Expense**

Income tax expense totaled \$252,000 for the three months ended June 30, 2016, for an effective tax rate of 27.1%, compared to \$321,000, or 17.6% of pre-tax income, for the same period in 2015. The Company's effective tax rate is significantly less than the federal statutory rate of 35.0% principally due to tax-free income, including interest earned on tax-free loans and securities, earnings on the cash surrender value of life insurance policies, offset by non-tax deductible expenses. The higher effective tax rate for the three months ended June 30, 2016 compared to the same period in 2015 is the result of non-tax deductible expenses representing a larger portion of pre-tax income in the current year's results.

**SIX MONTHS ENDED JUNE 30, 2016 COMPARED TO SIX MONTHS ENDED JUNE 30, 2015**

**Summary**

The Company recorded net income of \$3,258,000 for the six months ended June 30, 2016 compared to net income of \$3,964,000 for the same period in 2015. Diluted EPS for the six months ended June 30, 2016 were \$0.40, compared to \$0.49 for the six months ended June 30, 2015. The results of operations for the six months ended June 30, 2016 were negatively impacted by the establishment of a \$1,000,000 reserve for outstanding legal matters. Net interest income was \$17,601,000 for the six months ended June 30, 2016, a 4.1% increase compared to the same period in 2015. Net interest margin on a fully tax-equivalent basis was 3.11% for the six months ended June 30, 2016 compared to 3.18% for the same period in 2015. Despite higher average balances in loans during 2016 as compared to 2015 and a 25 bp increase in the prime lending rate between the two years, the flattening yield curve negatively affected the Company's net interest margin for the period.

There was no provision for loan losses recorded for the six months ended June 30, 2016 and 2015.

**Net Interest Income**

For the six months ended June 30, 2016, net interest income measured on a fully tax equivalent basis increased \$1,050,000 to \$18,615,000 from \$17,565,000 in the corresponding period in 2015. The primary reason for the increase in net interest income was an increase in the average balance of loans and average rates earned on securities, offset partially by a higher average in interest bearing liabilities and higher cost of funds on them.

Interest income earned on loans increased \$1,292,000 from \$15,622,000 for the six months ended June 30, 2015 to \$16,914,000 for the same period in 2016. The primary reason for the increase was growth in the average loan balance from \$729,022,000 for the six months ended June 30, 2015 to \$809,894,000 for the same period in 2016, offset partially by a 12 bp decrease in yield on the loans to 4.20% for the six months ended June 30, 2016. 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 decrease in lower average interest rates earned on loans.

Securities interest income increased \$406,000 to \$4,189,000 for the six months ended June 30, 2016, from \$3,783,000 for the same period in 2015. The average balance on securities decreased from \$363,037,000 for the six months ended

June 30, 2015 to \$347,294,000 for the same period in 2016. The increase in interest income on securities was positively affected by a

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higher composition of tax free securities, and the higher tax equivalent yields associated with them, and resulted in a yield earned on securities of 2.43% in 2016 compared to 2.10% for the same period in 2015. The decrease in the average balance of securities is the result of sales and pay downs used to fund loan growth, and the lack of purchases during 2016. Increases on yields on securities helped increase the average yield earned on interest earning assets in 2016.

Interest expense on deposits and borrowings for the six months ended June 30, 2016 was \$2,632,000, an increase of \$749,000, from \$1,883,000 in the same period in 2015. Our ability to attract new deposits in all categories, but in particular time deposits, allowed for an increase in average deposits. The Company's cost of funds on interest bearing liabilities has increased to 0.52% for the six months ended June 30, 2016 from 0.41% for the same period in 2015. The higher rate paid was primarily for intermediate term brokered deposits that were acquired in the latter half of 2015 to protect the bank's earnings from a rising rate environment. Additionally, the cost of interest bearing liabilities is influenced by changes in short-term interest rates.

The Company's net interest spread of 3.03% decreased 8 basis points for the six months ended June 30, 2016 as compared to the same period in 2015. Net interest margin for the six months ended June 30, 2016 was 3.11%, a 7 basis point decrease from 3.18% for the six months ended June 30, 2015. Despite higher average balances in loans during the six months ended June 30, 2016 as compared to 2015, the effect of the flattening yield curve negatively impacted the Company's net interest margin for the period. Maturing loans were reinvested at lower rates due to competitive market conditions. The increase on securities yields helped increase the average yield earned on interest earnings assets for the six months ended June 30, 2016 as compared to 2015, but it was not enough to offset increased funding costs.

The table that follows shows average balances and interest yields on a fully taxable equivalent basis (FTE) for the six months ended June 30, 2016 and 2015:

| (Dollars in thousands)                              | June 30, 2016   |                         |                     | June 30, 2015   |                         |                     |
|---|-----------------|-------------------------|---------------------|-----------------|-------------------------|---------------------|
|   | Average Balance | Tax Equivalent Interest | Tax Equivalent Rate | Average Balance | Tax Equivalent Interest | Tax Equivalent Rate |
| <b>Assets</b>                                       |                 |                         |                     |                 |                         |                     |
| Federal funds sold & interest bearing bank balances | \$46,867        | \$ 144                  | 0.62 %              | \$21,957        | \$ 43                   | 0.39 %              |
| Securities  | 347,294         | 4,189                   | 2.43                | 363,037         | 3,783                   | 2.10                |
| Loans   | 809,894         | 16,914                  | 4.20                | 729,022         | 15,622                  | 4.32                |
| Total interest-earning assets                       | 1,204,055       | 21,247                  | 3.55                | 1,114,016       | 19,448                  | 3.52                |
| Other assets  | 96,334          |                         |                     | 82,346          |                         |                     |
| Total   | \$1,300,389     |                         |                     | \$1,196,362     |                         |                     |
| <b>Liabilities and Shareholders' Equity</b>         |                 |                         |                     |                 |                         |                     |
| Interest bearing demand deposits                    | \$531,757       | \$ 532                  | 0.20                | \$503,277       | \$ 444                  | 0.18                |
| Savings deposits                                    | 89,522          | 71                      | 0.16                | 86,007          | 68                      | 0.16                |
| Time deposits                                       | 302,523         | 1,727                   | 1.15                | 232,981         | 1,045                   | 0.90                |
| Short term borrowings                               | 62,076          | 91                      | 0.29                | 86,708          | 141                     | 0.33                |
| Long term debt                                      | 24,419          | 211                     | 1.74                | 20,430          | 185                     | 1.83                |
| Total interest bearing liabilities                  | 1,010,297       | 2,632                   | 0.52                | 929,403         | 1,883                   | 0.41                |
| Non-interest bearing demand deposits                | 139,723         |                         |                     | 125,501         |                         |                     |
| Other   | 13,286          |                         |                     | 10,890          |                         |                     |
| Total Liabilities                                   | 1,163,306       |                         |                     | 1,065,794       |                         |                     |
| Shareholders' Equity                                | 137,083         |                         |                     | 130,568         |                         |                     |
| Total   | \$1,300,389     |                         |                     | \$1,196,362     |                         |                     |
| Net interest income (FTE)/net interest spread       |                 | 18,615                  | 3.03 %              |                 | 17,565                  | 3.11 %              |
| Net interest margin                                 |                 |                         | 3.11 %              |                 |                         | 3.18 %              |
| Tax-equivalent adjustment                           |                 | (1,014 )                |                     |                 | (652 )                  |                     |

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|                     |           |           |
|---------------------|-----------|-----------|
| Net interest income | \$ 17,601 | \$ 16,913 |
|---------------------|-----------|-----------|

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

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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 six months ended June 30, 2016, and 2015. In calculating 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. For both periods presented, favorable historical charge-off data combined with stable economic and market conditions has resulted in the determination that no additional provision for loan losses was required to offset net charge-offs, nor were additional reserves needed 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 \$8,782,000 for the six months ended June 30, 2016, compared to \$8,369,000 for the same period in 2015. Several factors contributed to the net change in noninterest income for the first six months of 2016 compared to the same period in 2015, as noted below.

The Company experienced an increase in service charges on deposit accounts of \$183,000 for the six months ended June 30, 2016 to \$2,675,000 compared to the corresponding period in 2015, due principally to revenues generated from new product offerings and higher interchange fees associated with increased usage by our customers.

Trust department and brokerage income was \$3,550,000 for the six months ended June 30, 2016, an increase of \$120,000, or 3.5% from the same period in 2015. Several estates were settled in the first quarter of 2016, which favorably impacted income.

Mortgage banking revenues totaled \$1,369,000 for the six months ended June 30, 2016, an increase of \$56,000 or 4.3%, over the six months ended June 30, 2015. The Company has been retaining a portion of its mortgage production for its portfolio in 2016 which has narrowed the gap between the revenues generated in 2016 and the corresponding period in 2015.

Earnings on life insurance totaled \$538,000 for the six months ended June 30, 2016, an increase of \$76,000, or 16.5%, over the same period in 2015, due principally to additional life insurance purchased in 2016 to fund a new compensation arrangement.

Securities gains totaled \$1,420,000 for the six months ended June 30, 2016 compared to \$1,882,000 for the same period in 2015. For all periods in which securities were sold, asset/liability management strategies and interest rate conditions resulted in gains on sales of securities, as market conditions presented opportunities to accelerate earnings on securities through gains, while also meeting the funding requirements of lending activity.

Noninterest Expenses

Noninterest expenses totaled \$23,679,000 for the six months ended June 30, 2016, compared to \$22,164,000 for the corresponding prior year period. The changes in certain components of noninterest expenses for the six months ended June 30, 2016 and 2015, are described below.

Salaries and employee benefits increased \$437,000 or 3.6%, from \$12,058,000 for the six months ended June 30, 2015 to \$12,495,000 for the same period in 2016. Excluding the impact of severance costs of \$63,000 and \$360,000 for the six months ended June 30, 2016, salaries and benefits increased 6.3% for the period. The higher expenses in 2016 were due to merit increases, additional employees, higher costs associated with supplemental executive compensation and additional share-based awards granted in 2016, with incremental expense on top of previous awards that have not fully vested.

Occupancy expense of \$1,118,000 for the six months ended June 30, 2016 represented a decrease of \$68,000 from \$1,186,000 the same period in 2015, due in part to rental income collected on a building purchased in the first quarter of 2016.



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Data processing costs of \$1,154,000 for the six months ended June 30, 2016, increased \$117,000, or 11.3%, compared to \$1,037,000 for the same period in 2015. The increase in costs is reflective of overall higher volumes and costs associated with new and more sophisticated product and service offerings.

Advertising and bank promotion expense increased from \$569,000 for the six months ended June 30, 2015 to \$811,000 for corresponding period in 2016. The increase is due to \$100,000 of incremental educational improvement tax credit ("EITC") contributions that carried over to the first quarter of 2016, and increased advertising and promotion expenditures as we continue to promote the Orrstown brand in the markets we presently serve.

Legal fees decreased \$283,000 to \$406,000 for the six months ended June 30, 2016 compared to \$689,000 for the same period in 2015, a decline of 41.1%. In the second quarter of 2015, the Company had higher than normal legal expenses as it attended to legal matters. Although legal matters are ongoing, the legal expenses associated with them in 2016 have been less than the heightened levels in 2015. There can be no assurances that future legal fees will remain lower than 2015 amounts. There can be no assurances that future legal fees will remain lower than 2015 amounts.

Directors' compensation totaled \$488,000 for the six months ended June 30, 2016, a 49.2% increase over \$327,000 for the same period in 2015. The increase is principally due to two new directors added in 2016, and related compensation paid to them for their services. The remainder of the increase is attributable to directors' compensation that resulted from the issuance of restricted stock in May 2016 and 2015 with expense totaling \$108,000 in 2016 compared to \$14,000 in the corresponding period in 2015.

Taxes, other than income, decreased \$44,000 from \$452,000 for the six months ended June 30, 2015 to \$408,000 for the six months ended June 30, 2016. As a result of the incremental EITC contributions made in the first quarter of 2016, a corresponding \$90,000 credit was recognized on our Bank Shares Tax liability, and reduced the tax expense for the period.

During the second quarter of 2016, a reserve of \$1,000,000 was established for outstanding legal matters which increased noninterest expense.

The Company's efficiency ratio improved slightly for the six months ended June 30, 2016 to 82.5%, compared to 85.3% for the same period in 2015. The improvement in the ratio was primarily the result of the increase in net interest income and noninterest income exceeding the increase in noninterest expenses.

### Income Tax Expense

Income tax expense totaled \$866,000, or an effective tax rate of 21.0% for the six months ended June 30, 2016, compared to \$1,036,000, or 20.7% of pre-tax earnings, for the six months ended June 30, 2015. The Company's effective tax rate is significantly less than the federal statutory rate of 35.0% principally due to tax-free income, including interest earned on tax-free loans and securities, earnings on the cash surrender value of life insurance policies, and non-tax deductible expenses. The slightly higher effective tax rate for the six months ended June 30, 2016 compared to the same period in 2015 is the result of a larger portion of expenses not being deductible for tax purposes, offset somewhat by a larger percentage of pre-tax income being tax-free and additional federal income tax credits in the current year's results.

## 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 to enhance income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings. As of



June 30, 2016, securities available for sale were \$324,540,000, a decrease of \$69,584,000, from December 31, 2015's balance of \$394,124,000. As a result of interest rate market conditions, the Company liquidated its government-sponsored enterprise

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commercial mortgage obligations portfolio during the first quarter of 2016 with an amortized cost of \$63,598,000, and fair value of \$63,770,000 at December 31, 2015, at a net gain of \$1,420,000. The proceeds from the sale were used to fund loan demand, including liquidity for loans that will fund later in 2016.

**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.

The loan portfolio, excluding residential loans held for sale, broken out by classes as of June 30, 2016 and December 31, 2015 was as follows:

| (Dollars in thousands)              | June 30,<br>2016 | December 31,<br>2015 |
|-------------------------------------|------------------|----------------------|
| Commercial real estate:             |                  |                      |
| Owner-occupied                      | \$ 106,649       | \$ 103,578           |
| Non-owner occupied                  | 190,558          | 145,401              |
| Multi-family                        | 38,957           | 35,109               |
| Non-owner occupied residential      | 56,100           | 54,175               |
| Acquisition and development:        |                  |                      |
| 1-4 family residential construction | 6,714            | 9,364                |
| Commercial and land development     | 24,748           | 41,339               |
| Commercial and industrial           | 82,616           | 73,625               |
| Municipal                           | 61,568           | 57,511               |
| Residential mortgage:               |                  |                      |
| First lien                          | 129,577          | 126,022              |
| Home equity - term                  | 16,216           | 17,337               |
| Home equity - lines of credit       | 110,908          | 110,731              |
| Installment and other loans         | 7,322            | 7,521                |
|                                     | \$831,933        | \$ 781,713           |

The loan portfolio at June 30, 2016 of \$831,933,000 reflected an increase of \$50,220,000, or 6.4%, from \$781,713,000 at December 31, 2015. Growth was experienced in nearly all loan segments from December 31, 2015 to June 30, 2016, with the largest increase coming in the commercial real estate segment, which grew by \$54,001,000, which includes construction loans that were converted to permanent amortization upon completion of the project. The Company's increased sales efforts and additional relationship managers have resulted in growth, as we capitalize on disruption in the market that has been caused by the acquisition of some of the competitors in the markets served by larger institutions.

**Asset Quality****Risk Elements**

The Company's loan portfolio is 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.



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

Nonperforming assets include nonaccrual 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, generally 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 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 June 30, 2016, December 31, 2015 and June 30, 2015. Relevant asset quality ratios are also presented.

| (Dollars in thousands)  | June 30,<br>2016 | December 31,<br>2015 | June 30,<br>2015 |   |  |
|---|------------------|----------------------|------------------|---|--|
| Nonaccrual loans (cash basis)   | \$14,092         | \$ 16,557            | \$10,261         |   |  |
| Other real estate (OREO)  | 651              | 710                  | 1,062            |   |  |
| Total nonperforming assets  | 14,743           | 17,267               | 11,323           |   |  |
| Restructured loans still accruing   | 907              | 793                  | 1,004            |   |  |
| Loans past due 90 days or more and still accruing                             | 0                | 24                   | 171              |   |  |
| Total risk assets   | \$15,650         | \$ 18,084            | \$12,498         |   |  |
| Loans 30-89 days past due   | \$1,051          | \$ 2,532             | \$1,984          |   |  |
| Asset quality ratios:   |                  |                      |                  |   |  |
| Nonaccrual loans to loans   | 1.69             | % 2.12               | % 1.37           | % |  |
| Nonperforming assets to assets  | 1.12             | % 1.34               | % 0.92           | % |  |
| Total nonperforming assets to total loans and OREO                            | 1.77             | % 2.21               | % 1.50           | % |  |
| Total risk assets to total loans and OREO                                     | 1.88             | % 2.31               | % 1.66           | % |  |
| Total risk assets to total assets   | 1.19             | % 1.40               | % 1.01           | % |  |
| Allowance for loan losses to total loans                                      | 1.62             | % 1.74               | % 1.84           | % |  |
| Allowance for loan losses to nonaccrual loans                                 | 95.37            | % 81.95              | % 135.00         | % |  |
| Allowance for loan losses to nonaccrual and restructured loans still accruing | 89.61            | % 78.20              | % 122.96         | % |  |

Risk assets, defined as nonaccrual loans, restructured loans, loans past due 90 days or more and still accruing, and other real estate owned, totaled \$15,650,000 at June 30, 2016, a decrease of \$2,434,000, or 13.5%, from the balance at

December 31, 2015 of \$18,084,000, and an increase of \$3,152,000, or 25.2% from June 30, 2015. In efforts by Company personnel to work

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through risk assets in order to reduce the risk of future credit losses in the portfolio, one relationship totaling \$6,692,000 was identified in the third quarter of 2015 with potential weaknesses, and was moved to nonaccrual status. The Company continues to work through risk assets in order to reduce the level of nonperforming assets and the risk of future credit losses.

A further breakdown of impaired loans at June 30, 2016 and December 31, 2015 is as follows:

| (Dollars in thousands)          | June 30, 2016       |   |           | December 31, 2015   |   |           |
|---------------------------------|---------------------|---|-----------|---------------------|---|-----------|
|                                 | Nonaccrual<br>Loans | Restructured<br>Loans Still<br>Accruing | Total     | Nonaccrual<br>Loans | Restructured<br>Loans Still<br>Accruing | Total     |
| Commercial real estate:         |                     |   |           |                     |   |           |
| Owner occupied                  | \$ 1,827            | \$ 0                                    | \$ 1,827  | \$ 2,109            | \$ 0                                    | \$ 2,109  |
| Non-owner occupied              | 7,055               | 0                                       | 7,055     | 7,856               | 0                                       | 7,856     |
| Multi-family                    | 216                 | 0                                       | 216       | 233                 | 0                                       | 233       |
| Non-owner occupied residential  | 560                 | 0                                       | 560       | 895                 | 0                                       | 895       |
| Acquisition and development     |                     |   |           |                     |   |           |
| Commercial and land development | 2                   | 0                                       | 2         | 5                   | 0                                       | 5         |
| Commercial and industrial       | 474                 | 0                                       | 474       | 734                 | 0                                       | 734       |
| Residential mortgage:           |                     |   |           |                     |   |           |
| First lien                      | 3,515               | 907                                     | 4,422     | 4,015               | 793                                     | 4,808     |
| Home equity - term              | 96                  | 0                                       | 96        | 103                 | 0                                       | 103       |
| Home equity - lines of credit   | 337                 | 0                                       | 337       | 590                 | 0                                       | 590       |
| Installment and other loans     | 10                  | 0                                       | 10        | 17                  | 0                                       | 17        |
|                                 | \$ 14,092           | \$ 907                                  | \$ 14,999 | \$ 16,557           | \$ 793                                  | \$ 17,350 |

As of June 30, 2016, the Company had 85 lending relationships with loans that were considered impaired, and were included in the impaired loan balance of \$14,999,000, compared to 84 lending relationships with an impaired loan balance of \$17,350,000 at December 31, 2015. 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 June 30, 2016 and December 31, 2015.

| (Dollars in thousands)   | # of<br>Relationships | Recorded<br>Investment | Partial<br>Charge-offs<br>to Date | Specific<br>Reserves |
|--|-----------------------|------------------------|-----------------------------------|----------------------|
| June 30, 2016  |                       |                        |                                   |                      |
| Relationships greater than \$1,000,000                         | 1                     | \$ 6,244               | \$ 0                              | \$ 0                 |
| Relationships greater than \$500,000 but less than \$1,000,000 | 2                     | 1,398                  | 620                               | 0                    |
| Relationships greater than \$250,000 but less than \$500,000   | 4                     | 1,169                  | 120                               | 0                    |
| Relationships less than \$250,000                              | 78                    | 6,188                  | 1,268                             | 234                  |
|  | 85                    | \$ 14,999              | \$ 2,008                          | \$ 234               |
| December 31, 2015  |                       |                        |                                   |                      |
| Relationships greater than \$1,000,000                         | 1                     | \$ 6,542               | \$ 0                              | \$ 0                 |
| Relationships greater than \$500,000 but less than \$1,000,000 | 2                     | 1,578                  | 475                               | 164                  |
| Relationships greater than \$250,000 but less than \$500,000   | 7                     | 2,659                  | 188                               | 0                    |
| Relationships less than \$250,000                              | 74                    | 6,571                  | 1,294                             | 125                  |
|  | 84                    | \$ 17,350              | \$ 1,957                          | \$ 289               |

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 June 30, 2016, one had an outstanding book balance in excess of \$1,000,000. Seventy-eight (78) of the relationships, or 92% 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.

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The largest impaired loan relationship, with an outstanding loan balance of \$6,522,000, migrated to impaired status during the third quarter of 2015. Despite the loan being current as to both principal and interest, the Company moved this loan secured by non-owner occupied commercial property to impaired status as the long-term revenue stream and the guarantors' ability to keep the loan current have weakened. The Company believes the loan is well secured, and no loss is anticipated at this time.

Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of \$500,000, which includes confirmation of risk rating by the appropriate credit authority, including Credit Administration for loans in excess of \$1,000,000. In addition, all relationships greater than \$250,000 rated Substandard, Doubtful or Loss are reviewed and corresponding risk ratings are reaffirmed by the Bank's Problem Loan Committee, with subsequent reporting to the ERM Committee.

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 June 30, 2016. 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 \$651,000 consists of fourteen properties owned by the Company, eleven of which were commercial properties and totaled \$427,000, and three residential properties that totaled \$224,000. All properties have carrying values of \$145,000 or less and are carried at the lower of cost or fair value, less costs to dispose.

As of June 30, 2016, 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 June 30, 2016 and December 31, 2015:

| (Dollars in thousands)              | Pass       | Special<br>Mention | Non-Impaired<br>Substandard | Impaired -<br>Substandard | Doubtful | Total      |
|-------------------------------------|------------|--------------------|-----------------------------|---------------------------|----------|------------|
| <b>June 30, 2016</b>                |            |                    |                             |                           |          |            |
| Commercial real estate:             |            |                    |                             |                           |          |            |
| Owner-occupied                      | \$ 101,005 | \$ 1,719           | \$ 2,098                    | \$ 1,827                  | \$ 0     | \$ 106,649 |
| Non-owner occupied                  | 167,320    | 16,031             | 152                         | 7,055                     | 0        | 190,558    |
| Multi-family                        | 36,190     | 1,298              | 1,253                       | 216                       | 0        | 38,957     |
| Non-owner occupied residential      | 53,132     | 1,224              | 1,184                       | 560                       | 0        | 56,100     |
| Acquisition and development:        |            |                    |                             |                           |          |            |
| 1-4 family residential construction | 6,432      | 0                  | 282                         | 0                         | 0        | 6,714      |
| Commercial and land development     | 23,986     | 107                | 653                         | 2                         | 0        | 24,748     |
| Commercial and industrial           | 81,480     | 627                | 35                          | 347                       | 127      | 82,616     |
| Municipal                           | 61,568     | 0                  | 0                           | 0                         | 0        | 61,568     |
| Residential mortgage:               |            |                    |                             |                           |          |            |
| First lien                          | 125,155    | 0                  | 0                           | 4,391                     | 31       | 129,577    |
| Home equity - term                  | 16,120     | 0                  | 0                           | 96                        | 0        | 16,216     |
| Home equity - lines of credit       | 110,271    | 248                | 52                          | 337                       | 0        | 110,908    |
| Installment and other loans         | 7,312      | 0                  | 0                           | 10                        | 0        | 7,322      |
|                                     | \$ 789,971 | \$ 21,254          | \$ 5,709                    | \$ 14,841                 | \$ 158   | \$ 831,933 |
| <b>December 31, 2015</b>            |            |                    |                             |                           |          |            |
| Commercial real estate:             |            |                    |                             |                           |          |            |
| Owner-occupied                      | \$ 96,715  | \$ 1,124           | \$ 3,630                    | \$ 2,109                  | \$ 0     | \$ 103,578 |
| Non-owner occupied                  | 125,043    | 12,394             | 108                         | 7,856                     | 0        | 145,401    |
| Multi-family                        | 31,957     | 1,779              | 1,140                       | 233                       | 0        | 35,109     |
| Non-owner occupied residential      | 50,601     | 1,305              | 1,374                       | 895                       | 0        | 54,175     |
| Acquisition and development:        |            |                    |                             |                           |          |            |
| 1-4 family residential construction | 9,364      | 0                  | 0                           | 0                         | 0        | 9,364      |
| Commercial and land development     | 40,181     | 219                | 934                         | 5                         | 0        | 41,339     |
| Commercial and industrial           | 70,967     | 1,380              | 544                         | 734                       | 0        | 73,625     |
| Municipal                           | 57,511     | 0                  | 0                           | 0                         | 0        | 57,511     |
| Residential mortgage:               |            |                    |                             |                           |          |            |
| First lien                          | 121,214    | 0                  | 0                           | 4,808                     | 0        | 126,022    |
| Home equity - term                  | 17,234     | 0                  | 0                           | 103                       | 0        | 17,337     |
| Home equity - lines of credit       | 109,731    | 230                | 180                         | 590                       | 0        | 110,731    |
| Installment and other loans         | 7,504      | 0                  | 0                           | 17                        | 0        | 7,521      |
|                                     | \$ 738,022 | \$ 18,431          | \$ 7,910                    | \$ 17,350                 | \$ 0     | \$ 781,713 |

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 June 30, 2016 and 2015 was as follows:

| (Dollars in thousands)       | Commercial Real Estate | Commercial Acquisition and Development | Commercial and Industrial | Municipal | Total    | Consumer Residential Mortgage | Installment and Other | Total   | Unallocated | Total    |
|------------------------------|------------------------|--|---------------------------|-----------|----------|-------------------------------|-----------------------|---------|-------------|----------|
| June 30, 2016                |                        |  |                           |           |          |                               |                       |         |             |          |
| Balance, beginning of period | \$7,996                | \$ 739                                 | \$ 1,030                  | \$ 62     | \$9,827  | \$2,677                       | \$ 179                | \$2,856 | \$ 664      | \$13,347 |
| Provision for loan losses    | (12 )                  | (152 )                                 | 112                       | (1 )      | (53 )    | 66                            | 26                    | 92      | (39 )       | 0        |
| Charge-offs                  | (26 )                  | 0                                      | 0                         | 0         | (26 )    | (80 )                         | (48 )                 | (128 )  | 0           | (154 )   |
| Recoveries                   | 175                    | 0                                      | 6                         | 0         | 181      | 43                            | 23                    | 66      | 0           | 247      |
| Balance, end of period       | \$8,133                | \$ 587                                 | \$ 1,148                  | \$ 61     | \$9,929  | \$2,706                       | \$ 180                | \$2,886 | \$ 625      | \$13,440 |
| June 30, 2015                |                        |  |                           |           |          |                               |                       |         |             |          |
| Balance, beginning of period | \$9,346                | \$ 588                                 | \$ 665                    | \$ 121    | \$10,720 | \$2,567                       | \$ 116                | \$2,683 | \$ 1,058    | \$14,461 |
| Provision for loan losses    | (750 )                 | 132                                    | 188                       | (2 )      | (432 )   | 479                           | 74                    | 553     | (121 )      | 0        |
| Charge-offs                  | (475 )                 | 0                                      | (24 )                     | 0         | (499 )   | (151 )                        | (9 )                  | (160 )  | 0           | (659 )   |
| Recoveries                   | 11                     | 0                                      | 15                        | 0         | 26       | 23                            | 1                     | 24      | 0           | 50       |
| Balance, end of period       | \$8,132                | \$ 720                                 | \$ 844                    | \$ 119    | \$9,815  | \$2,918                       | \$ 182                | \$3,100 | \$ 937      | \$13,852 |

Activity in the allowance for loan losses for the six months ended June 30, 2016 and 2015 was as follows:

| (Dollars in thousands)       | Commercial Real Estate | Commercial Acquisition and Development | Commercial and Industrial | Municipal | Total    | Consumer Residential Mortgage | Installment and Other | Total   | Unallocated | Total    |
|------------------------------|------------------------|--|---------------------------|-----------|----------|-------------------------------|-----------------------|---------|-------------|----------|
| June 30, 2016                |                        |  |                           |           |          |                               |                       |         |             |          |
| Balance, beginning of period | \$7,883                | \$ 850                                 | \$ 1,012                  | \$ 58     | \$9,803  | \$2,870                       | \$ 121                | \$2,991 | \$ 774      | \$13,568 |
| Provision for loan losses    | 21                     | (263 )                                 | 149                       | 3         | (90 )    | 111                           | 128                   | 239     | (149 )      | 0        |
| Charge-offs                  | (26 )                  | 0                                      | (21 )                     | 0         | (47 )    | (324 )                        | (112 )                | (436 )  | 0           | (483 )   |
| Recoveries                   | 255                    | 0                                      | 8                         | 0         | 263      | 49                            | 43                    | 92      | 0           | 355      |
| Balance, end of period       | \$8,133                | \$ 587                                 | \$ 1,148                  | \$ 61     | \$9,929  | \$2,706                       | \$ 180                | \$2,886 | \$ 625      | \$13,440 |
| June 30, 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    | (813 )                 | 45                                     | 51                        | (64 )     | (781 )   | 973                           | 89                    | 1,062   | (281 )      | 0        |
| Charge-offs                  | (541 )                 | (22 )                                  | (50 )                     | 0         | (613 )   | (352 )                        | (29 )                 | (381 )  | 0           | (994 )   |
| Recoveries                   | 24                     | 0                                      | 37                        | 0         | 61       | 35                            | 3                     | 38      | 0           | 99       |
| Balance, end of period       | \$8,132                | \$ 720                                 | \$ 844                    | \$ 119    | \$9,815  | \$2,918                       | \$ 182                | \$3,100 | \$ 937      | \$13,852 |

The allowance for loan losses totaled \$13,440,000 at June 30, 2016, a decrease of \$128,000 from \$13,568,000 at December 31, 2015, due to net charge-offs for the period. The allowance for loan losses to nonaccrual loans totaled 95.4% at June 30, 2016 compared to 82.0% at December 31, 2015, and the allowance for loan losses to nonaccrual

loans and restructured loans still accruing totaled 89.6% at June 30, 2016, compared to 78.2% at December 31, 2015. Management believes the allowance for loan losses to total loans ratio remains adequate at 1.62% as of June 30, 2016. Classified loans, defined as loans rated substandard, doubtful or loss, totaled \$20,708,000 at June 30, 2016, or approximately 2.5% of total loans outstanding, and decreased from \$25,260,000 at December 31, 2015, or 3.2% of loans outstanding.

Net recoveries were \$93,000 for the three months ended June 30, 2016 with net charge-offs of \$128,000 for the six months ended June 30, 2016, compared to net charge-offs of \$609,000 and \$895,000 for the same periods in 2015, resulting in a ratio of annualized net charge-offs to average loans outstanding of (0.05)% and 0.03% for the three and six months ended June 30, 2016 and 0.33% and 0.25% for the same periods in 2015. Favorable historical charge-off data combined with stable economic and market conditions has resulted in the determination that no additional provision for loan losses were required to offset net charge-offs and no additional reserves were needed on impaired loans or for loan growth experienced during both periods, as more fully discussed in the "Provision for Loan Losses" section in this Management and Discussion and Analysis.

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The following summarizes the ending loan balances individually or collectively evaluated for impairment based upon loan type, as well as the allowance for loan losses allocation for each at June 30, 2016 and December 31, 2015.

| (Dollars in thousands)                  | Commercial Real Estate | Commercial Acquisition and Development | Commercial and Industrial | Municipal | Total     | Consumer Residential Mortgage | Installment and Other | Total     | Unallocated | Total     |
|---|------------------------|--|---------------------------|-----------|-----------|-------------------------------|-----------------------|-----------|-------------|-----------|
| June 30, 2016                           |                        |  |                           |           |           |                               |                       |           |             |           |
| Loans allocated by:                     |                        |  |                           |           |           |                               |                       |           |             |           |
| Individually evaluated for impairment   | \$9,658                | \$2                                    | \$474                     | \$0       | \$10,134  | \$4,855                       | \$10                  | \$4,865   | \$0         | \$14,999  |
| Collectively evaluated for impairment   | 382,606                | 31,460                                 | 82,142                    | 61,568    | 557,776   | 251,846                       | 7,312                 | 259,158   | 0           | 816,934   |
|   | \$392,264              | \$31,462                               | \$82,616                  | \$61,568  | \$567,910 | \$256,701                     | \$7,322               | \$264,023 | \$0         | \$831,933 |
| Allowance for loan losses allocated by: |                        |  |                           |           |           |                               |                       |           |             |           |
| Individually evaluated for impairment   | \$0                    | \$0                                    | \$126                     | \$0       | \$126     | \$106                         | \$2                   | \$108     | \$0         | \$234     |
| Collectively evaluated for impairment   | 8,133                  | 587                                    | 1,022                     | 61        | 9,803     | 2,600                         | 178                   | 2,778     | 625         | 13,206    |
|   | \$8,133                | \$587                                  | \$1,148                   | \$61      | \$9,929   | \$2,706                       | \$180                 | \$2,886   | \$625       | \$13,440  |
| December 31, 2015                       |                        |  |                           |           |           |                               |                       |           |             |           |
| Loans allocated by:                     |                        |  |                           |           |           |                               |                       |           |             |           |
| Individually evaluated for impairment   | \$11,093               | \$5                                    | \$734                     | \$0       | \$11,832  | \$5,501                       | \$17                  | \$5,518   | \$0         | \$17,350  |
| Collectively evaluated for impairment   | 327,170                | 50,698                                 | 72,891                    | 57,511    | 508,270   | 248,589                       | 7,504                 | 256,093   | 0           | 764,363   |
|   | \$338,263              | \$50,703                               | \$73,625                  | \$57,511  | \$520,102 | \$254,090                     | \$7,521               | \$261,611 | \$0         | \$781,713 |
| Allowance for loan losses allocated by: |                        |  |                           |           |           |                               |                       |           |             |           |
| Individually evaluated for impairment   | \$0                    | \$0                                    | \$0                       | \$0       | \$0       | \$281                         | \$8                   | \$289     | \$0         | \$289     |
| Collectively evaluated for impairment   | 7,883                  | 850                                    | 1,012                     | 58        | 9,803     | 2,589                         | 113                   | 2,702     | 774         | 13,279    |
|   | \$7,883                | \$850                                  | \$1,012                   | \$58      | \$9,803   | \$2,870                       | \$121                 | \$2,991   | \$774       | \$13,568  |

The allowance for loan losses allocations presented above represent the reserve allocations on loan balances outstanding at June 30, 2016 and December 31, 2015. In addition to the reserve allocations on impaired loans noted above, 20 loans, with aggregate outstanding general ledger principal balances of \$3,781,000, have had cumulative partial charge-offs to the allowance for loan losses recorded totaling \$2,008,000 at June 30, 2016. 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 incurred 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 probable incurred losses within the portfolio that have not been identified to specific loans or portfolio segments. 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 \$774,000 at December 31, 2015 to \$625,000 at June 30, 2016 and represents 4.7% of the entire allowance for loan losses balance at June 30, 2016.

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

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## Deposits

Total deposits were \$1,087,969,000 at June 30, 2016, an increase of \$55,802,000, or 5.4%, from \$1,032,167,000 at December 31, 2015. Non-interest bearing deposits increased \$16,290,000, or 12.4%, from December 31, 2015 to June 30, 2016 and totaled \$147,680,000. Interest bearing deposits totaled \$940,289,000 at June 30, 2016, a 4.4% increase from December 31, 2015. The Company has been able to gather both non-interest bearing and interest bearing deposits as it increases its commercial relationships and obtains new relationships from its enhanced cash management offerings. The additional deposits that the Company obtained in the first half of 2016 were used to pay down short-term borrowings.

## 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.

Shareholders' equity totaled \$141,039,000 at June 30, 2016, an increase of \$7,978,000 or 6.0%, from \$133,061,000 at December 31, 2015. This increase was primarily the result of an increase in accumulated other comprehensive income, net of taxes of \$6,222,000 and net income of \$3,258,000 for the six months ended June 30, 2016, offset by dividends declared on common stock of \$1,410,000.

**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 June 30, 2016 and December 31, 2015, 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 previously effective U.S. risk-based capital rules. 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 levels 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 are subject to constraints on dividends, equity repurchases and discretionary bonuses to executive officers based on the amount of the shortfall.

Under the Basel III Capital Rules, the Company and Bank took the one-time option to permanently opt out of the requirement to include most components of accumulated other comprehensive income ("AOCI"), including unrealized gains or losses on certain securities available for sale, in regulatory capital. The Company and Bank made the one-time permanent election to opt out, with the result that most AOCI items will be excluded from regulatory capital. 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. As of June 30, 2016, \$6,967,000 of the Company's deferred tax asset was disallowed for Tier 1, CET1 and Total risk based capital, as it relates to operating loss and tax credit carryforwards which are not permissible as capital under Basel III Capital

Rules.

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 began on January 1, 2016 at the 0.625% level and be

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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).

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 provisions of the Basel III Capital Rules that impact the Company's capital calculations include, among other things:

- Restricting 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;

• Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due or in nonaccrual status; 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.

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 June 30, 2016, \$2,814,000 of the allowance for credit losses was excluded from Tier 2 capital.

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Regulatory Capital. As of June 30, 2016 and December 31, 2015, the Bank was considered well capitalized under applicable banking regulations. The Company's and the Bank's capital ratios as of June 30, 2016 and December 31, 2015 were as follows:

| (Dollars in thousands)                 | Actual     |        | Minimum Capital Requirement |       | Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|--|------------|--------|-----------------------------|-------|--|--------|
|  | Amount     | Ratio  | Amount                      | Ratio | Amount   | Ratio  |
| June 30, 2016                          |            |        |                             |       |  |        |
| Total capital to risk weighted assets  |            |        |                             |       |  |        |
| Orrstown Financial Services, Inc.      | \$ 137,860 | 15.2 % | \$ 72,496                   | 8.0 % | n/a  | n/a    |
| Orrstown Bank                          | 123,567    | 13.7 % | 72,412                      | 8.0 % | \$ 90,515  | 10.0 % |
| Tier 1 capital to risk weighted assets |            |        |                             |       |  |        |
| Orrstown Financial Services, Inc.      | 126,463    | 14.0 % | 54,372                      | 6.0 % | n/a  | n/a    |
| Orrstown Bank                          | 112,182    | 12.4 % | 54,309                      | 6.0 % | 72,412   | 8.0 %  |
| CET1 to risk weighted assets           |            |        |                             |       |  |        |
| Orrstown Financial Services, Inc.      | 126,463    | 14.0 % | 40,779                      | 4.5 % | n/a  | n/a    |
| Orrstown Bank                          | 112,182    | 12.4 % | 40,732                      | 4.5 % | 58,835   | 6.5 %  |
| Tier 1 capital to average assets       |            |        |                             |       |  |        |
| Orrstown Financial Services, Inc.      | 126,463    | 9.8 %  | 51,868                      | 4.0 % | n/a  | n/a    |
| Orrstown Bank                          | 112,182    | 8.6 %  | 51,881                      | 4.0 % | 64,851   | 5.0 %  |
| December 31, 2015                      |            |        |                             |       |  |        |
| Total capital to risk weighted assets  |            |        |                             |       |  |        |
| Orrstown Financial Services, Inc.      | \$ 134,562 | 15.8 % | \$ 68,078                   | 8.0 % | n/a  | n/a    |
| Orrstown Bank                          | 118,671    | 14.0 % | 68,027                      | 8.0 % | \$ 85,034  | 10.0 % |
| Tier 1 capital to risk weighted assets |            |        |                             |       |  |        |
| Orrstown Financial Services, Inc.      | 123,825    | 14.6 % | 51,058                      | 6.0 % | n/a  | n/a    |
| Orrstown Bank                          | 107,942    | 12.7 % | 51,021                      | 6.0 % | 68,027   | 8.0 %  |
| CET1 to risk weighted assets           |            |        |                             |       |  |        |
| Orrstown Financial Services, Inc.      | 123,825    | 14.6 % | 38,294                      | 4.5 % | n/a  | n/a    |
| Orrstown Bank                          | 107,942    | 12.7 % | 38,265                      | 4.5 % | 55,272   | 6.5 %  |
| Tier 1 capital to average assets       |            |        |                             |       |  |        |
| Orrstown Financial Services, Inc.      | 123,825    | 9.8 %  | 50,684                      | 4.0 % | n/a  | n/a    |
| Orrstown Bank                          | 107,942    | 8.5 %  | 50,695                      | 4.0 % | 63,368   | 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. In addition to the minimum capital ratio requirement and minimum capital ratio to be well capitalized presented above, the Company must maintain a capital conservation buffer as discussed above. As of June 30, 2016, the Company's capital conservation buffer, based on the most restrictive capital ratio, is 7.4%, well above the phase in requirements of 0.625% for December 31, 2016.

On January 19, 2016, the Company filed a shelf registration statement on Form S-3 with the SEC, covering up to an aggregate of \$100,000,000 of securities, through the sale of common stock, preferred stock, warrants, debt securities, and units. To date, the Company has not issued any securities under this shelf registration.

On September 14, 2015, the Board of Directors of the Company authorized a stock repurchase program under which Orrstown Financial Services, Inc. may repurchase up to 5% of the Company's outstanding shares of common stock, or approximately 416,000 shares, in the open market, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Securities Exchange Act of 1934, as amended. The extent to which the Company repurchases its shares, and the timing of such repurchases, will depend upon a variety of factors, including market conditions, regulatory requirements and other corporate considerations, as determined by management. Purchases may

be made from time to time on open market

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or privately negotiated transactions. The repurchase program may be suspended or discontinued at any time. As of June 30, 2016, 82,725 shares had been repurchased under the program at a total cost of \$1,438,000, or \$17.38 per share.

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 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.



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## 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 3a. These results, as of June 30, 2016, indicate that the Company would expect net interest income to decrease over the next twelve months by 1.8% assuming a downward shock in market interest rates of 1.00%, and to increase by 1.3% assuming an upward shock of 2.00%. 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 June 30, 2016, exhibited greater sensitivity to rising interest rates and similar sensitivity in a declining rate environment, and asset/liability management strategies were taken in the first quarter of 2016 that resulted in a reduction of the Company's risk in an upward interest rate environment.

## Value at Risk

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 3b. These results, as of June 30, 2016, indicate that the net present value would decrease 1.9% assuming a downward shift in market interest rates of 1.00% and increase 8.2% if interest rates shifted up 2.00% in the same manner, and indicates the Company would be positioned better if interest rates were to rise than it would if interest rates fell.

## Table 3a - Earnings at Risk

## Table 3b - Value at Risk

| % Change in Net Interest Income |                   |         | % Change in Market Value |                   |       |
|---------------------------------|-------------------|---------|--------------------------|-------------------|-------|
| Change in June 30, 2016         | December 31, 2015 |         | Change in June 30, 2016  | December 31, 2015 |       |
| (100)                           | (1.8%)            | (1.4 %) | (100)                    | (1.9%)            | 1.8 % |
| 100                             | 0.2 %             | (1.2 %) | 100                      | 3.9 %             | 0.5 % |
| 200                             | 1.3 %             | (1.8 %) | 200                      | 8.2 %             | 0.0 % |

## 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 June 30, 2016. Based on such evaluation, such officers have concluded that the Company's disclosure controls and procedures were designed and functioning effectively, as of June 30, 2016, 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.

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(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 June 30, 2016, 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 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, 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 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 were stayed pending the Court’s ruling on the motion to dismiss. The September 27, 2012 Order specified that if the motion to dismiss were denied, the Court would schedule a conference to address discovery and the filing of a motion for class certification. On October 26, 2012, SEPTA filed an unopposed motion for enlargement of time to file its amended complaint in order to permit the parties and new defendants to be named in the amended complaint time to discuss plaintiff’s claims and defendants’ defenses. On October 26, 2012, the Court granted SEPTA’s motion, mooted its September 27, 2012 scheduling Order, and requiring SEPTA to file its amended complaint on or before January 16, 2013 or otherwise advise the Court of circumstances that require a further enlargement of time. 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.

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



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.

On June 22, 2015, in a 96-page Memorandum, the Court dismissed without prejudice SEPTA's amended complaint against all defendants, finding that SEPTA failed to state a claim under either the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended. The Court ordered that, within 30 days, SEPTA either seek leave to amend its

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amended complaint, accompanied by the proposed amendment, or file a notice of its intention to stand on the amended complaint.

On July 22, 2015, SEPTA filed a motion for leave to amend under Local Rule 15.1, and attached a copy of its proposed second amended complaint to its motion. Many of the allegations of the proposed second amended complaint are essentially the same or similar to the allegations of the dismissed amended complaint. The proposed second amended complaint also alleges that the Orrstown Defendants did not publicly disclose certain alleged failures of internal controls over loan underwriting, risk management, and financial reporting during the period 2009 to 2012, in violation of the federal securities laws. On February 8, 2016, the Court granted SEPTA's motion for leave to amend and SEPTA filed its second amended complaint that same day.

On February 25, 2016, the Court issued a scheduling Order directing: all defendants to file any motions to dismiss by March 18, 2016; SEPTA to file an omnibus opposition to defendants' motions to dismiss by April 8, 2016; and all defendants to file reply briefs in support of their motions to dismiss by April 22, 2016. Defendants timely filed their motions to dismiss the second amended complaint and the parties filed their briefs in accordance with the Court-ordered schedule, above. The February 25, 2016 Order stays all discovery and other deadlines in the case (including the filing of SEPTA's motion for class certification) pending the outcome of the motions to dismiss. The Company believes that the allegations of SEPTA's second amended complaint are without merit and intends to vigorously defend itself against those claims. Given that the litigation is still in the pleading stage, it is not possible at this time to estimate reasonably possible losses, or even a range of reasonably possible losses, in connection with the litigation.

The allegations of SEPTA's proposed second amended complaint disclosed the existence of a confidential, non-public, fact-finding inquiry regarding the Company being conducted by the Commission. The Company has been cooperating fully with the investigation but has not yet reached any definitive agreement with the Commission regarding a resolution. Accordingly, there can be no assurances that the outcome of the investigation will not have a material adverse effect on the Company's financial condition or results of operations.

The Company has established a reserve of \$1,000,000 for legal matters as of June 30, 2016. There can be no assurances that the reserve will not be increased, or decreased in future periods.

Item 1A – Risk Factors

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, 2015, as updated by the Company's quarterly report on form 10-Q for the quarter ended March 31, 2016, except as described herein.

The risk factor included in the Company's Annual Report on Form 10-K entitled "Pending litigation and legal proceedings and the impact of any finding of liability or damages could adversely impact the Company and its financial condition and results of operations" is replaced with the following:

Pending litigation and legal proceedings and the impact of any finding of liability or damages could adversely impact the Company and its financial condition and results of operations.

As set forth in Part II, Item I - Legal Proceedings, of this Quarterly Report on Form 10-Q, the allegations of Southeastern Pennsylvania Transportation Authority's ("SEPTA") proposed second amended complaint disclosed the existence of a confidential, non-public, fact finding inquiry regarding the Company being conducted by the SEC. In cooperating fully with the SEC in connection with inquiry, the Company has incurred, and will continue to incur, significant additional noninterest expenses for professional fees such as legal fees. See "Noninterest Expenses" in Management's Discussion and Analysis of Financial Condition and Results of Operations - Results of Operations" as discussed in Part I, Item 2. The Company has been cooperating fully with the investigation but has not yet reached any definitive agreement with the Commission regarding a resolution.

The Company has established a reserve of \$1,000,000 for outstanding legal matters as of June 30, 2016. There can be no assurances that the reserve will not be increased, or decreased in future periods.

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

The following table represents the Company's monthly repurchases of its common stock during the quarter ended June 30, 2016:

|                                 | Total<br>Number of<br>Shares<br>Repurchased | Average<br>Price<br>Per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares<br>That May<br>Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|---------------------------------|---|----------------------------------|--|--|
| April 1, 2016 to April 30, 2016 | 5,649                                       | \$ 17.60                         | 5,649  | 349,053  |
| May 1, 2016 to May 31, 2016     | 12,778                                      | 18.09                            | 12,778   | 336,275  |
| June 1, 2016 to June 30, 2016   | 3,000                                       | 18.52                            | 3,000  | 333,275  |

On September 14, 2015, the Board of Directors of the Company authorized a stock repurchase program under which Orrstown Financial Services, Inc. may repurchase up to 5% of the Company's outstanding shares of common stock, or approximately 416,000 shares, in the open market, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Securities Exchange Act of 1934, as amended.

The extent to which the Company repurchases its shares, and the timing of such repurchases, will depend upon a variety of factors, including market conditions, regulatory requirements and other corporate considerations, as determined by management. Purchases may be made from time to time on open market or privately negotiated transactions. The repurchase program may be suspended or discontinued at any time. As of June 30, 2016, 82,725 shares had been repurchased under the program at a total cost of \$1,438,000, or \$17.38 per share.

The Company did not sell any unregistered securities during the quarter ended June 30, 2016.

## 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: August 5, 2016

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ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES  
EXHIBIT INDEX

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- 101.DEF XBRL Taxonomy Extension Definition Linkbase \*
- All other exhibits for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

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