ORRSTOWN FINANCIAL SERVICES INC
Form 10-K
March 14, 2014
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2013

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

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, No Par Value	**The NASDAQ Capital Market**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232,405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

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

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

The aggregate market value of the voting stock held by non-affiliates computed by reference to the price at which the common stock was last sold as of the last business day of the Registrant s most recently completed second quarter, was approximately $85 million. For purposes of this calculation, the term affiliate refers to all directors and executive officers of the registrant, and all persons beneficially owning more than 5% of the registrant s common stock.

Number of shares outstanding of the registrant s Common Stock as of February 28, 2014: 8,109,818.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2014 Annual Meeting of Shareholders are incorporated by reference in Part III of this Form 10-K.

Table of Contents

ORRSTOWN FINANCIAL SERVICES, INC.

FORM 10-K

INDEX

		Page
Part I		
Item 1.	Business	2
Item 1A.	Risk Factors	11
Item 1B.	Unresolved Staff Comments	19
Item 2.	Properties	20
Item 3.	Legal Proceedings	21
Item 4.	Mine Safety Disclosures	21
Part II		
Item 5.	Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	22
Item 6.	Selected Financial Data	24
Item 7.	Management s Discussion and Analysis of Financial Condition and Results of Operations	26
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	62
Item 8.	Financial Statements and Supplementary Data	64
Item 9.	Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	120
Item 9A.	Controls and Procedures	120
Item 9B.	Other Information	120
Part III		
Item 10.	Directors, Executive Officers and Corporate Governance	121
Item 11.	Executive Compensation	121
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	121
Item 13.	Certain Relationships and Related Transactions, and Director Independence	121
Item 14.	Principal Accounting Fees and Services	122
Part IV		
Item 15.	Exhibits and Financial Statement Schedules	123
Signatures		126

PART I

ITEM 1 BUSINESS

Orrstown Financial Services, Inc. (the Company), a Pennsylvania corporation, is the holding company for Orrstown Bank (the Bank). The Company s executive offices are located at 77 East King Street, Shippensburg, Pennsylvania, 17257. The Company was organized on November 17, 1987, for the purpose of acquiring the Bank and such other banks and bank related activities as are permitted by law and desirable. The Bank provides banking and bank related services through 22 offices, located in South Central Pennsylvania, principally in Cumberland, Franklin, Lancaster and Perry Counties and in Washington County, Maryland.

The Company files periodic reports with the Securities and Exchange Commission (SEC) in the form of quarterly reports on Form 10-Q, annual reports on Form 10-K, annual proxy statements and current reports on Form 8-K for any significant events that may arise during the year. Copies of these reports, and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), may be obtained free of charge through the SEC s internet site at www.sec.gov or by accessing the Company s website at www.orrstown.com as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the SEC. Information on our website shall not be considered a part of this Form 10-K.

History and Acquisitions

The Bank was originally organized in 1919 as a state-chartered bank. On March 8, 1988, in a bank holding company reorganization transaction, the Company acquired 100% ownership of the Bank, issuing 131,455 shares of the Company s common stock to the former shareholders of the Bank.

On May 1, 2006, the Company completed its acquisition of The First National Bank of Newport (First National), a national banking institution with $120 million in assets at the time of the acquisition. The final consideration paid in the transaction to stockholders of First National consisted of approximately 699,949 shares of the Company s common stock and $8.9 million in cash. The transaction was valued at approximately $34 million in the aggregate. As a result of this transaction, the Company added four branches located in Perry County, Pennsylvania, $120 million in assets, $72 million in loans and $106 million in deposits to its franchise. First National remained a separate subsidiary banking institution of the Company until June 15, 2007 when First National merged with and into the Bank with the Bank as the surviving institution.

Business

The Company s primary activity consists of owning and supervising its subsidiary, the Bank. The day-to-day management of the Company is conducted by the Bank s officers. The Company has historically derived most of its income through dividends from the Bank, however, the Bank is prohibited from paying such dividends under existing enforcement agreements (as more fully discussed below). As of December 31, 2013, the Company, on a consolidated basis, had total assets of $1,177,812,000, total shareholders equity of $91,439,000 and total deposits of $1,000,390,000.

The Company has no employees. Its seven officers are employees of the Bank. On December 31, 2013, the Bank had 323 full-time and 21 part-time employees.

The Bank is engaged in commercial banking and trust business as authorized by the Pennsylvania Banking Code of 1965. This involves accepting demand, time and savings deposits, and granting loans. The Bank grants commercial,

residential, consumer and agribusiness loans in its market areas of Cumberland, Franklin, Lancaster and Perry Counties in Pennsylvania and in Washington County, Maryland. The concentrations of credit by type of loan are set forth in Note 4, Loans Receivable and Allowance for Loan Losses filed herewith in Part II, Item 8, Financial Statements and Supplementary Data. The Bank maintains a diversified loan portfolio and

evaluates each customer s credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon the extension of credit, is based on management s credit evaluation of the customer pursuant to collateral standards established in the Bank s lending policies and procedures.

Lending

All secured loans are supported with appraisals or evaluations of collateral. Business equipment and machinery, inventories, accounts receivable, and farm equipment are considered appropriate security, provided they meet acceptable standards for liquidity and marketability. Loans secured by real estate generally do not exceed 80% of the appraised value of the property. Loan to collateral values are monitored as part of the loan review process, and appraisals are updated as deemed appropriate under the circumstances.

Commercial Lending

A majority of the Company s loan assets are loans for business purpose. Approximately 65% of the loan portfolio is comprised of commercial loans. The Bank makes commercial real estate, equipment, working capital and other commercial purpose loans as required by the broad range of borrowers across the Bank s various markets.

The Bank s loan policy dictates the underwriting requirements for the various types of loans the Bank would extend to borrowers. The policy covers such requirements as debt coverage ratios, advance rate against different forms of collateral, loan-to-value ratio (LTV) and maximum term.

Consumer Lending

The Bank provides home equity loans, home equity lines of credit and other consumer loans through its branch network. A large majority of the consumer loans are secured by either a first or second lien position on the borrower s primary residential real estate. The Bank requires a LTV of no greater than 90% of the value of the real estate being taken as collateral. The Bank s underwriting standards typically require that a borrower s debt to income ratio generally cannot exceed 43%.

Residential Lending

The Bank provides residential mortgages throughout its various markets through a network of mortgage loan officers. A majority of the residential mortgages originated are sold to secondary market investors, primarily Fannie Mae and the Federal Home Loan Bank of Pittsburgh. All mortgages, regardless of being sold or held in the Bank s portfolio, are underwritten to secondary market industry standards for prime mortgages. The Bank requires a LTV of no greater than 80% of the value of the real estate being taken as collateral, without the borrower obtaining private mortgage insurance.

Loan Review

The Bank has a loan review policy and program which is designed to identify and mitigate 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.

Table of Contents

Loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $1,000,000. Loan review documentation is submitted to the ERM Committee no less than quarterly with a formal review and confirmation of risk rating as presented by independent loan review personnel. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed by the ERM Committee on a quarterly basis, with reaffirmation of the rating as approved by the Bank s Loan Work Out Committee or loan review staff.

The Bank outsources its independent loan review to a third party provider, which continually monitors and evaluates loan customers utilizing risk-rating criteria established in the loan policy in order to identify deteriorating trends and detect conditions which might indicate potential problem loans. The third party loan review firm reports the results of the loan reviews quarterly to the ERM Committee for approval and provides the basis for evaluating the adequacy of the allowance for loan losses.

Orrstown Financial Advisors (OFA)

Through its trust department, the Bank renders services as trustee, executor, administrator, guardian, managing agent, custodian, investment advisor, and other fiduciary activities authorized by law under the trade name Orrstown Financial Advisors. OFA offers retail brokerage services through a third party broker/dealer arrangement with Financial Network Investment Company (FNIC). As of December 31, 2013, trust assets under management were $1,085,216,000.

Regulation and Supervision

The Company is a bank holding company registered with the Board of Governors of the Federal Reserve System (the FRB) and has elected status as a financial holding company. As a registered bank holding company and financial holding company, the Company is subject to regulation under the Bank Holding Company Act of 1956 (the BHC Act) and to inspection, examination, and supervision by the Federal Reserve Bank of Philadelphia (the Federal Reserve Bank).

The Bank is a Pennsylvania-chartered commercial bank and a member of the Federal Reserve System. As such, the operations of the Bank are subject to federal and state statutes applicable to banks chartered under Pennsylvania law, to FRB member banks and to banks whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC). The Bank s operations are also subject to regulations of the Pennsylvania Department of Banking (PDB), the FRB and the FDIC.

Several of the more significant regulatory provisions applicable to banks and bank holding companies to which the Company and the Bank are subject are discussed below, along with certain regulatory matters concerning the Company and the Bank. To the extent that the following information describes statutory or regulatory provisions, such information is qualified in its entirety by reference to the particular statutes or regulations. Any change in applicable law or regulation may have a material effect on the business and prospects of the Company and the Bank.

Enforcement

On March 22, 2012, the Company and the Bank entered into a Written Agreement with the Federal Reserve Bank and the Bank entered into a Consent Order with the PDB.

Pursuant to the Written Agreement, the Company and the Bank agreed to, among other things: (i) adopt and implement a plan, acceptable to the Federal Reserve Bank, to strengthen oversight of management and operations;

(ii) adopt and implement a plan, acceptable to the Federal Reserve Bank, to reduce the Bank s interest in criticized and classified assets; (iii) adopt a plan, acceptable to the Federal Reserve Bank, to strengthen the Bank s credit risk management practices; (iv) adopt and implement a program, acceptable to the Federal

4

Table of Contents

Reserve Bank, for the maintenance of an adequate allowance for loan and lease losses; (v) adopt and implement a written plan, acceptable to the Federal Reserve Bank, to maintain sufficient capital on a consolidated basis for the Company and on a stand-alone basis for the Bank; and (vi) revise the Bank s loan underwriting and credit administration policies. The Bank and the Company also agreed not to declare or pay any dividend without prior approval from the Federal Reserve Bank, and the Company agreed not to incur or increase debt or to redeem any outstanding shares without prior Federal Reserve Bank approval.

Pursuant to the Consent Order, the Bank agreed to, among other things, subject to review and approval by the PDB, (i) adopt and implement a plan to strengthen oversight of management and operations; (ii) adopt and implement a plan to reduce the Bank s interest in criticized and classified assets; (iii) adopt and implement a program for the maintenance of an adequate allowance for loan and lease losses; (iv) and adopt and implement a capital plan which includes specific benchmark capital ratios to be met at each quarter end; and (v) adopt a plan to strengthen the Bank s credit risk management practices. The Bank also agreed not to declare or pay any dividend without prior approval of the PDB.

The Company and the Bank have developed and continues to implement strategies and action plans to meet the requirements of the Written Agreement and the Consent Order. As part of its efforts on complying with the terms of the Written Agreement and the Consent Order, the Bank has filed a capital plan with the Federal Reserve Bank and the PDB.

The Written Agreement will continue until terminated by the Federal Reserve Bank, and the Consent Order will continue until terminated by the PDB. The foregoing description of the Written Agreement and Consent Order are qualified in their entirety by reference to the actual agreements which are attached as Exhibits 10.12 and Exhibit 10.13, respectively, and incorporated herein by this reference.

Additional regulatory restrictions require prior approval before appointing or changing the responsibilities of directors and executive officers, entering into any employment agreement or other agreement or plan providing for the payment of a golden parachute payment or the making of any golden parachute payment.

Financial and Bank Holding Company Activities

In general, the BHC Act and the FRB s regulations limit the nonbanking activities permissible for bank holding companies to those activities that the FRB has determined to be so closely related to banking or managing or controlling banks to be a proper incident thereto. A bank holding company that elects to be treated as a financial holding company, such as the Company, however, may engage in, and acquire companies engaged in, activities that are considered financial in nature, as defined by the Gramm-Leach-Bliley Act and FRB regulations. For a bank holding company to be eligible to elect financial holding company status, the holding company must be both well capitalized or well managed under applicable regulatory standards and all of its subsidiary banks must be well-capitalized and well-managed and must have received at least a satisfactory rating on such institution s most recent examination under the Community Reinvestment Act of 1977 (the CRA). A financial holding company that continues to meet all of such requirements may engage directly or indirectly in activities considered financial in nature, either de novo or by acquisition, as long as it gives the FRB after-the-fact notice of the new activities. If a financial holding company fails to continue to meet any of the prerequisites for financial holding company status after engaging in activities not permissible for bank holding companies that have not elected to be treated as financial holding companies, the company must enter into an agreement with the FRB that it will comply with all applicable capital and management requirements. If the financial holding company does not return to compliance within 180 days, or such longer period as agreed to by the FRB, the FRB may order the company to discontinue existing activities that are not generally permissible for bank holding companies or divest the company s investments in companies

engaged in such activities. In addition, if any banking subsidiary of a financial holding company receives a CRA rating of less than satisfactory, the company would be prohibited from engaging in any additional activities other than those permissible for bank holding companies that are not financial holding companies.

Table of Contents

FDIC Insurance and Assessments

The Bank s deposits are insured to applicable limits by the FDIC. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the maximum deposit insurance amount was permanently increased from $100,000 to $250,000.

The FDIC has adopted a risk-based premium system that provides for quarterly assessments based on an insured institution s ranking in one of four risk categories based on their examination ratings and capital ratios. Within its risk category, an institution is assigned an initial base assessment which is then adjusted to determine its final assessment rate based on its level of brokered deposits, secured liabilities and unsecured debt.

The Dodd-Frank Act required the FDIC to take such steps as necessary to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020. In setting the assessments, the FDIC is required to offset the effect of the higher reserve ratio against insured depository institutions with total consolidated assets of less than $10 billion. The Dodd-Frank Act also broadened the base for FDIC insurance assessments so that assessments will be based on the average consolidated total assets less average tangible equity capital of a financial institution rather than on its insured deposits. The FDIC has adopted a restoration plan to increase the reserve ratio to 1.15% by September 30, 2020 with additional rulemaking scheduled regarding the method to be used to achieve a 1.35% reserve ratio by that date and offset the effect on institutions with less than $10 billion in assets.

Pursuant to these requirements, the FDIC adopted new assessment regulations effective April 1, 2011 that redefined the assessment base as average consolidated assets less average tangible equity. Insured banks with more than $1.0 billion in assets must calculate quarterly average assets based on daily balances while smaller banks and newly chartered banks may use weekly averages. Average assets would be reduced by goodwill and other intangibles. Average tangible equity equals Tier 1 capital. For institutions with more than $1.0 billion in assets, average tangible equity is calculated on a weekly basis while smaller institutions may use the quarter-end balance. The base assessment rate for insured institutions in Risk Category I will range between 5 to 9 basis points and for institutions in Risk Categories II, III, and IV will be 14, 23 and 35 basis points. An institution s assessment rate will be reduced based on the amount of its outstanding unsecured long-term debt and for institutions in Risk Categories II, III and IV may be increased based on their brokered deposits.

Liability for Banking Subsidiaries

Under the Dodd-Frank Act and applicable FRB policy, a bank holding company such as the Company is expected to act as a source of financial and managerial strength to each of its subsidiary banks and to commit resources to their support. This support may be required at times when the bank holding company may not have the resources to provide it. Similarly, under the cross-guarantee provisions of the Federal Deposit Insurance Act (the FDIA), the FDIC can hold any FDIC-insured depository institution liable for any loss suffered or anticipated by the FDIC in connection with (1) the default of a commonly controlled FDIC-insured depository institution; or (2) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default.

Pennsylvania Banking Law

The Pennsylvania Banking Code (Banking Code) contains detailed provisions governing the organization, location of offices, rights and responsibilities of directors, officers, and employees, as well as corporate powers, savings and investment operations and other aspects of the Bank and its affairs. The Banking Code delegates extensive rule-making power and administrative discretion to the PDB so that the supervision and regulation of state chartered banks may be flexible and readily responsive to changes in economic conditions and in savings and lending practices.

The FDIA, however, prohibits state chartered banks from making new investments, loans, or becoming involved in activities as principal and equity investments which are not permitted for national banks unless (1) the FDIC determines the activity or investment does not pose a significant risk of loss to the Deposit Insurance Fund and (2) the bank meets all applicable capital requirements. Accordingly, the additional operating authority provided to the Bank by the Banking Code is significantly restricted by the FDIA.

Dividend Restrictions

The Company s funding for cash distributions to its shareholders is derived from a variety of sources, including cash and temporary investments. One of the principal sources of those funds has historically been dividends received from the Bank. Various federal and state laws limit the amount of dividends the Bank can pay to the Company without regulatory approval. In addition, federal bank regulatory agencies have authority to prohibit the Bank from engaging in an unsafe or unsound practice in conducting its business. The payment of dividends, depending upon the financial condition of the bank in question, could be deemed to constitute an unsafe or unsound practice. The ability of the Bank to pay dividends in the future is currently, and could be further, influenced by bank regulatory policies and capital guidelines. Additional information concerning the Company and the Bank with respect to dividends is incorporated by reference from the risk factors entitled The Company is subject to restrictions and conditions of formal agreements issued by the Federal Reserve Bank of Philadelphia and the Pennsylvania Department of Banking. Failure to comply with these formal agreements could result in additional enforcement action against us, including the imposition of monetary penalties and The Company discontinued its quarterly cash dividend and suspended the stock repurchase program based on regulatory requirements included under Item 1A of this report and Note 15, Restrictions on Dividends, Loans and Advances, of the Notes to Consolidated Financial Statements included under Item 8 of this report, and the Capital Adequacy and Regulatory Matters section of Management s Discussion and Analysis of Consolidated Financial Condition and Results of Operations, included under Item 7 of this report.

Regulatory Capital Requirements

Information concerning the compliance of the Company and the Bank with respect to capital requirements is incorporated by reference from Note 14, Shareholders Equity and Regulatory Capital, of the Notes to Consolidated Financial Statements included under Item 8 of this report, and from the Capital Adequacy and Regulatory Matters section of the Management s Discussion and Analysis of Consolidated Financial Condition and Results of Operations, included under Item 7 of this report.

Basel III Capital Rules

In July 2013, the Company and Bank s primary federal regulator, the FRB, approved final rules (the Basel III Capital Rules) establishing a new comprehensive capital framework for U.S. banking organizations, including community banks, which also incorporate provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including the Company and Bank, compared to existing U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions regulatory capital ratios, addresses risk weights and other issues affecting the denominator in banking institutions regulatory capital ratios and replace the current risk-weighting approach. The Basel III Capital Rules are effective for the Company and Bank on January 1, 2015 (subject to a phase-in period).

The Basel III Capital Rules, among other things, (i) introduce a new capital measure called Common Equity Tier 1 (CET1), (ii) specify that Tier 1 capital consist of CET1 and Additional Tier 1 capital instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures

be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments from capital as compared to existing regulations.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and Bank to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) may face 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 initial minimum capital ratios as of January 1, 2015 will be as follows:

- 4.5% CET1 to risk-weighted assets;
- 6.0% Tier 1 capital to risk-weighted assets; and
- 8.0% Total capital to risk-weighted assets.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Under current capital standards, the effects of accumulated other comprehensive income items included in capital are excluded for the purposes of determining regulatory capital ratios. Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive items are not excluded; however, the Company and Bank, may make a one-time permanent election to continue to exclude these items. The Company and Bank are still evaluating the benefits and limitations of making this election, and have not yet concluded if they will take advantage of the election.

Implementation of the deductions and other adjustments to CET1 will begin on January 1, 2015 and will be phased-in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter until fully phased-in at January 1, 2018). The implementation of the capital conservation buffer will begin on January 1, 2016 at the 0.625% level and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

With respect to the Bank, the Basel III Capital Rules also revise the prompt corrective action regulations pursuant to Section 38 of the FDIA, by (i) introducing a CET1 ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category (other than critically undercapitalized), with the minimum Tier 1

capital ratio for well-capitalized status being 8% (as compared to the current 6%), and (iii) eliminating the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3% leverage ratio and still be adequately capitalized. The Basel III Capital Rules do not change the total risk-based capital requirement for any prompt corrective action category.

The Basel III Capital Rules prescribe a standardized approach for risk weightings that expands the risk-weighting categories from the current four categories (0%, 20%, 50% and 100%) to a much larger and more risk-

sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories. Significant changes to current rules that will impact the Company s determination of risk-weighted assets include, among other things:

- Applying a 150% risk weight for certain high volatility commercial real estate acquisition, development and construction loans, compared to 100% risk weight currently in place;
- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due or in nonaccrual status, compared to 100% risk weight currently in place; and
- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, compared to 0% currently in place.

Management is currently evaluating the impact that the Basel III Capital Rules, on a fully phased-in basis, will have on our capital levels. Management anticipates that it will be in compliance with the phased in rules.

Bureau of Consumer Financial Protection

The Dodd-Frank Act created an independent regulatory body, the Bureau of Consumer Financial Protection (Bureau), with authority and responsibility to set rules and regulations for most consumer protection laws applicable to all banks, including the Company. The Bureau has responsibility for mortgage reform and enforcement, as well as broad new powers over consumer financial activities which could impact what consumer financial services would be available and how they are provided.

In late 2012, the Bureau formed a Community Bank Advisory Council. Representatives were drawn from small-to-medium-sized community banks to engage in discussions on how smaller institutions help level the playing field for consumers experiencing difficulty in managing their money and what opportunities and challenges exist in mortgage lending for small institutions. The Bureau has developed prototype designs for various disclosures and agreements and invited the public and financial industry to review and comment on what works. Their website (www.consumerfinance.gov) serves as a public information resource on laws and regulations, assistance with financial questions, participation with projects or initiatives, and submission of complaints. The Bureau has positioned itself to serve as a resource for submission of complaints and to provide help to consumers with complaints regarding credit cards, mortgages, student loans, checking accounts, savings accounts, credit reporting, bank services, and other consumer loans. Guidance and consumer tips on various financial topics have been issued since 2012 in blogs on the Bureau s website.

Significant final mortgage rules were issued by the Bureau in January 2013 most with mandatory effective dates in January 2014. These rules were mandated by the Dodd-Frank Act provisions enacted in response to the breakdown in the mortgage lending markets and to provide for consumer protections. The following rules are intended to address problems consumers face in the three major steps in buying a home shopping for a mortgage, closing on a mortgage, and paying off a mortgage.

Ability-to-Repay (ATR) and Qualified Mortgage (QM) rules were designed to address concerns that residential mortgage borrowers received loans for which they had no ability to repay. The ATR final rule requires a creditor to

make a reasonable and good faith determination at or before closing that the consumer will have a reasonable ability, at the time of consummation, to repay the loan, according to its terms, including any mortgage-related obligations. The ATR standards require consideration of eight specific underwriting factors. Information used must be documented and verified using reasonably reliable third-party records. The ATR rule provides for a wide variety of documents and sources of information that can be used and relied on to determine ATR. In addition, the ATR rules included provisions that create a legal advantage for lenders for loans that are qualified mortgages. A QM must have a fully amortizing payment, have a term of 30 years or less, and not have points and fees that exceed certain thresholds depending on the total loan amount. Safe Harbor QM loans are lower priced loans that meet QM requirements. Loans satisfying the QM requirements will be entitled to liability

protection from damage claims and defenses by borrowers based on an asserted failure to meet ATR requirements. Rebuttable Presumption QM loans are higher-priced loans that meet QM requirements and provide liability protection to a lesser degree from damage claims and defense by borrowers based on asserted failure to meet ATR requirements.

Loan servicing has become a key focus, especially when loan workouts and modifications are involved. New mortgage servicing rules effective in January 2014 implement new provisions regarding servicing standards. These new standards seek to ensure similar borrowers who default or become delinquent are treated in a similar, consistent manner. The Bank presently services 5,000 or fewer mortgage loans which it owns or originated, so it is considered a Small Servicer and is exempt from certain parts of the Mortgage Servicing Rules. The mortgage servicing requirements applicable to the Bank s servicing operations under the new mortgage servicing rules are as follows: 1) adjustable rate mortgage interest rate adjustment notices; 2) prompt payment crediting and payoff statements; 3) limits on force-placed insurance; 4) responses to written information requests and complaints of errors; 5) loss mitigation with regard to the first notice or filing for a foreclosure and no foreclosure proceedings if a borrower is performing pursuant to the terms of a loss mitigation agreement.

Other Federal Laws and Regulations

The Company s operations are subject to additional federal laws and regulations applicable to financial institutions, including, without limitation:

- Privacy provisions of the Gramm-Leach-Bliley Act and related regulations, which require us to maintain privacy policies intended to safeguard customer financial information, to disclose the policies to our customers and to allow customers to opt out of having their financial service providers disclose their confidential financial information to non-affiliated third parties, subject to certain exceptions;

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

- Consumer protection rules for the sale of insurance products by depository institutions, adopted pursuant to the requirements of the Gramm-Leach-Bliley Act; and

- USA PATRIOT Act, which requires financial institutions to take certain actions to help prevent, detect and prosecute international money laundering and the financing of terrorism.

Future Legislation and Regulation

Changes to the laws and regulations in the states where the Company and the Bank do business can affect the operating environment of both the Company and the Bank in substantial and unpredictable ways. The Company cannot accurately predict whether those changes in laws and regulations will occur, and, if those changes occur, the ultimate effect they would have upon the financial condition or results of operations of the Company. This is also true of federal legislation, particularly given the current challenging economic environment.

NASDAQ Capital Market

The Company s common stock is listed on The NASDAQ Capital Market under the trading symbol ORRF and is subject to NASDAQ s rules for listed companies.

Forward Looking Statements

Additional information concerning the Company and the Bank with respect to forward looking statements is incorporated by reference from the Caution About Forward Looking Statements section of the Management s Discussion and Analysis of Financial Condition and Results of Operations, included in this report under Item 7.

Table of Contents

Competition

The Bank s principal market area consists of Cumberland County, Franklin County, Lancaster County, and Perry County, Pennsylvania, and Washington County, Maryland. The Bank services a substantial number of depositors in this market area and contiguous counties, with the greatest concentration in Chambersburg, Shippensburg, and Carlisle, Pennsylvania and the surrounding areas.

The Bank, like other depository institutions, has been subjected to competition from less heavily regulated entities such as credit unions, brokerage firms, money market funds, consumer finance and credit card companies, and other commercial banks, many of which are larger than the Bank. The principal methods of competing effectively in the financial services industry include improving customer service through the quality and range of services provided, improving efficiencies and pricing services competitively. The Bank is competitive with the financial institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

The Bank continues to implement strategic initiatives focused on expanding our core businesses and to explore, on an ongoing basis, acquisition, divestiture, and joint venture opportunities to the extent permitted by our regulators. We analyze each of our products and businesses in the context of shareholder return, customer demands, competitive advantages, industry dynamics, and growth potential.

ITEM 1A RISK FACTORS

Our financial condition and results of operations may be adversely affected by various factors, many of which are beyond our control. These risk factors include the following:

The Company is subject to restrictions and conditions of formal agreements issued by the Federal Reserve Bank of Philadelphia and the Pennsylvania Department of Banking. Failure to comply with these formal agreements could result in additional enforcement action against us, including the imposition of monetary penalties.

In March 2012, the Company entered into a Written Agreement with the Federal Reserve Bank of Philadelphia and a Consent Order with the Pennsylvania Department of Banking (PDB). These formal agreements require the Company to discontinue a number of practices and to take a number of actions. In particular, we agreed with the Federal Reserve Bank to, among other things, prepare and submit plans regarding: (i) strengthening of credit risk management practices and underwriting, (ii) the repayment or disposition of properties classified as OREO and nonperforming or criticized assets, (iii) the allowance for loan loss methodology, (iv) capital, and (v) a management review. These formal agreements also restrict the ability of the Company and the Bank to pay dividends, to repurchase stock or to incur indebtedness without prior regulatory approval. We intend to fully comply with the formal agreements. However, if we fail to comply, the Federal Reserve Bank and/or the PDB could take additional enforcement action against the Company. Possible enforcement actions could include the issuance of a cease and desist order that could be judicially enforced, the imposition of civil monetary penalties, the issuance of directives to increase capital or to enter into a strategic transaction, whether by merger or otherwise, with a third party, the appointment of a conservator or receiver, the termination of insurance of deposits, the issuance of removal and prohibition orders against institution-affiliated parties and the enforcement of such actions through injunctions or restraining orders. Any remedial measure or further enforcement action, whether formal or informal, could impose restrictions on our ability to operate our business, harm our reputation and our ability to retain and attract customers, adversely affect our business, prospects, financial condition or results of operations and impact the trading price of our common stock.

We have incurred and expect to continue to incur additional regulatory compliance expense in connection with these formal agreements. Such additional regulatory compliance costs could have an adverse impact on our results of operations and financial condition. In addition, deviations from our business plan will likely have to be approved by the regulators, which could limit our ability to make any changes to our business. This could negatively impact the scope and flexibility of our business activities.

Table of Contents

The Company may not be able to pay any cash dividends or conduct any stock repurchases for the foreseeable future.

The Company is a bank holding company regulated by the FRB. In October 2011, the Company announced it had discontinued its quarterly dividend, which was the result of regulatory guidance from the FRB indicating that the Company s dividend application would not be approved. Due to subsequent regulatory restrictions included in the formal agreements with our regulators discussed above, the Company is restricted from paying any dividends or repurchasing any stock without prior regulatory approval. Accordingly, we do not anticipate being able to pay any cash dividends or conducting any stock repurchases until such time as the agreements are lifted.

The Company is a holding company dependent for liquidity on payments from the Bank, its sole subsidiary, which is subject to restrictions.

The Company is a holding company and depends on dividends, distributions and other payments from the Bank to fund dividend payments, if permitted, and to fund all payments on obligations. The Bank is subject to laws that restrict dividend payments or authorize regulatory bodies to block or reduce the flow of funds from it to us. Pursuant to the terms of the formal agreements we entered into with the Federal Reserve Bank and the PDB in March 2012, as discussed above, any dividend or similar payment from the Bank to us may only be made with prior regulatory approval. In addition, our right to participate in a distribution of assets upon the Bank s liquidation or reorganization is subject to the prior claims of the Bank s creditors.

The Company may be required to make further increases in the provisions for loan losses and to charge off additional loans in the future, which could materially adversely affect it.

There is no precise method of predicting loan losses and the required level of reserves, and related provision for loan losses, can fluctuate from year to year, based on charge-offs (recoveries), loan volumes, credit administration practices, and local and national economic conditions, among other factors. For 2013, we recorded a negative provision for loan losses of $3,150,000. The Company also recorded net loan recoveries of $949,000 in 2013 compared to net charge-offs of $68,849,000 in 2012. Risk elements, including nonperforming loans, troubled debt restructurings, loans greater than 90 days past due still accruing, and other real estate owned totaled $26,322,000 at December 31, 2013. The allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, represents management s best estimate of probable incurred losses within the existing portfolio of loans. The level of the allowance reflects management s evaluation of, among other factors, the status of specific impaired loans, trends in historical loss experience, delinquency, credit concentrations and economic conditions within our market area. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan losses.

In addition, bank regulatory agencies periodically review our allowance for loan losses and may require us to increase the provision for loan losses or to recognize further loan charge-offs, based on judgments that differ from those of management. If loan charge-offs in future periods exceed the allowance for loan losses, there could be a need to record additional provisions to increase our allowance for loan losses. Furthermore, growth in the loan portfolio would generally lead to an increase in the provision for loan losses. Generally, increases in our allowance for loan losses will result in a decrease in net income and stockholders equity, and may have a material adverse effect on the financial condition of the Company, results of operations and cash flows.

The allowance for loan losses was 3.12% of total loans and 83% of nonaccrual and restructured loans still accruing at December 31, 2013, compared to 3.29% of total loans and 110% of nonaccrual and restructured loans

12

still accruing at December 31, 2012. Material additions to the allowance could materially decrease our net income. In addition, at December 31, 2013, the top 25 lending relationships individually had commitments in excess of $190,000,000, and a total outstanding loan balance of nearly $167,000,000, or 28% of the loan portfolio. The deterioration of one or more of these loans could result in a significant increase in the nonperforming loans and the provisions for loan losses, which would negatively impact our results of operations.

Difficult economic and market conditions have adversely affected the financial services industry and may continue to materially and adversely affect the Company.

We are operating in a challenging economic environment, including generally uncertain national and local conditions. Additional concerns from some of the countries in the European Union and elsewhere have also strained the financial markets both abroad and domestically. Although there has been some improvement in the overall global macroeconomic conditions in 2013, financial institutions continue to be affected by conditions in the real estate market and the constrained financial markets. In recent years, declines in the housing market, increases in unemployment and under-employment have negatively impacted the credit performance of loans and resulted in significant write-downs of asset values by financial institutions, including the Bank. Reflecting concern over economic conditions, many lenders and institutional investors have reduced or ceased providing funding to borrowers. While the Company saw some improvement in 2013, there continued to be stress on the Bank s portfolio. A worsening of economic conditions may further impact the Bank s results of operations and financial condition. In particular, we may face the following risks in connection with these events:

- Loan delinquencies could increase further;
- Problem assets and foreclosures could increase further;
- Demand for our products and services could decline;
- Collateral for loans made by us, especially real estate, could decline further in value, in turn reducing a customer s borrowing power, and reducing the value of assets and collateral associated with our loans; and
- Investments in mortgage-backed securities could decline in value as a result of performance of the underlying loans or the diminution of the value of the underlying real estate collateral pressing the government sponsored agencies to honor its guarantees to principal and interest.

As these conditions or similar ones continue to exist or worsen, we may experience continuing or increased adverse effects on our financial condition and results of operations.

Governmental regulation and regulatory actions against us may impair our operations or restrict our growth.

The Company is subject to regulation and supervision under federal and state laws and regulations. The requirements and limitations imposed by such laws and regulations limit the manner in which we conduct our business, undertake new investments and activities and obtain financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit our shareholders. Financial institution regulation has been

the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is within our control. Federal and state regulatory agencies also frequently adopt changes to their regulations or change the manner in which existing regulations are applied or enforced. The Company cannot predict the substance or impact of pending or future legislation, regulation or the application thereof. Compliance with such current and potential regulation and scrutiny may significantly increase our costs, impede the efficiency of our internal business processes, require us to increase our regulatory capital and limit our ability to pursue business opportunities in an efficient manner. Bank regulations can hinder our ability to compete with financial services companies that are not regulated in the same manner or are subject to less regulation.

The Dodd-Frank Wall Street Reform and Consumer Protection Act may affect the Company s financial condition, results of operations, liquidity and stock price.

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act includes provisions affecting large and small financial institutions, including several provisions that will profoundly affect how community banks and bank holding companies will be regulated in the future. Among other things, these provisions relax rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, change the scope of federal deposit insurance coverage and impose new capital requirements on bank holding companies. Many of the requirements called for in the Dodd-Frank Act will be implemented over time and most will be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on our operations is unclear.

The Dodd-Frank Act also created a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions including the authority to prohibit unfair, deceptive or abusive acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks and savings institutions with $10 billion or less in assets will be examined by their applicable bank regulators.

The Company may be required to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under the Dodd-Frank Act. Failure to comply with the new requirements may negatively impact our results of operations and financial condition. While the Company cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have on us, these changes could be materially adverse to our investors.

The repeal of federal prohibitions on the payment of interest on demand deposits could increase our interest expense and reduce our net interest margin.

All federal prohibitions on the ability of financial institutions to pay interest on demand deposit accounts were repealed as part of the Dodd-Frank Act. As a result, beginning on July 21, 2011, financial institutions could commence offering interest on demand deposits to compete for clients. We do not know what interest rates or products other institutions may offer. Our interest expense could increase and our net interest margin could decrease if we begin offering interest on demand deposits to attract additional customers or maintain current customers. Consequently, our business, financial condition or results of operations could be adversely affected.

Changes in interest rates could adversely impact the Company s financial condition and results of operations.

Operating income, net income and liquidity depend to a great extent on our net interest margin, i.e., the difference between the interest yields we receive on loans, securities and other interest earning assets and the interest rates we pay on interest-bearing deposits, borrowings and other liabilities. These rates are highly sensitive to many factors beyond our control, including competition, general economic conditions and monetary and fiscal policies of various governmental and regulatory authorities, including the Board of Governors of the FRB. If the rate of interest we pay on our interest-bearing deposits, borrowings and other liabilities increases more than the rate of interest we receive on loans, securities and other interest earning assets, our net interest income, and therefore our earnings, and liquidity could be materially adversely affected. Our earnings and liquidity could also be materially adversely affected if the rates on our loans, securities and other investments fall more quickly than those on our deposits, borrowings and other liabilities. Our operations are subject to risks and uncertainties surrounding our exposure to changes in the interest rate

environment.

Additionally, based on an analysis of the interest rate sensitivity of the Company s assets, an increase in the general level of interest rates will negatively affect the market value of the investment portfolio because of the relatively long duration of certain securities included in the investment portfolio.

Changes in interest rates also can affect: (1) the ability to originate loans; (2) the value of interest-earning assets, which would negatively impact stockholders equity, and the ability to realize gains from the sale of such assets; (3) the ability to obtain and retain deposits in competition with other available investment alternatives; and (4) the ability of borrowers to repay adjustable or variable rate loans.

Increases in FDIC insurance premiums may have a material adverse effect on our results of operations.

Market developments significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits. As a result, the Company may be required to pay significantly higher premiums or additional special assessments or taxes that could adversely affect earnings. We are generally unable to control the amount of premiums that are required to be paid for FDIC insurance. If there are additional bank or financial institution failures, the Company may be required to pay even higher FDIC premiums than the levels currently imposed. Any future increases or required prepayments in FDIC insurance premiums may materially adversely affect the results of operations.

Because our business is concentrated in South Central Pennsylvania and Washington County, Maryland, our financial performance could be materially adversely affected by economic conditions and real estate values in these market areas.

Our operations and the properties securing our loans are primarily located in South Central Pennsylvania and in Washington County, Maryland. Our operating results depend largely on economic conditions and real estate valuations in these and surrounding areas. A further deterioration in the economic conditions in these market areas could materially adversely affect our operations and increase loan delinquencies, increase problem assets and foreclosures, increase claims and lawsuits, decrease the demand for our products and services and decrease the value of collateral securing loans, especially real estate, in turn reducing customers borrowing power, the value of assets associated with nonperforming loans and collateral coverage.

Commercial real estate lending may expose us to a greater risk of loss and impact our earnings and profitability.

Our business strategy involves making loans secured by commercial real estate. These types of loans generally have higher risk-adjusted returns and shorter maturities than other loans. Loans secured by commercial real estate properties are generally for larger amounts and may involve a greater degree of risk than other loans. Payments on loans secured by these properties are often dependent on the income produced by the underlying properties which, in turn, depends on the successful operation and management of the properties. Accordingly, repayment of these loans is subject to conditions in the real estate market or the local economy. Because of the current challenging economic environment, these loans represent higher risk, could result in an increase in our total net-charge offs and could require us to increase our allowance for loan losses, which could have a material adverse effect on our financial condition or results of operations. While we seek to minimize these risks in a variety of ways, there can be no assurance that these measures will protect against credit-related losses.

The Company is required to make a number of judgments in applying accounting policies and different estimates and assumptions in the application of these policies could result in a decrease in capital and/or other material changes to the reports of financial condition and results of operations. Also, changes in accounting standards can be difficult to predict and can materially impact how the Company records and reports our financial condition and results of operations.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, accounting for income taxes and the ability to recognize the deferred tax asset, and the

fair value of certain financial instruments, in particular securities. While we have identified those accounting policies that are considered critical and have procedures in place to facilitate the associated judgments, different assumptions in the application of these policies could result in a decrease to net income and, possibly, capital and may have a material adverse effect on our financial condition and results of operations.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time, the Financial Accounting Standards Board changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations.

Competition from other banks and financial institutions in originating loans, attracting deposits and providing various financial services may adversely affect profitability and liquidity.

We have substantial competition in originating loans, both commercial and consumer loans, in our market area. This competition comes principally from other banks, savings institutions, credit unions, mortgage banking companies and other lenders. Some of our competitors enjoy advantages, including greater financial resources, and higher lending limits, a wider geographic presence, more accessible branch office locations, the ability to offer a wider array of services or more favorable pricing alternatives, as well as lower origination and operating costs. This competition could reduce our net income and liquidity by decreasing the number and size of loans that we originate and the interest rates we may charge on these loans.

In attracting business and consumer deposits, we face substantial competition from other insured depository institutions such as banks, savings institutions and credit unions, as well as institutions offering uninsured investment alternatives, including money market funds. Some of our competitors enjoy advantages, more aggressive marketing campaigns, better brand recognition and more branch locations. These competitors may offer higher interest rates than we do, which could decrease the deposits that we attract or require us to increase our rates to retain existing deposits or attract new deposits. Increased deposit competition could materially adversely affect our ability to generate the funds necessary for lending operations. As a result, we may need to seek other sources of funds that may be more expensive to obtain and could increase our cost of funds.

The Company s business strategy includes the continuation of moderate growth plans, and our financial condition and results of operations could be negatively affected if we fail to grow or fail to manage our growth effectively.

Our assets increased $126,029,000, or 12.0% from $1,051,783,000 at January 1, 2009, to $1,177,812,000 at December 31, 2013, primarily due to organic growth through increases in residential mortgage loans and commercial real estate loans and securities available for sale funded by growth in deposits. Over the long term, we expect to continue to experience growth in the amount of our assets, the level of our deposits and the scale of our operations. Achieving our growth targets requires us to successfully execute our business strategies, which include continuing to grow our loan portfolio. Our ability to successfully grow will also depend on the continued availability of loan opportunities that meet underwriting standards. In addition, since our asset quality metrics have returned closer to historical levels, we may consider the acquisition of other financial institutions and branches within or outside of our market area to the extent permitted by our regulators, the success of which will depend on a number of factors, including our ability to integrate the acquired branches into the current operations of the Company, our ability to limit the outflow of deposits held by customers of the acquired institution or branch locations, our ability to control the incremental increase in non-interest expense arising from any acquisition and our ability to retain and integrate the appropriate personnel of the acquired institution or branches. We believe we have the resources and internal systems in place to successfully achieve and manage our future growth. If we do not manage our growth effectively, we may not be able to achieve our business plan, and our business and prospects could be harmed.

Table of Contents

If the Company wants to, or is compelled to, raise additional capital in the future, that capital may not be available when it is needed and on terms favorable to current shareholders.

Federal banking regulators require us and our banking subsidiaries to maintain adequate levels of capital to support our operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by our management and board of directors based on capital levels that, they believe, are necessary to support our business operations. At December 31, 2013, all three capital ratios for us and our banking subsidiary were above regulatory minimum levels to be deemed well capitalized under current bank regulatory guidelines. To be well capitalized, banking companies generally must maintain a tier 1 leverage ratio of at least 5%, a Tier 1 risk-based capital ratio of at least 6%, and a total risk-based capital ratio of at least 10%.

The Company s ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside of our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital on terms and time frames acceptable to us or to raise additional capital at all. Additionally, the inability to raise capital in sufficient amounts may adversely affect our operations, financial condition and results of operations. Our ability to borrow could also be impaired by factors that are nonspecific to us, such as severe disruption of the financial markets or negative news and expectations about the prospects for the financial services industry as a whole as evidenced by recent turmoil in the domestic and worldwide credit markets. If we raise capital through the issuance of additional shares of our common stock or other securities, we would likely dilute the ownership interests of current investors and the price at which we issue additional shares of stock could be less than the current market price of our common stock and, thus, could dilute the per share book value and earnings per share of our common stock. Furthermore, a capital raise through the issuance of additional shares may have an adverse impact on our stock price.

The short-term and long-term impact of the changing regulatory capital requirements and anticipated new capital rules is uncertain.

In July 2013, the Company and Bank s primary federal regulator, the Federal Reserve Bank, approved final Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations, including community banks, which also incorporate provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including the Company and Bank, compared to existing U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions regulatory capital ratios, addresses risk weights and other issues affecting the denominator in banking institutions regulatory capital ratios and replace the current risk-weighting approach. The Basel III Capital Rules are effective for the Company and Bank on January 1, 2015 (subject to a phase-in period).

The Basel III Capital Rules, among other things, (i) introduce a new capital measure called CET1, (ii) specify that Tier 1 capital consist of CET1 and Additional Tier 1 capital instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments from capital as compared to existing regulations. When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and Bank to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least

8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

The application of more stringent capital requirements to the Company and the Bank could, among other things, result in lower returns on invested capital, result in the need for additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets. Implementation of changes to asset risk weightings for risk based capital calculations, items included or deducted in calculating regulatory capital and/or additional capital conservation buffers could result in management modifying its business strategy and could limit our ability to make distributions, including paying out dividends or buying back shares.

The Company may be adversely affected by technological advances.

Technological advances impact our business. The banking industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to improving customer services, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success may depend, in part, on our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in operations.

The soundness of other financial institutions could adversely affect the Company.

Our ability to engage in routine funding and other transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have historically led to market-wide liquidity problems, losses of depositor, creditor and counterparty confidence and could lead to losses or defaults by us or by other institutions. We could experience increases in deposits and assets as a result of other banks difficulties or failure, which would increase the capital we need to support such growth.

An interruption or breach in security with respect to our information system, or our outsourced service providers, could adversely impact the Company s reputation and have an adverse impact on our financial condition or results of operations.

We rely on software, communication, and information exchange on a variety of computing platforms and networks and over the Internet. Despite numerous safeguards, we cannot be certain that all of our systems are entirely free from vulnerability to attack or other technological difficulties or failures. We rely on the services of a variety of vendors to meet our data processing and communication needs. If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and we could be exposed to claims from customers. Any of these results could have a material adverse effect on our financial condition, results of operations or liquidity.

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.

We have been named, from time to time, as a defendant in various legal actions or other proceedings arising in connection with our activities as a financial services institution. Certain of these actions include and future actual or threatened legal actions may include claims for substantial and indeterminate amounts of damages, or may result in other results adverse to us. Legal liability could materially adversely affect our business, financial condition or results of operations or cause us reputational harm, which could harm our business. For more information regarding legal proceedings in which we are involved, see Legal Proceedings in Part I, Item 3 herein.

Table of Contents

The Company may not be able to attract and retain skilled people.

The Company s success depends, in large part, on our ability to attract and retain skilled people. We recently experienced significant turnover among our senior officers and salary increases, bonuses, and other compensation for our senior executives has been frozen in recent years. Competition for the best people in most activities engaged in by us can be intense, and we may not be able to attract and hire sufficiently skilled people to fill open and newly created positions or to retain current or future employees. An inability to attract and retain individuals with the necessary skills to fill open positions, or the unexpected loss of services of one or more of our key personnel, could have a material adverse impact on our business due to the loss of their skills, knowledge of our markets, years of industry experience or the difficulty of promptly finding qualified replacement personnel.

The market price of our common stock has been subject to extreme volatility.

The market price of the Company s common stock has been subject to wide fluctuations in response to numerous factors, many of which are beyond our control. These factors include actual or anticipated variations in our operational results and cash flows, changes in financial estimates by securities analysts, trading volume, large purchases or sales of our common stock, market conditions within the banking industry, the general state of the securities markets and the market for stocks of financial institutions, as well as general economic conditions.

ITEM 1B UNRESOLVED STAFF COMMENTS

None.

Table of Contents

ITEM 2 PROPERTIES

The Bank owns and leases properties in Cumberland, Franklin, Lancaster and Perry Counties, Pennsylvania and Washington County, Maryland as branch banking offices and an operations center. The Company and the Bank maintain headquarters at the Bank s King Street Office in Shippensburg, Pennsylvania. A summary of these properties is as follows:

Office and Address	Acquired/Built
Properties Owned	
Orrstown Office 3580 Orrstown Road Orrstown, PA 17244	1919
Lurgan Avenue Office 121 Lurgan Avenue Shippensburg, PA 17257	1981
King Street Office 77 E. King Street Shippensburg, PA 17257	1986
Stonehedge Office 427 Village Drive Carlisle, PA 17015	1994
Path Valley Office 16400 Path Valley Road Spring Run, PA 17262	1995
Norland Avenue Office 625 Norland Avenue Chambersburg, PA 17201	1997
Silver Spring Office 3 Baden Powell Lane Mechanicsburg, PA 17050	2000
North Middleton Office (land lease) 2250 Spring Road Carlisle, PA 17013	2002
Orchard Drive Office (land lease) 1355 Orchard Drive Chambersburg, PA 17201	2003
Seven Gables Office 1 Giant Lane Carlisle, PA 17013	2003

Office and Address	Acquired/Built
Properties Owned (continued)	
Greencastle Office 308 Carolle Street Greencastle, PA 17225	2006
New Bloomfield Office 1 South Carlisle Street New Bloomfield, PA 17068	2006
Newport Office Center Square Newport, PA 17074	2006
Red Hill Office 18 Newport Plaza Newport, PA 17074	2006
Simpson Street Office 1110 East Simpson Street Mechanicsburg, PA 17055	2006
North Pointe Business Center Orrstown Operations Center 2695 Philadelphia Avenue Chambersburg, PA 17201	2007
Eastern Blvd. Office 1020 Professional Court Hagerstown, MD 21740	2008
Leased	
Hanover Street 22 S. Hanover St. Carlisle, PA 17013	1997
Camp Hill 3045 Market St. Camp Hill, PA 17011	2005

Lincoln Way East Office 1725 Lincoln Way East Chambersburg, PA 17202	2004	Carlisle Fairgrounds 1000 Bryn Mawr Road Carlisle, PA 17103	2011
Duncannon Office 403 North Market Street Duncannon, PA 17020	2006	Lancaster LPO 2098 Spring Valley Road Lancaster, PA 17601	2013

Table of Contents

ITEM 3 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 in Note 21, Contingencies in the Notes to the Consolidated Financial Statements, which such information is incorporated herein by reference, in the opinion of management, there are no legal proceedings that are expected to have a material effect on the results of operations, liquidity, or the financial position of the Company at this time.

ITEM 4 MINE SAFETY DISCLOSURES

Not applicable.

Table of Contents

PART II

ITEM 5 MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock began trading on the NASDAQ Capital Market under the symbol ORRF as of April 28, 2009, and continues to be listed there as of the date hereof. At the close of business on February 28, 2014, there were approximately 3,109 shareholders of record.

The following table sets forth, for the fiscal periods indicated, the high and low sales prices of our common stock for the two most recent fiscal years. Trading prices are based on published financial sources.

	2013			**2012**		
	Market Price		**Quarterly**	**Market Price**		**Quarterly**
	High	**Low**	**Dividend**	**High**	**Low**	**Dividend**
First quarter	**$ 15.15**	**$ 9.49**	**$ 0.00**	$ 9.84	$ 7.45	$ 0.00
Second quarter	**16.20**	**12.52**	**0.00**	9.05	7.45	0.00
Third quarter	**18.00**	**12.79**	**0.00**	11.29	7.98	0.00
Fourth quarter	**17.78**	**15.45**	**0.00**	11.15	7.71	0.00
			$ 0.00			$ 0.00

In October 2011, the Company announced that it had discontinued its quarterly dividend. In March 2012, the Company and the Bank entered into a Written Agreement with the Federal Reserve Bank and the Bank entered into a Consent Order with the PDB. Due to the regulatory restrictions included in the Written Agreement and the Consent Order with the respective regulators, the Company is restricted from paying any dividends. Accordingly, there can be no assurance that we will pay a cash dividend in the near future.

Issuer Purchases of Equity Securities

On April 27, 2006, the Company announced a Stock Repurchase Plan approving the purchase of up to 150,000 shares as conditions allow. 106,999 shares were repurchased pursuant to that program. On September 23, 2010, the Company announced an extension of its original Stock Repurchase Plan authorizing the repurchase of 150,000 shares of its common stock. The maximum number of shares that may yet be purchased under the plan is 189,694 shares at December 31, 2013.

For the quarter ended December 31, 2013, there were no repurchases of common equity securities by the Company under the Stock Repurchase Plan. In connection with the formal written agreements entered into with the Federal Reserve Bank and the PDB, the Company s Stock Repurchase Plan was suspended, and the Company does not expect to repurchase shares in the foreseeable future.

Table of Contents

PERFORMANCE GRAPH

The following graph shows a five-year comparison of the cumulative total return on the Company s common stock as compared to other indexes: the SNL index of banks with assets between $1 billion and $5 billion, the S&P 500 Index, and the NASDAQ Composite index. Shareholder returns on the Company s common stock are based upon trades on the NASDAQ Stock Market. The shareholder returns shown in the graph are not necessarily indicative of future performance.

			Period Ending			
Index	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**	**12/31/12**	**12/31/13**
Orrstown Financial Services, Inc.	100.00	133.04	108.21	33.61	39.28	66.61
SNL Bank $1B-$5B	100.00	71.68	81.25	74.10	91.37	132.87
S&P 500	100.00	126.46	145.51	148.59	172.37	228.19
NASDAQ Composite	100.00	145.36	171.74	170.38	200.63	281.22

In accordance with the rules of the SEC, this section captioned Performance Graph shall not be incorporated by reference into any of our future filings made under the Exchange Act or the Securities Act of 1933, as amended (the Securities Act). The Performance Graph and its accompanying table are not deemed to be soliciting material or to be filed under the Exchange Act or the Securities Act.

Recent Sales of Unregistered Securities

The Company has not sold any securities within the past three years which were not registered under the Securities Act.

Table of Contents

ITEM 6 SELECTED FINANCIAL DATA

	Year Ended December 31,				
(Dollars in thousands)	**2013**	**2012**	**2011**	**2010**	**2009**
Summary of Operations					
Interest income	**$ 37,098**	$ 45,436	$ 60,361	$ 58,423	$ 53,070
Interest expense	**5,011**	7,548	10,754	12,688	16,500
Net interest income	**32,087**	37,888	49,607	45,735	36,570
Provision for loan losses	**(3,150)**	48,300	58,575	8,925	4,865
Net interest income after provision for loan losses	**35,237**	(10,412)	(8,968)	36,810	31,705
Securities gains	**332**	4,824	6,224	3,636	1,661
Other noninterest income	**17,476**	18,438	20,396	19,340	15,549
Goodwill impairment charge	**0**	0	19,447	0	0
Other noninterest expenses (excluding goodwill impairment charge)	**43,247**	43,349	41,032	36,735	31,492
Income (loss) before income taxes (benefit)	**9,798**	(30,499)	(42,827)	23,051	17,423
Income tax expense (benefit)	**(206)**	7,955	(10,863)	6,470	4,050
Net income (loss)	**$ 10,004**	$ (38,454)	$ (31,964)	$ 16,581	$ 13,373
Per Common Share Data					
Net income (loss)	**$ 1.24**	$ (4.77)	$ (3.98)	$ 2.18	$ 2.09
Diluted net income (loss)	**1.24**	(4.77)	(3.98)	2.17	2.07
Cash dividend paid	**0.00**	0.00	0.69	0.89	0.88
Book value at December 31	**11.28**	10.85	15.92	20.10	17.21
Tangible book value at December 31	**11.20**	10.75	15.79	17.50	13.96
Average shares outstanding basic	**8,093,306**	8,066,148	8,017,307	7,609,933	6,406,106
Average shares outstanding diluted	**8,093,306**	8,066,148	8,026,726	7,637,824	6,458,752
Stock Price Statistics					
Close	**$ 16.35**	$ 9.64	$ 8.25	$ 27.41	$ 34.88
High	**18.00**	11.29	29.50	36.50	40.00
Low	**9.49**	7.45	7.90	20.00	22.00
Price earnings ratio at close	**13.2**	(2.0)	(2.1)	12.6	16.7
Diluted price earnings ratio at close	**13.2**	(2.0)	(2.1)	12.6	16.8
Price to book at close	**1.4**	0.9	0.5	1.4	2.0
Price to tangible book at close	**1.5**	0.9	0.5	1.6	2.5

Year-End Balance Sheet Data					
Total assets	**$ 1,177,812**	$ 1,232,668	$ 1,444,097	$ 1,511,722	$ 1,196,432
Total loans	**672,973**	711,601	967,993	966,986	881,074
Total investment securities	**416,864**	311,774	322,123	440,570	204,309
Deposits noninterest bearing	**116,371**	121,090	111,930	104,646	90,676
Deposits interest bearing	**884,019**	963,949	1,104,972	1,083,731	824,494
Total deposits	**1,000,390**	1,085,039	1,216,902	1,188,377	915,170
Repurchase agreements	**9,032**	9,650	15,013	87,850	64,614
Borrowed money	**66,077**	37,470	73,798	65,178	64,858
Total shareholders equity	**91,439**	87,694	128,197	160,484	110,886
Trust assets under management market value	**1,085,216**	992,378	947,273	929,327	740,028
Performance Statistics					
Average equity / average assets	**7.45%**	8.07%	10.36%	10.76%	9.55%
Return on average equity	**11.30%**	(35.22)%	(20.33)%	11.22%	12.48%
Return on average assets	**0.84%**	(2.84)%	(2.11)%	1.21%	1.19%

24

Table of Contents

Supplemental Reporting of Non-GAAP-Based Financial Measures

Tangible book value per share is computed by dividing shares outstanding into tangible common equity. Management uses tangible book value per share because it believes such ratio is useful in understanding the Company s capital position and ratios. A reconciliation of book value per share to tangible book value per share is set forth below.

	Year Ended December 31,				
(Dollars in thousands, except per share data)	**2013**	**2012**	**2011**	**2010**	**2009**
Shareholders equity	**$ 91,439**	$ 87,694	$ 128,197	$ 160,484	$ 110,886
Less: Intangible assets	**622**	832	1,041	20,698	20,938
Tangible equity	**$ 90,817**	$ 86,862	$ 127,156	$ 139,786	$ 89,948
Book value per share	**$ 11.28**	$ 10.85	$ 15.92	$ 20.10	$ 17.21
Less: Intangible assets per share	**0.08**	0.10	0.13	2.60	3.25
Tangible book value per share	**$ 11.20**	$ 10.75	$ 15.79	$ $17.50	$ $13.96

25

ITEM 7 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of the consolidated financial condition and results of operations for each of the three years ended December 31, 2013, 2012 and 2011. The following discussion and analysis should be read in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements presented in this report to assist in the evaluation of the Company s 2013 performance. Certain prior period amounts presented in this discussion and analysis have been reclassified to conform to current period classifications. It should also be read in conjunction with the Caution About Forward Looking Statements section at the end of this discussion.

Overview

Currently, the U.S. economy appears to be slowly recovering from one of its longest and most severe economic recessions in recent history. It is not clear at this time how quickly the economy will recover and whether regulatory and legislative efforts to stimulate job growth and spending will be successful. In addition, the U.S. housing market shows signs of mild recovery, as housing values have begun to recover some of the value lost in recent years.

The Company returned to profitability for the year ended December 31, 2013, recording net income of $10,004,000 after posting losses of $38,454,000 and $31,964,000 in 2012 and 2011. The Company was able to return to profitability as asset quality issues have been reduced significantly from their elevated levels in the past two years, allowing for a significant reduction in the provision for loan losses in 2013 compared to 2012 and 2011. The provision for loan losses was a negative $3,150,000 for the year ended December 31, 2013, compared to $48,300,000 and $58,575,000 in 2012 and 2011.

Based upon the level of historical taxable income, projections for future taxable income over the periods and other available evidence, management believed it was not more likely than not that the Company s net deferred tax asset, which represented future deductible temporary differences on the Company s tax returns would be realized at December 31, 2013 and 2012. Accordingly, a full valuation allowance for the net amount of the deferred tax asset of $18,964,000 and $20,235,000, was established at December 31, 2013 and 2012, respectively. The Company also recorded a full goodwill impairment charge in the fourth quarter of 2011 of $18,996,000, net of tax.

Critical Accounting Policies

The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (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 SEC. As this information changes, the consolidated financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources.

The most significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial

statement notes, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, the Company has identified the adequacy of the allowance for loan losses and accounting for income taxes as critical accounting policies.

The allowance for loan losses represents management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on 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 their judgments in this regard from one period to another should a material change occur in the business environment, tax legislation, or in any other business factor that could impair the Company s ability to benefit from the asset in the future. Based upon the Company s prior cumulative taxable losses, projections for future taxable income and other available evidence, management determined that there was not sufficient positive evidence to outweigh the cumulative loss, and concluded it was not more likely than not that the net deferred tax asset would be realized. Accordingly a full valuation allowance was recorded at December 31, 2013 and 2012. Management will continue to update its analysis quarterly, and after a period of sustainable taxable income, the valuation allowance may be reversed in part or in total.

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.

Corporate Profile and Significant Developments

The Company is a bank holding company (that has elected status as a financial holding company with the FRB) headquartered in Shippensburg, Pennsylvania with consolidated assets of $1,177,812,000 at December 31, 2013. The consolidated financial information presented herein reflects the Company and its wholly-owned commercial bank subsidiary, the Bank.

The Bank, with total assets of $1,177,380,000 at December 31, 2013, is a Pennsylvania chartered commercial bank with 22 offices. The Bank s deposit services include a variety of checking, savings, time and money market deposits along with related debit card and merchant services. Lending services include commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Orrstown Financial Advisors, a division of the Bank, offers a diverse line of financial services to our customers, including, but not limited to, brokerage, mutual funds, trusts, estate planning, investments and insurance products. At December 31, 2013, approximately $1,085,216,000 of assets under management was serviced by Orrstown Financial Advisors.

Economic Climate, Inflation and Interest Rates

The U.S. economy appears to be slowly recovering from one of its longest and most severe economic recessions in history. The recovery has been much weaker than past recoveries resulting in stubbornly high

unemployment, poor loan demand and continued credit quality challenges. This pattern remained in place throughout 2013.

The majority of the assets and liabilities of a financial institution are monetary in nature, and therefore, differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation does have an impact on the growth of total assets and on noninterest expenses, which tend to rise during periods of general inflation. Inflationary pressures over the last three years have been modest, and although the FRB has been monetizing the debt, which has historically led to increased inflation, the outlook for inflation appears modest for the foreseeable future.

As the Company s balance sheet consists primarily of financial instruments, interest income and interest expense is greatly influenced by the level of interest rates and the slope of the interest rate curve. During the three years presented in this financial statement review, interest rates have remained near all-time lows. Because of the low level of interest rates, we have not been able to lower the rate we pay for interest bearing non-maturity deposits to the same extent that has been experienced in the rates we have been able to earn on our interest earning assets. As a result, the Company s net interest margin has been negatively impacted.

Despite the challenging economic conditions during 2011, 2012, and into 2013, the Company believes it is positioned to withstand these conditions through its improving capital and liquidity positions, high quality debt securities portfolios and recent improvement in asset quality through continuing efforts to manage credit and interest rate risk.

Results of Operations

Summary

For the year ended December 31, 2013, the Company recorded net income (loss) of $10,004,000 compared to ($38,454,000) and ($31,964,000) for the same periods in 2012 and 2011, resulting in diluted earnings (loss) per share of $1.24, ($4.77) and ($3.98) for the years ended December 31, 2013, 2012 and 2011.

Each of the three years had events and circumstances that affect the comparability of the information for the periods presented. As a result of the asset quality issues the Company experienced in 2011 and 2012 and the aggressive manner in which these troubled assets were handled, large provisions for loan losses were recorded and totaled $58,575,000 and $48,300,000 for the years ended December 31, 2011 and 2012, respectively. Due to the significant impact these large provisions had on the Company s results of operations, it was determined that the recorded goodwill was impaired in 2011, and a full impairment charge of $18,996,000, net of tax, was recorded. In 2012, after continued losses were posted, it was determined that a valuation allowance was required on the Company s net deferred tax asset balance, and a charge of $20,235,000 was recorded.

As a result of the handling of troubled assets in 2012 and 2011, the Company experienced improvement in asset quality during 2013, and based on active monitoring and workout solutions of previously charged-off relationships, we were able to record net recoveries of $949,000 during the year ended December 31, 2013, compared to net charge-offs of $68,849,000 and $30,880,000 recorded in the two previous years. As a result, it was determined that no provision for loan losses was required in 2013, and that the recovery of a previously charged off relationship of $3,150,000 was not needed to replenish the reserve, and was treated as a negative provision for loan losses. Net income for the year ended December 31, 2013 also benefited from the full valuation allowance on deferred taxes established in the prior year, and only $60,000 of federal income tax expense was recorded during the year despite $9,798,000 of pre-tax income.

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

The Analysis of Net Interest Income table presents net interest income on a fully taxable equivalent basis, net interest spread and net interest margin for the years ending December 31, 2013, 2012 and 2011. The Changes in Taxable Equivalent Net Interest Income table below analyzes the changes in net interest income for the same periods broken down by their rate and volume components.

2013 versus 2012

For the year ended December 31, 2013, net interest income, measured on a fully tax equivalent basis, decreased $6,271,000, or 15.6%, to $33,882,000 from $40,153,000 for the same period in 2012. The primary reason for the decrease in net interest income was a decrease in average earning assets from $1,284,864,000 for the year ended December 31, 2012 to $1,118,612,000 for the same period in 2013. Compression in net interest margin from 3.12% for the year ended December 31, 2012 to 3.03% for the same period in 2013 also contributed to the decline in net interest income.

The largest contributor to the decrease in net interest income was the decline in the loan portfolio. Interest income on loans decreased from $40,994,000 for the year ended December 31, 2012 to $32,779,000 for the year ended December 31, 2013. The average loan balance declined to $683,272,000 for the year ended December 31, 2013, compared to $859,985,000 for the same period in 2012. Two large sales of criticized loans in 2012 resulted in lower average balances, as did management s workout efforts and scheduled amortization of loans exceeding new loan originations during the year. Partially offsetting the loan volume variance was an increase in rates earned on loans from 4.77% for the year ended December 31, 2012 to 4.80% for the same period in 2013, as the Company has been able to reduce its nonaccrual loan balance.

Securities interest income also declined in 2013 and totaled $5,940,000 for the year ended December 31, 2013, a decrease of $480,000 compared to the $6,420,000 for the same period in 2012. Although the average balance of securities has increased from $315,581,000 for the year ended December 31, 2012 to $368,208,000 for the same period in 2013, the volume increase was not enough to offset the decrease in rates earned on securities, which declined from a tax equivalent yield of 2.03% in 2012 to 1.61% in 2013. The low interest rate environment experienced during the first half of 2013, has resulted in increased refinancing activity and accelerated prepayments on mortgage backed securities and collateralized mortgage obligations, many of which have premiums associated with them. Furthermore, the proceeds from the sales or maturities of securities have been reinvested at lower interest rates, also negatively impacting the yield earned on securities.

Interest expense on deposits and borrowings for the year ended December 31, 2013 was $5,011,000, a decrease of $2,537,000, from $7,548,000 for the same period in 2012. The average balance of interest bearing liabilities decreased 13.2% from $1,115,644,000 for the year ended December 31, 2012 to $968,797,000 for the same period in 2013. In

addition, the Company s cost of funds on interest bearing liabilities has declined to 0.52% for the year ended December 31, 2013 from 0.68% for the same period in 2012. The interest rate environment has allowed the Company to lower the rates offered on its demand deposits, including interest bearing demand, money market and savings in 2013 compared to 2012, and as time deposits mature, we have

also been able to replace the funds at slightly lower rates. The rate paid on long-term debt has increased from 1.64% for the year ended December 31, 2012 to 1.76% for the same period in 2013, and is a direct result of the maturity of lower cost borrowings.

The Company s net interest spread of 2.96% declined 7 basis points for the year ended December 31, 2013 as compared to the same period in 2012. Net interest margin for the year ended December 31, 2013 was 3.03%, a 9 basis point decline from 3.12% for the year ended December 31, 2012.

2012 versus 2011

For the year ended December 31, 2012 net interest income, measured on a fully tax equivalent basis, decreased $12,259,000, or 23.4%, to $40,153,000 from $52,412,000 in 2011. The primary reason for the decrease in net interest income was a decrease in average earning assets from $1,432,991,000 in 2011 to $1,284,864,000 in 2012. Net interest margin decreased 54 basis points, from 3.66% in 2011 to 3.12% for 2012. As summarized on the Changes in Taxable Equivalent Net Interest Income table, $7,886,000 of the decline in net interest income was the result of a decrease in average volume, and $4,373,000 of the decrease was the result of average rate.

A large portion of the decline in interest income was the result of a decrease in interest earned on the securities portfolio, which totaled $6,420,000 for the year ended December 31, 2012, a decrease of $6,486,000, or 50.3%, from 2011. Year-over-year, average securities decreased $80,892,000, or 20.4%, which contributed $3,178,000 to the overall decline in tax equivalent interest income earned on securities. As a result of the recent regulatory climate related to nontraditional funding sources, management did not utilize brokered deposits in 2012 to the extent it had in the past, and as such, as the brokered deposits matured, securities proceeds were used to fund the payoffs, leading to a decrease in average securities balances during 2012 compared to 2011. The change in the average yield on investment securities contributed $3,308,000 of the decline in the interest income earned on securities, with a yield earned of 2.03% in 2012, a 123 basis point decline from the yield earned of 3.26% in 2011. The historic low interest rate environment in 2012 resulted in increased financing activity of mortgage loans in 2012, resulting in accelerated prepayments on the Company s mortgage backed securities portfolio, many of which had premiums associated with them. As the prepayments have accelerated, the amortization of the premiums has been faster than in the past, which has placed pressure on the yields earned on securities. Further, the proceeds from the sales or maturities of securities have been reinvested at lower interest rates, which have also negatively impacted the yield earned on securities.

Interest income earned on a tax equivalent basis on loans decreased from $50,122,000 for the year ended December 31, 2011 to $40,994,000 for the same period in 2012, a $9,128,000 decline. Several factors contributed to the decline. The most significant factor contributing to the decline in interest income earned on loans was the decline in the average balance of loans, from $993,828,000 in 2011 to $859,985,000 for the year ended December 31, 2012. This decline in average loan balance was the result of management s strategy to temporarily curtail its loan growth in order to address and enhance credit administration and underwriting processes and procedures. The rates earned on loans also negatively impacted net income during 2012, as the average balance of impaired loans, which generally are in nonaccrual status, increased from $50,874,000 for the year ended December 31, 2011 to $67,186,000 for 2012. The increase in loans not accruing interest combined with generally lower interest rates in 2012 resulted in the rates earned on loans decreasing from 5.04% in 2011 to 4.77% in 2012.

Interest expense on deposits and borrowings for the year ended December 31, 2012 was $7,548,000, a decrease of $3,206,000 from the $10,754,000 expensed in the same period in 2011. The Company s cost of funds on interest bearing liabilities declined from 0.87% in 2011 to 0.68% for 2012. The interest rate environment has allowed the Company to lower the rates offered on its demand deposits, including interest bearing demand, money markets and savings accounts in 2012 compared to 2011. As time deposits and long-term debt mature, the Company has been able

to replace the funds at slightly lower rates.

The Company s net interest spread for the year ended December 31, 2012 was 3.03%, a decrease of 51 basis points compared to the same period in 2011. Net interest margin for the year ended December 31, 2012 was 3.12%, a 54 basis point decline from 3.66% in 2011.

Table of Contents

ANALYSIS OF NET INTEREST INCOME

The following table presents interest income on a fully taxable equivalent basis, net-interest spread and net interest margin for the years ended December 31:

	2013			2012			2011		
(Dollars in thousands)	**Average Balance**	**Tax Equivalent Interest**	**Tax Equivalent Rate**	**Average Balance**	**Tax Equivalent Interest**	**Tax Equivalent Rate**	**Average Balance**	**Tax Equivalent Interest**	**Tax Equivalent Rate**
Assets									
Federal funds sold and interest bearing bank balances	**$ 67,132**	**$ 174**	**0.26%**	$ 109,298	$ 287	0.26%	$ 42,690	$ 138	0.32%
Taxable securities	**339,750**	**4,300**	**1.27**	270,170	3,798	1.41	318,185	8,334	2.62
Tax-exempt securities	**28,458**	**1,640**	**5.76**	45,411	2,622	5.77	78,288	4,572	5.84
Total securities	**368,208**	**5,940**	**1.61**	315,581	6,420	2.03	396,473	12,906	3.26
Taxable loans	**619,929**	**29,290**	**4.72**	796,873	37,145	4.66	940,063	46,680	4.97
Tax-exempt loans	**63,343**	**3,489**	**5.51**	63,112	3,849	6.10	53,765	3,442	6.40
Total loans	**683,272**	**32,779**	**4.80**	859,985	40,994	4.77	993,828	50,122	5.04
Total interest-earning assets	**1,118,612**	**38,893**	**3.48**	1,284,864	47,701	3.71	1,432,991	63,166	4.41
Cash and due from banks	**13,166**			14,597			13,577		
Bank premises and equipment	**26,496**			27,043			27,404		
Other assets	**52,179**			62,856			68,569		
Allowance for loan losses	**(21,912)**			(37,133)			(24,773)		
Total	**$ 1,188,541**			$ 1,352,227			$ 1,517,768		
Liabilities and Shareholders Equity									
Interest bearing demand deposits	**$ 484,114**	**785**	**0.16**	$ 511,800	1,236	0.24	$ 486,793	1,710	0.35
Savings deposits	**78,714**	**129**	**0.16**	74,180	124	0.17	71,059	140	0.20
Time deposits	**352,905**	**3,531**	**1.00**	455,507	5,352	1.17	574,079	7,518	1.31
Short-term borrowings	**24,312**	**61**	**0.25**	30,581	120	0.39	63,271	314	0.50
Long-term debt	**28,752**	**505**	**1.76**	43,576	716	1.64	42,308	1,072	2.53
	968,797	**5,011**	**0.52**	1,115,644	7,548	0.68	1,237,510	10,754	0.87

Total interest bearing liabilities									
Demand deposits	**119,146**			116,930			113,157		
Other	**12,051**			10,469			9,901		
Total Liabilities	**1,099,994**			1,243,043			1,360,568		
Shareholders Equity	**88,547**			109,184			157,200		
Total	**$ 1,188,541**		**0.45**	$ 1,352,227		0.59	$ 1,517,768		0.75
Net interest income (FTE)/net interest spread		**33,882**	**2.96%**		40,153	3.03%		52,412	3.54%
Net interest margin			**3.03%**			3.12%			3.66%
Tax-equivalent adjustment		**(1,795)**			(2,265)			(2,805)	
Net interest income		**$ 32,087**			$ 37,888			$ 49,607	

Note: 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.

Table of Contents

CHANGES IN TAXABLE EQUIVALENT NET INTEREST INCOME

The following table analyzes the changes in tax equivalent net interest income for the periods presented, broken down by their rate and volume components:

	2013 Versus 2012 Increase (Decrease) Due to Change in			2012 Versus 2011 Increase (Decrease) Due to Change in		
(Dollars in thousands)	**Average Volume**	**Average Rate**	**Total Increase (Decrease)**	**Average Volume**	**Average Rate**	**Total Increase (Decrease)**
Interest Income						
Federal funds sold & interest bearing deposits	**$ (111)**	**$ (2)**	**$ (113)**	$ 215	$ (66)	$ 149
Taxable securities	**978**	**(476)**	**502**	(1,258)	(3,278)	(4,536)
Tax-exempt securities	**(979)**	**(3)**	**(982)**	(1,920)	(30)	(1,950)
Taxable loans	**(8,248)**	**393**	**(7,855)**	(7,110)	(2,424)	(9,534)
Tax-exempt loans	**14**	**(374)**	**(360)**	598	(192)	406
Total interest income	**(8,346)**	**(462)**	**(8,808)**	(9,475)	(5,990)	(15,465)
Interest Expense						
Interest bearing demand deposits	**(67)**	**(384)**	**(451)**	88	(562)	(474)
Savings deposits	**8**	**(3)**	**5**	6	(22)	(16)
Time deposits	**(1,206)**	**(615)**	**(1,821)**	(1,553)	(613)	(2,166)
Short-term borrowings	**(25)**	**(34)**	**(59)**	(162)	(32)	(194)
Long-term debt	**(244)**	**33**	**(211)**	32	(388)	(356)
Total interest expense	**(1,534)**	**(1,003)**	**(2,537)**	(1,589)	(1,617)	(3,206)
Net Interest Income	**$ (6,812)**	**$ 541**	**$ (6,271)**	$ (7,886)	$ (4,373)	$ (12,259)

Note: The change attributed to volume is calculated by taking the average change in average balance times the prior year s average rate and the remainder is attributable to rate.

Provision for Loan Losses

The Company recorded a negative provision for loan losses, or a reversal of amounts previously provided, of $3,150,000 for the year ended December 31, 2013, compared to expense of $48,300,000 and $58,575,000 for the same periods in 2012 and 2011. During 2013, the Company received payments on classified loans with partial charge-offs previously recorded. As payments received on these classified loans exceeded the carrying value of these loans, the excess was included in recoveries of loan amounts previously charged off. Favorable charge-off history during the year ended December 31, 2013 combined with improvements in average levels of impaired loans has resulted in no additional provision for loan losses being required during the period, as the reserve balance at the beginning of 2013 was sufficient to absorb net charge-offs. In connection with the quarterly evaluation of the adequacy of the allowance for loan losses during 2013, it was determined that large recoveries specific to loans in one customer relationship were not needed to replenish the reserve, and were taken as a negative provision for loan losses.

The elevated provisioning levels for the years ended December 31, 2012 and 2011 are reflective of the asset quality issues the Company was facing at those times, and the aggressive manner in which the Company was working through its classified assets in order to improve its overall asset quality and balance sheet. Remediation efforts in 2012 included two separate sales of distressed assets, in order to reduce the level of loan losses in future periods.

See further discussion in the Asset Quality and Credit Risk Management sections of this Management s Discussion and Analysis of Financial Condition and Results of Operations.

Table of Contents

Noninterest Income

The following provides information regarding noninterest income changes over the past three years.

(Dollars in thousands)	**2013**	**2012**	**2011**	**% Change 2013-2012**	**% Change 2012-2011**
Service charges on deposit accounts	**$ 5,716**	$ 6,227	$ 6,411	**(8.2)%**	(2.9)%
Other service charges, commissions and fees	**1,070**	1,275	1,313	**(16.1)%**	(2.9)%
Trust department income	**4,770**	4,575	4,216	**4.3%**	8.5%
Brokerage income	**1,911**	1,478	1,573	**29.3%**	(6.0)%
Mortgage banking activities	**3,053**	3,393	3,007	**(10.0)%**	12.8%
Earnings on life insurance	**963**	1,018	1,110	**(5.4)%**	(8.3)%
Merchant processing revenue	**0**	149	1,850	**(100.0)%**	(91.9)%
Other income (loss)	**(7)**	323	916	**(102.2)%**	(64.7)%
Subtotal before securities gains	**17,476**	18,438	20,396	**(5.2)%**	(9.6)%
Investment securities gains	**332**	4,824	6,224	**(93.1)%**	(22.5)%
Total noninterest income	**$ 17,808**	$ 23,262	$ 26,620	**(23.4)%**	(12.6)%

2013 v. 2012 s Results

Noninterest income decreased to $17,808,000 for the year ended December 31, 2013, as compared to $23,262,000 in the same prior year period. Excluding the decrease in securities gains of $4,492,000 in 2013 compared to 2012, noninterest income decreased $962,000 or 5.2%.

Service charges on deposit accounts and other services charges, commissions and fees totaled $5,716,000 and $1,070,000 for the year ended December 31, 2013, both declines of 8.2% and 16.1% from 2012 s totals, and continued the trend noted in the prior year. The Company has experienced a decline in overdraft charges and other fee related charges, as consumers have been conscious of their spending.

Trust department and brokerage income, in total, increased $628,000, or 10.4%, to $6,681,000 for the year ended December 31, 2013 compared to $6,053,000 earned in the same period in 2012. Favorable market conditions and the Company s ability to promote new products and attract accounts and customers contributed to the increase.

Mortgage banking revenue for the year ended December 31, 2013 totaled $3,053,000, a 10.0% decline from the $3,393,000 earned for the year ended December 31, 2012. Despite interest rates favorably impacting mortgage banking revenues during the first half of 2013, the rise in interest rates in the second half of the year reduced refinancing volumes, resulting in mortgage banking revenue being lower in 2013 than 2012. The higher interest rates have resulted in decreased loan origination volumes and refinancing activity, which has slowed pre-payment speed on loans serviced for others. This slower prepayment speed favorably impacted the fair value of our mortgage servicing rights, and allowed for recovery of $638,000 of its impairment reserve during the year ended December 31, 2013, compared to an additional charge of $360,000 for the same period in 2012. As a result of lower anticipated loan origination volumes and full recovery of the impairment reserve, management expects mortgage banking revenues to be impacted in 2014.

The loss recorded in other income (loss) for the year ended December 31, 2013 was principally the result of losses on sales of real estate owned of $149,000, compared to gains of $28,000 recorded for the same period in 2012.

The Company had limited gains on securities available for sale of $332,000 for the year ended December 31, 2013, which resulted from management investment strategies given interest rate conditions. In 2012, gains of $4,824,000 were recorded, as asset/liability strategic considerations as well as maintaining capital levels factored into the decision as to the extent and timing of security gains taken during the year.

Table of Contents

2012 v. 2011 s Results

Noninterest income decreased to $23,262,000 for the year ended December 31, 2012, as compared to $26,620,000 in the same prior year period. Excluding the decrease in securities gains of $1,400,000 in 2012 compared to 2011, noninterest income decreased $1,958,000 or 9.6%.

The Company sold its merchant processing business in the third quarter of 2011, which contributed $1,850,000 in revenues for the year ended December 31, 2011, including the recognition of a gain of $995,000. In 2012, income recognized on merchant services consisted of amounts previously held back as gain until all conditions of the sales contract were satisfied. Noninterest income for the twelve months ended December 31, 2011 was favorably influenced by the sale of interest rate swaps of $791,000, with no similar gains occurring in 2012.

In 2012, two of the Company s non-margin lines of business posted increases in revenues. Mortgage banking revenue was favorably influenced by the continued low interest rate environment, coupled with greater stability in the real estate market. Mortgage banking revenues totaled $3,393,000 for the year ended December 31, 2012, a 12.8% increase over 2011. Orrstown Financial Advisors, which generates trust and brokerage income, recorded revenues of $6,053,000 for the year ended December 31, 2012, a $264,000, or 4.6% increase over the same period in 2011. Favorable market conditions, combined with new business opportunities, led to the enhanced revenue stream.

Service charges on deposit accounts and other services charges, commissions and fees totaled $6,227,000 and $1,275,000 for the year ended December 31, 2012, both declines of 2.9% from 2011 s totals. The Company has experienced a decline in overdraft charges and other fee related charges in 2012, as consumers were more conscious of their spending.

The Company continued to harvest gains on securities available for sale when it was strategically determined that the gains afforded on certain securities were more beneficial than the interest rate earned. Additionally, asset/liability management as well as maintaining capital levels factored into the decision as to the extent and timing of security gains taken during the year. Net gains on securities were $4,824,000 for the year ended December 31, 2012 compared to $6,224,000 in 2011.

Noninterest Expenses

The following provides information regarding noninterest expense over the past three years.

				% Change	
(Dollars in thousands)	**2013**	**2012**	**2011**	**2013-2012**	**2012-2011**
Salaries and employee benefits	**$ 22,954**	$ 19,864	$ 17,506	**15.6%**	13.5%
Occupancy expense	**2,055**	1,975	1,987	**4.1%**	(0.6)%
Furniture and equipment	**3,446**	2,913	2,705	**18.3%**	7.7%
Data processing	**542**	574	1,161	**(5.6)%**	(50.6)%
Automated teller machine and interchange fees	**1,054**	989	897	**6.6%**	10.3%
Advertising and bank promotions	**1,251**	1,411	1,246	**(11.3)%**	13.2%
FDIC insurance	**2,577**	2,727	2,417	**(5.5)%**	12.8%
Professional services	**2,255**	3,076	3,531	**(26.7)%**	(12.9)%
Collection and problem loan	**674**	2,297	1,167	**(70.7)%**	96.8%
Real estate owned	**137**	834	681	**(83.6)%**	22.5%

Taxes other than income	**939**	888	841	**5.7%**	5.6%
Goodwill impairment and intangible asset amortization	**210**	209	19,657	**0.5%**	(98.9)%
Other operating expenses	**5,153**	5,592	6,683	**(7.9)%**	(16.3)%
Total noninterest expenses	**$ 43,247**	$ 43,349	$ 60,479	**(0.2)%**	(28.3)%

34

Table of Contents

2013 v 2012 s Results

Noninterest expenses amounted to $43,247,000 for the year ended December 31, 2013 compared to $43,349,000 for the corresponding prior year period, a decrease of $102,000, or 0.2%. The following factors contributed to the net decrease in noninterest expenses.

Salaries and employee benefits totaled $22,954,000 for the year ended December 31, 2013, compared to $19,864,000 for the same period in 2012, an increase of $3,090,000. A large component of the increase pertains to an increase in the Company s number of full-time equivalents, which has increased as we enhance our enterprise risk management area, place less reliance on outside consultants, and enhance our technology and delivery channels to meet the changing needs of our customers. An additional factor contributing to the increase in salaries and benefit expense was the restoration of certain incentive based employee benefits as a result of the Company s return to profitability, which totaled $565,000 for the year ended December 31, 2013, with no similar expenses recorded in the same period in 2012.

In 2013, the Company began making increased investments in technology in order to enhance our enterprise risk management practices, and to provide our customers with a better customer experience when utilizing our automated delivery channels. As a result, the Company has seen an increase in furniture and equipment expense, which increased from $2,913,000 for the year ended December 31, 2012 to $3,446,000 for the same period in 2013. Additionally, as we promote the usage of debit cards to our customers for point of sale purchases and to withdraw funds from automated teller machines, these related fees charged to the Bank increased from $989,000 for the year ended December 31, 2012 to $1,054,000 for the same period in 2013, and increase of 6.6%.

Advertising and bank promotions expense decreased $160,000 to $1,251,000 for the year ended December 31, 2013 compared to $1,411,000 for the year ended December 31, 2012. This reduction in expense relates to the timing of promotions and charitable contributions, and the discretionary nature of the expense which the Company controlled during 2013. It is anticipated that the Company will actively advertise and promote the Bank in 2014, and as a result it is likely these expenses will increase.

FDIC insurance decreased $150,000 to $2,577,000 for the year ended December 31, 2013 compared to $2,727,000 for the same period in 2012. A reduction in the Bank s assets and deposits offset an increase in the quarterly deposit insurance assessment rate that went into effect in the second quarter of 2012 and resulted from an increased risk rating.

Professional services expenses totaled $2,255,000 for the year ended December 31, 2013, compared to $3,076,000 in 2012, a decrease of $821,000, or 26.7%. Professional services expenses include costs associated with third party loan review assistance, regulatory consulting, and legal and accounting services. The Company was able to reduce its reliance on outside service providers as it hired additional employees pertaining to enterprise risk management, which resulted in lower professional service fees in 2013 as compared to 2012.

Asset quality related costs, including collection and problem loan and real estate owned expenses, decreased significantly in 2013 compared to 2012. Collection and problem loan expense totaled $674,000 for the year ended December 31, 2013, a 70.7% reduction from the $2,297,000 of expense recorded for the same period in 2012. Real estate owned expenses were down 83.6%, from $834,000 for the year ended December 31, 2012 to $137,000 for the same period in 2013. Significant reductions in nonperforming assets, and the monitoring, legal and other costs associated with them, led to the significant reduction in asset quality related costs.

Other operating expenses decreased $439,000 for the year ended December 31, 2013, from $5,592,000 in 2012 to $5,153,000 in 2013. The primary reason for this fluctuation is a significant reduction in Regulation E losses that the Bank experienced in 2013, which totaled $62,000 for the year ended

December 31, 2013 compared to $544,000 for the same period in 2012. As a result of the losses experienced in 2012, the Company enhanced its Regulation E policies and operating procedures, including the purchase of software to assist in the identification of potential fraudulent transactions, which lowered the instances and magnitude of losses in 2013.

In order to better understand how noninterest expenses change in relation to related changes in revenue, operating expense levels are often measured in the financial services industry by the efficiency ratio, which expresses non-interest expense as a percentage of tax-equivalent net interest income and noninterest income, excluding securities gains, goodwill impairment, and other non-recurring items. The Company s efficiency ratio for the twelve months ended December 31, 2013 was 83.3%, compared to 72.2% for the same period in 2012. The higher, or less favorable, ratio was the result of declines in net interest and noninterest income between the two periods, which more than offset the lower noninterest expenses recorded in 2013 compared to 2012.

2012 v. 2011 s Results

Noninterest expenses decreased from $60,479,000 during the twelve months of 2011 to $43,349,000 for the same period in 2012, a decrease of $17,130,000 or 28.3%. Excluding the nonrecurring goodwill impairment charge of $19,447,000 recorded in 2011, noninterest expenses would have increased 5.6%, or $2,317,000, as compared to 2011. The following contributed to the net decrease in noninterest expenses.

Salaries and employee benefits increased $2,358,000, from $17,506,000 for the year ended December 31, 2011 to $19,864,000 for 2012. The increase in salaries and employee benefits was the result of the establishment of the Company s Special Assets Group to assist in working through troubled assets, increases in personnel in the Credit Administration Department, and other additions as the Company enhanced other risk management practices.

The decrease in data processing expenses from $1,161,000 for the year ended December 31, 2011 to $574,000 for the same period in 2012 is related to expenses associated with merchant processing that are no longer incurred. As noted in the Noninterest Income section above, the Company sold its merchant services business in 2011. Data processing expenses of $696,000 were incurred for the year ended December 31, 2011 related to these revenues with no similar charges in 2012.

FDIC insurance totaled $2,727,000 for the twelve months ended December 31, 2012, an increase of 12.8%, over 2011 s total of $2,417,000. This increase was the result of an increased risk rating and associated increased depository insurance rate, which has been partially offset by a reduction in the Bank s net assets and deposits.

Professional services expenses totaled $3,076,000 for the year ended December 31, 2012, compared to $3,531,000 in 2011, a decrease of $455,000. Professional services expenses include costs associated with third party loan review assistance, regulatory consulting, and legal and accounting services. In 2011, when the Company first began experiencing asset quality issues and increased regulatory compliance costs, it needed to consult with outside service providers as the Company did not have adequate staffing to address these issues. As the Special Assets Group, Credit Administration Department, and other risk management personnel were hired, the Company reduced its reliance on outside service providers, which resulted in lower

professional service fees in 2012 as compared to 2011.

Collection and problem loan expenses increased approximately $1,130,000 for the year ended December 31, 2012 and totaled $2,297,000, compared to $1,167,000 for 2011. These expenses increased as a result of the increase in classified assets with corrective action and work-out plans in order to mitigate the Company s risk of loss, and consists primarily of costs associated with obtaining updated appraisals on the collateral securing the outstanding loans and legal expenses as the Bank s credit exposure is clarified and work out plans are developed.

Real estate owned expenses, which include regular maintenance and upkeep expenses as well as write-downs of properties to fair value less costs to dispose, increased from $681,000 for the year ended December 31, 2011, to $834,000 in 2012, an increase of 22.5%. The increase was consistent with the higher number of properties that the Company owns and is managing, as well as continued softness in the real estate market, which led to further write-downs of properties.

The largest decrease in 2012 was in goodwill impairment and intangible asset amortization, which totaled $209,000 for the year ended December 31, 2012, a decrease of $19,448,000 compared to 2011. In the fourth quarter of 2011, the Company recorded a non-cash impairment charge in connection with its annual evaluation of goodwill. The impairment charge resulted from several factors, the most prominent being decreases in trading multiples of the Company s common stock, overall valuations of comparable organizations, a deterioration in asset quality of the commercial real estate portfolio, and the negative impact of deteriorating asset quality on expected cash flows. As a result of these negative indicators and subsequent analysis, the Company s entire goodwill balance was written off at December 31, 2011. The $209,000 of expense in 2012 is the amortization of intangible assets only.

Other operating expenses decreased $1,091,000 for the year ended December 31, 2012, from $6,683,000 in 2011 to $5,592,000 in 2012. The primary reason for this fluctuation was the difference in the provision for off-balance sheet credit liabilities recorded between the two periods. Off-balance sheet credit liabilities include providing a reserve on undrawn loan commitments, and the anticipated loss on those credits which are estimated using an approach similar to determining reserves on specific loans in the determination of the allowance for loan losses. During 2011, a charge of $782,000 was recorded to establish this off-balance sheet reserve, whereas in 2012, the reserve was lowered by $199,000 as the off-balance sheet exposures have been greatly reduced as a result of the two loan sales completed in 2012.

As a result of the increase in noninterest expense (net of goodwill impairment), combined with declining net interest income, the Company s efficiency ratio for the year ended December 31, 2012 increased to 72.2%, compared to 55.2% in the same period in 2011.

Federal Income Taxes

The Company recorded income tax benefit of $206,000 on pre-tax income of $9,798,000 for the year ended December 31, 2013, compared to income tax expense of $7,955,000 on pre-tax loss of $30,499,000 for the year ended December 31, 2012. For the year ended December 31, 2011, the Company recorded income tax benefit of $10,863,000 on pre-tax loss of $42,827,000. In 2012, the Company recorded a full deferred tax asset valuation allowance of $20,235,000, which resulted in the significant variances in income tax benefit and expense.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers taxes paid in prior years, projected future taxable income and available tax planning strategies, and other factors in making this assessment. Based upon the level of historical taxable income, projections for future taxable income over the periods and other available evidence, management believed it was not more likely than not that the net deferred tax asset, which represented future deductible temporary differences on our tax returns would be realized at December 31, 2013 and 2012. Accordingly, a full valuation allowance for the net amount of the deferred tax assets of $18,964,000 and $20,235,000, was established at December 31, 2013 and 2012, respectively. The lower valuation allowance in 2013 compared to 2012 is the result of the reversal of a portion of

certain net deductible temporary differences during the year, and the generation of taxable income which the net operating loss carryforward will absorb and result in limited payment of federal income taxes in 2013. Management assesses the necessity of the valuation allowance on deferred taxes on a quarterly basis, and at this time, it is not known when a partial, or full reversal, of the valuation allowance will occur as it is dependent on our ability to continue to generate net income, and our ability to forecast that net income is likely in the sustainable future.

The net income tax benefit recorded in 2013 pertains to state income tax refunds, offset partially by estimated federal alternative minimum tax.

A meaningful comparison is the effective tax rate, a measurement of income tax expense as a percent of pretax income, which is less than the 35% federal statutory rate, primarily due to tax-exempt loan and security income, life insurance earnings and tax credits associated with low-income housing and historic projects, offset by certain non-deductible expenses and state income taxes. See Note 8 Income Taxes in the Notes to the Consolidated Financial Statements for a reconciliation of the federal statutory rate of 35% to the effective tax rate for each of the years ended December 31, 2013, 2012 and 2011.

Financial Condition

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

Securities Available for Sale

The Company utilizes securities available for sale as a tool for managing interest rate risk, enhancing income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings. As of December 31, 2013, securities available for sale were $406,943,000, a $104,973,000 increase from the December 31, 2012 balance of $301,970,000.

The Company has established investment policies and an asset management policy to assist in administering its investment portfolio. Decisions to purchase or sell these securities are based on economic conditions and management s strategy to respond to changes in interest rates, liquidity, securitization of deposits and Repurchase Agreements and other factors while trying to maximize return on the investments. Under GAAP, the Company may segregate its investment portfolio into three categories: securities held to maturity , trading securities and securities available for sale. Management has classified the full securities portfolio as available for sale. Securities available for sale are to be accounted for at their current market value with unrealized gains and losses on such securities to be excluded from earnings and reported as a net amount in other comprehensive income.

The Company s securities available for sale include debt and equity instruments that are subject to varying degrees of credit and market risk. This risk arises from general market conditions, factors impacting specific industries, as well as corporate news that may impact specific issues. Management continuously monitors its debt securities, including updates of credit ratings, monitoring market, industry and segment news, as well as volatility in market prices. The Company uses various indicators in determining whether a debt security is other-than- temporarily-impaired, including the extent of time the security has been in an unrealized loss position, and the extent of the unrealized loss. In addition, management assesses whether it is likely the Company will have to sell the security prior to recovery, or if it is able to hold the security until the price recovers. For those debt securities in which management concludes the security is other than temporarily impaired, it will recognize the credit component of an other-than-temporary impairment in earnings and the remaining portion in other comprehensive income. Given the strong asset quality of the debt security portfolio, management has not had to take an other-than-temporary impairment charge in 2013, 2012 or 2011.

For equity securities, when the Company has decided to sell an impaired available-for-sale security and does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an

impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made. The Company recorded no other than temporary impairment expense on equity securities for the years ended December 31, 2013, 2012 and 2011.

Table of Contents

The following table shows the fair value of securities available for sale at December 31:

(Dollars in thousands)	**2013**	2012	2011
U.S. Treasury	**$ 0**	$ 26,010	$ 0
U.S. Government Agencies	**25,451**	0	0
U.S. Government Sponsored Enterprises (GSE)	**13,714**	44,762	43,622
States and political subdivisions	**71,544**	38,909	78,051
GSE residential mortgage-backed securities	**198,619**	116,854	118,646
GSE commercial mortgage-backed securities	**0**	24	34
GSE residential collateralized mortgage obligations (CMOs)	**40,532**	43,945	68,904
GSE commercial CMOs	**57,014**	31,397	0
Total debt securities	**406,874**	301,901	309,257
Equity securities	**69**	69	1,108
Totals	**$ 406,943**	$ 301,970	$ 310,365

The securities available for sale portfolio increased $104,973,000, or 34.8% from $301,970,000 at December 31, 2012 to $406,943,000 at December 31, 2013. During 2013, the Company s access to off-balance sheet liquidity improved as substantial progress was made in addressing loan quality issues experienced in 2011 and 2012. As the Company s access to off-balance sheet liquidity improved, it allowed for the investment of funds previously held at the Federal Reserve Bank and included in interest bearing deposits with banks, into higher yielding, longer duration, securities available for sale. As it is anticipated the loan portfolio will grow in 2014, purchases that took place in 2013 were primarily in mortgage backed securities or collateralized mortgage-backed obligations, as these instruments provide monthly cash flows that will allow the Company to meet loan demand. An additional consideration that factored into our investment strategy was to acquire securities that would allow for strengthening of capital ratios, and typically represented 0% or 20% risk weighted assets. State and political subdivisions, including those deemed to be taxable to the Company, provided an attractive yield to the Company, and were purchased during 2013.

Table of Contents

The following table shows the maturities of investment securities at book value as of December 31, 2013, and weighted average yields of such securities. Yields are shown on a tax equivalent basis, assuming a 34% federal income tax rate.

(Dollars in thousands)	**Within 1 year**	**After 1 year but within 5 years**	**After 5 years but within 10 years**	**After 10 years**	**Total**
U. S. Government Agencies					
Book value	**$ 0**	**$ 0**	**$ 1,693**	**$ 23,917**	**$ 25,610**
Yield	**0.00%**	**0.00%**	**0.77%**	**1.08%**	**1.06%**
Average maturity (years)	**0.0**	**0.0**	**9.7**	**23.9**	**23.0**
U.S. Government Sponsored Enterprises (GSE)					
Book value	**1,661**	**0**	**12,770**	**0**	**14,431**
Yield	**1.06%**	**0.00%**	**2.07%**	**0.00%**	**1.95%**
Average maturity (years)	**0.6**	**0.0**	**7.6**	**0.0**	**6.8**
States and political subdivisions					
Book value	**580**	**380**	**16,346**	**58,188**	**75,494**
Yield	**4.30%**	**3.32%**	**3.07%**	**3.48%**	**3.40%**
Average maturity (years)	**0.5**	**2.5**	**8.6**	**13.3**	**12.1**
GSE Residential mortgage-backed securities					
Book value	**0**	**1,065**	**9,511**	**187,873**	**198,449**
Yield	**0.00%**	**2.68%**	**2.12%**	**1.53%**	**1.56%**
Average maturity (years)	**0.0**	**4.8**	**8.0**	**21.7**	**21.0**
GSE residential collateralized mortgage obligations(CMO)					
Book value	**0**	**992**	**0**	**39,510**	**40,502**
Yield	**0.00%**	**3.10%**	**0.00%**	**2.44%**	**2.46%**
Average maturity (years)	**0.0**	**4.2**	**0.0**	**22.1**	**21.7**
GSE commercial CMOs					
Book value	**0**	**0**	**49,131**	**10,681**	**59,812**
Yield	**0.00%**	**0.00%**	**2.63%**	**1.14%**	**2.36%**
Average maturity (years)	**0.0**	**0.0**	**8.8**	**31.6**	**12.9**
Total					
Book value	**$ 2,241**	**$ 2,437**	**$ 89,451**	**$ 320,169**	**$ 414,298**
Yield	**1.90%**	**2.95%**	**2.54%**	**1.95%**	**2.08%**
Average maturity (years)	**0.6**	**4.2**	**8.5**	**20.7**	**17.9**

The average maturity is based on contractual terms of the debt or mortgage backed securities, and does not factor into required repayments or anticipated prepayments that may exist. As of December 31, 2013, the weighted average estimated life of the mortgage-backed and collateralized mortgage obligation securities is less than 5.3 years based on current interest rates and anticipated prepayment speeds.

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.

With certain exceptions, we are permitted under applicable law to make loans to single borrowers (including certain related persons and entities) in aggregate amounts of up to 15% of the sum of total capital and the allowance for loan losses. The Company s legal lending limit to one borrower was approximately $17,300,000 at December 31, 2013.

Table of Contents

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. For a further discussion on the types of loans the Company makes and related risks, please see Note 4 Loans Receivable and Allowance for Loan Losses in the Notes to the Consolidated Financial Statements, which is incorporated herein by reference.

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

(Dollars in thousands)	**December 31, 2013**	December 31, 2012	December 31, 2011	December 31, 2010	December 31, 2009
Commercial real estate:					
Owner-occupied	**$ 111,290**	$ 144,290	$ 199,646	$ 172,000	$ 149,149
Non-owner occupied	**135,953**	120,930	141,037	143,372	122,287
Multi-family	**22,882**	21,745	27,327	24,649	24,898
Non-owner occupied residential	**55,272**	66,381	147,027	153,467	151,014
Acquisition and development:					
1-4 family residential construction	**3,338**	2,850	7,098	29,297	21,977
Commercial and land development	**19,440**	30,375	77,564	88,105	88,902
Commercial and industrial	**33,446**	39,340	71,084	72,334	66,106
Municipal	**60,996**	68,018	59,789	38,142	29,215
Residential mortgage:					
First lien	**124,728**	108,601	104,327	119,450	100,413
Home equity term	**20,131**	14,747	37,513	40,818	55,993
Home equity Lines of credit	**77,377**	79,448	80,951	71,547	58,146
Installment and other loans	**6,184**	7,014	12,077	11,112	12,380
	$ 671,037	$ 703,739	$ 965,440	$ 964,293	$ 880,480

In addition to the Company monitoring its loan portfolio as segregated by loan class noted above, it also monitors concentrations by industry. The Bank s lending policy defines an industry concentration as one that exceeds 25% of the Bank s total risk-based capital. The following industry meets the concentration criteria defined by the Bank s Lending Policy at December 31, 2013:

(Dollars in thousands)	**Balance**	**% of Total Loans**	**% of Bank s Equity**
Hotels (except casinos)	$ 36,014	5.4%	39.4%

The loan portfolio at December 31, 2013 of $671,037,000 decreased $32,702,000 from $703,739,000 at December 31, 2012, which was below the $965,440,000 at December 31, 2011 that represents the Company s highest balance for the years presented. The Company s desire to improve its asset quality resulted in its disposal of a portion of its distressed asset portfolio during 2012, with an aggregate carrying balance of $73,820,000 during 2012. In addition, elevated charge-off levels were experienced in the commercial loan portfolio during 2012, primarily in the non-owner occupied, owner-occupied and commercial and land development portfolios. Given the softness in the economy within the Company s footprint, management feels this was a prudent course of action in order to rehabilitate its loan

portfolio. As a result of improved asset quality in 2013, the Company, in the second half of the year, again solicited current customers for new lending opportunities, as well as broadened its relationships within existing markets, and entered new markets. However, on a year-to-date basis, loan repayments have outpaced loan originations and resulted in the lower total loan balance.

Growth was experienced in the residential mortgage portfolio segment, which totaled $222,236,000 at December 31, 2013, a 9.6% increase over $202,796,000 at December 31, 2012. The Company elected to

Table of Contents

maintain, in its loan portfolio, a small portion of its shorter maturity (10 15 years) mortgage loans to provide a greater yield than what alternate investments could provide. Additionally, active promotion of home equity products led to increased balances during the year.

Commercial real estate, acquisition and development and commercial and industrial loan segments experienced lower balances at December 31, 2013 compared to December 31, 2012. This resulted from continued workout of classified loans in these categories which has resulted in payments outpacing new originations. Competition for these types of loans in our markets has been high, given the lack of activity and development in these markets.

Presented below are the expected maturities of the loans by type, and whether they are fixed-rate or adjustable rate loans as of December 31, 2013.

(Dollars in Thousands)	**One Year or Less**	**Due In One Year Through Five Years**	**After Five Years**	**Total**
Acquisition and development:				
1-4 family residential construction				
Fixed rate	**$ 46**	**$ 1,813**	**$ 28**	**$ 1,887**
Adjustable and floating rate	**346**	**340**	**765**	**1,451**
	392	**2,153**	**793**	**3,338**
Commercial and land development				
Fixed rate	**12**	**1,625**	**1,708**	**3,345**
Adjustable and floating rate	**3,477**	**1,746**	**10,872**	**16,095**
	3,489	**3,371**	**12,580**	**19,440**
Commercial and industrial				
Fixed rate	**399**	**4,852**	**1,723**	**6,974**
Adjustable and floating rate	**9,300**	**2,761**	**14,411**	**26,472**
	9,699	**7,613**	**16,134**	**33,446**
	$ 13,580	**$ 13,137**	**$ 29,507**	**$ 56,224**

The variable rate loans shown above include semi-fixed loans that contractually will adjust with prime after the interest lock period which may be up to 10 years. At December 31, 2013 there were approximately $10,696,000 of such loans.

Asset Quality

Risk Elements

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

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

Nonperforming assets include nonaccrual and restructured loans and foreclosed real estate. In addition, loans past due 90 days or more and still accruing are also deemed to be risk assets. For all loan classes, the

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

Loans, the terms of which are modified, are classified as troubled debt restructurings if a concession was granted, for legal or economic reasons, related to a debtor s financial difficulties. Concessions granted under a troubled debt restructuring 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 troubled debt restructurings 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. Troubled debt restructurings 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 past due 90 days or more, and foreclosed real estate as of December 31. Relevant asset quality ratios are also presented.

(Dollars in Thousands)	**2013**	**2012**	**2011**	**2010**	**2009**
Loans on nonaccrual basis	**$ 19,347**	$ 17,943	$ 83,697	$ 13,896	$ 4,267
Other real estate owned (OREO)	**987**	1,876	2,165	1,112	1,065
Total nonperforming assets	**20,334**	19,819	85,862	15,008	5,332
Restructured loans still accruing	**5,988**	3,092	27,917	1,180	0
Loans past due 90 days or more and still accruing	**0**	0	0	2,248	6,155
Total nonperforming and other risk assets	**$ 26,322**	$ 22,911	$ 113,779	$ 18,436	$ 11,487
Loans 30-89 days past due	**$ 3,963**	$ 3,578	$ 6,723	$ 5,335	$ 19,043
Ratio of:					
Total nonperforming loans to loans	**2.88%**	2.55%	8.67%	1.44%	0.48%
Total nonperforming assets to assets	**1.73%**	1.61%	5.95%	0.99%	0.45%
Total nonperforming assets to total loans and OREO	**3.03%**	2.81%	8.87%	1.55%	0.60%
Total risk assets to total loans and OREO	**3.92%**	3.25%	11.76%	1.91%	1.30%
Total risk assets to total assets	**2.23%**	1.86%	7.88%	1.22%	0.96%
Allowance for loan losses to total loans	**3.12%**	3.29%	4.53%	1.66%	1.26%

Allowance for loan losses to nonperforming loans	**108.36%**	129.11%	52.23%	115.28%	259.36%
Allowance for loan losses to nonperforming loans and restructured loans still accruing	**82.75%**	110.13%	39.17%	106.26%	259.36%

A further breakdown of impaired loans at December 31, 2013 and 2012 is as follows:

	2013			2012		
	Nonaccrual Loans	Restructured Loans Still Accruing	Total	Nonaccrual Loans	Restructured Loans Still Accruing	Total
Commercial real estate:						
Owner occupied	**$ 4,362**	**200**	**$ 4,562**	$ 2,417	$ 0	$ 2,417
Non-owner occupied	**2,849**	**4,268**	**7,117**	1,481	1,981	3,462
Multi-family	**322**	**0**	**322**	19	0	19
Non-owner occupied residential	**4,493**	**0**	**4,493**	5,164	204	5,368
Acquisition and development						
1-4 family residential construction	**0**	**0**	**0**	909	0	909
Commercial and land development	**2,106**	**1,071**	**3,177**	3,809	0	3,809
Commercial and industrial	**2,001**	**0**	**2,001**	1,696	122	1,818
Residential mortgage:						
First lien	**2,926**	**449**	**3,375**	1,833	749	2,582
Home equity term	**107**	**0**	**107**	57	0	57
Home equity lines of credit	**181**	**0**	**181**	556	36	592
Installment and other loans	**0**	**0**	**0**	2	0	2
	$ 19,347	**$ 5,988**	**$ 25,335**	$ 17,943	$ 3,092	$ 21,035

In the second quarter of 2011, the Company began to experience deterioration in asset quality as a result of the continued softness in economic conditions and collateral values. Subsequent to the highs levels of nonperforming assets and restructured loans recorded in 2011, the Company continued to actively identify and monitor nonperforming assets and other risk assets, and has acted aggressively to address the credit quality issues. Risk assets, defined as nonaccrual loans, restructured and loans past due 90 days or more and still accruing, and real estate owned, declined from the high of $113,779,000 at December 31, 2011, to significantly lower levels at December 31, 2012 and 2013. One strategy employed by the Company in 2012 to reduce its level of non-performing loans included two bulk sales of distressed assets. The bulk sales allowed the Company to sell nearly 240 loans with an aggregate carrying balance of $73,820,000 to third parties, which netted the Company $51,753,000 in cash proceeds. The difference between the carrying balance of the loans sold and the cash received, or $22,067,000, was recorded as a charge to the allowance for loan losses.

Risk assets at December 31, 2013 totaled $26,322,000, a 14.9% increase from December 31, 2012 s balance of $22,911,000. The risk element that showed the greatest percentage increase was restructured loans still accruing, which totaled $5,988,000 at December 31, 2013, a $2,896,000, or 93.7% increase from December 31, 2012. The increase was primarily the result of one relationship in which the borrower was experiencing reduced cash flows, and the Company has been working with the borrower during this period.

The allowance for loan losses totaled $20,965,000 at December 31, 2013, a $2,201,000 decrease from $23,166,000 at December 31, 2012, principally due to a negative provision for loan losses of $3,150,000 recorded in 2013, partially offset by net recoveries of $949,000 for the year. Despite the negative provision for loan losses recorded during 2013,

the allowance for loan losses to total loans ratio was 3.12% at December 31, 2013, and the allowance for loan losses coverage ratio of nonaccrual loans and restructured loans remained strong at 82.8%. A priority of the Company is to continue to work through its nonaccrual loans and other risk elements, in an attempt to reduce the levels of these underperforming assets, and to the extent possible, recover amounts previously charged-off. As new information is learned about borrowers or updated appraisals on real estate with lower fair values are obtained, the Company may continue to experience additional impaired loans.

Table of Contents

For the year ended December 31, 2013, recoveries of $6,676,000 have been credited to the allowance for loan losses, with recoveries on two large relationships contributing $5,639,000 of the total. These recoveries on previously charged off relationships are the result of successful loan monitoring and workout solutions. Although recoveries are difficult to predict, additional recoveries that the Company receives will be used to replenish the allowance for loan losses. Future negative provisions could result if it is determined that the reserve is adequate at the time of recovery.

As of December 31, 2013, the Company had 68 lending relationships that had loans that were considered impaired, and were included in the impaired loan balance of $25,335,000. 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 December 31, 2013.

(Dollars in thousands)	**# of Loans**	**Recorded Investment**	**Partial Charge-offs to Date**	**Specific Reserves at December 31, 2013**
Relationships greater than $1,000,000	6	$ 13,014	$ 543	$ 0
Relationships greater than $500,000 but less than $1,000,000	6	3,664	120	0
Relationships greater than $250,000 but less than $500,000	11	4,083	913	455
Relationships less than $250,000	45	4,574	1,050	158
	68	$ 25,335	$ 2,626	$ 613

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.

Of the relationships deemed to be impaired, six have outstanding book balances in excess of $1,000,000, totaling $13,014,000, or 51% of the total impaired loan balance. Forty-five of the relationships, or two-thirds of the total number of impaired relationships, have recorded balances less than $250,000. A summary of the impaired relationships in excess of $1,000,000 are discussed below.

In 2013, the Company classified a relationship with a borrower in the food service and entertainment industry as impaired, based on the restructuring negotiations with the borrower. Management expects the notes to continue to perform under the restructured terms and considers the loan adequately supported by the collateral securing the note, allowing for the note to remain on accrual status. This relationship, with a balance of nearly $3,600,000, represents the Company s largest impaired relationship at December 31, 2013, and is classified as impaired, as by definition, troubled debt restructurings are impaired. After evaluation of the relationship in accordance with impairment guidance, it was determined no reserve was required.

A second relationship with a book balance of approximately $2,600,000 is in nonaccrual status at December 31, 2013. The impaired relationship consists of several notes secured by multi-family rental properties and food services establishments. The borrower began to experience financial difficulties due to increased competition in the market area. After evaluation, the Company charged off loans that it deemed not to be collectible, and as of December 31,

2013, there were no specific reserves or partial charge-offs on the remaining loans. In the first quarter of 2014, approximately $1,900,000 of the relationship was paid off, with no additional charge-offs recorded.

An additional relationship that the Company has determined to be impaired at December 31, 2013 is with a real estate developer who also actively leases residential properties. This relationship consists of separate loans with total outstanding book balances of $2,150,000, secured by different parcels of land or residential structures.

Recent appraisals on the collateral securing the outstanding loans resulted in the relationship being placed in nonaccrual status, as the softening of real estate prices and rental prices, and the lengthening of absorption periods resulted in it being classified and evaluated as a collateral dependent impaired loan. To date, partial charge-offs or specific reserves of approximately 24.0% of the outstanding loan balances have been taken. The Company is actively working with the borrower to reduce its outstanding loan balances, which has resulted in a reduction of the loan balances of over $940,000 during 2013.

Another relationship that includes impaired loans and had a balance of approximately $1,941,000 is with a borrower that purchased a large parcel of land in the Company s market area. The loan is current with respect to the interest only payment requirements. Because there have been no sales to date, and several extension requests, the loan was placed in nonaccrual status. Due to the guarantee of this debt by several development authorities, combined with a strong loan to value ratio, no partial charge-offs or specific reserves have been established on this loan as of December 31, 2013. This loan was paid off in the first quarter of 2014, and all amounts contractually due were received by the Company.

In the fourth quarter of 2013, the Company moved a note to a commercial lessor with an outstanding balance of approximately $1,450,000 to nonaccrual status. This decision was made, despite the loan being current as to both principal and interest, as a result of declining cash flows of the Company, and the potential for further reduction in cash available to service debt in the near future. The Company believes it is well secured on this loan, and does not feel a loss will be incurred on it.

The last impaired relationship with a balance in excess of $1,000,000 at December 31, 2013, which is with a wholesaler that supplied inventory to the commercial construction industry, has a remaining balance of nearly $1,350,000 at December 31, 2013, and consists of one remaining loan and piece of collateral on a residence. This balance represents a substantial reduction from December 31, 2012, when the total exposure was $3,150,000. During 2013, the Company received payments of nearly $1,340,000, and charged-off an additional $450,000 of the aggregate loan balance. After liquidation of collateral in accordance with bankruptcy proceedings, the remaining balance at December 31, 2013 is adequately secured by the real estate, and it was determined no reserves were required on the balance. In the first quarter of 2014, the Company foreclosed on the property securing the loan and took title to the property.

The Company has approximately 62 additional relationships with borrowers that include loans that are individually evaluated for impairment, and has taken a similar approach to those mentioned above in determining the extent of full or partial charge-offs that were required, or ASC 310 reserves that may be needed. The determination of the Company s charge-offs or impairment reserve determination properly 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 December 31, 2013. 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 $987,000 consists of six properties owned by the Company, five of which were commercial properties and totaled $904,000, and one residential property that totaled $83,000. The largest commercial property is a commercial land parcel with a carrying value of $276,000. A second commercial property with a carrying value of $262,000 was land originally purchased by the Company for future expansion purposes. During 2011, it was determined that this property was no longer in the Company s strategic plans, and as such, the Company re-designated the property as held for sale. The remaining properties have carrying values less than $210,000 and are also carried at the lower of cost or fair value, less costs to dispose.

As of December 31, 2013, 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.

Table of Contents

Credit Risk Management

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level believed adequate by management to absorb losses inherent in the portfolio. The allowance is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the allowance for loan losses utilizing a defined methodology, which 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 4, 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.

In order to monitor ongoing risk associated with its loan portfolio and specific credits 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 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 mitigate risk in the lending function. The ERM Committee, comprised of executive officers and loan department personnel, is charged with oversight of the 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.

Loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $1,000,000. Loan review documentation is submitted to the ERM Committee no less than quarterly with a formal review and rating as presented by independent loan review personnel. In addition, all relationships greater than

$250,000 rated Substandard, Doubtful or Loss are reviewed by the ERM Committee on a quarterly basis, with reaffirmation of the rating as approved by the Bank s Loan Work Out Committee or loan review staff.

The following summarizes the Bank s ratings based on its internal risk rating system as of December 31:

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
December 31, 2013						
Commercial real estate:						
Owner-occupied	**$ 92,063**	**$ 3,305**	**$ 11,360**	**$ 4,107**	**$ 455**	**$ 111,290**
Non-owner occupied	**107,113**	**6,904**	**14,819**	**7,117**	**0**	**135,953**
Multi-family	**20,091**	**2,132**	**337**	**322**	**0**	**22,882**
Non-owner occupied residential	**42,007**	**4,982**	**3,790**	**4,493**	**0**	**55,272**
Acquisition and development:						
1-4 family residential construction	**3,292**	**0**	**46**	**0**	**0**	**3,338**
Commercial and land development	**14,118**	**1,433**	**712**	**3,177**	**0**	**19,440**
Commercial and industrial	**28,933**	**2,129**	**383**	**1,878**	**123**	**33,446**
Municipal	**60,996**	**0**	**0**	**0**	**0**	**60,996**
Residential mortgage:						
First lien	**121,353**	**0**	**0**	**3,327**	**48**	**124,728**
Home equity term	**20,024**	**0**	**0**	**94**	**13**	**20,131**
Home equity Lines of credit	**77,187**	**0**	**9**	**181**	**0**	**77,377**
Installment and other loans	**6,184**	**0**	**0**	**0**	**0**	**6,184**
	$ 593,361	**$ 20,885**	**$ 31,456**	**$ 24,696**	**$ 639**	**$ 671,037**
December 31, 2012						
Commercial real estate:						
Owner-occupied	$ 121,333	$ 11,917	$ 8,623	$ 2,229	$ 188	$ 144,290
Non-owner occupied	95,876	7,351	14,241	3,462	0	120,930
Multi-family	17,205	3,936	585	19	0	21,745
Non-owner occupied residential	45,468	12,199	3,346	5,368	0	66,381
Acquisition and development:						
1-4 family residential construction	1,608	333	0	198	711	2,850
Commercial and land development	14,793	8,937	2,836	3,208	601	30,375
Commercial and industrial	33,380	3,713	429	566	1,252	39,340
Municipal	68,018	0	0	0	0	68,018
Residential mortgage:						
First lien	101,390	3,026	1,604	2,581	0	108,601
Home equity term	14,403	52	235	57	0	14,747
Home equity Lines of credit	76,418	1,073	1,365	592	0	79,448
Installment and other loans	6,998	11	3	2	0	7,014
	$ 596,890	$ 52,548	$ 33,267	$ 18,282	$ 2,752	$ 703,739

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 information that may cause the potential weakness, and once resolved, the loan classification may be downgraded to Substandard, or alternatively, could be upgraded to Pass.

Table of Contents

The following summarizes the average recorded investment in impaired loans and related interest income recognized, on loans deemed impaired on a cash basis, and interest income earned but not recognized for the years ended December 31, 2013, 2012, and 2011:

(Dollars in thousands)	Average Impaired Balance	Interest Income Recognized	Interest Earned But Not Recognized
December 31, 2013			
Commercial real estate:			
Owner-occupied	**$ 3,528**	**$ 147**	**$ 192**
Non-owner occupied	**4,307**	**145**	**44**
Multi-family	**135**	**16**	**6**
Non-owner occupied residential	**4,799**	**77**	**180**
Acquisition and development:			
1-4 family residential construction	**481**	**0**	**0**
Commercial and land development	**3,009**	**49**	**127**
Commercial and industrial	**1,780**	**45**	**46**
Residential mortgage:			
First lien	**2,697**	**140**	**103**
Home equity term	**59**	**8**	**2**
Home equity lines of credit	**305**	**6**	**2**
Installment and other loans	**1**	**0**	**0**
	$ 21,101	**$ 633**	**$ 702**
December 31, 2012			
Commercial real estate:			
Owner-occupied	$ 8,374	$ 20	$ 131
Non-owner occupied	14,372	69	260
Multi-family	3,940	0	10
Non-owner occupied residential	20,284	61	288
Acquisition and development:			
1-4 family residential construction	1,542	26	16
Commercial and land development	12,652	252	168
Commercial and industrial	2,691	43	55
Residential mortgage:			
First lien	2,700	61	73
Home equity term	156	2	4
Home equity lines of credit	467	15	5
Installment and other loans	8	0	0
	$ 67,186	$ 549	$ 1,010
December 31, 2011			
Commercial real estate:			

Owner-occupied	$ 4,530	$ 369	$ 187
Non-owner occupied	6,820	702	297
Multi-family	2,080	125	103
Non-owner occupied residential	22,820	1,559	267
Acquisition and development:			
1-4 family residential construction	489	102	1
Commercial and land development	7,456	617	375
Commercial and industrial	5,355	75	82
Residential mortgage:			
First lien	639	19	15
Home equity term	685	69	1
	$ 50,874	$ 3,637	$ 1,328

Table of Contents

The following summarizes the average recorded investment in impaired loans and related interest income recognized for the periods indicated for the years ending December 31:

(Dollars in thousands)	**2010**	**2009**
Average investment in impaired loans	$ 26,066	$ 10,748
Interest income recognized on a cash basis on impaired loans	82	188
Interest income earned but not recognized on impaired loans	458	239

Activity in the allowance for loan losses for the years ended December 31, 2013, 2012, 2011 and 2010 is as follows:

(Dollars in thousands)	**Commercial Real Estate**	**Acquisition and Development**	**Commercial Commercial and Industrial**	**Municipal**	**Total**	**Residential Mortgage**	**Consumer Installment and Other**	**Total**	**Unallocated**	**Total**
December 31, 2013										
Balance, beginning of period	**$ 13,719**	**$ 3,502**	**$ 1,635**	**$ 223**	**$ 19,079**	**$ 2,275**	**$ 85**	**$ 2,360**	**$ 1,727**	**$ 23,166**
Provision for loan losses	**4,109**	**(6,087)**	**(3,478)**	**21**	**(5,435)**	**1,845**	**99**	**1,944**	**341**	**(3,150)**
Charge-offs	**(4,767)**	**(193)**	**(132)**	**0**	**(5,092)**	**(491)**	**(144)**	**(635)**	**0**	**(5,727)**
Recoveries	**154**	**3,448**	**2,839**	**0**	**6,441**	**151**	**84**	**235**	**0**	**6,676**
Balance, end of period	**$ 13,215**	**$ 670**	**$ 864**	**$ 244**	**$ 14,993**	**$ 3,780**	**$ 124**	**$ 3,904**	**$ 2,068**	**$ 20,965**
December 31, 2012										
Balance, beginning of period	$ 29,559	$ 9,708	$ 1,085	$ 789	$ 41,141	$ 933	$ 75	$ 1,008	$ 1,566	$ 43,715
Provision for loan losses	34,681	9,408	1,879	(566)	45,402	2,602	135	2,737	161	48,300
Charge-offs	(53,492)	(17,721)	(1,624)	0	(72,837)	(1,279)	(143)	(1,422)	0	(74,259)
Recoveries	2,971	2,107	295	0	5,373	19	18	37	0	5,410
Balance, end of period	$ 13,719	$ 3,502	$ 1,635	$ 223	$ 19,079	$ 2,275	$ 85	$ 2,360	$ 1,727	$ 23,166
December 31, 2011										
Balance, beginning of period	$ 7,875	$ 1,766	$ 3,870	$ 374	$ 13,885	$ 1,864	$ 106	$ 1,970	$ 165	$ 16,020
Provision for loan losses	31,407	18,557	7,037	415	57,416	(254)	12	(242)	1,401	58,575
Charge-offs	(9,748)	(10,615)	(9,827)	0	(30,190)	(680)	(62)	(742)	0	(30,932)
Recoveries	25	0	5	0	30	3	19	22	0	52
Balance, end of period	$ 29,559	$ 9,708	$ 1,085	$ 789	$ 41,141	$ 933	$ 75	$ 1,008	$ 1,566	$ 43,715

December 31, 2010										
Balance, beginning of period	$ 4,328	$ 2,703	$ 507	$ 749	$ 8,287	$ 1,422	$ 96	$ 1,518	$ 1,262	$ 11,067
Provision for loan losses	5,857	281	3,332	(207)	9,263	718	41	759	(1,097)	8,925
Charge-offs	(2,312)	(1,218)	(32)	(168)	(3,730)	(283)	(54)	(337)	0	(4,067)
Recoveries	2	0	63	0	65	7	23	30	0	95
Balance, end of period	$ 7,875	$ 1,766	$ 3,870	$ 374	$ 13,885	$ 1,864	$ 106	$ 1,970	$ 165	$ 16,020

Table of Contents

A summary of the activity in the allowance for loan losses, for the years ended before December 31, 2010 based on prior presentation, is as follows:

(Dollars in thousands)	**2009**
Balance, beginning of year	$ 7,140
Loans charged off:	
Commercial, financial and agricultural	470
Real estate Commercial	0
Real estate Mortgage	416
Consumer	72
Total loans charged off	958
Recoveries of loans previously charged off:	
Commercial, financial and agricultural	2
Real estate Commercial	1
Real estate Mortgage	6
Consumer	11
Total recoveries	20
Provision for loan losses	4,865
Balance, end of year	$ 11,067

A summary of relevant asset quality ratios for the five years ended December 31, 2013 is as follows:

	2013	**2012**	**2011**	**2010**	**2009**
Ratio of net charge-offs to average loans outstanding	**(0.14)%**	8.01%	3.11%	0.44%	0.11%
Provision for loan losses to net charge-offs (recoveries)	**331.93%**	70.15%	189.69%	224.70%	518.66%
Ratio of reserve to gross loans outstanding at December 31	**3.12%**	3.29%	4.53%	1.66%	1.26%

Due to the trends in the national and local economies, as well as declines in real estate values in the Company s market area, the allowance for loan losses continued to grow for the period from 2009 through 2011, consistent with the increase in the ratio of net charge-offs to average loans outstanding. As the Company worked through its risk assets, including the two loan sales in 2012, the allowance for loan losses decreased from $43,715,000 at December 31, 2011 to $23,166,000 at December 31, 2012. During 2013, the Company continued to focus on working through its risk assets, and based on favorable trends in charge-offs, it was able to further reduce the allowance for loan losses to $20,965,000 at December 31, 2013. During 2013, the Company experienced net recoveries of $949,000 compared to net charge-offs of $68,849,000 for the year ended December 31, 2012, with the majority of the 2012 charge-offs occurring in the commercial real estate and commercial and land development loan portfolios. The significantly different net-charge off (recoveries) between periods results in similar variances in the ratios presented.

The Company recorded a negative provision for loan losses, or a reversal of amounts previously provided, of $3,150,000 for the year ended December 31, 2013, compared to expense of $48,300,000 for the year ended December 31, 2012. During 2013, the Company received payments on classified loans with partial charge-offs previously recorded. As payments received during the periods exceeded the carrying value of these loans, the excess was included in recoveries of amounts previously charged-off. In connection with the quarterly evaluation of the adequacy of the allowance for loan losses, it was determined that large recoveries specific to loans in one customer relationship were not needed to replenish the reserve, and were taken into income during 2013 through a negative provision for loan losses. The provision for loan losses for the years ended December 31, 2012 and 2011 of $48,300,000 and $58,575,000 reflect the levels needed to address the credit deterioration that took place in the loan portfolio during these periods.

Table of Contents

See further discussion in the Provision for Loan Losses section of this Management s Discussion and Analysis of Financial Condition and Results of Operations.

The allocation of the allowance for loan losses, as well as the percent of each loan type in relation to the total loan balance, is as follows:

	2013		2012		2011		2010		2009	
	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans
Commercial real estate:										
Owner-occupied	**$ 3,583**	**17%**	$ 2,504	21%	$ 3,063	21%	$ 1,852	18%	$ 1,660	18%
Non-owner occupied	**6,024**	**20%**	5,022	17%	8,579	14%	3,034	15%	932	14%
Multi-family	**1,699**	**3%**	2,944	3%	2,222	3%	438	3%	15	3%
Non-owner occupied residential	**1,909**	**8%**	3,249	9%	15,695	15%	2,551	16%	1,721	17%
Acquisition and development:										
1-4 family residential construction	**196**	**0%**	198	0%	1,404	1%	314	3%	364	2%
Commercial and land development	**474**	**3%**	3,304	4%	8,304	8%	1,453	9%	2,339	10%
Commercial and industrial	**864**	**5%**	1,635	6%	1,085	8%	3,870	8%	507	8%
Municipal	**244**	**9%**	223	10%	789	6%	374	4%	749	3%
Residential mortgage:										
First lien	**1,682**	**19%**	957	16%	317	11%	1,033	12%	825	11%
Home equity - term	**465**	**3%**	252	2%	335	4%	345	4%	146	6%
Home equity - Lines of credit	**1,633**	**12%**	1,066	11%	281	8%	485	7%	451	7%
Installment and other loans	**124**	**1%**	85	1%	75	1%	106	1%	96	1%
Unallocated	**2,068**		1,727		1,566		165		1,262	
	$ 20,965	**100%**	$ 23,166	100%	$ 43,715	100%	$ 16,020	100%	$ 11,067	100%

Table of Contents

The following table summarizes the ending loan balance individually or collectively evaluated for impairment based upon loan type, as well as the allowance for loan loss allocation for each at December 31.

(Dollars in thousands)	**Commercial Real Estate**	**Acquisition and Development**	**Commercial Commercial and Industrial**	**Municipal**	**Total**	**Residential Mortgage**	**Consumer Installment and Other**	**Total**	**Unallocated**	**Total**
December 31, 2013										
Loans allocated by:										
Individually evaluated for impairment	**$ 16,494**	**$ 3,177**	**$ 2,001**	**$ 0**	**$ 21,672**	**$ 3,663**	**$ 0**	**$ 3,663**	**$ 0**	**$ 25,335**
Collectively evaluated for impairment	**308,903**	**19,601**	**31,445**	**60,996**	**420,945**	**218,573**	**6,184**	**224,757**	**0**	**645,702**
	$ 325,397	**$ 22,778**	**$ 33,446**	**$ 60,996**	**$ 442,617**	**$ 222,236**	**$ 6,184**	**$ 228,420**	**$ 0**	**$ 671,037**
Allowance for loan losses allocated by:										
Individually evaluated for impairment	**$ 552**	**$ 0**	**$ 0**	**$ 0**	**$ 552**	**$ 61**	**$ 0**	**$ 61**	**$ 0**	**$ 613**
Collectively evaluated for impairment	**12,663**	**670**	**864**	**244**	**14,441**	**3,719**	**124**	**3,843**	**2,068**	**20,352**
	$ 13,215	**$ 670**	**$ 864**	**$ 244**	**$ 14,993**	**$ 3,780**	**$ 124**	**$ 3,904**	**$ 2,068**	**$ 20,965**
December 31, 2012										
Loans allocated by:										
Individually evaluated for impairment	$ 11,266	$ 4,718	$ 1,818	$ 0	$ 17,802	$ 3,230	$ 2	$ 3,232	$ 0	$ 21,034
Collectively evaluated for impairment	342,080	28,507	37,522	68,018	476,127	199,566	7,012	206,578	0	682,705
	$ 353,346	$ 33,225	$ 39,340	$ 68,018	$ 493,929	$ 202,796	$ 7,014	$ 209,810	$ 0	$ 703,739
Allowance for loan losses allocated by:										
Individually evaluated for impairment	$ 375	$ 9	$ 928	$ 0	$ 1,312	$ 0	$ 0	$ 0	$ 0	$ 1,312
Collectively evaluated for impairment	13,344	3,493	707	223	17,767	2,275	85	2,360	1,727	21,854
	$ 13,719	$ 3,502	$ 1,635	$ 223	$ 19,079	$ 2,275	$ 85	$ 2,360	$ 1,727	$ 23,166

The allowance for loan losses allocations presented above represent the reserve allocations on loan balances outstanding at December 31 in the respective years. In addition to the reserve allocations on impaired loans noted above, approximately 19 loans, with outstanding general ledger principal balances of $5,342,000, have had cumulative

partial charge-offs to the allowance for loan losses recorded totaling $2,626,000. 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 inherent risk in each portfolio, and is based on the methodology outlined in Note 4 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 increased charge-offs, with noticeable differences between the different loan segments. Management believes these enhancements to the allowance for loan losses methodology improve the accuracy of quantifying losses presently inherent in the portfolio. Management charges actual loan losses to the reserve and bases the provision for loan losses on the overall analysis taking the methodology into account.

The largest component of the reserve for the years presented has been allocated to the commercial real estate segment, and in particular the non-owner occupied loan classes. The higher allocations in these loans

classes as compared to the other loan classes is consistent with the inherent risk associated with the loans, as well as generally higher levels of impaired and criticized loans for the periods presented.

The acquisition and development loan segment s allowance for loan losses has decreased from $3,502,000 at December 31, 2012 to $670,000 at December 31, 2013. The factors contributing to this decline are a 39% reduction in criticized assets, a 31% reduction in loan balances, as well as net recoveries during the year of $3,255,000 which positively impacted quantitative and qualitative loss factors.

The reserve allocation on the residential mortgage portfolio segment, in total, has increased from $2,275,000 at December 31, 2012 to $3,780,000 at December 31, 2013. This increase is consistent with generally higher outstanding loan balances of impaired loans in the first lien and home equity categories. In addition, some softening in the residential real estate market has led to increased qualitative reserves established on this portfolio.

The unallocated portion of the allowance for loan losses reflects estimated inherent losses within the portfolio that have not been detected. This reserve results due to risk of error in the specific and general reserve allocation, other potential exposure in the loan portfolio, variances in management s assessment of national and local economic conditions and other factors management believes appropriate at the time. The unallocated portion of the allowance has increased in 2013 from $1,727,000 at December 31, 2012 to $2,068,000 at December 31, 2013 and represents 9.9% of the entire allowance for loan losses balance at December 31, 2013, compared to 7.5% at December 31, 2012.

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.

Deposit Products

On an average daily basis, total deposits were $1,034,879,000 in 2013, a decrease of 10.7%, or $123,538,000, from 2012. In 2012, the average daily balance decreased 7.0% compared to 2011. Despite a decline in total deposits, the Company experienced growth in its non-interest bearing demand and savings deposit core funding sources. Interest bearing demand deposit account balances, which averaged $484,114,000 for the year ended December 31, 2013, represents a 5.4% decline from the average balance of $511,800,000 in 2012. Declines were noted in certain legacy account product offerings, which the Company has begun to migrate to other offerings, and we have lost some rate and fee sensitive customers. As the Company s liquidity is relatively strong, we have not matched competitor rates in certain product offerings, which has led to some lost customers.

Average time deposits were $352,905,000 in 2013, a decrease of 22.5%, or $102,602,000, compared to the average balance of $455,507,000 in 2012. This follows a 20.7% reduction in average time deposits that took place in 2012, from the $574,079,000 average balance in 2011. The steady decline in average time deposit balances reflects different growth strategies in each of the years presented. In the first half of 2011, the Company was growing its loan and asset balances, and was able to grow its time deposits, which funded asset growth. In the latter half of 2011 and in 2012, the Company s growth strategy changed as it experienced significant credit losses. As the Company began to re-engineer its loan origination and credit administration processes and procedures to better manage credit risk, loan growth slowed significantly which allowed the Company to enhance its procedures and maintain its capital ratios. This change in strategy in the latter half of 2011 that continued throughout 2012 reduced the need for time deposits. In addition, the Company has slowed its brokered deposit offerings as well. The average balance of brokered time deposits decreased from $88,317,000 for the year ended 2012 to $62,713,000 in 2013, which is included in time deposits above.

Management continually evaluates its utilization of brokered deposits, and considers the interest rate curve and regulatory views on non-core funding sources, and balances this funding source with its funding needs based

Table of Contents

on growth initiatives. The Company anticipates that as loan growth increases, it will be able to obtain deposit funding through offering competitive rates.

The average amounts of deposits are summarized below for the years ended December 31:

(Dollars in thousands)	**2013**	**2012**	**2011**
Demand deposits	**$ 119,146**	$ 116,930	$ 113,157
Interest bearing demand deposits	**484,114**	511,800	486,793
Savings deposits	**78,714**	74,180	71,059
Time deposits	**352,905**	455,507	574,079