

ORRSTOWN FINANCIAL SERVICES INC

Form 10-Q

May 10, 2011

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended **March 31, 2011**

or

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

For the transition period from _____ to _____.

Commission File Number 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Commonwealth of Pennsylvania
(State or other jurisdiction of incorporation or organization)

23-2530374
(I.R.S. Employer Identification No.)

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

17257
(Zip Code)

(717) 532-6114

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES

NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES

NO

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

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES

NO

As of May 5, 2011, 7,996,493 shares of common stock, no par value, of the registrant were outstanding.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

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

Consolidated Balance Sheets (Unaudited)

| <i>(Dollars in Thousands, Except per Share Data)</i> | March 31, 2011 | December 31, 2010 |
|---|---------------------------|------------------------------|
| Assets | | |
| Cash and due from banks | \$ 14,751 | \$ 10,400 |
| Federal funds sold | 21,500 | 8,800 |
| Cash and cash equivalents | 36,251 | 19,200 |
| Short-term investments | 2,746 | 2,728 |
| Interest bearing deposits with banks | 557 | 925 |
| Member stock, at cost which approximates market value | 8,515 | 8,798 |
| Securities available for sale | 395,792 | 431,772 |
| Loans held for sale | 3,807 | 2,693 |
| Loans | 984,967 | 964,293 |
| Allowance for loan losses | (18,398) | (16,020) |
| Net loans | 970,376 | 950,966 |
| Premises and equipment, net | 27,557 | 27,774 |
| Cash surrender value of life insurance | 22,946 | 22,649 |
| Goodwill and intangible assets | 20,646 | 20,698 |
| Accrued interest receivable | 5,849 | 5,715 |
| Other assets | 21,158 | 20,497 |
| Total assets | \$ 1,512,393 | \$ 1,511,722 |
| Liabilities | | |
| Deposits: | | |
| Non-interest bearing | \$ 116,418 | \$ 104,646 |
| Interest bearing | 1,090,955 | 1,083,731 |
| Total deposits | 1,207,373 | 1,188,377 |
| Short-term borrowings | 86,750 | 87,850 |
| Long-term debt | 45,068 | 65,178 |
| Accrued interest and other liabilities | 10,529 | 9,833 |
| Total liabilities | 1,349,720 | 1,351,238 |

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Shareholder s Equity

| | | |
|--|---------------------|---------------------|
| Preferred stock \$1.25 par value per share; 500,000 shares authorized; no shares issued or outstanding | 0 | 0 |
| Common stock, no par value - \$0.05205 stated value per share; 50,000,000 shares authorized; 7,991,791 and 7,986,966 shares issued; 7,991,512 and 7,985,667 shares outstanding | 416 | 416 |
| Additional paid-in capital | 121,579 | 121,508 |
| Retained earnings | 40,670 | 38,680 |
| Accumulated other comprehensive income (loss) | 15 | (88) |
| Treasury stock - common, 279 and 1,299, at cost | (7) | (32) |
| Total shareholders equity | 162,673 | 160,484 |
| Total liabilities and shareholders equity | \$ 1,512,393 | \$ 1,511,722 |

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

Table of Contents**ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY**

Consolidated Statements of Income (Unaudited)

| | Three Months Ended | |
|--|--------------------|-------------------|
| | March 31, 2011 | March 31, 2010 |
| <i>(Dollars in Thousands, Except per Share Data)</i> | | |
| Interest and dividend income | | |
| Interest and fees on loans | \$ 12,435 | \$ 11,839 |
| Interest and dividends on investment securities | | |
| Taxable | 2,095 | 1,546 |
| Tax-exempt | 771 | 368 |
| Short term investments | 24 | 30 |
| Total interest and dividend income | 15,325 | 13,783 |
| Interest expense | | |
| Interest on deposits | 2,525 | 2,680 |
| Interest on short-term borrowings | 123 | 164 |
| Interest on long-term debt | 289 | 442 |
| Total interest expense | 2,937 | 3,286 |
| Net interest income | 12,388 | 10,497 |
| Provision for loan losses | 3,195 | 1,420 |
| Net interest income after provision for loan losses | 9,193 | 9,077 |
| Other income | | |
| Service charges on deposit accounts | 1,485 | 1,439 |
| Other service charges, commissions and fees | 370 | 396 |
| Trust department income | 1,012 | 760 |
| Brokerage income | 404 | 373 |
| Mortgage banking activities | 696 | 361 |
| Earnings on life insurance | 330 | 162 |
| Merchant processing fees | 255 | 257 |
| Other income | 145 | 201 |
| Investment securities gains | 379 | 398 |
| Total other income | 5,076 | 4,347 |
| Other expenses | | |
| Salaries and employee benefits | 4,832 | 4,598 |
| Occupancy and equipment | 562 | 559 |
| Furniture and equipment | 681 | 601 |
| Data processing | 312 | 294 |
| Telephone | 176 | 172 |
| Advertising and bank promotions | 258 | 180 |
| FDIC insurance | 550 | 544 |

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| | | |
|-------------------------------|-----------------|-----------------|
| Professional services | 322 | 293 |
| Taxes other than income | 205 | 133 |
| Intangible asset amortization | 52 | 65 |
| Other operating expense | 1,489 | 1,221 |
| Total other expense | 9,439 | 8,660 |
| Income before income tax | 4,830 | 4,764 |
| Income tax expense | 1,003 | 1,358 |
| Net income | \$ 3,827 | \$ 3,406 |

Per share information:

| | | |
|----------------------------|---------|---------|
| Basic earnings per share | \$ 0.48 | \$ 0.52 |
| Diluted earnings per share | 0.48 | 0.52 |
| Dividends per share | 0.23 | 0.22 |

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

Table of Contents**ORRSTOWN FINANCIAL SERVICES, INC. AND ITS WHOLLY-OWNED SUBSIDIARY**

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

| <i>(Dollars in thousands)</i> | Three Months Ended March 31, 2011 and 2010 | | | | | Total Shareholders' Equity |
|---|--|----------------------------|-------------------|---|----------------|----------------------------|
| | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | |
| Balance, January 1, 2010 | \$337 | \$82,895 | \$28,857 | (\$501) | (\$702) | \$110,886 |
| Comprehensive income | | | | | | |
| Net income | 0 | 0 | 3,406 | 0 | 0 | 3,406 |
| Net unrealized securities gains | 0 | 0 | 0 | 681 | 0 | 681 |
| Net unrealized gains on derivatives | 0 | 0 | 0 | 404 | 0 | 404 |
| Comprehensive income | | | | | | 4,491 |
| Cash dividends (\$0.22 per share) | 0 | 0 | (1,417) | 0 | 0 | (1,417) |
| Issuance of treasury stock (18,324 shares) | 0 | 11 | 0 | 0 | 461 | 472 |
| Proceeds from issuance of common stock (1,481,481 shares) | 77 | 37,473 | 0 | 0 | 0 | 37,550 |
| Balance, March 31, 2010 | \$414 | \$120,379 | \$30,846 | \$584 | (\$241) | \$151,982 |
| Balance, January 1, 2011 | \$416 | \$121,508 | \$38,680 | (\$88) | (\$32) | \$160,484 |
| Comprehensive income | | | | | | |
| Net income | 0 | 0 | 3,827 | 0 | 0 | 3,827 |
| Net unrealized securities gains | 0 | 0 | 0 | 355 | 0 | 355 |
| Net unrealized losses on derivatives | 0 | 0 | 0 | (252) | 0 | (252) |
| Comprehensive income | | | | | | 3,930 |
| Cash dividends (\$0.23 per share) | 0 | 0 | (1,837) | 0 | 0 | (1,837) |
| Issuance of stock: | | | | | | |
| Stock-based compensation plans (4,825 shares) | 0 | 79 | 0 | 0 | 0 | 79 |
| Issuance of treasury stock (1,020 shares) | 0 | (8) | 0 | 0 | 25 | 17 |
| Balance, March 31, 2011 | \$416 | \$121,579 | \$40,670 | \$15 | (\$7) | \$162,673 |

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

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Consolidated Statements of Cash Flows (Unaudited)

| <i>(Dollars in Thousands, Except per Share Data)</i> | Three Months Ended | |
|--|--------------------|-------------------|
| | March 31, 2011 | March 31, 2010 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | \$ 3,827 | \$ 3,406 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization (accretion) of premiums (discounts) on securities available for sale | 1,633 | 432 |
| Depreciation and amortization | 775 | 666 |
| Provision for loan losses | 3,195 | 1,420 |
| Net change in loans held for sale | (1,114) | (38) |
| Net (gain) loss on disposal of other real estate owned | 18 | (8) |
| Net (gain) on disposal of bank premises and equipment | 0 | (119) |
| Investment securities (gains) losses | (379) | (398) |
| Earnings on cash surrender value of life insurance | (297) | (150) |
| Increase in accrued interest receivable | (134) | (109) |
| Increase in accrued interest payable | 63 | 41 |
| Other, net | (906) | (209) |
| Net cash provided by operating activities | 6,681 | 4,934 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Net (increase) decrease in interest bearing deposits with banks and short term investments | 350 | (55) |
| Sales of available for sale securities | 27,658 | 51,968 |
| Maturities, repayments and calls of available for sale securities | 14,879 | 7,738 |
| Purchases of available for sale securities | (7,335) | (115,566) |
| Net redemption of FHLB & FRB Stock | 283 | - |
| Net (increase) in loans | (21,441) | (17,631) |
| Investment in limited partnerships | (55) | (823) |
| Purchases of bank premises and equipment | (302) | (143) |
| Proceeds from disposal of other real estate owned | 180 | 199 |
| Proceeds from disposal of bank premises and equipment | 0 | 373 |
| Proceeds from sale of rate swap | 118 | 0 |
| Net cash provided (used) by investing activities | 14,335 | (73,940) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Net increase in deposits | 18,986 | 82,505 |
| Net increase (decrease) in short term purchased funds | (1,100) | 12,299 |
| Payments on long-term debt | (20,110) | (17,374) |
| Dividends paid | (1,837) | (1,417) |
| Proceeds from issuance of common stock | 79 | 37,550 |
| Net proceeds from issuance of treasury stock | 17 | 472 |
| Net cash provided (used) by financing activities | (3,965) | 114,035 |
| Net increase in cash and cash equivalents | 17,051 | 45,029 |
| Cash and cash equivalents at beginning of period | 19,200 | 21,940 |
| Cash and cash equivalents at end of period | 36,251 | \$ 66,969 |

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Supplemental disclosure of cash flow information:

Cash paid during the period for:

| | | |
|--------------|----------|----------|
| Interest | \$ 2,874 | \$ 3,327 |
| Income taxes | 2,200 | 2,000 |

Supplemental schedule of noncash investing and financing activities

| | | |
|---|----|---|
| Other real estate acquired in settlement of loans | 69 | - |
|---|----|---|

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

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ORRSTOWN FINANCIAL SERVICES, INC.

Notes to Consolidated Financial Statements

March 31, 2011

NOTE 1. SUMMARY OF CONSOLIDATED SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations - Orrstown Financial Services, Inc. (the Company) is a financial holding company whose primary activity consists of supervising its wholly-owned subsidiary, Orrstown Bank (the Bank). The Company operates through its office in Shippensburg, Pennsylvania. Orrstown Bank provides services through its network of offices in Franklin, Cumberland and Perry Counties of Pennsylvania and in Washington County, Maryland. The bank engages in lending services for commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Deposit services include checking, savings, time and money market deposits. Orrstown Bank also provides investment and brokerage services through its Orrstown Financial Advisors division. Orrstown Bank has twenty-one branches located in Shippensburg (2), Carlisle (5), Spring Run, Orrstown, Chambersburg (3), Mechanicsburg (2), Camp Hill, Greencastle, Newport (2), Duncannon, and New Bloomfield, Pennsylvania and Hagerstown, Maryland. The Company and its subsidiary are subject to the regulation of certain federal and state agencies and undergo periodic examinations by such regulatory authorities.

Basis of Presentation - The unaudited financial statements of Orrstown Financial Services, Inc. (the Company) and its subsidiary are presented for the three months ended March 31, 2011 and 2010 and have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. However, unaudited information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, considered necessary for a fair presentation of the financial position, results of operations and cash flows for the interim period. Information presented at December 31, 2010 is condensed from audited year-end financial statements. For further information, refer to the audited consolidated financial statements and footnotes thereto, included in the annual report on Form 10-K for the year ended December 31, 2010.

All significant intercompany transactions and accounts have been eliminated. Operating results for the three months ended March 31, 2011, are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

Use of Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowance for losses on loans and foreclosed real estate, management obtains independent appraisals for significant properties.

While management uses available information to recognize losses on loans and foreclosed real estate, future additions to the allowances may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for losses on loans and foreclosed real estate. Such agencies may require the Company to recognize additions to the allowance based on their judgments concerning information available to them at the time of their examination. Because of these factors, management's estimate of credit losses inherent in the loan portfolio and the related allowance may change in the near term.

Subsequent Events - Generally accepted accounting principles establishes standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The subsequent events principle sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements, identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that should be made about events or transactions that occur after the balance sheet date. In preparing these financial statements, the Company evaluated the events and transactions that occurred after March 31, 2011, through the date these financial statements were filed with the Commission.

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

The types of securities the Company invests in are included in Note 2, and the type of lending the Company engages in are included in Note 3.

Cash and Cash Equivalents - For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash, balances due from banks and federal funds sold and all of which have original maturities of 90 days or less.

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

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

The Company follows accounting guidance related to recognition and presentation of other-than-temporary impairment (FASB ASC 320-10). This accounting guidance specifies that (a) if a company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income.

The Company had no debt securities it deemed to be other than temporarily impaired for the periods presented.

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

For equity securities, when the Company has decided to sell an impaired available-for-sale security and the entity 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.

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

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

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

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 or a temporary reduction in interest 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.

Allowance for Loan Losses - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

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

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

Stock Compensation Plans - The Company has stock option plans for its employees and non-employee directors. Stock compensation accounting guidance (FASB ASC 718, *Compensation - Stock Compensation*) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost is measured based on the grant date fair value of the stock options, using a Black-Scholes model. Compensation cost for all stock awards are calculated and recognized over the employees' service period, generally defined as the vesting period.

Earnings Per Share - Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect the additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate solely to outstanding stock options. Treasury shares are not deemed outstanding for earnings per share calculations.

Comprehensive Income - Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains on securities available for sale, and unrealized losses related to factors other than credit on debt securities and unrealized gains and losses on cash flow hedges.

Derivative Instruments - Generally accepted accounting principles require that all derivatives be recognized in the Consolidated Financial Statements at their fair values. On the dates that derivative contracts are entered into, the Company designates derivatives as (a) hedges of fair values of recognized assets or liabilities or of unrecognized firm commitments (fair-value hedges); (b) hedges of forecasted

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transactions or variable cash flows to be received or paid in conjunction with recognized assets or liabilities (cash-flow hedges) or (c) instruments that are held for trading or non-hedging purposes (trading or economic-hedging instruments). For a derivative treated as a fair-value hedge, the effective portion of a change in fair value is recorded as an adjustment to the hedged item. The ineffective portion of the fair-value hedge is recognized in current period earnings. Upon termination of a fair-value hedge of a debt instrument, the resulting gain or loss is amortized to earnings through the maturity date of the debt instrument. For a derivative treated as a cash flow hedge, the ineffective portion of changes in fair value is reported in current period earnings. The effective portion of the cash flow hedge is recorded as an adjustment to the hedged item through other comprehensive income. For a derivative treated as a trading or economic hedging instrument, changes in fair value are reported in current period earnings. Fair values are determined based upon quoted market prices and mathematical models using current and historical data.

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

The Company follows generally accepted accounting principles, regarding disclosures about derivative instruments and hedging activities, which includes disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows.

Segment Reporting - The Company only operates in one significant segment Community Banking. The Company's non-banking activities are insignificant to the consolidated financial statements.

Reclassifications - Certain amounts in the 2010 consolidated financial statements have been reclassified to conform to the 2011 presentation.

Recent Accounting Pronouncements

In January 2010, the FASB issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends Subtopic 820-10 to clarify existing disclosures, require new disclosures, and includes conforming amendments to guidance on employers' disclosures about postretirement benefit plan assets. ASU 2010-06 was effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures were effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. The new disclosure guidance significantly expanded the existing requirements leading to greater transparency into the company's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period was effective for annual reporting periods ending on or after December 15, 2010 and has been presented in Note 3 to the Consolidated Financial Statements. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures was required to be adopted for periods beginning on or after December 15, 2010, and are also incorporated in Note 3.

In December 2010, the FASB issued ASU 2010-28, Intangibles Goodwill and Other (Topic 350), When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts. ASU 2010-28 affects all entities that have recognized goodwill and have one or more reporting units whose carrying amount for purposes of performing Step 1 of the goodwill impairment test is zero or negative. ASU 2010-28 modifies Step 1 so that for those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining

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whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that impairment may exist. The qualitative factors are consistent with existing guidance, which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This guidance is effective for the Company for fiscal years, and interim periods within those years, beginning after December 15, 2010. Adoption of ASU 2010-28 guidance did not have a material impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU 2011-2, A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring. This guidance clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for the purpose of recording an impairment charge and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-2, that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-2 will be effective for the Company on July 1, 2011, and applies retrospectively to restructurings occurring on or after January 1, 2011. The adoption ASU 2011-2 is not expected to have a material impact on the Company's consolidated financial statements.

NOTE 2. SECURITIES AVAILABLE FOR SALE

At March 31, 2011 and December 31, 2010, the investment securities portfolio was comprised exclusively of securities classified as available for sale, resulting in investment securities being carried at fair value. The amortized cost and fair values of investment securities available for sale at March 31, 2011 and December 31, 2010 were:

| <i>(Dollars in thousands)</i> | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|-------------------|---------------------|----------------------|------------|
| March 31, 2011 | | | | |
| U.S. Government Sponsored Enterprises (GSE) | \$ 97,641 | \$ 572 | \$ 1,999 | \$ 96,214 |
| States and political subdivisions | 100,746 | 987 | 967 | 100,766 |
| GSE residential mortgage-backed securities | 195,368 | 1,240 | 472 | 196,136 |
| Total debt securities | 393,755 | 2,799 | 3,438 | 393,116 |
| Equity securities | 2,544 | 168 | 36 | 2,676 |
| Totals | \$ 396,299 | \$ 2,967 | \$ 3,474 | \$ 395,792 |

| <i>(Dollars in thousands)</i> | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|-------------------|---------------------|----------------------|------------|
| December 31, 2010 | | | | |
| U.S. Government Sponsored Enterprises (GSE) | \$ 120,318 | \$ 1,491 | \$ 1,523 | \$ 120,286 |
| States and political subdivisions | 98,133 | 566 | 1,551 | 97,148 |
| GSE residential mortgage-backed securities | 212,260 | 960 | 1,044 | 212,176 |
| Total debt securities | 430,711 | 3,017 | 4,118 | 429,610 |
| Equity securities | 2,114 | 93 | 45 | 2,162 |
| Totals | \$ 432,825 | \$ 3,110 | \$ 4,163 | \$ 431,772 |

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

| <i>(Dollars in thousands)</i> | Less than 12 Months | | 12 Months or More | | Total | |
|-------------------------------|---------------------|----------------------|-------------------|----------------------|------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |

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| March 31, 2011 | | | | | | |
|--|------------|----------|----------|--------|------------|----------|
| GSE s | \$ 52,836 | \$ 1,999 | \$ 0 | \$ 0 | \$ 52,836 | \$ 1,999 |
| States and political subdivisions | 43,286 | 732 | 1,047 | 235 | 44,333 | 967 |
| GSE residential mortgage-backed securities | 75,578 | 472 | 0 | 0 | 75,578 | 472 |
| Total debt securities | 171,700 | 3,203 | 1,047 | 235 | 172,747 | 3,438 |
| Equity securities | 606 | 33 | 38 | 3 | 644 | 36 |
| Total temporarily impaired securities | \$ 172,306 | \$ 3,236 | \$ 1,085 | \$ 238 | \$ 173,391 | \$ 3,474 |

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| <i>(Dollars in thousands)</i> | Less than 12 Months | | 12 Months or More | | Total | |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2010 | | | | | | |
| GSE s | \$ 44,737 | \$ 1,523 | \$ 0 | \$ 0 | \$ 44,737 | \$ 1,523 |
| States and political subdivisions | 61,718 | 1,303 | 1,026 | 248 | 62,744 | 1,551 |
| GSE residential mortgage-backed securities | 124,685 | 1,044 | 0 | 0 | 124,685 | 1,044 |
| Total debt securities | 231,140 | 3,870 | 1,026 | 248 | 232,166 | 4,118 |
| Equity securities | 312 | 12 | 312 | 33 | 624 | 45 |
| Total temporarily impaired securities | \$ 231,452 | \$ 3,882 | \$ 1,338 | \$ 281 | \$ 232,790 | \$ 4,163 |

The Company has 94 securities and 126 securities at March 31, 2011 and December 31, 2010 in which the amortized cost exceeds their values, as discussed below.

U.S. Government Sponsored Enterprises (GSE). 44 GSE securities, including mortgage-backed securities, have amortized costs which exceed their fair values, all of which are in the less than 12 months at March 31, 2011. At December 31, 2010, the Company had 50 GSE with unrealized losses, all of which were category less than 12 months. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2011 or at December 31, 2010.

State and Political Subdivisions. 39 state and political subdivision securities have amortized cost which exceeds their fair value, including 3 of which have been for greater than 12 months at March 31, 2011. At December 31, 2010, 63 state and political subdivisions had unrealized losses, 3 of which were greater than 12 months. These unrealized losses have been caused by a rise in interest rates from the time the securities were purchased. All but two state and political subdivision securities in which the amortized cost exceeds fair value have investment grade ratings. The two without investment grade ratings have had an unrealized loss for greater than 12 months, and the unrealized loss is less than 0.50% of carrying value. Management considers the investment rating, the state of the issuer of the security and other credit support in determining whether the security is other-than-temporarily impaired. One security which has had an unrealized loss for over 24 months at March 31, 2011 is a California issue that is carrying a low market value due to it being a zero coupon bond, which is hindered by the state's economic issues, and not the underlying credit worthiness of the issuer. This security carries an investment grade rating. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2011.

Equity Securities. 11 equity securities have cost which exceeds their fair value, including 3 of which have been greater than 12 month at March 31, 2011. At December 31, 2010, 13 equity securities had unrealized losses, of which 7 had unrealized losses for greater than 12 months. These securities are among various industries, including financial, industrial, consumer, energy, health care and a large cap fund, In considering whether the equity securities are other-than-temporarily impaired, management reviews the severity and duration of decline in fair value, research reports, analysts recommendations, credit rating changes, news stories and other relevant information. Management believes the equity securities are not other-than-temporarily impaired and will equal or exceed our cost basis within a reasonable period of time. None of the individual unrealized losses exceed \$10,000 at March 31, 2011. Since these companies are considered viable and carry the possibility of price appreciation in the future, impairments are considered temporary. The Company recorded no other than temporary impairment expense on equity securities for the quarters ended March 31, 2011 and December 31, 2010.

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The amortized cost and fair values of securities available for sale at March 31, 2011 by contractual maturity are shown below. Contractual maturities will differ from expected maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Available for Sale | |
|--|--------------------|------------|
| <i>(Dollars in thousands)</i> | Amortized Cost | Fair Value |
| Due in one year or less | \$ 9,812 | \$ 9,836 |
| Due after one year through five years | 20,585 | 20,711 |
| Due after five years through ten years | 92,117 | 90,982 |
| Due after ten years | 75,873 | 75,451 |
| GSE residential mortgage-backed securities | 195,368 | 196,136 |
| | | |
| Total debt securities | 393,755 | 393,116 |
| Equity securities | 2,544 | 2,676 |
| | \$ 396,299 | \$ 395,792 |

Proceeds from sales of securities available for sale for the quarters ended March 31, 2011 and 2010 were \$27,658,000 and \$51,968,000. Gross gains on the sales of securities were \$421,000 and \$695,000 for the quarters ended March 31, 2011 and 2010. Gross losses on securities available for sale were \$42,000 and \$297,000.

Securities with a fair value of \$280,805,000 and \$271,689,000 at March 31, 2011 and December 31, 2010 were pledged to secure public funds and for other purposes as required or permitted by law.

NOTE 3. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

The Bank's loan portfolio is broken down into segments to an appropriate level of disaggregation to allow management to monitor the performance by the borrower and to monitor the yield on the portfolio. In 2010, management incorporated the provisions of ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Loan Losses*, resulting in a refinement in its portfolio segregation. Consistent with the standard, the segments were further broken down into classes, to allow for differing risk characteristics within a segment.

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

The Company has various types of commercial real estate which have differing levels of credit risk associated with them. Owner-occupied commercial real estate loans are generally dependent upon the successful operation of the borrower's business, with the cash flows generated from the business being the primary source of repayment of the loan. If the business suffers a downturn in sales or profitability, the borrower's ability to repay the loan could be in jeopardy. In order to minimize this credit risk, the Company has conservative underwriting standards which include the credit worthiness of the borrower, limitation on loan amounts to 75% of the value of the property securing the loan, and strong debt service coverage ratios.

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

Acquisition and development loans consist of 1-4 family residential construction and commercial and land development loans. The risk of loss on these loans is largely dependent on the Company's ability to assess the property's value at the completion of the project, which should exceed the property's construction costs. During the construction phase, a number of factors could potentially negatively impact the collateral value, including cost overruns, delays in completing the project, competition, and real estate market conditions which may change based on the supply

of similar properties in the area. In the event the collateral value at the completion

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of the project is not sufficient to cover the outstanding loan balance, the Company must rely upon other repayment sources, including the guarantors of the project or other collateral securing the loan. The Company attempts to mitigate credit risk through strict underwriting standards including evaluation of the credit worthiness of the borrower and their success in other projects, aggressive release fees, loan-to-value ratios not to exceed 75%, and continual monitoring of the project during its construction phase to determine the impact that overruns and delays may have on the project.

Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest rated borrowers, the majority of these loans are secured by the borrower's accounts receivable, inventory and machinery and equipment. In a majority of these loans, the collateral also includes the business real estate or the business owner's personal real estate or assets. Commercial and industrial loans present credit exposure to the Company, as they are more susceptible to risk of loss during a downturn in the economy, as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline. The Company attempts to mitigate this risk through strict underwriting standards, including evaluating the credit worthiness of the borrower and to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and meetings with the borrowers are common. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

The Company originates loans to its retail customers, including fixed-rate and adjustable first lien mortgage loans with the underlying 1-4 family owner-occupied residential property securing the credit. The Company's risk exposure is minimized in these types of loans through the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and underwriting standards which limits the loan-to-value ratio to generally no more than 80%, unless the borrower obtains private mortgage insurance.

Home equity loans, including term loans and lines of credit, present a slightly higher risk to the Company than 1-4 family first liens, as these loans can be first or second liens on 1-4 family owner occupied residential property, but can have loan-to-value ratios of no greater than 90% of the value of the real estate taken as collateral. The credit worthiness of the borrower is considered including credit scores and debt-to-income ratios, which generally cannot exceed 38%.

Installment and other loans' credit risk are mitigated through conservative underwriting standards, including the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and if secured, the collateral value of the assets. As these loans can be unsecured or secured by assets the value of which may depreciate quickly or may fluctuate, they present a greater risk to the Company than 1-4 family residential loans.

The loan portfolio, excluding residential loans held for sale, broken out by classes as of March 31, 2011 and December 31, 2010 is as follows:

| <i>(Dollars in thousands)</i> | March 31, 2011 | December 31, 2010 |
|-------------------------------------|---------------------------|------------------------------|
| Commercial real estate: | | |
| Owner-occupied | \$ 181,468 | \$ 172,000 |
| Non-owner occupied | 133,338 | 143,372 |
| Multi-family | 27,860 | 24,649 |
| Acquisition and development: | | |
| 1-4 family residential construction | 15,546 | 29,297 |
| Commercial and land development | 95,528 | 88,105 |
| Commercial and industrial | 285,277 | 263,943 |
| Residential mortgage: | | |
| First lien | 123,158 | 119,450 |
| Home equity - term | 40,008 | 40,818 |
| Home equity - Lines of credit | 71,476 | 71,547 |
| Installment and other loans | 11,308 | 11,112 |
| | \$ 984,967 | \$ 964,293 |

In order to monitor ongoing risk associated with its loan portfolio and specific credits within the segments, management uses an eight point internal grading system. The first four rating categories, representing the lowest risk to the Bank, are combined and given a 'Pass' rating. 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

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yet justify a more severe, or criticized rating. Management generally follows regulatory definitions in assigning criticized ratings to loans, including substandard, doubtful or loss. 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 reduce and control risk in the lending function. The Credit Administration Committee, comprised of members of the Board, is charged with the overall credit quality and risk exposure of the Company'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 internal, 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.

The Loan Review department performs annual reviews of all commercial relationships with a committed loan balance in excess of \$750,000, with ratification of the rating from the Board of Directors' Credit Administration Committee for loans between \$750,000 - \$1,000,000. Loans reviewed in excess of \$1,000,000 are presented to the Credit Administration Committee with a formal review and rating. All relationships rated Substandard, Doubtful or Loss are reviewed by the Credit Administration Committee on a quarterly basis, including reaffirmation of the rating, review of detailed collateral analysis and the development of an action plan.

The following summarizes the Bank's ratings based on its internal risk rating system as of March 31, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | Pass | Special Mention | Non- Impaired Substandard | Impaired - Substandard | Doubtful | Total |
|-------------------------------------|-------------------|--------------------|---------------------------------|---------------------------|-----------------|-------------------|
| March 31, 2011: | | | | | | |
| Commercial real estate: | | | | | | |
| Owner-occupied | \$ 163,446 | \$ 6,769 | \$ 10,101 | \$ 466 | \$ 686 | \$ 181,468 |
| Non-owner occupied | 110,105 | 7,985 | 14,149 | 1,099 | 0 | 133,338 |
| Multi-family | 20,955 | 535 | 6,370 | 0 | - | 27,860 |
| Acquisition and development: | | | | | | |
| 1-4 family residential construction | 14,671 | 600 | 275 | 0 | 0 | 15,546 |
| Commercial and land development | 71,878 | 7,532 | 16,118 | 0 | 0 | 95,528 |
| Commercial and industrial | 220,138 | 27,643 | 26,660 | 9,827 | 1,009 | 285,277 |
| Residential mortgage: | | | | | | |
| First lien | 120,673 | 0 | 2,018 | 467 | 0 | 123,158 |
| Home equity - term | 39,214 | 0 | 84 | 710 | 0 | 40,008 |
| Home equity - Lines of credit | 71,152 | 0 | 324 | 0 | 0 | 71,476 |
| Installment and other loans | 11,255 | 0 | 53 | 0 | 0 | 11,308 |
| | \$ 843,487 | \$ 51,064 | \$ 76,152 | \$ 12,569 | \$ 1,695 | \$ 984,967 |

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Commercial real estate:

| | | | | | | |
|-------------------------------------|------------|-----------|-----------|-----------|----------|------------|
| Owner-occupied | \$ 162,968 | \$ 2,035 | \$ 6,311 | 0 | \$ 686 | \$ 172,000 |
| Non-owner occupied | 120,633 | 4,274 | 15,495 | 2,970 | 0 | 143,372 |
| Multi-family | 20,030 | 676 | 3,853 | 0 | 90 | 24,649 |
| Acquisition and development: | | | | | | |
| 1-4 family residential construction | 24,199 | 2,297 | 2,801 | 0 | 0 | 29,297 |
| Commercial and land development | 79,391 | 2,487 | 6,134 | 93 | 0 | 88,105 |
| Commercial and industrial | 221,111 | 17,062 | 14,992 | 9,770 | 1,008 | 263,943 |
| Residential mortgage: | | | | | | |
| First lien | 117,607 | 0 | 1,373 | 470 | 0 | 119,450 |
| Home equity - term | 39,279 | 0 | 828 | 711 | 0 | 40,818 |
| Home equity - Lines of credit | 71,364 | 0 | 183 | 0 | 0 | 71,547 |
| Installment and other loans | 11,062 | 0 | 50 | 0 | 0 | 11,112 |
| | \$ 867,644 | \$ 28,831 | \$ 52,020 | \$ 14,014 | \$ 1,784 | \$ 964,293 |

Classified loans may also be evaluated for impairment. For commercial real estate, acquisition and development and commercial and industrial loans, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Generally, loans that are more than 90 days past due are assigned a Substandard rating. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Nonaccrual loans in the commercial and commercial real estate portfolios are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates on fair values are obtained, which may include updated appraisals. The updated fair values will be incorporated into the impairment analysis as of the next reporting period. In the event an updated appraisal that requires a higher impairment reserve is received after a reporting period, but prior to the issuance of the financial statements, an evaluation is made as to the significance of the difference and whether the amounts need to be reflected in the financial statements not yet issued.

Loan charge-offs, which may include, from time-to-time, a partial charge-off, are taken on an impaired loan that is collateral dependent if the loan's carrying balance exceeds its collateral's appraised value, the loan has been identified as uncollectible, and it is deemed to be a confirmed loss. Typically, impaired loans with a charge-off or partial charge-off will continue to be considered impaired, unless the note is split into two, and management expects the performing note to continue to perform and is adequately secured. The second, or non-performing note, would be charged-off. As of the periods presented, the Company has no loans to borrowers that resulted from splitting impaired loans into multiple notes. Further, an impaired loan with a partial charge-off may continue to have an impairment reserve on it after the partial charge-off, if factors warrant.

As of March 31, 2011 and December 31, 2010, nearly all of the Company's impaired loans' extent of impairment was measured based on the estimated fair value of the collateral securing the credit. For real estate loans, collateral generally consists of commercial real estate, but in the case of commercial and industrial loans, it would also consist of accounts receivable, inventory, equipment or other business assets. Commercial and industrial loans may also have real estate collateral.

At the time a real-estate secured loan is deemed impaired, management determines whether an updated certified appraisal of the real estate is necessary to assist in determining the extent of an impairment reserve, if any. The decision for requiring an updated appraisal takes into consideration the age of the most recent appraisal, the loan-to-value ratio based on the original certified appraisal, the Company's recent experience and knowledge of market conditions, recent list prices or broker opinions, the condition of the property, and environmental factors. If

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market conditions have changed significantly from the date of the most recent appraisal, an updated appraisal will be obtained. The as is value provided in the appraisal is often used as the fair value of the collateral in determining impairment, unless circumstances, such as subsequent improvements, approvals, or other circumstances dictate that another value provided by the appraiser is more appropriate.

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As of March 31, 2011, approximately 91% of impaired loans secured by real estate were measured at fair value using certified real estate appraisals that had been completed within the last year. Appraised values are further discounted for estimated costs to sell the property and other selling considerations to arrive at the properties' fair value.

In those situations in which it is determined an updated appraisal is not required for loans individually evaluated for impairment, fair values are based on one or a combination of the following approaches. In those situations in which a combination of approaches is considered, the factor that carries the most consideration will be the one management believes is warranted. The approaches are as follows:

Original appraisal - if the original appraisal provides a strong loan-to-value (generally 80% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the loan review staff that there has not been a significant deterioration in the collateral value, the original certified appraised value will be used. Discounts as deemed appropriate for selling costs are factored into the appraised value in arriving at fair value.

Discounted cash flows - In limited cases, discounted cash flows may be used on projects in which the collateral is liquidated to reduce the borrowings outstanding, and is used to validate collateral values derived from other approaches.

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

In the fourth quarter of 2010, the Company began to distinguish Substandard loans on both an impaired and non-impaired basis, as it placed less emphasis on a loan's classification, and increased reliance on whether the loan was performing in accordance with the contractual terms.

Substandard classification does not automatically meet the definition of impaired. A substandard credit is one that is inadequately protected by current sound worth, paying capacity of the obligor or the collateral pledged, if any. Extensions of credit so classified have well-defined weaknesses which may jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard. As a result, the Company revised its methodology in its evaluation of certain accruing commercial real estate, acquisition and development and commercial and industrial loans rated substandard collectively for impairment as opposed to evaluating these loans individually for impairment. Although we believe these loans have well defined weaknesses and meet the definition of substandard, they are generally performing and management has concluded that it is likely it will be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Approximately \$53,201,000 of loans that were in previous years evaluated individually for impairment were collectively evaluated for impairment at December 31, 2010, resulting in an additional allowance for loan losses allocation of \$3,710,000.

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

The following summarizes impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required as of March 31, 2011 and December 31, 2010:

| | Impaired Loans with a Specific Allowance | | | Interest income Recognized on Cash Basis | Impaired Loans with No Specific Allowance | | |
|-------------------------------|--|--|----------------------|---|---|---|---|
| | Recorded Investment (Book Balance) | Unpaid Principal Balance (Legal Balance) | Related Allowance | | Recorded Investment (Book Balance) | Unpaid Principal Balance (Legal Balance) | Interest income Recognized on Cash Basis |
| <i>(Dollars in thousands)</i> | | | | | | | |
| March 31, 2011 | | | | | | | |
| Commercial real estate: | | | | | | | |

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| | | | | | | | |
|---------------------------|-----------|-----------|----------|-------|--------|--------|------|
| Owner-occupied | \$ 1,153 | \$ 1,153 | \$ 196 | \$ 1 | \$ - | \$ - | \$ 0 |
| Non-owner occupied | 1,099 | 1,101 | 548 | - | - | - | - |
| Multi-family | - | - | - | - | - | - | - |
| Commercial and industrial | 9,715 | 10,306 | 3,522 | 0 | 968 | 968 | 1 |
| Residential mortgage: | | | | | | | |
| First lien | 467 | 467 | 4 | 4 | 0 | 0 | 0 |
| Home equity - term | 710 | 710 | 5 | 8 | 0 | 0 | 0 |
| | \$ 13,144 | \$ 13,737 | \$ 4,275 | \$ 13 | \$ 968 | \$ 968 | \$ 1 |

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| | | | | | | | |
|---------------------------|-----------|-----------|----------|-------|----------|----------|------|
| Commercial real estate: | | | | | | | |
| Owner-occupied | \$ 686 | \$ 687 | \$ 181 | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Non-owner occupied | 2,064 | 2,065 | 980 | 0 | 0 | 0 | 0 |
| Multi-family | 90 | 90 | 90 | 0 | 0 | 0 | 0 |
| Commercial and industrial | 9,600 | 10,191 | 3,232 | - | 1,118 | 1,118 | 6 |
| Residential mortgage: | | | | | | | |
| First lien | 470 | 470 | 12 | 32 | 0 | 0 | 0 |
| Home equity - term | 711 | 711 | 8 | 44 | 0 | 0 | 0 |
| | \$ 13,621 | \$ 14,214 | \$ 4,503 | \$ 76 | \$ 1,118 | \$ 1,118 | \$ 6 |

The following summarizes the average recorded investment in impaired loans recognized for the three months ended March 31, 2011:

(Dollars in thousands)

| | |
|---------------------------|------------------|
| Commercial real estate: | |
| Owner-occupied | \$ 920 |
| Non-owner occupied | 1,582 |
| Multi-family | 45 |
| Commercial and industrial | 10,701 |
| Residential mortgage: | |
| First lien | 469 |
| Home equity - term | 711 |
| Total | \$ 14,428 |

The following presents impaired loans that are troubled debt restructurings, as well as the number of loans modified during the three and twelve month periods, as of March 31, 2011 and December 31, 2010.

| (Dollars in thousands) | Troubled Debt Restructurings | | New Troubled Debt Restructurings During Current YTD Period | |
|--------------------------|------------------------------|------------------------|---|------------------------|
| | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |
| March 31, 2011 | | | | |
| Accruing: | | | | |
| Residential mortgage: | | | | |
| First lien | 1 | \$ 467 | - | \$ - |
| Home equity - term | 1 | 710 | - | - |
| | 2 | \$ 1,177 | - | \$ - |
| December 31, 2010 | | | | |
| Accruing: | | | | |
| Residential mortgage: | | | | |
| First lien | 1 | \$ 470 | 1 | \$ 470 |
| Home equity - term | 1 | 711 | 1 | 711 |
| | 2 | \$ 1,181 | 2 | \$ 1,181 |

The loans presented above were considered troubled debt restructurings as the result of the Company agreeing to a temporary reduction in interest rates for periods not exceeding 12 months in order to assist the borrowers to improve cash flows during such periods. To date, the only concessions the Company has made to borrowers in the form of troubled debt restructurings are reduced interest rates. No additional commitments have been made to borrowers whose loans are considered troubled debt restructurings.

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Management further monitors the performance and credit quality of the loan portfolio by analyzing the length of time a portfolio is past due, by aggregating loans based on its delinquencies. The following table presents the classes of loan portfolio summarized by aging categories of performing loans and nonaccrual loans as of March 31, 2011 and December 31, 2010:

| | Days Past Due | | | | Total Past Due | Non- Accrual | Total Loans |
|-------------------------------------|---------------|----------|----------|-------------------------|-------------------|-----------------|----------------|
| | Current | 30-59 | 60-89 | 90+ (still accruing) | | | |
| March 31, 2011: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner-occupied | \$ 178,910 | \$ 1,331 | \$ 74 | \$ - | \$ 1,405 | \$ 1,153 | \$ 181,468 |
| Non-owner occupied | 130,844 | 1,395 | - | - | 1,395 | 1,099 | 133,338 |
| Multi-family | 27,663 | 197 | - | - | 197 | - | 27,860 |
| Acquisition and development: | | | | | | | |
| 1-4 family residential construction | 15,503 | 43 | - | - | 43 | - | 15,546 |
| Commercial and land development | 89,688 | 542 | 4,568 | 637 | 5,747 | 93 | 95,528 |
| Commercial and industrial | 270,346 | 3,276 | 132 | 928 | 4,336 | 10,595 | 285,277 |
| Residential mortgage: | | | | | | | |
| First lien | 119,026 | 2,006 | 146 | 1,842 | 3,994 | 138 | 123,158 |
| Home equity - term | 39,561 | 186 | 85 | 151 | 422 | 25 | 40,008 |
| Home equity - Lines of credit | 71,213 | 134 | - | 129 | 263 | - | 71,476 |
| Installment and other loans | 11,148 | 147 | 10 | - | 157 | 3 | 11,308 |
| | \$ 953,902 | \$ 9,257 | \$ 5,015 | \$ 3,687 | \$ 17,959 | \$ 13,106 | \$ 984,967 |

| | Days Past Due | | | | Total Past Due | Non- Accrual | Total Loans |
|-------------------------------------|---------------|----------|----------|-------------------------|-------------------|-----------------|----------------|
| | Current | 30-59 | 60-89 | 90+ (still accruing) | | | |
| December 31, 2010: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner-occupied | \$ 169,030 | \$ 986 | \$ 832 | \$ 466 | \$ 2,284 | \$ 686 | \$ 172,000 |
| Non-owner occupied | 141,095 | 213 | - | - | 213 | 2,064 | 143,372 |
| Multi-family | 24,559 | - | - | - | - | 90 | 24,649 |
| Acquisition and development: | | | | | | | |
| 1-4 family residential construction | 29,297 | - | - | - | - | - | 29,297 |
| Commercial and land development | 87,995 | 1 | 16 | - | 17 | 93 | 88,105 |
| Commercial and industrial | 252,144 | 287 | 466 | 420 | 1,174 | 10,625 | 263,943 |
| Residential mortgage: | | | | | | | |
| First lien | 116,182 | 1,359 | 535 | 1,095 | 2,989 | 279 | 119,450 |
| Home equity - term | 40,503 | 161 | 62 | 75 | 298 | 17 | 40,818 |
| Home equity - Lines of credit | 71,215 | 60 | 89 | 142 | 291 | 41 | 71,547 |
| Installment and other loans | 10,793 | 251 | 17 | 50 | 318 | 1 | 11,112 |
| | \$ 942,813 | \$ 3,318 | \$ 2,017 | \$ 2,248 | \$ 7,584 | \$ 13,896 | \$ 964,293 |

The Bank maintains the allowance for loan losses at a level believed adequate by management to absorb losses inherent in the portfolio. It is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the allowance for loan losses utilizing a defined methodology, which considers specific credit evaluation of impaired loans as discussed above, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC 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.

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For each loan class presented above, general allowances are provided for loans that are collectively evaluated for impairment, which is based on quantitative factors, principally historical loss trends for the respective loan class, adjusted for qualitative factors. As of December 31, 2010, the historical loss factor was based on average charge-offs for the last 8 quarters (e.g. January 1, 2009 – December 31, 2010), whereas prior to December 31, 2010, the historical loss factor was based on an equally weighted rolling 12 quarters. Effective December 31, 2010, for loans rated special mention and substandard not deemed impaired, a weighted average rolling 8 quarters average charge-off percentage on the related graded loan type, with a two-third weight to the most recent four quarters, and a one-third weight for the furthest four quarters was utilized. For non-rated loans evaluated collectively for impairment, the charge-off factor for the last 8 quarters is factored into the reserve

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allocation. The refinement to the methodology was made as management determined that the most recent eight quarters, and in particular, the most recent four quarters for rated loans, is a better reflection of the losses inherent in the loan portfolio at December 31, 2010. Additional reserve allocations of approximately \$730,000 resulted due to the change to the most recent 8 quarter history, which management believes is a better reflection of losses inherent in the portfolio based on recent loss history. In making this determination, management considered current economic and real estate conditions, trends in historical charge-off percentages at the Company as well as peers, and feedback from regulators.

In addition to the quantitative analysis, additional reserves are allocated on loans collectively evaluated for impairment based on additional qualitative factors. The qualitative factors used by management to adjust the historical loss percentage to the anticipated loss allocation, which range from 0 to 10 bp per factor, include:

National and local economic trends (five factors) Ratios and factors considered include trends in the consumer price index (CPI); unemployment rates; housing price index; housing starts compared to the prior year; and bankruptcy rates.

Credit quality trends (four factors) Ratios and factors considered include trends in delinquency ratios; 90 days plus and nonaccrual loans; average net loan losses to loans outstanding; and classified loans to total loans.

Underwriting policies (three factors) Factors considered including the number of exceptions to loan policy; supervisory loan to value exceptions; and the instances of repeat criticisms of ratings.

Experience, ability and depth of lending and loan review staff (four factors) Factors considered include the years experience of the lending and loan review staff; turnover of the staff; instances of loan grade migration; and the penetration of loans reviewed.

Other (two factors) Other factors considered include concentrations of credit from loan type or shifts in industry or geographic region.

Activity in the allowance for loan losses for three months ended March 31, 2011 is as follows:

| <i>(Dollars in thousands)</i> | Acquisition | | | | | | Total |
|-------------------------------|------------------------|-----------------|---------------------------|----------------------|-----------------------|-------------|-----------|
| | Commercial Real Estate | and Development | Commercial and Industrial | Residential Mortgage | Installment and Other | Unallocated | |
| Balance, beginning of period | \$ 5,324 | \$ 1,767 | \$ 6,795 | \$ 1,863 | \$ 106 | \$ 165 | \$ 16,020 |
| Provision for loan losses | 272 | 1,478 | 1,461 | (90) | (13) | 87 | 3,195 |
| Charge-offs | (712) | - | (44) | (61) | (7) | - | (824) |
| Recoveries | - | - | - | - | 7 | - | 7 |
| Balance, end of period | \$ 4,884 | \$ 3,245 | \$ 8,212 | \$ 1,712 | \$ 93 | \$ 252 | \$ 18,398 |

Activity in the allowance for loan losses for the three months ended March 31, 2010 is as follows:

| | |
|-------------------------------|-----------|
| <i>(Dollars in thousands)</i> | |
| Balance, beginning of period | \$ 11,067 |
| Provision for loan losses | 1,420 |
| Chargeoffs | (485) |
| Recoveries | 18 |
| Balance, end of period | \$ 12,020 |

The following summarizes the ending loan balance individually evaluated for impairment based upon loan segment, as well as the related allowance for loan loss allocation for each at March 31, 2011 and December 31, 2010:

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| <i>(Dollars in thousands)</i> | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Residential Mortgage | Installment and Other | Unallocated | Total |
|--|---------------------------|-----------------------------------|---------------------------------|-------------------------|--------------------------|-------------|------------|
| March 31, 2011 | | | | | | | |
| Loans allocated by: | | | | | | | |
| Individually evaluated for impairment | \$ 2,252 | \$ - | \$ 10,683 | \$ 1,177 | \$ - | \$ - | \$ 14,112 |
| Collectively evaluated for impairment | 340,414 | 111,074 | 274,594 | 233,465 | 11,308 | - | 970,855 |
| | \$ 342,666 | \$ 111,074 | \$ 285,277 | \$ 234,642 | \$ 11,308 | \$ - | \$ 984,967 |

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| | | | | | | | | |
|---|----------|----------|----------|----------|-------|--------|------|-----------|
| Allowance for loan losses allocated by: | | | | | | | | |
| Individually evaluated for impairment | \$ 744 | \$ - | \$ 3,522 | \$ 9 | \$ - | \$ - | \$ - | \$ 4,275 |
| Collectively evaluated for impairment | 4,140 | 3,245 | 4,690 | 1,703 | 93 | 252 | | 14,123 |
| | \$ 4,884 | \$ 3,245 | \$ 8,212 | \$ 1,712 | \$ 93 | \$ 252 | | \$ 18,398 |

December 31, 2010

| | | | | | | | | |
|---------------------------------------|------------|------------|------------|------------|-----------|------|--|------------|
| Loans allocated by: | | | | | | | | |
| Individually evaluated for impairment | \$ 2,840 | \$ - | \$ 10,718 | \$ 1,181 | \$ - | \$ - | | \$ 14,739 |
| Collectively evaluated for impairment | 337,181 | 117,402 | 253,225 | 230,634 | 11,112 | - | | 949,554 |
| | \$ 340,021 | \$ 117,402 | \$ 263,943 | \$ 231,815 | \$ 11,112 | \$ - | | \$ 964,293 |

| | | | | | | | | |
|---|----------|----------|----------|----------|--------|--------|--|-----------|
| Allowance for loan losses allocated by: | | | | | | | | |
| Individually evaluated for impairment | \$ 1,251 | \$ - | \$ 3,232 | \$ 20 | \$ - | \$ - | | \$ 4,503 |
| Collectively evaluated for impairment | 4,073 | 1,767 | 3,563 | 1,843 | 106 | 165 | | 11,517 |
| | \$ 5,324 | \$ 1,767 | \$ 6,795 | \$ 1,863 | \$ 106 | \$ 165 | | \$ 16,020 |

NOTE 4. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITY

The Company entered into three (3) rate swap agreements - two on November 24, 2008, and one on May 22, 2009 related to fixed rate loans. The Company uses these interest rate swaps to reduce interest rate risks and to manage interest income. By entering into these agreements, the Company converts floating rate assets into fixed rate assets. These interest rate swap agreements are considered cash flow hedge derivative instruments that qualify for hedge accounting. A portion of the amount included in other comprehensive income is reclassified from other comprehensive income to the appropriate income statement line item as net settlements occur.

The notional amounts of the interest rate swaps are not exchanged and do not represent exposure to credit loss. In the event of default by a counter party, the risk in these transactions is the cost of replacing the agreements at current market rates. During the three months ended March 31, 2011, the Company sold one of its rate swaps and recognized a \$118,000 gain on the sale, which is included in the ineffective portion of the following table, once it no longer qualified as a hedge.

The balances of the derivative instruments on the consolidated financial statements as of March 31, 2011 and December 31, 2010 are as follows:

| (Dollars in thousands) | Notional/ Contract Amount | Estimated Net Fair Value | Fair Value Balance Sheet Location | Expiration Date | Fixed Rate |
|---------------------------------------|---------------------------------|--------------------------------|---|--------------------|---------------|
| March 31, 2011: | | | | | |
| Interest rate swap - 5 year cash flow | \$ 20,000 | \$ 638 | Other assets | 11/26/2013 | 5.28% |

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December 31, 2010:

| | | | | | |
|---------------------------------------|-----------|----------|--------------|------------|-------|
| Interest rate swap - 5 year cash flow | \$ 20,000 | \$ 804 | Other assets | 11/26/2013 | 5.28% |
| Interest rate swap - 4 year cash flow | 10,000 | 209 | Other assets | 05/27/2013 | 4.54% |
| | \$ 30,000 | \$ 1,013 | | | 5.03% |

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The effects of the interest rate swaps on the Company's income statement for the quarters ended March 31, 2011 and 2010 are as follows:

| Derivatives in cash flow hedging relationships (Dollars in thousands) | Amount of Gain (Loss) Recognized in OCI on Derivatives (Effective Portion) | | Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion) | Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (realized portion) | |
|--|--|--------|--|--|--------|
| | 2011 | 2010 | | 2011 | 2010 |
| Interest rate swap - 4 year cash flow | \$ - | \$ 254 | Interest income | \$ - | \$ 118 |
| Interest rate swap - 5 year cash flow | (179) | 246 | Interest income | 101 | 93 |
| Interest rate swap - 4 year cash flow | (92) | 120 | Interest income | 32 | 29 |
| | \$ (271) | 620 | | \$ 133 | 240 |

| Derivatives in cash flow hedging relationships (Dollars in thousands) | Location of Gain or (Loss) Recognized in Income on Derivative (Ineffective Portion) | Amount of Gain (Loss) Recognized in Income on Derivative (Ineffective Portion) | |
|--|--|--|-------|
| | | 2011 | 2010 |
| Interest rate swap - 4 year cash flow | Other income | \$ - | \$ 17 |
| Interest rate swap - 5 year cash flow | Other income | 13 | 11 |
| Interest rate swap - 4 year cash flow | Other income | 118 | 0 |
| | | \$ 131 | \$ 28 |

Under the terms of the agreement, the Bank pays interest monthly at the rate equivalent to Wall Street Journal prime and receives interest income monthly at the fixed rate shown above. The estimated net amount of the existing gains at March 31, 2011 that is expected to be reclassified into interest income over the next twelve months is approximately \$400,000.

NOTE 5. SHAREHOLDERS EQUITY AND REGULATORY CAPITAL

On February 9, 2010, the Company filed a shelf registration statement on Form S-3 with the Securities and Exchange Commission that provided the Company the ability to raise capital, from time to time, up to an aggregate of \$80,000,000, through the sale of stock, preferred stock, debt securities, warrants and other securities. The Company completed a public stock offering of 1,481,481 shares of common stock at a price of \$27.00 per share, for gross proceeds of approximately \$40,000,000 during the first quarter of 2010. Net proceeds after underwriting commissions and expenses were \$37,585,000. The Company believes that with this additional capital, it positions itself well to weather the economy and take advantage of future opportunities that may arise. The Company has no current plans to issue additional shares of common stock.

NOTE 6. EARNINGS PER SHARE

Earnings per share for the three months ended March 31, 2011 and March 2010 were as follows:

| (Dollars In Thousands, except per share data) | March 31, 2011 | March 31, 2010 |
|---|-------------------|-------------------|
| Net income | \$ 3,827 | \$ 3,406 |

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| | | |
|---|-------|-------|
| Weighted average shares outstanding (basic) | 7,988 | 6,498 |
| Impact of common stock equivalents | 38 | 48 |
| Weighted average shares outstanding (diluted) | 8,026 | 6,546 |

Per share information:

| | | |
|----------------------------|---------|---------|
| Basic earnings per share | \$ 0.48 | \$ 0.52 |
| Diluted earnings per share | 0.48 | 0.52 |

Stock options for 206,108 and 143,822 shares of common stock were not considered in computing diluted earnings per share for the three months ended March 31, 2011 and 2010, as their exercise would have been antidilutive, and the exercise price exceeded the average market value.

Table of Contents**NOTE 7. COMPREHENSIVE INCOME**

The Company's other comprehensive income (loss) items are limited to unrealized gains (losses) on securities available for sale and unrealized gains (losses) on derivatives used for cash flow hedges. The components of other comprehensive income (loss) for the three months ended March 31, 2011 and 2010 were as follows:

| <i>(Dollars in thousands)</i> | Three Months Ended March 31, | |
|--|---|-----------------|
| | 2011 | 2010 |
| Unrealized holding gains (losses) on securities available for sale arising during the period | \$ 925 | \$ 1,446 |
| Reclassification adjustment for (gains) losses realized in net income | (379) | (398) |
| Net unrealized gains (losses) | 546 | 1,048 |
| Tax effect | (191) | (367) |
| | 355 | 681 |
| Unrealized holding gains (losses) in fair value of derivatives used for cash flow hedges | (270) | 621 |
| Reclassification adjustment for (gains) realized in net income | (118) | 0 |
| Net unrealized gains (losses) | (388) | 621 |
| Tax effect | 136 | (217) |
| | (252) | 404 |
| Total other comprehensive income, net of tax and reclassification adjustments | \$ 103 | \$ 1,085 |

The components of accumulated other comprehensive income, net of taxes, are as follows:

| | March 31, 2011 | December 31, 2010 |
|--|---------------------------|------------------------------|
| Unrealized gains (losses) on securities available for sale | \$ (330) | \$ (685) |
| Unrealized gains (losses) on derivatives used for cash flow hedges | 345 | 597 |
| | \$ 15 | \$ (88) |

NOTE 8. OTHER COMMITMENTS

In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities which are not reflected in the accompanying financial statements. These commitments include various guarantees and commitments to extend credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company's subsidiary bank evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. Standby letters of credit and financial guarantees written are conditional commitments to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Bank holds collateral supporting those commitments when deemed necessary by management. At March 31, 2011 and December 31, 2010, \$28,599,000 and \$29,558,000 of performance standby letters of credit have been issued. The Company does not anticipate any losses as a result of these transactions.

NOTE 9. FAIR VALUE DISCLOSURES

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Fair Value Measurements under generally accepted accounting principles defines fair value, describes a framework for measuring fair value and requires disclosures about fair value measurements by establishing a three-level hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the assets or liabilities fall within different levels of the hierarchy, the classification is based on the lowest level input that is significant to the fair value measurement of the asset or liability. Classification of assets and liabilities within the hierarchy considers the markets in which the assets and liabilities are traded and the reliability and transparency of the assumptions used to determine fair value.

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

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

Securities

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

Interest Rate Swaps

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

The Company had no fair value liabilities at March 31, 2011 or December 31, 2010. A summary of assets at March 31, 2011 and December 31, 2010, measured at estimated fair value on a recurring basis were as follows:

| <i>(Dollars in Thousands)</i> | Level 1 | Level 2 | Level 3 | Total Fair Value Measurements |
|---|-----------|-------------|---------|-------------------------------|
| March 31, 2011 | | | | |
| Securities available for sale: | | | | |
| U.S. Government Sponsored Enterprises (GSE) | \$0 | \$96,214 | \$0 | \$96,214 |
| States and political subdivisions | 0 | 100,766 | 0 | 100,766 |
| GSE residential mortgage-backed securities | 0 | 196,136 | 0 | 196,136 |
| Total debt securities | 0 | 393,116 | 0 | 393,116 |
| Equity securities: | | | | |
| Diversified | 233 | 0 | 0 | 233 |
| Energy | 150 | 0 | 0 | 150 |
| Financial services | 280 | 70 | 0 | 350 |
| Industrials | 128 | 0 | 0 | 128 |
| Technology | 379 | 0 | 0 | 379 |
| Other | 1,436 | 0 | 0 | 1,455 |
| Total equity securities | 2,606 | 70 | 0 | 2,676 |
| Total securities | 2,606 | 393,186 | 0 | 395,792 |
| Interest rate swaps | \$0 | \$ 638 | \$0 | \$ 638 |
| December 31, 2010 | | | | |
| Securities available for sale: | | | | |
| U.S. Government Sponsored Enterprises (GSE) | \$0 | \$120,286 | \$0 | \$120,286 |

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| | | | | |
|--|-------|----------|-----|----------|
| States and political subdivisions | 0 | 97,148 | 0 | 97,148 |
| GSE residential mortgage-backed securities | 0 | 212,176 | 0 | 212,176 |
| Total debt securities | 0 | 429,610 | 0 | 429,610 |
| Equity securities: | | | | |
| Diversified | 267 | 0 | 0 | 267 |
| Energy | 60 | 0 | 0 | 60 |
| Financial services | 351 | 279 | 0 | 630 |
| Industrials | 208 | 0 | 0 | 208 |
| Technology | 147 | 0 | 0 | 147 |
| Other | 784 | 66 | 0 | 850 |
| Total equity securities | 1,817 | 345 | 0 | 2,162 |
| Total securities | 1,817 | 429,955 | 0 | 431,772 |
| Interest rate swaps | \$0 | \$ 1,013 | \$0 | \$ 1,013 |

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Certain financial assets are measured at fair value on a nonrecurring basis in accordance with accounting principles generally accepted in the United States. Adjustments to the fair value of these assets usually result from the application of lower-of-cost or fair value accounting or write-down of individual assets.

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

Impaired Loans

Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due, according to the contractual terms of the loan agreement, will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loan, less estimated costs to sell. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The value of the real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is older than two years, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal, if deemed significant, or the net book value on the applicable business financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans with an allocation to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statement of income. Specific allocations to the allowance for loan losses were \$4,275,000 and \$4,503,000 at March 31, 2011 and December 31, 2010, respectively.

Foreclosed Real Estate Owned

Other real estate property acquired through foreclosure is initially recorded at fair value of the property at the transfer date less estimated selling cost. Subsequently, other real estate owned is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. There were 8 other real estate owned properties with write-downs totaling \$64,000 for the quarter ended March 31, 2011.

Mortgage Servicing Rights

The fair value of mortgage servicing rights is estimated to be equal to its carrying value, unless the quarterly valuation model calculates the present value of the estimated net servicing income is less than its carrying value, in which case a lower of cost or market (LOCM) charge is taken. In the fourth quarter of 2010, a \$200,000 lower of cost or market charge was taken on the mortgage servicing right portfolio. Due to increases in mortgage servicing rights values, this LOCM reserve was reversed in the first quarter of 2011.

A summary of assets at March 31, 2011 and December 31, 2010 measured at fair value on a nonrecurring basis is as follows:

| <i>(Dollars in Thousands)</i> | Level 1 | Level 2 | Level 3 | Total Fair Value Measurements |
|-------------------------------|----------------|----------------|----------------|--------------------------------------|
| March 31, 2011 | | | | |
| Impaired loans, net | \$ 0 | \$ 0 | \$ 8,869 | \$ 8,869 |
| Foreclosed real estate | 0 | 0 | 72 | 72 |
| December 31, 2010 | | | | |
| Impaired loans, net | \$ 0 | \$ 0 | \$ 9,118 | \$ 9,118 |
| Foreclosed real estate | 0 | 0 | 259 | 259 |
| Mortgage servicing rights | 0 | 0 | 2,057 | 2,057 |

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Fair values of financial instruments

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

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

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

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

Loans Held for Sale

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

Loans Receivable

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

Restricted Investment in Bank Stock

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

Deposit Liabilities

The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposits and IRAs are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market to a schedule of aggregated expected maturities on time deposits.

Short-Term Borrowings

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

Long-Term Debt

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

Accrued Interest

The carrying amounts of accrued interest approximate their fair values.

Table of Contents**Off-Balance-Sheet Instruments**

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

The estimated fair values of the Company's financial statements were as follows at March 31, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | 2011 | | 2010 | |
|--------------------------------------|-----------------|--------------|-----------------|--------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial Assets | | | | |
| Cash and due from banks | \$ 14,751 | \$ 14,751 | \$ 10,400 | \$ 10,400 |
| Federal funds sold | 21,500 | 21,500 | 8,800 | 8,800 |
| Short-term investments | 2,728 | 2,728 | 2,728 | 2,728 |
| Interest bearing deposits with banks | 557 | 557 | 925 | 925 |
| Restricted investments in bank stock | 8,515 | 8,515 | 8,798 | 8,798 |
| Securities available for sale | 395,792 | 395,792 | 431,772 | 431,772 |
| Loans held for sale | 3,807 | | 2,693 | |
| Loans | 984,867 | | 964,293 | |
| Allowance for loan losses | (18,397) | | (16,020) | |
| Net loans | 970,376 | 957,138 | 950,966 | 937,928 |
| Accrued interest receivable | 5,849 | 5,849 | 5,715 | 5,715 |
| Mortgage servicing rights | 2,303 | 2,303 | 2,057 | 2,057 |
| Interest rate swaps | 638 | 638 | 1,013 | 1,013 |
| Financial Liabilities | | | | |
| Deposits | \$ 1,207,373 | \$ 1,210,601 | \$ 1,188,377 | \$ 1,192,028 |
| Short-term borrowings | 86,750 | 86,750 | 87,850 | 87,850 |
| Long-term debt | 45,068 | 45,835 | 65,178 | 66,397 |
| Accrued interest payable | 1,116 | 1,116 | 1,053 | 1,053 |
| Off-balance sheet instruments | 0 | 0 | 0 | 0 |

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PART I - FINANCIAL INFORMATION

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

OVERVIEW

Orrstown Financial Services, Inc. (the Company) is a financial holding Company with a wholly-owned bank subsidiary, Orrstown Bank. The following is a discussion of our consolidated financial condition at March 31, 2011 and results of operations for the three ended March 31, 2011 and March 31, 2010. Throughout this discussion, the yield on earning assets is stated on a fully taxable-equivalent basis and balances represent average daily balances unless otherwise stated. The discussion and analysis should be read in conjunction with our Condensed Consolidated Financial Statements (Unaudited) and Notes thereto presented in this report. Certain prior period amounts, presented in this discussion and analysis, have been reclassified to conform to current period classifications.

Certain statements appearing herein which are not historical in nature are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements refer to a future period or periods, reflecting management's current views as to likely future developments, and use words like may, will, expect, estimate, anticipate or similar terms. Because forward-looking statements involve certain risks, uncertainties and other factors over which the Company has no direct control, actual results could differ materially from those contemplated in such statements. These factors include (but are not limited to) the following: general economic conditions, changes in interest rates, changes in the Company's cost of funds, changes in government monetary policy, changes in government regulation and taxation of financial institutions, including changes resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act and related regulations, changes in the rate of inflation, changes in technology, the intensification of competition within the Company's market area and other similar factors. For a discussion of these forward-looking statements and important factors that could cause results to differ materially from the forward-looking statements contained in this Report, see "Important Factors Relating to Forward Looking Statements" contained in our Annual Report on Form 10-K for the year ended December 31, 2010.

Critical Accounting Policies

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

The most significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, the Company has identified the adequacy of the allowance for loan losses, evaluation of goodwill for potential impairment, 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.

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Goodwill and other intangible assets have been recorded on the books of the Company in connection with its acquisitions. Goodwill and other intangible assets are reviewed for potential impairment on an annual basis, or more often if events or circumstances indicate that there may be impairment. Goodwill is tested for impairment at the reporting unit level and an impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. Various market valuation methodologies are used to determine the fair value of the reporting unit. If the fair values of the reporting units exceed their book values, no write-downs of recorded goodwill are necessary. If the fair value of the reporting unit is less than its book value, an impairment expense may be required to be recorded to write down the related goodwill to the proper carrying value. To date, the Company has not had to take an impairment charge on its goodwill.

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. As of March 31, 2011, Management has concluded that a valuation allowance is not needed on its net deferred tax asset.

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.

SUMMARY OF FINANCIAL RESULTS

Orrstown Financial Services, Inc. recorded net income of \$3,827,000 for the first quarter of 2011 compared to \$3,406,000 for the same period in 2010, representing an increase of \$421,000 or 12.4%. Basic and diluted earnings per share (EPS) for the first quarter of 2011 were \$0.48, compared to \$0.52 for the first quarter of 2010. Earnings per share declined in 2011 compared to 2010, as a result of the issuance of approximately 1.481 million shares on March 31, 2010 in connection with the Company's highly successful common stock offering.

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

| | Three Months Ended | |
|-----------------------------------|---------------------------|---------------------------|
| | March 31, 2011 | March 31, 2010 |
| Return on average assets | 1.03% | 1.12% |
| Return on average tangible assets | 1.05% | 1.15% |
| Return on average equity | 9.63% | 12.18% |
| Return on average tangible equity | 11.15% | 15.12% |
| Average equity / average assets | 10.65% | 9.17% |

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 as follows:

| <i>(Dollars in thousands, except per share data)</i> | March 31, 2011 | December 31, 2010 |
|--|-----------------------|--------------------------|
| Common shareholder's equity | \$ 162,673 | \$ 160,484 |
| Less: intangible assets | 20,646 | 20,698 |
| Tangible common equity | \$ 142,027 | \$ 139,786 |
| Book value per share | \$ 20.36 | \$ 20.10 |
| Less: intangible assets per share | 2.58 | 2.60 |
| Tangible book value per share | \$ 17.76 | \$ 17.50 |
| Total assets | 1,512,393 | 1,511,722 |
| Less intangible assets | 20,646 | 20,698 |
| Tangible assets | \$ 1,491,747 | \$ 1,491,024 |

Return on average tangible assets and return on average tangible equity are non-GAAP-based financial measures calculated using non-GAAP-based amounts. The most directly comparable measure is return on average assets and return on average equity, which are calculated using GAAP-based amounts. The Company calculates the return on average tangible assets and equity by excluding the balance of intangible assets and their related amortization expense, net of tax, from the calculation of return on average assets and equity. Management uses the return on average tangible assets and equity to assess the Company's core operating results and believes that this is a better measure of our operating performance as it is based on the Company's tangible assets and capital. Further we believe that by excluding the impact of purchase accounting adjustments it allows for a meaningful comparison with the Company's peers; particularly those that may not have acquired other companies. Lastly, the exclusion of goodwill and other intangible assets is consistent with the treatment by bank regulatory agencies from the calculation of risk-based capital ratios, which excludes these amounts. However, these non-GAAP financial measures are supplemental and are not a substitute for an analysis based on GAAP measures. A reconciliation of return on average assets and equity to the return on average tangible assets and equity, is set forth below.

| For Quarter Ended: | March 31, 2011 | March 31, 2010 |
|--|-----------------------|-----------------------|
| Return on Average Assets (GAAP basis) | 1.03% | 1.12% |
| Effect of excluding average intangible assets and related amortization, net of tax | 0.02% | 0.03% |
| Return on Average Tangible Assets | 1.05% | 1.15% |
| Return on Average Equity (GAAP basis) | 9.63% | 12.18% |
| Effect of excluding average intangible assets and related amortization, net of tax | 1.52% | 2.94% |
| Return on Average Tangible Equity | 11.15% | 15.12% |

RESULTS OF OPERATIONS**Net Interest Income**

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The primary component of the Company's revenue is net interest income, which is the difference between interest income and fees on interest-earning assets and interest expense on interest-bearing liabilities. 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 (NIM) are two common statistics related to changes in net interest income. The net interest rate 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 rate spread, as these funding sources are non-interest bearing.

The Average Balances and Interest Rates table presents net interest income on a fully taxable equivalent basis, net interest rate spread and net interest margin for the quarters ended March 31, 2011 and 2010.

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For the three months ended March 31, 2011, net interest income measured on a full tax equivalent basis, increased \$2,188,000, or 20.1%, to \$13,073,000 from \$10,885,000 in the corresponding period in 2010. The primary reason for the increase in net interest income was an increase in average earning assets from \$1,142,675,000 for the first three months of 2010 to \$1,419,720,000 in 2011. Offsetting the growth in average interest earning assets was a decline in net interest margin by 8 basis points (b. p.), from 3.76% in 2010 to 3.68% for 2011. The net interest spread for the three months ending March 31, 2011 was 3.59%, compared to 3.64% for the same period in 2010. The net interest spread has been steadily increasing from 3.48% earned in the third quarter of 2010 and 3.54% earned in the fourth quarter of 2010. Despite the fact that we became more asset sensitive during the first quarter of 2011, we were still able to increase the net interest margin from 3.60% during the fourth quarter 2010 to 3.68% during 2011's first quarter.

The largest portion of the increase in interest income was the result of interest earned on the securities portfolio, which totaled \$3,281,000 for the three months ended March 31, 2011, an increase of 55.4%, or \$1,169,000 over 2010. Quarter-over-quarter average securities increased \$196,802,000, or 86.0%. Partially offsetting the increase on securities earnings due to volume was a reduction in the interest rate earned of 3.62% in 2010 to 3.08% in 2011.

The growth in securities was funded principally through the growth in money market and time deposit accounts. Average interest bearing deposits increased \$206,850,000, or 20.1%, resulting from the Company's overall customer service model, its market position in several attractive markets, and due to the favorable rating the Bank has received from IDC Financial Publishing, Inc. (IDC), an independent bank safety rating agency which uses its unique rankings of financial ratios to determine the quality ratings of financial institutions. This strong rating facilitates the Company's ability to attract time deposits and brokered deposits. Average balance of time deposits of \$599,833,000 for the quarter ended March 31, 2011 exceeded 2010's average balance of \$441,121,000 by 36.0%, however, interest expense only increased \$86,000, or 4.4%. The Company recognizes that brokered funds are more volatile funding source than core deposits. However, given the current interest rate environment and the steepness of the interest rate curve, the Company elected to collect these funds and earn a spread on them in order to enhance net interest income. Given the increased volatility in brokered deposits, the Company invested a large portion of these amounts in mortgage backed securities, which provide a regular stream of monthly cash flows, which can be used to meet the maturity needs of time and brokered deposits. We have matched cash flows from the debt securities portfolio with nontraditional cash flows to enable us to unwind the strategy if loan demand continues to increase or if the yield curve flattens.

Interest income earned on loans increased from \$12,026,000 for the quarter ended March 31, 2010 to \$12,705,000 in 2011, a 5.7% increase. The growth in the loan portfolio was the primary reason for the increase in net interest income. Quarter-over-quarter, average loans increased \$86,077,000, or 9.7%, from the quarter ended March 31, 2010 to March 31, 2011. The increase in average loans is the result of the Company's desire to continue to grow its loan portfolio and deploy its capital. This growth has come principally in some of the Company's less mature markets, in which we have hired additional lending officers, which has increased opportunities in these markets served. The growth experienced in the loan portfolio in the second half of 2010, supplemented with the loan demand in the first quarter of 2011, provided the strong growth in average loan balances. Due to the variable nature of a large portion of the loan portfolio, along with the implementation of floors as loans renewed, the decline in average rate earned on loans was not as severe as the securities portfolio or that paid on longer term borrowings. Additionally, the Company continued to utilize \$30,000,000 in notional amount of interest rate swaps which serve as a hedge against variable rate commercial loans linked to prime and converts them to a fixed rate of interest. The interest rate swaps that the Company had outstanding during 2011 yielded \$133,000, which was credited and included as commercial loan interest income. As part of the Company's asset/liability management, one swap with a notional amount of \$10,000,000 was settled at the end of the first quarter in 2011, and a \$118,000 gain was recognized. This swap was settled in an effort to increase our asset sensitivity in the event of rising rates. The rate earned on loans was 5.22%, or 16 b.p. less than 2010, and partially offset the increase in interest income that resulted from higher average balances.

As a result of the increase in its deposit base, the Company has placed less reliance on more costly long-term borrowings. Interest expense on long-term debt has decreased \$153,000 from \$442,000 for the quarter ended March 31, 2010 to \$289,000 in the corresponding quarter in 2011. Reduction in average daily balance of \$3,269,000 for 2011 compared to 2010 and the lower rate paid of 2.32% in 2011 compared to 3.32% in 2010 resulted in reduced interest expense.

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The Company's net interest spread and net interest margin have declined by 5 b.p. and 8 b.p. in the quarter ended March 31, 2011 compared to 2010. Given the continued low interest rate, reduced rates earned on interest earning assets outpaced the reduction in rates that we could pass on to our customers, and resulted in the lower interest rate spread and margin. The net interest spread was 3.59% and net interest margin was 3.68% in the first quarter of 2011.

The table that follows shows average balances and interest yields on a fully taxable equivalent basis (FTE):

Average Balances and Interest Rates

| <i>(Dollars in thousands)</i> | March 31, 2011 | | | Three Months Ended | | March 31, 2010 | |
|---|---------------------|-------------------------|---------------------|---------------------|-------------------------|---------------------|--|
| | Average Balance | Tax Equivalent Interest | Tax Equivalent Rate | Average Balance | Tax Equivalent Interest | Tax Equivalent Rate | |
| Assets | | | | | | | |
| Federal funds sold & interest bearing bank balances | \$ 17,877 | \$ 24 | 0.54 % | \$ 23,711 | \$ 30 | 0.51 % | |
| Securities | 425,701 | 3,281 | 3.08 | 228,899 | 2,112 | 3.62 | |
| Loans | 976,142 | 12,705 | 5.22 | 890,065 | 12,026 | 5.38 | |
| Total interest-earning assets | 1,419,720 | 16,010 | 4.52 | 1,142,675 | 14,168 | 4.92 | |
| Other assets | 92,215 | | | 93,616 | | | |
| Total | \$ 1,511,935 | | | \$ 1,236,291 | | | |
| Liabilities and Shareholders Equity | | | | | | | |
| Interest bearing demand deposits | \$ 420,235 | \$ 449 | 0.43 | \$ 350,336 | \$ 681 | 0.79 | |
| Savings deposits | 67,643 | 38 | 0.23 | 60,459 | 47 | 0.30 | |
| Time deposits | 599,833 | 2,038 | 1.32 | 441,121 | 1,952 | 1.78 | |
| Short term borrowings | 96,162 | 123 | 0.52 | 121,838 | 164 | 0.55 | |
| Long term debt | 50,027 | 289 | 2.32 | 53,296 | 442 | 3.32 | |
| Total interest bearing liabilities | 1,233,900 | 2,937 | 0.93 | 1,027,050 | 3,286 | 1.28 | |
| Non-interest bearing Demand deposits | 107,119 | | | 88,328 | | | |
| Other | 9,849 | | | 7,523 | | | |
| Total Liabilities | 1,350,868 | | | 1,122,901 | | | |
| Shareholders Equity | 161,067 | | | 113,390 | | | |
| Total | \$ 1,511,935 | | 0.84 % | \$ 1,236,291 | | 1.16 % | |
| Net interest income (FTE)/ net interest spread | | 13,073 | 3.59 % | | \$ 10,885 | 3.64 % | |
| Net interest margin | | | 3.68 % | | | 3.76 % | |
| Tax-equivalent adjustment | | (685) | | | (388) | | |
| Net interest income | | \$ 12,388 | | | \$ 10,497 | | |

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NOTES: Yields and interest income on tax-exempt assets have been computed on a fully taxable equivalent basis assuming a 35% tax rate. For yield calculation purposes, nonaccruing loans are included in the average loan balance.

Other Income

Noninterest income increased to \$5,076,000 for the three months ended March 31, 2011, as compared to \$4,347,000 in the same prior year period. Noninterest income generation increased across all business lines including Orrstown Financial Advisors, mortgage originations and retail fees generated from deposit accounts. These business lines have been able to capitalize on favorable market conditions, which include:

Service charges on deposit accounts increased 3.2%, from \$1,439,000 for the three months ended March 31, 2010 to \$1,485,000 in 2011. The increase was principally the result of increased revenues earned on debit cards, partially offset by a decline in overdraft charges to depositors in the period.

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An increase in trust department and brokerage income of \$283,000, or 25.0% for the three months ended March 31, 2011 compared to 2010, the result of increases in trust and brokerage activity as the stock market has started to show signs of recovery, and additional trust assets under management, which increased from \$854,327,000 at March 31, 2010 to \$977,819,000 at March 31, 2011.

The continued low interest rate environment and additional mortgage originators have led to an increase in new mortgage loan applications as well as refinancing activities. Given these low interest rates, the Company generally sells its 30-year conforming mortgage loans to investors. Mortgage banking activities increased \$335,000 from \$361,000 for the three months ended March 31, 2010 to \$696,000 for three months ended March 31, 2011.

The Company continues to see an increase in its deposit accounts and other customer related services, which has resulted in an increase in service charges. Service charges on deposit accounts totaled \$1,485,000 for the quarter ended March 31, 2011, an increase of \$46,000, or 3.2%, over \$1,439,000 for the quarter ended March 31, 2010.

Earnings on life insurance increased \$168,000 from \$162,000 for the three months ended March 31, 2010 compared to \$330,000 for the three months ended March 31, 2011. The increase was principally the result of higher average balances of bank owned life insurance during 2011 than in 2010 and enhanced earnings on the investments.

The Company continued to yield gains on securities available for sale when it was strategically determined that the gains afforded on certain securities was more beneficial than the interest rate earned. Securities gains totaled \$379,000 for the first quarter of 2011 compared to \$398,000 for the first quarter of 2010.

The Company continues to advertise and market itself in order for consumers to recognize the broad range of financial services and products the Company has to offer, and to increase its brand recognition. Through the use of enhanced technology, the Company expects it will be able to reach a broader market which will allow it to continue to grow its customer base.

Provision for Loan Losses

The provision for loan losses increased to \$3,195,000 for the three months ended March 31, 2011, as compared to \$1,420,000 for the corresponding prior year period. See further discussion in the [Allowance for Loan Losses](#) section.

Other Expenses

As a result of the growth the Company has experienced, noninterest expenses rose from \$8,660,000 during the first quarter of 2010 to \$9,439,000 for the same period in 2011, an increase of \$779,000, or 9.0%. The following contributed to the increase in other expenses.

The largest increase was in salaries and employee benefits, which was \$4,832,000 for the three months ended March 31, 2011 compared to \$4,598,000 in 2010, a 5.1% increase. The increase was attributable to the growth in the number of staff, which grew from 269 full-time equivalents at March 31, 2010 to 284 March 31, 2011, and normal merit increases. The addition of these employees directly contributed to the revenue growth the Company experienced, as many were revenue producers. Partially offsetting the increase in salaries expense was favorable employee health benefit costs, which declined approximately \$150,000 due to favorable claims experience in the Company's medical plan.

Advertising and bank promotions increased \$78,000 for the first three months of 2011 as compared to 2010. The increase in expense is a result of commitments to the communities that the Bank serves as we continue to build relationships and expand our presence in these market areas.

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Taxes, other than income, increased from \$133,000 during the first three months of 2010 to \$205,000 in 2011, a \$72,000 increase. Pennsylvania's Bank Shares Tax Expense is based on the last six years' rolling average equity, as defined. The increase in expense was a direct result of the growth that the bank has experienced in its average shareholders' equity, principally the result of the \$18,000,000 capital infusion from the Company during 2010 and the roll-off of 2004's balance.

Collection and real estate owned expenses, included in other operating expenses, increased approximately \$119,000, from \$74,000 for the three months ended March 31, 2010 to \$193,000. The level of effort and diligence that the Company has put into its collection efforts has allowed non-performing assets to decline since its high in March 2010. These expenses have reduced the company's risk of loan losses as corrective action and work-out plans are outlined with the customers in order to protect the Company from risk of loss.

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In 2011, the write-down of low income housing projects was approximately \$95,000 higher than in 2010, due to additional projects the Bank is participating in. The expenses associated with these projects are included in other operating expenses. Although these expenses increased during the period, the Company has been able to lower its income tax expense by utilizing the credits that the low-income housing partnerships generate. See further discussion in Income Tax Expense below.

The remainder of the increase in other expenses is primarily the result of the growth experiences by the Company. In order to better understand how other expenses increased in relation to related increases 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. The Company's efficiency ratio was 52.9% for the three months ended March 31, 2011, compared to 58.0% in 2010.

Income Tax Expense

Income tax expense totaled \$1,003,000 for the three months ended March 31, 2011, a decrease of \$355,000 from 2010. A meaningful comparison of income tax expense to levels of pre-tax income is its effective tax rate, 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.

The Company's effective tax rate declined to 20.8% for the three months ended March 31, 2011 compared to 28.5% for the corresponding prior year period. The lower effective tax rate in 2011, despite higher pre-tax income, is the direct result of greater levels of tax-free income as a percentage of taxable income, combined with additional low-income housing credits that the Company can utilize.

Financial Condition

The quality of the Company's asset structure continues to be strong. A substantial amount of time is devoted by management to overseeing the investment of funds in loans and securities and the formulation of policies directed toward the profitability and minimization of risk associated with such investments.

Securities Available for Sale

The Company utilizes securities available for sale as a tool for managing interest rate risk, enhancing income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings. As of March 31, 2011, securities available for sale were \$395,792,000, a decrease of \$35,980,000 from the December 31, 2010 balance of \$431,772,000.

The decline in securities available for sale was in the U.S. Government Sponsored Enterprises bullet and mortgage-backed securities portfolios, which declined by \$24,072,000 and \$16,040,000 from December 31, 2010 to March 31, 2011. The cash flows received from principal pay downs, maturities, and sales of securities from these portfolios were used to fund loan growth, or remain federal funds sold in anticipation of future loan commitments or securities that may arise in the near future.

Loan Portfolio

The Company offers various products to meet the credit needs of our borrowers, and principally consists of commercial real estate loans, commercial and industrial loans, and retail loans consisting of loans securitized by residential properties, and to a lesser extent, installment loans. Generally speaking, the Company follows conservative lending practices and continues to carry a high quality loan portfolio with no unusual or undue concentrations of credit. No loans are extended to non domestic borrowers or governments.

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

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

The Company has various types of commercial real estate which have differing levels of credit risk associated with them. Owner-occupied commercial real estate loans are generally dependent upon the successful operation of the borrower's business, with the cash flows generated from the business being the primary source of repayment of the loan. If the business suffers a downturn in sales or profitability, the borrower's ability to repay the loan could be in jeopardy. In order to minimize this credit risk, the Company has conservative underwriting standards which include the credit worthiness of the borrower, limitation on loan amounts to 75% of the value of the property securing the loan, and strong debt service coverage ratios.

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

Acquisition and development loans consists of 1-4 family residential construction and commercial and land development loans. The risk of loss on these loans is largely dependent on the Company's ability to assess the property's value at the completion of the project, which should exceed the property's construction costs. During the construction phase, a number of factors could potentially negatively impact the collateral value, including cost overruns, delays in completing the project, competition, and real estate market conditions which may change based on the supply of similar properties in the area. In the event the collateral value at the completion of the project is not sufficient to cover the outstanding loan balance, the Company must rely upon other repayment sources, including the guarantors of the project or other collateral securing the loan. The Company attempts to mitigate credit risk through strict underwriting standards including evaluation of the credit worthiness of the borrower and their success in other projects, aggressive release fees, loan-to-value ratios not to exceed 75%, and continual monitoring of the project during its construction phase to determine the impact that overruns and delays may have on the project.

Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest rated borrowers, the majority of these loans are secured by the borrower's accounts receivable, inventory and machinery and equipment. In a majority of these loans, the collateral also includes the business real estate or the business owner's personal real estate or assets. Commercial and industrial loans present credit exposure to the Company, as they are more susceptible to risk of loss during a downturn in the economy, as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline. The Company attempts to mitigate this risk through strict underwriting standards, including evaluating the credit worthiness of the borrower and to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and meetings with the borrowers are common. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

The Company originates loans to its retail customers, including fixed-rate and adjustable first lien mortgage loans with the underlying 1-4 family owner-occupied residential property securing the credit. The Company's risk exposure is minimized in these types of loans through the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and underwriting standards which limits the loan-to-value ratio to generally no more than 80%, unless the borrower obtains private mortgage insurance.

Home equity loans, including term loans and lines of credit, present a slightly higher risk to the Company than 1-4 family first liens, as these loans can be first or second liens on 1-4 family owner occupied residential property, but can have loan-to-value ratios of no greater than 90% of the value of the real estate taken as collateral. The credit worthiness of the borrower is considered including credit scores and debt-to-income ratios, which generally cannot exceed 38%.

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Installment and other loans credit risk are mitigated through conservative underwriting standards, including the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and if secured, the collateral value of the assets. As these loans can be unsecured or secured by assets the value of which may depreciate quickly or may fluctuate, they present a greater risk to the Company than 1-4 family residential loans.

The loan portfolio, excluding residential loans held for sale, broken out by classes as of March 31, 2011 and December 31, 2010 is as follows:

| | March 31, 2011 | December 31, 2010 |
|-------------------------------------|-------------------|----------------------|
| <i>(Dollars in thousands)</i> | | |
| Commercial real estate: | | |
| Owner-occupied | \$ 181,468 | \$ 172,000 |
| Non-owner occupied | 133,338 | 143,372 |
| Multi-family | 27,860 | 24,649 |
| Acquisition and development: | | |
| 1-4 family residential construction | 15,546 | 29,297 |
| Commercial and land development | 95,528 | 88,105 |
| Commercial and industrial | 285,277 | 263,943 |
| Residential mortgage: | | |
| First lien | 123,158 | 119,450 |
| Home equity - term | 40,008 | 40,818 |
| Home equity - Lines of credit | 71,476 | 71,547 |
| Installment and other loans | 11,308 | 11,112 |
| | \$ 984,967 | \$ 964,293 |

The loan portfolio at March 31, 2011 has grown 2.2% from December 31, 2010, from \$964,293,000 to \$984,967,000. Commercial and industrial loans have experienced the most growth, increasing from \$263,943,000 at December 31, 2010 to \$285,277,000 at March 31, 2011, an 8.1% increase. Owner occupied commercial real estate also grew, from \$172,000,000 at December 31, 2010 to \$181,468,000 at March 31, 2011, a 5.5% increase. Several experienced lenders have joined the Company in the past two years, which has led to additional opportunities in some of the Company's emerging markets.

Non-owner occupied commercial real estate declined \$10,034,000 to \$133,338,000 at March 31, 2011. This decrease was principally the result of two motels that paid off during the quarter. A decline was also noted in 1-4 family residential construction loans which decreased \$13,751,000 from December 31, 2010 to March 31, 2011. However, a large portion of this movement in 1-4 family construction was the result of an approximate \$9,000,000 townhouse development in which the construction phase ended and the loan moved to permanent financing, and is now included in the commercial category. Management intends to retain some shorter-lived 1-4 residential mortgages, generally with maturities of 10-20 years, to help diversify its loan portfolio, and as these mortgages earn more attractive rates than alternative investments, including federal funds sold and securities available for sale. Longer termed residential mortgage loans continue to be sold on the secondary market, as they present greater interest rate risk. The Company continues to experience paydowns on its first lien residential mortgages, with the principal reductions offsetting the increases noted from the permanent financing of the townhomes and the growth in the 10-20 year mortgages.

Asset Quality**Risk Elements**

The Company's loan portfolios are subject to varying degrees of credit risk. Credit risk is mitigated through conservative 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.

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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 a risk asset. For all loan classes, the accrual of interest income on loans, including impaired loans, 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, has performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contract terms of the loan for all loan classes.

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 or a temporary reduction in interest 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 March 31, 2011 and December 31, 2010. Relevant asset quality ratios are also presented.

| <i>(Dollars in Thousands)</i> | March 31, 2011 | December 31, 2010 | March 31, 2010 |
|---|-----------------------|--------------------------|-----------------------|
| Loans on nonaccrual (cash) basis | \$ 13,106 | \$ 13,896 | \$ 23,020 |
| Loans whose terms have been renegotiated | 1,177 | 1,180 | 0 |
| Total nonperforming loans | 14,283 | 15,076 | 23,020 |
| Other real estate owned (OREO) | 847 | 1,112 | 873 |
| Total nonperforming assets | 15,130 | 16,188 | 23,893 |
| Loans past due 90 or more days and still accruing | 3,687 | 2,248 | 8,929 |
| Total nonperforming and other risk assets | \$ 18,817 | \$ 18,436 | \$ 32,822 |
| Ratio of total nonperforming loans to loans | 1.45% | 1.56% | 2.56% |
| Ratio of total nonperforming assets to assets | 1.00% | 1.07% | 1.82% |
| Ratio of total nonperforming assets to total loans and OREO | 1.53% | 1.67% | 2.66% |
| Ratio of total risk assets to total loans and OREO | 1.91% | 1.90% | 3.65% |
| Ratio of total risk assets to total assets | 1.24% | 1.22% | 2.49% |
| Allowance for loan losses to nonperforming loans | 129% | 106% | 52% |

During the first quarter of 2010, the Company experienced deterioration in its nonperforming assets and loans greater than 90 days past due still accruing. These problem assets peaked at March 31, 2010, and throughout the remainder of 2010 the Company was able to work its way through a number of these assets, which included foreclosures, pay-downs received from the customers and write-downs. At December 31, 2010, nonperforming assets were \$16,188,000 and total nonperforming and loans greater than 90 days past due still accruing totaled \$18,436,000.

In 2011, the Company was able to dispose of several properties it acquired through foreclosure, one \$964,000 nonaccruing loan was eliminated after the underlying collateral was sold to a third party, and a \$500,000 charge was made to the allowance for loan losses. These actions reduced the Company's nonperforming assets from \$16,188,000 at year-end to \$15,130,000 at March 31, 2011, a 6.5% decline. Loans past due, 90 or more days, and still accruing increased from \$2,248,000 at December 31, 2010 to \$3,687,000 at March 31, 2011. Loans in this category are believed by management to be well secured and are in the process of collection.

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A further breakdown of nonaccrual loans, loans past due 90 days or more still accruing, and other delinquency information as of March 31, 2011 and December 31, 2010 is as follows:

| | Days Past Due | | | | Total Past Due | Non- Accrual | Total Loans |
|-------------------------------------|---------------|----------|----------|-------------------------|-------------------|-----------------|----------------|
| | Current | 30-59 | 60-89 | 90+ (still accruing) | | | |
| March 31, 2011: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner-occupied | \$ 178,910 | \$ 1,331 | \$ 74 | \$ - | \$ 1,405 | \$ 1,153 | \$ 181,468 |
| Non-owner occupied | 130,844 | 1,395 | - | - | 1,395 | 1,099 | 133,338 |
| Multi-family | 27,663 | 197 | - | - | 197 | - | 27,860 |
| Acquisition and development: | | | | | | | |
| 1-4 family residential construction | 15,503 | 43 | - | - | 43 | - | 15,546 |
| Commercial and land development | 89,688 | 542 | 4,568 | 637 | 5,747 | 93 | 95,528 |
| Commercial and industrial | 270,346 | 3,276 | 132 | 928 | 4,336 | 10,595 | 285,277 |
| Residential mortgage: | | | | | | | |
| First lien | 119,026 | 2,006 | 146 | 1,842 | 3,994 | 138 | 123,158 |
| Home equity - term | 39,561 | 186 | 85 | 151 | 422 | 25 | 40,008 |
| Home equity - Lines of credit | 71,213 | 134 | - | 129 | 263 | - | 71,476 |
| Installment and other loans | 11,148 | 147 | 10 | - | 157 | 3 | 11,308 |
| | \$ 953,902 | \$ 9,257 | \$ 5,015 | \$ 3,687 | \$ 17,959 | \$ 13,106 | \$ 984,967 |
| December 31, 2010: | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner-occupied | \$ 169,030 | \$ 986 | \$ 832 | \$ 466 | \$ 2,284 | \$ 686 | \$ 172,000 |
| Non-owner occupied | 141,095 | 213 | - | - | 213 | 2,064 | 143,372 |
| Multi-family | 24,559 | - | - | - | - | 90 | 24,649 |
| Acquisition and development: | | | | | | | |
| 1-4 family residential construction | 29,297 | - | - | - | - | - | 29,297 |
| Commercial and land development | 87,995 | 1 | 16 | - | 17 | 93 | 88,105 |
| Commercial and industrial | 252,144 | 287 | 466 | 420 | 1,174 | 10,625 | 263,943 |
| Residential mortgage: | | | | | | | |
| First lien | 116,182 | 1,359 | 535 | 1,095 | 2,989 | 279 | 119,450 |
| Home equity - term | 40,503 | 161 | 62 | 75 | 298 | 17 | 40,818 |
| Home equity - Lines of credit | 71,215 | 60 | 89 | 142 | 291 | 41 | 71,547 |
| Installment and other loans | 10,793 | 251 | 17 | 50 | 318 | 1 | 11,112 |
| | \$ 942,813 | \$ 3,318 | \$ 2,017 | \$ 2,248 | \$ 7,584 | \$ 13,896 | \$ 964,293 |

Past due loans increased from \$7,584,000 at December 31, 2010 to \$17,959,000 at March 31, 2011, an increase of \$10,375,000. Of this increase, \$4,568,000 which is included in the 60-89 days past due category pertained to one relationship, in which the borrower is currently experiencing financial difficulties, limiting its cash flows available to fund its real estate ventures. The Company is currently working with the borrower to rectify the delinquency and feels the collateral securing the loans mitigates the Company's risk of loss. If the delinquency is not cured, the loan

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could be considered impaired in future periods. The increase in the 30-59 days past due category is across the different loan segments, and different borrowers within those classes.

As of March 31, 2011, the Company has 10 commercial relationships that are included in the nonaccrual loan balance of \$13,106,000. The largest of these relationships has total outstanding loan balances of \$8,598,000, consisting of advances under a line of credit to a company that finances interim construction financing for mortgages, residential manufactured, modular and site-built homes. As a result of the downturn in the housing market, the company experienced financial difficulties and declared bankruptcy in the first quarter of 2010. The Company is in the process of pursuing a recovery of the amounts owed to it in the Bankruptcy Court proceedings as well as through other avenues of recovery that may be available to it, including, without limitation, the guarantees provided by the principals and other potential claims against third parties.

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A second relationship in nonaccrual status at March 31, 2011, with an outstanding loan balance of \$1,258,000, is to a professional service firm that provides services in the construction industry. Again, as result of the downturn in the economy, this firm has experienced financial difficulties and has not been able to meet their debt service requirements, resulting in the loan being placed in nonaccrual status. The Bank is in process of working out this relationship with the borrower, and will pursue recovery methods. The loan is secured by the commercial real estate, personal residences of the guarantors and UCC filings on the Company's assets.

A third relationship at March 31, 2011 included in the nonaccrual balance consists of a mixed use building, consisting of residential apartments and commercial retail space that has had difficulties in securing leases from tenants that will enable it to meet its debt service requirements. The Bank is working with the borrower through the lease up period, in order to allow sufficient time to increase the building's occupancy. This loan is secured by the commercial real estate property and has a loan balance at March 31, 2011 of \$1,100,000.

A fourth relationship consists of a loan collateralized by several parcels of farm land and one parcel that was acquired for development. The Company is in the process of legal actions against the borrower, including foreclosure proceedings. The loan has a balance of \$875,000 at March 31, 2011, and the Company feels it is adequately secured as the loan has a low loan-to-value ratio.

No other loan in nonaccrual status at March 31, 2011 has a balance in excess of \$500,000.

The Company believes through the combination of the collateral securing the loans and the reserves allocated for these four nonaccrual loans totaling \$4,094,000, with the first relationship comprising three-fourths of this reserve allocation, it has provided for the potential losses that it may incur on these relationships as of March 31, 2011. However, as additional time passes on these relationships, additional information may become known that could result in additional reserve allocations, or, alternatively, it may be deemed that the reserve allocations exceed that which is needed.

In 2010, the Company restructured two residential mortgages in order to assist the borrowers who were experiencing financial difficulties. The restructured loans resulted in concessions that the Bank made in interest rates for a short (less than twelve months) period of the remaining amortization schedule, and resulted in a reduction of the discounted cash flows of the loans, based on the original loans' interest rate, of approximately \$20,000.

Credit Risk Management

Allowance for Loan Losses

Historically, the Company has had an enviable record regarding its control of loan losses, but lending is a banking service that inherently contains elements of risk. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

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

The Company maintains the allowance for loan losses at a level believed adequate by management to absorb losses inherent in the portfolio. It is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the allowance for loan losses utilizing a defined methodology, which considers specific credit evaluation of impaired loans as discussed above, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC 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.

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In order to monitor ongoing risk associated with its loan portfolio and specific credits within the segments, management uses an eight point internal grading system. The first four rating categories, representing the lowest risk to the Bank, are combined and given a Pass rating. 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 criticized rating. Management generally follows regulatory definitions in assigning criticized ratings to loans, including substandard, doubtful or loss. 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 reduce and control risk in the lending function. The Credit Administration Committee, comprised of members of the Board, is charged with the overall credit quality and risk exposure of the Company'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 internal, 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.

The Loan Review department performs annual reviews of all commercial relationships with a committed loan balance in excess of \$750,000, with ratification of the rating from the Board of Directors' Credit Administration Committee for loans between \$750,000 - \$1,000,000. Loans reviewed in excess of \$1,000,000 are presented to the Credit Administration Committee with a formal review and rating. All relationships rated Substandard, Doubtful or Loss are reviewed by the Credit Administration Committee on a quarterly basis, including reaffirmation of the rating, review of detailed collateral analysis and the development of an action plan.

The following summarizes the Bank's ratings based on its internal risk rating system as of March 31, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | Pass | Special Mention | Non-Impaired Substandard | Impaired - Substandard | Doubtful | Total |
|-------------------------------------|------------|--------------------|-----------------------------|---------------------------|----------|------------|
| March 31, 2011: | | | | | | |
| Commercial real estate: | | | | | | |
| Owner-occupied | \$ 163,446 | \$ 6,769 | \$ 10,101 | \$ 466 | \$ 686 | \$ 181,468 |
| Non-owner occupied | 110,105 | 7,985 | 14,149 | 1,099 | 0 | 133,338 |
| Multi-family | 20,955 | 535 | 6,370 | 0 | - | 27,860 |
| Acquisition and development: | | | | | | |
| 1-4 family residential construction | 14,671 | 600 | 275 | 0 | 0 | 15,546 |
| Commercial and land development | 71,878 | 7,532 | 16,118 | 0 | 0 | 95,528 |
| Commercial and industrial | 220,138 | 27,643 | 26,660 | 9,827 | 1,009 | 285,277 |
| Residential mortgage: | | | | | | |
| First lien | 120,673 | 0 | 2,018 | 467 | 0 | 123,158 |
| Home equity - term | 39,214 | 0 | 84 | 710 | 0 | 40,008 |
| Home equity - Lines of credit | 71,152 | 0 | 324 | 0 | 0 | 71,476 |
| Installment and other loans | 11,255 | 0 | 53 | 0 | 0 | 11,308 |
| | \$ 843,487 | \$ 51,064 | \$ 76,152 | \$ 12,569 | \$ 1,695 | \$ 984,967 |

December 31, 2010:

| | | | | | | |
|-------------------------------------|------------|----------|----------|-------|--------|------------|
| Commercial real estate: | | | | | | |
| Owner-occupied | \$ 162,968 | \$ 2,035 | \$ 6,311 | 0 | \$ 686 | \$ 172,000 |
| Non-owner occupied | 120,633 | 4,274 | 15,495 | 2,970 | 0 | 143,372 |
| Multi-family | 20,030 | 676 | 3,853 | 0 | 90 | 24,649 |
| Acquisition and development: | | | | | | |
| 1-4 family residential construction | 24,199 | 2,297 | 2,801 | 0 | 0 | 29,297 |
| Commercial and land development | 79,391 | 2,487 | 6,134 | 93 | 0 | 88,105 |
| Commercial and industrial | 221,111 | 17,062 | 14,992 | 9,770 | 1,008 | 263,943 |

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| Residential mortgage: | | | | | | |
|-------------------------------|------------|-----------|-----------|-----------|----------|------------|
| First lien | 117,607 | 0 | 1,373 | 470 | 0 | 119,450 |
| Home equity - term | 39,279 | 0 | 828 | 711 | 0 | 40,818 |
| Home equity - Lines of credit | 71,364 | 0 | 183 | 0 | 0 | 71,547 |
| Installment and other loans | 11,062 | 0 | 50 | 0 | 0 | 11,112 |
| | \$ 867,644 | \$ 28,831 | \$ 52,020 | \$ 14,014 | \$ 1,784 | \$ 964,293 |

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Classified loans may also be evaluated for impairment. For commercial real estate, acquisition and development and commercial and industrial loans, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Generally, loans that are more than 90 days past due are assigned a Substandard rating. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Nonaccrual loans in the commercial and commercial real estate portfolios are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates on fair values are obtained, which may include updated appraisals. The updated fair values will be incorporated into the impairment analysis as of the next reporting period. In the event an updated appraisal that requires a higher impairment reserve is received after a reporting period, but prior to the issuance of the financial statements, an evaluation is made as to the significance of the difference and whether the amounts need to be reflected in the financial statements not yet issued.

Loan charge-offs, which may include, from time-to-time, a partial charge-off, are taken on an impaired loan that is collateral dependent if the loan's carrying balance exceeds its collateral's appraised value, the loan has been identified as uncollectible, and it is deemed to be a confirmed loss. Typically, impaired loans with a charge-off or partial charge-off will continue to be considered impaired, unless the note is split into two, and management expects the performing note to continue to perform and is adequately secured. The second, or non-performing note, would be charged-off. As of the periods presented, the Company has no loans to borrowers that resulted from splitting impaired loans into multiple notes. Further, an impaired loan with a partial charge-off may continue to have an impairment reserve on it after the partial charge-off, if factors warrant.

As of March 31, 2011 and December 31, nearly all of the Company's impaired loans' extent of impairment was measured based on the estimated fair value of the collateral securing the credit. For real estate loans, collateral generally consists of commercial real estate, but in the case of commercial and industrial loans, it would also consist of accounts receivable, inventory, equipment or other business assets. Commercial and industrial loans may also have real estate collateral.

At the time a real-estate secured loan is deemed impaired, management determines whether an updated certified appraisal of the real estate is necessary to assist in determining the extent of an impairment reserve, if any. The decision for requiring an updated appraisal takes into consideration the age of the most recent appraisal, the loan-to-value ratio based on the original certified appraisal, the Company's recent experience and knowledge of market conditions, recent list prices or broker opinions, the condition of the property, and environmental factors. If market conditions have changed significantly from the date of the most recent appraisal, an updated appraisal will be obtained. The appraiser's value provided in the appraisal is often used as the fair value of the collateral in determining impairment, unless circumstances, such as subsequent improvements, approvals, or other circumstances dictate that another value provided by the appraiser is more appropriate.

As of March 31, 2011, approximately 91% of impaired loans secured by real estate were measured at fair value using certified real estate appraisals that had been completed within the last year. Appraised values are further discounted for estimated costs to sell the property and other selling considerations to arrive at the properties' fair value.

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In those situations in which it is determined an updated appraisal is not required for loans individually evaluated for impairment, fair values are based on one or a combination of the following approaches. In those situations in which a combination of approaches is considered, the factor that carries the most consideration will be the one management believes is warranted. The approaches are as follows:

Original appraisal – if the original appraisal provides a strong loan-to-value (generally 80% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the loan review staff that there has not been a significant deterioration in the collateral value, the original certified appraised value will be used. Discounts as deemed appropriate for selling costs are factored into the appraised value in arriving at fair value.

Discounted cash flows – In limited cases, discounted cash flows may be used on projects in which the collateral is liquidated to reduce the borrowings outstanding, and is used to validate collateral values derived from other approaches.

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

In the fourth quarter of 2010, the Company began to distinguish Substandard loans on both an impaired and non-impaired basis, as it placed less emphasis on a loan's classification, and increased reliance on whether the loan was performing in accordance with the contractual terms.

Substandard classification does not automatically meet the definition of impaired. A substandard credit is one that is inadequately protected by current sound worth, paying capacity of the obligor or the collateral pledged, if any. Extensions of credit so classified have well-defined weaknesses which may jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard. As a result, the Company revised its methodology in its evaluation of certain accruing commercial real estate, acquisition and development and commercial and industrial loans rated substandard collectively for impairment as opposed to evaluating these loans individually for impairment. Although we believe these loans have well defined weaknesses and meet the definition of substandard, they are generally performing and management has concluded that it is likely it will be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Approximately \$53,201,000 of loans that were in previous years evaluated individually for impairment were collectively evaluated for impairment at December 31, 2010, resulting in an additional allowance for loan losses allocation of \$3,710,000.

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

The following summarizes impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required as of March 31, 2011 and December 31, 2010:

| | Impaired Loans with a Specific Allowance | | | | Impaired Loans with No Specific Allowance | | |
|-------------------------------|--|--|----------------------|---|---|--|---|
| | Recorded Investment Book Balance) | Unpaid Principal Balance (Legal Balance) | Related Allowance | Interest income Recognized on Cash Basis | Recorded Investment Book Balance) | Unpaid Principal Balance (Legal Balance) | Interest income Recognized on Cash Basis |
| <i>(Dollars in thousands)</i> | | | | | | | |
| March 31, 2011 | | | | | | | |
| Commercial real estate: | | | | | | | |
| Owner-occupied | \$ 1,153 | \$ 1,153 | \$ 196 | \$ 1 | \$ - | \$ - | \$ 0 |
| Non-owner occupied | 1,099 | 1,101 | 548 | - | - | - | - |
| Multi-family | - | - | - | - | - | - | - |
| Commercial and industrial | 9,715 | 10,306 | 3,522 | 0 | 968 | 968 | 1 |
| Residential mortgage: | | | | | | | |

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| | | | | | | | |
|--------------------|-----------|-----------|----------|-------|--------|--------|------|
| First lien | 467 | 467 | 4 | 4 | 0 | 0 | 0 |
| Home equity - term | 710 | 710 | 5 | 8 | 0 | 0 | 0 |
| | \$ 13,144 | \$ 13,737 | \$ 4,275 | \$ 13 | \$ 968 | \$ 968 | \$ 1 |

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December 31, 2010

| | | | | | | | |
|---------------------------|-----------|-----------|----------|-------|----------|----------|------|
| Commercial real estate: | | | | | | | |
| Owner-occupied | \$ 686 | \$ 687 | \$ 181 | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Non-owner occupied | 2,064 | 2,065 | 980 | 0 | 0 | 0 | 0 |
| Multi-family | 90 | 90 | 90 | 0 | 0 | 0 | 0 |
| Commercial and industrial | 9,600 | 10,191 | 3,232 | - | 1,118 | 1,118 | 6 |
| Residential mortgage: | | | | | | | |
| First lien | 470 | 470 | 12 | 32 | 0 | 0 | 0 |
| Home equity - term | 711 | 711 | 8 | 44 | 0 | 0 | 0 |
| | \$ 13,621 | \$ 14,214 | \$ 4,503 | \$ 76 | \$ 1,118 | \$ 1,118 | \$ 6 |

The following presents impaired loans that are troubled debt restructurings, as well as the number of loans modified during the three and twelve month periods, as of March 31, 2011 and December 31, 2010.

| <i>(Dollars in thousands)</i> | Troubled Debt Restructurings | | New Troubled Debt Restructurings During Current YTD Period | |
|-------------------------------|------------------------------|------------------------|---|------------------------|
| | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |
| March 31, 2011 | | | | |
| Accruing: | | | | |
| Residential mortgage: | | | | |
| First lien | 1 | \$ 467 | - | \$ - |
| Home equity - term | 1 | 710 | - | - |
| | 2 | \$ 1,177 | - | \$ - |
| December 31, 2010 | | | | |
| Accruing: | | | | |
| Residential mortgage: | | | | |
| First lien | 1 | \$ 470 | 1 | \$ 470 |
| Home equity - term | 1 | 711 | 1 | 711 |
| | 2 | \$ 1,181 | 2 | \$ 1,181 |

Potential problem loans are defined as performing loans, which have characteristics that cause management to have serious doubts 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.

Management further monitors the performance and credit quality of the loan portfolio by analyzing the length of time a portfolio is past due, by aggregating loans based on its delinquencies. For each loan class presented in the delinquency table previously presented, general allowances are provided for loans that are collectively evaluated for impairment, which is based on quantitative factors, principally historical loss trends for the respective loan class, adjusted for qualitative factors. As of December 31, 2010, the historical loss factor was based on average charge-offs for the last 8 quarters (e.g. January 1, 2009 – December 31, 2010), whereas prior to December 31, 2010, the historical loss factor was based on an equally weighted rolling 12 quarters. Effective December 31, 2010, for loans rated special mention and substandard not deemed impaired, a weighted average rolling 8 quarters average charge-off percentage on the related graded loan type, with a two-third weight to the most recent four quarters, and a one-third weight for the furthest four quarters was utilized. For non-rated loans evaluated collectively for impairment, the charge-off factor for the last 8 quarters is factored into the reserve allocation. The refinement to the methodology was made as management determined that the most recent eight quarters, and in particular, the most recent four quarters for rated loans, is a better reflection of the losses inherent in the loan portfolio at December 31, 2010. Additional reserve allocations of approximately \$730,000 resulted due to the change to the most recent 8 quarter history, which management believes is a better reflection of losses inherent in the portfolio based on recent loss history. In making this determination, management considered current economic and real estate conditions, trends in historical charge-off percentages at the Company as well as peers, and feedback from regulators.

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In addition to the quantitative analysis, additional reserves are allocated on loans collectively evaluated for impairment based on additional qualitative factors. The qualitative factors used by management to adjust the historical loss percentage to the anticipated loss allocation, which range from 0 to 10 bp per factor, include:

National and local economic trends (five factors) Ratios and factors considered include trends in the consumer price index (CPI); unemployment rates; housing price index; housing starts compared to the prior year; and bankruptcy rates.

Credit quality trends (four factors) Ratios and factors considered include trends in delinquency ratios; 90 days plus and nonaccrual loans; average net loan losses to loans outstanding; and classified loans to total loans.

Underwriting policies (three factors) Factors considered including the number of exceptions to loan policy; supervisory loan to value exceptions; and the instances of repeat criticisms of ratings.

Experience, ability and depth of lending and loan review staff (four factors) Factors considered include the years experience of the lending and loan review staff; turnover of the staff; instances of loan grade migration; and the penetration of loans reviewed.

Other (two factors) Other factors considered include concentrations of credit from loan type or shifts in industry or geographic region.

A summary of the activity in the allowance for loan losses for the three months ended March 31, 2011 is as follows:

| <i>(Dollars in thousands)</i> | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Residential Mortgage | Installment and Other | Unallocated | Total |
|-------------------------------|------------------------|-----------------------------|---------------------------|----------------------|-----------------------|-------------|-----------|
| Balance, beginning of period | \$ 5,324 | \$ 1,767 | \$ 6,795 | \$ 1,863 | \$ 106 | \$ 165 | \$ 16,020 |
| Provision for loan losses | 272 | 1,478 | 1,461 | (90) | (13) | 87 | 3,195 |
| Charge-offs | (712) | - | (44) | (61) | (7) | - | (824) |
| Recoveries | - | - | - | - | 7 | - | 7 |
| Balance, end of period | \$ 4,884 | \$ 3,245 | \$ 8,212 | \$ 1,712 | \$ 93 | \$ 252 | \$ 18,398 |

A summary of the activity in the allowance for loan losses for the three months ended March 31, 2010 is as follows:

| <i>(Dollars in thousands)</i> | Total |
|-------------------------------|-----------|
| Balance, beginning of period | \$ 11,067 |
| Provision for loan losses | 1,420 |
| Charge-offs | (485) |
| Recoveries | 18 |
| Balance, end of period | \$ 12,020 |

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The following summarizes the ending loan balances individually and collectively evaluated for impairment based upon loan segment, as well as the related allowance for loan losses allocation at March 31, 2011 and December 31, 2010:

| <i>(Dollars in thousands)</i> | Commercial Real Estate | Acquisition and Development | Commercial and Industrial | Residential Mortgage | Installment and Other | Unallocated | Total |
|---|---------------------------|--------------------------------|------------------------------|-------------------------|--------------------------|-------------|------------|
| March 31, 2011 | | | | | | | |
| Loans allocated by: | | | | | | | |
| Individually evaluated for impairment | \$ 2,252 | \$ - | \$ 10,683 | \$ 1,177 | \$ - | \$ - | \$ 14,112 |
| Collectively evaluated for impairment | 340,414 | 111,074 | 274,594 | 233,465 | 11,308 | - | 970,855 |
| | \$ 342,666 | \$ 111,074 | \$ 285,277 | \$ 234,642 | \$ 11,308 | \$ - | \$ 984,967 |
| Allowance for loan losses allocated by: | | | | | | | |
| Individually evaluated for impairment | \$ 744 | \$ - | \$ 3,522 | \$ 9 | \$ - | \$ - | \$ 4,275 |
| Collectively evaluated for impairment | 4,140 | 3,245 | 4,690 | 1,703 | 93 | 252 | 14,123 |
| | \$ 4,884 | \$ 3,245 | \$ 8,212 | \$ 1,712 | \$ 93 | \$ 252 | \$ 18,398 |
| December 31, 2010 | | | | | | | |
| Loans allocated by: | | | | | | | |
| Individually evaluated for impairment | \$ 2,840 | \$ - | \$ 10,718 | \$ 1,181 | \$ - | \$ - | \$ 14,739 |
| Collectively evaluated for impairment | 337,181 | 117,402 | 253,225 | 230,634 | 11,112 | - | 949,554 |
| | \$ 340,021 | \$ 117,402 | \$ 263,943 | \$ 231,815 | \$ 11,112 | \$ - | \$ 964,293 |
| Allowance for loan losses allocated by: | | | | | | | |
| Individually evaluated for impairment | \$ 1,251 | \$ - | \$ 3,232 | \$ 20 | \$ - | \$ - | \$ 4,503 |
| Collectively evaluated for impairment | 4,073 | 1,767 | 3,563 | 1,843 | 106 | 165 | 11,517 |
| | \$ 5,324 | \$ 1,767 | \$ 6,795 | \$ 1,863 | \$ 106 | \$ 165 | \$ 16,020 |

The provision for loan losses increased to \$3,195,000 for the three months ended March 31, 2011, as compared to \$1,420,000 for the corresponding prior year period. While loan delinquencies remain below levels posted the first three quarters of 2010, the continuing tough economic conditions that plague the national and local economies create ongoing pressure even for resilient borrowers, and the Company experienced increased delinquencies since December 31, 2010 as previously presented. Our ongoing credit review process led us to conduct a thorough review of watch and special mention loans during the quarter. This process led to increased provisioning of certain commercial credits, predominantly in our southern tier, as management felt it was prudent to increase the provision for loan losses to compensate for increased delinquencies and the migration of loans to higher risk loan rating, despite improvement in the ratio of nonperforming loans to total loans and

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nonperforming assets to total assets. The provision for loan loss for the first quarter of 2011 was nearly four times net charge-offs for the period, which enabled the Company to bolster the allowance for loan losses to 129% of nonperforming loans and 1.87% of loans outstanding. Management believes these coverage ratios will compare favorably to our peers.

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 previously discussed.

The largest component of the reserve remains allocated to the commercial and industrial portfolio. This reflects the inherent greater risk associated with this portfolio, as evidenced by the greater amounts of net charge-offs within the portfolio. Since December 31, 2010, the reserve allocated to the commercial and industrial portfolio has increased \$1,417,000, from \$6,795,000 to \$8,212,000. In connection with managements heightened awareness of the economic conditions that plague our commercial customers, several loans were re-evaluated with subsequent downgrades to the loans rating. Non-impaired substandard loans increased from \$14,992,000 at December 31, 2010 to \$26,660,000 at March 31, 2011, and special mention loans increased from \$17,062,000 to \$27,643,000. As a result, additional quantitative and qualitative reserves were established on these rated loans collectively evaluated for impairment.

In the first quarter of 2011, the reserve allocated to the acquisition and development segment increased from \$1,767,000 at December 31, 2010 to \$3,245,000 at March 31, 2011. Although there have been no loans in this segment individually identified as impaired, loans classified as special mention and substandard increased by \$3,348,000 and \$7,458,000 during the quarter. Similar to the commercial and industrial portfolio, these downgrades had a direct result in the quantitative and qualitative reserve allocations on this portfolio, leading to the additional provision for loan losses.

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.

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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.

Capital Adequacy and Regulatory Matters

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

Total shareholders' equity increased \$2,189,000 from \$160,484,000 at December 31, 2010 to \$162,673,000 at March 31, 2011. Historically, earnings retention, defined as net income less dividends declared, has served as a primary source of capital to the Company. Earnings retained during the three months ended March 31, 2011 were \$1,990,000, or 52% of net income.

On February 9, 2010, the Company filed a shelf registration statement on Form S-3, with the Securities and Exchange Commission, that provided the Company the ability to raise capital, from time to time, up to an aggregate of \$80 million, through the sale of stock, preferred stock, debt securities, warrants and other securities. The Company completed a public stock offering of 1,481,481 shares of common stock at a price of \$27.00 per share, for gross proceeds of approximately \$40,000,000 during the first quarter of 2010. Net proceeds after underwriting commissions and expenses were \$37,585,000. Although the Company recognized this offering would initially dilute earnings per share and reduce return on equity and tangible equity performance measurements, management felt it was necessary in order to support the continued growth of the Company. The additional capital allowed the Company to bolster its regulatory capital ratios during a time of an uncertain economy and the potential for increased government oversight and perhaps higher regulatory capital requirements. As noted below, the Company's capital ratios continue to well exceed the minimums to be well capitalized. The Company believes that with this additional capital, it positions itself well to weather the economy and take advantage of future opportunities that may arise. The Company has no current plans to issue additional shares of common stock.

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

As of March 31, 2011, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category. The Company and the Bank's actual capital ratios as of March 31, 2011 and December 31, 2010 are presented as follows:

| | Actual | | Minimum Capital Requirement | | Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--|------------|-------|-----------------------------|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| <i>(Dollars in thousands)</i> | | | | | | |
| March 31, 2011 | | | | | | |
| Total capital to risk weighted assets | | | | | | |
| Orrstown Financial Services, Inc. | \$ 154,091 | 15.4% | \$ 79,763 | 8.0% | n/a | n/a |
| Orrstown Bank | 136,353 | 13.8% | 79,137 | 8.0% | 98,921 | 10.0% |
| Tier 1 capital to risk weighted assets | | | | | | |
| Orrstown Financial Services, Inc. | 141,759 | 14.2% | 39,882 | 4.0% | n/a | n/a |
| Orrstown Bank | 124,021 | 12.5% | 39,571 | 4.0% | 59,352 | 6.0% |
| Tier 1 capital to average assets | | | | | | |
| Orrstown Financial Services, Inc. | 141,759 | 9.5% | 59,642 | 4.0% | n/a | n/a |
| Orrstown Bank | 124,021 | 8.4% | 58,885 | 4.0% | 73,606 | 5.0% |

Table of Contents**December 31, 2010**

| | | | | | | | | | |
|--|----|---------|-------|----|--------|------|-----|---------|-------|
| Total capital to risk weighted assets | | | | | | | | | |
| Orrstown Financial Services, Inc. | \$ | 152,550 | 14.8% | \$ | 82,486 | 8.0% | n/a | n/a | |
| Orrstown Bank | | 129,844 | 12.7% | | 81,808 | 8.0% | \$ | 102,260 | 10.0% |
| Tier 1 capital to risk weighted assets | | | | | | | | | |
| Orrstown Financial Services, Inc. | | 139,623 | 13.5% | | 41,243 | 4.0% | | n/a | n/a |
| Orrstown Bank | | 117,027 | 11.4% | | 40,904 | 4.0% | | 61,356 | 6.0% |
| Tier 1 capital to average assets | | | | | | | | | |
| Orrstown Financial Services, Inc. | | 139,623 | 9.4% | | 59,385 | 4.0% | | n/a | n/a |
| Orrstown Bank | | 117,027 | 8.0% | | 58,629 | 4.0% | | 73,287 | 5.0% |

Liquidity

The primary function of asset/liability management is to assure adequate liquidity and sensitivity to changing interest rates. Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Our primary sources of funds consist of deposit inflows, loan repayments, maturities and sales of investment securities and borrowings from the Federal Home Loan Bank of Pittsburgh. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is defined as the exposure to interest rate risk, foreign currency exchange rate risk, commodity price risk, and other relevant market rate or price risks. For domestic banks, including the Company, the majority of market risk is related to interest rate risk.

Interest rate sensitivity management requires the maintenance of an appropriate balance between interest sensitive assets and liabilities. Interest bearing assets and liabilities that are maturing or repricing should be adequately balanced to avoid fluctuating net interest margins and to enhance consistent growth of net interest income through periods of changing interest rates. The Company has consistently followed a strategy of pricing assets and liabilities according to prevailing market rates while largely matching maturities, within the guidelines of sound marketing and competitive practices. Rate sensitivity is measured by monthly gap analysis, quarterly rate shocks, and periodic simulation.

The Company has been able to significantly reduce its liability sensitivity, and increased its asset sensitivity during the past several months. While the Company was liability sensitive at September 30, 2010, we have moved the position, as measured by cumulative gaps, to asset sensitive on the short-end, and are very balanced at longer cumulative maturities, which we believe better positions us for the possibility that interest rates may rise in the future. The following gap summary demonstrates the shift in RSA/RSL (cumulative) position since year end:

| | 0-3 Months | 0-6 Months | 0-12 Months | 0-36 Months |
|-------------------|------------|------------|-------------|-------------|
| December 31, 2010 | 1.08 | 0.97 | 0.90 | 1.05 |
| March 31, 2011 | 1.19 | 1.02 | 0.95 | 1.08 |

The cumulative gap position at 12 months is negative at \$35,140,000 at March 31, 2011 and the RSA/RSL cumulative ratio is 0.95, versus a cumulative negative gap position at 12 months of \$65,822,000 or 0.90 RSA/RSL cumulative ratio reported at December 31, 2010. Overall, the Company enjoys a closely balanced position that does not place it at undue risk under any interest rate scenario. Many of the deposit dollars in transaction accounts are discretionarily priced so management maintains significant pricing flexibility.

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Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures:

The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of March 31, 2011. Based on such evaluation, such officers have concluded that, as of March 31, 2011, the Company's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Company (including its consolidated subsidiary) required to be included in the Company's periodic filings under the Exchange Act.

(b) Changes in internal controls:

The Company regularly assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments and internal and external audit and regulatory recommendations. There have not been any significant changes in the Company's internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, such controls during the quarter ended March 31, 2011.

PART II - OTHER INFORMATION

Item 1 - Legal Proceedings

The nature of Orrstown Financial Services, Inc.'s business generates a certain amount of litigation involving matters arising out of the ordinary course of business. In the opinion of management, there are no legal proceedings that might have a material effect on the results of operations, liquidity, or the financial position of the Company at this time.

Item 1A - Risk Factors

There have been no material changes from the risk factors as disclosed in the Annual Report on Form 10-K for the year ended December 31, 2010.

Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

The table below summarizes the Company's repurchase of common equity securities during the quarter ended March 31, 2011:

| | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | Maximum Number of Shares that may Yet be Purchased Under the Plans or Programs (1) |
|------------------------|--|------------------------------------|--|---|
| 1/1/11 through 1/31/11 | 0 | \$0 | N/A | 191,926 |
| 2/1/11 through 2/29/11 | 0 | 0 | N/A | 191,926 |
| 3/1/11 through 3/31/11 | 0 | 0 | N/A | 191,926 |
| Total | 0 | | | |

(1) On April 27, 2006, Orrstown Financial Services, Inc. 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, Orrstown Financial Services, Inc. announced an extension of the Stock Repurchase Plan authorizing the repurchase of an additional 150,000 shares, including the 43,001 shares remaining to be purchased under the plan as originally approved. The plan may be suspended at any time without prior notice and has no prescribed time limit in which to fill the authorized repurchase amount. As of December 31, 2010, 108,074 shares have been purchased under the program.

The Company did not sell any unregistered securities during the quarter ended March 31, 2011.

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Item 3 - Defaults upon Senior Securities

Not applicable

Item 4 - (Removed and Reserved)

Item 5 - Other Information

None

Item 6 - Exhibits

3.1 Articles of Incorporation, as amended, incorporated by reference to Exhibit 3.1 of the Registrant's Report on Form 8-K filed on January 29, 2010.

3.2 By-laws, as amended, incorporated by reference to Exhibit 3.2 of the Registrant's Report on Form 8-K filed on January 29, 2010.

4 Instruments defining the rights of security holders including indentures. The rights of the holders of Registrant's common stock are contained in:

(i) Articles of Incorporation, as amended, incorporated by reference to Exhibit 3.1.

(ii) By-laws, as amended, incorporated by reference to Exhibit 3.2.

31.1 Rule 13a - 14(a)/15d-14(a) Certification (Principal Executive Officer) filed herewith

31.2 Rule 13a - 14(a)/15d-14(a) Certifications (Principal Financial Officer) filed herewith

32.1 Section 1350 Certifications (Principal Executive Officer) filed herewith

32.2 Section 1350 Certifications (Principal Financial Officer) filed herewith

SIGNATURES

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

/s/ Thomas R. Quinn, Jr.
Thomas R. Quinn, Jr., President & CEO
(Duly Authorized Officer)

/s/ Bradley S. Everly
Bradley S. Everly, Executive
Vice President and CFO
(Principal Financial Officer)

Date: May 10, 2011

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ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

EXHIBIT INDEX

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- 31.1 Rule 13a - 14(a)/15d-14(a) Certification (Principal Executive Officer)
- 31.2 Rule 13a - 14(a)/15d-14(a) Certifications (Principal Financial Officer)
- 32.1 Section 1350 Certifications (Principal Executive Officer)
- 32.2 Section 1350 Certifications (Principal Financial Officer)