ORRSTOWN FINANCIAL SERVICES INC
Form 10-K
March 12, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended: December 31, 2008

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission file number: 33-18888

ORRSTOWN FINANCIAL SERVICES, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania	**23-2530374**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

77 East King Street, P. O. Box 250, Shippensburg, Pennsylvania 17257

(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: (717) 532-6114

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

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

Common Stock, No Par Value

Title of each class

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One)

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨	

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

Aggregate market value of the Common Stock held by non-affiliates computed by reference to the price at which the common equity was last sold on December 31, 2008 was $167,043,195.

Number of shares outstanding of the registrant s common stock as of December 31, 2008: 6,385,666.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2009 Annual Meeting of Security Holders are incorporated by reference in Part III of this Form 10-K.

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ORRSTOWN FINANCIAL SERVICES, INC.

FORM 10-K

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Part I

Item 1 Business

Orrstown Financial Services, Inc. (the Corporation) is a financial holding company registered under the Gramm-Leach-Bliley Act. The executive offices of Orrstown Financial Services, Inc. are located at 77 East King Street, Shippensburg, Pennsylvania, 17257. Orrstown Financial Services, Inc. was organized on November 17, 1987, under the laws of the Commonwealth of Pennsylvania for the purpose of acquiring Orrstown Bank, Shippensburg, Pennsylvania, and such other banks and bank related activities as are permitted by law and desirable.

The Corporation files periodic reports with the Securities and Exchange Commission (SEC) in the form of quarterly 10-Q reports, the annual 10-K report, annual proxy statement and Form 8-K for any significant events that may arise during the year. Copies of the Corporation s filings may be obtained free of charge through the SEC s internet site at www.sec.gov or by accessing the Corporation s website at www.orrstown.com. Copies of the Corporation s filings also are available to be read and copied at the SEC s Public Reference Room at 100 F Street N.W., Washington, DC 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330.

History and Acquisitions

Orrstown Bank was originally organized in 1919. Orrstown Bank was organized as a state-chartered bank in 1987 as part of an agreement and plan of merger between Orrstown Financial Services, Inc. and Orrstown Bank. On March 8, 1988, in a bank holding company reorganization transaction, Orrstown Financial Services, Inc. acquired 100% ownership of Orrstown Bank, issuing 131,455 shares of Orrstown Financial Services, Inc. s common stock to the former Orrstown Bank shareholders. Orrstown Bank is engaged in providing banking and bank related services in South Central Pennsylvania, principally Franklin, Perry and Cumberland Counties in Pennsylvania and in Washington County, Maryland. The twenty-one offices of Orrstown Bank are located in Shippensburg (2), Carlisle (4), Spring Run, Orrstown, Chambersburg (3), Greencastle, Mechanicsburg (2), Camp Hill, Newport (2), Duncannon, and New Bloomfield, Pennsylvania and Hagerstown, Maryland (2).

From its inception in January 2000 to December 31, 2005, Pennbanks Insurance Company Cell P1 (Pennbanks) was a wholly-owned subsidiary of the Corporation. As of January 1, 2006, the Corporation has divested the Pennbanks Insurance Company Cell P1 insurance book of business. The liabilities associated with the insurance business were assumed by American General under a contractual arrangement. Pennbanks is a reinsurer of credit, life, and disability insurance.

On May 1, 2006, Orrstown Financial Services, Inc. acquired 100% ownership of The First National Bank of Newport (First National) a national banking institution with $120 million in assets at the time of the merger. The Corporation issued 699,949 shares of Orrstown Financial Services, Inc. s common stock to the former First National shareholders. Each share of First National common stock outstanding at the time of the transaction was exchanged for 1.75 shares of Orrstown Financial Services, Inc. common stock and $22.20 in cash. The purchase price for shares exchanged for common stock was $35.49 with 400,000 shares of First National common stock outstanding. Fractional shares were paid out in cash at the time of the transaction. First National was engaged in providing banking and bank related services in Perry County, Pennsylvania with four branches, and was originally organized on May 23, 1893. As of the close of business on June 15, 2007, The First National Bank of Newport and Orrstown Bank combined the two bank charters into one bank with Orrstown Bank as the surviving bank.

Business

Orrstown Financial Services, Inc. s primary activity consists of owning and supervising its subsidiary, Orrstown Bank (the Bank). The day-to-day management of the Bank is conducted by the subsidiary s officers. Orrstown Financial Services, Inc. derives a majority of its current income from Orrstown Bank.

Orrstown Financial Services, Inc. has no employees other than its five officers who are also employees of its subsidiary bank. On December 31, 2008, Orrstown Bank had 242 full-time and 45 part-time employees.

The Bank is engaged in commercial banking and trust business as authorized by the Pennsylvania Banking Code of 1965. This involves accepting demand, time and savings deposits, and granting loans. The Bank grants commercial, agribusiness, residential and other consumer loans to customers in its market area of Franklin, Perry and Cumberland Counties of Pennsylvania and Washington County, Maryland. The concentrations of credit by type of loan are set forth on the face of the balance sheet filed herewith in Part II, Item 8, Financial Statements and Supplementary Data . The Bank maintains a diversified loan portfolio and evaluates each customer s credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon the extension of credit, is based on management s credit evaluation of the customer and collateral standards established in the Bank s lending policies and procedures.

All secured loans are supported with appraisals or evaluations of collateral. Business equipment and machinery, inventories, accounts receivable, and farm equipment are considered appropriate security, provided they meet acceptable standards for liquidity and marketability. Loans secured by equipment and/or other non real estate

collateral normally do not exceed 70% of appraised value or cost, whichever is lower. Loans secured by real estate generally do not exceed 80% of the appraised value of the property. Loan to collateral values are monitored as part of the loan review process, and appraisals are updated as deemed appropriate in the circumstances.

Administration and supervision over the lending process is provided by the Bank s Credit Administration Committee which is comprised of outside directors. Executive officers and loan department personnel regularly meet with and report to the Credit Administration Committee. The loan review process is continuous, commencing with the approval of a loan. Each new loan is reviewed by the Loan Department for compliance with banking regulations and lending policy requirements for documentation, collateral standards, and approvals. Orrstown Bank employs a Loan Review Officer, who is independent from the loan function and reports directly to the Credit Administration Committee. The Loan Review Officer continually monitors and evaluates loan customers utilizing risk-rating criteria established in the Loan Policy in order to spot deteriorating trends and detect conditions which might indicate potential problem loans. The Loan Review Officer reports the results of the loan reviews at least quarterly to the Credit Administration Committee for approval and provides the basis for evaluating the adequacy of the allowance for loan losses.

Through its trust department, Orrstown Bank renders services as trustee, executor, administrator, guardian, managing agent, custodian, investment advisor, and other fiduciary activities authorized by law.

As of December 31, 2008, the Corporation had total assets of approximately $1.052 billion, total shareholders equity of approximately $103 million and total deposits of approximately $757 million.

Regulation and Supervision

Orrstown Financial Services, Inc. is a financial holding company, and is registered as such with the Board of Governors of the Federal Reserve System (the Federal Reserve Board). As a registered bank holding company and financial holding company, the Corporation is subject to regulation under the Bank Holding Company Act of 1956 and to inspection, examination, and supervision by the Federal Reserve Board.

The operations of the Bank are subject to federal and state statutes applicable to banks chartered under the banking laws of the United States, and to banks whose deposits are insured by the Federal Deposit Insurance Corporation. The Bank s operation is also subject to regulations of the Pennsylvania Department of Banking, the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC).

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

Financial and Bank Holding Company Activities

As a financial holding company, the Corporation may engage in, and acquire companies engaged in, activities that are considered financial in nature , as defined by the Gramm-Leach-Bliley Act and Federal Reserve Board interpretations. These activities include, among other things, securities underwriting, dealing and market-making, sponsoring mutual funds and investment companies, insurance underwriting and agency activities, and merchant banking. If any banking subsidiary of the Corporation ceases to be well capitalized or well managed under applicable regulatory standards, the Federal Reserve Board may, among other things, place limitations on the Corporation s ability to conduct the broader financial activities permissible for financial holding companies or, if the deficiencies persist, require the Corporation to divest the banking subsidiary. In addition, if any banking subsidiary of the Corporation receives a Community Reinvestment Act rating of less than satisfactory, the Corporation would be prohibited from engaging in any additional activities other than those permissible for bank holding companies that are not financial holding companies. The Corporation may engage directly or indirectly in activities considered financial in nature, either de novo or by acquisition, as long as it gives the Federal Reserve Board after-the-fact notice of the new activities.

Interstate Banking and Branching

As a bank holding company, the Corporation is required to obtain prior Federal Reserve Board approval before acquiring more than 5% of the voting shares, or substantially all of the assets, of a bank holding company, bank, or savings association. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal), subject to certain concentration limits and other requirements, bank holding companies such as the Corporation may acquire banks and bank holding companies located in any state. Riegle-Neal also permits banks to acquire branch offices outside their home states by merging with out-of-state banks, purchasing branches in other states, and establishing de novo branch offices

in other states. The ability of banks to acquire branch offices is contingent, however, on the host state having adopted legislation opting in to those provisions of Riegle-Neal. In addition, the ability of a bank to merge with a bank located in another state is contingent on the host state not having adopted legislation opting out of that provision of Riegle-Neal. The Corporation has expanded its market south into Hagerstown, Maryland with its first branch opening in March 2006 and a second branch opening in September 2008.

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Control Acquisitions

The Change in Bank Control Act prohibits a person or group of persons from acquiring control of a bank holding company, unless the Federal Reserve Board has been notified and has not objected to the transaction. Under a rebuttable presumption established by the Federal Reserve Board, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, such as the Corporation, would, under the circumstances set forth in the presumption, constitute acquisition of control of the bank holding company. In addition, a company is required to obtain the approval of the Federal Reserve Board under the Bank Holding Company Act before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of any class of outstanding voting stock of a bank holding company, or otherwise obtaining control or a controlling influence over that bank holding company.

Liability for Banking Subsidiaries

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

Capital Requirements

Information concerning the Corporation and its subsidiary with respect to capital requirements is incorporated by reference from Note 15, Regulatory Matters , of the Notes to Consolidated Financial Statements included under Item 8 of this report, and from the Capital Adequacy and Regulatory Matters section of the Management s Discussion and Analysis of Consolidated Financial Condition and Results of Operations , included under Item 7 of this report.

FDICIA

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and the regulations promulgated under FDICIA, among other things, established five capital categories for insured depository institutions well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized and requires federal bank regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements based on these categories. Unless a bank is well capitalized, it is subject to restrictions on its ability to offer brokered deposits and on certain other aspects of its operations. An undercapitalized bank must develop a capital restoration plan and its parent bank holding company must guarantee the bank s compliance with the plan up to the lesser of 5% of the bank s assets at the time it became undercapitalized and the amount needed to comply with the plan. As of December 31, 2008, the Bank was considered well capitalized based on the guidelines implemented by the bank s regulatory agencies.

Dividend Restrictions

The Corporation s funding for cash distributions to its shareholders is derived from a variety of sources, including cash and temporary investments. One of the principal sources of those funds is dividends received from its subsidiary Orrstown Bank. Various federal and state laws limit the amount of dividends the Bank can pay to the Corporation without regulatory approval. In addition, federal bank regulatory agencies have authority to prohibit the Bank from engaging in an unsafe or unsound practice in conducting their business. The payment of dividends, depending upon the financial condition of the bank in question, could be deemed to constitute an unsafe or unsound practice. The ability of the Bank to pay dividends in the future is currently, and could be further, influenced by bank regulatory policies and capital guidelines. Additional information concerning the Corporation and its banking subsidiary with respect to dividends is incorporated by reference from Note 15, Regulatory Matters , of the Notes to Consolidated Financial Statements included under Item 8 of this report, and the Capital Adequacy and Regulatory Matters section of Management s Discussion and Analysis of Consolidated Financial Condition and Results of Operations , included under Item 7 of this report.

Depositor Preference Statute

In the liquidation or other resolution of an institution by any receiver, U.S. federal legislation provides that deposits and certain claims for administrative expenses and employee compensation against the insured depository institution would be afforded a priority over the general unsecured claims against that institution, including federal funds and letters of credit.

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Other Federal Laws and Regulations

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

- Privacy provisions of the Gramm-Leach-Bliley Act and related regulations, which require us to maintain privacy policies intended to safeguard customer financial information, to disclose the policies to our customers and to allow customers to opt out of having their financial service providers disclose their confidential financial information to non-affiliated third parties, subject to certain exceptions;
- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- Consumer protection rules for the sale of insurance products by depository institutions, adopted pursuant to the requirements of the Gramm-Leach-Bliley Act; and
- USA Patriot Act, which requires financial institutions to take certain actions to help prevent, detect and prosecute international money laundering and the financing of terrorism.

Sarbanes-Oxley Act of 2002

On July 30, 2002, the Sarbanes-Oxley Act of 2002 was enacted. The Sarbanes-Oxley Act represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. The Sarbanes-Oxley Act is applicable to all companies with equity securities registered or that file reports under the Securities Exchange Act of 1934. In particular, the Sarbanes-Oxley Act established: (i) new requirements for audit committees, including independence, expertise, and responsibilities; (ii) additional responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) new standards for auditors and regulation of audits; (iv) increased disclosure and reporting obligations for the reporting company and its directors and executive officers; and (v) new and increased civil and criminal penalties for violations of the securities laws. Many of the provisions were effective immediately while other provisions become effective over a period of time and are subject to rulemaking by the SEC. Because the Corporation s common stock is registered with the SEC, it is subject to this Act. As an accelerated filer as defined in Rule 12b-2 of the Securities Exchange Act of 1934, the Corporation was subject to section 404 of the Sarbanes-Oxley Act starting in the year ended December 31, 2004.

FDIC Insurance and Assessments

Deposit accounts in the Company s subsidiary bank are insured by the Federal Deposit Insurance Corporation. The Bank s deposits, therefore, are subject to FDIC deposit insurance. Assessments were generally insured up to a maximum of $100,000 per separately insured depositor and up to a maximum of $250,000 for self-directed retirement accounts. The Emergency Economic Stabilization Act of 2008 increased the maximum deposit insurance amount on certain deposit accounts from $100,000 to $250,000 until December 31, 2009.

On February 15, 2006, federal legislation to reform federal deposit insurance was enacted. This new legislation required, among other things, that the FDIC adopt regulations for considering an increase in the insurance limits on all deposit accounts (including retirement accounts) every five years starting in 2011 based, in part, on inflation, and modifying the deposit fund s reserve ratio for a range between 1.15% and 1.50% of estimated insured deposits.

On November 2, 2006, the FDIC adopted final regulations establishing a risk-based assessment system that will enable the Federal Deposit Insurance Corporation to more closely tie each financial institution s premiums to the risk it poses to the deposit insurance fund. Under the new risk-based assessment system, which became effective in the beginning of 2007, the FDIC will evaluate the risk of each financial institution based on three primary sources of information: (1) its supervisory rating, (2) its financial ratios, and (3) its long-term debt issuer rating, if the institution has one. The new rates for nearly all of the financial institution industry will vary between five and seven cents for every $100 of domestic deposits. At the same time, the FDIC also adopted final regulations designating the reserve ratio for the deposit insurance fund during 2007 at 1.25% of estimated insured deposits.

Effective March 31, 2006, the FDIC merged the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a single insurance fund called the Deposit Insurance Fund. As a result of the merger, the BIF and SAIF were abolished. The merger of the BIF and SAIF into the Deposit Insurance Fund does not affect the authority of the Financing Corporation (FICO) to impose and collect, with approval of the FDIC, assessments for anticipated payments, insurance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019.

On November 26, 2008, the FDIC issued the Temporary Liquidity Guarantee Program (TLG Program), effective October 14, 2008 for institutions opting into the program. The TLG Program consists of two components, Transaction Account Guarantee Program (TAG Program) and the Debt Guarantee Program (DGP). Orrstown Bank opted into the Transaction Account Guarantee Program. Under this program, through December 31, 2009, all noninterest-bearing transaction accounts and Now accounts, as defined by the final rule, are fully guaranteed by the FDIC for the entire amount in the account. Coverage under the TAG Program is in addition to and separate from the coverage available under the FDIC s general deposit insurance rules. Orrstown Bank and the Corporation opted out of the Debt Guarantee Program.

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In 2008, the FDIC assessment for Orrstown Bank was $296,000. The 2009 assessment will increase materially. It could exceed $2 million given proposed special amendments.

Emergency Economic Stabilization Act of 2008

In response to recent unprecedented market turmoil, the Emergency Economic Stabilization Act of 2008 (the EESA) was enacted on October 3, 2008. The EESA authorizes the Secretary of the U.S. Treasury (the Treasury) to purchase up to $700 billion in troubled assets from financial institutions under the Troubled Asset Relief Program (TARP). The EESA increases the maximum deposit insurance amount on certain deposit accounts from $100,000 to $250,000 until December 31, 2009 and removes the statutory limits on the FDIC ability to borrow from the Treasury during this period. The FDIC may not take the temporary increase in deposit insurance coverage into account when setting assessments. The EESA allows financial institutions to treat any loss on the preferred stock of the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation as an ordinary loss for tax purposes.

Pursuant to his authority under EESA, the Secretary of the Treasury has created the TARP Capital Purchase Program under which the Treasury will invest up to $250 billion in senior preferred stock of U.S. banks and savings associations or their holding companies. Qualifying financial institutions may issue senior preferred stock with a value equal to not less than 1% of risk-weighted assets and not more than the lesser of $25 billion or 3% of risk-weighted assets. The Corporation, after considerable analysis and deliberation, chose not to participate in the Capital Purchase Program.

Future Legislation

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

Forward Looking Statements

Additional information concerning the Corporation and its banking subsidiaries with respect to forward looking statements is incorporated by reference from the Important Factors Relating to Forward Looking Statements section of the Management s Discussion and Analysis of Financial Condition and Results of Operations, included in this Report under Item 7.

Competition

The Bank s principal market area consists of Franklin County, Perry County and Cumberland County, Pennsylvania, with a presence in Washington County, Maryland. It services a substantial number of depositors in this market area, with the greatest concentration within a radius of Chambersburg, Shippensburg, and Carlisle, Pennsylvania.

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

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

Item 1A Risk Factors

There are a number of significant risks and uncertainties which are difficult to predict, including those specified below, that may adversely affect the Corporation s business, financial results or stock price. As a financial institution, the Corporation has significant exposure to market risk, including interest-rate risk, liquidity risk and credit risk, among others. Adverse experience with these or additional risks that the Corporation currently does not know about, or currently views as immaterial, may also impair the Corporation s business or adversely impact its financial results or stock price.

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Interest Rate Risk The Corporation is exposed to interest rate risk in its core banking activities of lending and deposit-taking since assets and liabilities reprice at different times and by different amounts as interest rates change. As a result, net interest income, which represents the largest revenue source for the Corporation, is subject to the effects of changing interest rates. The Corporation closely monitors the sensitivity of net interest income to changes in interest rates and attempts to limit the variability of net interest income as interest rates change. The Corporation makes use of both on- and off-balance sheet financial instruments to mitigate exposure to interest rate risk. Possible actions to mitigate such risk include, but are not limited to, changes in the pricing of loan and deposit products, modifying the composition of earning assets and interest-bearing liabilities, and adding to, modifying or terminating interest rate swap agreements or other financial instruments used for interest rate risk management purposes.

Liquidity Risk Liquidity refers to the Corporation s ability to ensure that sufficient cash flow and liquid assets are available to satisfy current and future financial obligations, including demands for loans and deposit withdrawals, funding operating costs, and for other corporate purposes. Liquidity risk arises whenever the maturities of financial instruments included in assets and liabilities differ. The Corporation obtains funding through deposits and various short-term and long-term wholesale borrowings, including federal funds purchased and securities sold under agreements to repurchase, brokered certificates of deposit and borrowings from the Federal Home Loan Bank of Pittsburgh and others. Should the Corporation experience a substantial deterioration in its financial condition or its debt ratings, or should the availability of funding become restricted due to disruption in the financial markets, or the soundness of other financial institutions, the Corporation s ability to obtain funding could be negatively impacted. The Corporation attempts to quantify such credit-event risk by modeling scenarios that estimate the liquidity impact of various events in a contingency funding plan. The Corporation estimates such impact by attempting to measure the effect on available unsecured lines of credit, available capacity from secured borrowing sources and securitizable assets. To mitigate such risk, the Corporation maintains available lines of credit with the Federal Home Loan Bank of Pittsburgh that is secured by loans and unsecured lines with correspondent banks. On an ongoing basis, management closely monitors the Corporation s liquidity position for compliance with internal policies and believes that available sources of liquidity are adequate to meet funding needs in the normal course of business.

Credit Risk Factors that influence the Corporation s credit loss experience include overall economic conditions affecting businesses and consumers, in general, and, due to the size of the Corporation s real estate loan portfolio and mortgage-related investment securities portfolio, real estate valuations, in particular. Other factors that can influence the Corporation s credit loss experience, in addition to general economic conditions and borrowers specific abilities to repay loans, include: (i) the impact of declining real estate values on the portfolio of loans to residential real estate builders and developers; (ii) the repayment performance associated with residential mortgage loans and other loans supporting mortgage-related securities; (iii) the concentration of commercial real estate loans in the loan portfolio; (iv) consumer loan charge offs, which historically have experienced higher net charge-offs as a percentage of loans outstanding than other loan types; (v) the weakening housing market; (vi) the troubled state of financial and credit markets and the Federal Reserve positioning of monetary policy; (vii) sluggish job creation and rising unemployment, which have caused consumer spending to slow and the underlying impact on businesses operations and abilities to repay loans should consumer spending continue to slow; (viii) and continued slowing of domestic automobile sales. All of these factors can affect the Corporation s credit loss experience. To help manage credit risk, the Corporation maintains a detailed loan policy and utilizes various committees that include members of senior management to approve and monitor significant extensions of credit. The Corporation also maintains a credit review department that regularly reviews the loan portfolios to ensure compliance with established credit policy. The Corporation maintains an allowance for credit losses that in management s judgment is adequate to absorb losses inherent in the loan and lease portfolio.

Supervision and Regulation The Corporation is subject to extensive state and federal laws and regulations governing the banking industry, in particular, and public companies, in general, including laws related to corporate taxation. Many of those laws and regulations are described in Part I, Item 1 Business . Changes in those or other laws and regulations, or the degree of the Corporation s compliance with those laws and regulations as judged by any of several regulators, including tax authorities, could have a significant effect on the Corporation s operations and its financial results.

Detailed discussions of the specific risks outlined above and other risks facing the Corporation are included within this Annual Report on Form 10-K in Part I, Item 1 Business , and Part II, Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations . Furthermore, in Part II, Item 7 under the heading Forward-Looking Statements is included a description of certain risks, uncertainties and assumptions identified by management that are difficult to predict and that could materially affect the Corporation s financial condition and results of operations, as well as the value of the Corporation s common stock.

In addition, the market price of Orrstown Financial common stock may fluctuate significantly in response to a number of other factors, including changes in securities analysts estimates of financial performance, volatility of stock market prices and volumes, rumors or erroneous information, changes in market valuations of similar companies and changes in accounting policies or procedures as may be required by the Financial Accounting Standards Board or other regulatory agencies.

Item 1B Unresolved Staff Comments

None

Item 2 Properties

Orrstown Bank owns buildings in Orrstown, Shippensburg (2), Carlisle (2), Spring Run, Chambersburg (3), Mechanicsburg (2), Newport (2), Duncannon, and New Bloomfield, Pennsylvania and in Hagerstown, Maryland. Offices of Orrstown Bank are located in each of these buildings.

The Bank also leases space for offices located in Greencastle, Carlisle (2) and Camp Hill, Pennsylvania and in Hagerstown, Maryland.

Item 3 Legal Proceedings

Orrstown Financial Services, Inc. is an occasional party to legal actions arising in the ordinary course of its business. In the opinion of management, the Corporation has adequate legal defenses and/or insurance coverage respecting any and each of these actions and does not believe that they will materially affect the Corporation s operations or financial position.

Item 4 Submission of Matters to Vote of Security Holders

None

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Part II

Item 5 Market for Registrant s Common Equity, Related Security Holder Matters and Issuer Purchases of Equity Securities

Market Information

Orrstown Financial Services, Inc. s common stock is not traded on a national securities exchange. Quotations for shares of the Corporation s common stock are reported through the OTC Bulletin Board service under the symbol ORRF, and are traded over the counter with brokers who make a market in the stock. At December 31, 2008, the number of shareholders of record was approximately 3,100. The price ranges for Orrstown Financial Services, Inc. common stock set forth below represent prices in actual transactions as published by various financial sources.

	2008			2007		
	Market Price		Quarterly	Market Price		Quarterly
Dividend (1)	**High**	**Low**	**Dividend**	**High**	**Low**	**Dividend**
First quarter	**$ 31.50**	**$ 29.50**	**$ 0.21**	$ 36.19	$ 33.67	$ 0.20
Second quarter	**33.96**	**29.10**	**0.22**	35.60	31.00	0.20
Third quarter	**31.75**	**29.00**	**0.22**	33.40	28.00	0.21
Fourth quarter	**30.25**	**27.00**	**0.22**	34.00	30.00	0.21
			$ 0.87			$ 0.82

(1) Note: All per share data has been restated after giving retroactive recognition to a 5% stock dividend paid June 15, 2007.

The Corporation expects to continue its policy of paying regular cash dividends declared from time to time by the Board of Directors, although there is no assurance as to future dividends because they depend on future earnings, capital requirements, financial condition and other factors deemed relevant by the Board of Directors. See Note 15 in the Notes to Consolidated Financial Statements for the year ended December 31, 2008 for restrictions on the payment of dividends.

Issuer Purchases of Equity Securities

The table below summarizes the Corporation s repurchase of common equity securities during the quarter ended December 31, 2008. The maximum number of shares that may yet be purchased under the plan is 57,993 shares at December 31, 2008.

	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)
10/1/08 through 10/31/08	1,072	$ 29.94	N/A	100,803
11/1/08 through 11/30/08	35,007	27.03	N/A	65,796
12/1/08 through 12/31/08	7,803	29.50	N/A	57,993
Total	43,882	$ 27.54		

(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. 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, 2008, 92,007 shares have been purchased under the program. Orrstown did not sell any unregistered securities.

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PERFORMANCE GRAPH

The following graph shows a five-year comparison of the cumulative total return on the Corporation s common stock as compared to other indexes: the SNL index of banks with assets between $1 billion and $5 billion, the S&P 500 Index, and the NASDAQ Composite index. Shareholder returns on the Corporation s common stock are based upon trades reported by the National Association of Securities Dealers Inc. s OTC Bulletin Board service. The Corporation is not aware of all prices at which shares traded during such periods. The shareholder returns shown in the graph are not necessarily indicative of future performance. The performance illustrated assumes that $100 was invested in the Corporation s common stock and each index on December 31, 2003 and that all dividends were reinvested.

Orrstown Financial Services, Inc.

			Period Ending			
Index	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**
Orrstown Financial Services, Inc.	100.00	135.52	111.11	120.26	106.24	98.41
SNL Bank $1B-$5B	100.00	123.42	121.31	140.38	102.26	84.81
S&P 500	100.00	110.88	116.33	134.70	142.10	89.53
NASDAQ Composite	100.00	108.59	110.08	120.56	132.39	78.72

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Item 6 Selected Financial Data

Selected Financial Data at or for the Year

	Year Ended December 31,				
(Dollars in thousands)	2008	2007	2006**	2005	2004
Summary of Operations					
Interest income	**$ 52,313**	$ 53,106	$ 44,788	$ 32,415	$ 25,892
Interest expense	**19,408**	22,986	17,371	9,537	6,986
Net interest income	**32,905**	30,120	27,417	22,878	18,906
Provision for loan losses	**1,450**	750	390	144	210
Net interest income after provision for loan losses	**31,455**	29,370	27,027	22,734	18,696
Securities gains (losses)	**(27)**	58	41	(60)	88
Other operating income	**15,444**	13,248	11,042	9,119	6,881
Other operating expenses	**28,287**	24,921	21,628	17,397	14,718
Income before income taxes	**18,585**	17,755	16,482	14,396	10,947
Applicable income tax	**5,482**	5,197	4,850	4,409	3,177
Net income	**$ 13,103**	$ 12,558	$ 11,632	$ 9,987	$ 7,770
Per Common Share Data*					
Income before taxes	**$ 2.89**	$ 2.76	$ 2.66	$ 2.54	$ 1.94
Applicable income taxes	**0.85**	0.81	0.78	0.78	0.56
Net income	**2.04**	1.95	1.87	1.76	1.38
Diluted net income	**1.94**	1.86	1.79	1.69	1.33
Cash dividend paid	**0.87**	0.82	0.743	0.556	0.454
Book value at December 31	**16.18**	14.97	13.88	10.03	8.71
Average shares outstanding basic	**6,421,022**	6,428,853	6,201,978	5,677,927	5,630,118
Average shares outstanding diluted	**6,750,128**	6,735,174	6,475,721	5,917,933	5,836,730
Stock Price Statistics*					
Close	**$ 27.00**	$ 30.00	$ 34.81	$ 32.86	$ 40.82
High	**33.96**	36.19	37.14	45.35	45.35
Low	**27.00**	28.00	30.29	32.81	29.48
Price earnings ratio at close	**13.2**	15.4	18.6	18.7	29.6
Price to book at close	**1.7**	2.0	2.5	3.3	4.7
Year-End Balance Sheet Data					
Total assets	**$ 1,051,783**	$ 884,979	$ 809,031	$ 601,460	$ 514,651
Total loans	**820,468**	701,964	618,827	460,386	389,268
Total investment securities	**128,353**	96,355	91,393	71,677	82,801
Deposits noninterest bearing	**84,261**	91,365	85,420	68,697	66,784
Deposits interest bearing	**673,107**	554,991	553,299	394,125	338,579
Total deposits	**757,368**	646,356	638,719	462,822	405,363
Repurchase agreements	**63,407**	55,580	40,953	36,138	19,493
Liabilities for borrowed money	**118,887**	78,453	33,190	40,306	35,569
Total shareholders equity	**103,347**	96,124	89,388	57,310	49,250

Trust assets under management market value	**$ 354,000**	$ 415,000	$ 404,000	$ 368,000	$ 349,000
Performance Statistics					
Average equity / average assets	**10.45%**	10.98%	10.66%	9.67%	9.34%
Return on average equity	**13.20%**	13.64%	15.10%	18.69%	16.78%
Return on average tangible equity	**17.02%**	18.02%	18.98%	19.28%	17.09%
Return on average assets	**1.38%**	1.50%	1.61%	1.81%	1.57%
Return on average tangible assets	**1.43%**	1.56%	1.66%	1.81%	1.57%

* *Per share amounts have been restated to reflect: a 5% stock dividend paid June 15, 2007 and a 5% stock dividend paid June 29, 2005*

** *The First National Bank of Newport was acquired on May 1, 2006. Results above reflect First National s operations after May 1, 2006.*

Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operation

Overview

The following is a discussion of our consolidated financial condition and results of operations for each of the three years ended December 31, 2008, 2007 and 2006. The following discussion and analysis should be read in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements presented in this report to assist in the evaluation of Orrstown Financial Services, Inc. s 2008 performance. 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 Corporation 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, change in the Corporation s cost of funds, changes in government monetary policy, changes in government regulation and taxation of financial institutions, changes in the rate of inflation, changes in technology, the intensification of competition within the Corporation 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 Annual Report, see Important Factors Relating to Forward Looking Statements .

Corporate Profile and Significant Developments

Orrstown Financial Services, Inc. (the Corporation) is a financial holding company headquartered in Shippensburg, Pennsylvania with consolidated assets of $1.051 billion at December 31, 2008. The consolidated financial information presented herein reflects the Corporation and its wholly-owned commercial bank subsidiary, Orrstown Bank.

Orrstown Bank, with total assets of $1.049 billion at December 31, 2008, is a Pennsylvania chartered commercial bank with 21 offices. Nineteen of those offices are located in Pennsylvania and two in Maryland. On May 21, 2006 the Corporation acquired The First National Bank of Newport, located in Perry County, Pennsylvania. On June 15, 2007 The First National Bank of Newport was merged into Orrstown Bank. Results of their operations were included for the last eight months of 2006. Orrstown Bank s deposit services include a variety of checking, savings, time and money market deposits along with related debit card and merchant services. Lending services include commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Orrstown Financial Advisors offers a diverse line of financial services to our customers, including, but not limited to, brokerage, mutual funds, trusts, estate planning, investments and insurance products. At December 31, 2008, approximately $354 million of assets under management were serviced by the Financial Advisors.

At the May 2008 annual shareholders meeting President and Chief Executive Officer, Kenneth R. Shoemaker announced his retirement effective after the May 5, 2009 annual shareholder s meeting. On February 13, 2009 it was announced that Thomas R. Quinn, Jr. had been selected to succeed Mr. Shoemaker effective May 5, 2009.

On October, 29, 2007, Orrstown Bank purchased a facility to utilize as its Operations Center located at 2605 2695 Philadelphia Avenue, Chambersburg, Pennsylvania, in the North Pointe Business Center. During May 2008, this facility was completed. The loan operations, EFT department, deposit operations, information technology, human resources and other support staff moved into the renovated building. The reclamation and refurbishment of the largely unoccupied former strip shopping center has been widely recognized in the Chambersburg area.

On September 2, 2008 Orrstown Bank opened its second office in Hagerstown, Maryland at 1020 Professional Court, off Eastern Boulevard. Growth in Hagerstown has been above expectations and justified a flagship office.

The Corporation achieved a milestone during 2008 s third quarter by surpassing $1 billion of assets.

Economic Climate

During 2008, the U.S. economy faced significant challenges resulting in an overall economic downturn. Poor economic conditions, which were initially evident within the residential housing market beginning in 2007, spread throughout most sectors of the economy in 2008. A large overhang of vacant housing relative to historical norms and declines in housing starts during the beginning of 2009 has new construction at record lows. Industries like retailers, wholesalers and manufacturers are seeing inventories surge while sales are stagnant. Previous

overproduction and cut backs in new production could have unemployment rates rising above 9% during 2009. To help stabilize the financial markets, the Federal Open Market Committee expects to hold the fed funds target rate to 0%-25% for the foreseeable future. The government s plan to aid in the recovery of the financial markets will depend on the design and implementation of an effective program that will help the capital position of banks as well as clear devalued assets from their balance sheets. Although the Federal Reserve s Term Asset-Backed Securities Loans Facility is still being finalized, the resulting program could help the financial industry and consumers alike by increasing credit availability, increasing liquidity and by lowering rates.

The Corporation recorded $84,000 of equity securities impairment expense during 2008 and may face additional amounts in 2009. Despite this set back and the expectation of a challenging economy during 2009, the Corporation believes it is positioned to withstand these conditions through its strong capital and liquidity positions, high quality loan and debt securities portfolios and prudent management of credit and interest rate risk.

Results of Operations

For the year ended December 31, 2008, the Corporation recorded net income of $13,103,000, an increase of 4.3% over 2007 earnings of $12,558,000, which was an 8.0% increase over net income of $11,632,000 realized in 2006. Basic earnings per share have increased over the last three years from $1.87 in 2006 to $1.95 in 2007 and $2.04 in 2008.

The Corporation s earnings performance continues to be well above peer group averages as measured by various ratio analyses. Two widely recognized performance indicators are the return on average assets (ROA) and the return on average equity (ROE). The average publicly traded banking company and the average Mid-Atlantic Region banking company generated an ROA of approximately 0.36% and 0.62%, respectively, during 2008 per SNL Financial, a provider of financial information for the banking industry. SNL Financial indicates that approximately 3.81% is the median 2008 ROE for our industry while Mid-Atlantic banks returned approximately 6.61% on average. Return on average tangible assets (ROTA) and return on average tangible equity (ROTE) ratios exclude intangibles from the balance sheet and related amortization and tax expense from net income. The Corporation has goodwill and intangibles from the acquisition of companies and purchased deposits. The following table compares the last three year s performance ratios.

Performance Statistics	**2008**	**2007**	**2006**
Return on average assets	**1.38%**	**1.50%**	**1.61%**
Return on average tangible assets	**1.43%**	**1.56%**	**1.66%**
Return on average equity	**13.20%**	**13.64%**	**15.10%**
Return on average tangible equity	**17.02%**	**18.02%**	**18.98%**
Average equity / average assets	**10.45%**	**10.98%**	**10.66%**

Interest Income FTE

Throughout this discussion, the yield on earning assets is stated on a fully taxable-equivalent basis (FTE) and balances represent average daily balance unless otherwise stated. The marginal tax rate used in taxable equivalent equations is 35% for 2006, 2007 and 2008.

Average earning assets as a percent of average assets has remained relatively flat during 2008 as compared to 2007 resulting in ratios of 91.0% for 2008, 90.9% for 2007 and 91.3% for 2006. During 2007, the prime lending rate (prime) stayed at 8.25% through the first 8 months of the year; but by September, prime started to drop and ended the year at 7.25%. In January 2008, the prime rate took two quick hits dropping to 6.00% by the end of the month, creating a flurry of budget revisions across the industry. Prime continued to decline to 3.25% by December 16, 2008; an overall reduction of 400 basis points during the twelve month period. The 3.25% prime lending rate is the lowest it has been since October 1955. The federal funds target rate ended at 25 basis points by the end of December 2008. These declines have affected the banking industry as a whole, but the Corporation has managed a higher level of performance than many peers.

Average volume increases for 2008 were $7,280,000 while average volume increases for 2007 were $7,553,000. Although volume factors for interest earning assets were at approximately the same level, the decline in rate factors reduced interest earning income from an increase of $696,000 in 2007 compared to 2006, to a decrease of $8,064,000 compared to last year.

Interest earning assets for 2008, grew 13.5%, or $102.7 million on an average daily basis, and interest income declined by $784,000 or 1.4%, during the same period. Although the Bank typically maintains a funds-sold position, Federal funds sold earned 25 basis points or less by the end of the year. The interest rate on these funds has decreased dramatically from earning an average of 5.21% in 2007 to earning an average of 2.16% during 2008. During the last part of 2008, the rate of return has declined to under 1.00%. The securities portfolio has grown by 9.6% over last year and enhanced liquidity, but income earned on these balances has declined by 5.8%. The loan portfolio grew by $95.2 million during 2008 with most of the growth channeled into commercial loans. Commercial loan balances were up $87.2 million, or 19.7%, over 2007 levels. Mortgage loans saw a decline primarily in fixed loans and growth in the 5/1 adjustable rate mortgage loans, resulting in an overall decrease of $6.8 million in mortgage products. Generation and sales of mortgages into the secondary market continued at a brisk pace during 2008, however. Consumer loans increased by $14.9 million, or 16.2%, over the prior year. Compared to the robust growth in the volume of loans; interest income from these products declined by 0.3%. Interest income on all variable rate loans fell as rate drops occurred. Adjustable rate products are affected as individual loans hit adjustment dates. To stem the fall of interest income, rate floors were incorporated into some loan products.

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Interest Expense

Interest bearing liabilities grew 15.5%, or $101.0 million, during 2008. Demand deposit increases of $47.8 million contributed to the funding growth, including growth of $28.6 million in the reward checking. The increase in volume from the reward checking program and a higher rate of return resulted in an increase in interest expense. Money market account products grew by $22.1 million and although the balances have grown, interest expense has declined in the falling rate environment. Saving account deposits decreased $11.8 million due to some disintermediation. Although time deposit balances declined by 1.5%, brokered certificates of deposits were purchased during the course of the year adding $48.5 million by year end at competitive rates. Purchase of these deposits has helped to fund our strong loan demand. Short term borrowings in the form of repurchase agreements added $10.3 million. Long term borrowings increased by $52.3 million and increased associated interest expense by $2.1 million.

Net Interest Income

Net interest income is the amount by which interest income on earning assets exceeds interest paid on interest bearing liabilities. The amount of net interest income is affected by changes in interest rates, account balances or volumes and the mix of earning assets and interest bearing liabilities. Net interest income is still the primary source of commercial bank profits despite a continued focus on noninterest income sources.

For the year ended December 31, 2008, non FTE net interest income totaled $32,905,000, an increase of $2,785,000, or 9.2%, over 2007. The 2007 net interest total was $30,120,000, or 9.9%, over 2006 results. On a FTE basis, net interest income increased by 9.0% in 2008 and 9.2% in 2007. The Corporation s net interest spread was 3.85% in 2006, 3.58% in 2007, and 3.60% in 2008. The net interest margin, which factors in noninterest bearing funds sources, has moved from 4.32% to 4.08% to 3.93% in 2006, 2007 and 2008, respectively.

Throughout the declining rate environment, Bank management has continued to price deposits and loans such that the spread has remained relatively the same at 3.60% for 2008 and 3.58% for 2007. This has been a remarkable feat as other institutions in our peer group have had significant deterioration in their interest rate spreads. Net interest income growth has been achieved through volume, not rate.

Loan growth was robust during the fourth quarter of 2008, exceeding expectations. This was fueled somewhat by the lowering rate environment as prime dropped 175 basis points during the fourth quarter. Approximately 32% of our balance sheet consists of variable rate loans. To compensate for the large portfolio of variable rate loans, the Bank acquired $50 million of rate swaps during the fourth quarter 2008. The swaps trade variable rate, at Wall Street Journal prime, for fixed rate exceeding 5.0%. This helped to stabilize the net interest margin, but declines in the margin are still anticipated for 2009, due to the generally low rate environment. In addition, as member of the Federal Home Loan Bank of Pittsburgh (FHLB), the Bank holds approximately $6.4 million of FHLB stock. This stock was yielding 6.0% in the third quarter 2007 and 3.0% during the third quarter 2008, but the FHLB cut the dividend to zero effective October 1, 2008. This will remove approximately $200,000 from 2009 net interest income.

The rapid fourth quarter loan growth stressed our traditional funding sources, therefore, the Bank utilized the nontraditional sources of FHLB advances and brokered certificates of deposits. These buys were well within the confines of the Corporation s liquidity policy. These funds were acquired a lower rate than the cost of traditional retail deposits, thanks to our strong IDC rating and the overall strength of Orrstown Bank. Nevertheless, expectations are of net interest margin compression during 2009, but with continued growth in net interest income. The Corporation s 2008 net interest margin of 3.93% declined by 15 basis points from 2007 levels, but remained comfortably ahead of industry averages of 3.70% overall and 3.60% within the Mid-Atlantic region per SNL Financial.

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ANALYSIS OF NET INTEREST INCOME

Average Balances and Interest Rates, Taxable Equivalent Basis

		2008			2007			2006	
(Dollars in thousands)	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate
Assets									
Interest Earning Assets:									
Federal funds sold & interest bearing bank balances	**$ 10,356**	**$ 227**	**2.19%**	$ 11,618	$ 610	5.25%	$ 18,964	$ 956	5.04%
Taxable investment securities	**76,413**	**2,862**	**3.75**	64,323	2,931	4.56	60,432	2,480	4.10
Tax-exempt investment securities	**23,679**	**1,692**	**7.15**	27,005	1,901	7.04	26,395	1,948	7.38
Total investment securities	**100,092**	**4,554**	**4.55**	91,328	4,832	5.29	86,827	4,428	5.10
Taxable loans	**738,552**	**47,362**	**6.41**	646,707	47,720	7.38	538,637	39,380	7.31
Tax-exempt loans	**15,780**	**1,172**	**7.43**	12,437	937	7.53	14,954	1,086	7.26
Total Loans	**754,332**	**48,534**	**6.43**	659,144	48,657	7.38	553,591	40,466	7.31
Total interest-earning assets	**864,780**	**53,315**	**6.17**	762,090	54,099	7.10	659,382	45,850	6.95
Non-Interest Earning Assets:									
Cash and due from banks	**13,857**			14,767			15,206		
Bank premises and equipment	**29,144**			21,895			16,802		
Other assets	**48,542**			45,460			36,141		
Less allowance for loan losses	**(6,421)**			(5,632)			(4,960)		
Total	**$ 949,902**			$ 838,580			$ 722,571		
Liabilities and Shareholders Equity									
Interest Bearing Liabilities:									
Interest bearing demand deposits	**$ 251,547**	**$ 3,845**	**1.53**	$ 203,718	$ 4,202	2.06	$ 159,035	$ 1,887	1.19
Savings deposits	**61,881**	**618**	**1.00**	73,718	1,440	1.95	87,665	2,015	2.30
Time deposits	**279,127**	**9,558**	**3.42**	283,343	13,007	4.59	243,929	10,287	4.22
Short term borrowings	**67,175**	**1,248**	**1.86**	50,305	2,295	4.56	40,293	1,877	4.66
Long term borrowings	**94,737**	**4,139**	**4.37**	42,415	2,042	4.81	28,651	1,305	4.55
Total interest bearing liabilities	**754,467**	**19,408**	**2.57**	653,499	22,986	3.52	559,573	17,371	3.10
Non-Interest Bearing Liabilities:									
Demand deposits	**87,537**			85,383			79,733		

Other	**8,657**			7,635			6,237		
Total Liabilities	**850,661**			746,517			645,543		
Shareholders Equity	**99,241**			92,063			77,028		
Total	**$ 949,902**		**2.24**	$ 838,580		3.02	$ 722,571		2.63
Net interest income / net interest spread		**$ 33,907**	**3.60%**		$ 31,113	3.58%		$ 28,479	3.85%
Net interest margin			**3.93%**			4.08%			4.32%

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CHANGES IN TAXABLE EQUIVALENT NET INTEREST INCOME

(Dollars in thousands)	2008 Versus 2007 Increase (Decrease) Due to Change in			2007 Versus 2006 Increase (Decrease) Due to Change in		
	Average Volume	Average Rate	Total Increase (Decrease)	Average Volume	Average Rate	Total Increase (Decrease)
Interest Income						
Loans (net of unearned discounts)	**$ 7,029**	**$ (7,152)**	**$ (123)**	$ 7,718	$ 473	$ 8,191
Taxable investment securities	**551**	**(620)**	**(69)**	160	291	451
Tax-exempt investment securities	**(234)**	**25**	**(209)**	45	(92)	(47)
Other short-term investments	**(66)**	**(317)**	**(383)**	(370)	24	(346)
Total interest income	**7,280**	**(8,064)**	**(784)**	7,553	696	8,249
Interest Expense						
Interest bearing demand deposits	**987**	**(1,344)**	**(357)**	530	1,785	2,315
Savings deposits	**(231)**	**(591)**	**(822)**	(321)	(254)	(575)
Time deposits	**(194)**	**(3,255)**	**(3,449)**	1,662	1,058	2,720
Short-term borrowings	**770**	**(1,817)**	**(1,047)**	466	(48)	418
Long-term borrowings	**2,519**	**(422)**	**2,097**	627	110	737
Total interest expense	**3,851**	**(7,429)**	**(3,578)**	2,964	2,651	5,615
Net Interest Income			**$ 2,794**			**$ 2,634**

TAX-EQUIVALENT NET INTEREST INCOME

(Dollars in thousands)	December 31, 2008	2007	2006
GAAP Financial Measurements:			
Interest income-securities and other investment income	**$ 4,189**	$ 4,777	$ 4,702
Interest income loans	**48,124**	48,329	40,086
Interest expense deposits	**14,021**	18,649	14,189
Interest expense borrowings	**5,387**	4,337	3,182
Net interest income	**32,905**	30,120	27,417
Non-GAAP Financial Measurements:			
Add: tax benefit on tax-exempt investment securities	**$ 592**	$ 665	$ 682
Add: tax benefit on tax-exempt loans	**410**	328	380
Total tax benefit on tax-exempt interest income	**1,002**	993	1,062
Tax-equivalent net interest income	**$ 33,907**	$ 31,113	$ 28,479

Noninterest Income

Other noninterest income, excluding securities gains, increased $2,196,000, or 16.6%, in 2008. Other service charges on deposit accounts increased $107,000 and service charges and fees on loans increased $890,000.

The weakened economy has begun to effect consumer behavior and a slowing in growth of debit card fees and overdraft protection fees during 2009 is anticipated. Overdraft protection fees have increased by $386,000 over 2007. The convenience of debit card usage for consumers, and the popularity of our Reward Checking product, has increased debit card fees by 37.9%, or $383,000. Merchant account fees have increased by $74,000.

Loan service charges and fees increased 55.5% over 2007. Loan income, not including secondary market income, grew $325,000 due to a number of loan modifications taking place during the spring of 2008. The increase in loan modifications was a reflection of declining interest rates in the market. Commercial development loans contributed to a $66,000 increase in letter of credit fees over last year. Loans made on the secondary mortgage market program contributed fees of $565,000, or a 57.8% increase over last year. The outstanding balances of assets serviced for others at December 31, 2008, stood at $121.0 million and $92.9 million at December 31, 2007, a 30.2% increase in serviced mortgage loans.

ATM fees as well as ATM expense both declined in 2008 as compared to 2007; but net ATM fees increased by $10,000 over 2007. The Reward Checking product limits ATM fees. Orrstown Bank sold its interest in CBIA, a property and casualty insurance business; the sale on the investment provided a nonrecurring pretax gain of $219,000 in May 2007.

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During a very trying year of collapsing market values, assets under management have declined to $354 million at December 31, 2008 from $415 million at December 31, 2007. Orrstown Financial Advisors contributed $2,840,000 of trust income in 2008, an increase over 2007 of $258,000, while brokerage income decreased by $145,000 versus the prior year. Fees paid by customers are based on the value of their investment portfolios. The decrease in individual investment values traded in various markets has impacted the Bank s ability to generate asset management fees, particularly in the latter half of 2008. This trend will probably continue into 2009 as markets continue to struggle. The recent turmoil has left the general public wary of the stock market, but this has created opportunities for Orrstown Financial Advisors to showcase their experience and willingness to help current and new clients alike.

An increase in other operating income of $533,000 was due to a gain on the sale of land acquired in the North Pointe Business Park purchase and the gain on the sale of the Lurgan Avenue property that used to house the Human Resource and Training Departments. The sale of the Lurgan Avenue property included the land, building and some minor furniture. Rental income increased by $91,000 due primarily to rental income associated with the purchase of the North Pointe Business Center, which contains two rental units.

The Corporation had net securities losses in 2008 of $27,000 and net securities gains in 2007 of $58,000. These losses earlier in the year were taken to allow reinvestment as well as to reduce the taking of other than temporarily impaired losses. These losses were also offset by the capital gains mentioned above. Impairment losses of $84,000 are shown as an expense in the Analyses of Noninterest Expenses table below.

The table that follows provides additional information regarding noninterest income changes over the past three years:

ANALYSES OF NONINTEREST INCOME

	Year Ended December 31,			% Change	
(Dollars in thousands)	**2008**	**2007**	**2006**	**2008-2007**	**2007-2006**
Other Income					
Debit card fees	**$ 1,394**	$ 1,011	$ 744	**37.9%**	35.9%
Overdraft protection fees	**3,922**	3,536	2,683	**10.9%**	31.8%
Other service charges on deposit accounts	**1,442**	1,335	1,244	**8.0%**	7.3%
Loan service charges and fees	**2,495**	1,605	1,363	**55.5%**	17.8%
ATM fees	**462**	481	405	**-4.0%**	18.8%
Other service charges, commissions and fees	**99**	78	153	**26.9%**	-49.0%
Trust department income	**2,840**	2,582	2,325	**10.0%**	11.1%
Brokerage income	**1,413**	1,558	1,382	**-9.3%**	12.7%
Cash surrender value income	**683**	682	581	**0.1%**	17.4%
Non-recurring revenue	**0**	219	0	**-100.0%**	0.0%
Other operating income	**694**	161	162	**331.1%**	-0.6%
Subtotal before securities transactions	**15,444**	13,248	11,042	**16.6%**	20.0%
Securities gains (losses)	**(27)**	58	41	**-146.6%**	41.5%
Total other income	**$ 15,417**	$ 13,306	$ 11,083	**15.9%**	20.1%

Noninterest Expenses

Total operating expenses increased by $3,366,000 to $28,287,000, or a 13.5% increase over 2007. This percentage increase is down from the 15.2% increase realized between 2007 and 2006.

Salary expense, including incentive compensation, grew by $702,000, or 6.8% and employee benefits increased 9.1% or $410,000 over 2007. Included in employee benefits was a $251,000 increase in health care costs, a $53,000 increase in salary continuation, a $46,000 increase in employment taxes, a $42,000 addition to periodic post retirement expense and a $40,000 increase in profit sharing expense. Employee stock option expense was down compared to the prior year.

Occupancy and equipment costs rose by 17.0% compared to an 8.2% change over the prior year. The increase of $618,000 was caused primarily by an increase in depreciation expense of $338,000. The Bank completed renovations on its Orrstown office in August 2007 and the expansion at the Stonehedge office in November 2007. The fixed assets associated with these renovations were depreciated for a partial year in 2007 and a

full year during 2008 creating some of the increased expense. Depreciation expense was also realized starting in May 2008 for the newly occupied North Pointe Operations building and related furniture and equipment needed to outfit the center. The Eastern Boulevard office in Hagerstown, Maryland opened in September 2008 and resulted in additional depreciation expense for the remaining months of 2008. During the last half of 2008, the teller platform was upgraded to a new online system thus increasing equipment depreciation and adding to maintenance and licensing agreement expense, which had an increase of 24.7% over 2007. The addition of a new firewall protection and reporting system also added to increases in this area. We feel these outlays will serve us for many years to come.

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Data processing fees were up slightly due to an increase in merchant processing activity. Advertising in general and the cost of running the reward checking promotions increased this expense by 39.6% over last year. Printing and supplies should start to show some economies from the usage of the online teller system as printing and usage of paper entries has been greatly reduced.

Telephone costs grew by $181,000, or 36.3%, over 2007 due to the increased usage of mobile devices and the addition of the new operations center s phone connections. The move to a new phone network and the reduction in needed circuits during 2008 should help control theses costs. The non-recurring pretax expenses of $78,000, taken in the second quarter of 2007, were related to the combination of the two bank charters.

Other operating expenses increased over 2007 by $1,186,000, including increases of $183,000 of FDIC insurance. FDIC was discussed previously in Part 1, Item 1 of this report under FDIC Insurance and Assessments. FDIC insurance has become a larger expense compared to last year due to the expiration of credits used in 2007. FDIC assessments are slated to increase over the next few years due to inflation, modifying the deposit fund s reserve ratio, and to cover the number of bank failures that took place in 2008; a trend that may continue into 2009 because of the troubled economy. Banks will be required to pay a higher assessment based on their total deposits. The increase, effective January 1, 2009, will add approximately $500,000 to FDIC insurance expenses in 2009. Subsequent proposals at the beginning of March 2009 could add an additional $750,000 to $1,600,000 in the form of a one time assessment.

The Hanover Street Senior Apartments, a limited partnership investment, was placed in service at the end of 2007. Another project with Newport Hotel LLP, called Newport Senior Housing, was completed at the end of 2008 with additional investments to be paid in early 2009. This project, along with the Hanover Street project, increased the associated expense by $169,000 compared to 2007. Both of these projects will generate significant income tax credits. Increased loan demand for secondary market mortgage loans has increased the related expense by $161,000 due simply to the volume but the program remains quite profitable. Collection expense increased $116,000 due to a slight up tick in delinquency. The Bank s loan loss provision has been enhanced during 2008 given the softening economy. The reward checking product has seen remarkable growth since the beginning of the program in mid 2007, which has, in turn, increased related expenses by $100,000, in 2008. Employment agency fees grew by $97,000 due primarily to the search for qualified candidates for the CEO position.

The Corporation was able to maintain an enviable efficiency ratio for 2008 of 56.7% despite the falling rate environment and aforementioned building projects. Efficiency ratios of 55.6% and 54.0% had been generated during 2007 and 2006, respectively. SNL Financial reports average efficiency ratios of approximately 71.48% for the industry and 65.40% for banks of our peer size.

The table that follows provides additional information regarding noninterest expense changes over the past three years:

ANALYSES OF NONINTEREST EXPENSES

	Year Ended December 31,			% Change	
(Dollars in thousands)	**2008**	**2007**	**2006**	**2008-2007**	**2007-2006**
Other Expenses					
Salaries	**$ 9,950**	$ 9,367	$ 8,341	**6.2%**	12.3%
Incentive compensation	**1,014**	895	775	**13.3%**	15.5%
Employee benefits	**4,892**	4,482	3,899	**9.1%**	15.0%
Occupancy and equipment	**4,251**	3,633	3,357	**17.0%**	8.2%
Data processing	**999**	888	873	**12.5%**	1.7%
ATM expense	**164**	194	206	**-15.5%**	-5.8%
Telephone	**679**	498	350	**36.3%**	42.3%
Printing and supplies	**688**	621	487	**10.8%**	27.5%
Postage	**326**	350	274	**-6.9%**	27.7%
Directors fees	**385**	404	405	**-4.7%**	-0.2%
Advertising	**578**	414	406	**39.6%**	2.0%
PA capital stock & shares tax	**566**	552	445	**2.5%**	24.0%
Contributions	**357**	377	299	**-5.3%**	26.1%
Security impairment expense	**84**	0	0	**100.0%**	0.0%
Non-recurring expense	**0**	78	0	**-100.0%**	0.0%
Other operating expenses	**3,354**	2,168	1,511	**54.7%**	43.5%
Total operating expenses	**$ 28,287**	$ 24,921	$ 21,628	**13.5%**	15.2%

noninterest income as a % of noninterest expense	**54.5%**	53.4%	51.2%

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Federal Income Taxes

The Corporation s effective federal income tax rate for the year ended December 31, 2008 was 29.5% as compared to 29.3% in 2007 and 29.4% in 2006. Increased low income housing credits that arose from investment in community projects helped to minimally lower the effective rate. Corporate income tax rates for 2009 are forecast to be similar to 2008 levels. Although tax free debt securities will continue to mature, additional low income housing tax credits will be available in 2009. The Corporation was pushed into the 35% tax bracket during 2006 and remained in the 35% tax bracket through 2008. During 2009, taxable income for the Corporation will be at the 35% rate on average but marginally at the 38% rate.

Financial Condition

The quality of the Corporation 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.

Investment Securities

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

The following table shows the maturities of investment securities at book value as of December 31, 2008, and weighted average yields of such securities. Yields are shown on a tax equivalent basis, assuming a 35% federal income tax rate.

INVESTMENT MATURITY SCHEDULE

(Dollars in thousands)	Within 1 year	After 1 year but within 5 years	After 5 years but within 10 years	After 10 years	Total	Average Maturity	Weighted Average Yield
U. S. Treasury and government Agency securities	$ 37,118	$ 21,128	$ 0	$ 0	$ 58,246	1yr. 1mos.	3.15%
Obligations of states and political subdivisions	550	5,006	2,825	14,845	23,226	10yr. 6mos.	6.84%
Mortgage-backed securities	2,001	10,062	889	23,378	36,330	19yr. 2mos.	4.95%
Total amortized cost	$ 39,669	$ 36,196	$ 3,714	$ 38,223	$ 117,802	8yr. 6mos.	4.43%
Percentage of total	33.67%	30.73%	3.15%	32.45%	100.00%		
Weighted average yield	2.85%	4.22%	6.89%	6.04%	4.43%		

Loan Portfolio

The Bank 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, consistent with past practice and policy.

The loan portfolio at December 31 has grown 16.9% year over year, from $702.0 million to $820.5 million. On an average daily balance, loans have grown 14.4%, from $659.1 million in 2007 to $754.3 million in 2008. Loans considered commercial in purpose have been the leading growth area for the Bank. On an average daily basis commercial loans have grown from $441.7 million in 2007 to $528.9 million in 2008, which is a 19.7%, or $87.2 million increase. Mortgage loans have declined on an average daily basis by $6.8 million as loans generated and sold to the

secondary market increased by 30.2%. Consumer loans have increased on an average daily basis by $14.9 million, or 16.2%. The following table presents a breakdown of how loans are secured at the end of each of the last five years:

LOANS SECURED BY:

(Dollars in thousands)	2008	2007	2006	2005	2004
Commercial, financial and agricultural	**$ 78,880**	$ 55,698	$ 59,593	$ 50,104	$ 38,659
Real estate Commercial	**250,485**	243,210	221,460	181,587	151,259
Real estate Construction	**131,509**	92,050	46,947	30,532	18,744
Real estate Mortgage	**351,426**	302,419	281,902	191,823	173,444
Consumer	**8,168**	8,587	8,925	6,340	7,162
Total loans	**$ 820,468**	$ 701,964	$ 618,827	$ 460,386	$ 389,268

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Presented below are the approximate maturities of the loan portfolio (excluding real estate mortgages, installments, and credit cards) at December 31, 2008.

(Dollars in thousands)	Under One Year	One to Five Years	Over Five Years	Total
Commercial, financial and agricultural	$ 3,850	$ 13,336	$ 61,694	$ 78,880
Real estate Construction	33,849	36,879	60,781	131,509
Total loans	$ 37,699	$ 50,215	$ 122,475	$ 210,389

The following table presents the approximate amount of fixed rate loans and variable rate loans due as of December 31, 2008.

(Dollars in thousands)	Fixed Rate Loans	Variable Rate Loans
Due within one year	$ 9,121	$ 100,373
Due after one but within five years	38,162	46,188
Due after five years	111,598	515,026
Total loans	$ 158,881	$ 661,587

Deposit Products

On an average daily basis, total deposits grew 5.3% or $33.9 million over 2007. At December 31, 2008, total deposits grew to $757.4 compared to $646.4 at year end 2007, or a 17.2% increase.

The purchase of brokered certificates of deposit beginning in February 2008 grew to $48.5 million by the end of 2008 and was the primary factor of the year end increase. Although brokered time deposits were purchased, time deposit balances actually decreased on average by $4.2 million. Some growth occurred in time deposits with balances over $100,000 and in retirement accounts, while all other categories declined in differing degrees.

The reward checking program added $20.6 million of additional deposits by year end 2008; and was the main reason the interest bearing demand deposits increased by 23.5%, on average, over the prior year. Average balances of noninterest bearing deposits increased 2.5% over 2007. Some balances from savings accounts migrated into the higher rate checking products, lowering average balances by $11.8 million from 2007. As we move into 2009, building funding sources by traditional methods will continue to be a challenge.

The average amounts of deposits are summarized below:

	Years Ended December 31,		
(Dollars in thousands)	2008	2007	2006
Demand deposits	**$ 87,537**	$ 85,383	$ 79,733
Interest bearing demand deposits	**251,547**	203,718	159,035
Savings deposits	**61,881**	73,718	87,665
Time deposits	**279,127**	283,343	243,929
Total deposits	**$ 680,092**	$ 646,162	$ 570,362

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The following is a breakdown of maturities of time deposits of $100,000 or more as of December 31, 2008.

(Dollars in thousands)	
Three months or less	$ 66,348
Over three months through six months	15,166
Over six months through one year	32,257
Over one year	14,764
Total	$ 128,535

Credit Risk Management

Allowance for Loan Losses

Historically, the Corporation has had an enviable record regarding its control of loan losses, but lending is a banking service that inherently contains elements of risk. The Bank s policies, related to the allowance for loan losses, are considered to be critical accounting policies because the allowance for loan losses represents a particularly sensitive accounting estimate. The amount of the allowance is based on management s evaluation of the collectibility of the loan portfolio, including the nature of the loan portfolio and loan growth, credit concentrations, trends in historical loss experience, specific impaired loans, and national and local economic conditions. The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible, based on evaluations of the collectibility of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, charge-offs and recoveries in total, overall portfolio quality, review of specific problem loans, recent examinations, and current economic conditions that may affect the borrowers ability to pay.

Through this review and evaluation process, an amount deemed adequate to meet current growth and future loss expectations is charged to operations. The provision for loan losses amounted to $1,450,000, $750,000, and $390,000 for 2008, 2007 and 2006, respectively. These provisions compared to net charge-offs of $451,000, $129,000 and $18,000 for 2008, 2007 and 2006, respectively. The unallocated portion of the reserve was approximately 14.0% at December 31, 2008 and 12.0% at December 31, 2007. The reserve at December 31, 2007 and 2008 represented 0.87% of loans outstanding, the same level that existed at December 31, 2007. This ratio has remained relatively low in recognition of the quality of the loan portfolio.

The unallocated portion of the reserve ensures that any additional unforeseen losses that are not otherwise identifiable will be able to be absorbed. It is intended to provide for imprecise estimates in assessing projected losses, uncertainties in economic conditions and allocating pool reserves. Management deems the total of the allocated and unallocated portions of the allowance for loan losses to be adequate to absorb losses at this time.

In retrospect, the specific allocation in any particular category may prove excessive or inadequate and consequently may be reallocated in the future to reflect the then current conditions. Accordingly, the entire allowance is available to absorb losses in any category. The following is an allocation by loan categories of the allowance for loan losses for the last five years at December 31,

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ALLOCATION OF ALLOWANCE FOR LOAN LOSSES

(Dollars in thousands)	2008	2007	2006	2005	2004
Loans:					
Commercial, financial and agricultural	**$ 319**	$ 1,227	$ 1,206	$ 558	$ 1,381
Real estate Commercial	**2,393**	1,990	1,584	573	617
Real estate Construction	**598**	45	42	6	0
Real estate Mortgage	**2,567**	2,115	1,553	865	330
Consumer	**265**	30	13	44	105
Unallocated	**998**	734	1,122	2,382	1,885
Total	**$ 7,140**	$ 6,141	$ 5,520	$ 4,428	$ 4,318
Percentage of Loans to Total Loans					
Commercial, financial and agricultural	**10%**	8%	10%	11%	10%
Real estate Commercial	**30%**	35%	36%	39%	39%
Real estate Construction	**16%**	13%	8%	7%	5%
Real estate Mortgage	**43%**	43%	45%	42%	44%
Consumer	**1%**	1%	1%	1%	2%
Total	**100%**	100%	100%	100%	100%

Net charge-offs for the Bank s loan portfolio has historically been quite low, when compared to industry standards, and represented 0.06% of average outstanding loans during 2008, 0.02% in 2007, and 0.00% in 2006. Net charge-offs to average loans for the industry averaged approximately .32% of loans during 2008, .11% in 2007 and .06% in 2006, per SNL Financial.

SUMMARY OF LOAN LOSS EXPERIENCE

	Year Ended December 31,				
(Dollars in thousands)	2008	2007	2006	2005	2004
Amount of loans outstanding at end of period	**$ 820,468**	$ 701,964	$ 618,827	$ 460,386	$ 389,268
Daily average loans outstanding	**$ 754,332**	$ 659,144	$ 553,591	$ 421,728	$ 369,409
Balance of allowance for possible loan losses at beginning of period	**$ 6,141**	$ 5,520	$ 4,428	$ 4,318	$ 4,161
Loans charged off					
Commercial, financial and agricultural	**2**	8	12	0	21
Real estate	**415**	53	0	30	9
Consumer	**80**	120	85	52	55
Total loans charged off	**497**	181	97	82	85
Recoveries of loans previously charged off					
Commercial, financial and agricultural	**0**	3	50	0	0
Real estate	**19**	13	7	22	3
Consumer	**27**	36	22	26	29
Total recoveries	**46**	52	79	48	32

Net loans charged off (recovered)	**451**	129	18	34	53
Additions to allowance charged to expense	**1,450**	750	390	144	210
Additions established for acquired credit risk	**0**	0	720	0	0
Balance at end of period	**$ 7,140**	$ 6,141	$ 5,520	$ 4,428	$ 4,318
Ratio of net charge-offs to average loans outstanding	**0.06%**	0.02%	0.00%	0.01%	0.01%
Ratio of reserve to gross loans outstanding at December 31	**0.87%**	0.87%	0.89%	0.96%	1.11%

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Risk Elements

Nonperforming assets are comprised of nonaccrual and restructured loans and other real estate owned (OREO) not including bank premises. OREO represents property acquired through foreclosure or settlements of loans and is carried at the lower of the principal amount of the loan outstanding at the time acquired or the estimated fair value of the property. The excess, if any, of the principal balance at the time acquired over the carrying amount is charged against the reserve for loan losses. Nonaccrual loans are loans for which interest income is not accrued due to concerns about the collectibility of interest and/or principal. Restructured loans are loans whose terms have been renegotiated to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrower. Other credit risk elements include loans past due for 90 days or more. The Corporation s loan loss history has been much better than peer standards and analysis of the current credit risk position is favorable. The allowance for loan losses is ample given the current composition of the loan portfolio and adequately covers the credit risk management sees under present economic conditions. Management is prepared to make reserve adjustments that may become necessary as economic conditions continue to change.

Nonperforming loans, as represented by nonaccrual and renegotiated loans, were .05% of outstanding loans at December 31, 2008 and .02% at December 31, 2007. Loans 90 days or more past due and still accruing represented .75% and ..51% of outstanding loans at December 31, 2008 and 2007, respectively.

NONPERFORMING ASSETS

			December 31,		
(Dollars in thousands)	**2008**	**2007**	**2006**	**2005**	**2004**
Loans on nonaccrual (cash) basis	**$ 341**	$ 118	$ 120	$ 52	$ 314
Loans whose terms have been renegotiated to provide a reduction or deferral of interest or principal because of a deterioration in the financial position of the borrower	**0**	0	0	0	0
OREO	**608**	199	318	1,754	0
Total nonperforming loans and OREO	**$ 949**	$ 317	$ 438	$ 1,806	$ 314
Ratio of nonperforming assets to total loans and OREO	**0.12%**	0.05%	0.07%	0.39%	0.08%
Ratio of nonperforming assets to total assets	**0.09%**	0.04%	0.05%	0.30%	0.06%
OTHER CREDIT RISK ELEMENTS:					
Loans past due 90 or more days and still accruing	**$ 6,176**	$ 3,586	$ 1,084	$ 411	$ 2,550
Ratio of other credit risk elements to total loans and OREO	**0.75%**	0.51%	0.18%	0.09%	0.66%
Ratio of other credit risk elements to total assets	**0.59%**	0.41%	0.13%	0.07%	0.50%
Total nonperforming and other risk assets	**$ 7,125**	$ 3,903	$ 1,522	$ 2,217	$ 2,864
Ratio of total risk assets to total loans and OREO	**0.87%**	0.56%	0.25%	0.48%	0.74%
Ratio of total risk assets to total assets	**0.68%**	0.44%	0.19%	0.37%	0.56%

Liquidity, Rate Sensitivity and Interest Rate Risk Analysis

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. 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 Corporation 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. The goal is to maintain a predominantly matched position with very few planned mismatches. Rate spreads will be sacrificed at times in order to enable the overall rate sensitivity position to stay within the guidelines called for by asset/liability management policy. Rate sensitivity is measured by monthly gap analyses, quarterly rate shocks, and periodic simulation. Investment and pricing decisions are made using both liquidity and sensitivity analyses as tools. The schedule that follows reflects the degree to which the Corporation can adjust its various portfolios to meet interest rate changes. Additionally, the Bank is a Federal Home Loan Bank (FHLB) member, and standard credit arrangements available to FHLB members provide increased liquidity.

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RATE SENSITIVITY ANALYSIS AT DECEMBER 31, 2008

	Interest Sensitivity Period				
(Dollars in thousands)	Within 3 Months	After 3 Within 6 Months	After 6 Within 12 Months	After 1 Year	Total
Rate Sensitive Assets (RSA)					
Loans	$ 317,813	$ 20,433	$ 41,417	$ 440,805	$ 820,468
Investment securities	21,701	12,569	15,429	78,654	128,353
Other earning assets	14,342	0	0	0	14,342
Total RSA	$ 353,856	$ 33,002	$ 56,846	$ 519,459	$ 963,163
Rate Sensitive Liabilities (RSL)					
Interest bearing deposits	$ 239,284	$ 43,090	$ 85,325	$ 305,408	$ 673,107
Short term borrowed funds	64,007	0	0	0	64,007
Long term borrowed funds	40,354	7,858	30,228	39,847	118,287
Total RSL	$ 343,645	$ 50,948	$ 115,553	$ 345,255	$ 855,401
Rate Sensitive GAP					
Period	$ 10,211	$ (17,946)	$ (58,707)	$ 174,204	$ 107,762
Cumulative	$ 10,211	$ (7,735)	$ (66,442)	$ 107,762	
GAP as a Percent of Total Assets					
Period	0.97%	-1.71%	-5.58%	16.56%	
Cumulative	0.97%	-0.74%	-6.32%	10.25%	
RSA/RSL cumulative	1.03%	0.98%	0.87%	1.13%	

The slightly asset biased, or positive, gap position indicates that earnings are naturally enhanced, or more easily maintained, in a rising rate environment. The position is very closely balanced, though, so no strong bias exists. The cumulative RSA/RSL at December 31, 2008 is 1.03% at three months, 0.98% at six months and 0.87% at twelve months, so the Corporation is not at undue risk under any interest rate scenario. This indicates that the balance sheet is well positioned to be maintained in the current low rate environment and to react to any rate increases in the future. Many of the interest bearing deposits that are variable rate are subject to discretionary pricing so management retains flexibility with those funds which will enhance earnings in a rising rate environment. The majority of the loan portfolio is tied to prime, but the use of three to seven year rate locks helps to maintain the yield in a falling rate environment as well as placing rate floors on any new loans. Management will closely monitor the fiscal policies of our government and will react to any changes quickly in order to maintain a healthy earning asset / interest bearing liability balance.

Contractual Obligations

Contractual obligation payments of the Corporation as of December 31, 2008 are as follows:

(Dollars in thousands)	Less than 1 year	2 - 3 years	4 - 5 years	More than 5 years	Total
Long-term debt obligations	$ 53,456	$ 50,602	$ 7,722	$ 6,507	$ 118,287
Operating lease obligations	260	397	223	776	1,656
Total	$ 53,716	$ 50,999	$ 7,945	$ 7,283	$ 119,943

Capital Adequacy and Regulatory Matters

The Corporation maintains a strong capital base which provides adequate resources to absorb both normal and unusual risks inherent to the banking business. Internal capital generation has been supported, primarily, by net income retained after the declaration of dividends and also

through the exercise of options and employee stock purchases. Total shareholders equity rose $7.2 million during 2008, an increase of 7.5% over the balance at December 31, 2007. This followed growth of 7.5% and 56.0% during 2007 and 2006, respectively. Growth in 2006 was significantly enhanced by the First National acquisition.

Unrealized securities gains decreased $29,000 during 2008, while unrealized derivative gains of $831,000 resulted from interest rate swaps. These are both components of comprehensive income as shown in Note 1 of

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Item 8 included in this report. Treasury stock purchases of $1,376,000 and issuances of $478,000 were completed during 2008. Other growth experienced during 2008 has been provided primarily by net income. Equity represented 9.83% of assets at December 31, 2008, which is down slightly from the 10.86% at December 31, 2007. The increasing earnings stream during this period has allowed the Corporation to steadily increase cash dividends paid to shareholders. In 2008, cash dividends rose $317,000 or 6.0% over 2007 levels, while net income rose 4.3% during the same period. This followed a 13.1% increase in dividend payout for 2007 versus 2006. Dividends per share have moved from $0.74 to $0.82 to $0.87 for 2006 through 2008, respectively.

CAPITAL AND DIVIDEND RATIOS

(Dollars in thousands)	2008	2007	2006
At December 31:			
Shareholders equity	**$ 103,347**	$ 96,124	$ 89,388
Equity to asset ratio	**9.83%**	10.86%	11.05%
For the Year:			
Average assets	**$ 949,902**	$ 838,580	$ 722,571
Average shareholders equity	**99,241**	92,063	77,028
Net Income	**13,103**	12,558	11,632
Cash dividends paid	**5,588**	5,271	4,662
Equity to asset ratio	**10.45%**	10.98%	10.66%
Dividend payout ratio	**42.65%**	41.97%	40.07%
Return on average equity	**13.20%**	13.64%	15.10%
Return on average tangible equity	**17.02%**	18.02%	18.98%

Orrstown Financial Services