

ORRSTOWN FINANCIAL SERVICES INC

Form 10-K

March 15, 2007

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended: December 31, 2006

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
(State or other jurisdiction of incorporation

or organization)

23-2530374
(I.R.S. Employer

Identification No.)

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

17257
(Zip Code)

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

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-K

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 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

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, 2006 was \$217,225,714.

Number of shares outstanding of the registrant's common stock as of December 31, 2006: 6,134,332.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Annual Financial Report to shareholders for the year ended December 31, 2006 are incorporated by reference into Parts I and II.

Portions of the Proxy Statement for the 2007 Annual Meeting of Security Holders are incorporated by reference in Part III of this Form 10-K.

Table of Contents

ORRSTOWN FINANCIAL SERVICES, INC.

FORM 10-K

INDEX

| | Page |
|--|-------------|
| <u>Part I</u> | |
| Item 1. <u>Business</u> | 3 |
| Item 1A. <u>Risk Factors</u> | 7 |
| Item 1B. <u>Unresolved Staff Comments</u> | 8 |
| Item 2. <u>Properties</u> | 8 |
| Item 3. <u>Legal Proceedings</u> | 8 |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u> | 8 |
| <u>Part II</u> | |
| Item 5. <u>Market for Registrant's Common Equity and Related Security Holder Matters and Issuer Purchases of Equity Securities</u> | 9 |
| Item 6. <u>Selected Financial Data</u> | 9 |
| Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operation</u> | 10 |
| Item 7A. <u>Quantitative and Qualitative Disclosures about Market Risk</u> | 10 |
| Item 8. <u>Financial Statements and Supplementary Data</u> | 10 |
| Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u> | 18 |
| Item 9A. <u>Controls and Procedures</u> | 18 |
| Item 9B. <u>Other Information</u> | 18 |
| <u>Part III</u> | |
| Item 10. <u>Directors and Executive Officers of the Registrant</u> | 19 |
| Item 11. <u>Executive Compensation</u> | 19 |
| Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> | 19 |
| Item 13. <u>Certain Relationships and Related Transactions</u> | 19 |
| Item 14. <u>Principal Accountant Fees and Services</u> | 19 |
| <u>Part IV</u> | |
| Item 15. <u>Exhibits and Financial Statement Schedules</u> | 20 |
| <u>Signatures</u> | 22 |

Table of Contents

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 10-Q's - quarterly reports; 10-K - annual report; annual proxy statements 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

On March 8, 1988, 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 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, the predecessor of Orrstown Bank, under which Orrstown Bank became a wholly-owned subsidiary of Orrstown Financial Services, Inc. As indicated, Orrstown Bank is the successor to Orrstown Bank which was originally organized in 1919. Orrstown Bank is engaged in providing banking and bank related services in South Central Pennsylvania, principally Franklin and Cumberland Counties in Pennsylvania and in Washington County Maryland. The sixteen offices of Orrstown Bank are located in Shippensburg (2), Carlisle (4), Spring Run, Orrstown, Chambersburg (3), Greencastle, Mechanicsburg (2) and Camp Hill, Pennsylvania and Hagerstown, Maryland.

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 is engaged in providing banking and bank related services in Perry County, Pennsylvania and was originally organized on May 23, 1893. First National has four branches located in Newport (2), Duncannon, and New Bloomfield, Pennsylvania. Further discussion related to the acquisition is included in the Annual Financial Report under Note 2 Acquisition, in the Notes to Consolidated Financial Statements.

Business

Orrstown Financial Services, Inc.'s primary activity consists of owning and supervising its two subsidiaries, Orrstown Bank and The First National Bank of Newport (the Banks). The day-to-day management of the Banks is conducted by the subsidiaries' 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 six officers who are also employees of its subsidiary banks. On December 31, 2006, Orrstown Bank had 184 full-time and 41 part-time employees, while First National had 36 full-time and 13 part time employees.

The Banks are 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 Banks grant agribusiness, commercial and residential loans to customers in their 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 (page 4 of the annual report to shareholders). The Banks maintain a diversified loan portfolio and evaluate each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-K

necessary by the Banks upon the extension of credit, is based on management's credit evaluation of the customer and collateral standards established in the Banks' lending policies and procedures.

Table of Contents

All secured loans are supported with appraisals 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 collateral values are monitored as part of the loan review, and appraisals are updated as deemed appropriate in the circumstances.

Administration and supervision over the lending process is provided by the Banks' 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 Review 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, 2006, the Corporation had total assets of approximately \$809 million, total shareholders' equity of approximately \$89 million and total deposits of approximately \$639 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 operation of the Banks is 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 Banks' operations are also subject to regulations of the Pennsylvania Department of Banking, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC).

Several of the more significant regulatory provisions applicable to banks and financial holding companies to which the Corporation and its subsidiaries are subject are discussed below, along with certain regulatory matters concerning the Corporation and its subsidiaries. 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 subsidiaries.

Financial and Bank Holding Company Activities

Financial in Nature Requirement. 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.

Table of Contents

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. Orrstown Bank entered into an agreement to lease an existing banking office at 201 South Cleveland Avenue in Hagerstown.

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 subsidiaries with respect to capital requirements is incorporated by reference from Note 16, 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, 2006, both Banks were considered well capitalized based on the guidelines implemented by the banks' regulatory agencies.

Table of Contents

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 subsidiaries Orrstown Bank and First National. Various federal laws limit the amount of dividends the Banks can pay to the Corporation without regulatory approval. In addition, federal bank regulatory agencies have authority to prohibit the Banks 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 Banks 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 subsidiaries with respect to dividends is incorporated by reference from Note 16, "Regulatory Matters", of the "Notes to Consolidated Financial Statements" included under Item 8 of this report, and the "Capital Adequacy and Regulatory Matters" sections 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.

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, President Bush signed into law the Sarbanes-Oxley Act of 2002. 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 establishes: (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 currently 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 for the year ended December 31, 2004.

FDIC Insurance and Assessments

Deposit accounts in the Company's subsidiary banks are insured by the Federal Deposit Insurance Corporation generally 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 Banks' deposits, therefore, are subject to FDIC deposit insurance assessments.

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.

Table of Contents

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 becomes 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. For the quarter ended June 30, 2006, the FICO assessment was equal to 1.28 basis points for each \$100 in domestic deposits maintained at an institution.

In 2006, the FDIC assessment for Orrstown Bank was \$59,000, and for First National \$13,000.

Future Legislation

Changes to the laws and regulations in the state where the Corporation and the Banks do business can affect the operating environment of bank holding companies and their 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.

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 Banks' 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 Banks, like other depository institutions, have 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 Banks. 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 and First National are competitive with the financial institutions in their service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

One outgrowth of the competitive environment discussed above has been significant consolidation within the financial services industry on a global, national, and regional level. We continue 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, including those specified below, that may adversely affect the Corporation's business, financial results or stock price. 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.

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-K

Factors that might cause such differences include, but are not limited to the following: (1) competitive pressures among financial institutions increasing significantly in the markets where the Corporation operates; (2) general business and economic conditions, either nationally or locally being less favorable than expected; (3) changes in the domestic interest rate environment could reduce the Corporation's net interest income; (4) legislation or regulatory changes which adversely affect the ability of the Corporation to conduct its current or

Table of Contents

future operations; (5) acts or threats of terrorism and political or military actions taken by the United States or other governments and natural disasters globally or nationally could adversely affect general economic or industry conditions; (6) operational losses related to or resulting from: the risk of fraud by employees or persons outside of the Corporation, the execution of unauthorized transactions by employees, errors relating to transaction processing and technology, breaches of the internal control system, business continuation and disaster recovery, as well as security risks associated with hacking and identity theft ; (7) negative publicity could damage the Corporation's reputation and adversely impact its business and/or stock trades and prices; (8) acquisitions may not produce revenue enhancements or cost savings at levels or within timeframes originally anticipated and may result in unforeseen integration difficulties; (9) the Corporation relies on other companies to provide key components of business infrastructure in the form of third party vendors. Third party vendors could adversely affect the ability of the Corporation to perform its normal course of business or deliver products and services to its customers; (10) and other risk factors that may occur in current or future operations.

Item 1B Unresolved Staff Comments

None

Item 2. Properties.

Orrstown Bank owns buildings in Orrstown, Shippensburg (2), Carlisle (2), Spring Run, Chambersburg (3), and Mechanicsburg (2), Pennsylvania. Offices of Orrstown Bank are located in each of these buildings. It also leases space for offices located in Greencastle, Carlisle (2) and Camp Hill, Pennsylvania and in Hagerstown, Maryland. First National owns buildings in Newport (2), Duncannon, and New Bloomfield, Pennsylvania. Offices of First National are located in each of these buildings

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

Table of Contents

Part II

Item 5. Market for Registrant's Common Equity and 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, 2006, the number of shareholders of record was approximately 3,022. The price ranges for Orrstown Financial Services, Inc. common stock set forth below are the approximate bid prices obtained from brokers who make a market in the stock and does not reflect prices in actual transactions or include retail markups and markdowns or any commission to the broker/dealer.

| Dividend (1) | 2006 | | | 2005 | | |
|----------------|----------------------|---------------------|-----------------------|----------------------|---------------------|-----------------------|
| | Market Price High | Market Price Low | Quarterly Dividend | Market Price High | Market Price Low | Quarterly Dividend |
| First quarter | \$ 35.70 | \$ 31.80 | \$ 0.18 | \$ 47.62 | \$ 39.05 | \$ 0.133 |
| Second quarter | \$ 39.00 | \$ 32.00 | \$ 0.20 | \$ 43.75 | \$ 37.14 | \$ 0.140 |
| Third quarter | \$ 38.25 | \$ 36.50 | \$ 0.20 | \$ 42.20 | \$ 37.55 | \$ 0.150 |
| Fourth quarter | \$ 39.00 | \$ 36.55 | \$ 0.20 | \$ 37.95 | \$ 34.45 | \$ 0.160 |

(1) Note: All per share data has been restated after giving retroactive recognition to a 5% stock dividend paid June 29, 2005. See Note 16 in the Notes to Consolidated Financial Statements for the year ended December 31, 2006 for restrictions on the payment of dividends.

Issuer Purchases of Equity Securities

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, 2006, 14,749 shares have been purchased under the program. Orrstown did not sell any unregistered securities. The Company has not repurchased any common equity securities during the fourth quarter ended December 31, 2006. The maximum number of shares that may yet be purchased under the plan is 135,251 shares at December 31, 2006.

Item 6. Selected Financial Data.

The selected five-year financial data on page 41 of the Annual Financial Report to shareholders for the year ended December 31, 2006 is incorporated herein by reference.

Table of Contents**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation.**

Contractual obligation payments of the Corporation as of December 31, 2006 are as follows:

| (Dollars in thousands) | Less than | | | More than | Total |
|-----------------------------|-----------------|------------------|-----------------|------------------|------------------|
| | 1 year | 2 - 3 years | 4 - 5 years | 5 years | |
| Long-term debt obligations | \$ 922 | \$ 19,747 | \$ 643 | \$ 11,128 | \$ 32,440 |
| Operating lease obligations | 279 | 442 | 365 | 959 | 2,045 |
| Total | \$ 1,201 | \$ 20,189 | \$ 1,008 | \$ 12,087 | \$ 34,485 |

All other information required by Item 7 is included in Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), on pages 28 through 38 of the Annual Financial Report to shareholders which is incorporated herein by reference.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

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

Interest rate sensitivity management requires the maintenance of an appropriate balance between interest sensitive assets and liabilities. Interest bearing assets and liabilities that are maturing or repricing should be adequately balanced to avoid fluctuating net interest margins and to enhance consistent growth of net interest income through periods of changing interest rates. The 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. Interest-earning assets are substantially made up of loans and securities. Loans are priced by management with current market rates as guidelines while achieving a positive interest rate spread and limiting credit risk. A significant part of the loan portfolio is made up of variable rate loans and loans that will become variable after a fixed term and will reprice as market rates move. Securities are purchased using liquidity and maturity terms as guidelines to obtain a more matched position. The deposit base is a mix of transaction accounts and time deposits. Many of the interest bearing transaction accounts have discretionary pricing so great flexibility exists for deposit side price adjustments. Time deposits have set maturities as do short term and long term borrowings. Although deposit product cycles and growth are driven by the preferences of our customers, borrowings are structured with specific terms that, when aggregated with the terms for deposits and matched with interest-earning assets, mitigate our exposure to interest rate sensitivity. Rate sensitivity is measured by monthly gap analysis, quarterly rate shocks, and periodic simulation. At December 31, 2006, the twelve month cumulative gap was a negative \$41,976,000 and the RSA/ RSL cumulative ratio was 0.88% which has decreased from 1.14% since December 31, 2005. Further discussion related to the quantitative and qualitative disclosures about market risk is included under the heading of Liquidity, Rate Sensitivity and Interest Rate Risk Analysis in the MD&A of the Annual Financial Report to shareholders which is incorporated herein by reference.

Item 8. Financial Statements and Supplementary Data.

The financial statements and supplementary data, some of which is required under Guide 3 (statistical disclosures by bank holding companies) are shown on pages 4 through 42 of the annual shareholders' report for the year ended December 31, 2006 and are incorporated herein by reference. Certain statistical information required in addition to those included in the annual shareholders' report are submitted herewith as follows.

| Description of Statistical Information | Page |
|--|------|
| <u>Changes in taxable equivalent net interest income</u> | 11 |
| <u>Investment portfolio</u> | 12 |
| <u>Loan portfolio</u> | 13 |
| <u>Summary of loan loss experience</u> | 14 |
| <u>Nonaccrual, delinquent and impaired loans</u> | 14 |
| <u>Allocation of allowances for loan losses</u> | 15 |

| | |
|---|----|
| <u>Deposits</u> | 16 |
| <u>Return on equity and assets</u> | 16 |
| <u>Consolidated summary of operations</u> | 17 |

Table of Contents

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

CHANGES IN TAXABLE EQUIVALENT NET INTEREST INCOME

| | 2006 Versus 2005 | | | 2005 Versus 2004 | | |
|-----------------------------------|---------------------|-----------------|------------------------|---------------------|-----------------|------------------------|
| | Increase (Decrease) | | | Increase (Decrease) | | |
| | Due to Change in | | | Due to Change in | | |
| | Total | | | Total | | |
| (Dollars in thousands) | Average Volume | Average Rate | Increase (Decrease) | Average Volume | Average Rate | Increase (Decrease) |
| Interest Income | | | | | | |
| Loans (net of unearned discounts) | \$ 8,943 | \$ 2,899 | \$ 11,842 | \$ 3,156 | \$ 3,129 | \$ 6,285 |
| Taxable investment securities | 68 | 202 | 270 | (84) | 17 | (67) |
| Nontaxable investment securities | 363 | (141) | 222 | (97) | (5) | (102) |
| Other short-term investments | 99 | 318 | 417 | 46 | 315 | 361 |
| Total interest income | 9,473 | 3,278 | 12,751 | 3,021 | 3,456 | 6,477 |
| Interest Expense | | | | | | |
| Interest bearing demand | (39) | 277 | 238 | (220) | (73) | (293) |
| Savings deposits | 457 | 378 | 835 | 152 | 893 | 1,045 |
| Time deposits | 3,299 | 2,526 | 5,825 | 713 | 625 | 1,338 |
| Short-term borrowings | 421 | 660 | 1,081 | 26 | 466 | 492 |
| Long-term borrowings | (248) | 103 | (145) | (55) | 24 | (31) |
| Total interest expense | 3,890 | 3,944 | 7,834 | 616 | 1,935 | 2,551 |
| Net interest income | | | \$ 4,917 | | | \$ 3,926 |

Changes which are attributed in part to volume and in part to rate are allocated in proportion to their relationships to the amounts of changes.

Table of Contents

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

INVESTMENT PORTFOLIO

The following table shows the maturities of investment securities at book value as of December 31, 2006, and weighted average yields of such securities. Yields are shown on a tax equivalent basis, assuming a 35% federal income tax rate.

| (Dollars in thousands) | Within 1 year | After 1 year but within 5 years | After 5 years but within 10 years | After 10 years | Total |
|------------------------------------|------------------|--|--|------------------|------------------|
| Bonds: | | | | | |
| U. S. Treasury | | | | | |
| Book value | \$ 1,274 | \$ 505 | \$ 0 | \$ 0 | \$ 1,779 |
| Yield | 3.04% | 4.88% | 0% | 0% | 3.56% |
| U. S. Government agencies | | | | | |
| Book value | 10,502 | 10,563 | 2,500 | 0 | 23,565 |
| Yield | 3.43% | 4.25% | 5.60% | 0% | 4.03% |
| State and municipal | | | | | |
| Book value | 992 | 3,704 | 8,024 | 15,376 | 28,096 |
| Yield | 4.72% | 5.10% | 6.17% | 7.28% | 6.59% |
| Corporate bonds | | | | | |
| Book value | 402 | 700 | 200 | 0 | 1,302 |
| Yield | 3.04% | 5.02% | 5.84% | 0% | 4.53% |
| Total book value | \$ 13,170 | \$ 15,472 | \$ 10,724 | \$ 15,376 | \$ 54,742 |
| Yield | 3.48% | 4.51% | 6.03% | 7.28% | 5.34% |
| Mortgage-backed securities | | | | | |
| Total book value | | | | | \$ 29,963 |
| Yield | | | | | 4.20% |
| Equity Securities | | | | | |
| Total book value | | | | | \$ 2,448 |
| Yield | | | | | 5.06% |
| Total Investment Securities | | | | | \$ 87,153 |
| Yield | | | | | 4.94% |

Table of Contents

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

LOAN PORTFOLIO

The following table presents the loan portfolio at the end of each of the last five years:

| (Dollars in thousands) | 2006 | 2005 | 2004 | 2003 | 2002 |
|--|------------|------------|------------|------------|------------|
| Commercial, financial and agricultural | \$ 59,593 | \$ 50,104 | \$ 38,659 | \$ 38,186 | \$ 33,806 |
| Real estate Commercial | 221,460 | 181,587 | 151,259 | 123,531 | 88,130 |
| Real estate Construction | 46,947 | 30,532 | 18,744 | 21,016 | 22,048 |
| Real estate Mortgage | 281,902 | 191,823 | 173,444 | 154,454 | 129,661 |
| Consumer (net of unearned discount) | 8,925 | 6,340 | 7,162 | 7,867 | 7,746 |
| Total loans | \$ 618,827 | \$ 460,386 | \$ 389,268 | \$ 345,054 | \$ 281,391 |

Presented below are the approximate maturities of the loan portfolio (excluding real estate mortgages, installments, and credit cards) at December 31, 2006:

| (Dollars in thousands) | Over Five | | | Total |
|--|----------------|-------------------|-----------|------------|
| | Under One Year | One to Five Years | Years | |
| Commercial, financial and agricultural | \$ 8,296 | \$ 14,430 | \$ 36,867 | \$ 59,593 |
| Real estate Construction | 8,460 | 9,406 | 29,081 | 46,947 |
| Total loans | \$ 16,756 | \$ 23,836 | \$ 65,948 | \$ 106,540 |

The following table presents the approximate amount of fixed rate loans and variable rate loans due as of December 31, 2006:

| (Dollars in thousands) | Variable | |
|-------------------------------------|------------------|------------|
| | Fixed Rate Loans | Rate Loans |
| Due within one year | \$ 11,012 | \$ 57,702 |
| Due after one but within five years | 42,171 | 27,485 |
| Due after five years | 128,361 | 352,096 |
| Total loans | \$ 181,544 | \$ 437,283 |

Table of Contents

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

SUMMARY OF LOAN LOSS EXPERIENCE

| (Dollars in thousands) | Years Ended December 31 | | | | |
|--|-------------------------|------------|------------|------------|------------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Average total loans outstanding (net of unearned income) | \$ 553,591 | \$ 421,728 | \$ 369,409 | \$ 313,833 | \$ 264,296 |
| Allowance for loan losses, beginning of period | 4,428 | 4,318 | 4,161 | 3,734 | 3,104 |
| Additions to provision for loan losses charged to operations | 390 | 144 | 210 | 491 | 720 |
| Additions established for acquired credit risk | 720 | 0 | 0 | 0 | 0 |
| Loans charged off during the year | | | | | |
| Mortgages | 0 | 30 | 9 | 12 | 0 |
| Commercial | 12 | 0 | 21 | 4 | 48 |
| Installment | 49 | 31 | 39 | 33 | 36 |
| Personal credit lines and credit cards | 36 | 21 | 16 | 32 | 17 |
| Total charge-offs | 97 | 82 | 85 | 81 | 101 |
| Recoveries of loans previously charged off: | | | | | |
| Mortgages | 7 | 22 | 3 | 3 | 0 |
| Commercial | 50 | 0 | 0 | 0 | 3 |
| Installment | 13 | 19 | 25 | 8 | 8 |
| Personal credit lines and credit cards | 9 | 7 | 4 | 6 | 0 |
| Total recoveries | 79 | 48 | 32 | 17 | 11 |
| Net loans charged off (recovered) | 18 | 34 | 53 | 64 | 90 |
| Allowance for loan losses, end of period | \$ 5,520 | \$ 4,428 | \$ 4,318 | \$ 4,161 | \$ 3,734 |
| Ratio of net loans charged off to average loans outstanding | 0.00% | 0.01% | 0.01% | 0.02% | 0.03% |

The provision is based on an evaluation of the adequacy of the allowance for possible loan losses. The evaluation includes, but is not limited to, review of net loan losses for the year, the present and prospective financial condition of the borrowers, and evaluation of current and projected economic conditions.

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

NONACCRUAL, DELINQUENT AND IMPAIRED LOANS

The following table sets forth the outstanding balances of those loans on a nonaccrual status and those on accrual status which are contractually past due as to principal or interest payments for 30 days or more at December 31.

| (Dollars in thousands) | 2006 | 2005 | 2004 | 2003 | 2002 |
|-----------------------------|----------|----------|----------|----------|----------|
| Nonaccrual loans | \$ 120 | \$ 52 | \$ 314 | \$ 130 | \$ 85 |
| Accrual loans | | | | | |
| Restructured | 0 | 0 | 0 | 1,410 | 1,428 |
| 30 through 89 days past due | 7,607 | 4,249 | 1,643 | 1,440 | 1,419 |
| 90 days or more past due | 1,084 | 411 | 2,550 | 2,743 | 1,446 |
| Total accrual loans | \$ 8,691 | \$ 4,660 | \$ 4,193 | \$ 5,593 | \$ 4,293 |

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-K

See Note 7 of the Notes to Consolidated Financial Statements for details of income recognized and foregone revenue on nonaccrual loans for the past three years, and discussion concerning impaired loans at December 31, 2006.

Table of Contents

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

ALLOCATION OF ALLOWANCE FOR LOAN LOSSES

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,

| (Dollars in thousands) | 2006 | | 2005 | |
|--|-----------------|-------------|-----------------|-------------|
| | Percentage | | Percentage | |
| | of Loans to | | of Loans to | |
| | Allowance | Total Loans | Allowance | Total Loans |
| | Amount | | Amount | |
| Commercial, financial and agricultural | \$ 1,206 | 10% | \$ 558 | 11% |
| Real estate Commercial | 1,584 | 36% | 573 | 39% |
| Real estate Construction | 42 | 8% | 6 | 7% |
| Real estate Mortgage | 1,553 | 45% | 865 | 42% |
| Consumer | 13 | 1% | 44 | 1% |
| Unallocated | 1,122 | 0% | 2,382 | 0% |
| Total | \$ 5,520 | 100% | \$ 4,428 | 100% |

| (Dollars in thousands) | 2004 | | 2003 | |
|--|-----------------|-------------|-----------------|-------------|
| | Percentage | | Percentage | |
| | of Loans to | | of Loans to | |
| | Allowance | Total Loans | Allowance | Total Loans |
| | Amount | | Amount | |
| Commercial, financial and agricultural | \$ 1,381 | 10% | \$ 928 | 11% |
| Real estate Commercial | 617 | 39% | 828 | 44% |
| Real estate Construction | 0 | 5% | 0 | 6% |
| Real estate Mortgage | 330 | 44% | 326 | 36% |
| Consumer | 105 | 2% | 9 | 3% |
| Unallocated | 1,885 | 0% | 2,070 | 0% |
| Total | \$ 4,318 | 100% | \$ 4,161 | 100% |

| (Dollars in thousands) | 2002 | |
|--|-------------|-------------|
| | Percentage | |
| | of Loans to | |
| | Allowance | Total Loans |
| | Amount | |
| Commercial, financial and agricultural | \$ 806 | 12% |
| Real estate Commercial | 545 | 41% |
| Real estate Construction | 0 | 8% |
| Real estate Mortgage | 255 | 36% |
| Consumer | 28 | 3% |

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-K

| | | |
|--------------|-----------------|-------------|
| Unallocated | 2,100 | 0% |
| Total | \$ 3,734 | 100% |

Table of Contents

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

DEPOSITS

The average amounts of deposits are summarized below:

| (Dollars in thousands) | Years Ended December 31, | | |
|----------------------------------|--------------------------|-------------------|-------------------|
| | 2006 | 2005 | 2004 |
| Demand deposits | \$ 79,733 | \$ 66,829 | \$ 57,762 |
| Interest bearing demand deposits | 159,035 | 162,888 | 183,649 |
| Savings deposits | 87,665 | 63,174 | 29,752 |
| Time deposits | 243,929 | 140,245 | 114,181 |
| Total deposits | \$ 570,362 | \$ 433,136 | \$ 385,344 |

The following is a breakdown of maturities of time deposits of \$100,000 or more as of December 31, 2006:

| (Dollars in thousands) | |
|--------------------------------------|-------------------|
| Three months or less | \$ 72,569 |
| Over three months through six months | 14,570 |
| Over six months through one year | 14,483 |
| Over one year | 14,046 |
| Total | \$ 115,668 |

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

RETURN ON EQUITY AND ASSETS

The following table presents a summary of significant earnings and capital ratios applying daily average balances for the years ended December 31,

| (Dollars in thousands) | 2006 | 2005 | 2004 |
|------------------------|------------|------------|------------|
| Average assets | \$ 722,581 | \$ 552,592 | \$ 495,919 |
| Net income | \$ 11,632 | \$ 9,987 | \$ 7,770 |
| Average equity | \$ 77,028 | \$ 53,423 | \$ 46,309 |
| Cash dividends paid | \$ 4,662 | \$ 3,157 | \$ 2,556 |
| Return on assets | 1.61% | 1.81% | 1.57% |
| Return on equity | 15.10% | 18.69% | 16.78% |
| Dividend payout ratio | 40.07% | 31.62% | 32.89% |
| Equity to asset ratio | 10.66% | 9.67% | 9.34% |

Table of Contents

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

CONSOLIDATED SUMMARY OF OPERATIONS

| (Dollars in thousands) | Years Ended December 31, | | | | |
|---|--------------------------|-----------|-----------|-----------|-----------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Interest income | \$ 44,788 | \$ 32,415 | \$ 25,892 | \$ 23,484 | \$ 23,173 |
| Interest expense | 17,371 | 9,537 | 6,986 | 6,757 | 7,985 |
| Net interest income | 27,417 | 22,878 | 18,906 | 16,727 | 15,188 |
| Provision for loan losses | 390 | 144 | 210 | 491 | 720 |
| Net interest income after provision for loan losses | 27,027 | 22,734 | 18,696 | 16,236 | 14,468 |
| Other income: | | | | | |
| Trust and brokerage services | 3,707 | 3,164 | 2,471 | 1,948 | 1,780 |
| Service charges on deposits, other service charges, collection and exchange charges, commissions and fees | 6,592 | 5,575 | 4,082 | 3,866 | 3,171 |
| Other operating income | 784 | 320 | 416 | 618 | 409 |
| Total other income | 11,083 | 9,059 | 6,969 | 6,432 | 5,360 |
| Income before operating expense | 38,110 | 31,793 | 25,665 | 22,668 | 19,828 |
| Operating expenses: | | | | | |
| Salaries and employees benefits | 13,015 | 9,257 | 7,909 | 6,787 | 5,993 |
| Occupancy and equipment expense | 3,357 | 2,673 | 2,398 | 2,109 | 1,800 |
| Other operating expenses | 5,256 | 5,467 | 4,411 | 4,114 | 3,895 |
| Total operating expenses | 21,628 | 17,397 | 14,718 | 13,010 | 11,688 |
| Income before income taxes | 16,482 | 14,396 | 10,947 | 9,658 | 8,140 |
| Income tax | 4,850 | 4,409 | 3,177 | 2,678 | 2,225 |
| Net income applicable to common stock | \$ 11,632 | \$ 9,987 | \$ 7,770 | \$ 6,980 | \$ 5,915 |
| Per share data: (1) | | | | | |
| Basic earnings | \$ 1.97 | \$ 1.85 | \$ 1.45 | \$ 1.32 | \$ 1.12 |
| Diluted earnings | \$ 1.89 | \$ 1.77 | \$ 1.40 | \$ 1.27 | \$ 1.10 |
| Cash dividends | \$ 0.780 | \$ 0.583 | \$ 0.476 | \$ 0.401 | \$ 0.327 |
| Weighted average shares: | | | | | |
| Basic | 5,906,646 | 5,407,550 | 5,362,017 | 5,307,089 | 5,271,303 |
| Diluted | 6,167,422 | 5,636,191 | 5,558,851 | 5,476,292 | 5,390,015 |

(1) Per share amounts have been restated to reflect:
The 5% stock dividend paid June 29, 2005

The 2-for-1 stock split paid February 10, 2004

The 5% stock dividend paid May 30, 2003

Table of Contents

Item 9. Changes in, and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

The Corporation's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Corporation's disclosure controls and procedures (as such term is defined in Rules 13a-14(c) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of December 31, 2006. Based on such evaluation, such officers have concluded that the Corporation's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Corporation (including its consolidated subsidiaries) required to be included in the Corporation's periodic filings under the Exchange Act. Management's Report on internal control over financial reporting for December 31, 2006 is shown on page 3 of the annual shareholders' report for the year ended December 31, 2006 and is incorporated herein by reference. The attestation report of the registered public accounting firm on management's assessment of internal control over financial reporting is shown on pages 1 and 2 of the annual shareholders' report for the year ended December 31, 2006 and is incorporated herein by reference. There have not been any significant changes in the Corporation's internal control over financial reporting or in other factors that could significantly affect such control during the fourth quarter of 2006.

Item 9B. Other Information.

The Corporation had no other events that should have been disclosed on form 8K that were not already disclosed on such form.

Table of Contents

PART III

Item 10. Directors and Executive Officers of the Registrant.

The Corporation has adopted a code of ethics that applies to all senior financial officers (including its chief executive officer, chief financial officer, chief accounting officer, controller, and any person performing similar functions). The Corporation's Code of Ethics for Senior Financial Officers is available on Orrstown Bank's website at <http://www.orrstown.com>.

All other information required by Item 10 is incorporated by reference from Orrstown Financial Services, Inc.'s definitive proxy statement for the 2007 Annual Meeting of Shareholders filed pursuant to Regulation 14A.

Item 11. Executive Compensation.

The information required by Item 11 is incorporated by reference from Orrstown Financial Services, Inc.'s definitive proxy statement for the 2007 Annual Meeting of Shareholders filed pursuant to Regulation 14A.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Equity Compensation Plan Information

| Plan Category | Number of securities | Weighted-average | Number of securities remaining |
|---|----------------------|------------------|------------------------------------|
| | to be issued upon | exercise price | available for future issuance |
| | exercise of | of | under equity compensation plans |
| | outstanding options | outstanding | (excluding securities reflected in |
| | (a) | (b) | column (a)) |
| | | | (c) |
| Equity compensation plan approved by security holders | 245,121 | \$ 30.24 | 169,612 |
| Equity compensation plan not approved by security holders (1) | 29,491 | \$ 23.96 | 37,881 |
| Total | 274,612 | \$ 29.57 | 207,493 |

(1) *Non-Employee Director Stock Option Plan of 2000.* On January 27, 2000, the Board of Directors of the Corporation approved the Orrstown Financial Services, Inc. Non-Employee Director Stock Option Plan of 2000. The Directors' Option Plan is a formula plan under which options to purchase shares of the Corporation's Common Stock are granted each year to directors in office on April 1. The number of options granted each year is based on the Corporation's return on average equity for the most recent fiscal year. All options have a term of 10 years from the regular grant date, are fully exercisable from the regular grant date, and have an exercise price equal to the fair market value of the Corporation's Common Stock as of the date of the grant of the option based upon criteria as outlined in the plan. If a director retires, whether as a result of reaching mandatory retirement age, or under any other circumstances the Board of Directors, in its discretion, may determine to constitute retirement, the options previously granted to the director will expire at their scheduled expiration date. If a director's service as a director terminates for any other reason, the options previously granted to the director will expire six months after the date of termination of service unless scheduled to expire sooner.

All other information required by Item 12 is incorporated by reference from Orrstown Financial Services, Inc.'s definitive proxy statement for the 2007 Annual Meeting of Shareholders filed pursuant to Regulation 14A.

Item 13. Certain Relationships and Related Transactions.

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-K

The information required by Item 13 is incorporated by reference from Orrstown Financial Services, Inc.'s definitive proxy statement for the 2007 Annual Meeting of Shareholders filed pursuant to Regulation 14A.

Item 14. Principal Accountant Fees and Services.

The information required by Item 14 is incorporated by reference from Orrstown Financial Services, Inc.'s definitive proxy statement for the 2007 Annual Meeting of Shareholders filed pursuant to Regulation 14A.

Table of Contents

PART IV

Item 15. Exhibits, Financial Statement Schedules.

(a) The following documents are filed as part of this report:

(1) Financial Statements The following consolidated financial statements of Orrstown Financial Services, Inc. and its subsidiaries, included in the annual report of the registrant to its shareholders for the year ended December 31, 2006, are incorporated by reference in Item 8:

Consolidated balance sheets December 31, 2006 and 2005

Consolidated statements of income Years ended December 31, 2006, 2005, and 2004

Consolidated statements of shareholders equity Years ended December 31, 2006, 2005, and 2004

Consolidated statements of cash flows Years ended December 31, 2006, 2005, and 2004

Notes to consolidated financial statements December 31, 2006

(2) Financial Statement Schedules All financial statement schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

(3) Exhibits

- 2 Plan of acquisition, reorganization, arrangement, liquidation or succession. Agreement and Plan of Reorganization dated November 21, 2005, by and between Orrstown Financial Services, Inc. and The First National Bank of Newport, incorporated by reference to Exhibit 2.1 to the Registrant's Current Report on Form 8-K filed with the Commission on November 22, 2005.
- 3.1 Articles of incorporation. Incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No.333-131176.
- 3.2 By-laws. Incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 4 Instruments defining the rights of security holders including indentures. The rights of the holders of Registrant's common stock are contained in:
 - (i) Articles of Incorporation of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No.333-131176.
 - (ii) By-laws of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.
- 10.1 Change in control agreement between Orrstown Financial Services, Inc. and its chief executive officer. Incorporated by reference to Exhibit 99 of the Registrant's Form 10-K for the year ended December 31, 1996.
- 10.2 Salary continuation plan for selected officers incorporated by reference to the Registrant's Form 10-K for the year ended December 31, 1999

Table of Contents

- 10.3 Officer group term replacement plan for selected officers incorporated by reference to the Registrant's Form 10-K for the year ended December 31, 1999
- 10.4 Director retirement plan incorporated by reference to the Registrant's Form 10-K for the year ended December 31, 1999
- 10.5 Revenue neutral retirement plan incorporated by reference to the Registrant's Form 10-K for the year ended December 31, 1999
- 10.6 Non-employee director stock option plan of 2000 incorporated by reference to the Registrant's registration statement on Form S-8 dated April 11, 2000
- 10.7 Employee stock option plan of 2000 incorporated by reference to the Registrant's registration statement on Form S-8 dated March 31, 2000
- 10.8 Description of Executive Incentive Plan incorporated by reference to the Registrant's definitive schedule 14A proxy statement filed March 18, 2005
- 13 Annual report to security holders filed herewith
- 14 Code of Ethics Policy for Senior Financial Officers incorporated by reference under Item 10 of this Form 10-K
- 21 Subsidiaries of the registrant - filed herewith
- 23.1 Consent of independent auditors - filed herewith
- 31.1 Rule 13a - 14(a)/15d-14(a) Certification (Chief Executive Officer) filed herewith
- 31.2 Rule 13a - 14(a)/15d-14(a) Certifications (Chief Financial Officer) filed herewith
- 32.1 Section 1350 Certifications (Chief Executive Officer) filed herewith
- 32.2 Section 1350 Certifications (Chief Financial Officer) filed herewith

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

(b) Exhibits The exhibits required to be filed as part of this report are submitted as a separate section of this report.

(c) Financial statement schedules None required.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ORRSTOWN FINANCIAL SERVICES, INC.
(Registrant)

By /s/ Kenneth R. Shoemaker
Kenneth R. Shoemaker, President
(Duly authorized officer)

Dated: March 12, 2007

By /s/ Bradley S. Everly
Bradley S. Everly, Chief Financial Officer
(Principal Accounting Officer)

Dated: March 12, 2007

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|--|--|----------------|
| /s/ Kenneth R. Shoemaker Kenneth R. Shoemaker | President and CEO of Orrstown Bank and Director | March 12, 2007 |
| /s/ Peter C. Zimmerman Peter C. Zimmerman | President and CEO of The First National Bank of Newport and Director | March 12, 2007 |
| /s/ Joel R. Zullinger Joel R. Zullinger | Chairman of the Board and Director | March 12, 2007 |
| /s/ Jeffrey W. Coy Jeffrey W. Coy | Vice Chairman of the Board and Director | March 12, 2007 |
| /s/ Denver L. Tuckey Denver L. Tuckey | Secretary and Director | March 12, 2007 |
| /s/ Anthony F. Ceddia Dr. Anthony F. Ceddia | Director | March 12, 2007 |
| /s/ Andrea Pugh Andrea Pugh | Director | March 12, 2007 |
| /s/ Gregory A. Rosenberry Gregory A. Rosenberry | Director | March 12, 2007 |

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-K

/s/ Glenn W. Snoke

Director

March 12, 2007

Glenn W. Snoke

/s/ John S. Ward

Director

March 12, 2007

John S. Ward