ORRSTOWN FINANCIAL SERVICES INC
Form 10-K
March 11, 2016
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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, 2015
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number: 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.
(Exact Name of Registrant as Specified in its Charter)

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

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

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232,405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form

10-K. ¨

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

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

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

The aggregate market value of the voting stock held by non-affiliates computed by reference to the price at which the common stock was last sold as of the last business day of the Registrant's most recently completed second fiscal quarter, was approximately $115.6 million. For purposes of this calculation, the term "affiliate" refers to all directors and executive officers of the registrant, and all persons beneficially owning more than 5% of the registrant's common stock.

Number of shares outstanding of the registrant's Common Stock as of March 7, 2016: 8,295,092.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2016 Annual Meeting of Shareholders are incorporated by reference in Part III of this Form 10-K.

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PART I

ITEM 1 – BUSINESS

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

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

Business

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

The Company’s primary activity consists of owning and supervising its subsidiary, the Bank. The day-to-day management of the Company is conducted by its officers, who are also Bank officers. The Company has historically derived most of its income through dividends from the Bank. As of December 31, 2015, the Company, on a consolidated basis, had total assets of $1,292,816,000, total shareholders’ equity of $133,061,000 and total deposits of $1,032,167,000.

The Company has no employees. Its seven officers are employees of the Bank. On December 31, 2015, the Bank had 294 full-time and 12 part-time employees.

The Bank is engaged in commercial banking and trust business as authorized by the Pennsylvania Banking Code of 1965. This involves accepting demand, time and savings deposits, and granting loans. The Bank grants commercial, residential, consumer and agribusiness loans in its market areas of Cumberland, Franklin, Lancaster and Perry Counties in Pennsylvania, Washington County, Maryland, and in contiguous counties. The concentrations of credit by type of loan are set forth in Note 4, “Loans Receivable and Allowance for Loan Losses” filed herewith in Part II, Item 8, “Financial Statements and Supplementary Data.” The Bank maintains a diversified loan portfolio and evaluates each customer’s credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon the extension of credit, is based on management’s credit evaluation of the customer pursuant to collateral standards established in the Bank’s credit policies and procedures.

Lending

All secured loans are supported with appraisals or evaluations of collateral. Business equipment and machinery, inventories, accounts receivable, and farm equipment are considered appropriate security, provided they meet acceptable standards for liquidity and marketability. Loans secured by real estate generally do not exceed 90% of the appraised value of the property. Loan to collateral values are monitored as part of the loan review process, and appraisals are updated as deemed appropriate under the circumstances.

Commercial Lending

A majority of the Company’s loan assets are loans for business purposes. Approximately 59% of the loan portfolio is comprised of commercial loans. The Bank makes commercial real estate, equipment, working capital and other commercial purpose loans as required by the broad range of borrowers across the Bank’s various markets.

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

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Consumer Lending

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

Residential Lending

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

Loan Review

The Bank has a loan review policy and program which is designed to identify and mitigate risk in the lending function. The Enterprise Risk Management (“ERM”) Committee, comprised of executive officers and loan department personnel, is charged with the oversight of overall credit quality and risk exposure of the Bank’s loan portfolio. This includes the monitoring of the lending activities of all Bank personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The loan review program provides the Bank with an independent review of the Bank’s loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession, or death of the borrower occurs, which heightens awareness as to a possible negative credit event.

Internal loan relationship reviews are completed annually on all commercial relationships with a committed loan balance in excess of $500,000, which include a confirmation of the risk rating by the appropriate credit authority, including Credit Administration for loans in excess of $1,000,000. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed by the ERM Committee on a quarterly basis, with reaffirmation of the rating as approved by the Bank’s Loan Work Out Committee.

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

Orrstown Financial Advisors (“OFA”)

Through its trust department, the Bank renders services as trustee, executor, administrator, guardian, managing agent, custodian, investment advisor, and other fiduciary activities authorized by law under the trade name “Orrstown Financial Advisors.” OFA offers retail brokerage services through a third-party broker/dealer arrangement with Cetera Advisor Networks LLC. As of December 31, 2015, trust assets under management were $966,362,000.

Regulation and Supervision

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

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

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

Financial and Bank Holding Company Activities

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

FDIC Insurance and Assessments

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

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

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

Pursuant to these requirements, the FDIC adopted new assessment regulations effective April 1, 2011 that redefined the assessment base as average consolidated assets less average tangible equity. Insured banks with more than $1.0 billion in assets must calculate quarterly average assets based on daily balances while smaller banks and newly chartered banks may use weekly averages. Average assets would be reduced by goodwill and other intangibles. Average tangible equity equals Tier 1 capital. For institutions with more than $1.0 billion in assets, average tangible equity is calculated on a weekly basis while smaller institutions may use the quarter-end balance. The base assessment rate for insured institutions in Risk Category I will range from 5 to 9 basis points and for institutions in Risk

Categories II, III, and IV will be 14, 23 and 35 basis points. An institution's assessment rate will be reduced based on the amount of its outstanding unsecured long-term debt and for institutions in Risk Categories II, III and IV may be increased based on their brokered deposits. In addition, under the FDIC's 2011 insurance assessment regulation, a schedule of lower assessment rates will go into effect the quarter after the Deposit Insurance Fund reserve ratio reaches 1.15%, which the FDIC projects will be the first or second quarter of 2016.

The FDIC has proposed to amend its assessment regulations for established banks (generally, an institution that has been federally insured for at least five years as of the last day of any quarter for which it is being assessed) with less than $10 billion in assets to replace the current risk categories with updated financial ratios that are designed to better predict the risk of failure of insured institutions. The proposed rules would not become effective until the designated reserve ratio of the Deposit Insurance Fund reaches 1.15% and would remain in effect until the designated reserve ratio reaches 2.0%. The proposed regulations would set a maximum rate that banks rated CAMELS 1 or 2 could be charged and a minimum rate that CAMELS 3, 4 and 5 banks would be charged. Under the proposal, the FDIC would use a bank's weighted average CAMELS component ratings and the following financial measures to determine assessments: Tier 1 leverage ratio; ratio of net income before taxes to total assets; ratio of non-performing loans to gross assets; and ratio of other real estate owned to gross assets. In addition, assessments would take into consideration core deposits to total assets, one-year asset growth and a loan mix index. The loan mix index would measure the extent to which a bank's total assets include higher risk loans. To calculate the loan mix index, each category of loans in the bank's portfolio (other than credit card loans) would be divided by the bank's total assets to determine the percentage of assets represented by that loan category. Each percentage would then be multiplied by that loan category's historical weighted average industry-wide charge-off rate. The sum of these numbers would determine the loan mix index value for that bank. The FDIC proposal is intended to be revenue neutral to the FDIC but to shift premium payments to higher risk institutions. Most institutions are expected to see lower premiums. A companion proposal would assess banks over $10 billion in assets at higher rates for two years in accordance with the requirements of the Dodd-Frank Act.

Liability for Banking Subsidiaries

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

Pennsylvania Banking Law

The Pennsylvania Banking Code ("Banking Code") contains detailed provisions governing the organization, location of offices, rights and responsibilities of directors, officers, and employees, as well as corporate powers, savings and investment operations and other aspects of the Bank and its affairs. The Banking Code delegates extensive rule-making power and administrative discretion to the PDB so that the supervision and regulation of state chartered banks may be flexible and readily responsive to changes in economic conditions and in savings and lending practices. The FDIA, however, prohibits state chartered banks from making new investments, loans, or becoming involved in activities as principal and equity investments which are not permitted for national banks unless (1) the FDIC determines the activity or investment does not pose a significant risk of loss to the Deposit Insurance Fund and (2) the bank meets all applicable capital requirements. Accordingly, the additional operating authority provided to the Bank by the Banking Code is significantly restricted by the FDIA.

Dividend Restrictions

The Company's funding for cash distributions to its shareholders is derived from a variety of sources, including cash and temporary investments. One of the principal sources of those funds has historically been dividends received from the Bank. Various federal and state laws limit the amount of dividends the Bank can pay to the Company without regulatory approval. In addition, federal bank regulatory agencies have authority to prohibit the Bank from engaging in an unsafe or unsound practice in conducting its business. The payment of dividends, depending upon the financial condition of the bank in question, could be deemed to constitute an unsafe or unsound practice. The ability of the Bank to pay dividends in the future may be influenced by bank regulatory policies and capital guidelines.

Regulatory Capital Requirements

Information concerning the compliance of the Company and the Bank with respect to capital requirements is incorporated by reference from Note 14, "Shareholders' Equity and Regulatory Capital," of the "Notes to Consolidated

Financial Statements" included under Item 8 of this report, and from the "Capital Adequacy and Regulatory Matters" section of the "Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations," included under Item 7 of this report.

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Basel III Capital Rules

Effective January 1, 2015, the Company and the Bank became subject to the Basel III Capital Rules, which substantially revised the risk-based capital requirements in comparison to the previously effective U.S. risk-based capital rules. The Basel III Capital Rules, among other things, (i) introduced a new capital measure called “Common Equity Tier 1” (“CET1”), (ii) increased the minimum requirements for Tier 1 Capital ratio as well as the minimum levels to be considered well capitalized under prompt corrective action; (iii) and introduced the "capital conservation buffer”, designed to absorb losses during periods of economic stress. Institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer are subject to constraints on dividends, equity repurchases and discretionary bonuses to executive officers based on the amount of the shortfall.

Under the previously effective capital standards, the effects of accumulated other comprehensive income (“AOCI”) items included in capital were excluded for the purposes of determining regulatory capital ratios. Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive items are generally included in the calculation of CET1 and thus of Tier 1 capital. However, banking organizations were given a one-time option to permanently opt out of the requirement to include most components of AOCI, including unrealized gains or losses on certain securities available for sale, in CET1. The Company and Bank made the one-time permanent election to opt out, with the result that most AOCI items will be treated for regulatory capital purposes in the same manner in which they were under the previously effective capital rules.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1.

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

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

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer are subject to constraints on dividends, equity repurchases and discretionary bonuses to executive officers based on the amount of the shortfall.

Under the Basel III Capital Rules, the minimum capital ratios effective as of January 1, 2015 are as follows:

- 4.5% CET1 to risk-weighted assets;
- 6.0% Tier 1 capital to risk-weighted assets;
- 8.0% Total capital to risk-weighted assets; and
- 4.0% Tier 1 capital to average assets.

With respect to the Bank, the Basel III Capital Rules also revise the “prompt corrective action” regulations pursuant to Section 38 of the FDIA, by (i) introducing a CET1 ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each category (other than critically undercapitalized), with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the previous 6%), and (iii) eliminating the provision of the former regulation that provides that a bank with a composite supervisory rating of 1 may have a 3% leverage ratio and still be adequately capitalized. The Basel III Capital Rules do not change the total risk-based capital requirement for any prompt corrective action category.

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The Basel III Capital Rules prescribe a standardized approach for risk weightings that expands the risk-weighting categories from the four categories of the previous capital standards (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories. Significant changes to the previously effective capital rules that will impact the Company's determination of risk-weighted assets include, among other things:

- Greater restrictions on the amount of deferred tax assets that can be included in CET1 capital with assets relating to net operating loss and credit carry forwards being excluded, and a 10% - 15% limitation on deferred tax assets arising from temporary differences that cannot be realized through net operating loss carry backs.
- Applying a 150% risk weight for certain high volatility commercial real estate acquisition, development and construction loans, compared to 100% risk weight previously in place;
- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due or in nonaccrual status, compared to 100% risk weight previously in place; and
- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, compared to 0% previously in place.

Consumer Financial Protection Bureau

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

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

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

Ability-to-Repay ("ATR") and Qualified Mortgage ("QM") rules were designed to address concerns that residential mortgage borrowers received loans for which they had no ability to repay. The ATR final rule requires a creditor to make "a reasonable and good faith determination at or before closing that the consumer will have a reasonable ability, at the time of consummation, to repay the loan, according to its terms, including any mortgage-related obligations." The ATR standards require consideration of eight specific underwriting factors. Information used must be documented and verified using reasonably reliable third-party records. The ATR rule provides for a wide variety of documents and sources of information that can be used and relied on to determine ATR. In addition, the ATR rules included provisions that create a legal advantage for lenders for loans that are qualified mortgages. A QM must have a fully amortizing payment, have a term of 30 years or less, and not have points and fees that exceed certain thresholds depending on the total loan amount. Safe Harbor QM loans are lower priced loans that meet QM requirements. Loans satisfying the QM requirements will be entitled to liability protection from damage claims and defenses by borrowers based on an asserted failure to meet ATR requirements. Rebuttable Presumption QM loans are higher-priced loans

that meet QM requirements and provide liability protection to a lesser degree from damage claims and defense by borrowers based on asserted failure to meet ATR requirements.
In November 2013, the Bureau issued a final rule on integrated mortgage disclosures under the Truth in Lending Act and the Real Estate Settlement Procedures Act, compliance with which was required by October 3, 2015. The Bank has devoted significant resources to implement the changes required to comply with the new disclosure requirements.

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

Other Federal Laws and Regulations

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

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

Future Legislation and Regulation

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

NASDAQ Capital Market

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

Forward Looking Statements

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

Competition

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

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

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

ITEM 1A – RISK FACTORS

Our financial condition and results of operations may be adversely affected by various factors, many of which are beyond our control. These risk factors include, but are not limited to, the following:

Risks Related to Credit

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

There is no precise method of predicting loan losses and the required level of reserves, and related provision for loan losses, can fluctuate from year to year, based on charge-offs and/or recoveries, loan volume, credit administration practices, and local and national economic conditions, among other factors. For 2015, we recorded a negative provision for loan losses of $603,000. The Company recorded net charge-offs of $576,000 in 2015 compared to net charge-offs of $2,318,000 in 2014. Risk elements, including nonperforming loans, troubled debt restructurings still accruing, loans greater than 90 days past due still accruing, and other real estate owned totaled $18,084,000 at December 31, 2015. The allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, represents management’s best estimate of probable incurred losses within the existing portfolio of loans. The level of the allowance reflects management’s evaluation of, among other factors, the status of specific impaired loans, trends in historical loss experience, delinquency, credit concentrations and economic conditions within our market area. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan losses.

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

The allowance for loan losses was 1.74% of total loans and 78% of nonaccrual and restructured loans still accruing at December 31, 2015, compared to 2.09% of total loans and 95% of nonaccrual and restructured loans still accruing at December 31, 2014. Material additions to the allowance could materially decrease our net income. In addition, at December 31, 2015, the top 25 lending relationships individually had commitments of approximately $356,300,000, and an aggregate total outstanding loan balance of $298,427,000, or 38% of the loan portfolio. The deterioration of one or more of these loans could result in a significant increase in the nonperforming loans and the provisions for loan losses, which would negatively impact our results of operations.

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

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

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Almost 10% of our loan portfolio consists of commercial and industrial loans. The credit risk related to these types of loans is greater than the risk related to residential loans.

Our commercial and industrial loan portfolio grew by $24.6 million, or approximately 50%, during the year ended December 31, 2015 to $73.6 million at December 31, 2015. Commercial and industrial loans generally carry larger loan balances and involve a greater degree of risk of nonpayment or late payment than home equity loans or residential mortgage loans.

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

Our commercial and industrial lending operations are located primarily in South Central Pennsylvania and in Washington County, Maryland. Our borrowers' ability to repay these loans depend largely on economic conditions in these and surrounding areas. A deterioration in the economic conditions in these market areas could materially adversely affect our operations and increase loan delinquencies, increase problem assets and foreclosures, increase claims and lawsuits, decrease the demand for our products and services and decrease the value of collateral securing loans.

Risks Related to Interest Rates and Investments

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

Operating income, net income and liquidity depend to a great extent on our net interest margin, i.e., the difference between the interest yields we receive on loans, securities and other interest earning assets and the interest rates we pay on interest-bearing deposits, borrowings and other liabilities. These rates are highly sensitive to many factors beyond our control, including competition, general economic conditions and monetary and fiscal policies of various governmental and regulatory authorities, including the FRB. If the rate of interest we pay on our interest-bearing deposits, borrowings and other liabilities increases more than the rate of interest we receive on loans, securities and other interest earning assets, our net interest income, and therefore our earnings, and liquidity could be materially adversely affected. Our earnings and liquidity could also be materially adversely affected if the rates on our loans, securities and other investments fall more quickly than those on our deposits, borrowings and other liabilities. Our operations are subject to risks and uncertainties surrounding our exposure to changes in the interest rate environment. Additionally, based on an analysis of the interest rate sensitivity of the Company's assets, an increase in the general level of interest rates will negatively affect the market value of the investment portfolio because of the relatively long duration of certain securities included in the investment portfolio.

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

Risks Related to Competition and to Our Business Strategy

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

We are operating in a volatile economic environment, including generally uncertain global, national and local conditions. Additional concerns from some of the countries in the European Union, Russian Federation, China and elsewhere have also strained the financial markets both abroad and domestically. Although there has been some improvement in the overall global macroeconomic conditions in 2015, financial institutions continue to be affected by conditions in the real estate market and the constrained financial markets. In recent years, declines in the housing market, increases in unemployment and under-employment have negatively impacted the credit performance of loans and resulted in significant write-downs of asset values by financial institutions, including the Bank. While the Company saw continued improvement in 2015, a worsening of economic conditions, or a prolonged inconsistent recovery, may further impact the Bank's results of operations and financial condition. In particular, we may face the following risks in connection with these events:

- Loan delinquencies could increase further;
- Problem assets and foreclosures could increase further;
- Demand for our products and services could decline;
- Collateral for loans made by us, especially real estate, could decline further in value, in turn reducing a customer's borrowing power, and reducing the value of assets and collateral associated with our loans.

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

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

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

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

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

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

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

In 2015, loans grew $76,767,000, or 10.9% from $704,946,000 at January 1, 2015, to $781,713,000 at December 31, 2015, due to organic growth through increases in consumer, commercial and commercial real estate loans. Over the long term, we expect to continue to experience growth in loans and total assets, the level of our deposits and the scale of our operations. Achieving our growth targets requires us to successfully execute our business strategies, which include continuing to grow our loan portfolio. Our ability to successfully grow will also depend on the continued availability of loan opportunities that meet underwriting standards. In addition, since our asset quality metrics have returned closer to historical levels, we may consider the acquisition of other financial institutions and branches within or outside of our market area to the extent permitted by our regulators, the success of which will depend on a number of factors, including our ability to integrate the acquired institutions or branches into the current operations of the Company, our ability to limit the outflow of deposits held by customers of the acquired institution or branch locations, our ability to control the incremental increase in non-interest expense arising from any acquisition and our ability to retain and integrate the appropriate personnel of the acquired institution or branches. We believe we have the resources and internal systems in place to successfully achieve and manage our future growth. If we do not manage our growth effectively, we may not be able to achieve our business plan, and our business and prospects could be harmed.

The Company may be adversely affected by technological advances.

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

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

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

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

Information systems are critical to our business. We use various technological systems to manage our customer relationships, general ledger, securities investments, deposits and loans. We rely on software, communication, and information exchange on a variety of computing platforms and networks and over the internet. We have established policies and procedures in place to prevent or limit the effect of system failures, interruptions and security breaches, but we cannot be certain that all of our systems are entirely free from vulnerability to attack or other technological difficulties or failures. In addition, any compromise of our systems could deter customers from using our products and services. Although we rely on security systems to provide security and authentication necessary to effect the secure transmission of data, these precautions may not protect our systems from security breaches.

We rely on the services of a variety of vendors to meet our data processing and communication needs. If these third-party providers encounter difficulties, or if we have difficulty communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely affected. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and we could be exposed to claims from customers. Any of these results could have a material adverse effect on our financial condition, results of operations or liquidity.

We could be adversely affected by failure in our internal controls.

A failure in our internal controls could have a significant negative impact not only on our earnings, but also on the perception that customers, regulators and investors may have of us. We continue to devote a significant amount of effort and resources to continually strengthening our controls and ensuring compliance with complex accounting standards and banking regulations.

Risks Related to Regulatory Compliance and Legal Matters

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

The Company is subject to regulation and supervision under federal and state laws and regulations. The requirements and limitations imposed by such laws and regulations limit the manner in which we conduct our business, undertake new investments and activities and obtain financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit our shareholders. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is within our control. Federal and state regulatory agencies also frequently adopt changes to their regulations or change the manner in which existing regulations are applied or enforced. The Company cannot predict the substance or impact of pending or future legislation, regulation or the application thereof. Compliance with such current and potential regulation and scrutiny may significantly increase our costs, impede the efficiency of our internal business processes, require us to increase our regulatory capital and limit our ability to pursue business opportunities in an efficient manner. Bank regulations can hinder our ability to compete with financial services companies that are not regulated in the same manner or are subject to less regulation.

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

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

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

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

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

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

Changes in assessment rates of the Pennsylvania Bank Shares Tax, a tax calculated on the outstanding equity of the Bank, may have a material adverse effect on our results of operations.

The Government of the Commonwealth of Pennsylvania has yet to agree on a budget for the fiscal year 2015-2016, and forecast revenues generated are not sufficient to meet forecast expenditures. One tax subject to continue deliberation, which the Bank is currently subject to, is the Pennsylvania Bank Shares Tax. This tax is currently assessed at 0.89% of eligible capital. As part of the budget negotiation, the assessment rate has been discussed as one which may be increased to cover the deficiency in the Commonwealth's budget. If this assessment rate on the Pennsylvania Bank Shares tax is increased, including possible retroactive assessments, it may materially adversely affect the results of operations.

The Company is required to make a number of judgments in applying accounting policies and different estimates and assumptions in the application of these policies could result in a decrease in capital and/or other material changes to the reports of financial condition and results of operations.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, accounting for income taxes and the ability to recognize the deferred tax asset, and the fair value of certain financial instruments, in particular securities. While we have identified those accounting policies that are considered critical and have procedures in place to facilitate the associated judgments, different assumptions in the application of these policies could result in a decrease to net income and, possibly, capital and may have a material adverse effect on our financial condition and results of operations.

Changes in accounting standards could impact the Company's financial condition and results of operations.

The accounting standard setters, including the Financial Accounting Standards Board ("FASB"), the SEC and other regulatory bodies, periodically change the financial accounting and reporting standards that govern the preparation of the Company’s consolidated financial statements. These changes, including a significant proposal which would change the accounting for the determination of the allowance for loan losses from a probable loss to an expected loss model, can be hard to predict and can materially impact how the Company records and reports its financial condition and results of operations. In

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some cases, the Company could be required to apply a new or revised standard retroactively, which would result in the restating of the Company's prior period financial statements.

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

The Basel III Capital Rules which became effective for the Company and Bank on January 1, 2016, established a new comprehensive capital framework for U.S. banking organizations, including community banks, which also incorporate provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revised the risk-based capital requirements applicable to bank holding companies and depository institutions, compared to the previously effective U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios, address risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and replace the current risk-weighting approach.

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

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

As set forth in Part I, Item 3 - Legal Proceedings, of this Annual Report on Form 10-K, the allegations of Southeastern Pennsylvania Transportation Authority's ("SEPTA") proposed second amended complaint disclosed the existence of a confidential, non-public, fact-finding inquiry regarding the Company being conducted by the SEC. In cooperating fully with the SEC in connection with the inquiry, the Company has incurred, and will continue to incur, significant additional noninterest expenses for professional services such as legal fees. See "Noninterest Expenses" in Management's Discussion and Analysis of Financial Condition and Results of Operations - Results of Operations" as discussed in Part II, Item 7. The SEC's inquiry is not an indication that the SEC believes the Company or anyone else has violated federal securities laws or regulations. Nor does it mean that the SEC has a negative opinion of any person, entity, or security. If the SEC determines that there were violations of federal securities laws, the SEC could bring enforcement actions and/or monetary fines against the Company or certain individual former or current employees or directors of the Company, or administrative proceedings against the Company or its former or current employees or directors.

Risks Related to Liquidity

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

The Company is a holding company and depends on dividends, distributions and other payments from the Bank to fund dividend payments and stock repurchases, if permitted, and to fund all payments on obligations. The Bank is subject to laws that restrict dividend payments or authorize regulatory bodies to block or reduce the flow of funds from it to us. In addition, our right to participate in a distribution of assets upon the Bank's liquidation or reorganization is subject to the prior claims of the Bank's creditors.

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

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

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Risks Related to Owning our Stock

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

Federal banking regulators require us and our banking subsidiary to maintain adequate levels of capital to support our operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by our management and board of directors based on capital levels that, they believe, are necessary to support our business operations. At December 31, 2015, all four capital ratios for us and our banking subsidiary were above regulatory minimum levels to be deemed “well capitalized” under current bank regulatory guidelines. To be “well capitalized,” banking companies generally must maintain a tier 1 leverage ratio of at least 5.0%, CET1 capital ratio of 6.5%, Tier 1 risk-based capital ratio of at least 8.0%, and a total risk-based capital ratio of at least 10.0%. In addition, beginning January 1, 2016, the implementation of the capital conservation buffer included in the Basel III capital rules will begin at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each January 1, until it reaches 2.5% on January 1, 2019), resulting in additional capital that will be required of the Bank.

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

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

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

ITEM 1B – UNRESOLVED STAFF COMMENTS

None.

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ITEM 2 – PROPERTIES

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

Office and Address	Acquired/Built	Office and Address	Acquired/Built
Properties Owned		Properties Owned (continued)	
Orrstown Office 3580 Orrstown Road Orrstown, PA 17244	1919	Lincoln Way East Office 1725 Lincoln Way East Chambersburg, PA 17202	2004
Lurgan Avenue Office 121 Lurgan Avenue Shippensburg, PA 17257	1981	Duncannon Office 403 North Market Street Duncannon, PA 17020	2006
King Street Office 77 E. King Street Shippensburg, PA 17257	1986	Greencastle Office 308 Carolle Street Greencastle, PA 17225	2006
Stonehedge Office 427 Village Drive Carlisle, PA 17015	1994	New Bloomfield Office 1 South Carlisle Street New Bloomfield, PA 17068	2006
Path Valley Office 16400 Path Valley Road Spring Run, PA 17262	1995	Newport Office Center Square Newport, PA 17074	2006
Norland Avenue Office 625 Norland Avenue Chambersburg, PA 17201	1997	Red Hill Office 18 Newport Plaza Newport, PA 17074	2006
Silver Spring Office 3 Baden Powell Lane Mechanicsburg, PA 17050	2000	Simpson Street Office 1110 East Simpson Street Mechanicsburg, PA 17055	2006
North Middleton Office (land lease) 2250 Spring Road Carlisle, PA 17013	2002	North Pointe Operations Center Orrstown Operations Center 2695 Philadelphia Avenue Chambersburg, PA 17201	2007
Orchard Drive Office (land lease) 1355 Orchard Drive Chambersburg, PA 17201	2003	Eastern Blvd. Office 1020 Professional Court Hagerstown, MD 21740	2008
Seven Gables Office 1 Giant Lane	2003		

Carlisle, PA 17013

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Office and Address	Acquired/Built	Office and Address	Acquired/Built
Properties Leased		Properties Leased (continued)	
Hanover Street 22 S. Hanover St. Carlisle, PA 17013	1997	Rohrerstown 2098 Spring Valley Road Lancaster, PA 17601	2013
Camp Hill 3045 Market St. Camp Hill, PA 17011	2005	Commerce Drive 1589 Commerce Drive Lancaster, PA 17605	2015
Carlisle Fairgrounds 1000 Bryn Mawr Road Carlisle, PA 17103	2011		

ITEM 3 – LEGAL PROCEEDINGS

The nature of the Company’s business generates a certain amount of litigation involving matters arising out of the ordinary course of business. Except as described below, in the opinion of management, there are no legal proceedings that might have a material effect on the results of operations, liquidity, or the financial position of the Company at this time.

On May 25, 2012, SEPTA filed a putative class action complaint in the United States District Court for the Middle District of Pennsylvania against the Company, the Bank and certain current and former directors and executive officers (collectively, the “Defendants”). The complaint alleges, among other things, that (i) in connection with the Company’s Registration Statement on Form S-3 dated February 23, 2010 and its Prospectus Supplement dated March 23, 2010, and (ii) during the purported class period of March 24, 2010 through October 27, 2011, the Company issued materially false and misleading statements regarding the Company’s lending practices and financial results, including misleading statements concerning the stringent nature of the Bank’s credit practices and underwriting standards, the quality of its loan portfolio, and the intended use of the proceeds from the Company’s March 2010 public offering of common stock. The complaint asserts claims under Sections 11, 12(a) and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and seeks class certification, unspecified money damages, interest, costs, fees and equitable or injunctive relief. Under the Private Securities Litigation Reform Act of 1995 (“PSLRA”), motions for appointment of Lead Plaintiff in this case were due by July 24, 2012. SEPTA was the sole movant and the Court appointed SEPTA Lead Plaintiff on August 20, 2012. Pursuant to the PSLRA and the Court’s September 27, 2012 Order, SEPTA was given until October 26, 2012 to file an amended complaint and the Defendants until December 7, 2012 to file a motion to dismiss the amended complaint. SEPTA’s opposition to the Defendant’s motion to dismiss was originally due January 11, 2013. Under the PSLRA, discovery and all other proceedings in the case were stayed pending the Court’s ruling on the motion to dismiss. The September 27, 2012 Order specified that if the motion to dismiss were denied, the Court would schedule a conference to address discovery and the filing of a motion for class certification. On October 26, 2012, SEPTA filed an unopposed motion for enlargement of time to file its amended complaint in order to permit the parties and new defendants to be named in the amended complaint time to discuss plaintiff’s claims and defendants’ defenses. On October 26, 2012, the Court granted SEPTA’s motion, mooting its September 27, 2012 scheduling Order, and requiring SEPTA to file its amended complaint on or before January 16, 2013 or otherwise advise the Court of circumstances that require a further enlargement of time. On January 14, 2013, the Court granted SEPTA’s second unopposed motion for enlargement of time to file an amended complaint on or before March 22, 2013.

On March 4, 2013, SEPTA filed an amended complaint. The amended complaint expands the list of defendants in the action to include the Company’s independent registered public accounting firm and the underwriters of the Company’s March 2010 public offering of common stock. In addition, among other things, the amended complaint extends the purported 1934 Exchange Act class period from March 15, 2010 through April 5, 2012. Pursuant to the Court's March 28, 2013 Second Scheduling Order, on May 28, 2013 all defendants filed their motions to dismiss the amended complaint, and on July 22, 2013 SEPTA filed its "omnibus" opposition to all of the defendants' motions to dismiss. On August 23, 2013, all defendants filed reply briefs in further support of their motions to dismiss. On December 5, 2013, the Court ordered oral argument on the

Orrstown Defendants' motion to dismiss the amended complaint to be heard on February 7, 2014. Oral argument on the pending motions to dismiss SEPTA's amended complaint was held on April 29, 2014.
The Second Scheduling Order stayed all discovery in the case pending the outcome of the motions to dismiss, and informed the parties that, if required, a telephonic conference to address discovery and the filing of SEPTA's motion for class certification would be scheduled after the Court's ruling on the motions to dismiss.
On April 10, 2015, pursuant to Court order, all parties filed supplemental briefs addressing the impact of the United States Supreme Court's March 24, 2015 decision in Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund on defendants' motions to dismiss the amended complaint.
On June 22, 2015, in a 96-page Memorandum, the Court dismissed without prejudice SEPTA's amended complaint against all defendants, finding that SEPTA failed to state a claim under either the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended. The Court ordered that, within 30 days, SEPTA either seek leave to amend its amended complaint, accompanied by the proposed amendment, or file a notice of its intention to stand on the amended complaint.
On July 22, 2015, SEPTA filed a motion for leave to amend under Local Rule 15.1, and attached a copy of its proposed second amended complaint to its motion. Many of the allegations of the proposed second amended complaint are essentially the same or similar to the allegations of the dismissed amended complaint. The proposed second amended complaint also alleges that the Orrstown Defendants did not publicly disclose certain alleged failures of internal controls over loan underwriting, risk management, and financial reporting during the period 2009 to 2012, in violation of the federal securities laws. On February 8, 2016, the Court granted SEPTA's motion for leave to amend and SEPTA filed its second amended complaint that same day.
The allegations of SEPTA's proposed second amended complaint disclosed the existence of a confidential, non-public, fact-finding inquiry regarding the Company being conducted by the Commission. The Commission inquiry is not an indication that the Commission believes the Company or anyone else has violated federal securities laws or regulations. Nor does it mean that the Commission has a negative opinion of any person, entity, or security. The investigation is ongoing and the Company has been cooperating fully with the Commission.
On February 25, 2016, the Court issued a scheduling Order directing: all defendants to file any motions to dismiss by March 18, 2016; SEPTA to file an omnibus opposition to defendants' motions to dismiss by April 8, 2016; and all defendants to file reply briefs in support of their motions to dismiss by April 22, 2016. The Order stays all discovery and other deadlines in the case (including the filing of SEPTA's motion for class certification) pending the outcome of the motions to dismiss.
The Company believes that the allegations of SEPTA's second amended complaint are without merit and intends to vigorously defend itself against those claims.
Given that the litigation is still in the pleading stage, it is not possible at this time to estimate reasonably possible losses, or even a range of reasonably possible losses, in connection with the litigation.

ITEM 4 – MINE SAFETY DISCLOSURES

Not applicable.

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PART II

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

Market Information

Our common stock began trading on the NASDAQ Capital Market under the symbol "ORRF" as of April 28, 2009, and continues to be listed there as of the date hereof. At the close of business on March 7, 2016, there were approximately 2,975 shareholders of record.

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

	2015			2014		
	Market Price		Quarterly	Market Price		Quarterly
	High	Low	Dividend	High	Low	Dividend
First quarter	$17.50	$16.31	$0.00	$17.50	$15.35	$0.00
Second quarter	18.00	16.02	0.07	16.95	15.85	0.00
Third quarter	18.00	15.10	0.07	17.00	15.33	0.00
Fourth quarter	18.45	16.24	0.08	17.21	15.50	0.00
			$0.22			$0.00

In October 2011, the Company announced that it had discontinued its quarterly dividend. On April 21, 2015, the Company resumed its declaration of a quarterly dividend, once enforcement actions against the Company and the Bank were lifted. The Company 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 conditions and other factors deemed relevant by the Board of Directors. See Note 15, "Restrictions on Dividends, Loans, and Advances," in the "Notes to Consolidated Financial Statements" included in Item 8 for the year ended December 31, 2015 for restrictions on the payment of dividends.

Issuer Purchases of Equity Securities

The following table presents the Company's monthly repurchases of its common stock during the quarter ended December 31, 2015. The maximum number of shares that may yet be purchased under the plan is 368,923 shares at December 31, 2015.

	Total Number of Shares Repurchased	Average Price Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
October 1, 2015 to October 31, 2015	33,818	$17.21	33,818	373,369
November 1, 2015 to November 30, 2015	0	0.00	0	373,369
December 1, 2015 to December 31, 2015	4,446	17.48	4,446	368,923

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

The extent to which the Company repurchases its shares, and the timing of such repurchases, will depend upon a variety of factors, including market conditions, regulatory requirements and other corporate considerations, as determined by

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management. Purchases may be made from time to time on open market or privately negotiated transactions. The repurchase program may be suspended or discontinued at any time. As of December 31, 2015, 47,077 shares had been repurchased under the program at a total cost of $808,680, or $17.18 per share.

PERFORMANCE GRAPH

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

	Period Ending					
Index	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15
Orrstown Financial Services, Inc.	100.00	31.06	36.30	61.56	64.01	68.03
SNL Bank $1B-$5B	100.00	91.20	112.45	163.52	170.98	191.39
S&P 500	100.00	102.11	118.45	156.82	178.28	180.75
NASDAQ Composite	100.00	99.21	116.82	163.75	188.03	201.40

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

Recent Sales of Unregistered Securities

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

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ITEM 6 – SELECTED FINANCIAL DATA

	Year Ended December 31,				
(Dollars in thousands)	2015	2014	2013	2012	2011
Summary of Operations					
Interest income	$38,635	$38,183	$37,098	$45,436	$60,361
Interest expense	4,301	4,159	5,011	7,548	10,754
Net interest income	34,334	34,024	32,087	37,888	49,607
Provision for loan losses	(603)	(3,900)	(3,150)	48,300	58,575
Net interest income after provision for loan losses	34,937	37,924	35,237	(10,412)	(8,968)
Securities gains	1,924	1,935	332	4,824	6,224
Other noninterest income	17,254	16,919	17,476	18,438	20,396
Goodwill impairment charge	0	0	0	0	19,447
Other noninterest expenses (excluding goodwill impairment charge)	44,607	43,768	43,247	43,349	41,032
Income (loss) before income taxes (benefit)	9,508	13,010	9,798	(30,499)	(42,827)
Income tax expense (benefit)	1,634	(16,132)	(206)	7,955	(10,863)
Net income (loss)	$7,874	$29,142	$10,004	$(38,454)	$(31,964)
Per Common Share Data					
Net income (loss)	$0.97	$3.59	$1.24	$(4.77)	$(3.98)
Diluted net income (loss)	0.97	3.59	1.24	(4.77)	(3.98)
Cash dividend paid	0.22	0.00	0.00	0.00	0.69
Book value at December 31	16.08	15.40	11.28	10.85	15.92
Tangible book value at December 31	16.06	15.35	11.20	10.75	15.79
Average shares outstanding – basic	8,106,438	8,110,344	8,093,306	8,066,148	8,017,307
Average shares outstanding – diluted	8,141,600	8,116,054	8,093,306	8,066,148	8,026,726
Stock Price Statistics					
Close	$17.84	$17.00	$16.35	$9.64	$8.25
High	18.45	17.50	18.00	11.29	29.50
Low	15.10	15.33	9.49	7.45	7.90
Price earnings ratio at close	18.4	4.7	13.2	(2.0)	(2.1)
Diluted price earnings ratio at close	18.4	4.7	13.2	(2.0)	(2.1)
Price to book at close	1.1	1.1	1.4	0.9	0.5
Price to tangible book at close	1.1	1.1	1.5	0.9	0.5
Year-End Balance Sheet Data					
Total assets	$1,292,816	$1,190,443	$1,177,812	$1,232,668	$1,444,097
Loans	781,713	704,946	671,037	703,739	965,440
Total investment securities	402,844	384,549	416,864	311,774	322,123
Deposits – noninterest bearing	131,390	116,302	116,371	121,090	111,930
Deposits – interest bearing	900,777	833,402	884,019	963,949	1,104,972
Total deposits	1,032,167	949,704	1,000,390	1,085,039	1,216,902
Repurchase agreements	29,156	21,742	9,032	9,650	15,013
Borrowed money	84,495	79,812	66,077	37,470	73,798
Total shareholders' equity	133,061	127,265	91,439	87,694	128,197
Trust assets under management – market value	966,362	1,017,013	1,085,216	992,378	947,273
Performance Statistics					

Average equity / average assets	10.66 %	8.63 %	7.45 %	8.07 %	10.36 %
Return on average equity	5.99 %	28.78 %	11.30 %	(35.22)%	(20.33)%
Return on average assets	0.64 %	2.48 %	0.84 %	(2.84)%	(2.11)%

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Supplemental Reporting of Non-GAAP-Based Financial Measures

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

	Year Ended December 31,				
(Dollars in thousands, except per share data)	2015	2014	2013	2012	2011
Shareholders’ equity	$133,061	$127,265	$91,439	$87,694	$128,197
Less: Intangible assets	207	414	622	832	1,041
Tangible equity	$132,854	$126,851	$90,817	$86,862	$127,156
Book value per share	$16.08	$15.40	$11.28	$10.85	$15.92
Less: Intangible assets per share	0.02	0.05	0.08	0.10	0.13
Tangible book value per share	$16.06	$15.35	$11.20	$10.75	$15.79

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

The following is a discussion of the consolidated financial condition and results of operations for each of the three years ended December 31, 2015, 2014 and 2013. The following discussion and analysis should be read in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements presented in this report to assist in the evaluation of the Company's 2015 performance. Certain prior period amounts presented in this discussion and analysis have been reclassified to conform to current period classifications. It should also be read in conjunction with the "Caution About Forward Looking Statements" section at the end of this discussion.

Overview

The U.S. economy is in its sixth year of recovery from one of its longest and most severe economic recessions in recent history. The strength of the recovery has been modest by historical standards with GDP growth struggling to sustain momentum above 2.0%. Unemployment had been slow to decline until 2014, when it experienced its best employment growth in more than a decade adding over three million new jobs, and this favorable momentum in employment gains has continued in 2015. With continued improvement in the economic outlook, the FRB began its long awaited rise in interest rates, when it raised the short-term rate by 25 basis points in December 2015. Many of the world's economies appear to be in recession or experiencing decelerating growth, and as a result, the dollar has strengthened significantly and commodity prices have fallen precipitously. It is not certain that the U.S. economy will remain strong enough to allow the FRB to continue to raise interest rates while the rest of the world's major economies struggle.

The Company was profitable in 2015. Net income for the years ended December 31, 2015, 2014 and 2013 was $7,874,000, $29,142,000 and $10,004,000 after posting losses in the two previous years. The Company was able to return to profitability as asset quality issues have improved significantly in the past three years, from their elevated levels, allowing for significant reductions in the provision for loan losses in 2015, 2014 and 2013. The provision for loan losses was a negative $603,000, $3,900,000, and $3,150,000 for the years ended December 31, 2015, 2014 and 2013.

The results of operations of the Company in 2014 were also influenced by the establishment of a deferred tax asset valuation allowance reserve totaling $20,235,000 in 2012 due primarily to the cumulative losses posted in 2011 and 2012. As a result of sustained profitability for the prior nine quarters, strengthened asset quality metrics and regulatory capital, the valuation allowance was recaptured in the fourth quarter of 2014, and an income tax benefit of $16,204,000 was recorded.

Critical Accounting Policies

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States ("GAAP") and follow general practices within the financial services industry in which it operates. Management, in order to prepare the Company's consolidated financial statements, is required to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the balance sheet date through the date the financial statements are filed with the Commission. As this information changes, the consolidated financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources.

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

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

The Company recognizes deferred tax assets and liabilities for the future effects of temporary differences and tax credits. Enacted tax rates are applied to cumulative temporary differences based on expected taxable income in the periods in which the deferred tax asset or liability is anticipated to be realized. Future tax rate changes could occur that would require the recognition of income or expense in the statement of operations in the period in which they are enacted. Deferred tax assets must be reduced by a valuation allowance if in management's judgment it is "more likely than not" that some portion of the asset will not be realized. Management may need to modify their judgments in this regard, from one period to another, should a material change occur in the business environment, tax legislation, or in any other business factor that could impair the Company's ability to benefit from the asset in the future. Based upon the Company's prior cumulative taxable losses, projections for future taxable income and other available evidence, management determined that there was not sufficient positive evidence to outweigh the cumulative loss, and concluded it was not more likely than not that the net deferred tax asset would be realized for the quarters ended September 30, 2012 through September 30, 2014. Accordingly a full valuation allowance was recorded for each of these quarters in 2012. At December 31, 2014, management analyzed the Company's profitable operations over the prior nine quarters, improvements in asset quality, strengthened capital position, reduced regulatory risk, as well as improvement in economic conditions, and determined that a full valuation allowance was no longer necessary, and the full amount was recaptured as of December 31, 2014. The ultimate realization of deferred tax assets is dependent upon existence, or generation, of taxable income in the periods when those temporary differences and net operating loss and credit carryforwards are deductible. Management considered projected future taxable income, length of time needed for carryforwards to reverse, available tax planning strategies, and other factors in making its assessment that it was more likely than not the net deferred tax assets would be realized.

Readers of the consolidated financial statements should be aware that the estimates and assumptions used in the Company's current financial statements may need to be updated in future financial presentations for changes in circumstances, business or economic conditions in order to fairly represent the condition of the Company at that time.

Corporate Profile and Significant Developments

The Company is a bank holding company (that has elected status as a financial holding company with the FRB) headquartered in Shippensburg, Pennsylvania with consolidated assets of $1,292,816,000 at December 31, 2015. The consolidated financial information presented herein reflects the Company and its wholly-owned commercial bank subsidiary, the Bank.

The Bank, with total assets of $1,292,178,000 at December 31, 2015, is a Pennsylvania chartered commercial bank with 22 offices. The Bank's deposit services include a variety of checking, savings, time and money market deposits along with related debit card and merchant services. Lending services include commercial loans, residential loans, commercial mortgages and various forms of consumer lending. Orrstown Financial Advisors, a division of the Bank, offers a diverse line of financial services to our customers, including, but not limited to, brokerage, mutual funds, trusts, estate planning, investments and insurance products. At December 31, 2015, Orrstown Financial Advisors had approximately $966,362,000 of assets under management.

Economic Climate, Inflation and Interest Rates

The U.S. economy is in the sixth year of modest expansion following one of its longest and most severe economic recessions in history. The modest strength of the expansion has resulted in strong competition for quality lending opportunities, which together with a relatively flat yield curve, has pressured net interest margin and the ability to leverage our overhead expenses.

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

As the Company's balance sheet consists primarily of financial instruments, interest income and interest expense is greatly influenced by the level of interest rates and the slope of the interest rate curve. During the three years presented in this financial statement review, interest rates have remained near all-time lows. In December 2015, the FRB raised short term interest rates by 25 basis points, the first increase in rates in ten years. Because of the low level of interest rates, we have not been able to lower the rate we pay for interest bearing non-maturity deposits to the same extent that has been experienced in the

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rates we have been able to earn on our interest earning assets. As a result, the Company’s net interest margin has been negatively impacted.

Management believes that the Company is positioned to withstand the challenging economic conditions because of the steps it has taken to improve its capital, liquidity position, and asset quality.

Results of Operations

Summary

For the years ended December 31, 2015, 2014 and 2013, the Company recorded net income of $7,874,000, $29,142,000 and $10,004,000. Diluted earnings per share were $0.97, $3.59 and $1.24 for the years ended December 31, 2015, 2014 and 2013.

Each of the three years had events and circumstances that affect the comparability of the information for the periods presented, and reflects the impact that asset quality had on the results of our operations. In 2013 and 2014, improvements were noted in asset quality due to some success in remediation and workout efforts. As a result, it was determined that no provision for loan losses was needed for 2013, 2014 and 2015, and that a recovery of amounts previously provided for or charged off would be recognized. This resulted in a negative provision of $603,000, $3,900,000 and $3,150,000 for the years ended December 31, 2015, 2014 and 2013.

Noninterest expenses, in total, remained relatively consistent, and totaled $44,607,000, $43,768,000 and $43,247,000 for the years ended December 31, 2015, 2014 and 2013. Although the total was relatively flat, the changes in certain components of noninterest expenses between the three periods are reflective of the Company's asset quality remediation efforts, focus on investing in additional talent and technology to better serve the needs of our customers, and efforts to develop new relationships. Data processing costs increased from $682,000 for the year ended December 31, 2013 to $1,866,000 and $2,026,000 for the years ended December 31, 2014 and 2015. Salaries and employee benefits increased from $22,954,000 for the year ended December 31, 2013 to $23,658,000 and $24,056,000 for the years ended December 31, 2014 and 2015.

For the year ended December 31, 2015, net income included income tax expense of $1,634,000, or an effective tax rate 17.2%, whereas results for the years ended December 31, 2014 and 2013 were favorably impacted by issues surrounding a valuation allowance on deferred tax assets. The 2014 results benefited from the recapture of the valuation allowance on deferred tax assets of $16,204,000, and 2013 benefited from the valuation allowance and the fact no federal income tax expense was recorded, despite pre-tax income, due to the valuation allowance on deferred tax that was previously established and charged to income tax expense in 2012.

Net Interest Income

Net interest income, which is the difference between interest income and fees on interest-earning assets and interest expense on interest-bearing liabilities, is the primary component of the Company’s revenue. Interest-earning assets include loans, securities and federal funds sold. Interest bearing liabilities include deposits and borrowed funds. To compare the tax-exempt yields to taxable yields, amounts are adjusted to pretax equivalents based on a 35% federal corporate tax rate.

Net interest income is affected by changes in interest rates, volumes of interest-earning assets and interest-bearing liabilities and the composition of those assets and liabilities. The “net interest spread” and “net interest margin” are two common statistics related to changes in net interest income. The net interest spread represents the difference between the yields earned on interest-earning assets and the rates paid for interest-bearing liabilities. The net interest margin is defined as the ratio of net interest income to average earning assets. Through the use of non-interest bearing demand deposits and shareholders' equity, the net interest margin exceeds the net interest spread, as these funding sources are non-interest bearing.

The “Analysis of Net Interest Income” table presents net interest income on a fully taxable equivalent basis, net interest spread and net interest margin for the years ending December 31, 2015, 2014 and 2013. The “Changes in Taxable Equivalent Net Interest Income” table below analyzes the changes in net interest income for the same periods broken down by their rate and volume components.

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2015 versus 2014

For the year ended December 31, 2015, net interest income, measured on a fully tax equivalent basis, increased $493,000, or 1.4%, to $35,987,000 from $35,494,000 for the same period in 2014. The primary reason for the increase in net interest income was higher average balances in loans during 2015 as compared to 2014. However, net interest margin compressed from 3.20% for the year ended December 31, 2014 to 3.14% for the same period in 2015, due to the effects of the flattening yield curve throughout 2015 that negatively impacted the yields on interest-earning assets, and caused funding costs to increase.

Interest income on tax equivalent basis on loans increased from $30,719,000 for the year ended December 31, 2014 to $31,881,000 for the year ended December 31, 2015, for an increase of $1,162,000. The increase in interest income on loans was primarily a result of an increase in average loan volume, offset partially by a decrease in yield. The average loans balance increased to $746,679,000 for the year ended December 31, 2015, compared to $683,878,000 for the same period in 2014, and was the result of successful sales efforts across all loan segments. The average yield on the loan portfolio decreased 22 basis points from 4.49% for the year ended December 31, 2014 to 4.27% for the same period in 2015, which partially offset the income generated from higher average loan balances. During 2015, competition for loans remained strong, which resulted in competitive pricing in order to grow loan balances. Additionally, the proceeds from loan repayments were invested in new loans, generally at lower rates than those loans in which repayments were received.

Interest income earned on a tax equivalent basis on securities decreased in 2015 and totaled $8,326,000 for the year ended December 31, 2015, a decrease of $573,000 compared to the $8,899,000 for the same period in 2014. The average balance of securities has decreased from $413,072,000 for the year ended December 31, 2014 to $381,668,000 for the same period in 2015, with funds obtained from the maturing and prepaying securities used to fund a portion of the Company's loan growth, which resulted in a decline in the average balance of securities available for sale from 2014 to 2015. Partially offsetting the decrease in interest income on securities that resulted from lower average balances, was an increase in rates earned on securities, which increased from an average tax equivalent yield of 2.15% in 2014 to 2.18% in 2015. As a result of a greater composition of tax-exempt securities in the total securities portfolio, the overall yield increased slightly, as tax-exempt securities continued to provide attractive yields.

Interest expense on deposits and borrowings for the year ended December 31, 2015 was $4,301,000, an increase of $142,000, from $4,159,000 for the same period in 2014. The average balance of interest bearing liabilities increased 2.13% from $936,831,000 for the year ended December 31, 2014 to $956,740,000 for the same period in 2015. In addition, the Company’s cost of funds on interest bearing liabilities increased to 0.45% for the year ended December 31, 2015 from 0.44% for the same period in 2014. Interest expense on time deposits decreased for the year ended December 31, 2015 to $2,562,000, from $2,720,000 for the same period in 2014, due to a decrease in average balances. During the first six months of 2015, the Company was allowing its time deposits to run off which contributed greatly to the decline in average time deposits in comparison to 2014, as there were cheaper funding alternatives available. As opportunities to deploy funds at more favorable returns for the risk taken became available, the Company increased its time deposits resulting in an increase in the average rates paid for time deposits from 0.93% for the year ended December 31, 2014 to 0.97% in 2015. The Company replaced short term borrowings with callable brokered time deposits to fund loan and securities growth during the last six months of 2015. The Company made this choice because the call option gave the Company the flexibility to reduce its cost of funds if interest rates fall while protecting its net interest margin if rates should rise.

In addition, the increased use of short-term borrowings for temporary funding sources, and additional long-term borrowings, which generally have higher interest rates associated with them, also resulted in the increase in the cost of funds. The average balance of short-term borrowings increased $33,340,000 during the year ended December 31, 2015 to $85,262,000. The average rate paid on short-term borrowings for 2015 was 0.35%, an increase of 6 basis points from that paid in 2014. The increase in average balances and rates paid resulted in an increase in interest expense on short-term borrowings from $148,000 for the year ended December 31, 2014 to $295,000 in 2015. Additionally, the Company added to its long-term borrowings, resulting in a higher average balance of $22,522,000 for the year ended December 31, 2015 compared to $17,773,000 in 2014, and was the primary reason for the increase in expense of $67,000, from $333,000 for the year ended December 31, 2014 to $400,000 for the year end December

31, 2015.
The Company’s net interest spread of 3.06% decreased 7 basis points for the year ended December 31, 2015 as compared to the same period in 2014. Net interest margin for the year ended December 31, 2015 was 3.14%, a 6 basis point decrease from 3.20% for the year ended December 31, 2014, and is reflective of a flattening yield curve.

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2014 versus 2013

For the year ended December 31, 2014, net interest income, measured on a fully tax equivalent basis, increased $1,612,000, or 4.8%, to $35,494,000 from $33,882,000 for the same period in 2013. The primary reason for the increase in net interest income was the investment of excess liquidity, previously kept in interest bearing bank balances, into higher yielding securities and the loan portfolio. Expansion in net interest margin from 3.03% for the year ended December 31, 2013 to 3.20% for the same period in 2014 reflects the investments in the higher yielding securities and loans. This shift in investment philosophy was made possible as a result of the sustained improvement in the Company's asset quality and earnings performance, which allowed for increased liquidity available at our correspondent banks, and decreasing the amount of liquidity we needed on hand. Average earning assets decreased nominally from $1,118,612,000 for the year ended December 31, 2013 to $1,111,087,000 for the same period in 2014. The largest contributor to the increase in net interest income was the investment of excess liquidity into the securities portfolio. Interest income on securities increased from $5,940,000 for the year ended December 31, 2013 to $8,899,000 for the year ended December 31, 2014. The average securities balance increased to $413,072,000 for the year ended December 31, 2014, compared to $368,208,000 for the same period in 2013. The average yield on the securities portfolio improved from 1.61% for the year ended December 31, 2013 to 2.15% for the same period in 2014. The change in interest income due to the increase in the average yield on investment securities resulted in additional interest income of $3,039,000, partially offset by an $80,000 decrease due to a decrease in the average rate received.

Interest income earned on a tax equivalent basis on loans decreased in 2014 to $30,719,000 for the year ended December 31, 2014, a decrease of $2,060,000 compared to the $32,779,000 for 2013. Although the average balance of loans has increased marginally from $683,272,000 for the year ended December 31, 2013 to $683,878,000 for 2014, the volume increase was not enough to offset the decrease in rates earned on loans, which declined from an average tax equivalent yield of 4.80% in 2013 to 4.49% in 2014.

Interest expense on deposits and borrowings for the year ended December 31, 2014 was $4,159,000, a decrease of $852,000, from $5,011,000 for the same period in 2013. The average balance of interest bearing liabilities decreased 3.30% from $968,797,000 for the year ended December 31, 2013 to $936,831,000 for the same period in 2014. In addition, the Company’s cost of funds on interest bearing liabilities declined to 0.44% for the year ended December 31, 2014 from 0.52% for the same period in 2013. As time deposits matured, we have been able to replace the funds at lower rates.

During the year ended December 31, 2014, the Company utilized short-term borrowings as a temporary funding source of funds, rather than utilizing more expensive time deposits and long-term borrowings. As a result, the average balance of short-term borrowings increased $27,610,000 during the year, and averaged $51,922,000. In addition, the average rate paid on short-term borrowings for 2014 was 0.29% an increase of 4 basis points from that paid in 2013. The increase in average balances and rates paid resulted in an increase in interest expense on short-term borrowings from $61,000 for the year ended December 31, 2013 to $148,000 in 2014. Conversely, the Company allowed its long-term borrowings to run off without full replacement, resulting in a lower average balance of $17,773,000 for the year ended December 31, 2014 compared to $28,752,000 in 2013. This was a reason that interest expense on long-term debt decreased by $172,000, from $505,000 for the year ended December 31, 2013 to $333,000. Offsetting the lower average balances were higher average rates paid, which increased from 1.76% in 2013 to 1.87% in 2014, as some of the maturing long-term debt had rates below the average of the total.

The Company’s net interest spread of 3.13% increased 17 basis points for the year ended December 31, 2014 as compared to 2013. Net interest margin for the year ended December 31, 2014 was 3.20%, a 17 basis point improvement from 3.03% for the year ended December 31, 2013.

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ANALYSIS OF NET INTEREST INCOME

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

	2015			2014			2013		
(Dollars in thousands)	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate	Average Balance	Tax Equivalent Interest	Tax Equivalent Rate
Assets									
Federal funds sold and interest bearing bank balances	$18,901	$81	0.43 %	$14,137	$35	0.25 %	$67,132	$174	0.26 %
Taxable securities	348,613	6,697	1.92	399,014	8,051	2.02	339,750	4,300	1.27
Tax-exempt securities	33,055	1,629	4.93	14,058	848	6.03	28,458	1,640	5.76
Total securities	381,668	8,326	2.18	413,072	8,899	2.15	368,208	5,940	1.61
Taxable loans	687,079	28,787	4.19	620,701	27,368	4.41	619,929	29,290	4.72 %
Tax-exempt loans	59,600	3,094	5.19	63,177	3,351	5.30	63,343	3,489	5.51
Total loans	746,679	31,881	4.27	683,878	30,719	4.49	683,272	32,779	4.80
Total interest-earning assets	1,147,248	40,288	3.51	1,111,087	39,653	3.57	1,118,612	38,893	3.48
Cash and due from banks	19,155			14,161			13,166		
Bank premises and equipment	24,386			25,921			26,496		
Other assets	56,894			41,499			52,179		
Allowance for loan losses	(14,134)			(19,268)			(21,912)		
Total	$1,233,549			$1,173,400			$1,188,541		
Liabilities and Shareholders' Equity									
Interest bearing demand deposits	$500,474	908	0.18	$491,046	823	0.17	$484,114	785	0.16
Savings deposits	85,068	136	0.16	83,941	135	0.16	78,714	129	0.16
Time deposits	263,414	2,562	0.97	292,149	2,720	0.93	352,905	3,531	1.00
Short-term borrowings	85,262	295	0.35	51,922	148	0.29	24,312	61	0.25
Long-term debt	22,522	400	1.78	17,773	333	1.87	28,752	505	1.76
Total interest bearing liabilities	956,740	4,301	0.45	936,831	4,159	0.44	968,797	5,011	0.52
	134,040			123,224			119,146		

Demand deposits										
Other	11,316			12,095				12,051		
Total Liabilities	1,102,096			1,072,150				1,099,994		
Shareholders' Equity	131,453			101,250				88,547		
Total	$1,233,549			$1,173,400				$1,188,541		
Net interest income (FTE)/net interest spread		35,987	3.06 %		35,494	3.13 %			33,882	2.96 %
Net interest margin			3.14 %			3.20 %				3.03 %
Tax-equivalent adjustment		(1,653)			(1,470)				(1,795)	
Net interest income		$34,334			$34,024				$32,087	

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

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CHANGES IN TAXABLE EQUIVALENT NET INTEREST INCOME

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

(Dollars in thousands)	2015 Versus 2014 Increase (Decrease) Due to Change in			2014 Versus 2013 Increase (Decrease) Due to Change in		
	Average Volume	Average Rate	Total Increase (Decrease)	Average Volume	Average Rate	Total Increase (Decrease)
Interest Income						
Federal funds sold & interest bearing deposits	$12	$34	$46	$(137)	$(2)	$(139)
Taxable securities	(1,017)	(337)	(1,354)	750	3,001	3,751
Tax-exempt securities	1,146	(365)	781	(830)	38	(792)
Taxable loans	2,927	(1,508)	1,419	36	(1,958)	(1,922)
Tax-exempt loans	(190)	(67)	(257)	(9)	(129)	(138)
Total interest income	2,878	(2,243)	635	(190)	950	760
Interest Expense						
Interest bearing demand deposits	16	69	85	11	27	38
Savings deposits	2	(1)	1	9	(3)	6
Time deposits	(268)	110	(158)	(608)	(203)	(811)
Short-term borrowings	95	52	147	69	18	87
Long-term debt	89	(22)	67	(193)	21	(172)
Total interest expense	(66)	208	142	(712)	(140)	(852)
Net Interest Income	$2,944	$(2,451)	$493	$522	$1,090	$1,612

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

Provision for Loan Losses

The Company recorded a negative provision for loan losses, or a reversal of amounts previously provided, of $603,000, $3,900,000 and $3,150,000 for the years ended December 31, 2015, 2014 and 2013. The negative provision in 2015 is the result of a recovery on a loan with prior charge-offs totaling this amount. The negative provision recorded in 2014 was the result of several factors, including: 1) favorable recoveries of loan amounts previously charged off; 2) successful resolution of a loan in workout with a smaller charge-off than the reserve established for it; and 3) significant improvement in asset quality metrics. Recent favorable charge-off data, combined with relatively stable economic and market conditions, resulted in the determination that a negative provision could be recorded in 2015 and 2014 despite net charge-offs for the periods, as allowance for loan losses coverage metrics remain strong. During 2013, or the first year that improvements were noted in asset quality since the recession, the Company received payments on classified loans with partial charge-offs previously recorded. As payments received on these classified loans exceeded the carrying value of these loans, the excess was included in recoveries of loan amounts previously charged off. In connection with the quarterly evaluation of the adequacy of the allowance for loan losses during 2013, it was determined that large recoveries specific to loans in one customer relationship were not needed to replenish the reserve, and were taken as a negative provision for loan losses.

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

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Noninterest Income

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

(Dollars in thousands)	2015	2014	2013	% Change 2015-2014	2014-2013
Service charges on deposit accounts	$5,226	$5,415	$5,716	(3.5)%	(5.3)%
Other service charges, commissions and fees	1,223	1,033	1,070	18.4 %	(3.5)%
Trust department income	4,598	4,687	4,770	(1.9)%	(1.7)%
Brokerage income	2,025	2,150	1,911	(5.8)%	12.5 %
Mortgage banking activities	2,747	2,207	3,053	24.5 %	(27.7)%
Earnings on life insurance	1,025	950	963	7.9 %	(1.3)%
Other income (loss)	410	477	(7)	(14.0)%	(6,914.3)%
Subtotal before securities gains	17,254	16,919	17,476	2.0 %	(3.2)%
Investment securities gains	1,924	1,935	332	(0.6)%	482.8 %
Total noninterest income	$19,178	$18,854	$17,808	1.7 %	5.9 %

2015 v. 2014's Results

Noninterest income increased to $19,178,000 for the year ended December 31, 2015, as compared to $18,854,000 for the year ended December 31, 2014, an increase of 1.7%.

Service charges on deposit accounts totaled $5,226,000 for the year ended December 31, 2015, compared to $5,415,000 for the year ended December 31, 2014, continuing the declining trend noted in 2014. The Company has experienced a decline in overdraft charges as consumers have greater awareness of their available balances given new technology, and are less likely to incur charges.

Other service charges, commissions and fees increased $190,000, or 18.4%, from $1,033,000 for the year ended December 31, 2014, to $1,223,000 for the corresponding period in 2015. In 2015, the Company's revenues were favorably impacted by $205,000 on the gain on sale of Small Business Administration (SBA) and U.S. Department of Agriculture (USDA) loans, with no similar gains in 2014.

Trust department and brokerage income totaled $6,623,000 for the year ended December 31, 2015 compared to $6,837,000 earned for the year ended December 31, 2014, a decline of $214,000, or 3.1%. Unfavorable market conditions, in which declines in the stock market were experienced, negatively impacted revenues.

Mortgage banking revenue for the year ended December 31, 2015 totaled $2,747,000, a 24.5% increase from the $2,207,000 earned for the year ended December 31, 2014. Favorable real estate and interest rate market conditions led to the increase in 2015, as the Company was able to enhance its new home purchase mortgage revenues, and relied less on mortgage loan refinancings.

Other income of $410,000 for the year ended December 31, 2015 was a $67,000 decrease compared to the $477,000 reported for 2014. The primary reason for the decrease was due to $234,000 in gains on sales of other real estate owned for the year ended December 31, 2015, compared to $299,000 in gains on sales recorded in 2014.

Security gains totaled $1,924,000 for the year ended December 31, 2015, which was relatively comparable to $1,935,000 in 2014. For both years, asset/liability management strategies and interest rate conditions resulted in gains on sales of securities, as market conditions presented opportunities to realize earnings on securities through gains, while funding the cash requirements of lending activity.

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2014 v. 2013’s Results

Noninterest income increased to $18,854,000 for the year ended December 31, 2014, as compared to $17,808,000 for the year ended December 31, 2013. Excluding the increase in securities gains of $1,603,000 in 2014 compared to 2013, noninterest income decreased $557,000 or 3.2%.

Service charges on deposit accounts and other services charges, commissions and fees totaled $5,415,000 and $1,033,000 for the year ended December 31, 2014, declines of 5.3% and 3.5% from 2013’s totals, and continued trends noted in prior years. The Company has experienced a decline in overdraft charges and other fee related charges, as consumers have been more conservative in their spending habits.

Trust department and brokerage income, in total, increased $156,000, or 2.3%, to $6,837,000 for the year ended December 31, 2014 compared to $6,681,000 earned in 2013. Favorable market conditions and new brokerage accounts led to an increase in brokerage income. Also, the Company’s ability to promote new products and attract accounts and customers contributed to the increase.

Mortgage banking revenue for the year ended December 31, 2014 totaled $2,207,000, a 27.7% decline from the $3,053,000 earned for the year ended December 31, 2013. During 2014 there was a reduction in the number of customers refinancing their residential mortgages and new home sale mortgage opportunities remained flat. These events resulted in an $846,000 decline in mortgage banking revenues to $2,207,000 for the year ended December 31, 2014 compared to 2013. The generally higher interest rates in 2013 slowed pre-payment speeds on loans serviced for others. This rate environment positively impacted 2013's results as the fair value of our mortgage servicing rights improved and allowed for the recovery of $638,000 of the impairment reserve during 2013, compared to a slight charge of $22,000 in 2014.

Security gains totaled $1,935,000 for the year ended December 31, 2014 compared to $332,000 in 2013. For both years, asset/liability management strategies and interest rate conditions resulted in gains on sales of securities, as market conditions presented opportunities to reduce interest rate risk while maintaining earnings for our securities portfolio.

Noninterest Expenses

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

				% Change			
(Dollars in thousands)	2015	2014	2013	2015-2014		2014-2013	
Salaries and employee benefits	$24,056	$23,658	$22,954	1.7	%	3.1	%
Occupancy	2,221	2,251	2,055	(1.3	)%	9.5	%
Furniture and equipment	3,061	3,328	3,446	(8.0	)%	(3.4	)%
Data processing	2,026	1,866	682	8.6	%	173.6	%
Telephone and communication	692	569	451	21.6	%	26.2	%
Automated teller machine and interchange fees	798	865	1,054	(7.7	)%	(17.9	)%
Advertising and bank promotions	1,564	1,195	1,251	30.9	%	(4.5	)%
FDIC insurance	859	1,621	2,577	(47.0	)%	(37.1	)%
Legal	1,440	705	793	104.3	%	(11.1	)%
Other professional services	1,262	1,580	1,462	(20.1	)%	8.1	%
Directors' compensation	737	624	622	18.1	%	0.3	%
Collection and problem loan	447	729	674	(38.7	)%	8.2	%
Real estate owned	162	300	137	(46.0	)%	119.0	%
Taxes other than income	916	562	939	63.0	%	(40.1	)%
Intangible asset amortization	207	208	210	(0.5	)%	(1.0	)%
Other operating expenses	4,159	3,707	3,940	12.2	%	(5.9	)%
Total noninterest expenses	$44,607	$43,768	$43,247	1.9	%	1.2	%

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2015 v. 2014's Results

Noninterest expenses amounted to $44,607,000 for the year ended December 31, 2015 compared to $43,768,000 for the prior year, an increase of $839,000, or 1.9%. The following factors contributed to the net increase in noninterest expenses.

- Salaries and employee benefits totaled $24,056,000 for the year ended December 31, 2015, compared to $23,658,000 in 2014, an increase of $398,000, or 1.7%. The 2015 results were impacted by merit increases to employees, incentive compensation including incremental share-based compensation expense of $449,000, and severance costs that totaled approximately $446,000 that were recognized during the year ended December 31, 2015.
- Furniture and equipment expense of $3,061,000 for the year ended December 31, 2015 represented a decrease of $267,000, or 8.0% from $3,328,000 in 2014. The decrease was due principally to lower depreciation charges and the absence of any losses on disposal of equipment, which totaled $41,000 for the year ended December 31, 2014.
- Data processing charges were $2,026,000 for the year ended December 31, 2015, an 8.6% increase from 2014. Similarly, telephone and communication charges totaled $692,000 for the year ended December 31, 2015, compared to $569,000 for the same period in 2014. The annual increases are reflective of overall higher volumes and costs associated with more sophisticated product and service offerings.
- Advertising and bank promotion increased from $1,195,000 for the year ended December 31, 2014 to $1,564,000 for the same period in 2015, and reflects the timing and advertising associated with the opening of our new full service branch in Lancaster, increased promotion of several of our products and general brand awareness.
- FDIC insurance expenses totaled $859,000 for the year ended December 31, 2015, a 47.0% reduction from the $1,621,000 incurred in 2014. The decrease was the result of a lower assessment rate, as the Company's risk profile improved.
- Legal fees totaled $1,440,000 for the year ended December 31, 2015, compared to $705,000 in 2014. The increase in legal fees is primarily the result of costs associated with certain legal matters, including outstanding litigation against the Company and an ongoing confidential investigation being conducted by the Commission as well as general corporate matters. It is anticipated that legal fees will continue to be at elevated levels until the litigation and the confidential investigation is completed.
- Other professional services, which includes accounting and consulting, totaled $1,262,000 for the year ended December 31, 2015, compared to $1,580,000 in 2014. The decrease is principally the result of less reliance on outside consulting firms, as some work previously handled by consultants was assumed by employees.
- Directors' compensation totaled $737,000 for the year ended December 31, 2015, a $113,000, or 18.1% increase from $624,000 for the same period in 2014. The increase was primarily attributed to share based compensation awarded to the directors in May 2015, with a one year vesting period, which resulted in seven months of expense in 2015 with no similar charge in 2014.
- Collection and problem loan expense totaled $447,000 in 2015, representing a decrease of $282,000 from 2014. Similarly, real estate owned expenses also declined from $300,000 for the year ended December 31, 2015 to $162,000 for the same period in 2014. The declines in collection and problem loan and real estate owned expenses reflect improvement in the level of classified assets between the two periods.
- Taxes, other than income, totaled $916,000 for the year ended December 31, 2015, an approximate 63.0% increase compared to 2014 as Pennsylvania's Bank Shares tax is based on shareholders' equity at the beginning of the year. A combination of 2014's earnings and other comprehensive income, resulted in the increase in this equity-based tax, assessed each year on January 1.
- Other operating expenses increased $452,000, or 12.2%, for the year ended December 31, 2015, from $3,707,000 in 2014 to $4,159,000 in 2015. In 2015, incremental charges of $384,000 were incurred associated with the Company's investment in low-income housing projects compared to $150,000 in 2014, an increase of $234,000 or 156.0%. The prior year's results were positively impacted by favorable operating results of the partnerships, which resulted in less expense in 2014.

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In order to better understand how noninterest expenses change in relation to related changes in revenue, operating expense levels are often measured in the financial services industry by the efficiency ratio, which expresses non-interest expense as a percentage of tax-equivalent net interest income and noninterest income, excluding securities gains, intangible asset amortization and other real estate income and expenses. The Company’s efficiency ratio for the twelve months ended December 31, 2015 was 83.5%, compared to 83.0% in 2014. The higher, or less favorable, ratio between the two years was primarily the result of higher noninterest expenses, which outpaced growth in revenues.

2014 v. 2013’s Results

Noninterest expenses amounted to $43,768,000 for the year ended December 31, 2014 compared to $43,247,000 for the prior year, an increase of $521,000, or 1.2%. The following factors contributed to the net increase in noninterest expenses.

- Salaries and employee benefits totaled $23,658,000 for the year ended December 31, 2014, compared to $22,954,000 in 2013, an increase of $704,000, or 3.1%. The net increase is the result of several factors. Staff were hired in the latter part of 2013, which supported enhanced risk management processes and practices and greater depth in information technology. The outsourcing of the core processing led to a reduction in work force, which partially offset the increase for the additional risk management and information technology employees. Additionally, as the Company returned to sustained profitability, incentive based compensation awards were earned and awarded to employees.
- Occupancy expense totaled $2,251,000 for the year ended December 31, 2014, an increase of $196,000, or 9.5%, compared to $2,055,000 in 2013. In the fourth quarter of 2013, the Company opened its financial services facility office in Lancaster, Pennsylvania, resulting in a full twelve months of occupancy charges in 2014, with only three months of expense in 2013.
- Data processing charges were $1,866,000 for the year ended December 31, 2014, a 273.6% increase from 2013. In December 2013, the Company outsourced its core processing system to a third-party provider, to capitalize on additional products and services that the outsourced solution offered.
- FDIC insurance expenses totaled $1,621,000 for the year ended December 31, 2014, a 37.1% reduction, from the $2,577,000 incurred in 2013, primarily because of a lower assessment rate, as the Company’s risk profile improved.
- Real estate owned expenses totaled $300,000 for the year ended December 31, 2014, compared to $137,000 in 2013. This unfavorable variance was principally related to obtaining updated appraisals on several properties, and the resulting $170,000 in write downs that were required based on this updated information, for the year ended December 31, 2014 compared to $46,000 in 2013.
- Taxes, other than income, decreased from $939,000 for the year ended December 31, 2013 to $562,000 in 2014, due to a change in the assessment rate and methodology for state bank shares tax.
- Other operating expenses decreased $233,000, or 5.9%, for the year ended December 31, 2014, from $3,940,000 in 2013 to $3,707,000 in 2014.

The Company’s efficiency ratio for the twelve months ended December 31, 2014 was 83.0%, compared to 83.3% in December 31, 2013.

Federal Income Taxes

The Company recorded an income tax expense of $1,634,000 for the year ended December 31, 2015, compared to an income tax benefit of $16,132,000 and $206,000 for the years ended December 31, 2014 and 2013. The income tax expense, or benefit, recorded during the year was impacted by the reversal of the valuation allowance on the Company's net deferred tax asset in 2014, which resulted in expense occurring in 2015.

In assessing whether or not some or all of our deferred tax asset is more likely than not to be realized in the future, management considers all positive and negative evidence, including projected future taxable income, tax planning strategies and recent financial operating results. Based upon our evaluation of both positive and negative evidence, a full valuation on the net deferred tax assets was established as of September 30, 2012, totaling $20,235,000. Specifically, it was determined that the negative evidence, which included recent cumulative history of operating losses, deterioration in asset quality and resulting impact on profitability, and that we had exhausted our carryback availability, outweighed the positive evidence, and the reserve was established.

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Each subsequent quarter-end, the Company continued to weigh both positive and negative evidence and re-analyzed its position that a valuation allowance was required. At December 31, 2014, management concluded that based on the Company's profitable operations over the prior nine quarters, improvements in asset quality, strengthened capital position, reduced regulatory risk, and improvement in economic conditions, a full valuation allowance was no longer necessary. The full amount was recaptured as of December 31, 2014, and resulted in income tax benefit for the year ended December 31, 2014 of $16,132,000, after recording a minimal benefit of $206,000 in 2013, which related to state income taxes. The ultimate realization of deferred tax assets is dependent upon existence, or generation, of taxable income in the periods when those temporary differences and net operating loss and credit carryforwards are deductible. Management considered projected future taxable income, length of time needed for carryforwards to reverse, available tax planning strategies, and other factors in making its assessment that it was more likely than not the deferred tax assets would be realized and recaptured the full valuation allowance at December 31, 2014.

For the year ended December 31, 2015, the Company began recording income tax expense which totaled $1,634,000. A meaningful comparison is the effective tax rate, a measurement of income tax expense as a percent of pretax income, which totaled 17.2% for the year ended December 31, 2015, and is less than the 35% federal statutory rate, primarily due to tax-exempt loan and security income, life insurance earnings and tax credits associated with low-income housing and historic projects, offset by certain non-deductible expenses and state income taxes. See "Note 8 – Income Taxes" in the Notes to the Consolidated Financial Statements for a reconciliation of the federal statutory rate of 35% to the effective tax rate for each of the years ended December 31, 2015, 2014 and 2013.

Financial Condition

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

Securities Available for Sale

The Company utilizes securities available for sale as a tool for managing interest rate risk, enhancing income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings. As of December 31, 2015, securities available for sale were $394,124,000, a $17,925,000 increase from the December 31, 2014 balance of $376,199,000. Despite higher end of year balances, the average balance of securities declined from $413,072,000 for the year ended December 31, 2014 to $381,668,000 for the year ended December 31, 2015, and reflects proceeds from repayments used to partially fund loan growth.

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

The Company's securities available for sale include debt and equity instruments that are subject to varying degrees of credit and market risk. This risk arises from general market conditions, factors impacting specific industries, as well as news that may impact specific issues. Management continuously monitors its debt securities, including updates of credit ratings, monitoring market, industry and segment news, as well as volatility in market prices. The Company uses various indicators in determining whether a debt security is other-than- temporarily-impaired, including the extent of time the security has been in an unrealized loss position, and the extent of the unrealized loss. In addition, management assesses whether it is likely the Company will have to sell the security prior to recovery, or if it is able to hold the security until the price recovers. For those debt securities in which management concludes the security is other than temporarily impaired, it will recognize the credit component of an other-than-temporary impairment in earnings and the remaining portion in other comprehensive income. Given the strong asset quality of the debt security portfolio, management has not had to take an other-than-temporary impairment charge in 2015, 2014 or 2013.

For equity securities, when the Company has decided to sell an impaired available-for-sale security and does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. The Company recognizes an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made. The Company recorded no other than temporary impairment expense on equity securities for the years ended December 31, 2015, 2014 and 2013.

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

(Dollars in thousands)	2015	2014	2013
U.S. Government Agencies	$47,227	$23,958	$25,451
U.S. Government Sponsored Enterprises (GSE)	0	0	13,714
States and political subdivisions	125,961	52,401	71,544
GSE residential mortgage-backed securities	132,349	175,596	198,619
GSE residential collateralized mortgage obligations (CMOs)	15,843	58,705	40,532
GSE commercial CMOs	63,770	65,472	57,014
Private label CMOs	8,901	0	0
Total debt securities	394,051	376,132	406,874
Equity securities	73	67	69
Totals	$394,124	$376,199	$406,943

The securities available for sale portfolio increase $17,925,000, or 4.8%, from $376,199,000 at December 31, 2014 to $394,124,000 at December 31, 2015. The increase in the securities portfolio during 2015 was consistent with the Company's intention to increase the size of the balance sheet to enhance interest income. During 2015 and 2014, the Company’s access to off-balance sheet liquidity improved as substantial progress was made in addressing loan quality issues. As the Company’s access to off-balance sheet liquidity improved, it allowed for the investment of funds previously held at the Federal Reserve Bank and included in interest bearing deposits with banks, into higher yielding, longer duration, securities available for sale.

As it is anticipated the loan portfolio will grow in 2016, repayments from mortgage-backed securities or collateralized mortgage-backed obligations will be used to partially meet this loan demand, as these instruments provide monthly cash flows that may be reinvested in the loan portfolio. Despite the Company having a net operating loss for tax purposes, the yields available on state and political subdivision securities were attractive during 2015, and this factored into our consideration to increase holdings in state and political subdivisions, while decreasing our investment in GSE residential mortgage-backed and CMO securities. The Company also invested in private label CMOs in the fourth quarter of 2015 as they too provided attractive yields, and may continue to represent a larger portion of the securities available for sale portfolio going forward.

As a result of changes in interest rate and economic market conditions, in the first quarter of 2016, the Company evaluated its GSE commercial CMO security portfolio and elected to liquidate this entire portfolio, which had a book value of $63,598,000 at December 31, 2015, at a net gain of $1,419,000. The proceeds from the sales will be used to pay down maturing debt, meet loan demand, or be reinvested in the securities portfolio.

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The following table shows the maturities of investment securities at book value as of December 31, 2015, 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	
U. S. Government Agencies										
Book value	$0		$0		$1,071		$46,138		$47,209	
Yield	0.00	%	0.00	%	1.04	%	1.30	%	1.30	%
Average maturity (years)	0.0		0.0		7.7		22.9		22.6	
States and political subdivisions										
Book value	365		3,244		61,844		58,968		124,421	
Yield	4.88	%	3.38	%	3.06	%	4.41	%	3.72	%
Average maturity (years)	0.4		4.8		7.9		17.2		12.2	
GSE residential mortgage-backed securities										
Book value	0		0		0		132,389		132,389	
Yield	0.00	%	0.00	%	0.00	%	1.79	%	1.79	%
Average maturity (years)	0.0		0.0		0.0		45.4		45.4	
GSE residential collateralized mortgage obligations (CMO)										
Book value	0		0		0		15,668		15,668	
Yield	0.00	%	0.00	%	0.00	%	2.57	%	2.57	%
Average maturity (years)	0.0		0.0		0.0		20.8		20.8	
GSE commercial CMOs										
Book value	0		13,843		40,069		9,686		63,598	
Yield	0.00	%	1.69	%	2.68	%	2.00	%	2.36	%
Average maturity (years)	0.0		3.7		6.8		29.6		9.6	
Private label CMOs										
Book value	0		0		0		8,944		8,944	
Yield	0.00	%	0.00	%	0.00	%	1.35	%	1.35	%
Average maturity (years)	0.0		0.0		0.0		20.6		20.6	
Total										
Book value	$365		$17,087		$102,984		$271,793		$392,229	
Yield	4.88	%	2.01	%	2.89	%	2.31	%	2.45	%
Average maturity (years)	0.4		3.9		7.5		32.7		24.8	

The average maturity is based on the contractual terms of the debt or mortgage-backed securities, and does not factor into required repayments or anticipated prepayments that may exist. As of December 31, 2015, the weighted average estimated life of the mortgage-backed and collateralized mortgage obligation securities is less than 4.3 years based on current interest rates and anticipated prepayment speeds.

Loan Portfolio

The Company offers various products to meet the credit needs of our borrowers, principally consisting of commercial real estate loans, commercial and industrial loans, and retail loans consisting of loans secured by residential properties, and to a lesser extent, installment loans. No loans are extended to non-domestic borrowers or governments.

With certain exceptions, we are permitted under applicable law to make loans to single borrowers (including certain related persons and entities) in aggregate amounts of up to 15% of the sum of total capital and the allowance for loan losses. The Company’s legal lending limit to one borrower was approximately $18,700,000 at December 31, 2015. As of December 31, 2015, the Company had one relationship with an outstanding exposure totaling $19,076,000;

however this relationship's total outstanding did not exceed the legal lending limit at the time of loan origination and, therefore, was legal when made.

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The risks associated with lending activities differ among the various loan classes, and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans, and general economic conditions. All of these factors may adversely impact the borrower's ability to repay its loans, and impact the associated collateral. For a further discussion on the types of loans the Company makes and related risks, please see Note 4 – "Loans Receivable and Allowance for Loan Losses" in the Notes to the Consolidated Financial Statements, which is incorporated herein by reference.
The loan portfolio, excluding residential loans held for sale, broken out by classes as of December 31 is as follows:

(Dollars in thousands)	December 31, 2015	December 31, 2014	December 31, 2013	December 31, 2012	December 31, 2011
Commercial real estate:					
Owner-occupied	$103,578	$100,859	$111,290	$144,290	$199,646
Non-owner occupied	145,401	144,301	135,953	120,930	141,037
Multi-family	35,109	27,531	22,882	21,745	27,327
Non-owner occupied residential	54,175	49,315	55,272	66,381	147,027
Acquisition and development:					
1-4 family residential construction	9,364	5,924	3,338	2,850	7,098
Commercial and land development	41,339	24,237	19,440	30,375	77,564
Commercial and industrial	73,625	48,995	33,446	39,340	71,084
Municipal	57,511	61,191	60,996	68,018	59,789
Residential mortgage:					
First lien	126,022	126,491	124,728	108,601	104,327
Home equity – term	17,337	20,845	20,131	14,747	37,513
Home equity – lines of credit	110,731	89,366	77,377	79,448	80,951
Installment and other loans	7,521	5,891	6,184	7,014	12,077
	$781,713	$704,946	$671,037	$703,739	$965,440

In addition to the Company monitoring its loan portfolio as segregated by loan class noted above, it also monitors concentrations by industry. The Bank's lending policy defines an industry concentration as one that exceeds 25% of the Bank's total risk-based capital (RBC). The following industries meet the concentration criteria defined by the Bank's Lending Policy at December 31, 2015:

(Dollars in thousands)	Balance	% of Total Loans	% of Total RBC
Office space	$60,300	7.7%	50.8%
Hotels (except casinos)	30,900	4.0%	26.0%

The loan portfolio at December 31, 2015 of $781,713,000 increased $76,767,000, or 10.9%, from $704,946,000 at December 31, 2014. In 2015, loan growth was experienced in all loan segments, with the exception of municipal loans, as our sales and market efforts have increased after our regulatory issues were resolved, and asset quality improved. The largest increase was in the commercial and industrial loan segment, which grew by $24,630,000, or nearly one-third of the total growth, as our sales efforts focused on expanding this portfolio.
Despite the increase in loans in 2015, the total loan portfolio remains below the $965,440,000 at December 31, 2011 that represented the Company's highest balance for the five years presented. The Company's desire to improve its asset quality during 2012 and 2013 resulted in its disposal of a portion of its distressed asset portfolio, with an aggregate carrying balance of $73,820,000 during 2012. In addition, elevated charge-off levels were experienced in the commercial loan portfolio during 2012, primarily in the non-owner occupied, owner-occupied and commercial and land development portfolios. Given the softness in the economy within the Company's market area, management felt this was a prudent course of action in order to rehabilitate its loan portfolio during these years. As a result of improved asset quality in 2013, the Company, in the second half of the year, again solicited current customers for new lending opportunities, as well as broadened its relationships within existing markets, and entered new markets. In 2014,

growth was achieved in the loan portfolio despite active loan collection

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efforts, in which the Company collected approximately $21,800,000 in pay downs/payoffs, charge-offs, loan sales or foreclosure on nonaccrual loans.

Growth was experienced in the residential mortgage portfolio segment, which totaled $254,090,000 at December 31, 2015, a 7.3% increase over $236,702,000 at December 31, 2014, with the majority of the growth achieved in the home equity lines of credit class. This trend has developed over the past two years, as the Company continues to market this residential mortgage product as it provides attractive yields and shorter durations than first lien residential mortgages. Competition for new business opportunities remains strong, which may temper loan growth in future quarters. However, we anticipate hiring additional lenders in order to capitalize on disruptions that has been caused by the acquisition of some of the competitors in the markets served by larger institutions.

Presented below are the expected maturities of certain loans by type, and whether they are fixed-rate or adjustable rate loans as of December 31, 2015.

	Due In			
(Dollars in thousands)	One Year or Less	One Year Through Five Years	After Five Years	Total
Acquisition and development:				
1-4 family residential construction				
Fixed rate	$1,002	$0	$3,749	$4,751
Adjustable and floating rate	419	733	3,461	4,613
	1,421	733	7,210	9,364
Commercial and land development				
Fixed rate	1,353	861	12,263	14,477
Adjustable and floating rate	367	5,589	20,906	26,862
	1,720	6,450	33,169	41,339
Commercial and industrial				
Fixed rate	197	8,008	13,656	21,861
Adjustable and floating rate	33,423	4,834	13,507	51,764
	33,620	12,842	27,163	73,625
	$36,761	$20,025	$67,542	$124,328

The final maturity is used in the determination of maturity of acquisition and development loans that convert from construction to permanent status. Variable rate loans shown above include semi-fixed loans that contractually will adjust with prime or LIBOR after the interest lock period which may be up to 10 years. At December 31, 2015, there were approximately $17,175,000 of such loans.

Asset Quality

Risk Elements

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

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

Nonperforming assets include nonaccrual loans and foreclosed real estate. In addition, restructured loans still accruing and loans past due 90 days or more and still accruing are also deemed to be risk assets. For all loan classes, generally the accrual of interest income ceases when principal or interest is past due 90 days or more and collateral is inadequate to cover principal and interest or immediately if, in the opinion of management, full collection is unlikely. Interest will continue to accrue on loans past due 90 days or more if the collateral is adequate to cover principal and interest, and the loan is in the process of collection. Interest accrued, but not collected, as of the date of placement on nonaccrual status, is generally reversed and charged against interest income, unless fully collateralized. Subsequent payments received are either applied to the outstanding principal

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balance or recorded as interest income, depending on management's assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan classes, when all the principal and interest amounts contractually due are brought current, the loans have performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contract terms of the loan.

Loans, the terms of which are modified, are classified as troubled debt restructurings ("TDRs") if, in connection with the modification, a concession was granted, for legal or economic reasons, related to a debtor's financial difficulties. Concessions granted under a TDR typically involve a temporary deferral of scheduled loan payments, an extension of a loan's stated maturity date, temporary reduction in interest rates, or below market rates given the risk of the transaction. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual TDRs may be restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for six months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. TDRs are evaluated individually for impairment if they have been restructured during the most recent calendar year, or if they are not performing according to their modified terms.

The following table presents the Company's risk elements, including information concerning the aggregate balances of nonaccrual, restructured, loans past due 90 days or more, and foreclosed real estate as of December 31. Relevant asset quality ratios are also presented.

(Dollars in thousands)	2015	2014	2013	2012	2011
Nonaccrual loans (cash basis)	$16,557	$14,432	$19,347	$17,943	$83,697
Other real estate owned (OREO)	710	932	987	1,876	2,165
Total nonperforming assets	17,267	15,364	20,334	19,819	85,862
Restructured loans still accruing	793	1,100	5,988	3,092	27,917
Loans past due 90 days or more and still accruing	24	0	0	0	0
Total nonperforming and other risk assets	$18,084	$16,464	$26,322	$22,911	$113,779
Loans 30-89 days past due	$2,532	$1,612	$3,963	$3,578	$6,723
Ratio of:					
Total nonperforming loans to loans	2.12 %	2.05 %	2.88 %	2.55 %	8.67 %
Total nonperforming assets to assets	1.34 %	1.29 %	1.73 %	1.61 %	5.95 %
Total nonperforming assets to total loans and OREO	2.21 %	2.18 %	3.03 %	2.81 %	8.87 %
Total risk assets to total loans and OREO	2.31 %	2.33 %	3.92 %	3.25 %	11.76 %
Total risk assets to total assets	1.40 %	1.38 %	2.23 %	1.86 %	7.88 %
Allowance for loan losses to total loans	1.74 %	2.09 %	3.12 %	3.29 %	4.53 %
Allowance for loan losses to nonperforming loans	81.95 %	102.18 %	108.36 %	129.11 %	52.23 %
Allowance for loan losses to nonperforming loans and restructured loans still accruing	78.20 %	94.95 %	82.75 %	110.13 %	39.17 %

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A further breakdown of impaired loans at December 31, 2015 and 2014 is as follows:

(Dollars in thousands)	2015 Nonaccrual Loans	2015 Restructured Loans Still Accruing	2015 Total	2014 Nonaccrual Loans	2014 Restructured Loans Still Accruing	2014 Total
Commercial real estate:						
Owner occupied	$2,109	$0	$2,109	$3,288	$0	$3,288
Non-owner occupied	7,856	0	7,856	1,680	0	1,680
Multi-family	233	0	233	320	0	320
Non-owner occupied residential	895	0	895	1,500	0	1,500
Acquisition and development						
Commercial and land development	5	0	5	123	287	410
Commercial and industrial	734	0	734	2,437	0	2,437
Residential mortgage:						
First lien	4,015	793	4,808	4,509	813	5,322
Home equity – term	103	0	103	70	0	70
Home equity – lines of credit	590	0	590	479	0	479
Installment and other loans	17	0	17	26	0	26
	$16,557	$793	$17,350	$14,432	$1,100	$15,532

In the second quarter of 2011, the Company began to experience deterioration in asset quality as a result of the continued softness in economic conditions and collateral values. Subsequent to the highs levels of nonperforming assets and restructured loans recorded in 2011, the Company continued to actively identify and monitor nonperforming assets and other risk assets, and has acted aggressively to address the credit quality issues. Risk assets, defined as nonaccrual loans, restructured and loans past due 90 days or more and still accruing, and real estate owned, declined from the high of $113,779,000 at December 31, 2011, to $18,084,000 at December 31, 2015. One strategy employed by the Company in 2012 to reduce its level of non-performing loans included two bulk sales of distressed assets. The bulk sales allowed the Company to sell nearly 240 loans with an aggregate carrying balance of $73,820,000 to third parties, which netted the Company $51,753,000 in cash proceeds. The difference between the carrying balance of the loans sold and the cash received, or $22,067,000, was recorded as a charge to the allowance for loan losses.

Risk assets at December 31, 2015 totaled $18,084,000, an increase of $1,620,000, or 9.8%, from December 31, 2014's balance of $16,464,000. Efforts have been made by Company personnel to work through risk assets in order to reduce the risk of future credit losses in the portfolio, and resulted in a decline in the number of risk assets. However, one relationship with potential weaknesses totaling $6,542,000 was identified in 2015 and was moved to nonaccrual status, and resulted in a net increase in nonaccrual loans of $2,125,000 between December 31, 2014 to December 31, 2015. Restructured loans still accruing were $793,000 at December 31, 2015, a decrease of $307,000, from the prior year end, which was primarily the result of the full payoff of one restructured loan totaling $287,000.

The allowance for loan losses totaled $13,568,000 at December 31, 2015, a $1,179,000 decrease from $14,747,000 at December 31, 2014, due to a negative provision for loan losses of $603,000 recorded in 2015, combined with net charge-offs of $576,000 for the year. As a result of the migration of one large relationship to nonaccrual status during 2015 and the decrease in the allowance for loan losses, the Company's allowance coverage ratios declined. The allowance for loan losses to nonperforming loans totaled 82.0% at December 31, 2015 compared to 102.2% at December 31, 2014, and the allowance for loan losses to nonperforming loans and restructured loans still accruing totaled 78.2% at December 31, 2015 compared to 95.0% at December 31, 2014. Management believes the allowance for loan losses to total loans ratio remains strong at 1.74% at December 31, 2015. The Company's ratio of classified loans to Tier 1 capital and the allowance for loans losses totaled 18.9%, the lowest this key ratio has been for the five years presented. The Company continues to work through its nonaccrual loans and other risk elements, in an attempt

to reduce the levels of these under-performing assets, and to the extent possible, recover amounts previously charged-off. As new information is learned about borrowers or updated appraisals on real estate with lower fair values are obtained, the Company may continue to experience additional impaired loans.
For the years ended December 31, 2015, 2014, and 2013 recoveries of $926,000, $1,423,0000 and $6,676,000 have been credited to the allowance for loan losses, with recoveries on two large relationships contributing $5,639,000 to the 2013 total.

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These recoveries on previously charged-off relationships are the result of successful loan monitoring and workout solutions. Although recoveries are difficult to predict, additional recoveries that the Company receives will be used to replenish the allowance for loan losses. These recoveries favorably impacted historical charge-off factors, which contributed to changes in quantitative and qualitative factors used during 2015, 2014 and 2013 and the negative provisions for loan losses that were recorded. Future negative provisions could result if it is determined that the reserve is adequate at the time of recovery. However, as charge-offs stabilize, and the loan portfolio continues to grow, future provisions for loan losses may result and be charged to operations in subsequent periods.

As of December 31, 2015, the Company had 84 lending relationships that had loans that were considered impaired, and were included in the impaired loan balance of $17,350,000, compared to 94 lending relationships with an impaired loan balance of $15,532,000 at December 31, 2014. The exposure to these borrowers with impaired loans is summarized in the following table, along with the partial charge-offs taken to date and the specific reserves established on the relationships at December 31, 2015 and 2014.

(Dollars in thousands)	# of Relationships	Recorded Investment	Partial Charge-offs to Date	Specific Reserves
December 31, 2015				
Relationships greater than $1,000,000	1	$6,542	$0	$0
Relationships greater than $500,000 but less than $1,000,000	2	1,578	475	164
Relationships greater than $250,000 but less than $500,000	7	2,659	188	0
Relationships less than $250,000	74	6,571	1,294	125
	84	$17,350	$1,957	$289
December 31, 2014				
Relationships greater than $1,000,000	2	$3,687	$0	$0
Relationships greater than $500,000 but less than $1,000,000	2	1,156	0	0
Relationships greater than $250,000 but less than $500,000	11	3,558	804	0
Relationships less than $250,000	79	7,131	3,421	188
	94	$15,532	$4,225	$188

The Company takes partial charge-offs on collateral dependent loans whose carrying value exceeded their estimated fair value, as determined by the most recent appraisal adjusted for current (within the quarter) conditions, less costs to dispose. ASC 310 impairment reserves remain in those situations in which updated appraisals are pending, and represent management’s estimate of potential loss.

Of the relationships deemed to be impaired at December 31, 2015, one had an outstanding book balance in excess of $1,000,000, totaling $6,542,000 or 37.7% of the total impaired loan balance. Seventy-four of the relationships, or 88.1% of the total number of impaired relationships, had recorded balances less than $250,000.

The largest impaired loan relationship, with an outstanding balance of $6,542,000 migrated to impaired status during the third quarter of 2015. Despite the loan being current as to both principal and interest, the Company moved this loan, which is secured by non-owner occupied commercial property, to impaired status as the long-term revenue stream and the guarantors' ability to keep the loan current have weakened. The Company believes the loan is well secured, and no loss is anticipated at this time.

In its individual loan impairment analysis, the Company determines the extent of any full or partial charge-offs that may be required, or any ASC 310 reserves that may be needed. The determination of the Company’s charge-offs or impairment reserve determination included an evaluation of the outstanding loan balance, and the related collateral securing the credit. Through a combination of collateral securing the loans and partial charge-offs taken to date, the Company believes that it has adequately provided for the potential losses that it may incur on these relationships as of December 31, 2015. However, over time, additional information may become known that could result in increased reserve allocations or, alternatively, it may be deemed that the reserve allocations exceed those that are needed.

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The Company’s foreclosed real estate balance of $710,000 at December 31, 2015 consisted of 11 properties, eight of which were commercial properties and totaled $405,000, and three residential properties that totaled $305,000. All properties have carrying values less than $165,000 and are carried at the lower of cost or fair value, less costs to dispose.

As of December 31, 2015, the Company believes the value of foreclosed assets represents their fair values, but if the real estate market remains challenging, additional charges may be needed. During 2015, writedown of other real estate owned properties totaled $46,000.

Credit Risk Management

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level believed adequate by management for probable incurred credit losses. The allowance is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the allowance for loan losses utilizing a defined methodology, which considers specific credit evaluation of impaired loans, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC Section 310-10-35 for loans individually identified as impaired, and ASC Subtopic 450-20 for loans collectively evaluated for impairment, and other bank regulatory guidance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management’s periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower’s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. See Note 4, “Loans Receivable and Allowance for Loan Losses” in the Notes to the Consolidated Financial Statements for a description of the methodology for establishing the allowance and provision for loan losses and related procedures in establishing the appropriate level of reserve, which information is incorporated herein by reference.

Prior to December 31, 2015, the look back period for historical losses was 12 quarters, weighted one-half for the most recent four quarters, and one-quarter for each of the two previous four quarter periods in order to appropriately capture the loss history in the loan segment. Effective December 31, 2015, the Company extended the look back period to 16 quarters on a prospective basis, weighted four-tenths to the most recent four quarters, and then declining by one-tenth for each of the remaining annual periods. The look back period was extended as it was determined that a longer look back period is more consistent with the duration of an economic cycle. Management considers current economic and real estate conditions, and the trends in historical charge-off percentages that resulted from applying partial charge-offs to impaired loans, and the impact of distressed loan sales during the year in determining the look back period.

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

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
December 31, 2015						
Commercial real estate:						
Owner-occupied	$96,715	$1,124	$ 3,630	$2,109	$0	$103,578
Non-owner occupied	125,043	12,394	108	7,856	0	145,401
Multi-family	31,957	1,779	1,140	233	0	35,109
Non-owner occupied residential	50,601	1,305	1,374	895	0	54,175
Acquisition and development:						
1-4 family residential construction	9,364	0	0	0	0	9,364
Commercial and land development	40,181	219	934	5	0	41,339
Commercial and industrial	70,967	1,380	544	734	0	73,625
Municipal	57,511	0	0	0	0	57,511
Residential mortgage:						
First lien	121,214	0	0	4,808	0	126,022
Home equity – term	17,234	0	0	103	0	17,337
Home equity – lines of credit	109,731	230	180	590	0	110,731
Installment and other loans	7,504	0	0	17	0	7,521
	$738,022	$18,431	$ 7,910	$17,350	$0	$781,713
December 31, 2014						
Commercial real estate:						
Owner-occupied	$89,815	$2,686	$ 5,070	$3,288	$0	$100,859
Non-owner occupied	120,829	20,661	1,131	1,680	0	144,301
Multi-family	24,803	1,086	1,322	320	0	27,531
Non-owner occupied residential	43,020	2,968	1,827	1,500	0	49,315
Acquisition and development:						
1-4 family residential construction	5,924	0	0	0	0	5,924
Commercial and land development	22,261	233	1,333	410	0	24,237
Commercial and industrial	43,794	850	1,914	2,437	0	48,995
Municipal	61,191	0	0	0	0	61,191
Residential mortgage:						
First lien	121,160	9	0	5,290	32	126,491
Home equity – term	20,775	0	0	70	0	20,845
Home equity – lines of credit	88,164	630	93	479	0	89,366
Installment and other loans	5,865	0	0	26	0	5,891
	$647,601	$29,123	$ 12,690	$15,500	$32	$704,946

Potential problem loans are defined as performing loans, which have characteristics that cause management to have concerns as to the ability of the borrower to perform under present loan repayment terms and which may result in the reporting of these loans as non-performing loans in the future. Generally, management feels that "Substandard" loans that are currently performing and not considered impaired, result in some doubt as to the borrower's ability to continue to perform under the terms of the loan, and represent potential problem loans. Additionally, the "Special Mention" classification is intended to be a temporary classification, and is reflective of loans that have potential weaknesses that may, if not monitored or corrected, weaken the asset or inadequately protect the Bank's position at some future date.

“Special Mention” loans represent an elevated risk, but their weakness does not yet justify a more severe, or classified rating. These loans require follow-up by lenders on the information that may cause the potential weakness, and once resolved, the loan classification may be downgraded to “Substandard,” or alternatively, could be upgraded to “Pass.”

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The following summarizes the average recorded investment in impaired loans and related interest income recognized, on loans deemed impaired on a cash basis, and interest income earned but not recognized for the years ended December 31, 2015, 2014, 2013, 2012 and 2011:

(Dollars in thousands)	Average Impaired Balance	Interest Income Recognized	Interest Earned But Not Recognized
December 31, 2015			
Commercial real estate:			
Owner-occupied	$2,613	$0	$177
Non-owner occupied	3,470	0	256
Multi-family	402	0	15
Non-owner occupied residential	1,020	0	56
Acquisition and development:			
Commercial and land development	266	137	2
Commercial and industrial	1,208	0	28
Residential mortgage:			
First lien	4,644	37	167
Home equity – term	130	0	3
Home equity – lines of credit	571	0	29
Installment and other loans	22	0	3
	$14,346	$174	$736
December 31, 2014			
Commercial real estate:			
Owner-occupied	$3,740	$20	$179
Non-owner occupied	6,711	143	156
Multi-family	274	2	6
Non-owner occupied residential	2,095	13	62
Acquisition and development:			
Commercial and land development	1,250	34	59
Commercial and industrial	1,700	5	19
Residential mortgage:			
First lien	4,226	53	196
Home equity – term	85	0	5
Home equity – lines of credit	111	3	25
Installment and other loans	9	1	1
	$20,201	$274	$708
December 31, 2013			
Commercial real estate:			
Owner-occupied	$3,528	$147	$192
Non-owner occupied	4,307	145	44
Multi-family	135	16	6
Non-owner occupied residential	4,799	77	180
Acquisition and development:			
1-4 family residential construction	481	0	0
Commercial and land development	3,009	49	127
Commercial and industrial	1,780	45	46
Residential mortgage:			
First lien	2,697	140	103

Home equity – term	59	8	2
Home equity – lines of credit	305	6	2
Installment and other loans	1	0	0
	$21,101	$633	$702

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(Dollars in thousands)	Average Impaired Balance	Interest Income Recognized	Interest Earned But Not Recognized
December 31, 2012			
Commercial real estate:			
Owner-occupied	$8,374	$20	$131
Non-owner occupied	14,372	69	260
Multi-family	3,940	0	10
Non-owner occupied residential	20,284	61	288
Acquisition and development:			
1-4 family residential construction	1,542	26	16
Commercial and land development	12,652	252	168
Commercial and industrial	2,691	43	55
Residential mortgage:			
First lien	2,700	61	73
Home equity – term	156	2	4
Home equity – lines of credit	467	15	5
Installment and other loans	8	0	0
	$67,186	$549	$1,010
December 31, 2011			
Commercial real estate:			
Owner-occupied	$4,530	$369	$187
Non-owner occupied	6,820	702	297
Multi-family	2,080	125	103
Non-owner occupied residential	22,820	1,559	267
Acquisition and development:			
1-4 family residential construction	489	102	1
Commercial and land development	7,456	617	375
Commercial and industrial	5,355	75	82
Residential mortgage:			
First lien	639	19	15
Home equity – term	685	69	1
Home equity – lines of credit	0	0	0
Installment and other loans	0	0	0
	$50,874	$3,637	$1,328

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Activity in the allowance for loan losses for the years ended December 31, 2015, 2014, 2013, 2012 and 2011 is as follows:

(Dollars in thousands)	Commercial Real Estate	Commercial Acquisition and Development	Commercial and Industrial	Municipal	Total	Consumer Residential Mortgage	Installment and Other	Total	Unallocated	Total
December 31, 2015										
Balance, beginning of year	$9,462	$ 697	$ 806	$ 183	$11,148	$2,262	$ 119	$2,381	$ 1,218	$14,747
Provision for loan losses	(1,020)	(440)	249	(125)	(1,336)	1,122	55	1,177	(444)	(603)
Charge-offs	(711)	(22)	(115)	0	(848)	(592)	(62)	(654)	0	(1,502)
Recoveries	152	615	72	0	839	78	9	87	0	926
Balance, end of year	$7,883	$ 850	$ 1,012	$ 58	$9,803	$2,870	$ 121	$2,991	$ 774	$13,568
December 31, 2014										
Balance, beginning of year	$13,215	$ 670	$ 864	$ 244	$14,993	$3,780	$ 124	$3,904	$ 2,068	$20,965
Provision for loan losses	(1,674)	92	(554)	(61)	(2,197)	(960)	107	(853)	(850)	(3,900)
Charge-offs	(2,637)	(70)	(270)	0	(2,977)	(587)	(177)	(764)	0	(3,741)
Recoveries	558	5	766	0	1,329	29	65	94	0	1,423
Balance, end of year	$9,462	$ 697	$ 806	$ 183	$11,148	$2,262	$ 119	$2,381	$ 1,218	$14,747
December 31, 2013										
Balance, beginning of year	$13,719	$ 3,502	$ 1,635	$ 223	$19,079	$2,275	$ 85	$2,360	$ 1,727	$23,166
Provision for loan losses	4,109	(6,087)	(3,478)	21	(5,435)	1,845	99	1,944	341	(3,150)
Charge-offs	(4,767)	(193)	(132)	0	(5,092)	(491)	(144)	(635)	0	(5,727)
Recoveries	154	3,448	2,839	0	6,441	151	84	235	0	6,676
Balance, end of year	$13,215	$ 670	$ 864	$ 244	$14,993	$3,780	$ 124	$3,904	$ 2,068	$20,965
December 31, 2012										
Balance, beginning of year	$29,559	$ 9,708	$ 1,085	$ 789	$41,141	$933	$ 75	$1,008	$ 1,566	$43,715
Provision for loan losses	34,681	9,408	1,879	(566)	45,402	2,602	135	2,737	161	48,300
Charge-offs	(53,492)	(17,721)	(1,624)	0	(72,837)	(1,279)	(143)	(1,422)	0	(74,259)
Recoveries	2,971	2,107	295	0	5,373	19	18	37	0	5,410
	$13,719	$ 3,502	$ 1,635	$ 223	$19,079	$2,275	$ 85	$2,360	$ 1,727	$23,166

Balance, end of year										
December 31, 2011										
Balance, beginning of year	$7,875	$ 1,766	$ 3,870	$ 374	$13,885	$1,864	$ 106	$1,970	$ 165	$16,020
Provision for loan losses	31,407	18,557	7,037	415	57,416	(254)	12	(242)	1,401	58,575
Charge-offs	(9,748)	(10,615)	(9,827)	0	(30,190)	(680)	(62)	(742)	0	(30,932)
Recoveries	25	0	5	0	30	3	19	22	0	52
Balance, end of year	$29,559	$ 9,708	$ 1,085	$ 789	$41,141	$933	$ 75	$1,008	$ 1,566	$43,715

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A summary of relevant asset quality ratios for the five years ended December 31, 2015 is as follows:

	2015	2014	2013	2012	2011
Ratio of net charge-offs (recoveries) to average loans outstanding	0.08 %	0.34 %	(0.14)%	8.01 %	3.11 %
Provision for loan losses to net charge-offs (recoveries)	(104.69)%	(168.25)%	331.93 %	70.15 %	189.69 %
Ratio of reserve to gross loans outstanding at December 31	1.74 %	2.09 %	3.12 %	3.29 %	4.53 %

Due to the trends in the national and local economies, as well as declines in real estate values in the Company's market area, the allowance for loan losses grew for the period from 2010 through 2011, consistent with the increase in the ratio of net charge-offs to average loans outstanding. As the Company worked through its risk assets, including the two loan sales in 2012, the allowance for loan losses decreased from $43,715,000 at December 31, 2011 to $23,166,000 at December 31, 2012. The Company continued to focus on working through its risk assets, and based on favorable trends in net charge-offs and improving asset quality ratios, it was able to further reduce the allowance for loan losses over the next three years to $13,568,000 at December 31, 2015. The significant variations in net charge-offs for the five years presented, with a high of $68,849,000 for the year ended December 31, 2012 to a low of $949,000 in net recoveries for the year ended December 31, 2013 has resulted in similar variances in the ratios presented.

The Company recorded negative provisions for loan losses, or reversals of amounts previously provided, of $603,000, $3,900,000 and $3,150,000 for the years ended December 31, 2015, 2014 and 2013, compared to expense of $48,300,000 and $58,575,000 for the years ended December 31, 2012 and 2011. For each of the years in which a negative provision for loan losses was recorded, it was due to recovery of loans with prior charge-offs, allowing for the recovery. In addition, in certain cases, the loans were successfully worked out with smaller charge-offs than the reserve established on them. Lastly, significant improvements were noted in asset quality metrics. Both quantitative and qualitative factors are considered in the determination of the adequacy of the allowance for loan losses. For the most recent three years presented, the favorable historical charge-off data combined with relatively stable economic and market conditions resulted in the conclusion that a negative provision could be recorded despite net charge-offs recorded. Further the allowance for loan losses did not need to be replenished for impaired loans or for the loan growth experienced during the periods.

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

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The allocation of the allowance for loan losses, as well as the percent of each loan type in relation to the total loan balance as of December 31, is as follows:

	2015		2014		2013		2012		2011	
	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans
Commercial real estate:										
Owner-occupied	$1,998	13 %	$2,059	14 %	$3,583	17 %	$2,504	21 %	$3,063	21 %
Non-owner occupied	4,033	19 %	4,887	20 %	6,024	20 %	5,022	17 %	8,579	14 %
Multi-family	709	5 %	1,231	4 %	1,699	3 %	2,944	3 %	2,222	3 %
Non-owner occupied residential	1,143	7 %	1,285	7 %	1,909	8 %	3,249	9 %	15,695	15 %
Acquisition and development:										
1-4 family residential construction	236	1 %	222	1 %	196	0 %	198	0 %	1,404	1 %
Commercial and land development	614	5 %	475	3 %	474	3 %	3,304	4 %	8,304	8 %
Commercial and industrial	1,012	10 %	806	7 %	864	5 %	1,635	6 %	1,085	8 %
Municipal	58	7 %	183	9 %	244	9 %	223	10 %	789	6 %
Residential mortgage:										
First lien	1,667	16 %	1,295	18 %	1,682	19 %	957	16 %	317	11 %
Home equity - term	184	2 %	206	3 %	465	3 %	252	2 %	335	4 %
Home equity - lines of credit	1,019	14 %	761	13 %	1,633	12 %	1,066	11 %	281	8 %
Installment and other loans	121	1 %	119	1 %	124	1 %	85	1 %	75	1 %
Unallocated	774		1,218		2,068		1,727		1,566	
	$13,568	100 %	$14,747	100 %	$20,965	100 %	$23,166	100 %	$43,715	100 %

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

(Dollars in thousands)	Commercial Real Estate	Commercial Acquisition and Development	Commercial and Industrial	Municipal	Total	Consumer Residential Mortgage	Installment and Other	Total	Unallocated	Total
December 31, 2015										
Loans allocated by:										
Individually evaluated for impairment	$11,093	$ 5	$ 734	$ 0	$11,832	$5,501	$ 17	$5,518	$ 0	$17,350
Collectively evaluated for impairment	327,170	50,698	72,891	57,511	508,270	248,589	7,504	256,093	0	764,363
	$338,263	$ 50,703	$ 73,625	$						