

ORRSTOWN FINANCIAL SERVICES INC

Form 10-Q

May 08, 2008

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10 - Q**

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

For the quarterly period ended March 31, 2008

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 33-18888

**ORRSTOWN FINANCIAL SERVICES, INC.**

(Exact name of registrant as specified in its charter)

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

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

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

**17257**  
(Zip Code)

**(717) 532-6114**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

As of March 31, 2008, 6,419,552 shares of common stock, no par value, of the registrant were outstanding.

**Table of Contents**

ORRSTOWN FINANCIAL SERVICES, INC.

INDEX

	<b>Page</b>
<b><u>Part I - FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements (unaudited)</u>	
<u>Condensed consolidated balance sheets - March 31, 2008 and December 31, 2007</u>	3
<u>Condensed consolidated statements of income - Three months ended March 31, 2008 and 2007</u>	4
<u>Condensed consolidated statements of changes in shareholders' equity - Three months ended March 31, 2008 and 2007</u>	5
<u>Condensed consolidated statements of comprehensive income - Three months ended March 31, 2008 and 2007</u>	5
<u>Condensed consolidated statements of cash flows - Three months ended March 31, 2008 and 2007</u>	6
<u>Notes to condensed consolidated financial statements</u>	7 10
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	11 15
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	16
Item 4. <u>Controls and Procedures</u>	16
<b><u>PART II - OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	17
Item 1A. <u>Risk Factors</u>	17
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	17
Item 3. <u>Defaults upon Senior Securities</u>	18
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	18
Item 5. <u>Other Information</u>	18
Item 6. <u>Exhibits</u>	18
<b><u>SIGNATURES</u></b>	<b>19</b>
<b><u>EXHIBIT INDEX</u></b>	<b>20</b>

**Table of Contents**

## PART I FINANCIAL INFORMATION

Item 1. Financial Statements  
ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)	(Unaudited) March 31, 2008	(Audited) * December 31, 2007
<b>ASSETS</b>		
Cash and due from banks	\$ 17,970	\$ 17,625
Federal funds sold	24,130	808
Cash and cash equivalents	42,100	18,433
Interest bearing deposits with banks	1,053	231
Member stock, at cost which approximates market value	6,477	5,751
Securities available for sale	77,005	90,604
Loans	721,234	701,964
Allowance for loan losses	(6,187)	(6,141)
Net Loans	715,047	695,823
Premises and equipment, net	27,180	25,980
Goodwill and intangible assets	21,324	21,368
Cash surrender value of life insurance	16,208	16,067
Accrued interest receivable	3,409	3,490
Other assets	7,756	7,232
Total assets	\$ 917,559	\$ 884,979
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits:		
Non-interest bearing	\$ 93,075	\$ 91,365
Interest bearing	574,029	554,991
Total deposits	667,104	646,356
Short term borrowings	53,524	58,130
Long term debt	88,455	75,903
Accrued interest payable	1,277	1,172
Other liabilities	9,086	7,294
Total liabilities	819,446	788,855
Common stock, no par value - \$ .05205 stated value per share; 50,000,000 shares authorized; 6,453,427 and 6,452,845 shares issued	336	336
Additional paid - in capital	82,488	82,488
Retained earnings	15,507	13,868
Accumulated other comprehensive income	934	567

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Treasury stock, 33,875 and 33,303 shares, at cost	(1,152)	(1,135)
Total shareholders' equity	98,113	96,124
Total liabilities and shareholders' equity	\$ 917,559	\$ 884,979

\* Condensed from audited financial statements  
The accompanying notes are an integral part of these condensed financial statements.

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Dollars in Thousands)	Three Months Ended	
	March 2008	March 2007
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 12,245	\$ 11,341
Interest and dividends on investment securities	1,018	1,006
Interest on short term investments	125	212
<b>Total interest income</b>	<b>13,388</b>	<b>12,559</b>
<b>INTEREST EXPENSE</b>		
Interest on deposits	4,085	4,503
Interest on short-term borrowings	411	500
Interest on long-term debt	975	396
<b>Total interest expense</b>	<b>5,471</b>	<b>5,399</b>
<b>Net interest income</b>	<b>7,917</b>	<b>7,160</b>
Provision for loan losses	158	60
<b>Net interest income after provision for loan losses</b>	<b>7,759</b>	<b>7,100</b>
<b>OTHER INCOME</b>		
Service charges on deposits	1,535	1,228
Other service charges	708	486
Trust department income	710	610
Brokerage income	379	356
Other income	230	191
Securities gains / (losses)	49	54
<b>Total other income</b>	<b>3,611</b>	<b>2,925</b>
<b>OTHER EXPENSES</b>		
Salaries and employee benefits	4,017	3,704
Occupancy and equipment	957	897
Data processing	221	224
Advertising	98	78
Other operating expense	1,407	1,066
<b>Total other expense</b>	<b>6,700</b>	<b>5,969</b>
<b>Income before income taxes</b>	<b>4,670</b>	<b>4,056</b>
Income tax expense	1,420	1,193
<b>Net income</b>	<b>\$ 3,250</b>	<b>\$ 2,863</b>
<b>PER SHARE DATA</b>		
Basic earnings per share	\$ 0.51	\$ 0.45

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Diluted earnings per share	\$ 0.48	\$ 0.42
Dividends per share	\$ 0.21	\$ 0.20

The accompanying notes are an integral part of these condensed financial statements.

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

(Dollars in thousands)	Three Months Ended March 31, 2008 and 2007					
	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Shareholders Equity
Beginning Balance, January 1, 2007	\$ 320	\$ 72,023	\$ 16,934	\$ 507	\$ (396)	\$ 89,388
<b>Comprehensive income</b>						
Net income	0	0	2,863	0	0	2,863
Change in unrealized gain on investment securities available for sale, net of tax	0	0	0	47	0	47
Total comprehensive income						2,910
Cash dividends (\$.20 per share)	0	0	(1,288)	0	0	(1,288)
Stock-based compensation plans:						
Issuance of stock	0	15	0	0	0	15
Purchase of treasury stock (5,000 shares)	0	0	0	0	(185)	(185)
Balance, March 31, 2007	\$ 320	\$ 72,038	\$ 18,509	\$ 554	\$ (581)	\$ 90,840
Beginning Balance, January 1, 2008	\$ 336	\$ 82,488	\$ 13,868	\$ 567	\$ (1,135)	\$ 96,124
<b>Comprehensive income</b>						
Net income	0	0	3,250	0	0	3,250
Change in unrealized gain on investment securities available for sale, net of tax	0	0	0	367	0	367
Total comprehensive income						3,617
Cash dividends (\$.21 per share)	0	0	(1,348)	0	0	(1,348)
Split dollar post retirement plan	0	0	(263)	0	0	(263)
Purchase of treasury stock (582 shares)	0	0	0	0	(18)	(18)
Issuance of treasury stock (10 shares)	0	0	0	0	1	1
Balance, March 31, 2008	\$ 336	\$ 82,488	\$ 15,507	\$ 934	\$ (1,152)	\$ 98,113

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in Thousands)	Three Months Ended	
	March 2008	March 2007
<b>COMPREHENSIVE INCOME</b>		
Net Income	\$ 3,250	\$ 2,863



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Other comprehensive income, net of tax

Unrealized gain on investment securities available for sale

367

47

Comprehensive Income

\$ 3,617

\$ 2,910

The accompanying notes are an integral part of these condensed financial statements.

**Table of Contents**

## ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in Thousands)	Three Months Ended	
	March 2008	March 2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 3,250	\$ 2,863
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	471	461
Provision for loan losses	158	60
Other, net	747	(490)
<b>Net cash provided by operating activities</b>	<b>4,626</b>	<b>2,894</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net (increase) decrease in interest bearing deposits with banks	(822)	418
Purchases of available for sale securities	(11,843)	(4,108)
Sales and maturities of available for sale securities	26,063	5,766
Purchase of intangible assets	18	0
Net (increase) in loans	(19,382)	(17,440)
Purchases of bank premises and equipment	(1,596)	(251)
Other, net	(726)	(175)
<b>Net cash (used) by investing activities</b>	<b>(8,288)</b>	<b>(15,790)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	20,748	4,954
Dividends paid	(1,348)	(1,287)
Proceeds from issuance of common stock	0	15
Purchase of treasury stock	(17)	(185)
Net change in short-term borrowings	(4,606)	2,525
Proceeds from long-term borrowings	13,000	4,000
Repayment of long-term borrowings	(448)	(228)
<b>Net cash provided by financing activities</b>	<b>27,329</b>	<b>9,794</b>
Net increase (decrease) in cash and cash equivalents	23,667	(3,102)
Cash and cash equivalents at beginning of period	18,433	39,134
<b>Cash and cash equivalents at end of period</b>	<b>\$ 42,100</b>	<b>\$ 36,032</b>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 5,366	\$ 5,482
Income Taxes	0	0
<b>Supplemental schedule of noncash investing and financing activities:</b>		
Unrealized gain (loss) on investments available for sale (net of deferred taxes of \$195 and \$20 at March 31, 2008 and 2007, respectively)	367	47
The accompanying notes are an integral part of these condensed financial statements.		



## Table of Contents

ORRSTOWN FINANCIAL SERVICES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

March 31, 2008

Note 1: Summary of Significant Accounting Policies

Basis of Presentation

The unaudited financial statements of Orrstown Financial Services, Inc. (the Company) and its subsidiary are presented at and for the three months ended March 31, 2008 and 2007 and have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. However, unaudited information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the interim period. Information presented at December 31, 2007 is condensed from audited year-end financial statements. For further information, refer to the audited consolidated financial statements and footnotes thereto, included in the annual report on Form 10-K for the year ended December 31, 2007.

Operating

Orrstown Financial Services, Inc. is a financial holding company including its wholly-owned subsidiary, Orrstown Bank. All significant intercompany transactions and accounts have been eliminated. Operating results for the three months ended March 31, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

Cash Flows

For purposes of the Statements of Cash Flows, cash and cash equivalents include Cash and due from banks and Federal funds sold. As permitted by Statement of Financial Accounting Standards No. 104, the Company has elected to present the net increase or decrease in deposits with banks, loans and deposits in the Statement of Cash Flows.

Federal Income Taxes

For financial reporting purposes, the provision for loan losses charged to operating expense is based on management's judgment, whereas for federal income tax purposes the amount allowable under present tax law is deducted. Additionally, deferred compensation is charged to operating expense in the period the liability is incurred for financial reporting purposes, whereas for federal income tax purposes these expenses are deducted when paid. As a result of the aforementioned timing differences plus the timing differences associated with depreciation expense, deferred income taxes are provided in the financial statements. Income tax expense is less than the amount calculated using the statutory tax rate primarily as a result of tax exempt income earned from state and political subdivision obligations.

Investment Securities

Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold securities until maturity, they are classified as securities held to maturity and carried at amortized historical cost. Securities to be held for indefinite periods of time, and not intended to be held to maturity, are classified as available for sale and carried at fair value. Securities held for indefinite periods of time include securities that management intends to use as part of its asset and liability management strategy and that may be sold in response to changes in interest rates, resultant prepayment risk, and other factors related to interest rate and resultant prepayment risk changes.

Realized gains and losses on dispositions are based on the net proceeds and the adjusted book value of the securities sold, using the specific identification method. Unrealized gains and losses on investment securities available for sale are based on the difference between book value and fair value of each security. These gains and losses are credited or charged to other comprehensive income, whereas realized gains and losses flow through the Company's results of operations.

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The Company has classified all investment securities as available for sale . At December 31, 2007, fair value exceeded amortized cost by \$865,000 and at March 31, 2008 fair value exceeded amortized cost by \$1,428,000. In shareholders equity, the balance of accumulated other comprehensive income increased to \$934,000 at March 31, 2008 from \$567,000 at December 31, 2007.

**Table of Contents**

## Stock-Based Compensation

The Company maintains two stock-based compensation plans. These plans provide for the granting of stock options to the Company's directors and the Bank's employees. FAS Statement No 123R, Share-Based Payment requires financial statement recognition of compensation cost for stock options and other stock-based awards. Both of the Company's stock-based compensation plans are fully vested when granted and, therefore, are expensed on the date of grant using the Black-Scholes option-pricing model.

## Earnings per Share of Common Stock

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect the addition of an incremental number of shares added as a result of converting common stock equivalents. A reconciliation of the weighted average shares outstanding used to calculate basic net income per share and diluted net income per share follows. There is no adjustment to net income to arrive at diluted net income per share.

Earnings per share for the three months ended March 31, have been computed as follows:

	<b>Three Months Ended</b>	
	<b>March 2008</b>	<b>March 2007</b>
<b>(In Thousands, except per share data)</b>		
Net Income	\$ 3,250	\$ 2,863
Weighted average shares outstanding (basic)	6,420	6,436
Impact of common stock equivalents	323	288
Weighted average shares outstanding (diluted)	6,743	6,724
<b>Per share information:</b>		
Basic earnings per share	\$ 0.51	\$ 0.45
Diluted earnings per share	\$ 0.48	\$ 0.42
Change in Accounting Principle		

In September of 2006, the Emerging Issues Task Force of the FASB (EITF) issued EITF 06-04. This pronouncement affects the recording of post retirement costs of insurance of bank owned life insurance policies in instances where the Company has promised a continuation of life insurance coverage to persons post retirement. EITF 06-04 requires that a liability equal to the present value of the cost of post retirement insurance be recorded during the insured employees' term of service. The terms of this pronouncement require the initial recording of this liability with a corresponding adjustment to retained earnings to reflect the implementation of the pronouncement. This EITF became effective for fiscal years beginning after December 15, 2007. The effect of this change on January 1, 2008 was a reduction in retained earnings and an increase in accrued benefit liabilities of \$263,000.

## Recent Accounting Pronouncements

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. The fair value option established by this SFAS, permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. This SFAS is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted as of the fiscal year that begins before November 15, 2007, provided the entity also elects to apply the provisions of SFAS No. 157, Fair Value Measurement. The Company elected not to early adopt SFAS No. 159 or SFAS No. 157, and has no current plan to exercise the fair value option for any eligible items under SFAS No. 159.

In November 2007, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 109, Written Loan Commitments Recorded at Fair Value through Earnings (SAB 109). SAB 109 expresses the current view of the staff that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SEC registrants are expected to apply the views in Question 1 of SAB 109 on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Company does not expect the implementation of SAB 109 to have a material impact on its financial statements.

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In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), Business Combinations (SFAS 141 (R)). The Statement replaces SFAS No. 141, Business Combinations . This statement retains the fundamental requirements of SFAS 141 that the acquisition method of accounting be used for all business

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**Table of Contents**

combinations and for an acquirer to be identified for each business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity's first year annual reporting period that begins after December 15, 2008. The Company does not expect the implementation of SFAS 141(R) to have a material impact on its financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Noncontrolling Interest in Consolidated Financial Statements an Amendment of ARB No. 51 (SFAS 160). The Standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interest in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008, with early adoption permitted. The Company does not expect the implementation of SFAS 160 to have a material impact on its financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company does not expect the implementation of SFAS 161 to have a material impact on its financial statements.

**Note 2: Other Commitments**

In the normal course of business, the Bank makes various commitments and incurs certain contingent liabilities which are not reflected in the accompanying financial statements. These commitments include various guarantees and commitments to extend credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company's subsidiary bank evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. Standby letters of credit and financial guarantees written are conditional commitments to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Bank holds collateral supporting those commitments when deemed necessary by management. As of March 31, 2008, \$24,954,000 of performance standby letters of credit have been issued. The Company does not anticipate any losses as a result of these transactions.

**Note 3: Fair Value Measurements**

SFAS 157, *Fair Value Measurements*, (SFAS 157) defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, establishes a three-level valuation hierarchy for disclosure of fair value measurement and expands disclosures requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows: Level 1- inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement. Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

**Securities**

Where quoted prices are available in an active market, securities are classified within level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within level 3 of the valuation hierarchy. At March 31, 2008, Level 1 securities were \$2,471,000 and Level 2 securities were \$74,534,000. All of the Company's securities are classified as available for sale.



## Table of Contents

### Loans Held for Sale

Loans held for sale which is required to be measured in a lower of cost or fair value. Under SFAS No 157, market value is to represent fair value. Management obtains quotes or bids on all or part of these loans directly from the purchasing financial institutions. Premiums received or to be received on the quotes or bids are indicative of the fact that cost is lower than fair value. At March 31, 2008, loans held for sale of \$505,000 were included in total loans on the balance sheet and were recorded at cost.

### Impaired Loans

SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114, Accounting by Creditors for Impairment of a Loan, including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

### Other Real Estate Owned

Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of SFAS No. 157.

### Note 4: Changes in Common Stock

On April 26, 2007, the Board of Directors of Orrstown Financial Services, Inc. approved a 5% stock dividend, payable on June 15, 2007 to shareholders of record on May 25, 2007. Under this stock dividend, shareholders received one additional share of common stock for every twenty shares owned as of the record date. Fractional shares were paid in cash. All per share amounts have been adjusted to give retroactive recognition to the 5% stock dividend.

**Table of Contents**

## PART I FINANCIAL INFORMATION

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

Orrstown Financial Services, Inc. (the Company) is a financial holding company with a wholly-owned bank subsidiary, Orrstown Bank. The following is a discussion of our consolidated financial condition at March 31, 2008 and results of operations for the three months ended March 31, 2008 and three months ended March 31, 2007. Throughout this discussion, the yield on earning assets is stated on a fully taxable-equivalent basis and balances represent average daily balances unless otherwise stated.

Some statements and information may contain forward-looking statements. Factors that could cause actual results to differ materially from forward-looking statements include, but are not limited to: general political and economic conditions, unforeseen changes in the general interest rate environment, developments concerning credit quality in various corporate lending industry sectors, legislative or regulatory developments, legal proceedings, and pending or proposed changes in accounting rules, policies, practices, and procedures. Each of these factors could affect estimates and assumptions used to produce forward looking statements causing actual results to differ materially from those anticipated. Future results could also differ materially from historical performance.

## Critical Accounting Policies

The Bank policy related to the allowance for loan losses is considered to be a critical accounting policy because the allowance for loan losses represents a particularly sensitive accounting estimate. The amount of the allowance is based on management's evaluation of the collectibility of the loan portfolio, including the nature of the loan portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, and economic conditions.

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible, based on evaluations of the collectibility of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, grouping of like loans, grading of individual loan quality, review of specific problem loans, the examination of underlying collateral and current economic conditions that may affect the borrowers' ability to pay.

## SUMMARY OF FINANCIAL RESULTS

Orrstown Financial Services, Inc. recorded net income of \$3,250,000 for the first quarter of 2008 compared to \$2,863,000 for the same period in 2007, representing an increase of \$387,000 or 13.5%. Basic earnings per share (EPS) increased \$0.06 to \$0.51 in the recent quarter from the \$0.45 earned during the first quarter of 2007. Diluted earnings per share for the first quarter were \$0.48 versus \$0.42 last year. All per share amounts have been restated to reflect the 5% stock dividend paid to shareholders on June 15, 2007.

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

The following statistics compare the first quarter's performance of 2008 to that of 2007:

	Three Months Ended	
	March 2008	March 2007
Return on average assets	1.45%	1.44%
Return on average tangible assets	1.50%	1.50%
Return on average equity	13.52%	12.95%
Return on average tangible equity	17.58%	17.29%

Average equity / Average assets	10.73%	11.13%
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**Table of Contents**

## RESULTS OF OPERATIONS

Quarter ended March 31, 2008 compared to Quarter ended March 31, 2007

Net interest income for the first quarter of 2008 was \$7,917,000 representing a growth of \$757,000, or 10.6% over the \$7,160,000 realized during the first quarter last year. On a fully taxable equivalent basis (FTE), net interest income for the first quarter of 2008 and 2007 was \$8,153,000 and \$7,402,000, respectively.

The table that follows states rates on a fully taxable equivalent basis (FTE):

	Three Months Ended					
	Average Balance	March 2008 Tax Equivalent Interest	March 2008 Tax Equivalent Rate	Average Balance	March 2007 Tax Equivalent Interest	March 2007 Tax Equivalent Rate
<b>(Dollars in thousands)</b>						
<b>Interest Earning Assets:</b>						
Federal funds sold & interest bearing bank balances	\$ 17,311	\$ 125	2.90%	\$ 16,170	\$ 212	5.32%
Investment securities	89,679	1,170	5.26%	90,043	1,173	5.24%
Total loans	713,965	12,329	6.86%	625,660	11,416	7.31%
<b>Total interest-earning assets</b>	<b>820,955</b>	<b>13,624</b>	<b>6.60%</b>	<b>731,873</b>	<b>12,801</b>	<b>7.01%</b>
<b>Interest Bearing Liabilities:</b>						
Interest bearing demand deposits	\$ 232,713	\$ 1,102	1.90%	\$ 179,933	\$ 754	1.70%
Savings deposits	62,967	215	1.37%	81,074	424	2.12%
Time deposits	273,938	2,768	4.06%	292,712	3,325	4.61%
Short term borrowings	56,096	411	2.95%	41,805	500	4.85%
Long term borrowings	86,522	975	4.46%	33,095	396	4.79%
<b>Total interest bearing liabilities</b>	<b>712,236</b>	<b>5,471</b>	<b>3.09%</b>	<b>628,619</b>	<b>5,399</b>	<b>3.48%</b>
<b>Net interest income / net interest spread</b>		<b>\$ 8,153</b>	<b>3.51%</b>		<b>\$ 7,402</b>	<b>3.53%</b>
<b>Net interest margin</b>			<b>3.92%</b>			<b>4.02%</b>
<b>Interest Income FTE</b>						

FTE interest income totaled \$13,624,000 for the first quarter of 2008 versus \$12,801,000 for the same period last year, a difference of \$823,000, or 6.4%. Although the Company had a substantial increase in volume variance over all, the rate variance was the contributing factor to the decline in the earning asset yield from 7.01% during the first quarter 2007 to 6.60% for the first quarter 2008. The decline in the prime lending rate, from 825 basis points on January 1, 2007 to 525 basis points at the end of March 2008, as well as a similar decline in the federal funds rate over the same period, resulted in a lower interest earning rate. 200 basis points of the drop in the prime lending rate occurred during the first quarter 2008, affecting many of the variable rate loan yields immediately. Loan demand continued to be strong over this period as loans grew \$88.3 million, or 14.1%. Commercial loans continue to be the largest segment of loan growth, increasing by \$81.0 million. Consumer loans increased by \$10.4 million while mortgage loans decreased by \$3.1 million. Although the balances on in house mortgage loans have declined, secondary market mortgage originations have continued to grow from \$73.4 million at March 31, 2007 to \$100.0 million at March 31, 2008 contributing to noninterest income. The balances of federal funds sold, investment securities and other interest earning assets remained relatively flat, but federal funds income declined due to the aforementioned rate drop

**Interest Expense**

Interest expense increased \$72,000 or 1.3%, to \$5,471,000. Interest bearing liabilities increased by \$83.6 million to \$712.2 million, or 13.3%. The rate paid on interest bearing liabilities decreased from 3.48% during first quarter 2007 to 3.09% for first quarter 2008.

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The reward checking product introduced early in the second quarter of 2007 has grown to \$32.2 million at March 31, 2008. With a higher average interest rate than the basic interest checking account products, the Reward Checking product increased the overall weighted rate in interest bearing demand deposits. Money market account deposits also grew significantly, adding \$43.8 million in deposits. Increases in interest expense for money market accounts were solely caused by volume factors as interest rates declined on these products.

Savings account balances have declined \$18.1 million from the first quarter 2007 with some disintermediation to higher rate deposit products. Time deposit accounts have decreased by \$18.8 million versus the first quarter of 2007 due to our declining interest rate environment.

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## **Table of Contents**

Borrowed funds in the form of repurchase agreements and other short term borrowings have increased by \$14.3 million, but interest expense has declined due to the falling rate environment. Long term borrowing balances have increased by \$53.4 million and are the main factor in interest expense increases in response to a challenging environment for the growth of deposits. The Company still maintains over \$200 million of availability, however, at the Federal Home Loan Bank.

### **Net Interest Income**

Net interest income has continued to increase each quarter primarily due to volume factors as growth has remained strong, particularly in the commercial loan area. Although the Company has had steady growth in net interest income, the net interest spread has decreased slightly from 3.53% to 3.51% and the net interest margin has decreased from 4.02% during first quarter 2007 to 3.92% during first quarter 2008. The tightening of the net interest margin is due, in part, to the reduction in the prime lending rate and the federal funds rate throughout the first quarter of 2008, as the Bank has many prime based loans. In addition, the Bank is experiencing some disintermediation of existing deposits to higher rate products. The Company is positioned adequately, however, to avoid material earnings damage under any interest rate scenario.

### **Noninterest Income**

Total noninterest income, excluding securities gains, increased \$691,000, or 24.1%, from \$2,871,000 to \$3,562,000. Net securities gains in the first quarter 2007 were \$54,000 compared to the \$49,000 of net gains taken in the first quarter of 2008. Service charges on deposits increased 25.0% or \$307,000. Overdraft protection fees rose \$197,000 and revenue from debit card utilization grew \$109,000 due to changing consumer habits and the popularity of our reward checking product. Other service charges increased by \$222,000, or 45.7%, due primarily to secondary market mortgage fees as we have seen significant refinancing demands. Asset management fees contributed an additional \$100,000, or 16.4% and brokerage fees increased \$23,000, as Orrstown Financial Advisors continues to grow in both assets managed and profitability. Other income increased by \$39,000 due in part to additional rental income associated with the purchase of the North Pointe Business Center in October of 2007. This building will be used predominately as an operations center but contains two rental units.

### **Noninterest Expense**

Other expenses rose from \$5,969,000 during the first quarter 2007 to \$6,700,000 during the first quarter of 2008, an increase of \$731,000, or 12.2%. The increase in salaries and benefits of 8.5%, or \$313,000 was the major contributor to noninterest expense. Of that amount, salary expense rose by \$116,000, profit sharing expense increased by \$75,000, employee health care benefits rose \$56,000, salary continuation and retirement plans added \$26,000, and employment taxes grew by \$22,000. The employee base continues to grow as the Company grows and most annual increases take effect during the first quarter. Personnel expenses continue to be our largest expense apart from interest expense.

The growth in the Company has caused occupancy and equipment expense to rise 6.7%, or \$60,000. Depreciation expense increased by \$22,000 to \$396,000 and is the largest contributor to occupancy and equipment expense. Maintenance and repairs added \$28,000, while equipment leasing and rental expenses declined.

Other operating expenses increased to \$1,407,000 or 32.0%. The increase is generally due to organic growth. The move to remote deposit capture has helped to contain operation expenses. Deposit write offs grew \$46,000, mortgage servicing expense increased by \$40,000 due to the increased loan demand for secondary market mortgage loans. Increased long distance usage and increased costs in remote phones contributed to a \$36,000 increase in telephone expense. Expanded usage of debit cards caused an increase of \$32,000 in processing expense.

The overhead efficiency ratio for Orrstown Financial Services, Inc. improved to 56.6% for the current quarter versus the first quarter 2007 ratio of 57.5%. The Company is pleased to have held its efficiency ratio below 60% consistently, which is admirable for a banking company with less than \$1 billion of assets. Noninterest income is growing at a faster pace than noninterest expense as we continually work to contain costs.

### **INCOME TAX EXPENSE**

Income tax expense increased \$227,000, or 19.0%, during the first quarter of 2008 versus the first quarter of 2007. The marginal federal income tax bracket is 38% for 2008 and 2007, but the use of tax free investments and an increase in low income housing credit investments has helped us lower our effective income tax rate.

**Table of Contents**

Effective income tax rates were as follows:

	<b>Three Months Ended</b>	
	<b>March</b>	<b>March</b>
	<b>2008</b>	<b>2007</b>
Effective income tax rate	30.4%	29.4%
<b>PROVISION AND ALLOWANCE FOR LOAN LOSSES</b>		

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible based on evaluations of the collectibility of loans and prior loan loss experience. The evaluations take into consideration factors such as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Through this review and evaluation process, an amount deemed adequate to meet current growth and future loss expectations is charged to operations. The unallocated portion of the reserve ensures that any additional unforeseen losses that are not otherwise identifiable will be able to be absorbed. It is intended to provide for imprecise estimates in assessing projected losses, uncertainties in economic conditions and allocating pool reserves. Management deems the total of the allocated and unallocated portions of the allowance for loan losses to be adequate to absorb any losses at this time.

The provision for loan losses amounted to \$158,000 and \$60,000 for the first quarter of 2008 and 2007, respectively. These provisions compared to net charge-offs of \$112,000 during the first quarter 2008 and \$10,000 during the same period last year. The reserve to loan ratio for the Company was 0.86% at March 31, 2008 compared to 0.88% on March 31, 2007.

The provision for loan losses and the other changes in the allowance for loan losses are shown below:

	<b>Three Months Ended</b>	
	<b>March</b>	<b>March</b>
	<b>2008</b>	<b>2007</b>
<b>(Dollars in Thousands)</b>		
Balance at beginning of period	\$ 6,141	\$ 5,520
Provision for loan losses	158	60
Recoveries	6	10
Loan charge-offs	(118)	(20)
<b>Balance at end of period</b>	<b>\$ 6,187</b>	<b>\$ 5,570</b>

**NONPERFORMING ASSETS / RISK ELEMENTS**

Nonperforming assets at March 31, are as follows:

	<b>2008</b>	<b>2007</b>
<b>(Dollars in Thousands)</b>		
Loans on nonaccrual (cash) basis	\$ 84	\$ 91
Loans whose terms have been renegotiated	0	0
OREO	225	318
<b>Total nonperforming loans and OREO</b>	<b>309</b>	<b>409</b>
Loans past due 90 or more days and still accruing	4,261	1,538
<b>Total nonperforming and other risk assets</b>	<b>\$ 4,570</b>	<b>\$ 1,947</b>

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Ratio of total risk assets to total loans and OREO	0.63%	0.31%
Ratio of total risk assets to total assets	0.50%	0.24%
Any loans classified for regulatory purposes as loss, doubtful, substandard or special mention that have not been disclosed under Item III of Industry Guide 3 do not represent or result from trends or uncertainties which management reasonably expects will materially impact future operating results, liquidity or capital resources.		



**Table of Contents**

## CAPITAL

Orrstown Financial Services, Inc. is a financial holding company and, as such, must maintain a well capitalized status in its bank subsidiary. Management foresees no problem in maintaining capital ratios well in excess of regulatory minimums. A comparison of Orrstown Financial Services, Inc.'s capital ratios to regulatory minimum requirements at March 31, 2008 are as follows:

	<b>Orrstown Financial Services, Inc.</b>	<b>Regulatory Minimum</b>	<b>Regulatory Well Capitalized Minimum</b>
Leverage Ratio	8.5%	4%	5%
Risk Based Capital Ratios:			
Tier I Capital Ratio	10.7%	4%	6%
Total (Tier I & II) Capital Ratio (core capital plus allowance for loan losses)	11.6%	8%	10%

All growth experienced during 2008 has been supported by capital growth in the form of retained earnings. Equity represented 10.7% of assets at March 31, 2008 and 10.9% at December 31, 2007.

Management is not aware of any current recommendations by regulatory authorities which, if implemented, would have a material effect on the Company's liquidity, capital resources or operations.

## LIQUIDITY

The primary function of asset/liability management is to assure adequate liquidity while minimizing interest rate risk. Liquidity management involves the ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Sources of liquidity include investment securities, loan and lease income and payments, and increases in customer's deposit accounts. Additionally, Orrstown Bank is a Federal Home Loan Bank (FHLB) member, and standard credit arrangements available to FHLB members provide increased liquidity. Funds provided from financing activities, including proceeds from long-term borrowings, were the primary source of liquidity for the first three months of 2008. Additional liquidity was provided by operating activities and the sale and maturities of available for sale securities.

**Table of Contents**

PART I FINANCIAL INFORMATION

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Interest rate sensitivity management requires the maintenance of an appropriate balance between interest sensitive assets and liabilities. Interest bearing assets and liabilities that are maturing or repricing should be adequately balanced to avoid fluctuating net interest margins and to enhance consistent growth of net interest income through periods of changing interest rates. The Company has consistently followed a strategy of pricing assets and liabilities according to prevailing market rates while largely matching maturities, within the guidelines of sound marketing and competitive practices. Rate sensitivity is measured by monthly gap analysis, quarterly rate shocks, and periodic simulation. The cumulative gap position at 12 months is slightly positive at \$17.2 million at March 31, 2008 and the RSA/ RSL cumulative ratio was 1.05%, which is an increase from the 0.99% at December 31, 2007. The cumulative RSA/RSL at March 31, 2008 is 1.09% at three months and 1.00% at six months. The Company enjoys a closely balanced position that does not place it at undue risk under any interest rate scenario. Many of the deposit dollars in transaction accounts are discretionarily priced so management maintains significant pricing flexibility.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures:

The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-14(c) under the Securities Exchange Act of 1934, as amended) as of March 31, 2008. Based on such evaluation, such officers have concluded that, as of March 31, 2008, the Company's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Company (including its consolidated subsidiary) required to be included in the Company's periodic filings under the Exchange Act.

(b) Changes in internal controls:

There have not been any significant changes in the Company's internal control over financial reporting or in other factors that could significantly affect such control during the first quarter of 2008.

**Table of Contents**

## PART II OTHER INFORMATION

## Item 1 - Legal Proceedings

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

## Item 1A - Risk Factors

There are a number of significant risks and uncertainties, including those specified below, that may adversely affect the Company's business, financial results or stock price. Additional risks that the Company currently does not know about or currently views as immaterial may also impair the Company's business or adversely impact its financial results or stock price.

Factors that might cause such differences include, but are not limited to the following: (1) competitive pressures among financial institutions increasing significantly in the markets where the Company operates; (2) general business and economic conditions, either nationally or locally being less favorable than expected; (3) changes in the domestic interest rate environment could reduce the Company's net interest income; (4) legislation or regulatory changes which adversely affect the ability of the Company to conduct its current or future operations; (5) acts or threats of terrorism and political or military actions taken by the United States or other governments and natural disasters globally or nationally could adversely affect general economic or industry conditions; (6) operational losses related to or resulting from: the risk of fraud by employees or persons outside of the Company, the execution of unauthorized transactions by employees, errors relating to transaction processing and technology, breaches of the internal control system, business continuation and disaster recovery, as well as security risks associated with hacking and identity theft; (7) negative publicity could damage the Company's reputation and adversely impact its business and/or stock trades and prices; (8) acquisitions may not produce revenue enhancements or cost savings at levels or within timeframes originally anticipated and may result in unforeseen integration difficulties; (9) the Company relies on other companies to provide key components of business infrastructure in the form of third party vendors. Third party vendors could adversely affect the ability of the Company to perform its normal course of business or deliver products and services to its customers; (10) and other risk factors that may occur in current or future operations.

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

The table below summarizes the Company's repurchase of common equity securities during the quarter ended March 31, 2008:

	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that may Yet be Purchased Under the Plans or Programs (1)
1/1/08 through 1/31/08	32	\$ 31.13	N/A	107,255
2/1/08 through 2/29/08	250	30.63		107,005
3/1/08 through 3/31/08	300	30.17		106,705
Total	582	\$ 30.42		

(1) On April 27, 2006, Orrstown Financial Services, Inc. announced a Stock Repurchase Plan approving the purchase of up to 150,000 shares as conditions allow. The plan may be suspended at any time without prior notice and has no prescribed time limit in which to fill the authorized repurchase amount. As of March 31, 2008, 43,295 shares have been purchased under the program. The Company did not sell any unregistered securities.

**Table of Contents**

Item 3 - Defaults upon Senior Securities

Not applicable

Item 4 - Submission of Matters to a Vote of Security Holders

None

Item 5 - Other Information

None

Item 6 Exhibits

3.1 Articles of Incorporation. Incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No. 333-131176.

3.2 By-laws. Incorporated by reference to Exhibit 3.2 of the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.

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

(i) Articles of Incorporation of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-4, Registration No.333-131176.

(ii) By-laws of Orrstown Financial Services, Inc., incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-4, Registration No. 33-18888.

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

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

32.1 Section 1350 Certifications (Chief Executive Officer) filed herewith

32.2 Section 1350 Certifications (Chief Financial Officer) filed herewith

**Table of Contents**

SIGNATURES

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

*/s/ Kenneth R. Shoemaker*  
(Kenneth R. Shoemaker, President & CEO)  
(Duly Authorized Officer)

*/s/ Bradley S. Everly*  
(Bradley S. Everly, Senior Vice  
President & CFO)  
(Chief Financial Officer)

*/s/ Robert B. Russell*  
(Robert B. Russell, Controller)  
(Chief Accounting Officer)

Date: May 5, 2008

**Table of Contents**

ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES

EXHIBIT INDEX

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