

ACNB CORP  
Form 10-Q  
November 06, 2009

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2009

Commission file number 0-11783

**ACNB CORPORATION**

(Exact name of Registrant as specified in its charter)

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

**23-2233457**  
(I.R.S. Employer  
Identification No.)

**16 Lincoln Square, Gettysburg, Pennsylvania**  
(Address of principal executive offices)

**17325-3129**  
(Zip Code)

Registrant's telephone number, including area code: **(717) 334-3161**

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**Common Stock, Par Value \$2.50 per Share**

(Title of class)

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes  No

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

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

The number of shares of the Registrant's Common Stock outstanding on October 30, 2009, was 5,928,343.

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## PART I - FINANCIAL INFORMATION

## ACNB CORPORATION

## ITEM 1 - FINANCIAL STATEMENTS

## CONSOLIDATED STATEMENTS OF CONDITION (UNAUDITED)

Dollars in thousands	September 30, 2009	September 30, 2008	December 31, 2008
<b>ASSETS</b>			
Cash and due from banks	\$ 14,665	\$ 15,427	\$ 16,033
Interest bearing deposits with banks	24,424	2,502	892
<b>Cash and Cash Equivalents</b>	<b>39,089</b>	17,929	16,925
Securities available for sale	214,222	231,346	252,536
Securities held to maturity, fair value \$10,394; \$0; \$0	10,060		
Loans held for sale	285	304	969
Loans, net of allowance for loan losses \$10,994; \$9,618; \$7,393	629,764	612,882	630,330
Premises and equipment	14,811	14,447	14,457
Restricted investment in bank stocks	9,170	8,501	9,170
Investment in bank-owned life insurance	26,162	25,055	25,297
Investments in low-income housing partnerships	4,480	4,801	4,737
Other assets	19,991	21,433	22,258
<b>Total Assets</b>	<b>\$ 968,034</b>	\$ 936,698	\$ 976,679
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>			
<b>LIABILITIES</b>			
Deposits:			
Non-interest bearing	\$ 89,001	\$ 85,666	\$ 82,486
Interest bearing	626,324	592,714	607,811
<b>Total Deposits</b>	<b>715,325</b>	678,380	690,297
Short-term borrowings	55,369	36,991	83,453
Long-term borrowings	95,396	132,027	106,951
Other liabilities	12,755	6,452	11,539
<b>Total Liabilities</b>	<b>878,845</b>	853,850	892,240
<b>STOCKHOLDERS EQUITY</b>			
Common stock, \$2.50 par value; 20,000,000 shares authorized; 5,990,943 shares issued; 5,928,343, 5,990,943 and 5,955,943 shares outstanding	14,977	14,977	14,977
Treasury stock, at cost (62,600, 0 and 35,000 shares)	(728)		(442)
Additional paid-in capital	8,787	8,787	8,787
Retained earnings	64,977	62,301	62,916
Accumulated other comprehensive income (loss)	1,176	(3,217)	(1,799)
<b>Total Stockholders Equity</b>	<b>89,189</b>	82,848	84,439

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<b>Total Liabilities and Stockholders Equity</b>	\$	<b>968,034</b>	\$	936,698	\$	976,679
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*The accompanying notes are an integral part of the consolidated financial statements.*

## ACNB CORPORATION

## CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

Dollars in thousands, except per share data	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
<b>INTEREST INCOME</b>				
Loans, including fees	\$ 8,989	\$ 9,010	\$ 26,922	\$ 26,510
Securities:				
Taxable	2,113	2,417	6,595	7,778
Tax-exempt	368	476	1,120	1,410
Dividends	8	73	30	207
Other	7	35	13	83
<b>Total Interest Income</b>	<b>11,485</b>	<b>12,011</b>	<b>34,680</b>	<b>35,988</b>
<b>INTEREST EXPENSE</b>				
Deposits	2,265	2,967	7,403	10,281
Short-term borrowings	83	176	278	537
Long-term borrowings	938	1,318	2,961	3,673
<b>Total Interest Expense</b>	<b>3,286</b>	<b>4,461</b>	<b>10,642</b>	<b>14,491</b>
<b>Net Interest Income</b>	<b>8,199</b>	<b>7,550</b>	<b>24,038</b>	<b>21,497</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>1,200</b>	<b>3,600</b>	<b>3,550</b>	<b>4,270</b>
<b>Net Interest Income after Provision for Loan Losses</b>	<b>6,999</b>	<b>3,950</b>	<b>20,488</b>	<b>17,227</b>
<b>OTHER INCOME</b>				
Service charges on deposit accounts	644	628	1,775	1,667
Income from fiduciary activities	265	275	761	804
Earnings on investment in bank-owned life insurance	264	266	765	787
Gains on sales of securities	14	57	17	158
Impairment charges on equity securities	(522)		(522)	
Service charges on ATM and debit card transactions	260	248	742	714
Commissions from insurance sales	1,336	939	4,265	3,100
Other	378	206	1,047	710
<b>Total Other Income</b>	<b>2,639</b>	<b>2,619</b>	<b>8,850</b>	<b>7,940</b>
<b>OTHER EXPENSES</b>				
Salaries and employee benefits	4,368	3,629	13,039	10,649
Net occupancy	542	514	1,714	1,639
Equipment	521	489	1,622	1,446
Other tax	200	189	554	581
Professional services	177	238	608	704
Supplies and postage	174	185	519	581
Marketing	108	241	338	781
FDIC and regulatory	346	80	1,622	223
Other operating	944	899	2,827	2,779
<b>Total Other Expenses</b>	<b>7,380</b>	<b>6,464</b>	<b>22,843</b>	<b>19,383</b>

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<b>Income before Income Taxes</b>	<b>2,258</b>	<b>105</b>	<b>6,495</b>	<b>5,784</b>
<b>PROVISION FOR (BENEFIT FROM) INCOME TAXES</b>	<b>361</b>	<b>(379)</b>	<b>1,048</b>	<b>762</b>
<b>Net Income</b>	<b>\$ 1,897</b>	<b>\$ 484</b>	<b>\$ 5,447</b>	<b>\$ 5,022</b>
<b>PER SHARE DATA</b>				
Basic earnings	<b>\$ 0.32</b>	<b>\$ 0.08</b>	<b>\$ 0.92</b>	<b>\$ 0.84</b>
Cash dividends declared	<b>\$ 0.19</b>	<b>\$ 0.19</b>	<b>\$ 0.57</b>	<b>\$ 0.57</b>

*The accompanying notes are an integral part of the consolidated financial statements.*

## ACNB CORPORATION

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)

Nine Months Ended September 30, 2009 and 2008

Dollars in thousands, except per share data		Common Stock	Treasury Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
<b>BALANCE</b>	<b>JANUARY 1, 2008</b>	\$ 14,977	\$	\$ 8,787	\$ 61,439	\$ (73)	\$ 85,130
Cumulative effect of adoption of EITF 06-4					(745)		(745)
Comprehensive income:							
Net income					5,022		5,022
Other comprehensive loss, net of taxes						(3,144)	(3,144)
<b>Total Comprehensive Income</b>							1,878
Cash dividends declared (\$0.57 per share)					(3,415)		(3,415)
<b>BALANCE</b>	<b>SEPTEMBER 30, 2008</b>	\$ 14,977	\$	\$ 8,787	\$ 62,301	\$ (3,217)	\$ 82,848
<b>BALANCE</b>	<b>JANUARY 1, 2009</b>	\$ 14,977	\$ (442)	\$ 8,787	\$ 62,916	\$ (1,799)	\$ 84,439
Comprehensive income:							
Net income					5,447		5,447
Other comprehensive income, net of taxes						2,975	2,975
<b>Total Comprehensive Income</b>							8,422
Treasury stock purchased (27,600 shares)			(286)				(286)
Cash dividends declared (\$0.57 per share)					(3,386)		(3,386)
<b>BALANCE</b>	<b>SEPTEMBER 30, 2009</b>	\$ 14,977	\$ (728)	\$ 8,787	\$ 64,977	\$ 1,176	\$ 89,189

The accompanying notes are an integral part of the consolidated financial statements.

## ACNB CORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

Dollars in thousands	Nine Months Ended September 30,	
	2009	2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 5,447	\$ 5,022
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of loans, property and foreclosed real estate	(508)	(686)
Earnings on investment in bank-owned life insurance	(765)	(787)
Gain on sales of securities	(17)	(158)
Impairment charges on equity securities	522	
Depreciation and amortization	1,716	1,380
Provision for loan losses	3,550	4,270
Net accretion of investment securities discounts	(154)	(26)
Decrease in accrued interest receivable	293	956
Decrease in accrued interest payable	(163)	(941)
Loans originated for sale	(45,276)	(14,907)
Proceeds from loans sold to others	46,459	16,465
Decrease in other assets	270	878
Increase (decrease) in other liabilities	1,765	(235)
<b>Net Cash Provided by Operating Activities</b>	<b>13,139</b>	<b>11,231</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from maturities of investment securities held to maturity		4,137
Proceeds from maturities of investment securities available for sale	62,387	88,745
Proceeds from sales of investment securities available for sale	2,956	26,936
Purchase of investment securities held to maturity	(10,064)	
Purchase of investment securities available for sale	(23,341)	(65,248)
Net sale of restricted investment in bank stocks		544
Net decrease in loans	(3,086)	(74,941)
Purchase of bank-owned life insurance	(100)	
Final purchase consideration-insurance subsidiary		(3,000)
Investments in insurance books of business		(1,156)
Capital expenditures	(1,595)	(999)
Proceeds from sales of property and foreclosed real estate	151	137
<b>Net Cash Provided by (Used in) Investing Activities</b>	<b>27,308</b>	<b>(24,845)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in demand deposits	6,515	8,474
Net increase (decrease) in time certificates of deposits and interest bearing deposits	18,513	(734)
Net increase (decrease) in short-term borrowings	(28,084)	6,223
Dividends paid	(3,386)	(3,415)
Purchase of treasury stock	(286)	
Proceeds from long-term borrowings	68,000	37,000
Repayments on long-term borrowings	(79,555)	(35,217)
<b>Net Cash Provided by (Used in) Financing Activities</b>	<b>(18,283)</b>	<b>12,331</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>22,164</b>	<b>(1,283)</b>
<b>CASH AND CASH EQUIVALENTS BEGINNING</b>	<b>16,925</b>	<b>19,212</b>



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<b>CASH AND CASH EQUIVALENTS</b>	<b>ENDING</b>	<b>\$</b>	<b>39,089</b>	<b>\$</b>	<b>17,929</b>
<b>Interest paid</b>		<b>\$</b>	<b>10,805</b>	<b>\$</b>	<b>15,432</b>
<b>Incomes taxes paid</b>		<b>\$</b>	<b>1,500</b>	<b>\$</b>	<b>1,500</b>
<b>Loans transferred to foreclosed real estate</b>		<b>\$</b>	<b>102</b>	<b>\$</b>	<b>143</b>

*The accompanying notes are an integral part of the consolidated financial statements.*

**ACNB CORPORATION**

**ITEM 1 - NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments necessary to present fairly ACNB Corporation's financial position as of September 30, 2009 and 2008, and the results of its operations, changes in stockholders equity, and cash flows for the nine months ended September 30, 2009 and 2008. All such adjustments are of a normal recurring nature.

The accounting policies followed by the Corporation are set forth in Note A to the Corporation's financial statements in the 2008 ACNB Corporation Annual Report on Form 10-K, filed with the SEC on March 13, 2009. It is suggested that these consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Corporation's Annual Report on Form 10-K. The results of operations for the nine month period ended September 30, 2009, are not necessarily indicative of the results to be expected for the full year. For comparative purposes, the September 30, 2008, balances have been reclassified to conform with the 2009 presentation. Such reclassifications had no impact on net income.

The Corporation has evaluated events and transactions occurring subsequent to the balance sheet date of September 30, 2009, for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through November 6, 2009, the date these financial statements were issued.

**2. Earnings Per Share**

The Corporation has a simple capital structure. Basic earnings per share of common stock is computed based on 5,938,581 and 5,990,943 weighted average shares of common stock outstanding for the nine months ended September 30, 2009 and 2008, respectively, and 5,928,343 and 5,990,943 for the three months ended September 30, 2009 and 2008, respectively. The Corporation does not have dilutive securities outstanding.

**3. Retirement Benefits**

The components of net periodic benefit costs related to the non-contributory pension plan for the three month and nine month periods ended September 30 were as follows:

**Three Months Ended  
September 30,**

**Nine Months Ended  
September 30,**

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In thousands	2009		2008		2009		2008	
Service cost	\$	140	\$	147	\$	421	\$	442
Interest cost		247		259		741		777
Expected return on plan assets		(241)		(399)		(723)		(1,198)
Other, net		158		15		473		45
<b>Net Periodic Benefit Cost</b>	\$	<b>304</b>	\$	<b>22</b>	\$	<b>912</b>	\$	<b>66</b>

The Corporation previously disclosed in its financial statements for the year ended December 31, 2008, that it expected to contribute \$1,250,000 to its pension plan in 2009. The full contribution was made to the plan during the second quarter of 2009.

GAAP requires split-dollar insurance arrangements to have a liability to be recorded during the service period when a split-dollar life insurance agreement continues after the participant's employment or retirement. The required accrued liability is based on either the post-employment benefit cost for continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. The Corporation's liability is based on the post-employment benefit cost for continuing life insurance. The

Corporation adopted this guidance on January 1, 2008, and recorded a cumulative effect adjustment of \$745,000 as a reduction of retained earnings effective January 1, 2008.

#### 4. Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are written conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Corporation generally holds collateral and/or personal guarantees supporting these commitments. The Corporation had \$6,444,000 in standby letters of credit as of September 30, 2009. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees should be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The current amount of the liability, as of September 30, 2009, for guarantees under standby letters of credit issued is not material.

#### 5. Comprehensive Income

The Corporation's other comprehensive income (loss) items are unrealized gains (losses) on securities available for sale and unfunded pension liability. The components of other comprehensive income (loss) for the three month and nine month periods ended September 30 were as follows:

In thousands	Three Months Ended		Nine Months Ended	
	September 30, 2009	2008	September 30, 2009	2008
Unrealized holding gains (losses) on available for sale securities arising during the period	\$ 4,320	\$ (975)	\$ 3,530	\$ (4,606)
Reclassification of (gains) losses realized in net income	508	(57)	505	(158)
Net Unrealized Gains (Losses)	4,828	(1,032)	4,035	(4,764)
Tax effect	1,641	(351)	1,372	(1,620)
	3,187	(681)	2,663	(3,144)
Change in pension liability	158		473	
Tax effect	55		161	
	103		312	
<b>Other Comprehensive Income (Loss)</b>	<b>\$ 3,290</b>	<b>\$ (681)</b>	<b>\$ 2,975</b>	<b>\$ (3,144)</b>



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The components of the accumulated other comprehensive income (loss), net of taxes, are as follows:

In thousands	Unrealized Gains (Losses) on Securities	Pension Liability	Accumulated Other Comprehensive Income (Loss)
<b>BALANCE, SEPTEMBER 30, 2009</b>	\$ 6,459	\$ (5,283)	\$ 1,176
BALANCE, DECEMBER 31, 2008	\$ 3,796	\$ (5,595)	(1,799)
BALANCE, SEPTEMBER 30, 2008	\$ (2,394)	\$ (823)	(3,217)

6. **Segment Reporting**

Russell Insurance Group, Inc. (RIG) is managed separately from the banking segment, which includes the bank and related financial services that the Corporation offers. RIG offers a broad range of property and casualty, life and health insurance to both commercial and individual clients.

Segment information for the nine month periods ended September 30, 2009 and 2008, is as follows:

In thousands	Banking	Insurance	Intercompany Eliminations	Total
<b>2009</b>				
Net interest income and other income from external customers	\$ 28,632	\$ 4,256	\$	\$ 32,888
Income before income taxes	5,689	806		6,495
Total assets	957,436	13,484	(2,886)	968,034
Capital expenditures	1,562	33		1,595
<b>2008</b>				
Net interest income and other income from external customers	\$ 26,341	\$ 3,096	\$	\$ 29,437
Income before income taxes	5,241	543		5,784
Total assets	927,421	11,075	(1,798)	936,698
Capital expenditures	978	21		999

Segment information for the three month periods ended September 30, 2009 and 2008, is as follows:

In thousands	Banking	Insurance	Intercompany Eliminations	Total
<b>2009</b>				
Net interest income and other income from external customers	\$ 9,505	\$ 1,333	\$	\$ 10,838
Income before income taxes	2,070	188		2,258

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Total assets	957,436	13,484	(2,886)	968,034
Capital expenditures	321	23		344

**2008**

Net interest income and								
other income from external customers	\$	9,231	\$	938	\$		\$	10,169
Income before income taxes		18		87				105
Total assets		927,421		11,075		(1,798)		936,698
Capital expenditures		438		1				439

In 2008, RIG acquired a book of business with an aggregate purchase price of \$1,165,000, all of which was classified as an intangible asset. Also, on December 31, 2008, RIG acquired Marks Insurance & Associates, Inc. with an aggregate purchase price of \$1,853,000, of which \$1,300,000 was recorded as an intangible asset and \$553,000 was recorded as goodwill. The intangible assets are being amortized over ten years on a straight line basis. The contingent consideration for both 2008 purchases is payable three years after closing, based on multiples of sellers commissions, with a maximum payment of \$1,800,000.

## 7. Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported, net of tax, in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Accounting Standards Codification (ASC) Topic 320, Investment Debt and Equity Securities, *Investments - Others*, clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are done before assessing whether the entity will recover the cost basis of the investment. Previously, this assessment required management to assert it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in fair value to avoid recognizing an other-than-temporary impairment. This change does not affect the need to forecast recovery of the value of the security through either cash flows or market price.

In instances when a determination is made that an other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, ASC Topic 320 changes the presentation and amount of the other-than-temporary impairment recognized in the income statement. The other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income. This guidance is effective for the Corporation for interim and annual reporting periods ending June 30, 2009, and after.



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Amortized cost and fair value at September 30, 2009, and December 31, 2008, were as follows:

In thousands	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>SECURITIES AVAILABLE FOR SALE:</b>				
<b>SEPTEMBER 30, 2009:</b>				
U.S. Government and agencies	\$ 16,066	\$ 523	\$	\$ 16,589
Mortgage-backed securities	137,019	7,182	4	144,197
State and municipal	40,729	1,948		42,677
Corporate bonds	9,996	163	9	10,150
Stock in other banks	626		17	609
	\$ 204,436	\$ 9,816	\$ 30	\$ 214,222
<b>DECEMBER 31, 2008:</b>				
U.S. Government and agencies	\$ 48,068	\$ 957	\$	\$ 49,025
Mortgage-backed securities	152,765	5,300	63	158,002
State and municipal	42,007	462	494	41,975
Corporate bonds	2,795		140	2,655
Stock in other banks	1,149		270	879
	\$ 246,784	\$ 6,719	\$ 967	\$ 252,536
<b>SECURITIES HELD TO MATURITY:</b>				
<b>SEPTEMBER 30, 2009:</b>				
U.S. Government and agencies	\$ 10,060	\$ 334	\$	\$ 10,394

At September 30, 2009, two mortgage-backed securities had unrealized losses, and one of the securities had been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities. None of the securities in this category had an unrealized loss that exceeded 1% of amortized cost. At September 30, 2009, one corporate bond had an unrealized loss, which has not been in a continuous loss position for 12 months or more. In analyzing the issuer's financial condition, management considers industry analysts' reports, financial performance, and projected target prices of investment analysts within a one-year time frame. The security in this category had an unrealized loss that did not exceed 1% of amortized cost. Based on the above information, management has determined that none of these investments are other-than-temporarily impaired.

The fair values of securities available for sale (carried at fair value) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on securities' relationship to other benchmark quoted prices. The Corporation uses an independent service provider to provide matrix pricing and uses the valuation of another provider to compare for reasonableness.

Management conducted an evaluation for other-than-temporary impairment of investment securities in which the fair value is below the adjusted historical cost and identified the two equity investments the Corporation holds of bank holding companies as other-than-temporarily impaired. The Corporation took impairment charges of \$522,000 on these two equity securities held by the Corporation during the third quarter of 2009. Both holding companies continue to pay cash dividends, which was one of the driving forces in the investment decision. However, current market prices for these stocks are below the acquisition prices of these stocks. A review of the



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factors that may be contributing to these price declines led to a conclusion that the prices on these securities were not likely to recover in the near term and that they were other-than-temporarily impaired.

Management routinely sells securities from its available for sale portfolio in an effort to manage and allocate the portfolio. At September 30, 2009, management had not identified any securities with an unrealized loss that it intends to sell. As management has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available for sale, no declines were deemed to be other than temporary in nature.

The following table shows the Corporation's gross unrealized losses and fair value related to investments, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2009, and December 31, 2008:

In thousand	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>SECURITIES AVAILABLE FOR SALE:</b>						
<b>SEPTEMBER 30, 2009:</b>						
Mortgage-backed securities	\$ 769	\$ 1	\$ 485	\$ 3	\$ 1,254	\$ 4
Corporate bonds	1,033	9			1,033	9
Stock in other banks			609	17	609	17
	\$ 1,802	\$ 10	\$ 1,094	\$ 20	\$ 2,896	\$ 30
<b>DECEMBER 31, 2008:</b>						
Mortgage-backed securities	\$ 592	\$ 22	\$ 14,695	\$ 41	\$ 15,287	\$ 63
State and municipal	18,399	429	921	65	19,320	494
Corporate bonds	2,654	140			2,654	140
Stock in other banks	318	127	561	143	879	270
	\$ 21,963	\$ 718	\$ 16,177	\$ 249	\$ 38,140	\$ 967

Amortized cost and fair value at September 30, 2009, by contractual maturity are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay with or without penalties.

In thousands	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
1 year or less	\$ 1,469	\$ 1,493	\$	\$
Over 1 year through 5 years	12,862	13,208	10,060	10,394
Over 5 years through 10 years	31,008	32,397		
Over 10 years	21,452	22,318		
Mortgage-backed securities	137,019	144,197		
Equity securities	626	609		
	\$ 204,436	\$ 214,222	\$ 10,060	\$ 10,394

The Corporation realized gross gains of \$17,000 through September 30, 2009 and \$158,000 through September 30, 2008, respectively.



At September 30, 2009, and December 31, 2008, securities with a carrying value of \$101,949,000 and \$87,332,000, respectively, were pledged as collateral as required by law on public and trust deposits, repurchase agreements, and for other purposes.

#### 8. Fair Value of Financial Instruments

Management uses its best judgment in estimating the fair value of the Corporation's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Corporation could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective period and have not been reevaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period end.

ASC Topic 820, *Fair Value Measurements and Disclosures*, is effective for financial assets and liabilities in fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, and nonfinancial assets and liabilities in fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

Fair value measurement and disclosure guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Additional guidance is provided on determining when the volume and level of activity for the asset or liability has significantly decreased. The standard also includes guidance on identifying circumstances when a transaction may not be considered orderly.

Fair value measurement and disclosure guidance provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with fair value measurement and disclosure guidance.

This guidance further clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. The guidance provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

Fair value measurement and disclosure guidance establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

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For financial assets measured at fair value, the fair value measurements by level within the fair value hierarchy used at September 30, 2009, and December 31, 2008, are as follows:

**Fair Value Measurements at September 30, 2009**

In thousands	Basis	Total	Level 1	Level 2	Level 3
Securities available for sale	Recurring	\$ 214,222	\$ 609	\$ 213,613	
Impaired loans	Non-recurring	5,698			5,698
Foreclosed real estate	Non-recurring	585			585
Loans held for sale	Non-recurring	285			285

**Fair Value Measurements at December 31, 2008**

In thousands	Basis	Total	Level 1	Level 2	Level 3
Securities available for sale	Recurring	\$ 252,536	\$ 879	\$ 251,657	
Impaired loans	Non recurring	2,966			2,966
Foreclosed real estate	Non recurring	625			625
Loans held for sale	Non recurring	969			969

**Fair Value Measurements at September 30, 2008**

In thousands	Basis	Total	Level 1	Level 2	Level 3
Securities available for sale	Recurring	\$ 231,346	\$ 1,070	\$ 230,276	
Impaired loans	Non-recurring	6,006			6,006
Foreclosed real estate	Non-recurring	143			143
Loans held for sale	Non-recurring	304			304

The following table presents a reconciliation of impaired loans, foreclosed real estate, and loans held for sale measured at fair value, using significant unobservable inputs (Level 3) for the quarter ended September 30, 2009:

In thousands	Impaired Loans	Foreclosed Real Estate	Loans Held for Sale
<b>Balance January 1, 2009</b>	\$ 2,966	\$ 625	\$ 969
Charged off			
Settled or otherwise removed from impaired status		(142)	
Additions to impaired status	4,615		
Payments made	(93)		
Increase in valuation allowance	(1,790)		
Loans transferred to foreclosed real estate		102	
Loan originations			45,276
Loan sales			(45,960)

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<b>Balance</b>	<b>September 30, 2009</b>	\$	<b>5,698</b>	\$	<b>585</b>	\$	<b>285</b>
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ASC Topic 825, *Financial Instruments*, requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies, as well as in annual financial statements.

The following information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due



to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at September 30, 2009, and December 31, 2008:

**Cash and Cash Equivalents (Carried at Cost)**

The carrying amounts reported in the balance sheet for cash and short-term instruments approximate those assets' fair value.

**Securities**

The fair values of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the security's relationship to other benchmark quoted prices. The Corporation uses an independent service provider to provide matrix pricing and uses the valuation of another provider to compare for reasonableness.

**Mortgage Loans Held for Sale (Carried at Lower of Cost or Fair Value)**

The fair values of mortgage loans held for sale are determined as the par amounts to be received at settlement by establishing the respective buyer and rate in advance.

**Loans (Carried at Cost)**

The fair values of loans are estimated using discounted cash flow analyses, as well as using market rates at the balance sheet date that reflect the credit and interest rate risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments, and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

**Impaired Loans (Generally Carried at Fair Value)**

Loans for which the Corporation has measured impairment are generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of the loan balances less the valuation allowance.

**Foreclosed Real Estate**

Fair value of real estate acquired through foreclosure is based on independent third-party appraisals of the properties. These assets are included as Level 3 fair values, based on appraisals that consider the sales prices of similar properties in the proximate vicinity.

**Restricted Investment in Bank Stock (Carried at Cost)**

The carrying amount of required and restricted investment in correspondent bank stock approximates fair value, and considers the limited marketability of such securities.

**Accrued Interest Receivable and Payable (Carried at Cost)**

The carrying amount of accrued interest receivable and accrued interest payable approximates its fair value.

**Deposits (Carried at Cost)**

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

**Short-Term Borrowings (Carried at Cost)**

The carrying amounts of short-term borrowings approximate their fair values.

**Long-Term Borrowings (Carried at Cost)**

Fair values of Federal Home Loan Bank (FHLB) advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

**Off-Balance Sheet Credit-Related Instruments**

Fair values for the Corporation's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

Estimated fair values of financial instruments at September 30, 2009, and December 31, 2008, were as follows:

In thousands	September 30, 2009		December 31, 2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets:</b>				
Cash and due from banks	\$ 14,665	\$ 14,665	\$ 16,033	\$ 16,033
Interest bearing deposits in banks	24,424	24,424	892	892
<b>Investment securities:</b>				
Available for sale	214,222	214,222	252,536	252,536
Held to maturity	10,060	10,394		
Loans held for sale	285	285	969	969
Loans, less allowance for loan losses	629,764	644,062	630,330	644,642

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Accrued interest receivable	<b>3,930</b>	<b>3,930</b>	4,223	4,223
Restricted investment in bank stocks	<b>9,170</b>	<b>9,170</b>	9,170	9,170
Financial liabilities:				
Deposits	\$ <b>715,325</b>	\$ <b>718,154</b>	\$ 690,297	\$ 699,513
Short-term borrowings	<b>55,369</b>	<b>55,369</b>	83,453	83,453
Long-term borrowings	<b>95,396</b>	<b>98,741</b>	106,951	112,017
Accrued interest payable	<b>2,853</b>	<b>2,853</b>	3,016	3,016
Off-balance sheet financial instruments	\$	\$	\$	\$

## NEW ACCOUNTING PRONOUNCEMENTS

In June 2009, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 168, *The FASB Accounting Standards Codification*™ and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162, ( SFAS 168 ). SFAS 168 establishes the *FASB Accounting Standards Codification*™ ( Codification ) as the source of authoritative generally accepted accounting principles ( GAAP ) for nongovernmental entities. The Codification does not change GAAP. Instead, it takes the thousands of individual pronouncements that currently comprise GAAP and reorganizes them into approximately 90 accounting Topics, and displays all Topics using a consistent structure. Contents in each Topic are further organized first by Subtopic, then Section and finally Paragraph. The Paragraph level is the only level that contains substantive content. Citing particular content in the Codification involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure. FASB suggests that all citations begin with FASB ASC, where ASC stands for *Accounting Standards Codification*. Changes to the ASC subsequent to June 30, 2009 are referring to Accounting Standards Updates ( ASU ).

In conjunction with the issuance of SFAS 168, the FASB also issued its first Accounting Standards Update No. 2009-1, Topic 105 Generally Accepted Accounting Principles ( ASU 2009-1 ) which includes SFAS 168 in its entirety as a transition to the ASC. ASU 2009-1 is effective for interim and annual periods ending after September 15, 2009 and will not have an impact on the Corporation's financial position or results of operations but will change the referencing system for accounting standards.

### ASU 2009-05

In August 2009, the FASB issued ASU 2009-05, *Fair Value Measurements and Disclosures (Topic 820): Measuring Liabilities at Fair Value*. The amendments within ASU 2009-05 clarify that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following techniques:

A valuation technique that uses:

- a. The quoted price of the identical liability when traded as an asset.
- b. Quoted prices for similar liabilities or similar liabilities when traded as assets.

Another valuation technique that is consistent with the principles of Topic 820.

Two examples would be an income approach, such as a present value technique, or a market approach, such as a technique that is based on the amount at the measurement date that the reporting entity would pay to transfer the identical liability or would receive to enter into the identical liability.

When estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability.

Both a quoted price in an active market for the identical liability at the measurement date and the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements.

This guidance is effective for the first reporting period (including interim periods) beginning after issuance. The Corporation is currently reviewing the effect this new pronouncement will have on its consolidated financial statements.

**ACNB CORPORATION**

**ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

**INTRODUCTION AND FORWARD-LOOKING STATEMENTS**

**Introduction**

The following is management's discussion and analysis of the significant changes in the financial condition, results of operations, capital resources, and liquidity presented in its accompanying consolidated financial statements for ACNB Corporation (the Corporation or ACNB), a financial holding company. Please read this discussion in conjunction with the consolidated financial statements and disclosures included herein. Current performance does not guarantee, assure or indicate similar performance in the future.

**Forward-Looking Statements**

In addition to historical information, this Form 10-Q contains forward-looking statements. Examples of forward-looking statements include, but are not limited to, (a) projections or statements regarding future earnings, expenses, net interest income, other income, earnings or loss per share, asset mix and quality, growth prospects, capital structure, and other financial terms, (b) statements of plans and objectives of management or the Board of Directors, and (c) statements of assumptions, such as economic conditions in the Corporation's market areas. Such forward-looking statements can be identified by the use of forward-looking terminology such as believes, expects, may, intends, will, should, anticipates, or other variations thereon or comparable terminology, or by discussion of strategy. Forward-looking statements are subject to certain risks and uncertainties such as local economic conditions, competitive factors, and regulatory limitations. Actual results may differ materially from those projected in the forward-looking statements. Such risks, uncertainties and other factors that could cause actual results and experience to differ from those projected include, but are not limited to, the following: ineffectiveness of the business strategy due to changes in current or future market conditions; the effects of economic deterioration on current customers, specifically the effect of the economy on loan customers' ability to repay loans; the effects of competition, and of changes in laws and regulations on competition, including industry consolidation and development of competing financial products and services; interest rate movements; the inability to achieve merger-related synergies; difficulties in integrating distinct business operations, including information technology difficulties; disruption from the transaction making it more difficult to maintain relationships with customers and employees, and challenges in establishing and maintaining operations in new markets; volatilities in the securities markets; and, deteriorating economic conditions. We caution readers not to place undue reliance on these forward-looking statements. They only reflect management's analysis as of this date. The Corporation does not revise or update these forward-looking statements to reflect events or changed circumstances. Please carefully review the risk factors described in other documents the Corporation files from time to time with the Securities and Exchange Commission, including the Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and any Current Reports on Form 8-K.

**CRITICAL ACCOUNTING POLICIES**

The accounting policies that the Corporation's management deems to be most important to the portrayal of its financial condition and results of operations, and that require management's most difficult, subjective or complex judgment, often result in the need to make estimates about the

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effect of such matters which are inherently uncertain. The following policies are deemed to be critical accounting policies by management:

The allowance for loan losses represents management's estimate of probable losses inherent in the loan portfolio. Management makes numerous assumptions, estimates and adjustments in determining an adequate allowance. The Corporation assesses the level of potential loss associated with its loan portfolio and provides for that exposure through an allowance for loan losses. The allowance is established through a provision for loan losses charged to earnings. The allowance is an estimate of the losses inherent in the loan portfolio as of the end of each reporting period. The Corporation assesses the adequacy of its allowance on a quarterly basis. The specific methodologies applied on a consistent basis are discussed in greater detail under the caption, *Allowance for Loan Losses*, in a subsequent section of this Management's Discussion and Analysis of Financial Condition and Results of Operations.



The evaluation of securities for other-than-temporary impairment requires a significant amount of judgment. In estimating other-than-temporary impairment losses, management considers various factors including the length of time the fair value has been below cost, the financial condition of the issuer, and the Corporation's intent to sell, or requirement to sell, the securities before recovery of its value. Declines in fair value that are determined to be other than temporary are charged against earnings.

ASC Topic 350, *Intangibles - Goodwill and Other*, requires that goodwill is not amortized to expense, but rather that it be tested for impairment at least annually. Impairment write-downs are charged to results of operations in the period in which the impairment is determined. The Corporation did not identify any impairment on its outstanding goodwill from its most recent testing, which was performed as of December 31, 2008. If certain events occur which might indicate goodwill has been impaired, the goodwill is tested when such events occur. Other acquired intangible assets with finite lives, such as customer lists, are required to be amortized over the estimated lives. These intangibles are generally amortized using the straight line methods over estimated useful lives of ten years.

## RESULTS OF OPERATIONS

### Quarter ended September 30, 2009, compared to quarter ended September 30, 2008

#### *Executive Summary*

Net income for the three months ended September 30, 2009, was \$1,897,000 compared to \$484,000 for the same quarter in 2008, an increase of \$1,413,000 or 292%. Earnings per share increased from \$0.08 in 2008 to \$0.32 in 2009. Net interest income increased \$649,000 or 9%; provision for loan losses decreased \$2,400,000 or 67%; other income increased \$20,000 or 1%; and, other expenses increased \$916,000 or 14%.

#### *Net Interest Income*

Net interest income totaled \$8,199,000 for the quarter ended September 30, 2009, compared to \$7,550,000 for the same period in 2008, an increase of \$649,000 or 9%. Net interest income increased due to a decrease in interest expense resulting from reductions in market rates associated with the continued weakness in broader financial markets. Alternative funding sources, such as the FHLB, and other market driver rates are factors in rates the Corporation and the local market pay for deposits. At the end of the third quarter of 2009, several of the core deposit rates continued at practical floors after the Federal Open Market Committee decreased the Federal Funds Target Rate by 400 basis points during 2008. Interest expense decreased \$1,175,000 or 26%. The lower funding costs were partially offset by lower interest income, which decreased \$526,000 or 4%. Interest income was lower as a result of investment securities paydowns that were not reinvested due to artificially low market rates resulting from Federal Reserve buying activities. Interest income also decreased due to declines in the Federal Funds Target Rate and other market driver rates. These driver rates are indexed to a portion of the loan portfolio in a manner that a decrease in the driver rates decreases the yield on the loans at subsequent rate reset dates. For more information about interest rate risk, please refer to Item 7A - Quantitative and Qualitative Disclosures about Market Risk in the Annual Report on Form 10-K dated December 31, 2008, and filed with the SEC on March 13, 2009. Over the longer term, the Corporation continues its strategic direction to increase asset yield and interest income by means of loan growth and rebalancing the composition of earning assets.

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The net interest spread for the third quarter of 2009 was 3.46% compared to 3.18% during the same period in 2008. Also comparing the third quarter of 2009 to 2008, the yield on interest earning assets decreased by 0.37% and the cost of interest bearing liabilities decreased by 0.65%. The net interest margin was 3.68% for the third quarter of 2009 and 3.49% for the third quarter of 2008. The net interest margin improvement was mainly a result of the cost of funding decreasing at a higher rate than the rate of change in the yield on assets due to timing of repricing, local market competition, and the steepening slope of the yield curve.

Average earning assets were \$890,375,000 during the third quarter of 2009, an increase of \$23,685,000 from the average for the third quarter of 2008. Average interest bearing liabilities were \$771,853,000 in the third quarter of 2009, an increase of \$19,084,000 from the same quarter in 2008.

### *Provision for Loan Losses*

The provision for loan losses was \$1,200,000 in the third quarter of 2009 compared to \$3,600,000 in the third quarter of 2008, a decrease of \$2,400,000 or 67%. The decrease was a result of higher specific potential loss allocations and charge-offs experienced in the third quarter of 2008. Each quarter, the Corporation measures risk in the loan portfolio compared with the balance in the allowance for loan losses and the current evaluation factors. A continued recession and specific potential loss allocations contributed to impaired loans remaining in the portfolio. For more information, please refer to *Allowance for Loan Losses* in the subsequent Financial Condition section. ACNB adjusts the provision for loan losses as necessary to maintain the allowance at a level deemed to meet the

risk characteristics of the loan portfolio. For the third quarter of 2009, the Corporation had net charge-offs of \$67,000, as compared to net charge-offs of \$319,000 for the third quarter of 2008.

#### *Other Income*

Total other income was \$2,639,000 for the three months ended September 30, 2009, up \$20,000, or 1%, from the third quarter of 2008. Fees from deposit accounts and ATM/debit card revenue increased by \$28,000, or 3%, due to higher volume and an increase in service fees charged. Income from fiduciary activities, which include both institutional and personal trust management services, totaled \$265,000 for the three months ended September 30, 2009, as compared to \$275,000 during the third quarter of 2008, a 4% decrease as a result of less fees from estate settlements. Earnings on bank-owned life insurance declined by \$2,000, or 1%, as a result of decreases in crediting rates. The Corporation's wholly-owned subsidiary, Russell Insurance Group, Inc., increased revenue by \$397,000 or 42%. The increase was due to additional revenue from the two acquisition transactions late in 2008 offsetting generally lower commissions in a soft insurance market. Gains on securities were \$14,000 for the three months ended September 30, 2009, and \$57,000 in the same period in 2008. The Corporation holds equity investments in the common stock of two bank holding companies headquartered and operating in Pennsylvania. Both holding companies continue to pay cash dividends, which was one of the driving forces in the investment decision. However, current market prices for these stocks are below the acquisition prices of these stocks. A review of the factors that may be contributing to these price declines led to a conclusion that the prices on these securities were not likely to recover in the near term and that they were other-than-temporarily impaired. The Corporation took an impairment charge of \$522,000 on these two equity securities held by the Corporation during the third quarter of 2009. Other income in the quarter ended September 30, 2009, was positively impacted by increased fees related to higher residential mortgage loan volume.

#### *Other Expenses*

The largest component of other expenses is salaries and employee benefits, which increased by \$739,000, or 20%, when comparing the third quarter of 2009 to the same quarter a year ago. Overall, the increase in salaries and employee benefits was the result of:

- Normal merit and promotion increases to employees; and,
- A change in the mix of employees that included three new commercial lenders, two new Senior Vice Presidents, and a new Executive Vice President that were hired during the second half of 2008 and in the first quarter of 2009.

Also contributing to increased compensation expense was significantly higher defined benefit pension expense of \$282,000 due to the decreased fair value of plan assets. The decline in the fair value of plan assets resulted from 2008 investment performance related to severe downturns in the broad financial markets.

Net occupancy expense increased \$28,000, or 5%, in part due to additional rental expense associated with the second office location for Russell Insurance Group, Inc. in Germantown, Maryland. Equipment expense increased by \$32,000, or 7%, as a result of higher maintenance contracts and depreciation on new technology purchases.

Professional services expense totaled \$177,000 during the third quarter of 2009, as compared to \$238,000 for the same period in 2008, a decrease of \$61,000 or 26%. This decrease was due in part from lower audit costs and a decreased use of consultants.

Marketing expense decreased by \$133,000, or 55%, due to the continued execution of general budgeted reductions in such expenditures. The Corporation continued to advertise its products and services and to promote its brand via marketing communications, but in a more targeted and limited manner than during the third quarter of 2008.

FDIC expense for the third quarter of 2009 was \$294,000, an increase of \$266,000 from the third quarter of 2008. The much higher expense is required of all FDIC-insured banks to restore the deposit insurance fund due to the cost of protecting depositors' accounts at failed banks during the severe recession. At the end of the third quarter of 2009, the FDIC announced a plan in which most banks would prepay an estimated 3.25 years of regular quarterly premiums at year-end 2009, as opposed to a special assessment similar to which was levied on all insured banks in the second quarter of 2009. Unlike special assessments, prepaid assessments would not immediately affect bank earnings. Each institution would record the entire amount of its prepaid assessment as a prepaid expense (an asset) as of December 31, 2009, the date the payment would be made. As of December 31, 2009, and each quarter thereafter, each institution would record an expense for its regular quarterly assessment and an offsetting credit to the prepaid expense until the asset is exhausted. Once the asset is exhausted, the institution would resume paying and accounting for quarterly deposit insurance assessments as they currently do. They would record an accrued expense payable each quarter for the assessment payment, which

would be made to the FDIC at the end of the following quarter. Even though an estimated premium is prepaid under this plan, the actual expense will vary based on several factors including quarter-end deposit levels and risk ratings; however, ACNB estimates that each quarter's expense will approximate the 2009 third quarter expense in the foreseeable future.

Other operating expenses increased by \$45,000, or 5%, in the third quarter of 2009, as compared to the third quarter of 2008. Telecommunications, electronic banking, and loan collections expenses were among the higher other operating expenses in 2009.

#### *Income Tax Expense*

The Corporation recognized income taxes of \$361,000, or 16% of pretax income, during the third quarter of 2009, as compared to an income tax benefit of \$379,000 during the same period in 2008. The variances from the federal statutory rate of 34% in both periods are generally due to tax-exempt income and investments in low-income housing partnerships (which qualify for federal tax credits). The income tax provision during the third quarters ended September 30, 2009 and 2008, included historical and low-income housing tax credits of \$170,000 and \$172,000, respectively.

#### **Nine months ended September 30, 2009, compared to nine months ended September 30, 2008**

#### *Executive Summary*

Net income for the nine months ended September 30, 2009, was \$5,447,000 compared to \$5,022,000 for the same period in 2008, an increase of \$425,000 or 8%. Earnings per share increased from \$0.84 in 2008 to \$0.92 in 2009. Net interest income increased \$2,541,000 or 12%; provision for loan losses decreased \$720,000 or 17%; other income increased \$910,000 or 11%; and, other expenses increased \$3,460,000 or 18%.

#### *Net Interest Income*

Net interest income totaled \$24,038,000 for the nine months ended September 30, 2009, compared to \$21,497,000 for the same period in 2008, an increase of \$2,541,000 or 12%. Net interest income increased due to a decrease in interest expense resulting from reductions in market rates associated with the continued weakness in broader financial markets. At the end of the first nine months of 2009, several of the core deposit rates were at practical floors after the Federal Open Market Committee decreased the Federal Funds Target Rate to a range of 0% to 0.25%. In addition, after experiencing loss of principal in equity investments, ACNB customers perhaps valued local institutions and FDIC protection over yield on their funds allocated to bank deposits, thereby lowering the cost of funds despite the increase in volume. Interest expense decreased \$3,849,000 or 27%. The decreased funding costs were partially offset by lower interest income, which decreased \$1,308,000 or 4%. Interest income was lower as a result of investment securities maturities that were not reinvested due to unfavorable market conditions. Interest income also decreased due to declines in the Federal Funds Target Rate and other market driver rates. These driver rates are indexed to a portion of the loan portfolio in a manner that a decrease in the driver rates decreases the yield on the loans at various rate reset dates. For more information about interest rate risk, please refer to Item 7A - Quantitative and Qualitative Disclosures about Market Risk in the Annual Report on Form 10-K dated December 31, 2008, and filed with the SEC on March 13, 2009.

The net interest spread for the first nine months of 2009 was 3.43% compared to 3.07% during the same period in 2008. Also comparing the first nine months of 2009 to 2008, the yield on interest earning assets decreased by 0.38%, primarily due to rates resetting and new loan origination at lower rates, and the cost of interest bearing liabilities decreased by 0.74%. The net interest margin was 3.66% for the first nine months of 2009 and 3.39% for the first nine months of 2008.

Average earning assets were \$885,159,000 during the first nine months of 2009, an increase of \$32,375,000 from the average for the first nine months of 2008. The increase in earning assets is a result of increases in local funding sources. Average interest bearing liabilities were \$771,763,000 in the first nine months of 2009, an increase of \$26,328,000 from the same nine months in 2008. Expansion of experienced lending staff, access to funding at favorable rates, and the local market that preferred dealing with a stable local institution were all factors in the increase in earning assets and in local funding sources between the two periods.

*Provision for Loan Losses*

The provision for loan losses was \$3,550,000 in the first nine months of 2009 compared to \$4,270,000 in the first nine months of 2008. The decrease was a result of higher specific potential loss allocations and charge-offs experienced in the third quarter of 2008. Each quarter, the Corporation measures risk in the loan portfolio compared with the balance in the allowance for loan losses and the current evaluation factors. A continued recession and specific potential loss allocations contributed to impaired loans remaining in the portfolio. For more information, please refer to *Allowance for Loan Losses* in the subsequent Financial Condition section. For the first nine months of 2009, the Corporation had net recoveries of \$51,000, as compared to net charge-offs of \$500,000 for the first nine months of 2008.

*Other Income*

Total other income was \$8,850,000 for the nine months ended September 30, 2009, up \$910,000, or 11%, from the first nine months of 2008. Fees from deposit accounts and ATM/debit card revenue increased by \$136,000, or 6%, due to higher volume and an increase in service fees charged. Income from fiduciary activities, which include both institutional and personal trust management services, totaled \$761,000 for the nine months ended September 30, 2009, as compared to \$804,000 during the first nine months of 2008, a 5% decrease as a result of fewer estate settlements. Earnings on bank-owned life insurance decreased by \$22,000, or 3%, as a result of lower crediting rates. The Corporation's subsidiary, Russell Insurance Group, Inc., experienced a revenue increase of \$1,165,000 or 38%. The increase was due to additional revenue from the two acquisition transactions late in 2008 and varying amounts of contingent commissions. The contingent or extra commission payments from insurance carriers are mostly received in the first quarter of each year, and the amount is at the discretion of various insurance carriers in accordance with state insurance regulations. Currently, insurance revenue is negatively impacted by a soft insurance market with lower premium rates and commercial customers scaling back operations or exiting business due to the recession. Gains on securities were \$17,000 for the nine months ended September 30, 2009, compared with a gain of \$158,000 in the same period in 2008. The Corporation holds equity investments in the common stock of two bank holding companies headquartered and operating in Pennsylvania. Both holding companies continue to pay cash dividends, which was one of the driving forces in the investment decision. However, current market prices for these stocks are below the acquisition prices of these stocks. A review of the factors that may be contributing to these price declines led to a conclusion that the prices on these securities were not likely to recover in the near term and that they were other-than-temporarily impaired. The Corporation took an impairment charge of \$522,000 on these two equity securities held by the Corporation during the third quarter of 2009. Other income was positively impacted by increased fees related to higher residential mortgage loan volume.

*Other Expenses*

The largest component of other expenses is salaries and employee benefits, which increased by \$2,390,000, or 22%, when comparing the first nine months of 2009 to the same period a year ago. Overall, the increase in salaries and employee benefits was the result of:

- Normal merit and promotion increases to employees; and,
- A change in the mix of employees that included three new commercial lenders, two new Senior Vice Presidents, and a new Executive Vice President that were hired during the second half of 2008 and in the first quarter of 2009.

Also contributing to increased compensation expense was significantly higher defined benefit pension expense of \$846,000 due to the decreased fair value of plan assets. The decline in the fair value of plan assets resulted from 2008 investment performance related to severe downturns in the broad financial markets.

Net occupancy expense increased by \$75,000, or 5%, when comparing the first nine months of 2009 to the same period a year ago due to a new insurance agency location in Maryland and a loan production facility in Pennsylvania. Equipment expense increased by \$176,000, or 12%, as a result of maintenance and depreciation of new technology purchases.

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Professional services expense totaled \$608,000 during the first nine months of 2009, as compared to \$704,000 for the same period in 2008, a decrease of \$96,000 or 14%. The decrease was due in part to higher costs in 2008 to conduct due diligence on insurance acquisitions and to wind down a tax and accounting services practice. Other tax expense decreased due to a refund of sales and use tax recognized in 2009. Marketing expense decreased by \$443,000, or 57%, due to the execution of general budgeted reductions in such expenditures for 2009.

FDIC expense for the first nine months of 2009 was \$1,460,000, an increase of \$1,393,000. The much higher expense is required of all FDIC-insured banks to restore the deposit insurance fund due to the cost of protecting depositors' accounts at failed banks during the severe recession. At the end of the third quarter of 2009, the FDIC announced a plan in which most banks would prepay an estimated 3.25 years of regular quarterly premiums at year-end 2009, as opposed to a special assessment similar to which was levied on all insured banks in the second quarter of 2009. Unlike special assessments, prepaid assessments would not immediately affect bank earnings. Each institution would record the entire amount of its prepaid assessment as a prepaid expense (an asset) as of December 31, 2009, the date the payment would be made. As of December 31, 2009, and each quarter thereafter, each institution would record an expense for its regular quarterly assessment and an offsetting credit to the prepaid expense until the asset is exhausted. Once the asset is exhausted, the institution would resume paying and accounting for quarterly deposit insurance.



assessments as they currently do. They would record an accrued expense payable each quarter for the assessment payment, which would be made to the FDIC at the end of the following quarter. Even though an estimated premium is prepaid under this plan, the actual expense will vary based on several factors including quarter-end deposit levels and risk ratings; however, ACNB estimates that each quarter's expense will approximate the 2009 third quarter expense in the foreseeable future.

Other operating expenses increased \$48,000, or 2%, in the first nine months of 2009, as compared to the first nine months of 2008. Telecommunications, electronic banking, and loan collections expenses were among the higher other operating expenses in 2009.

#### *Income Tax Expense*

The Corporation recognized income taxes of \$1,048,000, or 16%, of pretax income, during the first nine months of 2009, as compared to \$762,000, or 13% of pretax income, during the same period in 2008. The increase in the effective tax rate is attributable to tax-exempt income comprising a lower percentage of pretax income in 2009 versus 2008. The variances from the federal statutory rate of 34% in both periods are generally due to tax-exempt income and investments in low-income housing partnerships (which qualify for federal tax credits). The income tax provision during the nine months ended September 30, 2009 and 2008, included historical and low-income housing tax credits of \$509,000 and \$516,000, respectively.

#### **FINANCIAL CONDITION**

Assets totaled \$968,034,000 at September 30, 2009, compared to \$976,679,000 at December 31, 2008, and \$936,698,000 at September 30, 2008. Average earning assets during the nine months ended September 30, 2009, increased to \$885,159,000 from \$852,784,000 during the same period in 2008. Average interest bearing liabilities increased in 2009 to \$771,763,000 from \$745,435,000 in 2008.

#### *Investment Securities*

ACNB uses investment securities to generate interest and dividend income, manage interest rate risk, provide collateral for certain funding products, and provide liquidity. The contraction in the securities portfolio during 2009 and 2008 was designed to fund increased lending in the earning asset mix, but was also a result of relatively low yields available on investments within the credit quality and interest rate sensitivity targets of ACNB. The investment portfolio is comprised of U.S. Government agency, municipal, and corporate securities. These securities provide the appropriate characteristics with respect to credit quality, yield and maturity relative to the management of the overall balance sheet.

At September 30, 2009, the securities balance included a net unrealized gain of \$6,459,000, net of taxes, on available for sale securities versus a net unrealized gain of \$3,796,000, net of taxes, at December 31, 2008. The increase in fair value of securities during 2009 was a result of change in the U.S. Treasury yield curve and the spread from this yield curve required by investors on the types of investment securities that ACNB owns. Actions by the Federal Reserve to stimulate the housing market and lessen the impact of the recession is effecting the spread and currently generally increasing the value of the securities held by ACNB. Management conducted an evaluation for other-than-temporary impairment of investment securities in which the fair value is below the adjusted historical cost and identified the two equity securities held at the Corporation as other-than-temporarily impaired. The Corporation does not own investments consisting of pools of Alt A or subprime mortgages, private label mortgage-backed securities, or trust preferred investments. The fair values of securities available for sale (carried at fair

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value) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on securities' relationship to other benchmark quoted prices. The Corporation uses an independent service provider to provide matrix pricing and uses the valuation of another provider to compare for reasonableness. The Corporation holds equity investments in the common stock of two bank holding companies headquartered and operating in Pennsylvania. Both holding companies continue to pay cash dividends, which was one of the driving forces in the investment decision. However, current market prices for these stocks are below the prices paid at the time of acquisition. A review of the factors that may be contributing to these price declines led to a conclusion that the prices on these securities were not likely to recover in the near term and that they were other-than-temporarily impaired. A charge against current earnings of \$522,000 was taken in the third quarter of 2009 from a write-down in value of these securities. Please refer to Note 7 - Securities in the Notes to Consolidated Financial Statements for more information on the security portfolio and Note 8 - Fair Value of Financial Instruments in the Notes to Consolidated Financial Statements for more information about fair value.

### *Loans*

Loans outstanding increased by \$18,239,000, or 3%, from September 30, 2008, to September 30, 2009, and by \$2,351,000, or 1%, from December 31, 2008, to September 30, 2009, demonstrating the marked slowdown in lending activity in recent quarters. The growth in loans is a result of ACNB's strategy to increase loans by lending to support existing and new customers. Compared to

September 30, 2008, commercial loans decreased by approximately \$3,000,000 or 1%. The commercial loan decline during this period was the result of reduced business activity in the market area that hindered new originations, as well as management's decision to not renew certain commercial loans, primarily participation credits in conjunction with other financial institutions, due to potential credit risk. Residential real estate mortgage lending increased by \$23,000,000, or 9%, to local borrowers who preferred loan types that would not be sold into the secondary mortgage market. Of the \$23,000,000 increase, \$3,600,000 was residential mortgage loans secured by junior liens. Home equity loans, which are also in many cases junior liens, decreased by \$1,700,000 because of refinancing into other ACNB lending products, competition from other financial institutions, and customers paying off debt in the uncertain job market and slow real estate market. Although there is no discernable difference in delinquency compared to first mortgage loans and there has been no actual losses on junior liens in recent ACNB history, junior liens inherently have more credit risk by virtue of the fact that another financial institution has a superior security position in the case of foreclosure liquidation of collateral to extinguish the debt. Generally, foreclosure actions could become more prevalent in a prolonged economic downturn. Compared to December 31, 2008, commercial loans outstanding were down by 4% as the local economy slowed and the Corporation elected not to renew certain commercial loans. The largest declines in this category were in loans classified as residential real estate construction loans and non-real estate secured commercial and industrial loans. During the same nine-month period, 7% growth in residential mortgage loans resulted from refinancing from other financial institutions during periods of lower market rates. Home equity loans declined by 6% in this nine-month period and other consumer loans were stable.

Most of the Corporation's lending activities are with customers located within the southcentral Pennsylvania and in the northern Maryland area that is contiguous to its Pennsylvania retail banking offices. This region currently and historically has lower unemployment than the U.S. as a whole. Included in commercial real estate loans are loans made to lessors of non-residential dwellings that total \$79,500,000, or 12% of total loans, at September 30, 2009. These borrowers are geographically dispersed throughout ACNB's marketplace and are leasing commercial properties to a varied group of tenants including medical offices, retail space, and recreational facilities. Because of the varied nature of the tenants, in aggregate, management believes that these loans do not present any greater risk than commercial loans in general. ACNB does not originate or hold subprime mortgages in its loan portfolio.

#### *Allowance for Loan Losses*

The allowance for loan losses at September 30, 2009, was \$10,994,000, or 1.72% of loans, as compared to \$9,618,000, or 1.54% of loans, at September 30, 2008, and \$7,393,000, or 1.16% of loans, at December 31, 2008. The ratio of non-performing loans plus foreclosed assets to total assets was 1.44% at September 30, 2009, as compared to 1.40% at September 30, 2008, and 1.06% at December 31, 2008.

Loans past due 90 days and still accruing were \$1,951,000 and nonaccrual loans were \$11,397,000 as of September 30, 2009, of which approximately 92% are secured by real estate. Loans past due 90 days and still accruing were \$1,544,000 at September 30, 2008, while nonaccruals were \$11,404,000. Loans past due 90 days and still accruing were \$1,963,000 at December 31, 2008, while nonaccruals were \$7,723,000. Nonaccrual loans for the periods indicated are principally due to the following credits. A commercial real estate loan in the amount of \$2,400,000 was identified in the third quarter of 2008, for which further scheduled payments are unlikely in the absence of the sale of the underlying collateral. This loan was added to nonaccrual in the third quarter of 2008. Subsequent unit sales have reduced the outstanding balance to \$1,900,000. In the third quarter of 2008, \$2,300,000 in related start-up enterprise commercial loans were placed on nonaccrual status, and the specific loss allocation was increased by \$955,000 when the loan became 90 days past due. A charge-off in the fourth quarter of 2008 and subsequent payments have reduced the carrying balance to \$1,200,000. In addition, during the third quarter of 2008, a real estate development loan of \$6,300,000 was placed on nonaccrual status and the specific loss allocation was increased by \$2,500,000. A charge-off in the fourth quarter of 2008 and subsequent payments have reduced the carrying balance to \$3,600,000. As appropriate, new appraisals were obtained on certain credits and adjustments were made to the corresponding specific loss allocation. In the second quarter of 2009, a \$2,200,000 loan to a local development corporation was added to nonaccrual status when the loan matured with various sales agreements and grants still pending prior to any further development activity. Subsequent payment has reduced the carrying balance to \$1,850,000. During the third quarter of 2009, \$2,178,000 in loans to unrelated borrowers were placed on nonaccrual status including one residential mortgage with a balance of \$957,000 which was included in loans past due 90 days as of June 30, 2009, two commercial mortgages secured by real estate with an aggregate balance of \$528,000, and one unsecured drawn commercial line of credit with an outstanding balance of \$100,000. These nonaccrual loans for the third quarter of 2009 are all in the process of workout for collection purposes.

Impaired loans at September 30, 2009, totaled \$11,830,000, of which \$9,569,000 required a specific valuation allowance and \$2,261,000 required no valuation allowance based on management's estimate. The related allowance for loan losses totaled \$3,871,000. Impaired loans at December 31, 2008, totaled \$8,754,000. Of this amount, \$5,047,000 required a specific valuation allowance and \$3,707,000 required no valuation allowance based on management's estimate. The related allowance for loan losses totaled \$2,081,000. The increase of \$1,790,000 in related allowance for loan losses on impaired loans from December 31, 2008, to September 30, 2009, was mainly a result of the development loan and residential mortgage discussed above. The decrease in impaired loans without a

provision from December 31, 2008, to September 30, 2009, was related to the \$957,000 residential mortgage loan that did not have a valuation allowance at year-end 2008.

A summary of impaired loans at September 30, 2009, is as follows: The Corporation has two unrelated impaired loans to two borrowers totaling \$5,670,000 to finance residential real estate development projects in the Corporation's primary trading area of southcentral Pennsylvania, both of which are in nonaccrual of interest status. The loans have standard terms and conditions including repayment from the sales of the respective properties. Both loans were originated during the first half of 2006. One loan, which was extended by receipt of required payments in 2009, was placed in nonaccrual because of the inability of the borrower to fund the necessary infrastructure improvements; on the other loan, foreclosure has been held in abeyance while allowing the borrower to pursue a workout plan to sell individual units of the property. The total specific valuation allowance on the two unrelated loans is \$1,322,000, which is net of charge-offs of \$2,765,000 taken in 2008. The respective allowances were derived by estimating the cash flow from the sale of the property given the respective stage of completion and/or the zoning without required infrastructure. Also included in other impaired loans are related term loans and a fully disbursed line of credit, all originated in the second quarter of 2006 for a start-up enterprise in the food industry in southcentral Pennsylvania, that total \$1,186,000 with a specific valuation allowance of \$709,000 which is net of a \$1,000,000 charge-off taken in 2008. These loans, with standard terms and conditions including repayment from conversion of trade assets, are under a forbearance agreement and in nonaccrual status. The valuation allowance on this set of loans was derived by estimating the cash flow from the liquidation of personal and business assets pledged as collateral. Commencement of liquidation will proceed if the terms of the forbearance agreement are not met. With regard to the impaired loans added in the second and third quarters of 2009, the local development corporation loan was originated in third quarter 2007 and totaled \$2,172,000 which subsequently was paid down to \$1,847,000. The corresponding specific valuation allowance of \$1,135,000 was based on cash flow projections from selling the real estate collateral that partially secures this loan. A local credit relationship totaling \$1,791,000 from 2004 includes both a commercial real estate loan and the \$957,000 past due residential mortgage construction loan. A specific allocation of \$489,000 on the residential mortgage was based on the estimated cash from selling the incomplete construction and the specialty nature of the property. Foreclosure will proceed if the mortgage loan is not brought current; however, the commercial real estate loan is current and does not have a specific valuation allowance. Other impaired loans totaled \$1,336,000 at September 30, 2009, all of which were in nonaccrual status and in management's estimate required \$216,000 in valuation allowance.

As detailed above, the Corporation utilizes a systematic review of its loan portfolio on a quarterly basis in order to determine the adequacy of the allowance for loan losses. In addition, ACNB engages the services of an outside loan review function and sets the timing and coverage of loan reviews during the year. The results of this independent loan review are included in the systematic review of the loan portfolio. The allowance for loan losses consists of a component for individual loan impairment, primarily based on the loan's collateral fair value and expected cash flow. A watch list of loans is identified for evaluation based on internal and external loan grading and reviews. Loans other than those determined to be impaired are grouped into pools of loans with similar credit risk characteristics. These loans are evaluated as groups with allocations made to the allowance based on historical loss experience adjusted for current trends in delinquencies, trends in underwriting and oversight, concentrations of credit, and general economic conditions within the Corporation's trading area. The decrease in the provision for loan losses for 2009 compared to 2008 was a result of the measurement of the adequacy of the allowance for loan losses at each period end. Reasons that the 2008 provision was higher include charge-offs, changes in allocations for specific loans, deteriorating local economic conditions, and continued growth in the loan portfolio during 2008 which caused the amounts assigned to homogeneous pools to increase.

The allocation of the allowance for loan losses between the various loan categories is consistent with the change in estimated specific losses measured at each period-end and the historical net loss experience in each of the categories. The unallocated portion of the allowance reflects estimated inherent losses within the portfolio that have not been detected. The unallocated portion of this reserve exists due to risk of error in the specific and general reserve allocations, as well as to allow for consumer and small business loans with demonstrated weaknesses where it is not practicable to develop specific allocations, variances in management's assessment of national and local economic conditions, and other internal and external factors that management believes appropriate at the time. The unallocated portion of the reserve has increased due to significant loan charge-offs and the uncertain state of the local economy. While management believes ACNB's allowance for loan losses is adequate based on information currently available, future adjustments to the reserve may be necessary due to changes in economic conditions and management's assumptions as to future delinquencies or loss rates.

#### *Deposits*

ACNB continues to rely on deposits as a primary source of funds for lending activities with total deposits of \$715,325,000 as of September 30, 2009. Deposits increased by \$36,945,000, or 5%, from September 30, 2008, to September 30, 2009, and by \$25,028,000, or 4%, from December 31, 2008, to September 30, 2009. ACNB's deposit pricing function employs a disciplined pricing approach based upon alternative funding rates, but also strives to price deposits to be competitive with relevant local competition, including credit unions and larger regional banks. The 2009 deposit growth mix experienced a shift to transaction

accounts as customers put more value in liquidity and FDIC insurance. Products, such as money market accounts and interest-bearing transaction accounts, that had suffered declines in recent years regained balances. With continued low market interest rates in a recession economy, ACNB's ability to maintain and add to its deposit base may be impacted by the reluctance of consumers to accept low rates and by competition willing to pay above market rates to attract market share.

#### *Borrowings*

Short-term borrowings are comprised primarily of securities sold under agreements to repurchase and short-term borrowings at the Federal Home Loan Bank (FHLB). Investment securities are pledged in sufficient amounts to collateralize these agreements. As of September 30, 2009, short-term borrowings were \$55,369,000, as compared to \$83,453,000 at December 31, 2008, and \$36,991,000 at September 30, 2008. Compared to year-end 2008, repurchase agreement balances were up \$22,750,000 due to seasonal fluctuations in the business activities of ACNB's commercial customer base; however, short-term FHLB borrowings declined \$50,160,000 from investment security cash flow. The increase from third quarter 2008 in short-term borrowings was due to an overall increase in repurchase agreement balances. Long-term borrowings consist primarily of advances from the FHLB. Long-term borrowings totaled \$95,396,000 at September 30, 2009, versus \$106,951,000 at December 31, 2008, and \$132,027,000 at September 30, 2008. The Corporation decreased long-term borrowings by 11% since year-end 2008 from deposit growth and proceeds of investment security calls and paydowns.

#### *Capital*

ACNB's capital management strategies have been developed to provide an appropriate rate of return to stockholders, while maintaining its well-capitalized position. Total stockholders' equity was \$89,189,000 at September 30, 2009, compared to \$84,439,000 at December 31, 2008, and \$82,848,000 at September 30, 2008. Stockholders' equity increased in the first nine months of 2009 by \$4,750,000 due to earnings retained in capital and an increase in accumulated other comprehensive gain due to the rise in the fair value of the investment portfolio less \$286,000 in ACNB common stock purchased by the Corporation. Other comprehensive income or loss is mainly caused by fixed-rate investment securities gaining or losing value in different interest rate environments and changes in the net funded position of the defined benefit pension plan.

The primary source of additional capital to ACNB is earnings retention, which represents net income less dividends declared. During the first nine months of 2009, ACNB earned \$5,447,000 and paid dividends of \$3,386,000 for a dividend payout ratio of 62%. During the first nine months of 2008, ACNB earned \$5,022,000 and paid dividends of \$3,415,000 for a dividend payout ratio of 68%.

ACNB is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on ACNB. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, ACNB must meet specific capital guidelines that involve quantitative measures of its assets and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require ACNB and its banking subsidiary to maintain minimum amounts and ratios of total and Tier 1 capital to average and risk-weighted assets. Management believes, as of September 30, 2009, that ACNB and its banking subsidiary met all capital adequacy requirements to which they are subject and are, therefore, categorized as well-capitalized.

*Risk-Based Capital*

ACNB's capital ratios are as follows:

	September 30, 2009	December 31, 2008	To Be Well Capitalized Under Banking Regulation
Tier 1 leverage ratio (to average assets)	8.14%	7.96%	5.00%
Tier 1 risk-based capital ratio (to risk-weighted assets)	12.11%	11.66%	6.00%
Total risk-based capital ratio	13.36	% 12.81	% 10.00

In October 2008, the U.S. Department of Treasury announced a voluntary Capital Purchase Program under the Troubled Asset Relief Program (TARP), as authorized by the Emergency Economic Stabilization Act of 2008. After evaluating the merits of participating in the TARP Capital Purchase Program, ACNB decided against applying for and participating in this voluntary program. This



decision was based principally upon the fact that the banking subsidiary was well capitalized, as well as the uncertainty of the potential requirements of the program.

### *Liquidity*

Effective liquidity management ensures the cash flow requirements of depositors and borrowers, as well as the operating cash needs of ACNB, are met.

ACNB's funds are available from a variety of sources, including assets that are readily convertible to cash, maturities and repayments from the securities portfolio, scheduled repayments of loans receivable, the core deposit base, and the ability to borrow from the FHLB. At September 30, 2009, ACNB's banking subsidiary had a borrowing capacity of approximately \$291,846,000 from the FHLB, of which \$199,846,000 was available. During the past year, financial institutions have experienced difficulties in bank-to-bank liquidity worldwide. ACNB has been insulated from the freeze in credit markets by its relationship with the FHLB, a government-sponsored enterprise regulated by the Federal Housing Finance Agency. The FHLB system is self-capitalizing, member-owned, and its member banks' stock is not publicly traded. ACNB creates its borrowing capacity with the FHLB by granting a security interest in certain loan assets with requisite credit quality. ACNB has reviewed recent information on the FHLB system and the FHLB of Pittsburgh, and has concluded that they have the capacity and intent to continue to provide both operational and contingency liquidity. The FHLB of Pittsburgh recently instituted a requirement that a member's investment securities must be moved into a safekeeping account under FHLB control to be considered in the calculation of maximum borrowing capacity. The Corporation currently has securities in safekeeping at the FHLB of Pittsburgh; however, the safekeeping account is under the Corporation's control. As better contingent liquidity is maintained by keeping the securities under the Corporation's control, the Corporation has not moved the securities which, in effect, lowered the Corporation's maximum borrowing capacity by \$71,380,000 as of September 30, 2009. However, there is no practical reduction in borrowing capacity as the securities can be moved into the FHLB-controlled account on any day they are needed for borrowing purposes.

Another source of liquidity is securities sold under repurchase agreements to customers of ACNB's banking subsidiary totaling \$55,030,000 and \$32,285,000 at September 30, 2009, and December 31, 2008, respectively. These agreements vary in balance according to the cash flow needs of customers and competing accounts at other financial organizations.

The liquidity of the parent company, ACNB Corporation, also represents an important aspect of liquidity management. The parent company's cash outflows consist principally of dividends to stockholders and corporate expenses. The main source of funding for the parent company is the dividends it receives from its banking subsidiary. Federal and state banking regulations place certain restrictions on dividends paid to the parent company from subsidiary banks. The total amount of dividends that may be paid from the subsidiary bank to ACNB was \$4,461,000 at September 30, 2009.

ACNB manages liquidity by monitoring projected cash inflows and outflows on a daily basis, and believes it has sufficient funding sources to maintain sufficient liquidity under varying degrees of business conditions.

### *Off-Balance Sheet Arrangements*

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The Corporation is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and, to a lesser extent, standby letters of credit. At September 30, 2009, the Corporation had unfunded outstanding commitments to extend credit of approximately \$128,324,000 and outstanding standby letters of credit of approximately \$6,444,000. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements.

Financial institutions can be exposed to several market risks that may impact the value or future earnings capacity of the organization. These risks involve interest rate risk, foreign currency exchange risk, commodity price risk, and equity market price risk. ACNB's primary market risk is interest rate risk. Interest rate risk is inherent because, as a financial institution, ACNB derives a significant amount of its operating revenue from purchasing funds (customer deposits and wholesale borrowings) at various terms and rates. These funds are then invested into earning assets (primarily loans and investments) at various terms and rates.

### **Recent Developments**

The global and U.S. economies are experiencing significantly reduced business activity as a result of, among other factors, disruptions in the financial system during the past year. Dramatic declines in the housing market during the past year, with falling home prices and increasing foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities and major commercial and investment banks. These write-downs, initially of mortgage-backed

securities but spreading to credit default swaps and other derivative securities, have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail.

Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced and, in some cases, ceased to provide funding to borrowers, including other financial institutions. The availability of credit, confidence in the financial sector, and level of volatility in the financial markets have been significantly adversely affected as a result. In recent times, volatility and disruption in the capital and credit markets have reached unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit capacity for certain issuers without regard to those issuers' underlying financial strength.

In response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, in October 2008, the Emergency Economic Stabilization Act of 2008 (the EESA) was signed into law. Pursuant to the EESA, the U.S. Treasury was given the authority to, among other things, purchase up to \$700 billion of mortgages, mortgage-backed securities, and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. The EESA included a provision for a temporary increase in FDIC insurance from \$100,000 to \$250,000 per depositor through December 31, 2009. In May 2009, this temporary increase in FDIC insurance to \$250,000 per depositor was extended through December 31, 2013.

In October 2008, U.S. Treasury Secretary Paulson, after consulting with the Federal Reserve and the FDIC, announced that the Department of the Treasury would purchase equity stakes in a wide variety of banks and thrifts. Under this program, known as the Troubled Asset Relief Program (TARP) Capital Purchase Program, from the \$700 billion authorized by the EESA, the Treasury made \$250 billion of capital available to U.S. financial institutions in the form of preferred stock. In conjunction with the purchase of preferred stock, the Treasury received warrants to purchase common stock with an aggregate market price equal to 15% of the preferred investment. Participating financial institutions were required to adopt the Treasury's standards for executive compensation and corporate governance for the period during which the Treasury holds equity issued under the TARP Capital Purchase Program.

Also in October 2008, after receiving a recommendation from the boards of the FDIC and the Federal Reserve, and consulting with the President, Secretary Paulson signed the systemic risk exception to the FDIC Act, enabling the FDIC to temporarily provide a 100% guarantee of the senior debt of all FDIC-insured institutions and their holding companies, as well as for deposits in non-interest bearing transaction deposit accounts, under a Temporary Liquidity Guarantee Program. Coverage under the Temporary Liquidity Guarantee Program was available for a 30-day period without charge, and thereafter at a cost of 75 basis points per annum for senior unsecured debt and 10 basis points per annum for non-interest bearing transaction deposits.

It is not clear at this time what impact the EESA, TARP Capital Purchase Program, Temporary Liquidity Guarantee Program, other liquidity and funding initiatives of the Federal Reserve and other agencies that have been previously announced, and any additional programs that may be initiated in the future will have on the financial markets, the economy, or individual institutions, as well as the other difficulties described above, including the extreme levels of volatility and limited credit availability experienced, or on the U.S. banking and financial industries and the broader U.S. and global economies. Further adverse effects could have an adverse effect on the Corporation and its business.

### **ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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Management monitors and evaluates changes in market conditions on a regular basis. Based upon the most recent review, management has determined that there have been no material changes in market risks since year-end. For further discussion of year-end information, please refer to the Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

### **ITEM 4 - CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Corporation's disclosure controls and procedures pursuant to the Securities Exchange Act of 1934 (Exchange Act) Rule 13a-15e. Based upon that evaluation, the Corporation's Chief Executive Officer along with the Corporation's Chief Financial Officer concluded that the Corporation's disclosure controls and procedures are effective.

Disclosure controls and procedures are Corporation controls and other procedures that are designed to ensure that information required to be disclosed by the Corporation in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

There were no changes in the Corporation's internal control over financial reporting during the fiscal quarter ended September 30, 2009, that has materially affected, or is reasonably likely to materially affect, the internal control over financial reporting.

**ITEM 4T - CONTROLS AND PROCEDURES**

**Not Applicable.**

**PART II - OTHER INFORMATION**

**ACNB CORPORATION**

**ITEM 1 - LEGAL PROCEEDINGS**

Management is not aware of any litigation that would have a material adverse effect on the consolidated financial position or results of operations of the Corporation. There are no proceedings pending other than the ordinary routine litigation incident to the business of the Corporation and its subsidiaries. In addition, no material proceedings are pending, or are known to be threatened or contemplated, against the Corporation and its subsidiaries by government authorities.

**ITEM 1A - RISK FACTORS**

Management has reviewed the risk factors that were previously disclosed in the Annual Report on Form 10-K for the fiscal year ended December 31, 2008. It was determined that there are no material changes from the risk factors as previously disclosed in the Form 10-K.

**ITEM 2 - UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

On November 3, 2008, the Corporation announced a plan to purchase up to 120,000 shares of its outstanding common stock. There were no treasury shares purchased under this plan during the quarter ended September 30, 2009. The maximum number of shares that may yet be purchased under this stock repurchase plan is 57,400.

**ITEM 3 - DEFAULTS UPON SENIOR SECURITIES - NOTHING TO REPORT.**

**ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS - NOTHING TO REPORT.**

**ITEM 5 - OTHER INFORMATION - NOTHING TO REPORT.**

**ITEM 6 - EXHIBITS**

The following exhibits are included in this report:

- Exhibit 3(i) Articles of Incorporation of ACNB Corporation, as amended. (Incorporated by reference to Exhibit 3.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on June 2, 2009.)
- Exhibit 3(ii) Bylaws of ACNB Corporation, as amended. (Incorporated by reference to Exhibit 3.2 of the Registrant's Current Report on Form 8-K, filed with the Commission on April 28, 2008.)
- Exhibit 10.1 ACNB Corporation, ACNB Acquisition Subsidiary LLC, and Russell Insurance Group, Inc. Stock Purchase Agreement. (Incorporated by reference to Exhibit 10.2 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the Commission on March 15, 2005.)

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- Exhibit 10.2 Salary Continuation Agreement - Applicable to Ronald L. Hankey, Thomas A. Ritter and Lynda L. Glass. (Incorporated by reference to Exhibit 10.2 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Commission on March 13, 2009.)
- Exhibit 10.3 Executive Supplemental Life Insurance Plan - Applicable to Ronald L. Hankey, Thomas A. Ritter, David W. Cathell and Lynda L. Glass. (Incorporated by reference to Exhibit 10.3 of the Registrant's Quarterly Report on Form 10-Q for the period ended September 30, 2008, filed with the Commission on November 7, 2008.)
- Exhibit 10.4 Director Supplemental Life Insurance Plan - Applicable to Philip P. Asper, Frank Elsner III, James J. Lott, Robert W. Miller, Daniel W. Potts, John K. Schnitzer, Marian B. Schultz, Alan J. Stock, Jennifer L. Weaver, Harry L. Wheeler and James E. Williams. (Incorporated by reference to Exhibit 10.5 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the Commission on March 15, 2005.)
- Exhibit 10.5 Director Deferral Fee Plan - Applicable to Frank Elsner III, James J. Lott, Robert W. Miller, Marian B. Schultz, Alan J. Stock, Jennifer L. Weaver, Harry L. Wheeler and James E. Williams. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on November 27, 2007.)
- Exhibit 10.6 Adams County National Bank Salary Savings Plan. (Incorporated by reference to Exhibit 10.7 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the Commission on March 15, 2005.)
- Exhibit 10.7 Group Pension Plan for Employees of Adams County National Bank. (Incorporated by reference to Exhibit 10.8 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the Commission on March 15, 2005.)
- Exhibit 10.8 Complete Settlement Agreement and General Release made among ACNB Corporation, Adams County National Bank and John W. Krichen effective June 13, 2006. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on June 15, 2006.)
- Exhibit 10.9 Employment Agreement between ACNB Corporation, Adams County National Bank and Thomas A. Ritter dated as of December 31, 2008. (Incorporated by reference to Exhibit 10.9 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Commission on March 13, 2009.)
- Exhibit 10.10 Employment Agreement between ACNB Corporation, Adams County National Bank and Lynda L. Glass dated as of December 31, 2008. (Incorporated by reference to Exhibit 10.10 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Commission on March 13, 2009.)
- Exhibit 10.11 Employment Agreement between ACNB Corporation, Russell Insurance Group, Inc. and Frank C. Russell, Jr. dated as of November 9, 2007. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on November 16, 2007.)
- Exhibit 10.12 Employment Agreement between ACNB Corporation, Adams County National Bank and David W. Cathell dated as of April 17, 2009. (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K, filed with the Commission on April 23, 2009.)
- Exhibit 11 Statement re Computation of Earnings. (Incorporated by reference to page 6 of this Form 10-Q.)
- Exhibit 14 Code of Ethics. (Incorporated by reference to Exhibit 14 of the Registrant's Current Report on Form 8-K, filed with the Commission on March 20, 2009.)
- Exhibit 21 Subsidiaries of the Registrant. (Incorporated by reference to Exhibit 21 of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Commission on March 13, 2009.)
- Exhibit 31.1 Chief Executive Officer Certification of Quarterly Report on Form 10-Q.

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- Exhibit 31.2 Chief Financial Officer Certification of Quarterly Report on Form 10-Q.
- Exhibit 32.1 Chief Executive Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- Exhibit 32.2 Chief Financial Officer Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



**SIGNATURES**

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

**ACNB CORPORATION** (Registrant)

Date: November 6, 2009

*/s/ Thomas A. Ritter*  
Thomas A. Ritter  
President & Chief Executive Officer

*/s/ David W. Cathell*  
David W. Cathell  
Executive Vice President, Treasurer &  
Chief Financial Officer (Principal Financial Officer)