

ACNB CORP
Form 10-Q
August 01, 2014

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 June 30, 2014

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
(Zip Code)

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

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Title of each class
Common Stock, \$2.50 par value per share

Name of each exchange on which registered
The NASDAQ Stock Market, LLC

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 definitions 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 August 1, 2014, was 6,005,346.

PART I - FINANCIAL INFORMATION

ACNB CORPORATION

ITEM 1 - FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF CONDITION (UNAUDITED)

Dollars in thousands, except per share data	June 30, 2014	June 30, 2013	December 31, 2013
ASSETS			
Cash and due from banks	\$ 15,423	\$ 15,398	\$ 13,963
Interest bearing deposits with banks	13,703	22,820	4,153
Total Cash and Cash Equivalents	29,126	38,218	18,116
Securities available for sale	122,938	141,536	129,983
Securities held to maturity, fair value \$76,916; \$88,351; \$92,082	77,593	90,314	94,373
Loans held for sale	2,013	2,427	496
Loans, net of allowance for loan losses \$15,763; \$17,239; \$16,091	733,534	683,357	712,557
Premises and equipment	16,320	15,147	15,991
Restricted investment in bank stocks	5,439	4,603	6,861
Investment in bank-owned life insurance	37,386	31,757	32,237
Investments in low-income housing partnerships	4,143	5,180	4,687
Goodwill	6,308	6,308	6,308
Intangible assets	1,521	2,089	1,845
Foreclosed assets held for resale	1,486	2,485	1,762
Other assets	19,446	15,435	20,831
Total Assets	\$ 1,057,253	\$ 1,038,856	\$ 1,046,047
LIABILITIES AND STOCKHOLDERS EQUITY			
LIABILITIES			
Deposits:			
Non-interest bearing	\$ 142,245	\$ 132,776	\$ 128,011
Interest bearing	679,031	693,609	672,632
Total Deposits	821,276	826,385	800,643
Short-term borrowings	42,202	51,250	49,052
Long-term borrowings	76,572	52,830	82,703
Other liabilities	6,749	6,595	6,847
Total Liabilities	946,799	937,060	939,245
STOCKHOLDERS EQUITY			
Preferred stock, \$2.50 par value; 20,000,000 shares authorized; no shares outstanding			
Common stock, \$2.50 par value; 20,000,000 shares authorized; 6,067,946, 6,043,616 and 6,053,911 shares issued; 6,005,346, 5,981,016 and 5,991,311 shares outstanding			
	15,170	15,109	15,135

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Treasury stock, at cost (62,600 shares)	(728)	(728)	(728)
Additional paid-in capital	9,860	9,475	9,628
Retained earnings	85,586	80,360	82,661
Accumulated other comprehensive income (loss)	566	(2,420)	106
Total Stockholders Equity	110,454	101,796	106,802
Total Liabilities and Stockholders Equity	\$ 1,057,253	\$ 1,038,856	\$ 1,046,047

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 June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
INTEREST INCOME				
Loans, including fees	\$ 8,033	\$ 7,980	\$ 16,023	\$ 16,234
Securities:				
Taxable	951	1,048	1,962	2,088
Tax-exempt	267	294	540	642
Dividends	60	6	89	10
Other	14	28	30	48
Total Interest Income	9,325	9,356	18,644	19,022
INTEREST EXPENSE				
Deposits	441	560	866	1,221
Short-term borrowings	14	15	34	27
Long-term borrowings	450	443	907	902
Total Interest Expense	905	1,018	1,807	2,150
Net Interest Income	8,420	8,338	16,837	16,872
PROVISION FOR LOAN LOSSES		500	150	1,150
Net Interest Income after Provision for Loan Losses	8,420	7,838	16,687	15,722
OTHER INCOME				
Service charges on deposit accounts	533	548	998	1,086
Income from fiduciary activities	411	312	737	643
Earnings on investment in bank-owned life insurance	289	254	544	495
Net gains on sales or calls of securities	52		52	
Service charges on ATM and debit card transactions	400	356	759	675
Commissions from insurance sales	1,532	1,399	2,597	2,530
Other	175	271	307	656
Total Other Income	3,392	3,140	5,994	6,085
OTHER EXPENSES				
Salaries and employee benefits	4,954	4,864	9,709	9,612
Net occupancy	490	493	1,074	1,008
Equipment	677	792	1,320	1,450
Other tax	182	232	371	470
Professional services	270	191	574	435
Supplies and postage	120	185	273	316
Marketing and corporate relations	204	113	301	212
FDIC and regulatory	201	192	399	401
Intangible assets amortization	163	161	325	321
Foreclosed real estate expenses (income)	74	(72)	117	(93)
Other operating	885	866	1,439	1,641
Total Other Expenses	8,220	8,017	15,902	15,773

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Income before Income Taxes	3,592	2,961	6,779	6,034
PROVISION FOR INCOME TAXES	861	639	1,576	1,294
Net Income	\$ 2,731	\$ 2,322	\$ 5,203	\$ 4,740
PER SHARE DATA				
Basic earnings	\$ 0.46	\$ 0.38	\$ 0.87	\$ 0.79
Cash dividends declared	\$ 0.19	\$ 0.19	\$ 0.38	\$ 0.38

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

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

Dollars in thousands	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
NET INCOME	\$ 2,731	\$ 2,322	\$ 5,203	\$ 4,740
OTHER COMPREHENSIVE INCOME (LOSS)				
SECURITIES				
Unrealized gains (losses) arising during the period, net of income taxes of \$178, \$(1,023), \$243 and \$(1,254), respectively	349	(1,987)	474	(2,436)
Reclassification adjustment for net gains included in net income, net of income taxes of \$(18), \$0, \$(18) and \$0, respectively (A) (C)	(34)		(34)	
PENSION				
Amortization of pension net loss, transition liability, and prior service cost, net of income taxes of \$11, \$59, \$11 and \$118, respectively (B) (C)	20	114	20	228
TOTAL OTHER COMPREHENSIVE INCOME (LOSS)	335	(1,873)	460	(2,208)
TOTAL COMPREHENSIVE INCOME	\$ 3,066	\$ 449	\$ 5,663	\$ 2,532

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

(A) Gross amounts are included in net gains on sales or calls of securities on the Consolidated Statement of Income in total other income.

(B) Gross amounts are included in the computation of net periodic benefit cost and are included in salaries and employee benefits on the Consolidated Statements of Income in total other expenses.

(C) Income tax amounts are included in the provision for income taxes on the Consolidated Statements of Income.

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)

Six Months Ended June 30, 2014 and 2013

Dollars in thousands	Common Stock	Treasury Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
BALANCE JANUARY 1, 2013	\$ 15,070	\$ (728)	\$ 9,246	\$ 77,888	\$ (212)	\$ 101,264
Net income				4,740		4,740
Other comprehensive loss, net of taxes					(2,208)	(2,208)
Common stock shares issued (15,648 shares)	39		229			268
Cash dividends declared				(2,268)		(2,268)
BALANCE JUNE 30, 2013	\$ 15,109	\$ (728)	\$ 9,475	\$ 80,360	\$ (2,420)	\$ 101,796
BALANCE JANUARY 1, 2014	\$ 15,135	\$ (728)	\$ 9,628	\$ 82,661	\$ 106	\$ 106,802
Net income				5,203		5,203
Other comprehensive income, net of taxes					460	460
Common stock shares issued (14,035 shares)	35		232			267
Cash dividends declared				(2,278)		(2,278)
BALANCE JUNE 30, 2014	\$ 15,170	\$ (728)	\$ 9,860	\$ 85,586	\$ 566	\$ 110,454

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

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

Dollars in thousands	Six Months Ended June 30,	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 5,203	\$ 4,740
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sales of loans originated for sale	(47)	(353)
Gain on sales of foreclosed assets held for resale, including writedowns	(23)	(185)
Earnings on investment in bank-owned life insurance	(544)	(495)
Gain on sales or calls of securities	(52)	
Depreciation and amortization	1,001	1,002
Provision for loan losses	150	1,150
Net amortization of investment securities premiums	425	483
Decrease in accrued interest receivable	104	160
Increase (decrease) in accrued interest payable	2	(378)
Mortgage loans originated for sale	(3,825)	(16,699)
Proceeds from sales of loans originated for sale	2,355	21,312
Decrease in other assets	1,370	490
(Decrease) increase in other liabilities	(69)	21
Net Cash Provided by Operating Activities	6,050	11,248
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from maturities of investment securities held to maturity	16,529	5,319
Proceeds from maturities of investment securities available for sale	10,277	27,177
Proceeds from sales of investment securities available for sale	1,228	
Purchase of investment securities held to maturity		(45,695)
Purchase of investment securities available for sale	(3,917)	(6,875)
Net (increase) decrease in loans	(21,651)	6,366
Redemption of restricted investment in bank stocks	1,422	715
Purchase of bank-owned life insurance	(4,605)	(140)
Capital expenditures	(1,006)	(699)
Proceeds from sale of low-income housing partnerships	219	
Proceeds from sale of foreclosed real estate	823	2,385
Net Cash Used in Investing Activities	(681)	(11,447)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in demand deposits	14,234	13,479
Net increase (decrease) in time certificates of deposits and interest bearing deposits	6,399	(21,270)
Net (decrease) increase in short-term borrowings	(6,850)	3,947
Dividends paid	(2,278)	(2,268)
Common stock issued	267	268
Proceeds from long-term borrowings	10,000	
Repayments on long-term borrowings	(16,131)	(7,124)
Net Cash Provided by (Used in) Financing Activities	5,641	(12,968)
Net Increase (Decrease) in Cash and Cash Equivalents	11,010	(13,167)
CASH AND CASH EQUIVALENTS BEGINNING	18,116	51,385

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CASH AND CASH EQUIVALENTS	ENDING	\$	29,126	\$	38,218
Interest paid		\$	1,805	\$	2,528
Income taxes paid		\$	500	\$	2,225
Loans transferred to foreclosed assets held for resale		\$	524	\$	438

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

ACNB CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

ACNB Corporation (the Corporation or ACNB), headquartered in Gettysburg, Pennsylvania, provides banking, insurance, and financial services to businesses and consumers through its wholly-owned subsidiaries, ACNB Bank (Bank) and Russell Insurance Group, Inc. (RIG). The Bank engages in full-service commercial and consumer banking and trust services through its twenty retail banking office locations in Adams, Cumberland, Franklin and York Counties, Pennsylvania. There is also a loan production office situated in York County, Pennsylvania.

RIG is a full-service insurance agency based in Westminster, Maryland. The agency offers a broad range of property and casualty, life, and health insurance to both commercial and individual clients. In 2008, as part of an agency acquisition, a second location of RIG was established in Germantown, Maryland.

The Corporation's primary source of revenue is interest income on loans and investment securities and fee income on its products and services. Expenses consist of interest expense on deposits and borrowed funds, provisions for loan losses, and other operating expenses.

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 and the results of operations, comprehensive income, changes in stockholders' equity, and cash flows. 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 consolidated financial statements in the 2013 ACNB Corporation Annual Report on Form 10-K, filed with the SEC on March 7, 2014. It is suggested that the consolidated financial statements contained herein be read in conjunction with the consolidated financial statements and notes included in the Corporation's Annual Report on Form 10-K. The results of operations for the three and six month periods ended June 30, 2014, are not necessarily indicative of the results to be expected for the full year.

The Corporation has evaluated events and transactions occurring subsequent to the statement of condition date of June 30, 2014, for items that should potentially be recognized or disclosed in the consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

2. Earnings Per Share

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The Corporation has a simple capital structure. Basic earnings per share of common stock is computed based on 5,995,165 and 5,969,089 weighted average shares of common stock outstanding for the six months ended June 30, 2014 and 2013, respectively, and 5,997,999 and 5,971,929 for the three months ended June 30, 2014 and 2013, respectively. The Corporation does not have dilutive securities outstanding.

3. Retirement Benefits

The components of net periodic benefit (income) cost related to the non-contributory, defined benefit pension plan for the three and six month periods ended June 30 were as follows:

In thousands	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Service cost	\$ 172	\$ 194	\$ 344	\$ 388
Interest cost	259	223	518	446
Expected return on plan assets	(578)	(489)	(1,156)	(978)
Amortization of net loss	5	163	11	326
Amortization of prior service cost	10	10	20	20
Net Periodic Benefit (Income) Cost	\$ (132)	\$ 101	\$ (263)	\$ 202

The Corporation previously disclosed in its consolidated financial statements for the year ended December 31, 2013, that it had not yet determined the amount the Bank planned on contributing to the defined benefit plan in 2014. As of June 30, 2014, this contribution amount had still not been determined. Effective April 1, 2012, no inactive or former participant in the plan is eligible to again participate in the plan, and no employee hired after March 31, 2012, is eligible to participate in the plan. As of the last annual census, ACNB Bank had a combined 368 active, vested, terminated and retired persons in the plan.

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 \$4,009,000 in standby letters of credit as of June 30, 2014. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The current amount of the liability, as of June 30, 2014, for guarantees under standby letters of credit issued is not material.

5. Accumulated Other Comprehensive Income (Loss)

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

In thousands	Unrealized Gains on Securities	Pension Liability	Accumulated Other Comprehensive Income (Loss)
BALANCE JUNE 30, 2014	\$ 3,012	\$ (2,446)	\$ 566

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BALANCE	DECEMBER 31, 2013	\$	2,572	\$	(2,466)	\$	106
BALANCE	JUNE 30, 2013	\$	3,178	\$	(5,598)	\$	(2,420)

6. **Segment Reporting**

The Corporation has two reporting segments, the Bank and RIG. RIG is managed separately from the banking segment, which includes the Bank and related financial services that the Corporation offers through its banking subsidiary. RIG offers a broad range of property and casualty, life, and health insurance to both commercial and individual clients.

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Segment information for the six month periods ended June 30, 2014 and 2013, is as follows:

In thousands	Banking		Insurance		Total
2014					
Net interest income and other income from external customers	\$	20,229	\$	2,602	\$ 22,831
Income before income taxes		6,297		482	6,779
Total assets		1,048,410		8,843	1,057,253
Capital expenditures		1,006			1,006
2013					
Net interest income and other income from external customers	\$	20,443	\$	2,514	\$ 22,957
Income before income taxes		5,657		377	6,034
Total assets		1,029,276		9,580	1,038,856
Capital expenditures		692		7	699

Segment information for the three month periods ended June 30, 2014 and 2013, is as follows:

In thousands	Banking		Insurance		Total
2014					
Net interest income and other income from external customers	\$	10,280	\$	1,532	\$ 11,812
Income before income taxes		3,173		419	3,592
Total assets		1,048,410		8,843	1,057,253
Capital expenditures		563			563
2013					
Net interest income and other income from external customers	\$	10,084	\$	1,394	\$ 11,478
Income before income taxes		2,682		279	2,961
Total assets		1,029,276		9,580	1,038,856
Capital expenditures		466			466

Intangible assets, representing customer lists, are amortized over 10 years on a straight line basis. Goodwill is not amortized, but rather is analyzed annually for impairment. If certain events occur which might indicate goodwill has been impaired, the goodwill is tested for impairment when such events occur. Amortization of goodwill and the intangible assets is deductible for tax purposes.

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 (loss).

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 on debt securities, management considers (1) whether

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management intends to sell the security, or (2) if it is more likely than not that management will be required to sell the security before recovery, or (3) if management does not expect to recover the entire amortized cost basis. In assessing potential other-than-temporary impairment for equity securities, consideration is given to management's intention and ability to hold the securities until recovery of unrealized losses. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

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Amortized cost and fair value of securities at June 30, 2014, and December 31, 2013, were as follows:

In thousands	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
SECURITIES AVAILABLE FOR SALE				
JUNE 30, 2014				
U.S. Government and agencies	\$ 19,035	\$ 504	\$	\$ 19,539
Mortgage-backed securities, residential	49,089	2,500	3	51,586
State and municipal	38,583	1,327	39	39,871
Corporate bonds	10,002	137	4	10,135
CRA mutual fund	1,044	7		1,051
Stock in other banks	627	129		756
	\$ 118,380	\$ 4,604	\$ 46	\$ 122,938
DECEMBER 31, 2013				
U.S. Government and agencies	\$ 21,094	\$ 557	\$	\$ 21,651
Mortgage-backed securities, residential	51,541	2,322	123	53,740
State and municipal	40,780	1,117	375	41,522
Corporate bonds	11,004	192	31	11,165
CRA mutual fund	1,044		11	1,033
Stock in other banks	627	245		872
	\$ 126,090	\$ 4,433	\$ 540	\$ 129,983
SECURITIES HELD TO MATURITY				
JUNE 30, 2014				
U.S. Government and agencies	\$ 24,508	\$	\$ 403	\$ 24,105
Mortgage-backed securities, residential	53,085	252	526	52,811
	\$ 77,593	\$ 252	\$ 929	\$ 76,916
DECEMBER 31, 2013				
U.S. Government and agencies	\$ 37,528	\$ 142	\$ 923	\$ 36,747
Mortgage-backed securities, residential	56,845	40	1,550	55,335
	\$ 94,373	\$ 182	\$ 2,473	\$ 92,082

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The following table shows the Corporation's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2014, and December 31, 2013:

In thousands	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE FOR SALE						
JUNE 30, 2014						
Mortgage-backed securities, residential	\$ 171	\$ 2	\$ 644	\$ 1	\$ 815	\$ 3
State and municipal	149	1	4,625	38	4,774	39
Corporate bond	4,996	4			4,996	4
	\$ 5,316	\$ 7	\$ 5,269	\$ 39	\$ 10,585	\$ 46
DECEMBER 31, 2013						
Mortgage-backed securities, residential	\$ 6,944	\$ 123	\$	\$	\$ 6,944	\$ 123
State and municipal	11,107	340	1,070	35	12,177	375
Corporate bond	4,969	31			4,969	31
CRA mutual fund	1,033	11			1,033	11
	\$ 24,053	\$ 505	\$ 1,070	\$ 35	\$ 25,123	\$ 540
SECURITIES HELD TO MATURITY						
JUNE 30, 2014						
U.S. Government and agencies	\$ 1,933	\$ 67	\$ 22,172	\$ 336	\$ 24,105	\$ 403
Mortgage-backed securities, residential			25,278	526	25,278	526
	\$ 1,933	\$ 67	\$ 47,450	\$ 862	\$ 49,383	\$ 929
DECEMBER 31, 2013						
U.S. Government and agencies	\$ 22,710	\$ 812	\$ 2,889	\$ 111	\$ 25,599	\$ 923
Mortgage-backed security, residential	45,891	1,446	1,755	104	47,646	1,550
	\$ 68,601	\$ 2,258	\$ 4,644	\$ 215	\$ 73,245	\$ 2,473

All mortgage-backed security investments are government sponsored enterprise (GSE) pass-through instruments issued by the Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA) or Federal Home Loan Mortgage Corporation (FHLMC), which guarantee the timely payment of principal on these investments.

At June 30, 2014, two available for sale residential mortgage-backed securities had unrealized losses that individually did not exceed 2% of amortized cost. One of these securities has 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.

At June 30, 2014, eleven available for sale state and municipal bonds had unrealized losses that individually did not exceed 3% of amortized cost. Ten of these securities have 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.

At June 30, 2014, one available for sale corporate bond had an unrealized loss that did not exceed 1% of amortized cost. This security has not been in a continuous loss position for 12 months or more. This unrealized loss relates principally to changes in interest rates subsequent to the

acquisition of the specific security.

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At June 30, 2014, sixteen held to maturity U.S. Government and agency securities had unrealized losses that individually did not exceed 5% of amortized cost. Fifteen of these securities have 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.

At June 30, 2014, eighteen held to maturity residential mortgage-backed securities had unrealized losses that individually did not exceed 3% of amortized cost. All of these securities have 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.

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. 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) 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 independent service providers to provide matrix pricing.

Management routinely sells securities from its available for sale portfolio in an effort to manage and allocate the portfolio. At June 30, 2014, management had not identified any securities with an unrealized loss that it intends to sell or will be required to sell. In estimating other-than-temporary impairment losses on debt securities, management considers (1) whether management intends to sell the security, or (2) if it is more likely than not that management will be required to sell the security before recovery, or (3) if management does not expect to recover the entire amortized cost basis. In assessing potential other-than-temporary impairment for equity securities, consideration is given to management's intention and ability to hold the securities until recovery of unrealized losses.

Amortized cost and fair value at June 30, 2014, by contractual maturity, where applicable, 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	\$ 7,856	\$ 8,007	\$	\$
Over 1 year through 5 years	29,685	30,822	16,053	15,833
Over 5 years through 10 years	27,860	28,403	8,455	8,272
Over 10 years	2,219	2,313		
Mortgage-backed securities, residential	49,089	51,586	53,085	52,811
CRA mutual fund	1,044	1,051		
Stock in other banks	627	756		
	\$ 118,380	\$ 122,938	\$ 77,593	\$ 76,916

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The Corporation realized gross gains of \$52,000 and \$0 in gross losses on sales of securities available for sale during the three and six month periods ended June 30, 2014. The Corporation did not realize any gross gains or losses on sales of securities available for sale during the three and six month period ended June 30, 2013.

At June 30, 2014, and December 31, 2013, securities with a carrying value of \$125,593,000 and \$139,966,000, respectively, were pledged as collateral as required by law on public and trust deposits, repurchase agreements, and for other purposes.

8. **Loans**

The Corporation grants commercial, residential, and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout southcentral Pennsylvania and northern Maryland. The ability of the Corporation's debtors to honor their contracts is dependent upon the real estate values and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The loans receivable portfolio is segmented into commercial, residential mortgage, home equity lines of credit, and consumer loans. Commercial loans consist of the following classes: commercial and industrial, commercial real estate, and commercial real estate construction.

The accrual of interest on residential mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Consumer loans (consisting of home equity lines of credit and consumer loan classes) are typically charged off no later than 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued, but not collected, for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Credit Losses

The allowance for credit losses consists of the allowance for loan losses and the reserve for unfunded lending commitments. The allowance for loan losses (the allowance) is established as losses are estimated to occur through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and is recorded in other liabilities on the consolidated statement of condition. The amount of the reserve for unfunded lending commitments is not material to the consolidated financial statements.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

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The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard, or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity, and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for the previous twelve quarters for each of these categories of loans, adjusted for qualitative risk factors. These qualitative risk factors include:

- lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices;
- national, regional and local economic and business conditions, as well as the condition of various market segments, including the impact on the value of underlying collateral for collateral dependent loans;

- the nature and volume of the portfolio and terms of loans;
- the experience, ability and depth of lending management and staff;
- the volume and severity of past due, classified and nonaccrual loans, as well as other loan modifications; and,
- the existence and effect of any concentrations of credit and changes in the level of such concentrations.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

The unallocated component of the allowance is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. It covers risks that are inherently difficult to quantify including, but not limited to, collateral risk, information risk, and historical charge-off risk.

A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal and/or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and/or interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and commercial construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

A specific allocation within the allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of the Corporation's impaired loans are measured based on the estimated fair value of the loan's collateral or the discounted cash flows method.

It is the policy of the Corporation to order an updated valuation on all real estate secured loans when the loan becomes 90 days past due and there has not been an updated valuation completed within the previous 12 months. In addition, the Corporation orders third-party valuations on all impaired real estate collateralized loans within 30 days of the loan being classified as impaired. Until the valuations are completed, the Corporation utilizes the most recent independent third-party real estate valuation to estimate the need for a specific allocation to be assigned to the loan. These existing valuations are discounted downward to account for such things as the age of the existing collateral valuation, change in the condition of the real estate, change in local market and economic conditions, and other specific factors involving the collateral. Once the updated valuation is completed, the collateral value is updated accordingly.

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For commercial and industrial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging reports, equipment appraisals, or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

The Corporation actively monitors the values of collateral as well as the age of the valuation of impaired loans. Management believes that the Corporation's market area is not as volatile as other areas throughout the United States, therefore valuations are ordered at least every 18 months, or more frequently if management believes that there is an indication that the fair value has declined.

For impaired loans secured by collateral other than real estate, the Corporation considers the net book value of the collateral, as recorded in the most recent financial statements of the borrower, and determines fair value based on estimates made by management.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a troubled debt restructure.

Loans whose terms are modified are classified as troubled debt restructured loans if the Corporation grants such borrowers concessions that it would not otherwise consider and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate, a below market interest rate given the risk associated with the loan, or an extension of a loan's stated maturity date. Nonaccrual troubled debt restructurings may be restored to accrual status if principal and interest payments, under the modified terms, are current for a sustained period of time and, based on a well-documented credit evaluation of the borrower's financial condition, there is reasonable assurance of repayment. Loans classified as troubled debt restructurings are generally designated as impaired.

The allowance calculation methodology includes further segregation of loan classes into credit quality rating categories. The borrower's overall financial condition, repayment sources, guarantors, and value of collateral, if appropriate, are generally evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments.

Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful, and loss. Loans classified special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

In addition, federal and state regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses and may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio and economic conditions, management believes the current level of the allowance for loan losses is adequate.

Commercial and Industrial Lending The Corporation originates commercial and industrial loans primarily to businesses located in its primary market area and surrounding areas. These loans are used for various business purposes which include short-term loans and lines of credit to finance machinery and equipment purchases, inventory, and accounts receivable. Generally, the maximum term for loans extended on machinery and equipment is based on the projected useful life of such machinery and equipment. Most business lines of credit are written on demand and may be renewed annually.

Commercial and industrial loans are generally secured with short-term assets; however, in many cases, additional collateral such as real estate is provided as additional security for the loan. Loan-to-value maximum values have been established by the Corporation and are specific to the type of collateral. Collateral values may be determined using invoices, inventory reports, accounts receivable aging reports, collateral appraisals, etc.

In underwriting commercial and industrial loans, an analysis is performed to evaluate the borrower's character and capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as the conditions affecting the borrower. Evaluation of the borrower's past, present and future cash flows is also an important aspect of the Corporation's analysis.

Commercial loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions.

Commercial Real Estate Lending The Corporation engages in commercial real estate lending in its primary market area and surrounding areas. The Corporation's commercial loan portfolio is secured primarily by commercial retail space, office buildings, and hotels. Generally, commercial real estate loans have terms that do not exceed 20 years, have loan-to-value ratios of up to 80% of the appraised value of the property, and are typically secured by personal guarantees of the borrowers.

In underwriting these loans, the Corporation performs a thorough analysis of the financial condition of the borrower, the borrower's credit history, and the reliability and predictability of the cash flow generated by the property securing the loan. Appraisals on properties securing commercial real estate loans originated by the Corporation are performed by independent appraisers.

Commercial real estate loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions and the complexities involved in valuing the underlying collateral.

Commercial Real Estate Construction Lending The Corporation engages in commercial real estate construction lending in its primary market area and surrounding areas. The Corporation's commercial real estate construction lending consists of commercial and residential site development loans, as well as commercial building construction and residential housing construction loans.

The Corporation's commercial real estate construction loans are generally secured with the subject property. Terms of construction loans depend on the specifics of the project, such as estimated absorption rates, estimated time to complete, etc.

In underwriting commercial real estate construction loans, the Corporation performs a thorough analysis of the financial condition of the borrower, the borrower's credit history, and the reliability and predictability of the cash flow generated by the project using feasibility studies, market data, etc. Appraisals on properties securing commercial real estate construction loans originated by the Corporation are performed by independent appraisers.

Commercial real estate construction loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions and the uncertainties surrounding total construction costs.

Residential Mortgage Lending One-to-four family residential mortgage loan originations, including home equity closed-end loans, are generated by the Corporation's marketing efforts, its present customers, walk-in customers, and referrals. These loans originate primarily within the Corporation's market area or with customers primarily from the market area.

The Corporation offers fixed-rate and adjustable-rate mortgage loans with terms up to a maximum of 30 years for both permanent structures and those under construction. The Corporation's one-to-four family residential mortgage originations are secured primarily by properties located in its primary market area and surrounding areas. The majority of the Corporation's residential mortgage loans originate with a loan-to-value of 80% or less. Loans in excess of 80% are required to have private mortgage insurance.

In underwriting one-to-four family residential real estate loans, the Corporation evaluates both the borrower's financial ability to repay the loan as agreed and the value of the property securing the loan. Properties securing real estate loans made by the Corporation are appraised by independent appraisers. The Corporation generally requires borrowers to obtain an attorney's title opinion or title insurance, as well as fire and property insurance (including flood insurance, if necessary) in an amount not less than the amount of the loan. The Corporation has not engaged in subprime residential mortgage originations.

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Residential mortgage loans present a moderate level of risk due primarily to general economic conditions, as well as a continued weak housing market.

Home Equity Lines of Credit Lending The Corporation originates home equity lines of credit primarily within the Corporation's market area or with customers primarily from the market area. Home equity lines of credit are generated by the Corporation's marketing efforts, its present customers, walk-in customers, and referrals.