ACNB CORP
Form 10-Q
November 07, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008

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**

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 x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or 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 o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares of the Registrant s Common Stock outstanding on November 3, 2008, was 5,990,943.

PART I

ACNB CORPORATION

ITEM 1 - FINANCIAL INFORMATION

CONSOLIDATED STATEMENTS OF CONDITION (UNAUDITED)

Dollars in thousands, except per share data	September 30, 2008	September 30, 2007	December 31, 2007
ASSETS			
Cash and due from banks	**$ 15,427**	$ 17,869	$ 18,319
Interest bearing deposits in banks	**2,502**	892	893
Cash and Cash Equivalents	**17,929**	18,761	19,212
Securities available for sale	**231,346**	351,344	286,346
Securities held to maturity, fair value $0; $14,615; $4,123		14,642	4,150
Loans held for sale	**304**	1,025	1,175
Loans, net of allowance for loan losses $9,618; $5,537; $5,848	**612,882**	545,770	542,354
Premises and equipment	**14,447**	14,404	14,530
Restricted investment in bank stocks	**8,501**	11,506	9,045
Investment in bank-owned life insurance	**25,055**	24,060	24,297
Investments in low-income housing partnerships	**4,801**	5,088	5,028
Other assets	**21,433**	19,610	20,528
Total Assets	**$ 936,698**	$ 1,006,210	$ 926,665
LIABILITIES AND STOCKHOLDERS EQUITY			
LIABILITIES			
Deposits:			
Non-interest bearing	**$ 85,666**	$ 81,180	$ 77,192
Interest bearing	**592,714**	606,121	593,448
Total Deposits	**678,380**	687,301	670,640
Short-term borrowings	**36,991**	109,488	30,768
Long-term borrowings	**132,027**	115,315	130,244
Other liabilities	**6,452**	12,009	9,883
Total Liabilities	**853,850**	924,113	841,535
STOCKHOLDERS EQUITY			

Common stock, $2.50 par value; 20,000,000 shares authorized; 5,990,943, 5,706,970 and 5,990,943 shares issued and outstanding, respectively	**14,977**	14,267	14,977
Additional paid-in capital	**8,787**	4,741	8,787
Retained earnings	**62,301**	65,234	61,439
Accumulated other comprehensive loss	**(3,217)**	(2,145)	(73)
Total Stockholders Equity	**82,848**	82,097	85,130
Total Liabilities and Stockholders Equity	**$ 936,698**	$ 1,006,210	$ 926,665

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

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
Dollars in thousands, except per share data	**2008**	**2007**	**2008**	**2007**
INTEREST INCOME				
Loans, including fees	**$ 9,010**	$ 9,059	**$ 26,510**	$ 26,629
Securities:				
Taxable	**2,417**	3,811	**7,778**	10,294
Tax-exempt	**476**	340	**1,410**	955
Dividends	**73**	147	**207**	485
Other	**35**	39	**83**	123
Total Interest Income	**12,011**	13,396	**35,988**	38,486
INTEREST EXPENSE				
Deposits	**2,967**	4,367	**10,281**	12,626
Short-term borrowings	**176**	1,156	**537**	2,319
Long-term debt	**1,318**	1,572	**3,673**	5,050
Total Interest Expense	**4,461**	7,095	**14,491**	19,995
Net Interest Income	**7,550**	6,301	**21,497**	18,491
PROVISION FOR LOAN LOSSES	**3,600**	25	**4,270**	165
Net Interest Income after Provision for Loan Losses	**3,950**	6,276	**17,227**	18,326
OTHER INCOME				
Service charges on deposit accounts	**628**	521	**1,667**	1,542
Income from fiduciary activities	**275**	253	**804**	680
Earnings on investment in bank-owned life insurance	**266**	229	**787**	672
Gains on sales of securities	**57**		**158**	10
Service charges on ATM and debit card transactions	**248**	242	**714**	708
Commissions from insurance sales	**939**	962	**3,100**	3,287
Other	**206**	234	**710**	824
Total Other Income	**2,619**	2,441	**7,940**	7,723
OTHER EXPENSES				
Salaries and employee benefits	**3,629**	3,234	**10,649**	9,901
Net occupancy expense	**514**	543	**1,639**	1,713

Equipment expense	**489**	527	**1,446**	1,715
Other tax expense	**189**	184	**581**	502
Professional services	**238**	216	**704**	593
Supplies and postage	**185**	183	**581**	596
Marketing expense	**241**	263	**781**	906
Other operating	**979**	961	**3,002**	2,901
Total Other Expenses	**6,464**	6,111	**19,383**	18,827
Income before Income Taxes	**105**	2,606	**5,784**	7,222
PROVISION (BENEFIT) FOR INCOME TAXES	**(379)**	524	**762**	1,408
Net Income	**$ 484**	$ 2,082	**$ 5,022**	$ 5,814
PER SHARE DATA				
Basic earnings	**$ 0.08**	$ 0.35	**$ 0.84**	$ 0.97
Cash dividends declared	**$ 0.19**	$ 0.19	**$ 0.57**	$ 0.57

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, 2008 and 2007

Dollars in thousands	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders Equity
BALANCE - DECEMBER 31, 2006	$ 14,267	$ 4,741	$ 62,845	$ (4,549)	$ 77,304
Comprehensive income:					
Net income			5,814		5,814
Other comprehensive income, net of taxes				2,404	2,404
Total Comprehensive Income					8,218
Cash dividends declared			(3,425)		(3,425)
BALANCE - SEPTEMBER 30, 2007	$ 14,267	$ 4,741	$ 65,234	$ (2,145)	$ 82,097
BALANCE - DECEMBER 31, 2007	**$ 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)**
Total Comprehensive Income					**1,878**
Cash dividends declared			**(3,415)**		**(3,415)**
BALANCE - SEPTEMBER 30, 2008	**$ 14,977**	**$ 8,787**	**$ 62,301**	**$ (3,217)**	**$ 82,848**

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

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

In thousands	Nine Months Ended September 30, 2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income	**$ 5,022**	$ 5,814
Adjustments to reconcile net income to net cash provided by operating activities:		
(Gain) loss on sales of loans and property	**688**	(281)
Earnings on investment in bank-owned life insurance	**(787)**	(672)
Gain on sales of securities	**(158)**	(10)
Depreciation and amortization	**1,380**	1,245
Provision for loan losses	**4,270**	165
Net amortization (accretion) of investment securities premiums (discounts)	**(26)**	334
(Increase) decrease in interest receivable	**956**	(937)
Increase (decrease) in interest payable	**(941)**	712
(Increase) decrease in mortgage loans held for sale	**184**	(215)
Decrease in other assets	**878**	70
Decrease in other liabilities	**(235)**	(2,044)
Net Cash Provided by Operating Activities	**11,231**	4,181
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from maturities of investment securities held-to-maturity	**4,137**	1,854
Proceeds from maturities of investment securities available-for-sale	**88,745**	88,941
Proceeds from sales of investment securities available for sale	**26,936**	1,589
Purchase of investment securities available-for-sale	**(65,248)**	(101,073)
Net sale (purchase) of restricted investment in bank stocks	**544**	(1,243)
Net increase in loans	**(74,941)**	(27,092)
Purchase of bank-owned life insurance		(1,525)
Investments in low-income housing partnerships		(131)
Final purchase consideration Insurance subsidiary	**(3,000)**	
Investments in insurance books of business	**(1,156)**	(429)
Capital expenditures	**(999)**	(633)
Proceeds from sales of property	**137**	195
Net Cash Used in Investing Activities	**(24,845)**	(39,547)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in demand deposits, interest bearing deposits, and savings accounts	**8,474**	6,261
Net increase (decrease) in time certificates of deposit	**(734)**	11,335
Net increase in short-term borrowings	**6,223**	49,505
Dividends paid	**(3,415)**	(3,425)
Proceeds from long-term borrowings	**37,000**	40,000
Repayments on long-term borrowings	**(35,217)**	(70,205)
Net Cash Provided by Financing Activities	**12,331**	33,471
Net Decrease in Cash and Cash Equivalents	**(1,283)**	(1,895)
CASH AND CASH EQUIVALENTS BEGINNING	**19,212**	20,656

CASH AND CASH EQUIVALENTS ENDING	**$**	**17,929**	$	18,761
Interest paid	**$**	**15,432**	$	19,283
Income taxes paid	**$**	**1,500**	$	1,075
Loans transferred to foreclosed real estate	**$**	**143**	$	

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**

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, 2008 and 2007, and the results of its operations, changes in stockholders equity, and cash flows for the nine months ended September 30, 2008 and 2007. 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 2007 ACNB Corporation Annual Report on Form 10-K, filed with the SEC on March 14, 2008. The results of operations for the nine month period ended September 30, 2008, are not necessarily indicative of the results to be expected for the full year. For comparative purposes, the September 30, 2007 balances have been reclassified to conform with the 2008 presentation. Such reclassifications had no impact on net income.

2. **Earnings Per Share**

The Corporation has a simple capital structure. Basic earnings per share of common stock is computed based on 5,990,943 weighted average shares of common stock outstanding for all periods presented. The weighted average shares have been retroactively adjusted to give effect to the 5% common stock dividend distributed in December 2007. The Corporation does not have dilutive securities outstanding.

3. **Retirement Benefits**

The components of net periodic benefit costs for the three month and nine month periods ended September 30 were as follows:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
In thousands	**2008**	**2007**	**2008**	**2007**
Service cost	**$ 147**	$ 125	**$ 442**	$ 375
Interest cost	**259**	211	**777**	633
Expected return on plan assets	**(399)**	(295)	**(1,198)**	(885)
Other, net	**15**	13	**45**	39
Net Periodic Benefit Cost	**$ 22**	$ 54	**$ 66**	$ 162

The Corporation previously disclosed in its financial statements for the year ended December 31, 2007, that it expected to contribute $1,250,000 to its pension plan in 2008. As of September 30, 2008, no contributions have been made, with the full contribution expected to be made in the fourth quarter of 2008.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4 (EITF 06-4), Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Insurance Arrangements . EITF 06-4 requires a liability to be recorded during the service period when a split-dollar life insurance agreement continues after participants 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 EITF 06-4 on January 1, 2008, and recorded a cumulative effect adjustment in the first quarter of 2008 of $586,000 as a reduction of retained earnings effective January 1, 2008. The amount was further adjusted in the second quarter of 2008 by $159,000 due to a specific discount rate calculation compared to an estimated discount rate used in the first quarter of 2008. The Corporation expects approximately an $84,000 impact on 2008 expense due to implementation of this new accounting pronouncement.

ACNB CORPORATION

ITEM 1 - NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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 $6,076,000 in standby letters of credit as of September 30, 2008. 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, 2008, 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. There was no change in the unfunded pension liability during the three month and nine month periods ended September 30, 2008 and 2007. The components of other comprehensive income for the three month and nine month periods ended September 30 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
In thousands	**2008**	**2007**	**2008**	**2007**
Unrealized holding gains (losses) on available for sale securities arising during the period	**$ (975)**	$ 3,423	**$ (4,606)**	$ 3,654
Reclassification of gains realized in net income	**(57)**		**(158)**	(10)
Net Unrealized Gains (Losses)	**(1,032)**	3,423	**(4,764)**	3,644
Tax effect	**(351)**	1,165	**(1,620)**	1,240
Other Comprehensive Income (Loss)	**$ (681)**	$ 2,258	**$ (3,144)**	$ 2,404

6. **Segment Information**

Russell Insurance Group, Inc. (RIG) is managed separately from the banking 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.

On January 5, 2005, the Corporation acquired 100 percent of Russell Insurance Group, Inc. The carrying amounts of the tangible assets acquired and the liabilities assumed on January 5, 2005, approximated their fair value. The excess of the acquisition cost over the fair value of the net assets acquired has been recorded as goodwill. The initial aggregate purchase price was $5,663,000, including certain capitalized costs.

ACNB CORPORATION

ITEM 1 - NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

In accordance with the terms of the acquisition, there was contingent consideration associated with this transaction of up to $3,000,000, payable in 2008 for the three-year period subject to performance criteria subsequent to the acquisition. Due to performance at a higher level than the performance criteria, the liability for this consideration was recorded at December 31, 2006, with a related increase in goodwill. Payment was made in the second quarter of 2008 after it was ascertained that the performance criteria had been met for the full three-year period; after which, the total aggregate purchase price was $8,663,000. In addition, on November 9, 2007, the Corporation entered into another three-year employment contract with Frank C. Russell, Jr., President and Chief Executive Officer of RIG, effective as of January 1, 2008.

In 2007, Russell Insurance Group acquired two additional books of business with an aggregate purchase price of $637,000. In 2008, Russell Insurance Group acquired an additional book of business with an aggregate purchase price of $1,860,000, of which $1,156,000 was paid during the third quarter of 2008. These amounts were recorded as an intangible asset and are being amortized over ten years on a straight line basis.

Segment information for the three and nine month periods ended September 30, 2008 and 2007, is as follows:

In thousands	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Commissions from insurance sales	**$ 939**	$ 962	**$ 3,100**	$ 3,287
Income before income taxes	**87**	177	**543**	867
Total assets			**$ 11,075**	$ 11,869

7. **Fair Value of Financial Instruments**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements. The new guidance is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years.

The primary effect of SFAS No. 157 on the Corporation was to expand the required disclosures pertaining to the methods used to determine fair values.

SFAS No. 157 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 under SFAS No. 157 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.

ACNB CORPORATION

ITEM 1 - NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

After reviewing FSP No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active , the Corporation determined that all securities held by the Corporation are traded in active markets and therefore did not use the guidance for determining values of financial assets in inactive markets. The following table summarizes the Corporation s valuation of assets and liabilities measured at fair value on a recurring basis, in accordance with the above SFAS No. 157 pricing observability as of September 30, 2008:

		Fair Value Measurements at Reporting Date		
In thousands	**Total**	**Level 1**	**Level 2**	**Level 3**
Securities available for sale	$ **231,346**	$ **1,070**	$ **230,276**	$
Loans accounted for under SFAS No. 114	**6,746**			**6,746**
Foreclosed real estate	**143**			**143**

Securities available for sale Fair values for securities available for sale were based upon a market approach. Securities that are debenture bonds and pass through mortgage-backed investments that are not quoted on an exchange, but are traded in active markets, were obtained through third-party data service providers who use matrix pricing on similar securities. The Corporation compares evaluations provided by more than one service provider to judge the adequacy of the estimated fair value.

Loans accounted for under SFAS No. 114 Loans included in the above table were those that were accounted for under SFAS No. 114, Accounting by Creditors for Impairment of a Loan , in which the Corporation has measured impairment 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 as determined under SFAS No. 114. The fair value decreased $6,294,000 from December 31, 2007, due to higher losses attributable to loans measured by current appraisals of the collateral underlying these loans and by movement of loans out of impaired loans requiring a valuation reserve. A roll forward of this activity is as follows:

In thousands	
Balance-December 31, 2007	$ **13,040**
Charged off	**(265)**
Settled or otherwise removed from impaired status	**(2,173)**
Payments made	**(43)**
Increase in valuation allowance	**(3,813)**
Balance-September 30, 2008	$ **6,746**

Foreclosed real estate Fair value of real estate acquired through foreclosure was based on independent third-party appraisals of the properties. These values were determined based on the sales prices of similar properties in the proximate vicinity.

During the period, there were no assets or liabilities that were required to be remeasured on a nonrecurring basis.

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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 negative of any of the foregoing 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. 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 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 the following 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 length of time the fair value has been below cost, the financial condition of the issuer, and the intent and ability of the Corporation to hold the securities until recovery. Declines in fair value that are determined to be other than temporary are charged against earnings.

SFAS No. 142, Goodwill and Other Intangible Assets , 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, 2007. If certain events occur which might indicate goodwill has been impaired, the goodwill is tested when such events occur. No such events occurred in 2008. 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 method over estimated useful lives of ten years.

New Accounting Pronouncements

FASB Statement No. 162

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles . This statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements. This statement is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles .The Corporation is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

FASB FSP 142-3

In April 2008, the FASB issued FASB Staff Position (FSP) 142-3, Determination of the Useful Life of Intangible Assets . This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets . The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R and other GAAP. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Corporation is currently evaluating the potential impact the new pronouncement will have on its consolidated financial statements.

FASB FSP 157-3

In October 2008, the FASB issued FSP No. 157-3, Determining the Fair Value of a Financial Asset When The Market for That Asset Is Not Active , to clarify the application of the provisions of SFAS 157 in an inactive market and how an entity would determine fair value in an inactive market. FSP 157-3 is effective immediately and applies to our September 30, 2008, financial statements. The Corporation determined that all securities held by the Corporation are traded in active markets and therefore did not use the guidance for determining values of financial assets in inactive markets.

RESULTS OF OPERATIONS

Quarter ended September 30, 2008, compared to quarter ended September 30, 2007

Executive Summary

Net income for three months ended September 30, 2008, was $484,000 compared to $2,082,000 for the same quarter in 2007, a decrease of $1,598,000 or 77%. Earnings per share decreased from $.35 in 2007 to $.08 in 2008. Net interest income increased $1,249,000 or 20%; however, the provision for loan losses increased $3,575,000, other income increased $178,000 or 7%, and other expenses increased $353,000 or 6%.

Net Interest Income

Net interest income totaled $7,550,000 during the quarter ended September 30, 2008, as compared to $6,301,000 for the same period in 2007, an increase of $1,249,000 or 20%. Net interest income increased due to a decrease in interest expense resulting from a reduction in volume of interest bearing liabilities in conjunction with a planned de-leveraging strategy, as well as from reductions in market rates associated with the turmoil in broader financial markets and Federal Reserve actions over the last four quarters. Declines in the Fed Funds Target Rate and other market driver rates are factors in rates the Corporation and other financial institutions in the local market pay for deposits. At the end of the third quarter of 2008, several of the core deposit rates continued at practical floors after the Federal Open Market Committee decreased the Fed Funds Target Rate by 325 basis points in the period from September 18, 2007, to April 30, 2008 (followed by another 50 basis point cut in early October 2008 that will impact net interest income in future quarters). Interest expense decreased $2,634,000 or 37%. The decrease in funding costs was partially offset by lower interest income, which decreased $1,385,000 or 10%. Interest income was lower as a result of investment securities maturities that were not reinvested, but instead used to pay off higher cost wholesale borrowings. Interest income also decreased due to declines in the Fed 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. For more information about interest rate risk, see Item 7A-Quantitative and Qualitative Disclosures about Market Risk in the Annual Report on Form 10-K dated December 31, 2007, and filed on March 14, 2008. Over the longer term, the Corporation continues its strategic direction to increase asset yield and interest income, while rebalancing the composition of earning assets and interest bearing liabilities.

The net interest spread for the third quarter of 2008 was 3.18% compared to 2.29% during the same period in 2007. Also comparing the third quarter of 2008 to 2007, the yield on interest earning assets decreased from 5.72% to 5.49% due to new loan originations at lower rates or existing loans with variable rate features repricing to lower rates; while the cost of interest bearing liabilities decreased by 0.99% due to lower market rates and an improvement in the mix of lower cost transaction accounts. The net interest margin was 3.49% for the third quarter of 2008 and 2.66% for the third quarter of 2007.

Average earning assets were $866,690,000 during the third quarter of 2008, a decrease of $79,129,000 from the average for the third quarter of 2007. Average interest bearing liabilities were $752,769,000 in the third quarter of 2008, a decrease of $87,992,000 from the same quarter in 2007. See the discussion above regarding the de-leveraging strategy that caused the decreases in assets and liabilities.

Provision for Loan Losses

The provision for loan losses was $3,600,000 in the third quarter of 2008 compared to $25,000 in the third quarter of 2007. The increase was a result of measured risk in the loan portfolio compared with the balance in the allowance for loan losses in light of strong loan growth and specific allocations necessary for certain commercial loans negatively impacted primarily by the sharp retraction in the housing market and/or the deteriorating national economy. 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 as further explained under the caption, Allowance for Loan Losses , in the Financial Condition section. For the third quarter of 2008, the Corporation had net charge-offs of $319,000, as compared to net charge-offs of $2,000 for the third quarter of 2007.

Other Income

Total other income was $2,619,000 for the three months ended September 30, 2008, up $178,000, or 7%, from the third quarter of 2007. Fees from deposit accounts and ATM/debit card revenue rose by $113,000, primarily due to an increase in the non-sufficient funds fee. Income from fiduciary activities, which include both institutional and personal trust management services, totaled $275,000 for the three months ended September 30, 2008, as compared to $253,000 during the third quarter of 2007, a 9% increase as a result of higher volume assets under management. Earnings on bank-owned life insurance increased by $37,000, or 16%, as a result of additional insurance coverage and higher crediting rates. The Corporation s insurance subsidiary, Russell

Insurance Group, Inc., experienced a revenue decrease of $23,000 or 2%. This decrease was due to a soft insurance market with lower premium rates and lost business from customers connected to the housing and construction sectors. Gains on sales of securities increased by $57,000 as securities were sold in the third quarter of 2008 to shorten duration.

Other Expenses

The largest component of other expenses is salaries and employee benefits, which increased by $395,000, or 12%, when comparing the third quarter of 2008 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;
- A change in the mix of employees that included higher paid revenue-producing personnel;
- Increased production-based incentive compensation for employees; and,
- Signing bonuses to four new commercial lenders and a new executive vice president hired in the quarter.

Also included in the increase was an expense of $21,000 from the 2008 implementation of EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Insurance Arrangements .

Net occupancy expense decreased by $29,000, or 5%, when comparing the third quarter of 2008 to the same period a year ago due to leasing space at the Corporation s Operations Center to a third party and lower repair expenditures. Equipment expense decreased by $38,000, or 7%, as a result of renegotiated outsourced processing arrangements.

Professional services expense totaled $238,000 during the third quarter of 2008, as compared to $216,000 for the same period in 2007, an increase of $22,000 or 10%. The increase was due in part to work in process in obtaining additional insurance books of business. Other tax expense, as well as supplies and postage, increased less than 1% when comparing the third quarter of both years.

Marketing expense decreased by $22,000, or 8%, due to higher expenditures in 2007 to highlight the banking subsidiary s 150th anniversary in that year. Otherwise, the Corporation strives in its marketing initiatives to heighten its franchise awareness, stress stability in a financial marketplace that is experiencing continued turmoil and promote specific products and services.

Other operating expenses increased $18,000, or 2%, in the third quarter of 2008, as compared to the third quarter of 2007, due in part to higher electronic data and delivery channel expense and corporate governance expense.

Income Tax Expense

The Corporation recognized an income benefit of $379,000 during the third quarter of 2008, as compared to $524,000 of income tax expense, or 20% of pre-tax income, during the same period in 2007. The income tax benefit in the third quarter of 2008 was the result of lower pre-tax income primarily due to the $3,600,000 in provision for loan losses expense during the quarter. 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, 2008 and 2007, each included historical and low-income housing tax credits of $172,000.

Nine months ended September 30, 2008, compared to nine months ended September 30, 2007

Executive Summary

Net income for the nine months ended September 30, 2008, was $5,022,000 compared to $5,814,000 for the same period in 2007, a decrease of $792,000 or 14%. Earnings per share decreased from $.97 in 2007 to $.84 in 2008. Net interest income increased $3,006,000 or 16%; provision for loan losses increased $4,105,000; other income increased $217,000 or 3%; and, other expenses increased $556,000 or 3%.

Net Interest Income

Net interest income totaled $21,497,000 during the nine months ended September 30, 2008, as compared to $18,491,000 for the same period in 2007, an increase of $3,006,000 or 16%. Net interest income increased due to a decrease in interest expense resulting from a reduction in wholesale borrowings during the second half of 2007 in conjunction with the previously mentioned de-leveraging strategy, as well as from reductions in market rates associated with the turmoil in broader financial markets.

Declines in the Fed Funds Target Rate and other market driver rates are factors in rates the Corporation and other financial institutions in the local market pay for deposits. At the end of the first nine months of 2008, several of the core deposit rates were at practical floors after the Federal Open Market Committee decreased the Fed Funds Target Rate by 325 basis points since September 2007. Interest expense decreased $5,504,000 or 28%. The decrease in funding costs was partially offset by lower interest income, which decreased $2,498,000 or 7%. Interest income was lower as a result of investment securities maturities that were not reinvested, but instead used to pay off borrowings and fund loans. Interest income also decreased due to declines in the Fed 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. For more information about interest rate risk, see Item 7A-Quantitative and Qualitative Disclosures about Market Risk in the Annual Report on Form 10-K dated December 31, 2007, and filed on March 14, 2008.

The net interest spread for the first nine months of 2008 was 3.07% compared to 2.36% during the same period in 2007. Also comparing the first nine months of 2008 to 2007, the yield on interest earning assets increased by 0.03% and the cost of interest bearing liabilities decreased by 0.68%. The increase in the yield on earning assets is due to the change in the mix of assets as loans comprise a higher portion of the total. The net interest margin was 3.39% for the first nine months of 2008 and 2.72% for the first nine months of 2007.

Average earning assets were $852,784,000 during the first nine months of 2008, a decrease of $64,252,000 from the average for the first nine months of 2007. Average interest bearing liabilities were $745,435,000 in the first nine months of 2008, a decrease of $69,591,000 from the same nine months in 2007. See the discussion above regarding the de-leveraging strategy that caused the decreases in assets and liabilities.

Provision for Loan Losses

The provision for loan losses was $4,270,000 in the first nine months of 2008 compared to $165,000 in the first nine months of 2007. The increase was a result of measured risk in the loan portfolio compared with the balance in the allowance for loan losses in light of strong loan growth and specific allocations necessary for certain commercial loans negatively impacted primarily by the sharp retraction in the housing market and/or the deteriorating national economy. 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 as further explained under the caption Allowance for Loan Losses , in the Financial Condition section. For the first nine months of 2008, the Corporation had net charge-offs of $500,000, as compared to net charge-offs of $3,000 for the first nine months of 2007.

Other Income

Total other income was $7,940,000 for the nine months ended September 30, 2008, up $217,000, or 3%, from the first nine months of 2007. Fees from deposit accounts and ATM/debit card revenue increased by $131,000, or 6%, primarily due to an upward adjustment in the service fee schedule effective in the third quarter of 2008. Income from fiduciary activities, which include both institutional and personal trust management services, totaled $804,000 for the nine months ended September 30, 2008, as compared to $680,000 during the first nine months of 2007, an 18% increase as a result of higher volume in assets under management. Earnings on bank-owned life insurance increased by $115,000, or 17%, as a result of additional insurance coverage and higher crediting rates. The Corporation s insurance subsidiary, Russell Insurance Group, Inc., experienced a revenue decrease of $187,000 or 6%. The decrease was mostly due to lower contingent or extra commission payments in 2008 from insurance carriers that are received in the first quarter of each year; however, ongoing revenue was also reduced due to a soft insurance market with lower premium rates and by loss of customers impacted by the downturn in the housing and construction sectors. Gains on sales of securities increased by $148,000 as securities were sold earlier in 2008 that were likely to be called later in 2008 and to shorten the duration of the portfolio.

Other Expenses

The largest component of other expenses is salaries and employee benefits, which increased by $748,000, or 8%, when comparing the first nine months of 2008 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;
- A change in the mix of employees that included higher paid revenue-producing staff;
- Increased production-based incentive compensation for employees; and,
- Signing bonuses to four new commercial lenders and a new executive vice president hired in the third quarter.

Also included in the increase was an expense of $63,000 from the 2008 implementation of EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Insurance Arrangements .

Net occupancy expense decreased by $74,000, or 4%, when comparing the first nine months of 2008 to the same period a year ago due to leasing unused space at the Corporation s Operations Center to a third party. Equipment expense decreased by $269,000, or 16%, as a result of renegotiated outsourced processing arrangements.

Professional services expense totaled $704,000 during the first nine months of 2008, as compared to $593,000 for the same period in 2007, an increase of $111,000 or 19%. The increase was due primarily to the outsourcing of technology project management, as well as internal audit, compliance and other similar work. Other tax expense increased 16% due to a refund of sales and use tax recognized in 2007. Postage decreased due to coding technology applied to outgoing mail.

Marketing expense decreased by $125,000, or 14%, due to higher expenditures in 2007 to highlight the banking subsidiary s 150th anniversary in that year. Otherwise, the Corporation strives in its marketing initiatives to heighten its franchise awareness, stress stability in a financial marketplace that is experiencing continued turmoil, and promote specific products and services.

Other operating expenses increased $101,000, or 3%, in the first nine months of 2008, as compared to the first nine months of 2007. Higher electronic data and delivery channel expenses and corporate governance expenditures were partially offset by lower deposit losses as a result of heightened fraud awareness and procedures.

Income Tax Expense

The Corporation recognized income taxes of $762,000, or 13.2% of pretax income, during the first nine months of 2008, as compared to $1,408,000, or 19.5% of pre-tax income, during the same period in 2007. 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, 2008 and 2007 included historical and low-income housing tax credits of $516,000 in both periods.

FINANCIAL CONDITION

Executive Summary

Assets totaled $936,698,000 at September 30, 2008, compared to $926,665,000 at December 31, 2007, and $1,006,210,000 at September 30, 2007. Average earning assets during the nine months ended September 30, 2008, decreased to $852,784,000 from $917,036,000 during the same period in 2007. Average interest bearing liabilities decreased in 2008 to $745,435,000 from $815,026,000 in 2007. See the discussion above regarding the de-leveraging strategy that caused these decreases.

Investment Securities

ACNB uses investment securities to generate interest and dividend income, manage interest rate risk, and provide liquidity. The investment portfolio is comprised of U.S. Government agencies (government-sponsored enterprises), tax-advantaged municipal, and high-grade corporate securities. These securities provide the appropriate characteristics with respect to yield and maturity relative to the management of the overall balance sheet. All mortgage-backed security investments are pass through instruments issued by the Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC), which guarantee the timely payment of principal on these investments. ACNB s prepurchase analysis of the borrowers in its FNMA and FHLMC loan pools reveal high credit scores, loans with conservative weighted average loan-to-value ratios and loans that are predominately owner-occupied. In addition, FNMA and FHLMC have been provided with strong support by the federal government, in effect guaranteeing this type of debt instrument. There is no exposure to subprime mortgages in the mortgage-backed securities.

At September 30, 2008, the securities balance included a net unrealized loss of $2,394,000, net of taxes, on available for sale securities versus a net unrealized gain of $749,000, net of taxes, at December 31, 2007. An increase in the yield curve relevant to the securities, increased supply (which widened spreads) caused by larger financial institutions selling for liquidity, and concern about the current health of the housing markets were significant factors that led to the decrease in the fair value of securities during the third quarter of 2008. Management conducted an evaluation for other than temporary impairment of investment securities, in which the fair value is below the adjusted historical cost, and did not identify any securities that are considered other than temporarily impaired. See Note 7 Fair Value of Financial Instruments in the Notes to Consolidated Financial Statements for more information about fair value.

Loans

Loans outstanding increased by $70,472,000, or 12.8%, from September 30, 2007, to September 30, 2008, and by $73,427,000, or 13.3%, from December 31, 2007, to September 30, 2008. The growth in loans is a result of lending to support existing and new customers. Compared to September 30, 2007, commercial loans grew by approximately $49,000,000 or 19%. Commercial loan growth is the result of the strategic plan to actively lend to businesses in the market area and to participate with other local institutions on commercial lending credits. Residential real estate mortgage lending increased by $17,000,000 or 7%. Home equity and other consumer lending increased by approximately $5,000,000, or 10%, as a result of promotional efforts.