ACNB CORP
Form 10-K
March 06, 2015

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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, DC 20549**

# FORM 10-K

**(Mark One)**

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

**For the fiscal year-ended December 31, 2014**

**OR**

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

**For the transition period from to**
**Commission file number 0-11783**

# ACNB CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Pennsylvania**<br>(State or other jurisdiction of incorporation or organization) | **23-2233457**<br>(I.R.S. Employer Identification No.) |
| **16 Lincoln Square, Gettysburg, Pennsylvania**<br>(Address of principal executive offices) | **17325**<br>(Zip Code) |

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

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

| **Title of each class** | **Name of each exchange on which registered** |
|---|---|
| Common Stock, $2.50 par value per share | The NASDAQ Stock Market, LLC |

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ý

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 ý No o

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 ý No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý

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. (Check One)

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer ý | Non-accelerated filer o<br>(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 Act). Yes o No ý

The aggregate market value of the voting stock held by nonaffiliates of the registrant at June 30, 2014, was approximately $113,225,680.

The number of shares of the registrant's common stock outstanding on March 6, 2015, was 6,015,650.

**Documents Incorporated by Reference**

Portions of the registrant's 2015 definitive Proxy Statement are incorporated by reference into Part III of this report.

**ACNB CORPORATION**

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## PART I

### FORWARD-LOOKING STATEMENTS

In addition to historical information, this Form 10-K contains forward-looking statements. Examples of forward-looking statements include, but are not limited to, (a) projections or statements regarding future earnings, expenses, net interest income, other income, earnings or loss per share, asset mix and quality, growth prospects, capital structure, and other financial terms, (b) statements of plans and objectives of management or the Board of Directors, and (c) statements of assumptions, such as economic conditions in the Corporation's market areas. Such forward-looking statements can be identified by the use of forward-looking terminology such as "believes", "expects", "may", "intends", "will", "should", "anticipates", or the 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. Such risks, uncertainties and other factors that could cause actual results and experience to differ from those projected include, but are not limited to, the following: the effects of governmental and fiscal policies, as well as legislative and regulatory changes; the effects of new laws and regulations, specifically the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act; impacts of the new capital and liquidity requirements of the Basel III standards; the effects of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters; ineffectiveness of the business strategy due to changes in current or future market conditions; future actions or inactions of the United States government, including the effects of short-and long-term federal budget and tax negotiations and a failure to increase the government debt limit or a prolonged shutdown of the federal government; the effects of economic deterioration and the prolonged economic malaise on current customers, specifically the effect of the economy on loan customers' ability to repay loans; the effects of competition, and of changes in laws and regulations on competition, including industry consolidation and development of competing financial products and services; the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities, and interest rate protection agreements, as well as interest rate risks; difficulties in acquisitions and integrating and operating acquired business operations, including information technology difficulties; challenges in establishing and maintaining operations in new markets; the effects of technology changes; volatilities in the securities markets; slow economic conditions; the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities; acts of war or terrorism; disruption of credit and equity markets; the ability to manage current levels of impaired assets; the loss of certain key officers; the ability to maintain the value and image of ACNB's brand and protect ACNB's intellectual property rights; continued relationships with major customers; and, potential impacts to ACNB from continually evolving cybersecurity and other technological risks and attacks, including additional costs, reputational damage, regulatory penalties, and financial losses. 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 Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

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## ITEM 1 BUSINESS

### ACNB CORPORATION

ACNB Corporation (the Corporation or ACNB) is a $1.1 billion financial holding company headquartered in Gettysburg, Pennsylvania. Through its banking and nonbanking subsidiaries, ACNB provides a full range of banking and financial services to individuals and businesses, including commercial and retail banking, trust and investment management, and insurance. ACNB's banking operations are conducted through its primary operating subsidiary, ACNB Bank, with twenty retail banking offices in Adams, Cumberland, Franklin and York Counties, Pennsylvania, as well as one loan production office in York County, Pennsylvania, as of December 31, 2014. The Corporation was formed in 1982, then became the holding company for Adams County National Bank (now ACNB Bank) in 1983.

On January 5, 2005, ACNB Corporation completed the acquisition of Russell Insurance Group, Inc. (RIG) and RIG began to operate as a separate subsidiary of ACNB Corporation. 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 subject to performance criteria for the three-year period 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 January 13, 2011, the Corporation entered into another three-year employment agreement with Frank C. Russell, Jr., President & Chief Executive Officer of RIG, effective as of January 1, 2011. That agreement is subject to automatic renewal for successive one-year periods beginning on the third anniversary date of the effective date, subject to the terms and conditions set forth in that agreement, unless either party notifies the other in writing at least 90 days prior to termination of the then current term of the party's desire to terminate the agreement.

Beginning in 2007, RIG acquired additional books of business and acquired Marks Insurance & Associates, Inc. Details regarding these acquisitions are included in the Notes to Consolidated Financial Statements, Note R "Acquisitions".

RIG is managed separately from the banking and related financial services that the Corporation offers and is reported as a separate segment. Financial information on this segment is included in the Notes to Consolidated Financial Statements, Note S "Segment and Related Information".

ACNB's major source of operating funds is dividends that it receives from its subsidiaries. ACNB's expenses consist principally of losses from low-income housing investments and interest paid on a term loan used to purchase RIG. Dividends that ACNB pays to stockholders consist of dividends declared and paid to ACNB by the subsidiary bank.

ACNB and its subsidiaries are not dependent upon a single customer or a small number of customers, the loss of which would have a material adverse effect on the Corporation. ACNB does not depend on foreign sources of funds, nor does it make foreign loans.

The common stock of ACNB is listed on The NASDAQ Capital Market under the symbol ACNB.

### BANKING SUBSIDIARY

*ACNB Bank*

On October 4, 2010, the banking subsidiary, then Adams County National Bank, completed the process of converting from a national banking association to a Pennsylvania state-chartered bank and trust company with the filing and effectiveness of its Articles of Conversion with the Pennsylvania Department of State. Accordingly, Adams County National Bank became ACNB Bank (Bank). Reasons

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for the conversion included the Corporation's belief that a state bank charter serves the needs of a community bank more effectively. The Pennsylvania Department of Banking and Securities focuses solely on Pennsylvania financial institutions, so there was an anticipation of a better understanding of the Bank and the environment in which it operates, as well as an enhanced level of communication. In addition, the Bank serves customers in four counties Adams, Cumberland, York and Franklin and the name of Adams County National Bank no longer served the organization well in expansion beyond Adams County.

ACNB Bank is a full-service commercial bank operating under charter from the Pennsylvania Department of Banking and Securities. The Bank's principal market area is Adams County, Pennsylvania, which is located in southcentral Pennsylvania. Adams County depends on agriculture, industry and tourism to provide employment for its residents. No single sector dominates the county's economy. At December 31, 2014, ACNB Bank had total assets of $1,077,000,000, total gross loans of $799,000,000, total deposits of $851,000,000, and total equity capital of $92,000,000.

The main office of the Bank is located at 16 Lincoln Square, Gettysburg, Pennsylvania. In addition to its main office, as of December 31, 2014, the Bank had thirteen branches in Adams County, four branches in York County, one branch in Cumberland County, and one branch in Franklin County, as well as a loan production office in York County, Pennsylvania. ACNB Bank's service delivery channels for its customers also include the ATM network, Customer Contact Center, and Online, Telephone and Mobile Banking. The Bank is subject to regulation and periodic examination by the Pennsylvania Department of Banking and Securities and the Federal Deposit Insurance Corporation (FDIC). The FDIC, as provided by law, insures the Bank's deposits.

Commercial lending includes commercial mortgages, real estate development and construction loans, accounts receivable and inventory financing, and agricultural and governmental loans. Consumer lending programs include home equity loans and lines of credit, automobile and recreational vehicle loans, manufactured housing loans, and personal lines of credit. Mortgage lending programs include personal residential mortgages, residential construction loans, and investment mortgage loans.

A trust is a legal fiduciary agreement whereby the ACNB Bank Trust Department is named as trustee of financial assets. As trustee, the Trust Department invests, protects, manages and distributes financial assets as defined in the agreement. Estate settlement governed by the last will and testament of an individual constitutes another part of the Trust Department business. One purpose of having a will is to name an executor to settle the estate. ACNB Bank has the knowledge and expertise to act as executor. Other services include, but are not limited to, those related to testamentary trusts, life insurance trusts, charitable remainder trusts, guardianships, powers of attorney, custodial accounts, and investment management and advisory accounts. Total trust assets under management were $165,000,000 at December 31, 2014.

**NONBANKING SUBSIDIARIES**

*Russell Insurance Group, Inc.*

In January 2005, ACNB Corporation acquired Russell Insurance Group, Inc. (RIG), a full-service insurance agency that offers a broad range of property and casualty, life, and health insurance to both commercial and individual clients. Based in Westminster, Maryland, RIG has served the needs of its clients since its founding as an independent insurance agency by Frank C. Russell, Jr. in 1978. With the acquisition of Marks Insurance & Associates, Inc. as of December 31, 2008, RIG operates a second office location in Germantown, Maryland. Total assets of RIG as of December 31, 2014, were $11,262,000.

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*BankersRe Insurance Group, SPC*

BankersRe Insurance Group, SPC (formerly Pennbanks Insurance Co., SPC) was organized in 2000 and holds an unrestricted Class "B" Insurer's License under Cayman Islands Insurance Law. The segregated portfolio was novated to a third party during 2012. This entity is not material to ACNB's financial condition or results of operations.

**MARKET AREA ECONOMIC FEATURES AND CONDITIONS**

ACNB Corporation, headquartered in Gettysburg, Pennsylvania, is the financial holding company for the wholly-owned subsidiaries of ACNB Bank, Gettysburg, Pennsylvania, and Russell Insurance Group, Inc., Westminster, Maryland. ACNB Bank serves its marketplace via a network of twenty retail banking offices located throughout Adams County, Pennsylvania, as well as in Dillsburg, Hanover and Spring Grove, York County, Pennsylvania, in Newville, Cumberland County, Pennsylvania, and in Chambersburg, Franklin County, Pennsylvania. In addition, the Bank operates a loan office in York, York County, Pennsylvania. Russell Insurance Group, Inc. offers a broad range of commercial and personal insurance lines with licenses in 36 states, including Pennsylvania and Maryland, through offices in Westminster, Carroll County, and Germantown, Montgomery County, Maryland. Accordingly, ACNB Corporation's major operations are in the more rural areas of the Harrisburg-Carlisle MSA and the York-Hanover MSA, along with all of Adams County, Pennsylvania, and parts of Franklin County, Pennsylvania. Approximately 60% of the population resides in areas designated rural. Major types of employers include those focused on manufacturing, education, healthcare, agriculture, tourism, and transportation/warehousing, as well as local governments. A material amount of land surrounding Gettysburg is under the control of the National Park Service, limiting certain types of development. Unemployment figures in the bank's market recently, and historically, have been better than those for Pennsylvania and the United States. Per capita and household incomes are generally under Pennsylvania averages.

**COMPETITION**

The financial services industry in ACNB's market area is highly competitive, including competition for similar products and services from commercial banks, credit unions, finance and mortgage companies, and other nonbank providers of financial services. Several of ACNB's competitors have legal lending limits that exceed those of ACNB's subsidiary bank, as well as funding sources in the capital markets that exceed ACNB's availability. The high level of competition has resulted from changes in the legal and regulatory environment, as well as from the economic climate, customer expectations, and service alternatives via the Internet. There are 80 publicly-traded banks in Pennsylvania, 20 have higher market share than ACNB. In addition, there are 18 thrift institutions and numerous credit unions in Pennsylvania, some with higher market share. Banks, thrifts, credit unions, and other financial service providers in northern Maryland are also competition.

**SUPERVISION AND REGULATION**

*Regulation of Bank Holding Company and Subsidiaries*

BANK HOLDING COMPANY ACT OF 1956 ACNB is a financial holding company and is subject to the regulations of the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956. Bank holding companies are required to file periodic reports with and are subject to examination by the Federal Reserve. The Federal Reserve has issued regulations under the Bank Holding Company Act that require a financial holding company to serve as a source of financial and managerial strength to its subsidiary bank. As a result, the Federal Reserve may require ACNB to stand ready to use its resources to provide adequate capital funds to the Bank during periods of financial stress or adversity.

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In addition, the Federal Reserve may require a financial holding company to end a nonbanking business if the nonbanking business constitutes a serious risk to the financial soundness and stability of any banking subsidiary of the financial holding company.

The Bank Holding Company Act prohibits ACNB from acquiring direct or indirect control of more than 5% of the outstanding voting stock of any bank, or substantially all of the assets of any bank, or merging with another bank holding company, without the prior approval of the Federal Reserve. The Bank Holding Company Act allows interstate bank acquisitions and interstate branching by acquisition and consolidation in those states that had not elected to opt out by the required deadline. The Pennsylvania Department of Banking and Securities also must approve any similar consolidation. Pennsylvania law permits Pennsylvania financial holding companies to control an unlimited number of banks.

Further, the Bank Holding Company Act restricts ACNB's nonbanking activities to those that are determined by the Federal Reserve Board to be financial in nature, incidental to such financial activity, or complementary to a financial activity. The Bank Holding Company Act does not place territorial restrictions on the activities of nonbanking subsidiaries of financial holding companies.

GRAMM-LEACH-BLILEY ACT OF 1999 (GLBA) The Gramm-Leach-Bliley Act of 1999 eliminated many of the restrictions placed on the activities of bank holding companies that become financial holding companies. Among other things, the Gramm-Leach-Bliley Act repealed certain Glass-Steagall Act restrictions on affiliations between banks and securities firms, and amended the Bank Holding Company Act to permit bank holding companies that are financial holding companies to engage in activities, and acquire companies engaged in activities, that are: financial in nature (including insurance underwriting, insurance company portfolio investment, financial advisory, securities underwriting, dealing and market-making, and merchant banking activities); incidental to financial activities; or, complementary to financial activities if the Federal Reserve determines that they pose no substantial risk to the safety or soundness of depository institutions or the financial system in general.

REGULATION W Transactions between a bank and its "affiliates" are quantitatively and qualitatively restricted under the Federal Reserve Act. The Federal Deposit Insurance Act applies Sections 23A and 23B to insured nonmember banks in the same manner and to the same extent as if they were members of the Federal Reserve System. The Federal Reserve has also issued Regulation W, which codifies prior regulations under Sections 23A and 23B of the Federal Reserve Act, and interpretative guidance with respect to affiliate transactions. Regulation W incorporates the exemption from the affiliate transaction rules, but expands the exemption to cover the purchase of any type of loan or extension of credit from an affiliate. Affiliates of a bank include, among other entities, the bank's holding company and companies that are under common control with the bank. ACNB Corporation and Russell Insurance Group, Inc. are considered to be affiliates of ACNB Bank.

USA PATRIOT ACT OF 2001 In October 2001, the USA Patriot Act of 2001 was enacted in response to the terrorist attacks in New York, Pennsylvania and Washington, D.C., which occurred on September 11, 2001. The Patriot Act is intended to strengthen U.S. law enforcement's and the intelligence communities' abilities to work cohesively to combat terrorism on a variety of fronts. The impact of the Patriot Act on financial institutions of all kinds is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

SARBANES-OXLEY ACT OF 2002 (SOA) In 2002, the Sarbanes-Oxley Act of 2002 became law. The stated goals of the SOA are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly-traded companies, and to protect

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investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities law.

The SOA is the most far-reaching U.S. securities legislation enacted in some time. The SOA generally applies to all companies, both U.S. and non-U.S., that file or are required to file periodic reports with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, or the Exchange Act.

The SOA includes very specific additional disclosure requirements and corporate governance rules, as well as requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance, and other related rules. The SOA represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

The SOA addresses, among other matters:

- Audit committees for all reporting companies;
- Certification of financial statements by the chief executive officer and the chief financial officer;
- The forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and senior officers in the twelve-month period following initial publication of any financial statements that later require restatement;
- A prohibition on insider trading during pension plan blackout periods;
- Disclosure of off-balance sheet transactions;
- A prohibition on personal loans to directors and officers;
- Expedited filing requirements for SEC Forms 4;
- Disclosure of a code of ethics and filing an SEC Form 8-K for a change or waiver of such code;
- "Real time" filing of periodic reports;
- Formation of a public accounting oversight board;
- Auditor independence; and,
- Increased criminal penalties for violations of securities laws.

The SEC has been delegated the task of enacting rules to implement various provisions of the SOA with respect to, among other matters, disclosure in periodic filings pursuant to the Exchange Act.

AMERICAN JOBS CREATION ACT OF 2004 In 2004, the American Jobs Creation Act was enacted as the first major corporate tax act in years. The act addresses a number of areas of corporate taxation including executive deferred compensation restrictions. The impact of the act on

ACNB is not material.

BANK SECRECY ACT (BSA) Under the Bank Secrecy Act, banks and other financial institutions are required to report to the Internal Revenue Service currency transactions of more than $10,000 or multiple transactions of which a bank is aware in any one day that aggregate in excess of $10,000 and to report suspicious transactions under specified criteria. Civil and criminal penalties are provided under the BSA for failure to file a required report, for failure to supply information required by the BSA, or for filing a false or fraudulent report.

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (DODD-FRANK) In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was

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signed into law. Dodd-Frank was intended to effect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank created the Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators new authority to take control of and liquidate financial firms. Dodd-Frank additionally created a new independent federal regulator to administer federal consumer protection laws. Dodd-Frank has had and will continue to have a significant impact on ACNB's business operations as its provisions take effect. It is expected that, as various implementing rules and regulations are released, they will increase ACNB's operating and compliance costs and could increase the Bank's interest expense. Among the provisions that are likely to affect ACNB are the following:

*Holding Company Capital Requirements*

Dodd-Frank requires the Federal Reserve to apply consolidated capital requirements to bank holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010, by a bank holding company with less than $15 billion in assets as of December 31, 2009. Dodd-Frank additionally requires that bank regulators issue countercyclical capital requirements so that the required amount of capital increases in times of economic expansion, consistent with safety and soundness. For further information, please refer to *Regulatory Capital Changes* in Management's Discussion and Analysis.

*Deposit Insurance*

Dodd-Frank permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to $250,000 per depositor. Dodd-Frank also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Dodd-Frank also eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

*Corporate Governance*

Dodd-Frank requires publicly-traded companies to give stockholders a non-binding vote on executive compensation at least every three years, a non-binding vote regarding the frequency of the vote on executive compensation at least every six years, and a non-binding vote on "golden parachute" payments in connection with approvals of mergers and acquisitions unless previously voted on by stockholders. The SEC has finalized the rules implementing these requirements which took effect on January 21, 2011. Additionally, Dodd-Frank directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of $1.0 billion, regardless of whether the company is publicly traded. Dodd-Frank also gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

*Prohibition Against Charter Conversions of Troubled Institutions*

Dodd-Frank prohibits a depository institution from converting from a state to a federal charter, or vice versa, while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the

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conversion application with its current federal regulator, which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating thereto.

*Interstate Branching*

Dodd-Frank authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks are able to enter new markets more freely.

*Limits on Interstate Acquisitions and Mergers*

Dodd-Frank precludes a bank holding company from engaging in an interstate acquisition the acquisition of a bank outside its home state unless the bank holding company is both well capitalized and well managed. Furthermore, a bank may not engage in an interstate merger with another bank headquartered in another state unless the surviving institution will be well capitalized and well managed. The previous standard in both cases was adequately capitalized and adequately managed.

*Limits on Interchange Fees*

Dodd-Frank amended the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over $10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer.

*Consumer Financial Protection Bureau*

Dodd-Frank created the independent federal agency called the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB, but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. Dodd-Frank authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, Dodd-Frank allows borrowers to raise certain defenses to foreclosure if they receive any loan other than a "qualified mortgage" as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

ABILITY-TO-REPAY AND QUALIFIED MORTGAGE RULE Pursuant to Dodd-Frank as highlighted above, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine the consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors

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when making the credit decision: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and, (8) credit history. Alternatively, the mortgage lender can originate "qualified mortgages", which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a "qualified mortgage" is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage, the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Loans which meet these criteria will be considered qualified mortgages and, as a result, generally protect lenders from fines or litigation in the event of foreclosure. Qualified mortgages that are "higher-priced" (e.g., subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not "higher-priced" (e.g., prime loans) are given a safe harbor of compliance. The impact of the final rule, and the subsequent amendments thereto, on the Corporation's lending activities and the Corporation's statements of income and condition are uncertain at this time; however, management will continue to monitor the implementation of the rule for any potential effects on the Corporation's business.

FEDERAL DEPOSIT INSURANCE CORPORATION ACT OF 1991   Under the Federal Deposit Insurance Corporation Act of 1991, any depository institution, including the subsidiary bank, is prohibited from paying any dividends, making other distributions or paying any management fees if, after such payment, it would fail to satisfy the minimum capital requirement.

FEDERAL RESERVE ACT   A subsidiary bank of a bank holding company is subject to certain restrictions and reporting requirements imposed by the Federal Reserve Act, including:

- Extensions of credit to the bank holding company, its subsidiaries, or principal shareholders;
- Investments in the stock or other securities of the bank holding company or its subsidiaries; and,
- Taking such stock or securities as collateral for loans.

COMMUNITY REINVESTMENT ACT OF 1977 (CRA)   Under the Community Reinvestment Act of 1977, the FDIC is required to assess the record of all financial institutions regulated by it to determine if these institutions are meeting the credit needs of the community, including low- and moderate-income neighborhoods, which they serve and to take this record into account in its evaluation of any application made by any of such institutions for, among other things, approval of a branch or other deposit facility, office relocation, merger, or acquisition of bank shares. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 amended the CRA to require, among other things, that the FDIC make publicly available the evaluation of a bank's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods. This evaluation includes a descriptive rating like "outstanding", "satisfactory", "needs to improve" or "substantial noncompliance" and a statement describing the basis for the rating. These ratings are publicly disclosed.

FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT OF 1991 (FDICIA)   The Federal Deposit Insurance Corporation Improvement Act requires that institutions be classified, based on their risk-based capital ratios into one of five defined categories, as follows and as

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illustrated below: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized.

| **Capital Category** | **Total Risk-Based Ratio** | **Tier 1 Risk-Based Ratio** | **Tier 1 Leverage Ratio** | **Under a Capital Order or Directive** |
|---|---|---|---|---|
| Well capitalized | ≥10.0% | ≥6.0% | ≥5.0% | NO |
| Adequately capitalized | ≥8.0% | ≥4.0% | ≥4.0%* | |
| Undercapitalized | <8.0% | <4.0% | <4.0%* | |
| Significantly undercapitalized | <6.0% | <3.0% | <3.0% | |
| Critically undercapitalized | | | <2.0% | |

* 3.0% for those banks having the highest available regulatory rating.

In the event an institution's capital deteriorates to the undercapitalized category or below, FDICIA prescribes an increasing amount of regulatory intervention, including the institution of a capital restoration plan and a guarantee of the plan by a parent institution and the placement of a hold on increases in assets, number of branches, or lines of business. If capital reaches the significantly or critically undercapitalized levels, further material restrictions can be imposed, including restrictions on interest payable on accounts, dismissal of management, and, in critically undercapitalized situations, appointment of a receiver. For well capitalized institutions, FDICIA provides authority for regulatory intervention when the institution is deemed to be engaging in unsafe or unsound practices or receives a less than satisfactory examination report rating for asset quality, management, earnings or liquidity. All but well capitalized institutions are prohibited from accepting brokered deposits without prior regulatory approval. Under FDICIA, financial institutions are subject to increased regulatory scrutiny and must comply with certain operational, managerial and compensation standards established by Federal Reserve Board regulations.

JUMPSTART OUR BUSINESS STARTUPS (JOBS) ACT In 2012, the JOBS Act became law. The JOBS Act is aimed at facilitating capital raising by smaller companies and banks and bank holding companies by implementing the following changes:

- Raising the threshold requiring registration under the Securities Exchange Act of 1934 (Exchange Act) for banks and bank holding companies from 500 to 2,000 holders of record;

- Raising the threshold for triggering deregistration under the Exchange Act for banks and bank holding companies from 300 to 1,200 holders of record;

- Raising the limit for Regulation A offerings from $5 million to $50 million per year and exempting some Regulation A offerings from state blue sky laws;

- Permitting advertising and general solicitation in Rule 506 and Rule 144A offerings;

- Allowing private companies to use "crowd funding" to raise up to $1 million in any 12-month period, subject to certain conditions; and,

- Creating a new category of issuer, called an "Emerging Growth Company", for companies with less than $1 billion in annual gross revenue, which will benefit from certain changes that reduce the cost and burden of carrying out an equity initial public offering (IPO) and complying with public company reporting obligations for up to five years.

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While the JOBS Act was not expected to have any immediate application to the Corporation, and since 2012 has had no material impact, management will continue to monitor the implementation rules for potential effects which might benefit the Corporation.

*Dividends*

ACNB is a legal entity separate and distinct from its subsidiary bank. ACNB's revenues, on a parent company only basis, result primarily from dividends paid to the Corporation by its subsidiaries. Federal and state laws regulate the payment of dividends by ACNB's subsidiary bank. For further information, please refer to *Regulation of Bank* below.

*Regulation of Bank*

The operations of the subsidiary bank are subject to statutes applicable to banks chartered under the banking laws of Pennsylvania, to state nonmember banks, and to banks whose deposits are insured by the FDIC. The subsidiary bank's operations are also subject to regulations of the Pennsylvania Department of Banking and Securities, Federal Reserve, and FDIC.

The Pennsylvania Department of Banking and Securities, which has primary supervisory authority over banks chartered in Pennsylvania, regularly examines banks in such areas as reserves, loans, investments, management practices, and other aspects of operations. The subsidiary bank is also subject to examination by the FDIC for safety and soundness, as well as consumer compliance. These examinations are designed for the protection of the subsidiary bank's depositors rather than ACNB's stockholders. The subsidiary bank must file quarterly and annual reports to the Federal Financial Institutions Examination Council, or FFIEC.

*Monetary and Fiscal Policy*

ACNB and its subsidiary bank are affected by the monetary and fiscal policies of government agencies, including the Federal Reserve and FDIC. Through open market securities transactions and changes in its discount rate and reserve requirements, the Board of Governors of the Federal Reserve exerts considerable influence over the cost and availability of funds for lending and investment. The nature of monetary and fiscal policies on future business and earnings of ACNB cannot be predicted at this time. From time to time, various federal and state legislation is proposed that could result in additional regulation of, and restrictions on, the business of ACNB and the subsidiary bank, or otherwise change the business environment. Management cannot predict whether any of this legislation will have a material effect on the business of ACNB.

**ACCOUNTING POLICY DISCLOSURE**

Disclosure of the Corporation's significant accounting policies is included in Note A "Summary of Significant Accounting Policies" in the Notes to Consolidated Financial Statements. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by management. Additional information is contained in Management's Discussion and Analysis for the most sensitive of these issues, including the provision and allowance for loan losses which is located in Note D "Loans" in the Notes to Consolidated Financial Statements.

Management, in determining the allowance for loan losses, makes significant judgments. Consideration is given to a variety of factors in establishing this estimate. In estimating the allowance for loan losses, management considers current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan review, financial and managerial strengths of borrowers, adequacy of collateral if collateral dependent or present value of future cash flows, and other relevant factors.

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**STATISTICAL DISCLOSURES**

The following statistical disclosures are included in Management's Discussion and Analysis, Item 7 hereof, and are incorporated by reference in this Item 1:

Interest Rate Sensitivity Analysis

Interest Income and Expense, Volume and Rate Analysis

Investment Portfolio

Loan Maturity and Interest Rate Sensitivity

Loan Portfolio

Allocation of Allowance for Loan Losses

Deposits

Short-Term Borrowings

**AVAILABLE INFORMATION**

The Corporation's reports, proxy statements, and other information are available for inspection and copying at the SEC Office of Investor Education and Advocacy at 100 F Street, N.E., Washington, DC 20549, at prescribed rates. The public may obtain information from the Office of Investor Education and Advocacy by calling the Commission at 1-800-SEC-0330. The Corporation is an electronic filer with the Commission. The Commission maintains a website that contains reports, proxy and information statements, and other information regarding registrants that file electronically with the Commission. The address of the Commission's website is http://www.sec.gov.

Upon a shareholder's written request, a copy of the Corporation's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K, as required to be filed with the SEC pursuant to Securities Exchange Act Rule 13a-1, may be obtained, without charge, from Lynda L. Glass, Executive Vice President, Secretary & Chief Governance Officer, ACNB Corporation, 16 Lincoln Square, P.O. Box 3129, Gettysburg, PA 17325, or visit our website at http://www.acnb.com and click on "ACNB Corporation".

**EMPLOYEES**

As of December 31, 2014, ACNB had 297 full-time equivalent employees. None of these employees are represented by a collective bargaining agreement, and ACNB believes it enjoys good relations with its personnel.

**ITEM 1A RISK FACTORS**

**ACNB IS SUBJECT TO INTEREST RATE RISK.**

ACNB's earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets, such as loans and securities, and interest expense paid on interest-bearing liabilities, such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond ACNB's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the amount of interest ACNB receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) ACNB's ability to originate loans and obtain deposits, (ii) the fair value of ACNB's financial assets and liabilities, and (iii) the average duration of ACNB's mortgage-backed securities portfolio. If the

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interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, ACNB's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on ACNB's results of operations, any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on ACNB's financial condition and results of operations.

**ACNB IS SUBJECT TO CREDIT RISK.**

As of December 31, 2014, approximately 45% of ACNB's loan portfolio consisted of commercial and industrial, construction, and commercial real estate loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because ACNB's loan portfolio contains a significant number of commercial and industrial, construction, and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses, and an increase in loan charge-offs, all of which could have a material adverse effect on ACNB's financial condition and results of operations.

**ACNB'S ALLOWANCE FOR LOAN LOSSES MAY BE INSUFFICIENT.**

ACNB maintains an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, that represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of the following: industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions; and, unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires ACNB to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans, and other factors, both within and outside of ACNB's control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review ACNB's allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. Further, if charge-offs in future periods exceed the allowance for loan losses, ACNB will need additional provisions to increase the allowance for loan losses. Any increases in the allowance for loan losses will result in a decrease in net income, and possibly capital, and may have a material adverse effect on ACNB's financial condition and results of operations.

**COMPETITION FROM OTHER FINANCIAL INSTITUTIONS MAY ADVERSELY AFFECT ACNB'S PROFITABILITY.**

ACNB's banking subsidiary faces substantial competition in originating both commercial and consumer loans. This competition comes principally from other banks, credit unions, mortgage banking companies, and other lenders. Many of its competitors enjoy advantages, including greater financial resources with higher lending limits, wider geographic presence, more branch office locations, the ability to offer a wider array of services or more favorable pricing alternatives, and lower origination

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and operating costs. This competition could reduce the Corporation's net income by decreasing the number and size of loans that its banking subsidiary originates and the interest rates it may charge on these loans.

In attracting business and consumer deposits, its banking subsidiary faces substantial competition from other insured depository institutions such as banks, savings institutions, and credit unions, as well as institutions offering uninsured investment alternatives, including money market funds. Many of ACNB's competitors enjoy advantages, including greater financial resources, wider geographic presence, more aggressive marketing campaigns, better brand recognition, more branch office locations, the ability to offer a wider array of services or more favorable pricing alternatives, and lower origination and operating costs. These competitors may offer higher interest rates than ACNB, which could decrease the deposits that it attracts or require it to increase its rates to retain existing deposits or attract new deposits. Increased deposit competition could adversely affect the subsidiary's ability to generate the funds necessary for lending operations. As a result, it may need to seek other sources of funds that may be more expensive to obtain and could increase its cost of funds.

ACNB's banking subsidiary also competes with nonbank providers of financial services, such as brokerage firms, consumer finance companies, credit unions, insurance agencies, and governmental organizations which may offer more favorable terms. Some of its nonbank competitors are not subject to the same extensive regulations that govern ACNB's banking operations. As a result, such nonbank competitors may have advantages over ACNB's banking subsidiary in providing certain products and services. This competition may reduce or limit ACNB's margins on banking services, reduce its market share, and adversely affect its earnings and financial condition.

**THE BASEL III CAPITAL REQUIREMENTS MAY REQUIRE ACNB TO MAINTAIN HIGHER LEVELS OF CAPITAL, WHICH COULD REDUCE ACNB'S PROFITABILITY.**

Basel III targets higher levels of base capital, certain capital buffers, and a migration toward common equity as the key source of regulatory capital. Although the new capital requirements are phased in over the next decade and may change substantially before final implementation, Basel III signals a growing effort by domestic and international bank regulatory agencies to require financial institutions, including depository institutions, to maintain higher levels of capital. The direction of the Basel III implementation activities or other regulatory viewpoints could require additional capital to support our business risk profile prior to final implementation of the Basel III standards. If ACNB and the subsidiary bank are required to maintain higher levels of capital, ACNB and the subsidiary bank may have fewer opportunities to invest capital into interest-earning assets, which could limit the profitable business operations available to ACNB and the subsidiary bank and adversely impact ACNB's financial condition and results of operations.

**THE CORPORATION'S OPERATIONS OF ITS BUSINESS, INCLUDING ITS TRANSACTIONS WITH CUSTOMERS, ARE INCREASINGLY DONE VIA ELECTRONIC MEANS, AND THIS HAS INCREASED ITS RISKS RELATED TO CYBERSECURITY.**

The Corporation is exposed to the risk of cyber-attacks in the normal course of business. In addition, the Corporation is exposed to cyber-attacks on vendors and merchants that affect the Corporation and its customers. In general, cyber incidents can result from deliberate attacks or unintentional events. The Corporation has observed an increased level of attention in the industry focused on cyber-attacks that include, but are not limited to, gaining unauthorized access to digital systems for purposes of misappropriating assets or sensitive information, corrupting data, or causing operational disruption. To combat against these attacks, policies and procedures are in place to prevent or limit the effect of the possible security breach of its information systems. While ACNB maintains insurance coverage that may, subject to policy terms and conditions including significant self-insured deductibles, cover certain aspects of cyber risks, such insurance coverage may be insufficient to cover

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all losses. While the Corporation has not incurred any material losses related to cyber-attacks, nor is it aware of any specific or threatened cyber incidents as of the date of this report, it may incur substantial costs and suffer other negative consequences if it falls victim to successful cyber-attacks. Such negative consequences could include remediation costs that may include liability for stolen assets or information and repairing system damage that may have been caused; deploying additional personnel and protection technologies, training employees, and engaging third-party experts and consultants; lost revenues resulting from unauthorized use of proprietary information or the failure to retain or attract customers following an attack; disruption or failures of physical infrastructure, operating systems or networks that support ACNB's business and customers resulting in the loss of customers and business opportunities; additional regulatory scrutiny and possible regulatory penalties; litigation; and, reputational damage adversely affecting customer or investor confidence.

**ACNB'S CONTROLS AND PROCEDURES MAY FAIL OR BE CIRCUMVENTED.**

Management regularly reviews and updates ACNB's internal controls, disclosure controls and procedures, as well as corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of ACNB's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on ACNB's business, financial condition, and results of operations.

**ACNB'S ABILITY TO PAY DIVIDENDS DEPENDS PRIMARILY ON DIVIDENDS FROM ITS BANKING SUBSIDIARY, WHICH ARE SUBJECT TO REGULATORY LIMITS AND THE BANKING SUBSIDIARY PERFORMANCE.**

ACNB is a financial holding company and its operations are conducted by its subsidiaries. Its ability to pay dividends depends on its receipt of dividends from its subsidiaries. Dividend payments from its banking subsidiary are subject to legal and regulatory limitations, generally based on net profits and retained earnings, imposed by the various banking regulatory agencies. The ability of its subsidiaries to pay dividends is also subject to their profitability, financial condition, capital expenditures, and other cash flow requirements. There is no assurance that its subsidiaries will be able to pay dividends in the future or that ACNB will generate adequate cash flow to pay dividends in the future. ACNB's failure to pay dividends on its common stock could have a material adverse effect on the market price of its common stock.

**ACNB'S PROFITABILITY DEPENDS SIGNIFICANTLY ON ECONOMIC CONDITIONS IN THE COMMONWEALTH OF PENNSYLVANIA AND THE STATE OF MARYLAND.**

ACNB's success depends primarily on the general economic conditions of the Commonwealth of Pennsylvania, the State of Maryland, and the specific local markets in which ACNB operates. Unlike larger national or other regional banks that are more geographically diversified, ACNB provides banking and financial services to customers primarily in the southcentral Pennsylvania and northern Maryland region of the country. The local economic conditions in these areas have a significant impact on the demand for ACNB's products and services, as well as the ability of ACNB's customers to repay loans, the value of the collateral securing the loans, and the stability of ACNB's deposit funding sources. A significant decline in general economic conditions caused by inflation, recession, acts of terrorism, outbreak of hostilities or other international or domestic occurrences, unemployment, changes in securities markets, or other factors could impact these local economic conditions and, in turn, have a material adverse effect on ACNB's financial condition and results of operations.

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**THE EARNINGS OF FINANCIAL SERVICES COMPANIES ARE SIGNIFICANTLY AFFECTED BY GENERAL BUSINESS AND ECONOMIC CONDITIONS.**

ACNB's operations and profitability are impacted by general business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, money supply, political issues, legislative and regulatory changes, fluctuations in both debt and equity capital markets, broad trends in industry and finance, and the strength of the U.S. economy and the local economies in which ACNB operates, all of which are beyond ACNB's control. Deterioration in economic conditions could result in an increase in loan delinquencies and non-performing assets, decreases in loan collateral values, and a decrease in demand for ACNB's products and services, among other things, any of which could have a material adverse impact on ACNB's financial condition and results of operations.

The regulatory environment for the financial services industry is being significantly impacted by financial regulatory reform initiatives in the United States and elsewhere, including Dodd-Frank and regulations promulgated to implement it.

Dodd-Frank, which was signed into law on July 21, 2010, comprehensively reforms the regulation of financial institutions, products and services. Dodd-Frank requires various federal regulatory agencies to implement numerous rules and regulations. Because the federal agencies are granted broad discretion in drafting these rules and regulations, many of the details and the impact of Dodd-Frank may not be known for many months or years.

While much of how the Dodd-Frank and other financial industry reforms will change ACNB's current business operations depends on the specific regulatory reforms and interpretations, many of which have yet to be released or finalized, it is clear that the reforms, both under Dodd-Frank and otherwise, will have a significant effect on the entire industry. Although Dodd-Frank and other reforms will affect a number of the areas in which ACNB does business, it is not clear at this time the full extent of the adjustments that will be required and the extent to which ACNB will be able to adjust its businesses in response to the requirements. Although it is difficult to predict the magnitude and extent of these effects at this stage, ACNB believes compliance with Dodd-Frank and implementing its regulations and initiatives will negatively impact revenue and increase the cost of doing business, both in terms of transition expenses and on an ongoing basis, and it may also limit ACNB's ability to pursue certain business opportunities.

**NEW LINES OF BUSINESS OR NEW PRODUCTS AND SERVICES MAY SUBJECT ACNB TO ADDITIONAL RISKS.**

From time to time, ACNB may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services, ACNB may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business and/or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of ACNB's system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business and new products or services could have a material adverse effect on ACNB's business, financial condition, and results of operations.

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**ACNB MAY NOT BE ABLE TO ATTRACT AND RETAIN SKILLED PEOPLE.**

ACNB's success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities engaged in by ACNB can be intense, and ACNB may not be able to hire people or to retain them. The unexpected loss of services of one or more of ACNB's key personnel could have a material adverse impact on ACNB's business because the Corporation would no longer have the benefit of their skills, knowledge of ACNB's market, as well as years of industry experience, and it would be difficult to promptly find qualified replacement personnel. ACNB currently has employment agreements, including covenants not to compete, with the following named executive officers: its President & Chief Executive Officer; Executive Vice President, Secretary & Chief Governance Officer; Executive Vice President, Treasurer & Chief Financial Officer; the Executive Vice President of Banking Services of ACNB Bank; and, the President & Chief Executive Officer of Russell Insurance Group, Inc.

**ACNB IS SUBJECT TO CLAIMS AND LITIGATION PERTAINING TO FIDUCIARY RESPONSIBILITY.**

From time to time, customers make claims and take legal action pertaining to ACNB's performance of its fiduciary responsibilities. Whether customer claims and legal action related to ACNB's performance of its fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to ACNB, they may result in significant financial liability and/or adversely affect the market perception of ACNB and its products and services, as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on ACNB's business, which, in turn, could have a material adverse effect on ACNB's financial condition and results of operations.

**THE TRADING VOLUME IN ACNB'S COMMON STOCK IS LESS THAN THAT OF OTHER LARGER FINANCIAL SERVICES COMPANIES.**

ACNB's common stock trades on NASDAQ, and the trading volume in its common stock is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of ACNB's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which ACNB has no control. Given the lower trading volume of ACNB's common stock, significant sales of ACNB's common stock, and the expectation of these sales, could cause ACNB's stock price to fall.

**ACNB OPERATES IN A HIGHLY REGULATED ENVIRONMENT AND MAY BE ADVERSELY AFFECTED BY CHANGES IN FEDERAL, STATE AND LOCAL LAWS AND REGULATIONS.**

ACNB, primarily through its banking subsidiary, is subject to extensive regulation, supervision and/or examination by federal and state banking authorities. Any change in applicable regulations or federal, state or local legislation could have a substantial impact on ACNB and its operations. Additional legislation and regulations that could significantly affect ACNB's powers, authority and operations may be enacted or adopted in the future, which could have a material adverse effect on its financial condition and results of operations. Further, regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws by banks and bank and financial holding companies in the performance of their supervisory and enforcement duties. The exercise of regulatory authority may have a negative impact on ACNB's financial condition and results of operations.

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Like other financial holding companies and financial institutions, ACNB must comply with significant anti-money laundering and anti-terrorism laws. Under these laws, ACNB is required, among other things, to enforce a customer identification program and file currency transaction and suspicious activity reports with the federal government. Government agencies have substantial discretion to impose significant monetary penalties on institutions which fail to comply with these laws or make required reports. While ACNB has policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur.

**THE SOUNDNESS OF OTHER FINANCIAL INSTITUTIONS MAY ADVERSELY AFFECT ACNB.**

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. ACNB has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and institutional clients. Many of these transactions expose ACNB to credit risk in the event of a default by a counterparty or client. In addition, ACNB's credit risk may be exacerbated when the collateral held by ACNB cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the credit exposure due to ACNB. Any such losses could have a material adverse effect on ACNB's financial condition and results of operations.

**MARKET VOLATILITY MAY HAVE MATERIALLY ADVERSE EFFECTS ON ACNB'S LIQUIDITY AND FINANCIAL CONDITION.**

The capital and credit markets have experienced extreme volatility and disruption. Over the last several years, in some cases, the markets have exerted downward pressure on stock prices, security prices, and credit capacity for certain issuers without regard to those issuers' underlying financial strength. If the market disruption and volatility returns, there can be no assurance that ACNB will not experience adverse effects, which may be material, on its liquidity, financial condition, and profitability.

**ACNB MAY NEED OR BE COMPELLED TO RAISE ADDITIONAL CAPITAL IN THE FUTURE WHICH COULD DILUTE SHAREHOLDERS OR BE UNAVAILABLE WHEN NEEDED OR AT UNFAVORABLE TERMS.**

ACNB's regulators or market conditions may require it to increase its capital levels. If ACNB raises capital through the issuance of additional shares of its common stock or other securities, it would likely dilute the ownership interests of current investors and would likely dilute the per share book value and earnings per share of its common stock. Furthermore, it may have an adverse impact on ACNB's stock price. New investors may also have rights, preferences and privileges senior to ACNB's current shareholders, which may adversely impact its current shareholders. ACNB's ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside its control, and on its financial performance. Accordingly, ACNB cannot be assured of its ability to raise additional capital on terms and time frames acceptable to it or to raise additional capital at all. If ACNB cannot raise additional capital in sufficient amounts when needed, its ability to comply with regulatory capital requirements could be materially impaired. Additionally, the inability to raise capital in sufficient amounts may adversely affect ACNB's operations, financial condition, and results of operations.

**ACNB'S FUTURE ACQUISITIONS COULD DILUTE SHAREHOLDER OWNERSHIP AND MAY CAUSE IT TO BECOME MORE SUSCEPTIBLE TO ADVERSE ECONOMIC EVENTS.**

ACNB may use its common stock to acquire other companies or make investments in banks and other complementary businesses in the future. ACNB may issue additional shares of common stock to pay for future acquisitions, which would dilute current investors' ownership interest in ACNB. Future business acquisitions could be material to ACNB, and the degree of success achieved in acquiring and integrating these businesses into ACNB could have a material effect on the value of ACNB's common stock. In addition, any acquisition could require it to use substantial cash or other liquid assets or to incur debt. In those events, ACNB could become more susceptible to economic downturns and competitive pressures.

**PENNSYLVANIA BUSINESS CORPORATION LAW AND VARIOUS ANTI-TAKEOVER PROVISIONS UNDER ACNB'S ARTICLES AND BYLAWS COULD IMPEDE THE TAKEOVER OF ACNB.**

Various Pennsylvania laws affecting business corporations may have the effect of discouraging offers to acquire ACNB, even if the acquisition would be advantageous to shareholders. In addition, ACNB has various anti-takeover measures in place under its articles of incorporation and bylaws, including a supermajority vote requirement for mergers, a staggered Board of Directors, and the absence of cumulative voting. Any one or more of these measures may impede the takeover of ACNB without the approval of the Board of Directors and may prevent shareholders from taking part in a transaction in which they could realize a premium over the current market price of ACNB common stock.

**IF ACNB CONCLUDES THAT THE DECLINE IN VALUE OF ANY OF ITS INVESTMENT SECURITIES IS AN OTHER-THAN-TEMPORARY IMPAIRMENT, ACNB IS REQUIRED TO WRITE DOWN THE VALUE OF THAT SECURITY THROUGH A CHARGE TO EARNINGS.**

ACNB reviews its investment securities portfolio at each quarter-end to determine whether the fair value is below the current carrying value. When the fair value of any of its investment securities has declined below its carrying value, ACNB is required to assess whether the decline is an other-than-temporary impairment. If ACNB determines that the decline is an other-than-temporary impairment, it is required to write down the value of that security through a charge to earnings for credit related impairment. Non-credit related reductions in the value of a security do not require a write down of the value through earnings unless ACNB intends to, or is required to, sell the security. Changes in the expected cash flows related to the credit related piece of the investment of a security in ACNB's investment portfolio or a prolonged price decline may result in ACNB's conclusion in future periods that an impairment is other than temporary, which would require a charge to earnings to write down the security to fair value. Due to the complexity of the calculations and assumptions used in determining whether an asset has an impairment that is other than temporary, the impairment disclosed may not accurately reflect the actual impairment in the future.

**ACNB IS SUBJECT TO POTENTIAL IMPAIRMENT OF GOODWILL AND INTANGIBLES.**

RIG has certain long-lived assets including purchased intangible assets subject to amortization, such as insurance books of business, and associated goodwill assets which are reviewed for impairment annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the statement of condition and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

Goodwill, which has an indefinite useful life, is evaluated for impairment annually and is evaluated for impairment more frequently if events and circumstances indicate that the asset might be impaired. During the quarter ended June 30, 2012, the Corporation changed its method of applying ASC Topic 350, *Intangibles Goodwill and Other*, such that the annual goodwill impairment testing date was changed from December 31 to October 1. This new testing date is preferable, because it allows the Corporation more time to accurately complete its impairment testing process, in order to incorporate

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the results in the annual consolidated financial statements. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. The goodwill impairment analysis currently used by the Corporation is a two-step test. The first step, used to identify potential impairment, involves comparing the reporting unit's estimated fair value to its carrying value, including goodwill. If the estimated fair value of the reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment. If required, the second step involves calculating an implied fair value of goodwill for the reporting unit for which the first step indicated potential impairment. The implied fair value of goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit to a group of likely buyers whose cash flow estimates could differ from those of the reporting entity, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill assigned to the reporting unit exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess. Subsequent reversal of goodwill impairment losses is not permitted. ACNB performs an annual evaluation to determine if there is goodwill impairment.

**ACNB IS SUBJECT TO ENVIRONMENTAL LIABILITY RISK ASSOCIATED WITH LENDING ACTIVITIES.**

A significant portion of ACNB's banking subsidiary loan portfolio is secured by real property. During the ordinary course of business, ACNB may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, ACNB may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require ACNB to incur substantial expense and may materially reduce the affected property's value or limit ACNB's ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase ACNB's exposure to environmental liability. Although ACNB has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on ACNB's financial condition and results of operations.

**THE SEVERITY AND DURATION OF A FUTURE DOWNTURN AND THE COMPOSITION OF THE BANKING SUBSIDIARY'S LOAN PORTFOLIO COULD IMPACT THE LEVEL OF LOAN CHARGE-OFFS AND THE PROVISION FOR LOAN LOSSES AND MAY AFFECT ACNB'S NET INCOME OR LOSS.**

Lending money is a substantial part of ACNB's business through its banking subsidiary. However, every loan that ACNB makes carries a certain risk of non-payment. ACNB cannot assure that its allowance for loan losses will be sufficient to absorb actual loan losses. ACNB also cannot assure that it will not experience significant losses in its loan portfolio that may require significant increases to the allowance for loan losses in the future.

Although ACNB evaluates every loan that it makes against its underwriting criteria, ACNB may experience losses by reasons of factors beyond its control. Some of these factors include changes in market conditions affecting the value of real estate and unexpected problems affecting the creditworthiness of ACNB's borrowers.

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ACNB determines the adequacy of its allowance for loan losses by considering various factors, including:

- An analysis of the risk characteristics of various classifications of loans;
- Previous loan loss experience;
- Specific loans that would have loan loss potential;
- Delinquency trends;
- Estimated fair value of the underlying collateral;
- Current economic conditions;
- The views of ACNB's regulators;
- Reports of internal auditors;
- Reports of external auditors;
- Reports of loan reviews conducted by independent organizations; and,
- Geographic and industry loan concentrations.

Local economic conditions could impact the loan portfolio of ACNB. For example, an increase in unemployment, a decrease in real estate values, or increases in interest rates, as well as other factors, could weaken the economies of the communities ACNB serves. Weakness in the market areas served by ACNB could depress the Corporation's earnings and, consequently, its financial condition because:

- Borrowers may not be able to repay their loans;
- The value of the collateral securing ACNB's loans to borrowers may decline; and/or,
- The quality of ACNB's loan portfolio may decline.

Although, based on the aforementioned procedures implemented by ACNB, management believes the current allowance for loan losses is adequate, ACNB may have to increase its provision for loan losses should local economic conditions deteriorate which could negatively impact its financial condition and results of operations.

**CHANGES IN REAL ESTATE VALUES MAY ADVERSELY IMPACT ACNB'S BANKING SUBSIDIARY LOANS THAT ARE SECURED BY REAL ESTATE.**

A significant portion of ACNB's banking subsidiary loan portfolio consists of residential and commercial mortgages, as well as consumer loans, secured by real estate. These properties are concentrated in Adams County, Pennsylvania. Real estate values and real estate markets generally are affected by, among other things, changes in national, regional or local economic conditions, fluctuations in interest rates, the availability of loans to potential purchasers, changes in the tax laws and other government statutes, regulations and policies, and acts of nature. If real estate prices decline, particularly in ACNB's market area, the value of the real estate collateral securing ACNB's loans could be reduced. This reduction in the value of the collateral could increase the number of non-performing loans and could have a material adverse impact on ACNB's financial condition and results of operations.

**ACNB'S INFORMATION SYSTEMS MAY EXPERIENCE AN INTERRUPTION OR BREACH IN SECURITY.**

ACNB relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in

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ACNB's customer relationship management, general ledger, deposit, loan and other systems. While ACNB has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. Although ACNB maintains insurance coverage that may, subject to policy terms and conditions including significant self-insured deductibles, cover certain aspects of cyber risks, such insurance coverage may be insufficient to cover all losses. The occurrence of any failures, interruptions or security breaches of ACNB's information systems could damage ACNB's reputation, adversely affecting customer or investor confidence, result in a loss of customer business, subject ACNB to additional regulatory scrutiny and possible regulatory penalties, or expose ACNB to civil litigation and possible financial liability, any of which could have a material adverse effect on ACNB's financial condition and results of operations.

**ACNB CONTINUALLY ENCOUNTERS TECHNOLOGICAL CHANGE.**

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. ACNB's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in ACNB's operations. Many of ACNB's competitors have substantially greater resources to invest in technological improvements. ACNB may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on ACNB's business and, in turn, ACNB's financial condition and results of operations.

**FINANCIAL SERVICES COMPANIES DEPEND ON THE ACCURACY AND COMPLETENESS OF INFORMATION ABOUT CUSTOMERS AND COUNTERPARTIES.**

In deciding whether to extend credit or enter into other transactions, ACNB may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports, and other financial information. ACNB may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports, or other financial information could have a material adverse impact on ACNB's business and, in turn, ACNB's financial condition and results of operations.

**CONSUMERS MAY DECIDE NOT TO USE BANKS TO COMPLETE THEIR FINANCIAL TRANSACTIONS.**

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds in brokerage accounts or mutual funds that would have historically been held as bank deposits. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as "disintermediation", could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on ACNB's financial condition and results of operations.

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**FUTURE ECONOMIC CONDITIONS MAY ADVERSELY AFFECT SECONDARY SOURCES OF LIQUIDITY.**

In addition to primary sources of liquidity in the form of deposits and principal and interest payments on outstanding loans and investments, ACNB maintains secondary sources that provide it with additional liquidity. These secondary sources include secured and unsecured borrowings from sources such as the Federal Reserve Bank, Federal Home Loan Bank of Pittsburgh, and third-party commercial banks. However, market liquidity conditions have been negatively impacted by past disruptions in the capital markets and could, in the future, have a negative impact on ACNB's secondary sources of liquidity.

**SEVERE WEATHER, NATURAL DISASTERS, ACTS OF WAR OR TERRORISM, AND OTHER EXTERNAL EVENTS COULD SIGNIFICANTLY IMPACT ACNB'S BUSINESS.**

The unpredictable nature of events such as severe weather, natural disasters, acts of war or terrorism, and other adverse external events could have a significant impact on ACNB's ability to conduct business. If any of its financial, accounting, network or other information processing systems fail or have other significant shortcomings due to external events, ACNB could be materially adversely affected. Third parties with which ACNB does business could also be sources of operational risk to ACNB, including the risk that the third parties' own network and information processing systems could fail. Any of these occurrences could materially diminish ACNB's ability to operate one or more of the Corporation's businesses, or result in potential liability to clients, reputational damage, and regulatory intervention, any of which could materially adversely affect ACNB. Such events could affect the stability of ACNB's deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, impair ACNB's liquidity, cause significant property damage, result in loss of revenue, and/or cause ACNB to incur additional expenses.

ACNB may be subject to disruptions or failures of the financial, accounting, network and other information processing systems arising from events that are wholly or partially beyond ACNB's control, which may include, for example, computer viruses, electrical or telecommunications outages, natural disasters, disease pandemics, damage to property or physical assets, or terrorist acts. ACNB has developed a comprehensive business continuity plan which includes plans to maintain or resume operations in the event of an emergency, such as a power outage or disease pandemic, and contingency plans in the event that operations or systems cannot be resumed or restored. The business continuity plan is updated as needed, periodically reviewed, and components are regularly tested. ACNB also reviews and evaluates the business continuity plans of critical third-party service providers. While ACNB believes its business continuity plan and efforts to evaluate the business continuity plans of critical third-party service providers help mitigate risks, disruptions or failures affecting any of these systems may cause interruptions in service to customers, damage to ACNB's reputation, and loss or liability to the Corporation.

**FUTURE CREDIT DOWNGRADES OF THE UNITED STATES GOVERNMENT DUE TO ISSUES RELATING TO DEBT AND THE DEFICIT MAY ADVERSELY AFFECT ACNB.**

As a result of past difficulties of the federal government to reach agreement over federal debt and issues connected with the debt ceiling, certain rating agencies placed the United States government's long-term sovereign debt rating on their equivalent of negative watch and announced the possibility of a rating downgrade. The rating agencies, due to constraints related to the rating of the United States, also placed government-sponsored enterprises in which ACNB invests and receives lines of credit on negative watch and a downgrade of the United States government's credit rating would trigger a similar downgrade in the credit rating of these government-sponsored enterprises. Furthermore, the credit rating of other entities, such as state and local governments, may also be downgraded should the United States government's credit rating be downgraded. The impact that a credit rating downgrade

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may have on the national and local economy could have an adverse effect on ACNB's financial condition and results of operations.

**ACNB'S BANKING SUBSIDIARY MAY BE REQUIRED TO PAY HIGHER FDIC INSURANCE PREMIUMS OR SPECIAL ASSESSMENTS WHICH MAY ADVERSELY AFFECT ITS EARNINGS.**

Poor economic conditions and the resulting bank failures have increased the costs of the FDIC and adversely impacted its Deposit Insurance Fund. Additional bank failures may prompt the FDIC to increase its premiums or to issue special assessments. ACNB is generally unable to control the amount of premiums or special assessments that its banking subsidiary is required to pay for FDIC insurance. Any future changes in the calculation or assessment of FDIC insurance premiums may have a material adverse effect on ACNB's financial condition and results of operations.

**INCOME TAXATION CHANGES COULD HAVE NEGATIVE EFFECTS ON RESULTS OF OPERATIONS AND ASSET VALUES.**

Discussions of proposed major overhauls of the federal corporate tax code could result in unknown and unpredictable effects on ACNB's results of operations and value of assets. Proposals that would lower the corporate tax rate and, at the same time, reduce certain deductions from taxable income are aimed to increase overall revenue from corporate taxation. For example, reducing the tax deductibility of state and local government investments and loans would increase income tax expense and could perhaps decrease the value of those assets. Lowering tax rates would decrease the value of certain deferred tax assets. In addition, changes to individual income tax laws could have the effect of lowering demand for important sources of lending and revenue to ACNB, such as residential mortgages.

**THE INCREASING USE OF SOCIAL MEDIA PLATFORMS PRESENTS NEW RISKS AND CHALLENGES AND THE INABILITY OR FAILURE TO RECOGNIZE, RESPOND TO, AND EFFECTIVELY MANAGE THE ACCELERATED IMPACT OF SOCIAL MEDIA COULD MATERIALLY ADVERSELY IMPACT ACNB'S BUSINESS.**

There has been a marked increase in the use of social media platforms, including weblogs (blogs), social media websites, and other forms of Internet-based communications which allow individuals access to a broad audience of consumers and other interested persons. Social media practices in the banking industry are evolving, which creates uncertainty and risk of noncompliance with regulations applicable to ACNB's business. Consumers value readily available information concerning businesses and their goods and services and often act on such information without further investigation and without regard to its accuracy. Many social media platforms immediately publish the content their subscribers and participants post, often without filters or checks on accuracy of the content posted. Information posted on such platforms at any time may be adverse to ACNB's interests and/or may be inaccurate. The dissemination of information online could harm ACNB's business, prospects, financial condition, and results of operations, regardless of the information's accuracy. The harm may be immediate without affording ACNB an opportunity for redress or correction.

Other risks associated with the use of social media include improper disclosure of proprietary information, negative comments about ACNB's business, exposure of personally identifiable information, fraud, out-of-date information, and improper use by employees and customers. The inappropriate use of social media by ACNB's customers or employees could result in negative consequences including remediation costs including training for employees, additional regulatory scrutiny and possible regulatory penalties, litigation, or negative publicity that could damage ACNB's reputation adversely affecting customer or investor confidence.

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**ITEM 1B UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2 PROPERTIES**

ACNB Bank, in addition to its main office in Gettysburg, Adams County, Pennsylvania, had a retail banking office network of nineteen offices at December 31, 2014. Thirteen retail banking offices are located in Adams County, one is located in Cumberland County, one is located in Franklin County, and four are located in York County, Pennsylvania. There is also a loan production office situated in York County, Pennsylvania. Bank offices at sixteen locations are owned, while five are leased. All real estate owned by the subsidiary bank is free and clear of encumbrances. During 2014, RIG had two leased offices located in Carroll County and Montgomery County, Maryland.

**ITEM 3 LEGAL PROCEEDINGS**

As of December 31, 2014, there were no material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which ACNB or its subsidiaries are a party or by which any of their property is the subject, which could have a material adverse effect on ACNB or its subsidiaries or their results of operations. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Corporation or its subsidiaries by governmental authorities.

**ITEM 4 MINE SAFETY DISCLOSURES**

Not Applicable.

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## PART II

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

ACNB Corporation's common stock trades on NASDAQ under the symbol ACNB. At December 31, 2014 and 2013, there were 20,000,000 shares of common stock authorized, 6,078,250 and 6,053,911 shares issued, respectively, and 6,015,650 and 5,991,311 shares outstanding, respectively. As of December 31, 2014, ACNB had approximately 2,323 stockholders of record. At December 31, 2014 and 2013, there were 62,600 shares of treasury stock purchased by the Corporation through the common stock repurchase program approved in October 2008. There have been no shares purchased during the most recent quarter and 57,400 shares can still be purchased under the program. ACNB is restricted as to the amount of dividends that it can pay to stockholders by virtue of the restrictions on the banking subsidiary's ability to pay dividends to ACNB under the Pennsylvania Banking Code, the Federal Deposit Insurance Corporation Act, and the regulations of the FDIC. For further information, please refer to Notes J "Regulatory Restrictions on Dividends" and N "Regulatory Matters" in the Notes to Consolidated Financial Statements.

On May 5, 2009, stockholders approved and ratified the ACNB Corporation 2009 Restricted Stock Plan, effective as of February 24, 2009, in which awards shall not exceed, in the aggregate, 200,000 shares of common stock. As of December 31, 2014, there were no shares of common stock granted as restricted stock awards to either employees or directors. The Corporation's Registration Statement under the Securities Act of 1933 on Form S-8 for the ACNB Corporation 2009 Restricted Stock Plan was filed with the Securities and Exchange Commission on January 4, 2013.

On May 5, 2009, stockholders approved and adopted the amendment to the Articles of Incorporation of ACNB Corporation to authorize up to 20,000,000 shares of preferred stock, par value $2.50 per share. As of December 31, 2014, there were no issued or outstanding shares of preferred stock.

On January 24, 2011, the ACNB Corporation Dividend Reinvestment and Stock Purchase Plan was introduced for stockholders of record. This plan provides registered holders of ACNB Corporation common stock with a convenient way to purchase additional shares of common stock by permitting participants in the plan to automatically reinvest cash dividends on all or a portion of the shares owned and to make quarterly voluntary cash payments under the terms of the plan. Participation in the plan is voluntary, and there are eligibility requirements to participate in the plan. As of December 31, 2014, there were 87,307 shares of common stock issued through the ACNB Corporation Dividend Reinvestment and Stock Purchase Plan.

There have been no unregistered sales of stock in 2014, 2013 or 2012.

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The following table reflects the quarterly high and low prices of ACNB's common stock and the cash dividends on the common stock for the periods indicated.

| | Price Range Per Share | | Per Share |
| --- | --- | --- | --- |
| | High | Low | Dividend |
| **2014:** | | | |
| First Quarter | **$ 19.50** | **$ 18.00** | **$ 0.19** |
| Second Quarter | **19.99** | **18.37** | **0.19** |
| Third Quarter | **19.87** | **18.69** | **0.19** |
| Fourth Quarter | **21.83** | **19.08** | **0.20** |
| | | | |
| **2013:** | | | |
| First Quarter | $ 17.00 | $ 16.01 | $ 0.19 |
| Second Quarter | 17.00 | 16.26 | 0.19 |
| Third Quarter | 17.74 | 16.57 | 0.19 |
| Fourth Quarter | 18.49 | 16.65 | 0.19 |

The Corporation has added the Mid-Atlantic Custom Peer Group Asset $700M-$2B to the performance graph below, which management believes better represents the Corporation's performance versus other financial institutions of similar size.

| | Period Ending | | | | | |
|---|---|---|---|---|---|---|
| **Index** | **12/31/2009** | **12/31/2010** | **12/31/2011** | **12/31/2012** | **12/31/2013** | **12/31/2014** |
| ACNB Corporation | 100.00 | 127.81 | 118.59 | 145.88 | 170.15 | 213.16 |
| NASDAQ Composite | 100.00 | 118.15 | 117.22 | 138.02 | 193.47 | 222.16 |
| Mid-Atlantic Custom Peer Group Asset <$1B* | 100.00 | 109.29 | 109.02 | 127.18 | 150.66 | 164.62 |
| Mid-Atlantic Custom Peer Group Asset $700M-$2B** | 100.00 | 107.68 | 98.18 | 120.40 | 154.40 | 170.44 |

* *Mid-Atlantic Custom Peer Group Asset <$1B consists of Mid-Atlantic commercial banks with assets less than $1B as of September 30, 2014, and indicated below. Source: SNL Financial LC, Charlottesville, VA*

** *Mid-Atlantic Custom Peer Group Asset $700M-$2B consists of Mid-Atlantic commercial banks with assets between $700M to $2B as of September 30, 2014, and indicated below. Source: SNL Financial LC, Charlottesville, VA*

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***Mid-Atlantic Custom Peer Group Asset <$1B***

| Company | City | State | Company | City | State |
|---|---|---|---|---|---|
| 1st Colonial Bancorp, Inc. | Cherry Hill | NJ | Harford Bank | Aberdeen | MD |
| 1st Constitution Bancorp | Cranbury | NJ | Harmony Bank | Jackson | NJ |
| 1st Summit Bancorp of Johnstown, Inc. | Johnstown | PA | Harvest Community Bank | Pennsville | NJ |
| Absecon Bancorp | Absecon | NJ | Highlands Bancorp, Inc. | Vernon | NJ |
| Allegheny Valley Bancorp, Inc. | Pittsburgh | PA | Honat Bancorp, Inc. | Honesdale | PA |
| American Bank Incorporated | Allentown | PA | Hopewell Valley Community Bank | Pennington | NJ |
| Apollo Bancorp, Inc. | Apollo | PA | Howard Bancorp, Inc. | Ellicott City | MD |
| Ballston Spa Bancorp, Inc. | Ballston Spa | NY | IBW Financial Corporation | Washington | DC |
| Bancorp of New Jersey, Inc. | Fort Lee | NJ | Integrity Bancshares, Inc. | Camp Hill | PA |
| Bank of Akron | Akron | NY | Jeffersonville Bancorp | Jeffersonville | NY |
| Bay Bancorp, Inc. | Lutherville | MD | Jonestown Bank and Trust Co. | Jonestown | PA |
| Berkshire Bancorp, Inc. | New York | NY | JTNB Bancorp, Inc. | Jim Thorpe | PA |
| Brunswick Bancorp | New Brunswick | NJ | Juniata Valley Financial Corp. | Mifflintown | PA |
| Bucks County Bank | Doylestown | PA | Kinderhook Bank Corporation | Kinderhook | NY |
| Calvin B. Taylor Bankshares, Inc. | Berlin | MD | Kish Bancorp, Inc. | Belleville | PA |
| Carroll Bancorp, Inc. | Sykesville | MD | Landmark Bancorp, Inc. | Pittston | PA |
| CB Financial Services, Inc. | Carmichaels | PA | Liberty Bell Bank | Marlton | NJ |
| CBT Financial Corporation | Clearfield | PA | Lyons Bancorp, Inc. | Lyons | NY |
| CCFNB Bancorp, Inc. | Bloomsburg | PA | Manor Bank | Manor | PA |
| Citizens Financial Services, Inc. | Mansfield | PA | Marlin Business Services Corp. | Mount Laurel | NJ |
| Citizens National Bank of Meyersdale | Meyersdale | PA | Mars National Bancorp, Inc. | Mars | PA |
| Clarion County Community Bank | Clarion | PA | Mauch Chunk Trust Financial Corp. | Jim Thorpe | PA |
| Colonial American Bank | Middletown | NJ | Mercersburg Financial Corporation | Mercersburg | PA |
| Commercial National Financial Corporation | Latrobe | PA | Mid Penn Bancorp, Inc. | Millersburg | PA |
| Community Bank of Bergen County, NJ | Maywood | NJ | Mifflinburg Bancorp, Inc. | Mifflinburg | PA |
| Community First Bank | Somerset | NJ | MNB Corporation | Bangor | PA |
| Community National Bank | Melville | NY | Muncy Bank Financial, Inc. | Muncy | PA |
| County First Bank | La Plata | MD | National Bank of Coxsackie | Coxsackie | NY |
| Damascus Community Bank | Damascus | MD | National Capital Bank of Washington | Washington | DC |
| Delhi Bank Corp. | Delhi | NY | Neffs Bancorp, Inc. | Neffs | PA |
| Delmar Bancorp | Salisbury | MD | New Jersey Community Bank | Freehold | NJ |
| Dimeco, Inc. | Honesdale | PA | New Millennium Bank | New Brunswick | NJ |
| DNB Financial Corporation | Downingtown | PA | New Tripoli Bancorp, Inc. | New Tripoli | PA |
| Elmer Bancorp, Inc. | Elmer | NJ | Northumberland Bancorp | Northumberland | PA |
| Elmira Savings Bank | Elmira | NY | Norwood Financial Corp. | Honesdale | PA |
| Embassy Bancorp, Inc. | Bethlehem | PA | Orange County Bancorp, Inc. | Middletown | NY |
| Emclaire Financial Corp. | Emlenton | PA | Parke Bancorp, Inc. | Sewell | NJ |
| Empire Bancorp, Inc. | Islandia | NY | Peoples Bancorp, Inc. | Chestertown | MD |
| ENB Financial Corp | Ephrata | PA | Peoples Limited | Wyalusing | PA |
| Enterprise National Bank N.J. | Kenilworth | NJ | PSB Holding Corporation | Preston | MD |
| ES Bancshares, Inc. | Newburgh | NY | Putnam County National Bank of Carmel | Carmel | NY |
| Evans Bancorp, Inc. | Hamburg | NY | QNB Corp. | Quakertown | PA |
| Farmers and Merchants Bank | Upperco | MD | Riverview Financial Corporation | Halifax | PA |
| Fidelity D & D Bancorp, Inc. | Dunmore | PA | Royal Bancshares of Pennsylvania, Inc. | Bala Cynwyd | PA |
| First American International Corp. | Brooklyn | NY | Scottdale Bank & Trust Company | Scottdale | PA |
| First Bank | Hamilton | NJ | Shore Community Bank | Toms River | NJ |
| First Keystone Corporation | Berwick | PA | Solvay Bank Corporation | Solvay | NY |
| First National Bank of Groton | Groton | NY | Somerset Trust Holding Company | Somerset | PA |
| | Dunmore | PA | Steuben Trust Corporation | Hornell | NY |

| | | | | | |
|---|---|---|---|---|---|
| First National Community Bancorp, Inc. | | | | | |
| First Resource Bank | Exton | PA | Stewardship Financial Corporation | Midland Park | NJ |
| Fleetwood Bank Corporation | Fleetwood | PA | Sussex Bancorp | Rockaway | NJ |
| FNB Bancorp, Inc. | Newtown | PA | Turbotville National Bancorp, Inc. | Turbotville | PA |
| FNBM Financial Corporation | Minersville | PA | Two River Bancorp | Tinton Falls | NJ |
| FNBPA Bancorp, Inc. | Port Allegany | PA | UNB Corporation | Mount Carmel | PA |
| Frederick County Bancorp, Inc. | Frederick | MD | Unity Bancorp, Inc. | Clinton | NJ |
| Glen Burnie Bancorp | Glen Burnie | MD | VSB Bancorp, Inc. | Staten Island | NY |
| GNB Financial Services, Inc. | Gratz | PA | West Milton Bancorp, Inc. | West Milton | PA |
| Greater Hudson Bank, National Association | Middletown | NY | Woodlands Financial Service Company | Williamsport | PA |
| Hamlin Bank and Trust Company | Smethport | PA | York Traditions Bank | York | PA |

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***Mid-Atlantic Custom Peer Group Asset $700M-$2B***

| Company | City | State | Company | City | State |
|---|---|---|---|---|---|
| 1st Constitution Bancorp | Cranbury | NJ | FNB Bancorp, Inc. | Newtown | PA |
| 1st Summit Bancorp of Johnstown, Inc. | Johnstown | PA | Franklin Financial Services Corporation | Chambersburg | PA |
| ACNB Corporation | Gettysburg | PA | Integrity Bancshares, Inc. | Camp Hill | PA |
| Adirondack Trust Company | Saratoga Springs | NY | Lyons Bancorp, Inc. | Lyons | NY |
| AmeriServ Financial, Inc. | Johnstown | PA | Marlin Business Services Corp. | Mount Laurel | NJ |
| Bancorp of New Jersey, Inc. | Fort Lee | NJ | Mid Penn Bancorp, Inc. | Millersburg | PA |
| Bank of Utica | Utica | NY | Norwood Financial Corp. | Honesdale | PA |
| BCB Bancorp, Inc. | Bayonne | NJ | Old Line Bancshares, Inc. | Bowie | MD |
| Berkshire Bancorp, Inc. | New York | NY | Orange County Bancorp, Inc. | Middletown | NY |
| Chemung Financial Corporation | Elmira | NY | Orrstown Financial Services, Inc. | Shippensburg | PA |
| Citizens & Northern Corporation | Wellsboro | PA | Parke Bancorp, Inc. | Sewell | NJ |
| Citizens Financial Services, Inc. | Mansfield | PA | Penns Woods Bancorp, Inc. | Williamsport | PA |
| Codorus Valley Bancorp, Inc. | York | PA | Peoples Financial Services Corp. | Scranton | PA |
| Community Financial Corporation | Waldorf | MD | QNB Corp. | Quakertown | PA |
| Community National Bank | Melville | NY | Republic First Bancorp, Inc. | Philadelphia | PA |
| Embassy Bancorp, Inc. | Bethlehem | PA | Royal Bancshares of Pennsylvania, Inc. | Bala Cynwyd | PA |
| ENB Financial Corp | Ephrata | PA | Shore Bancshares, Inc. | Easton | MD |
| Evans Bancorp, Inc. | Hamburg | NY | Solvay Bank Corporation | Solvay | NY |
| First Keystone Corporation | Berwick | PA | Somerset Trust Holding Company | Somerset | PA |
| First National Community Bancorp, Inc. | Dunmore | PA | Suffolk Bancorp | Riverhead | NY |
| First United Corporation | Oakland | MD | Two River Bancorp | Tinton Falls | NJ |
| | | | Unity Bancorp, Inc. | Clinton | NJ |

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## ITEM 6 SELECTED FINANCIAL DATA

| | For the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| **Dollars in thousands, except per share data** | **2014** | **2013** | **2012** | **2011** | **2010** |
| **INCOME STATEMENT DATA** | | | | | |
| Interest income | **$ 37,526** | $ 37,601 | $ 40,439 | $ 41,832 | $ 44,640 |
| Interest expense | **3,646** | 3,989 | 6,095 | 7,462 | 9,623 |
| Net interest income | **33,880** | 33,612 | 34,344 | 34,370 | 35,017 |
| Provision for loan losses | **150** | 1,450 | 4,675 | 5,435 | 6,410 |
| Net interest income after provision for loan losses | **33,730** | 32,162 | 29,669 | 28,935 | 28,607 |
| Other income | **11,904** | 11,703 | 11,867 | 11,737 | 12,172 |
| Other expenses | **32,264** | 32,015 | 30,331 | 30,016 | 30,303 |
| Income before income taxes | **13,370** | 11,850 | 11,205 | 10,656 | 10,476 |
| Provision for income taxes | **3,080** | 2,535 | 2,319 | 2,154 | 2,057 |
| Net income | **$ 10,290** | $ 9,315 | $ 8,886 | $ 8,502 | $ 8,419 |

| | | | | | |
|---|---|---|---|---|---|
| **BALANCE SHEET DATA (AT YEAR-END)** | | | | | |
| Assets | **$ 1,089,808** | $ 1,046,047 | $ 1,049,995 | $ 1,004,823 | $ 968,667 |
| Securities | **$ 191,346** | $ 224,356 | $ 215,949 | $ 219,259 | $ 200,774 |
| Loans, net | **$ 784,100** | $ 712,557 | $ 691,311 | $ 678,986 | $ 650,039 |
| Deposits | **$ 844,876** | $ 800,643 | $ 834,176 | $ 782,795 | $ 746,526 |
| Borrowings | **$ 126,636** | $ 131,755 | $ 107,257 | $ 117,153 | $ 120,585 |
| Stockholders' equity | **$ 110,022** | $ 106,802 | $ 101,264 | $ 97,474 | $ 93,754 |
| **COMMON SHARE DATA** | | | | | |
| Earnings per share basic | **$ 1.71** | $ 1.56 | $ 1.49 | $ 1.43 | $ 1.42 |
| Cash dividends declared | **$ 0.77** | $ 0.76 | $ 0.76 | $ 0.76 | $ 0.76 |
| Book value per share | **$ 18.29** | $ 17.83 | $ 16.98 | $ 16.39 | $ 15.81 |
| Weighted average number of common shares | **6,002,240** | 5,976,960 | 5,953,723 | 5,936,030 | 5,928,343 |
| Dividend payout ratio | **44.92%** | 48.76% | 50.91% | 53.15% | 53.52% |
| **PROFITABILITY RATIOS AND CONDITION** | | | | | |
| Return on average assets | **0.97%** | 0.90% | 0.86% | 0.85% | 0.86% |
| Return on average equity | **9.32%** | 9.00% | 8.91% | 8.80% | 9.15% |
| Average stockholders' equity to average assets | **10.43%** | 9.95% | 9.61% | 9.72% | 9.40% |
| **SELECTED ASSET QUALITY RATIOS** | | | | | |
| Non-performing loans to total loans | **1.04%** | 1.44% | 1.00% | 2.02% | 2.35% |
| Net charge-offs to average loans outstanding | **0.14%** | 0.31% | 0.48% | 0.77% | 0.47% |
| Allowance for loan losses to total loans | **1.90%** | 2.21% | 2.38% | 2.23% | 2.29% |
| Allowance for loan losses to non-performing loans | **183.15%** | 153.26% | 237.04% | 110.29% | 97.43% |

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

**INTRODUCTION**

The following is management's discussion and analysis of the significant changes in the financial condition, results of operations, comprehensive income, 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.

**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 this Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

Accounting Standards Codification (ASC) Topic 350, *Intangibles Goodwill and Other,* requires that goodwill is not amortized to expense, but rather that it be assessed or 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 October 1, 2014. If certain events occur which might indicate goodwill has been impaired, the goodwill is tested for impairment when such events occur. During the quarter ended June 30, 2012, the Corporation changed its method of applying ASC Topic 350 such that the annual goodwill impairment testing date was changed from December 31 to October 1. This new testing date is preferable under the circumstances, because it allows the Corporation more time to accurately complete its impairment testing process in order to incorporate the results in the annual consolidated financial statements. 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.

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**EXECUTIVE OVERVIEW**

The primary source of the Corporation's revenues is net interest income derived from interest earned on loans and investments, less deposit and borrowing funding costs. Revenues are influenced by general economic factors, including market interest rates, the economy of the markets served, stock market conditions, as well as competitive forces within the markets.

The Corporation's overall strategy is to increase loan growth in local markets, while maintaining a reasonable funding base by offering competitive deposit products and services. The year 2014 continued to be challenging for financial institutions with new expensive compliance regulations, slowly recovering housing markets, lingering wage stagnation, and slow uneven growth. ACNB continued to be profitable and well capitalized despite the aftershocks of the unprecedented challenge to the United States economy in recent years past. Lower provision for loan losses offset increased expenses resulting in increased net income of $10,290,000, or $1.71 per share, in 2014, compared to $9,315,000, or $1.56 per share, in 2013 and $8,886,000, or $1.49 per share, in 2012. Returns on average equity were 9.32%, 9.00% and 8.91% in 2014, 2013 and 2012, respectively.

Because funding costs were near practical floors, they could not be decreased at the same increments as earning asset decreases; therefore, the Corporation's net interest margin decreased to 3.47% in 2014, compared to 3.48% and 3.56% in 2013 and 2012, respectively. Net interest income was $33,880,000 in 2014, as compared to $33,612,000 in 2013 and $34,344,000 in 2012.

Other income was $11,904,000, $11,703,000 and $11,867,000 in 2014, 2013 and 2012, respectively. The largest source of other income is commissions from insurance sales from Russell Insurance Group, Inc. (RIG), which increased by 3.6% in 2014 to $4,839,000, boosted by higher contingent commissions and stable commercial insurance volume despite the continued weak economic conditions. In 2014, a $62,000 gain was recognized on sold or called investments compared to net gains of $0 in 2013 and $7,000 in 2012. Income from fiduciary activities totaled $1,418,000 for 2014, as compared to $1,299,000 for 2013 and $1,224,000 for 2012. Trust fiduciary income increased from increased estate settlements and new account relationships. Service charges on deposit accounts decreased 5.7% to $2,118,000 for 2014 due to changes in customer behaviors, while revenue from ATM and debit card transactions increased 8.1% to $1,550,000 due to higher volume.

Other expenses increased to $32,264,000, or by 0.8%, in 2014, as compared to $32,015,000 in 2013. Other expenses totaled $30,331,000 in 2012. The largest component of other expenses is salaries and employee benefits, which increased 3.0% to $19,516,000 in 2014 compared to $18,950,000 in 2013, due to an increase in employees, merit increases, and the increased cost of benefits, offset by lower pension expense. Compared to 2013, occupancy expense increased 4.8% in 2014 due to harsh winter expenses and new locations, and equipment expense decreased 2.1% from temporary variance in expenditures. Professional services expense increased 4.6% despite lower problem loan-related legal expenses in 2014, due to higher compliance and corporate governance. Marketing and corporate relations expense increased by 48.2% due to website redesign, product specific campaigns and brand awareness activities. FDIC and regulatory expense decreased by 2.6%; however, it is still a significant expense as the result of a requirement of all FDIC-insured banks to restore and maintain the Deposit Insurance Fund due to protecting depositors' accounts. In 2014, foreclosed real estate expenses decreased $230,000 or 39.9% resulting from higher final sale losses in 2013. A more thorough discussion of the Corporation's results of operations is included in the following pages.

**RESULTS OF OPERATIONS**

*Net Interest Income*

The primary source of ACNB's traditional banking revenue is net interest income, which represents the difference between interest income on earning assets and interest expense on liabilities

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used to fund those assets. Earning assets include loans, securities, and interest bearing deposits with banks. Interest bearing liabilities include deposits and borrowings.

Net interest income is affected by changes in interest rates, volume of interest bearing assets and liabilities, and the composition of those assets and liabilities. The "interest rate spread" and "net interest margin" are two common statistics related to changes in net interest income. The interest rate spread represents the difference between the yields earned on interest earning assets and the rates paid for interest bearing liabilities. The net interest margin is defined as the percentage of net interest income to average earning assets, which also considers the Corporation's net non-interest bearing funding sources, the largest of which are non-interest bearing demand deposits and stockholders' equity.

The following table includes average balances, rates, interest income and expense, interest rate spread, and net interest margin:

**Table 1 Average Balances, Rates and Interest Income and Expense**

| | **2014** | | | **2013** | | | **2012** | | |
|---|---|---|---|---|---|---|---|---|---|
| **Dollars in thousands** | **Average Balance** | **Interest** | **Yield/ Rate** | **Average Balance** | **Interest** | **Yield/ Rate** | **Average Balance** | **Interest** | **Yield/ Rate** |
| **INTEREST EARNING ASSETS** | | | | | | | | | |
| Loans | **$ 752,837** | **$ 32,573** | **4.33%** | $ 711,841 | $ 32,084 | 4.51% | $ 701,243 | $ 33,990 | 4.85% |
| Taxable securities | **172,698** | **3,647** | **2.11%** | 186,900 | 4,230 | 2.26% | 178,783 | 4,876 | 2.73% |
| Tax-exempt securities | **38,380** | **1,042** | **2.71%** | 41,597 | 1,197 | 2.88% | 45,952 | 1,457 | 3.17% |
| **Total Securities** | **211,078** | **4,689** | **2.22%** | 228,497 | 5,427 | 2.38% | 224,735 | 6,333 | 2.82% |
| Other | **13,474** | **264** | **1.96%** | 25,107 | 90 | 0.36% | 37,907 | 116 | 0.31% |
| **Total Interest Earning Assets** | **977,389** | **37,526** | **3.84%** | 965,445 | 37,601 | 3.89% | 963,885 | 40,439 | 4.20% |
| Cash and due from banks | **12,838** | | | 13,663 | | | 13,197 | | |
| Premises and equipment | **15,930** | | | 14,603 | | | 14,302 | | |
| Other assets | **67,189** | | | 63,099 | | | 62,345 | | |
| Allowance for loan losses | **(15,833)** | | | (17,072) | | | (15,761) | | |
| **Total Assets** | **$ 1,057,513** | | | $ 1,039,738 | | | $ 1,037,968 | | |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | | | | | | | |
| **INTEREST BEARING LIABILITIES** | | | | | | | | | |
| Interest bearing demand deposits | **$ 179,903** | **$ 127** | **0.07%** | $ 183,341 | $ 140 | 0.08% | $ 165,569 | $ 139 | 0.08% |
| Savings deposits | **264,467** | **194** | **0.07%** | 260,093 | 197 | 0.08% | 243,050 | 280 | 0.12% |
| Time deposits | **239,000** | **1,489** | **0.62%** | 251,312 | 1,840 | 0.73% | 282,568 | 3,022 | 1.07% |
| **Total Interest Bearing Deposits** | **683,370** | **1,810** | **0.26%** | 694,746 | 2,177 | 0.31% | 691,187 | 3,441 | 0.50% |
| Short-term borrowings | **44,399** | **63** | **0.14%** | 53,184 | 61 | 0.11% | 48,300 | 76 | 0.16% |
| Long-term borrowings | **81,042** | **1,773** | **2.19%** | 55,311 | 1,751 | 3.17% | 74,942 | 2,578 | 3.44% |
| **Total Interest Bearing Liabilities** | **808,811** | **3,646** | **0.45%** | 803,241 | 3,989 | 0.50% | 814,429 | 6,095 | 0.75% |
| Non-interest bearing demand deposits | **134,355** | | | 126,047 | | | 116,507 | | |
| Other liabilities | **4,013** | | | 6,969 | | | 7,255 | | |
| Stockholders' equity | **110,334** | | | 103,481 | | | 99,777 | | |
| **Total Liabilities and Stockholders' Equity** | **$ 1,057,513** | | | $ 1,039,738 | | | $ 1,037,968 | | |

| | | | |
|---|---|---|---|
| **NET INTEREST INCOME** | **$ 33,880** | $ 33,612 | $ 34,344 |
| **INTEREST RATE SPREAD** | **3.39%** | 3.39% | 3.45% |
| **NET INTEREST MARGIN** | **3.47%** | 3.48% | 3.56% |

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For yield calculation purposes, nonaccruing loans are included in average loan balances. Loan fees of $23,000, $154,000 and $6,000 as of December 31, 2014, 2013 and 2012, respectively, are included in interest income. Yields on tax-exempt securities and loans are not tax effected.

Table 1 presents balance sheet items on a daily average basis, net interest income, interest rate spread, and net interest margin for the years ending December 31, 2014, 2013 and 2012. Table 2 analyzes the relative impact on net interest income for changes in the volume of interest earning assets and interest bearing liabilities and changes in rates earned and paid by the Corporation on such assets and liabilities.

Net interest income totaled $33,880,000 in 2014, as compared to $33,612,000 in 2013 and $34,344,000 in 2012. During 2014, net interest income increased as changes to the earning asset mix stabilized interest income while lower funding cost allowed for the overall increase. The decrease in net interest income in 2013 was due to declines in rates on earning assets exceeding the ability to decrease low deposit rates.

The net interest margin during 2014 was 3.47% compared to 3.48% during 2013. The margin decreased due to continued decreasing earning asset yields that exceeded decreasing funding costs from lower rates on new or renewed time deposits and lower market rates on savings products. The Federal Open Market Committee repeatedly decreased the federal funds rate from September 2007 to December 2008 and has maintained it at 0% to 0.25% since that time. In addition, the Federal Reserve Bank has embarked on various programs referred to as Quantitative Easing which, in effect, attempted to lower rates on longer term portions of the yield curve. These decreases allowed interest rate reductions on lower-cost transactional deposit products and higher-cost certificates of deposit; the result was a 0.05% decrease in funding costs in 2014. Overtaking the benefit of a lower cost of funds in 2014, however, was earning asset yields decreasing 0.05% from declines in the investment portfolio as new purchases were at lower rates, as well as declines in the loan portfolio from new originations at lower market rates and existing adjustable-rate loans resetting at lower rates based on declines in index rates. The decreased earning asset yields in 2013 were 0.31% compared to funding cost declines of 0.25%. Maintaining the net interest margin going forward will be challenged by the fact that substantial amounts of deposits are at practical rate floors, while loans and the investment securities portfolio will most likely continue to decrease in yields. The cost and availability of wholesale funding could also be affected by a variety of internal and external factors resulting from interest rate market factors and the creditworthiness of the Corporation and the credit providers.

Average earning assets were $977,389,000 in 2014, an increase of 1.2% from the balance of $965,445,000 in 2013, which was an increase from $963,885,000 in 2012. Loan growth represented the largest increase in average assets in 2014, 2013 and 2012, in conjunction with changes in the investment portfolio in those years to balance liquidity needs and to fund the loans. Average interest bearing liabilities were $808,811,000 in 2014, up from $803,241,000 in 2013 and down from $814,429,000 in 2012. Average non-interest bearing demand deposits increased 6.6% in 2014, continuing the upward trend from 2013 and 2012. This increase was attributed to new relationships and the value placed on stability and FDIC insurance by depositors. On average, deposits (including non-interest bearing) were down 0.4%, while borrowings increased by 15.6% due to partially funding loan growth and to better match loan terms with Federal Home Loan Bank (FHLB) advances in 2014. Lower-cost transaction and savings deposits grew while time deposits decreased in 2014, continuing a trend started in 2008. This lower time deposit trend is attributed to depositors dissatisfied by the Federal Reserve induced low rate environment and perhaps investing in equity markets.

The rate/volume analysis detailed in Table 2 shows that the increase in net interest income in 2014 was due to funding cost rate decreases exceeding earning asset rate decreases and volume increases. Earning asset yields declined due to new purchases at lower rates in the investment portfolio and declines in the loan portfolio from existing adjustable-rate loans resetting at lower rates and new lower-rate originations replacing loan amortizations at higher rates. In 2014, the decrease in interest expense was 4.6 times higher than the decrease in interest income. Interest expense decreased due to changes in rates for all interest bearing liability categories.

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The following table shows changes in net interest income attributed to changes in rates and changes in average balances of interest earning assets and interest bearing liabilities:

**Table 2 Rate/Volume Analysis**

| | 2014 versus 2013 | | | 2013 versus 2012 | | |
|---|---|---|---|---|---|---|
| | Due to Changes in | | | Due to Changes in | | |
| In thousands | Volume | Rate | Total | Volume | Rate | Total |
| **INTEREST EARNING ASSETS** | | | | | | |
| Loans | **$ 1,804** | **$ (1,315)** | **$ 489** | $ 507 | $ (2,413) | $ (1,906) |
| Taxable securities | **(310)** | **(273)** | **(583)** | 213 | (859) | (646) |
| Tax-exempt securities | **(90)** | **(65)** | **(155)** | (132) | (128) | (260) |
| Total Securities | **(400)** | **(338)** | **(738)** | 81 | (987) | (906) |
| Other | **(59)** | **233** | **174** | (44) | 18 | (26) |
| **Total** | **$ 1,345** | **$ (1,420)** | **$ (75)** | $ 544 | $ (3,382) | $ (2,838) |
| **INTEREST BEARING LIABILITIES** | | | | | | |
| Interest bearing demand deposits | **$ (3)** | **$ (10)** | **$ (13)** | $ 14 | $ (13) | $ 1 |
| Savings deposits | **3** | **(6)** | **(3)** | 18 | (101) | (83) |
| Time deposits | **(87)** | **(264)** | **(351)** | (307) | (875) | (1,182) |
| Short-term borrowings | **(11)** | **13** | **2** | 7 | (22) | (15) |
| Long-term borrowings | **663** | **(641)** | **22** | (634) | (193) | (827) |
| **Total** | **565** | **(908)** | **(343)** | (902) | (1,204) | (2,106) |
| **Change in Net Interest Income** | **$ 780** | **$ (512)** | **$ 268** | $ 1,446 | $ (2,178) | $ (732) |

The net change attributable to the combination of rate and volume has been allocated on a consistent basis between volume and rate based on the absolute value of each. For yield calculation purposes, nonaccruing loans are included in average balances.

*Provision for Loan Losses*

The provision for loan losses charged against earnings was $150,000 in 2014, as compared to $1,450,000 in 2013 and $4,675,000 in 2012. The decrease was a result of the analysis of the adequacy of the allowance for loan losses calculation, as well as improvement in asset quality including, nonaccrual loans decreasing by 22% and all substandard loans decreasing by 5%. Each quarter, the Corporation assesses risk in the loan portfolio compared with the balance in the allowance for loan losses and the current evaluation factors.

For additional discussion of the provision and the loans associated therewith, please refer to the *Asset Quality* section of this Management's Discussion and Analysis. ACNB charges confirmed loan losses to the allowance and credits the allowance for recoveries of previous loan charge-offs. For 2014, the Corporation had net charge-offs of $1,069,000 as compared to net charge-offs of $2,184,000 for 2013.

*Other Income*

Other income was $11,904,000 for the year ended December 31, 2014, a $201,000, or 1.7%, increase from 2013. Other income was $11,703,000 for the year ended December 31, 2013, a $164,000, or 1.4%, decrease from 2012. The largest source of other income is commissions from insurance sales from RIG, which increased 3.6% to $4,839,000 in 2014, decreased 3.4% to $4,671,000 in 2013. The increase in 2014 was due to higher contingent commission payments and a stabilization of customer commission income; the 2013 decrease was due to lost customers in continued weak economic

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conditions and lower contingent commission payments from insurance carriers. These contingent, or extra, commissions are mostly received in March and April of each year, and the amount is at the discretion of various insurance carriers in accordance with applicable insurance regulations. Heightened pressure on commissions is expected to continue in this business line, and contingent commissions are not predictable.

In 2014, a gain of $62,000 was recognized on sold or called securities compared to no gains or losses in 2013, and gains of $7,000 in 2012. Securities were sold in all periods to balance state and local geographic mix. Income from fiduciary activities, which includes fees from both institutional and personal trust and investment management services and estate settlement services, totaled $1,418,000 for the year ended December 31, 2014, as compared to $1,299,000 for 2013 and $1,224,000 for 2012. At December 31, 2014, ACNB had total assets under administration of approximately $165,000,000, compared to $151,000,000 at the end of 2013 and $141,000,000 at the end of 2012. The variations in income were in part due to more assets under management and the result of higher estate settlement income in 2014 which varies with specific activity.

Service charges on deposit accounts decreased 5.7% to $2,118,000, after decreasing 7.7% in 2013, based upon varying customer actions that affect the volume of fees. Further, certain government regulations and policies effective since 2010 limited service charge increases and make future revenue levels uncertain. Revenue from ATM and debit card transactions increased 8.1% to $1,550,000 due to higher volume. The increase resulted from consumer desire to use more electronic delivery channels; however, regulations or legal challenges for large financial institutions may impact industry pricing for such transactions and fees in connection therewith in future periods, the effect of which cannot be currently quantified. Another more recent threat to this revenue source is the security breaches in the merchant base that are negatively affecting consumer confidence in the debit card channel. Fee income from sold mortgages decreased by $217,000, or 50.5%, to $213,000 in 2014 as new originations markedly decreased with increased interest rates in the first half of 2014. This revenue source is projected to continue at lower than normal levels in 2015 due to national and local economic trends.

*Impairment Testing*

RIG has certain long-lived assets, including purchased intangible assets subject to amortization such as insurance books of business, and associated goodwill assets, which are reviewed for impairment annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the statement of condition and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

Goodwill, which has an indefinite useful life, is evaluated for impairment annually and is evaluated for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. Recent changes to accounting rules permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. The goodwill impairment analysis currently used by the Corporation is a two-step test. The first step, used to identify potential impairment, involves comparing the reporting unit's estimated fair value to its carrying value, including goodwill. If the estimated fair value of the reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds the estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment. If required, the second step involves calculating an implied fair value of goodwill for the reporting unit for which the first step indicated potential impairment. The implied fair value of

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goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit to a group of likely buyers whose cash flow estimates could differ from those of the reporting entity, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill assigned to the reporting unit exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess. Subsequent reversal of goodwill impairment losses is not permitted.

During the quarter ended June 30, 2012, the Corporation changed its method of applying ASC Topic 350 such that the annual goodwill impairment testing date was changed from December 31 to October 1. This new testing date is preferable in the circumstances, because it allows the Corporation more time to accurately complete its impairment testing process, in order to incorporate the results in the annual consolidated financial statements.

As noted above, commissions from insurance sales were up 3.6% in 2014, and RIG's stand alone net income increased 24.8% in 2014 compared to 2013 because of expense controls. The testing for potential impairment involves methods that include both current and projected income amounts, and RIG's fair value remained above the carrying value as of the most recent annual impairment test date. Thus, the results of the annual evaluations determined that there was no impairment of goodwill, including the testing at October 1, 2014. However, declines in RIG's net income or changes in external market factors, including likely buyers that are assumed in impairment testing, may require an impairment charge to goodwill. Should it be determined in a future period that the goodwill has been impaired, then a charge to earnings will be recorded in the period that such a determination is made.

*Other Expenses*

Other expenses increased 0.8% to $32,264,000 for the year ended December 31, 2014. The largest component of other expenses is salaries and employee benefits, which increased 3.0% in 2014 to $19,516,000 compared to $18,950,000 in 2013, and increased $397,000, or 2.1%, from 2012 to 2013. The reasons for the increase in salaries and employee benefits expenses include the following:

- staffing a new office plus other staff increases and higher skilled mix of employees necessitated by growth;
- normal merit increases to employees and associated payroll taxes;
- higher performance-based commissions and incentives;
- higher employee benefit plan costs, including health insurance;
- increases related to 401(k) plan and non-qualified retirement plan benefits; and,
- offset, in part, by decreased defined benefit pension expense due to improved prior year plan investment performance and a higher than recent years' discount rates (decreasing the liabilities for future obligations).

The Corporation reduced the benefit formula for the defined benefit pension plan effective January 1, 2010, in order to manage total benefit costs. Subsequently, the Corporation amended the defined benefit pension plan effective April 1, 2012, in that no employee hired after March 31, 2012, shall be eligible to participate in the Plan and no inactive or former plan participant shall be eligible to again participate in the Plan. The Corporation's overall pension plan investment strategy is to achieve a mix of investments to meet the long-term rate of return assumption and near-term pension obligations with a diversification of asset types, fund strategies, and fund managers. The mix of investments is adjusted periodically by retaining an advisory firm to recommend appropriate allocations after

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reviewing the Corporation's risk tolerance on contribution levels, funded status, plan expense, as well as any applicable regulatory requirements. However, the determination of future benefit expense is also dependent on the fair value of assets and the discount rate on the year-end measurement date, which in recent years has experienced fair value volatility and low discount rates. The expense will be higher in 2015 due to a lower discount rate at the latest measurement date, lower plan return in 2014, and change in mortality tables utilized. A pension provision in a public law known as MAP-21, enacted in July 2012, had no effect on reducing the GAAP expense associated with the plan. In addition, the ACNB plan has maintained a well-funded status.

Net occupancy expense was up 4.8% at $2,050,000 in 2014, $1,957,000 in 2013, and $1,952,000 in 2012. Equipment expense totaled $2,768,000 during 2014, as compared to $2,826,000 during 2013 and $2,537,000 during 2012. Occupancy expense was up in 2014 due to a harsh winter season and additional locations; however, equipment expense decreased in 2014 due to the budgeted replacement of outdated technology devices expensed in 2013, causing that year to be increased. Equipment expense is subject to ever increasing technology demands and the need for system upgrades for security and reliability purposes, making the decrease in expense in 2014 outside the normal increased expense trend.

Professional services expense totaled $936,000 for 2014, as compared to $895,000 for 2013 and $825,000 for 2012. The variation in expense from year to year included varying legal costs associated corporate governance, as well as the expense of heightened compliance monitoring on existing regulations and the expense of implementing new regulations including the Dodd-Frank Act. Other tax expense decreased $164,000 or 18.2% in 2014 compared to 2013 due to a lower rate applied to the capital base at the Bank. Supplies and postage expense increased in 2014 compared to the prior year due to outsourcing that reduced other expense categories, otherwise 2013 decreased from the prior year due to customers' increased use of electronic channels.

Marketing and corporate relations expense increased 48.2% during 2014 due to product promotions and image expenditures. In 2013, this expense category was 6.5% higher than in 2012 due to higher promotional and public relations expenditures.

FDIC and regulatory expense for 2014 was $748,000, a decrease of $20,000 from $768,000 in 2013. FDIC and regulatory expense in 2012 was $843,000. FDIC expense varies with changes in net asset size, risk ratings, and FDIC derived assessment rates.

Foreclosed assets held for resale consist of the fair value of real estate acquired through foreclosure on real estate loan collateral or the acceptance of ownership of real estate in lieu of the foreclosure process. Fair values are based on appraisals that consider the sales prices of similar properties in the proximate vicinity less estimated selling costs. Foreclosed real estate expenses (income) were $346,000, $576,000 and $(119,000) for the years ended December 31, 2014, 2013 and 2012, respectively. The net recovery in 2012 was on two properties that sold for more than the values after prior write-downs. The higher expense in 2013 and to a lesser extent in 2014 was a result of properties that suffered decreases in value after acquisition (requiring write-downs to fair value) during prolonged marketing cycles for these distressed properties and, in some cases, during which the debtor remained in physical possession while eviction actions were contested and finally executed. Values are written down based upon updated appraisals less selling costs (which in the often extended marketing periods can create multiple year expenses) and other fair value adjustments, or in some cases properties are written down based on sales agreements that do not subsequently close. In all, the historically high costs consisted of these write-downs and other costs to carry and was due to the increased number and varying mix of commercial and residential collateral for which such carrying costs include insurance, property maintenance, unpaid and ongoing property taxes, and deferred maintenance required upon acquisition. Foreclosed real estate expenses will vary in 2015 depending on the successful closing of sales agreements on some existing properties and the unknown expenses related to new properties acquired.

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Other operating expense decreased $197,000 or 5.6% in 2014 as a result of a one-time reduction of $272,000 associated with closing out two low-income housing projects. Otherwise, increases were centered in upgrades in data channels and heightened corporate governance and risk management expenditures. Other operating expense increased 8.0% in 2013 from 2012 mainly as a result of costs associated with corporate governance and communications. All periods include higher cost of the Bank's legal responsibility to reimburse customers in electronic transactions disputes even when another party is at fault.

*Provision for Income Taxes*

ACNB recognized income taxes of $3,080,000, or 23.0% of pretax income, during 2014, as compared to $2,535,000, or 21.4%, during 2013 and $2,319,000, or 20.7%, during 2012. The variances from the federal statutory rate are generally due to tax-exempt income from investments in and loans to state and local units of government at below-market rates (an indirect form of taxation), investment in bank-owned life insurance, and investments in low-income housing partnerships (which qualify for federal tax credits). Some tax-exempt investments have been allowed to run off due to concerns of interest rate risk related to these investments, while a limited amount were sold to reduce the chance of future credit risk.

The increasing effective tax rate during 2014, 2013, and 2012 was a result of increasing pretax income in relationship to declining tax-exempt income. Pretax income increased in each year due to revenue and expense elements described above.

At December 31, 2014, net deferred tax assets amounted to $1,512,000. Deferred tax assets are realizable primarily through future reversal of existing taxable temporary differences and future earnings. Management currently anticipates future earnings and capital gains will be adequate to utilize deferred tax assets. Accordingly, no valuation allowance has been established for deferred tax assets at December 31, 2014.

**FINANCIAL CONDITION**

Average earning assets increased in 2014 to $977,389,000, or by 1.2%, from $965,445,000 in 2013 following $963,885,000 in 2012. ACNB's overnight interest bearing deposits and investment portfolio decreased in 2014 on average, as less funds were allocated into liquid short-term investment due to availability of borrowing based liquidity. Investments decreased in 2014 as repayments and maturities were used to fund loan demand. Investments increased in 2013 from deposit growth. Loans increased 5.8% and 1.5% on average in 2014 and 2013, respectively. Growth in loans was funded by increased stable deposits, investment cash flow and term FHLB borrowings. Average deposits decreased less than 1.0% in 2014 to $817,725,000 from $820,793,000 in 2013 and $807,694,000 in 2012. Average borrowings increased in 2014 to $125,441,000 from $108,495,000 in 2013 and $123,242,000 in 2012. Fluctuations in borrowings are term borrowing to fund loan demand and variations in local customer repurchase accounts, which are akin to deposits.

*Investment Securities*

ACNB uses investment securities to generate interest and dividend income, manage interest rate risk, provide collateral for certain funding products, and provide liquidity. The changes in the securities portfolio in 2014 were mainly to deploy available funds into the appropriate mix of earning assets. Investing into investment security portfolio assets over the last several years was made more challenging due to the Federal Reserve's program commonly called Quantitative Easing in which, by the Federal Reserve's open market purchases, the yields were maintained at a lower level than would otherwise be the case. The mix in the securities portfolio during 2014 was changed to deploy available funds into the appropriate mix of earning assets. The investment portfolio is comprised of U.S. Government agency,

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municipal, and corporate securities. These securities provide the appropriate characteristics with respect to credit quality, yield and maturity relative to the management of the overall balance sheet.

At December 31, 2014, the securities balance included a net unrealized gain on available for sale securities of $2,570,000, net of taxes, on amortized cost of $114,106,000 versus a net unrealized gain of $2,572,000, net of taxes, on amortized cost of $126,090,000 at December 31, 2013. The change in fair value of available for sale securities during 2014 was a result of a lower amount of investments in the available for sale portfolio, offset by a decrease in the U.S. Treasury yield curve rates and the spread from this yield curve required by investors on the types of investment securities that ACNB owns. Even though Federal Reserve ceased their rate-decreasing Quantitative Easing program in 2014, events in the domestic and international economies caused interest rates to continue to contract. Previously, actions by the Federal Reserve to lower rates on the yield curve most conducive to stimulating the housing market and to boost employment and consumption were offset the bond markets' concern about the level of U.S. debt and inflation, leading to generally higher rates on the yield curve at the end of 2013. However, fair values were volatile on any given day in 2014 and such volatility will continue.

At December 31, 2014, the securities balance included held to maturity securities with an amortized cost of $73,346,000 and a fair value of $73,057,000, as compared to an amortized cost of $94,373,000 and a fair value of $92,082,000 at December 31, 2013. The held to maturity securities are U.S. government agency debentures and pass-through mortgage-backed securities in which the full payment of principal and interest is guaranteed; however, they are not classified as available for sale because of prevailing low interest rates at purchase, therefore these securities are projected not to be practicable to sell for liquidity needs in future periods. These securities are generally used as required collateral for certain eligible government accounts or repurchase agreements. They are also held for possible pledging to access additional liquidity for banking subsidiary needs in the form of Federal Home Loan Bank borrowings.

The Corporation does not own investments consisting of pools of Alt A or subprime mortgages, private label mortgage-backed securities, or trust preferred investments.

The fair values of securities available for sale (carried at fair value) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1) or by 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 security but rather by relying on the security's relationship to other benchmark quoted prices. The Corporation uses independent service providers to provide matrix pricing. Please refer to Note C "Securities" in the Notes to Consolidated Financial Statements for more information on the security portfolio and Note L "Fair Value Measurements" in the Notes to Consolidated Financial Statements for more information about fair value.

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The following tables set forth the composition of the securities portfolio and the securities maturity schedule, including weighted average yield, as of the end of the years indicated:

**Table 3 Investment Securities**

| In thousands | 2014 | 2013 | 2012 |
|---|---|---|---|
| **AVAILABLE FOR SALE SECURITIES AT FAIR VALUE** | | | |
| U.S. Government and agencies | **$ 17,317** | $ 21,651 | $ 24,241 |
| Mortgage-backed securities | **53,262** | 53,740 | 80,583 |
| State and municipal | **35,445** | 41,522 | 51,804 |
| Corporate bonds | **10,083** | 11,165 | 7,286 |
| CRA mutual fund | **1,058** | 1,033 | 1,096 |
| Stock in other banks | **835** | 872 | 780 |
| | **118,000** | 129,983 | 165,790 |
| **HELD TO MATURITY SECURITIES AT AMORTIZED COST** | | | |
| U.S. Government and agencies | **24,497** | 37,528 | 30,115 |
| Mortgage-backed securities | **48,849** | 56,845 | 20,044 |
| | **73,346** | 94,373 | 50,159 |
| **TOTAL** | **$ 191,346** | $ 224,356 | $ 215,949 |

Table 4 discloses investment securities at the scheduled maturity date at December 31, 2014. Many securities have call features that make their redemption possible before the stated maturity date.

**Table 4 Securities Maturity Schedule**

| | 1 Year or Less | | Over 1-5 Years | | Over 5-10 Years | | Over 10 Years or No Maturity | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Dollars in thousands** | **Amount** | **Yield** | **Amount** | **Yield** | **Amount** | **Yield** | **Amount** | **Yield** | **Amount** | **Yield** |
| U.S. Government and agencies | **$ 4,033** | **4.55%** | **$ 31,992** | **1.67%** | **$ 5,452** | **1.87%** | **$** | **%** | **$ 41,477** | **1.97%** |
| Mortgage-backed securities | | | **5,862** | **4.78** | **33,932** | **3.02** | **60,131** | **2.63** | **99,925** | **2.89** |
| State and municipal | **2,142** | **3.10** | **12,929** | **3.37** | **17,094** | **3.30** | **2,213** | **4.17** | **34,378** | **3.37** |
| Corporate bonds | **3,002** | **2.47** | **1,999** | **2.70** | **5,000** | **1.23** | | | **10,001** | **1.90** |
| CRA mutual fund | | | | | | | **1,044** | | **1,044** | |
| Stock in other banks | | | | | | | **627** | | **627** | |
| | **$ 9,177** | **3.53%** | **$ 52,782** | **2.47%** | **$ 61,478** | **2.85%** | **$ 64,015** | **2.62%** | **$ 187,452** | **2.70%** |

Securities are at amortized cost. Mortgage-backed securities are allocated based upon scheduled maturities.

*Loans*

Year over year, loans outstanding increased by $70,624,000, or 9.7%, in 2014, as compared to 2.9% growth experienced in 2013, both years demonstrating the determined efforts to lend to creditworthy borrowers subject to the Corporation's disciplined underwriting standards despite the continued slow economic conditions and intense competition. The higher increase in 2014 was created by concerted efforts to produce new loans whereas several payoffs of large local and participated loans produced a lower increase in 2013. Within the portfolio, the higher growth was centered in increased commercial purpose loans/commercial construction loans, while lower growth was in local market residential mortgages. The commercial purpose segments increased $58,034,000, or 19.5%, during 2014, spread among diverse categories that include farmland secured, loans to local government units, and other

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types of commercial lending. Residential real estate mortgage lending, which includes smaller commercial purpose loans secured by the owner's home, increased by $10,487,000, or 2.6%, to local borrowers who preferred loan types that would not be sold into the secondary mortgage market. Of the $10,487,000 increase, $2,900,000 were residential mortgage loans secured by junior liens or home equity loans, which are also in many cases junior liens. Junior liens inherently have more credit risk by virtue of the fact that another financial institution may have a senior security position in the case of foreclosure liquidation of collateral to extinguish the debt. Generally, foreclosure actions could become more prevalent if the real estate market weakens, property values deteriorate, or rates increase sharply. Real estate construction loans increased in 2014, up $1,014,000, or 9.1%, as a result of some stabilization in the residential real estate market despite stricter underwriting on this loan type due to the category's credit attributes.

The residential real estate category was higher in 2013 compared to 2012 as the result of more concentrated efforts to book consumer loans secured by real estate. In 2013, commercial lending staff concentrated in maintaining business lending outstandings despite reduced business activity in the market area that hindered new originations, as well as management's decision to not renew certain commercial loans, primarily participation credits in conjunction with other financial institutions, due to perceived potential credit risk.

**Table 5 Loan Portfolio**

Loans at December 31 were as follows:

| In thousands | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|
| Commercial, financial and agricultural | **$ 74,855** | $ 59,217 | $ 49,004 | $ 56,145 | $ 52,676 |
| Real estate: | | | | | |
| Commercial | **281,582** | 239,186 | 243,019 | 236,017 | 225,950 |
| Construction | **12,210** | 11,196 | 19,154 | 22,757 | 26,635 |
| Residential | **415,348** | 404,861 | 381,966 | 363,798 | 345,854 |
| Consumer | **15,277** | 14,188 | 14,993 | 15,751 | 14,176 |
| **Total Loans** | **$ 799,272** | $ 728,648 | $ 708,136 | $ 694,468 | $ 665,291 |

The repricing range of the loan portfolio at December 31, 2014, and the amounts of loans with predetermined and fixed rates are presented in the tables below:

**Table 6 Loan Sensitivities**

**LOANS MATURING**

| In thousands | Less than 1 Year | 1-5 Years | Over 5 Years | Total |
|---|---|---|---|---|
| Commercial, financial and agricultural | **$ 10,266** | **$ 30,723** | **$ 33,866** | **$ 74,855** |
| Real estate: | | | | |
| Commercial | **10,322** | **91,155** | **180,105** | **281,582** |
| Construction | **3,005** | **4,406** | **4,799** | **12,210** |
| Residential | **51,888** | **84,489** | **278,971** | **415,348** |
| **Total** | **$ 75,481** | **$ 210,773** | **$ 497,741** | **$ 783,995** |

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**LOANS BY REPRICING OPPORTUNITY**

| In thousands | Less than 1 Year | 1-5 Years | Over 5 Years | Total |
|---|---|---|---|---|
| Commercial, financial and agricultural | $ 14,238 | $ 32,492 | $ 28,125 | $ 74,855 |
| Real estate: | | | | |
| Commercial | 66,142 | 141,785 | 73,655 | 281,582 |
| Construction | 5,391 | 2,026 | 4,793 | 12,210 |
| Residential | 74,118 | 73,513 | 267,717 | 415,348 |
| **Total** | $ 159,889 | $ 249,816 | $ 374,290 | $ 783,995 |
| | | | | |
| Loans with a fixed interest rate | $ 24,130 | $ 51,288 | $ 335,007 | $ 410,425 |
| Loans with a variable interest rate | 135,759 | 198,528 | 39,283 | 373,570 |
| **Total** | $ 159,889 | $ 249,816 | $ 374,290 | $ 783,995 |

Most of the Corporation's lending activities are with customers located within southcentral Pennsylvania and in the northern Maryland area that is contiguous to its Pennsylvania retail banking offices. This region currently and historically has lower unemployment than the U.S. as a whole. Included in commercial real estate loans are loans made to lessors of non-residential properties that total $123,422,000, or 15.4% of total loans, at December 31, 2014. These borrowers are geographically dispersed throughout ACNB's marketplace and are leasing commercial properties to a varied group of tenants including medical offices, retail space, and other commercial purpose facilities. Because of the varied nature of the tenants, in aggregate, management believes that these loans present an acceptable risk when compared to commercial loans in general. ACNB does not originate or hold Alt-A or subprime mortgages in its loan portfolio.

*Asset Quality*

The ACNB loan portfolio is subject to varying degrees of credit risk. Credit risk is mitigated through prudent underwriting standards, ongoing credit review, and monitoring and reporting asset quality measures. Additionally, loan portfolio diversification, limiting exposure to a single industry or borrower, and requiring collateral also reduces ACNB's credit risk.

ACNB's commercial, consumer and residential mortgage loans are principally to borrowers in southcentral Pennsylvania and northern Maryland. As the majority of ACNB's loans are located in this area, a substantial portion of the debtor's ability to honor the obligation may be affected by the level of economic activity in the market area.

Although materially elevated from several years back, the unemployment rate in ACNB's market area remained below the state and national average during 2014. Additionally, low interest rates, a less volatile local economy, and minimal inflation continued to provide some support to the economic conditions in the area. During 2014, continued contraction in new residential real estate development/construction and general lower economic activity lingered from the recent major recession, challenging the Corporation's marketplace commercial activity. Slower growth areas such as ACNB's marketplace generally do not retract in economic recessions as quickly and as low as other areas of the country, however the recovery from low economic cycles are also generally slower.

Non-performing assets include nonaccrual loans and restructured loans (troubled debt restructures or TDRs), accruing loans past due 90 days or more, and other foreclosed assets. The accrual of interest on residential mortgage and commercial loans (consisting of commercial and industrial, commercial real estate, and commercial real estate construction loan categories) is discontinued at the time the loan is 90 days past due unless the credit is well secured and in the process of collection. Consumer loans (consisting of home equity lines of credit and consumer loan categories) are typically charged off no

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later than 120 days past due. Past due status is based on 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. ACNB occasionally returns nonaccrual loans to performing status when the borrower brings the loan current and performs in accordance with contractual terms for a reasonable period of time. ACNB categorizes a loan as a TDR if it changes the terms of the loan, such as interest rate, repayment schedule or both, to terms that it otherwise would not have granted to a borrower, for economic or legal reasons related to the borrower's financial difficulties.

The following table sets forth the Corporation's non-performing assets as of the end of the years indicated:

**Table 7 Non-Performing Assets**

| **Dollars in thousands** | **2014** | **2013** | **2012** | **2011** | **2010** |
|---|---|---|---|---|---|
| Nonaccrual loans, including TDRs | **$ 6,648** | $ 8,573 | $ 6,327 | $ 12,846 | $ 14,657 |
| Accruing loans 90 days past due | **1,636** | 1,926 | 771 | 1,191 | 997 |
| **Total Non-Performing Loans** | **8,284** | 10,499 | 7,098 | 14,037 | 15,654 |
| Foreclosed assets | **1,617** | 1,762 | 4,247 | 4,437 | 7,859 |
| **Total Non-Performing Assets** | **$ 9,901** | $ 12,261 | $ 11,345 | $ 18,474 | $ 23,513 |
| **Total Accruing Troubled Debt Restructurings** | **$ 6,968** | $ 7,139 | $ 4,815 | $ | $ |
| Ratios: | | | | | |
| Non-performing loans to total loans | **1.04%** | 1.44% | 1.00% | 2.02% | 2.35% |
| Non-performing assets to total assets | **0.91%** | 1.17% | 1.08% | 1.84% | 2.43% |
| Allowance for loan losses to non-performing loans | **183.15%** | 153.26% | 237.04% | 110.29% | 97.43% |

If interest due on all nonaccrual loans had been accrued at original contract rates, it is estimated that income before income taxes would have been greater by $570,000 in 2014, $704,000 in 2013, and $543,000 in 2012. The decrease in nonaccrual loans from 2013 to 2014 is discussed further below.

Impaired loans at December 31, 2014 and 2013, totaled $13,616,000 and $15,712,000, respectively. At December 31, 2014 and 2013, $866,000 and $2,036,000, respectively, of the impaired loans were troubled debt restructured loans, which were also classified as nonaccrual. $6,968,000 and $7,139,000 of the impaired loans were accruing troubled debt restructured loans at December 31, 2014 and 2013, respectively. Loans whose terms are modified are classified as troubled debt restructurings if the borrowers have been granted concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve interest rates being granted below current market rates for the credit risk of the loan or an extension of a loan's stated maturity date. Nonaccrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired. The related allowance for loan losses on impaired loans totaled $302,000 and $201,000 at December 31, 2014 and 2013, respectively. The decrease in accruing troubled debt restructurings was due to payments made. The decrease in nonaccrual loans was related to customer payments made and complete payoffs exceeding new non-accrual loans added in 2014 (most with adequate real estate collateral), net of other loan amounts that were charged-off. Further discussion on nonaccrual loans is included below in a separate discussion on nonaccrual loans. Potential problem loans are defined as performing loans that have characteristics that cause management to have doubts as to the ability of the borrower to perform under present loan repayment terms and which may result in the reporting of these loans as non-performing loans in the future. Total additional potential problem loans approximated $9,896,000 at December 31, 2014, compared to $9,083,000 at December 31, 2013.

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Foreclosed assets held for resale consists of the fair value of real estate acquired through foreclosure on real estate loan collateral or the acceptance of ownership of such real estate in lieu of the foreclosure process. Fair values are based on appraisals that consider the sale prices of similar properties in the proximate vicinity less estimated selling costs. Foreclosed assets held for resale totaled $1,617,000 at December 31, 2014. Seven unrelated commercial use or construction real estate properties were brought into foreclosed real estate in 2014, 2013, 2012, or 2010 with an aggregate fair value of $1,199,000. In addition, the fair value of $418,000 for foreclosed real estate at December 31, 2014, represented five residential real estate single family homes, which were taken into foreclosed real estate in 2014. All properties are being actively marketed to targeted buyers by external and internal resources. The total of $1,762,000 in foreclosed real estate at December 31, 2013, represented six commercial use or construction real estate properties, and three single family homes.

*Allowance for Loan Losses*

ACNB maintains the allowance for loan losses at a level believed to be adequate by management to absorb potential losses in the loan portfolio, and it is funded through a provision for loan losses charged to earnings. On a quarterly basis, ACNB utilizes a defined methodology in determining the adequacy of the allowance for loan losses, which considers specific credit reviews, past loan losses, historical experience, and qualitative factors. This methodology results in an allowance that is considered appropriate in light of the high degree of judgment required and that is prudent and conservative, but not excessive.

Management assigns internal risk ratings for each commercial lending relationship. Utilizing historical loss experience, adjusted for changes in trends, conditions and other relevant factors, management derives estimated losses for non-rated and non-classified loans. When management identifies impaired loans with uncertain collectability of principal and interest, it evaluates a specific reserve on a quarterly basis in order to estimate potential losses. Management's analysis considers:

- adverse situations that may affect the borrower's ability to repay;
- the current estimated fair value of underlying collateral; and,
- prevailing market conditions.

If management determines a loan is not impaired, a specific reserve allocation is not required. Management then places the loan in a pool of loans with similar risk factors and assigns the general loss factor to determine the reserve. For homogeneous loan types, such as consumer and residential mortgage loans, management bases specific allocations on the average loss ratio for the previous three years for each specific loan pool. Additionally, management adjusts projected loss ratios for other factors, including the following:

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

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Management determines the unallocated portion of the allowance for loan losses, which represents the difference between the reported allowance for loan losses and the calculated allowance for loan losses, based on the following criteria:

- risk of imprecision in the specific and general reserve allocations;
- the perceived level of consumer and small business loans with demonstrated weaknesses for which it is not practicable to develop specific allocations;
- other potential exposure in the loan portfolio;
- variances in management's assessment of national, regional, and local economic conditions; and,
- other internal or external factors that management believes appropriate at that time.

The unallocated portion of the allowance is deemed to be appropriate as it reflects an uncertainty that remains in the loan portfolio; specifically reserves where the Corporation believes that tertiary losses are probable above the loss amount derived using appraisal-based loss estimation, where such additional loss estimates are in accordance with regulatory and GAAP guidance. Appraisal-based loss derivation does not fully develop the loss present in certain unique, ultimately bank-owned collateral. The Corporation has determined that the amount of provision in 2014 and the resulting allowance at December 31, 2014, are appropriate given the level of risk in the loan portfolio. Further, management believes the unallocated allowance is appropriate, although the impaired loans added in 2014 demonstrate generally low risk because of adequate real estate collateral, the value of such collateral can decrease; plus, the growth in the loan portfolio is centered around commercial real estate which continues to have little increase in value and low liquidity. In addition, there are certain loans that, although they did not meet the criteria for impairment, management believes there was a strong possibility that these loans represented probable losses at December 31, 2014.

Management believes the above methodology accurately reflects losses inherent in the portfolio. Management charges actual loan losses to the allowance for loan losses. Management periodically updates the methodology and the assumptions discussed above.

Management bases the provision for loan losses, or lack of provision, on the overall analysis taking into account the methodology discussed above. The provision for 2014 was $1,300,000 less than the provision for 2013. The provision for 2013 was $3,225,000 less than the provision for 2012. Management believes that the decrease in the provision reflects that potential losses inherent in the portfolio were reflected in previous period provision expense and is consistent with recent improving credit quality in the loan portfolio.

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.

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The following tables set forth information on the analysis of the allowance for loan losses and the allocation of the allowance for loan losses as of the dates indicated:

**Table 8 Analysis of Allowance for Loan Losses**

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| **Dollars in thousands** | **2014** | **2013** | **2012** | **2011** | **2010** |
| Beginning balance | **$ 16,091** | $ 16,825 | $ 15,482 | $ 15,252 | $ 11,981 |
| Provision for loan losses | **150** | 1,450 | 4,675 | 5,435 | 6,410 |
| Loans charged-off: | | | | | |
| Commercial, financial and agricultural | **132** | 178 | 2,180 | 1,861 | 204 |
| Real estate | **121** | 996 | 955 | 2,550 | 2,049 |
| Residential mortgage | **874** | 1,062 | 551 | 802 | 810 |
| Consumer | **64** | 191 | 71 | 30 | 118 |
| **Total Loans Charged-Off** | **1,191** | 2,427 | 3,757 | 5,243 | 3,181 |
| Recoveries: | | | | | |
| Commercial, financial and agricultural | **15** | 235 | 22 | 34 | 2 |
| Real estate | | | 399 | | |
| Residential mortgage | **97** | 4 | 1 | 2 | 35 |
| Consumer | **10** | 4 | 3 | 2 | 5 |
| **Total Recoveries** | **122** | 243 | 425 | 38 | 42 |
| Net charge-offs | **1,069** | 2,184 | 3,332 | 5,205 | 3,139 |
| Ending balance | **$ 15,172** | $ 16,091 | $ 16,825 | $ 15,482 | $ 15,252 |
| Ratios: | | | | | |
| Net charge-offs to average loans | **0.14%** | 0.31% | 0.48% | 0.77% | 0.47% |
| Allowance for loan losses to total loans | **1.90%** | 2.21% | 2.38% | 2.23% | 2.29% |

**Table 9 Allocation of the Allowance for Loan Losses**

| | 2014 | | 2013 | | 2012 | | 2011 | | 2010 | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Dollars in thousands** | **Amount** | **Percent of Loan Type to Total Loans** | **Amount** | **Percent of Loan Type to Total Loans** | **Amount** | **Percent of Loan Type to Total Loans** | **Amount** | **Percent of Loan Type to Total Loans** | **Amount** | **Percent of Loan Type to Total Loans** |
| Commercial, financial and agricultural | **$ 2,048** | **9.4%** | $ 1,915 | 8.1% | $ 1,507 | 6.9% | $ 2,582 | 8.1% | $ 2,074 | 7.9% |
| Real estate: | | | | | | | | | | |
| Commercial | **5,872** | **35.2** | 5,819 | 32.8 | 6,576 | 34.4 | 6,007 | 34.0 | 6,346 | 34.0 |
| Construction | **194** | **1.5** | 247 | 1.5 | 518 | 2.7 | 548 | 3.3 | 1,154 | 4.0 |
| Residential | **4,402** | **52.0** | 4,550 | 55.6 | 4,238 | 53.9 | 4,131 | 52.4 | 3,449 | 44.6 |
| Consumer | **1,050** | **1.9** | 947 | 2.0 | 633 | 2.1 | 419 | 2.3 | 520 | 9.5 |
| Unallocated | **1,606** | **N/A** | 2,613 | N/A | 3,353 | N/A | 1,795 | N/A | 1,709 | N/A |
| **Total** | **$ 15,172** | **100.0%** | $ 16,091 | 100.0% | $ 16,825 | 100.0% | $ 15,482 | 100.0% | $ 15,252 | 100.0% |

The allowance for loan losses at December 31, 2014, was $15,172,000, or 1.90% of loans, as compared to $16,091,000, or 2.21% of loans, at December 31, 2013. The ratio of non-performing loans plus foreclosed assets to total assets was 0.91% at December 31, 2014, as compared to

1.17% at December 31, 2013.

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Loans past due 90 days and still accruing were $1,636,000 and nonaccrual loans were $6,648,000 as of December 31, 2014. Loans past due 90 days and still accruing were $1,926,000 at December 31, 2013, while nonaccruals were $8,573,000.

Additional information on nonaccrual loans at December 31, 2014 and 2013, is as follows:

| Dollars in thousands | Number of Credit Relationships | Balance | Current Specific Loss Allocations | Current Year Charge-Offs | Location | Originated | |
|---|---|---|---|---|---|---|---|
| **December 31, 2014** | | | | | | | |
| Commercial real estate construction | **2** | **$ 368** | **$** | **$** | **In market** | **2006** | **2010** |
| Owner occupied commercial real estate | **12** | **3,325** | | **111** | **In market** | **1995** | **2012** |
| **Investment/rental residential real estate** | **3** | **1,226** | **302** | **543** | **In market** | **2003** | **2011** |
| Commercial and industrial | **3** | **1,729** | | | **In market** | **2006** | **2007** |
| **Total** | **20** | **$ 6,648** | **$ 302** | **$ 654** | | | |
| **December 31, 2013** | | | | | | | |
| Commercial real estate construction | 3 | $ 788 | $ | $ 22 | In market | 2006 | 2009 |
| Owner occupied commercial real estate | 14 | 4,363 | | 109 | In market | 1995 | 2011 |
| Investment/rental residential real estate | 6 | 1,848 | 201 | 848 | In market | 1998 | 2011 |
| Commercial and industrial | 3 | 1,574 | | | In market | 2007 | 2008 |
| **Total** | 26 | $ 8,573 | $ 201 | $ 979 | | | |

All nonaccrual impaired loans are to borrowers located within the market area served by the Corporation in southcentral Pennsylvania and nearby areas of northern Maryland. All nonaccrual impaired loans were originated by ACNB's banking subsidiary, except for one participation loan discussed below, between 1995 and 2012 for purposes listed in the classifications in the table above.

Included in commercial real estate construction at December 31, 2014, the Corporation had one impaired and nonaccrual loan of $274,000 to finance a project in the Corporation's primary trading area of southcentral Pennsylvania. The loan had standard terms and conditions including repayment from the sales of the respective properties and no interest reserves, and was originated during the first half of 2006. Foreclosure has been held in abeyance while allowing the pursuit of a workout plan. The workout plan resulted in payments of $420,000 in 2014. One smaller commercial real estate construction loan, added in 2010, was reduced by collateral sales to $94,000, which is supported by the remaining collateral's current fair value.

Owner occupied commercial real estate and construction includes 12 unrelated loan relationships, all of which but a loan relationship for farmland have balances of less than $850,000 each, for which the real estate is collateral and is used in connection with a business enterprise that is suffering economic stress or is out of business. A farmland relationship with an outstanding balance of $849,000, with normal terms and conditions, was added to nonaccrual in the second quarter of 2013 after the loan matured and the borrower commenced a bankruptcy filing. Based on recent appraisals, the loan appears to be adequately collateralized and some principal payments are being made. The other loans in this category were originated between 1995 and 2010 and are business loans impacted by the general economic downturn that has not recovered. Collection efforts will continue until it is deemed in the best interest of the Corporation to initiate foreclosure procedures.

Investment/rental residential real estate includes three unrelated loan relationships totaling $1,226,000 for which the real estate is collateral and the purpose of which is for speculation, rental, or other non-owner occupied uses; of which one loan was approximately $508,000, originated in 2009 with normal terms and conditions. The credit was deemed nonaccrual impaired in the first quarter of 2013

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and had a specific allocation and subsequent partial charge-off to arrive at the fair value. This property will be converted to foreclosed assets held for resale in the first quarter 2015 upon receipt of legal title. One loan with a balance of $694,000 had a specific allocation of $302,000 based on appraisal less estimated costs to sell.

Included in impaired commercial and industrial loans is a participation loan with standard terms and conditions including repayment from conversion of trade assets for a business in southcentral Pennsylvania in Chapter 11 bankruptcy that has a balance of $1,683,000. This loan was moved to nonaccrual in the third quarter of 2014 after becoming delinquent with no indication of when regular payments would resume. Besides trade assets, the loan is fully guaranteed by a government sponsored entity so no specific allocation was deemed to be necessary.

The Corporation utilizes a systematic review of its loan portfolio on a quarterly basis in order to determine the adequacy of the allowance for loan losses. In addition, ACNB engages the services of an outside independent loan review function and sets the timing and coverage of loan reviews during the year. The results of this independent loan review are included in the systematic review of the loan portfolio. The allowance for loan losses consists of a component for individual loan impairment, primarily based on the loan's collateral fair value and expected cash flow. A watch list of loans is identified for evaluation based on internal and external loan grading and reviews. Loans other than those determined to be impaired are grouped into pools of loans with similar credit risk characteristics. These loans are evaluated as groups with allocations made to the allowance based on historical loss experience adjusted for current trends in delinquencies, trends in underwriting and oversight, concentrations of credit, and general economic conditions within the Corporation's trading area. The provision expense was based on the loans discussed above, as well as current trends in the watch list and the local economy as a whole. The charge-offs discussed elsewhere in this Management's Discussion and Analysis create the recent loss history experience and result in the qualitative adjustment which, in turn, affects the calculation of losses inherent in the portfolio. The provision for loan losses for 2014 compared to 2013 and 2012 was a result of the measurement of the adequacy of the allowance for loan losses at each period. The decrease in the provision was also a result of the analysis of the adequacy of the allowance for loan losses. More specifically, nonaccrual loans decreased and provision expense decreased due to the amount of the allowance necessary in proportion to substandard loans in accordance with management's belief that adequate collateralization generally exists for substandard loans in accordance with GAAP. Each quarter, the Corporation assesses risk in the loan portfolio compared with the balance in the allowance for loan losses and the current evaluation factors.

*Foreclosed Assets Held for Resale*

The carrying value of real estate acquired through foreclosure was $1,617,000 at December 31, 2014, compared to $1,762,000 at December 31, 2013. The decrease was mainly due to four properties that were disposed of in 2014. Three additional commercial properties were added in 2010 through 2013 that remain unsold at December 31, 2014, with an aggregate fair value of $1,008,000. Three unrelated commercial properties totaling $191,000 and five residential properties totaling $418,000 were added in 2014 and remain unsold at December 31, 2014. All properties are actively being marketed. The Corporation expects to obtain and market additional foreclosed assets in 2015; however, the total amount and timing is currently not certain.

*Other Assets*

Other assets decreased $562,000, or 2.7%, in 2014 compared to 2013, primarily because of a decrease in the Bank's pension plan, including the related deferred tax effect due to the change in discount rate, rate of return, and change in mortality assumptions in 2014.

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*Deposits*

ACNB relies on deposits as the primary source of funds for lending activities. Average deposits decreased 0.4%, or $3,068,000, during 2014, as compared to a 1.6% increase during 2013. ACNB's deposit pricing function employs a disciplined pricing approach based upon alternative funding rates, but also strives to price deposits to be competitive with relevant local competition, including credit unions and larger regional banks. The 2014 average deposit decrease in part was a return to more normal conditions after several years experienced a shift to transaction accounts as customers put more value in liquidity and FDIC insurance. Products, such as money market accounts and interest-bearing transaction accounts that had suffered declines in past years, continued with recovered balances while retail time deposits decreased. Year-end 2013 to year-end 2014 recorded an increase in deposits of $44,233,000, or 5.5%, most of which was in large local government non maturity and time deposits, as such funds typically are held for liquidity by those agencies or a no risk alternative to other currently low rate investments. With persistent low market interest rates in a slow economy, ACNB's ability to maintain and add to its deposit base may be impacted by the reluctance of consumers to accept low rates and by competition willing to pay above market rates to attract market share. Alternatively, if rates rise rapidly and the equity markets continue to improve, funds could leave the Corporation or be priced higher to maintain deposits.

**Table 10 Time Deposits**

Maturities of time deposits of $100,000 or more outstanding at December 31, 2014, are summarized as follows:

| **In thousands** | | |
|---|---|---|
| Three months or less | **$** | **27,308** |
| Over three through six months | | **14,451** |
| Over six through twelve months | | **18,581** |
| Over twelve months | | **29,341** |
| **Total** | **$** | **89,681** |

*Borrowings*

Short-term borrowings are comprised primarily of securities sold under agreements to repurchase and short-term borrowings from the Federal Home Loan Bank (FHLB). As of December 31, 2014, short-term borrowings were $45,699,000, a decrease of $3,353,000, or 6.8%, from the December 31, 2013, balance of $49,052,000. Agreements to repurchase accounts are within the commercial customer base and have attributes similar to core deposits. Investment securities are pledged in sufficient amounts to collateralize these agreements. Compared to year-end 2013, repurchase agreement balances were up due to normal fluctuations in the business activities of ACNB's commercial customer base. At December 31, 2014, there were $0 in short-term FHLB borrowings, due to daily fluctuation in deposits and loans. Long-term borrowings consist primarily of longer-term advances from the FHLB that provides term funding of loan assets and contribute to a more balanced net repricing position. In addition, such borrowings include a $1.4 million loan from a commercial bank to fund the initial purchase of RIG. Long-term borrowings totaled $80,937,000 at December 31, 2014, versus $82,703,000 at December 31, 2013. The Corporation decreased long-term borrowings 2.1% as funding for loan demand was available from other sources. Generally however, as term advances matured, new laddered FHLB fixed-rate term advances were taken in 2014 to reduce net liability sensitivity and to take advantage of lower rates. Further borrowings will be used when necessary for a variety of risk management and funding purposes. Please refer to the *Liquidity* discussion below for more information on the Corporation's ability to borrow.

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The following tables set forth information about the Corporation's borrowings as of the dates indicated:

| In thousands | 2014 | 2013 | 2012 |
|---|---|---|---|
| Short-term borrowings outstanding at end of year: | | | |
| FHLB overnight advance | **$** | $ 6,800 | $ |
| Securities sold under repurchase agreements | **45,699** | 42,252 | 47,303 |
| **Total** | **$ 45,699** | $ 49,052 | $ 47,303 |

| Dollars in thousands | 2014 | 2013 | 2012 |
|---|---|---|---|
| Average interest rate at year-end | **0.14%** | 0.14% | 0.14% |
| Maximum amount outstanding at any month-end | **$ 74,846** | $ 76,333 | $ 58,343 |
| Average amount outstanding | **$ 44,399** | $ 53,184 | $ 48,300 |
| Weighted average interest rate | **0.14%** | 0.11% | 0.16% |

*Capital*

ACNB's capital management strategies have been developed to provide an appropriate rate of return, in the opinion of management, to stockholders, while maintaining its "well capitalized" position in relationship to its risk exposure. Total stockholders' equity was $110,022,000 at December 31, 2014, compared to $106,802,000 at December 31, 2013. Stockholders' equity increased during 2014 , a net result of earnings retained in capital during 2014, and a decrease in accumulated other comprehensive income resulting from amounts associated with the pension plan, and the change in fair value of the assets in the available for sale investment portfolio.

The primary source of additional capital to ACNB is earnings retention, which represents net income less dividends declared. During 2014, ACNB retained $5,668,000, or 55.1%, of its net income, as compared to $4,773,000, or 51.2%, in 2013 and $4,362,000, or 49.1%, in 2012.

ACNB Corporation has a Dividend Reinvestment and Stock Purchase Plan that provides registered holders of ACNB Corporation common stock with a convenient way to purchase additional shares of common stock by permitting participants in the plan to automatically reinvest cash dividends on all or a portion of the shares owned and to make quarterly voluntary cash payments under the terms of the plan. Participation in the plan is voluntary, and there are eligibility requirements to participate in the plan. Cumulative to December 31, 2014, 87,307 shares were issued under this plan with proceeds in the amount of $1,380,000. Proceeds are used for general corporate purposes.

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

Quantitative measures established by regulation to ensure capital adequacy require ACNB to maintain minimum amounts and ratios of total and Tier 1 capital to average assets. Management believes, as of December 31, 2014 and 2013, that ACNB's banking subsidiary met all minimum capital adequacy requirements to which it is subject and is categorized as "well capitalized". There are no subsequent conditions or events that management believes have changed the banking subsidiary's category.

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*Regulatory Capital Changes*

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations begins January 1, 2015, while larger institutions (generally those with assets of $250 billion or more) were required to begin compliance effective January 1, 2014. The final rules call for the following capital requirements:

- a minimum ratio of common Tier 1 capital to risk-weighted assets of 4.5%;
- a minimum ratio of Tier 1 capital to risk-weighted assets of 6.0%;
- a minimum ratio of total capital to risk-weighted assets of 8.0%, which is no change from the current rule; and,
- a minimum leverage ratio of 4.0%.

In addition, the final rules establish a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation and countercyclical capital buffers for all banking organizations will begin on January 1, 2016.

Under the proposed rules, accumulated other comprehensive income (AOCI) would have been included in a banking organization's common equity Tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The opt-out election must be made in the first call report or FR Y-9 series report that is filed after the financial institution becomes subject to the final rule.

The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010, for inclusion in the Tier 1 capital of banking organizations with total consolidated assets of less than $15 billion as of December 31, 2009, and banking organizations that were mutual holding companies as of May 19, 2010.

The proposed rules would have modified the risk-weight framework applicable to residential mortgage exposures to require banking organizations to divide residential mortgage exposures into two categories in order to determine the applicable risk weight. In response to commenter concerns about the burden of calculating the risk weights and the potential negative effect on credit availability, the final rules do not adopt the proposed risk weights, but retain the current risk weights for mortgage exposures under the general risk-based capital rules.

Consistent with the Dodd-Frank Act, the new rules replace the ratings-based approach to securitization exposures, which is based on external credit ratings, with the simplified supervisory formula approach in order to determine the appropriate risk weights for these exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

Under the new rules, mortgage servicing assets and certain deferred tax assets are subject to stricter limitations than those applicable under the current general risk-based capital rule. The new rules also increase the risk weights for past due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

The Corporation has assessed the impact of these changes on the regulatory ratios of the Corporation and the banking subsidiary, as well as on the capital, operations, liquidity, and earnings of

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the Corporation and the banking subsidiary and concluded that the new rules will not have a material negative effect.

**Table 11 Risk-Based Capital**

The banking subsidiary's capital ratios are as follows:

| | 2014 | 2013 | To be Well Capitalized under Prompt Corrective Action Regulations |
|---|---|---|---|
| Tier 1 leverage ratio (to average assets) | **8.86%** | 8.76% | 5.00% |
| Tier 1 risk-based capital ratio (to risk-weighted assets) | **12.75%** | 12.99% | 6.00% |
| Total risk-based capital ratio | **14.01%** | 14.26% | 10.00% |

For further information on the actual and required capital amounts and ratios, please refer to Note N "Regulatory Matters" in the Notes to Consolidated Financial Statements.

*Liquidity*

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

ACNB's funds are available from a variety of sources, including assets that are readily convertible such as interest bearing deposits with banks, maturities and repayments from the securities portfolio, scheduled repayments of loans receivable, the core deposit base, and the ability to borrow from the FHLB. At December 31, 2014, ACNB could borrow approximately $456,258,000 from the FHLB of which $376,758,000 was available. Because of various restrictions and requirements on utilizing the available balance, ACNB considers $283,000,000 to be the practicable additional borrowing capacity, which is considered to be sufficient for operational needs. The FHLB system is self-capitalizing, member-owned, and its member banks' stock is not publicly traded. ACNB creates its borrowing capacity with the FHLB by granting a security interest in certain loan assets with requisite credit quality. ACNB has reviewed information on the FHLB system and the FHLB of Pittsburgh, and has concluded that they have the capacity and intent to continue to provide both operational and contingency liquidity. The FHLB of Pittsburgh instituted a requirement that a member's investment securities must be moved into a safekeeping account under FHLB control to be considered in the calculation of maximum borrowing capacity. The Corporation currently has securities in safekeeping at the FHLB of Pittsburgh; however, the safekeeping account is under the Corporation's control. As better contingent liquidity is maintained by keeping the securities under the Corporation's control, the Corporation has not moved the securities which, in effect, lowered the Corporation's maximum borrowing capacity. However, there is no practical reduction in borrowing capacity as the securities can be moved into the FHLB-controlled account promptly if they are needed for borrowing purposes.

Another source of liquidity is securities sold under repurchase agreements to customers of ACNB's banking subsidiary totaling $45,699,000 and $42,252,000 at December 31, 2014 and 2013, respectively.

The liquidity of the parent company also represents an important aspect of liquidity management. The parent company's cash outflows consist principally of dividends to stockholders and corporate expenses. The main source of funding for the parent company is the dividends it receives from its subsidiaries. Federal and state banking regulations place certain legal restrictions and other practicable safety and soundness restrictions on dividends paid to the parent company from the subsidiary bank. For a discussion of ACNB's dividend restrictions, please refer to Item 1 "Business" and Note J "Regulatory Restrictions on Dividends" in the Notes to Consolidated Financial Statements.

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

*Aggregate Contractual Obligations*

The following table represents the Corporation's on- and off-balance sheet aggregate contractual obligations to make future payments as of December 31, 2014:

| In thousands | Less than 1 Year | 1 - 3 Years | 4 - 5 Years | Over 5 Years | Total |
|---|---|---|---|---|---|
| Time deposits | $ 156,329 | $ 88,623 | $ 6,975 | $ | $ 251,927 |
| Short-term borrowings | 45,699 | | | | 45,699 |
| Long-term debt | 21,281 | 33,110 | 26,546 | | 80,937 |
| Operating leases | 381 | 403 | 279 | 317 | 1,380 |
| Payments under nonqualified benefit plans(1) | 100 | 244 | 282 | 6,323 | 6,949 |
| **Total** | **$ 223,790** | **$ 122,380** | **$ 34,082** | **$ 6,640** | **$ 386,892** |

(1) The payments under nonqualified benefit plans excludes expected benefit retirement payments that will be paid from plan assets.

In addition, the Corporation, in the conduct of business operations, routinely enters into contracts for services and equipment. These contracts may require payment to be provided in the future, and may also contain penalty clauses for early termination of the contracts. Major expenditures are controlled by various approval authorities. Management is not aware of any other commitments or contingent liabilities which may have a material adverse impact on the liquidity or capital resources of the Corporation.

*Off-Balance Sheet Arrangements*

The Corporation is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and, to a lesser extent, standby letters of credit. At December 31, 2014, the Corporation had unfunded outstanding commitments to extend credit of $217,837,000 and outstanding standby letters of credit of $6,072,000. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. Please refer to Note O "Financial Instruments with Off-balance Sheet Risk" in the Notes to Consolidated Financial Statements for a discussion of the nature, business purpose, and importance of the Corporation's off-balance sheet arrangements.

*New Accounting Pronouncements*

See Note A "Summary of Significant Accounting Policies" in the Notes to Consolidated Financial Statements for a summary of these new accounting pronouncements not yet adopted.

## ITEM 7A QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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various terms and rates. These funds are then invested into earning assets (primarily loans and investments) at various terms and rates. This risk is further discussed below.

ACNB does not have any exposure to foreign currency exchange risk, commodity price risk, or equity market risk.

*Interest Rate Risk*

Interest rate risk is the exposure to fluctuations in the Corporation's future earnings (earnings at risk) and value (value at risk) resulting from changes in interest rates. This exposure results from differences between the amounts of interest earning assets and interest bearing liabilities that reprice within a specified time period as a result of scheduled maturities and repayment and contractual interest rate changes.

The primary objective of the Corporation's asset/liability management process is to maximize current and future net interest income within acceptable levels of interest rate risk while satisfying liquidity and capital requirements. Management recognizes that a certain amount of interest rate risk is inherent, appropriate and necessary to ensure the Corporation's profitability. Thus, the goal of interest rate risk management is to maintain a balance between risk and reward such that net interest income is maximized while risk is maintained at a tolerable level.

Management endeavors to control the exposure to changes in interest rates by understanding, reviewing and making decisions based on its risk position. The banking subsidiary's asset/liability committee is responsible for these decisions. The Corporation primarily uses the securities portfolio and FHLB advances to manage its interest rate risk position. Additionally, pricing, promotion and product development activities are directed in an effort to emphasize the loan and deposit term or repricing characteristics that best meet current interest rate risk objectives. At present, there is no use of hedging instruments.

The asset/liability committee operates under management policies defining guidelines and limits on the level of risk. These policies are approved by the Board of Directors.

The Corporation uses simulation analysis to assess earnings at risk and net present value analysis to assess value at risk. These methods allow management to regularly monitor both the direction and magnitude of the Corporation's interest rate risk exposure. These modeling techniques involve assumptions and estimates that inherently cannot be measured with complete precision. Key assumptions in the analyses include maturity and repricing characteristics of both assets and liabilities, prepayments on amortizing assets, non-maturity deposit sensitivity, and loan and deposit pricing. These assumptions are inherently uncertain due to the timing, magnitude and frequency of rate changes and changes in market conditions and management strategies, among other factors. However, the analyses are useful in quantifying risk and provide a relative gauge of the Corporation's interest rate risk position over time.

*Earnings at Risk*

Simulation analysis evaluates the effect of upward and downward changes in market interest rates on future net interest income. The analysis involves changing the interest rates used in determining net interest income over the next twelve months. The resulting percentage change in net interest income in various rate scenarios is an indication of the Corporation's short-term interest rate risk. The analysis utilizes a "static" balance sheet approach. The measurement date balance sheet composition (or mix) is maintained over the simulation time period, with maturing and repayment dollars being rolled back into like instruments for new terms at current market rates. Additional assumptions are applied to modify volumes and pricing under the various rate scenarios. These include prepayment assumptions on mortgage assets, sensitivity of non-maturity deposit rates, and other factors deemed significant.

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The simulation analysis results are presented in Table 13a. These results, as of December 31, 2014, indicate that the Corporation would expect net interest income to increase over the next twelve months by 1.35% assuming an upward ramp in market interest rates of 3.00%, and to decrease by 5.16% if rates ramped downward 3.00%. This profile reflects an acceptable short-term interest rate risk position. However, a decrease of 3.00% would create an environment in which deposit rates could not practically decline further, thus decreasing net interest income.

Earnings at risk simulations for December 31, 2013, exhibited similar sensitivity in a declining rate environment reflecting an interest rate environment in which larger rate declines could be expected.

*Value at Risk*

The net present value analysis provides information on the risk inherent in the balance sheet that might not be taken into account in the simulation analysis due to the shorter time horizon used in that analysis. The net present value of the balance sheet is defined as the discounted present value of expected asset cash flows minus the discounted present value of the expected liability cash flows. The analysis involves changing the interest rates used in determining the expected cash flows and in discounting the cash flows. The resulting percentage change in net present value in various rate scenarios is an indication of the longer term repricing risk and options embedded in the balance sheet.

The net present value analysis results are presented in Table 13b. These results, as of December 31, 2014, indicate that the net present value would increase 2.82% assuming an upward shift in market interest rates of 3.00% and increase 2.48% if rates shifted 1.00% in the same manner.

| December 31, 2014<br>Table 13a<br>Net Interest Income Projections | | December 31, 2014<br>Table 13b<br>Present Value of Equity | |
|---|---|---|---|
| **Changes in Basis Points** | **% Change** | **Changes in Basis Points** | **% Change** |
| **(300)** | **(5.16)%** | **(300)** | **0.75 %** |
| **(100)** | **(1.25)%** | **(100)** | **(8.44)%** |
| | | | |
| **100** | **0.35 %** | **100** | **2.48 %** |
| **300** | **1.35 %** | **300** | **2.82 %** |

| December 31, 2013<br>Table 13a<br>Net Interest Income Projections | | December 31, 2013<br>Table 13b<br>Present Value of Equity | |
|---|---|---|---|
| **Changes in Basis Points** | **% Change** | **Changes in Basis Points** | **% Change** |
| (300) | (6.19)% | (300) | (11.49)% |
| (100) | (1.42)% | (100) | (6.66)% |
| | | | |
| 100 | (0.15)% | 100 | (0.64)% |
| 300 | (0.30)% | 300 | (3.91)% |

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## ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

(a)

The following audited consolidated financial statements and related documents are set forth in this Annual Report on Form 10-K on the following pages:

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders
ACNB Corporation
Gettysburg, Pennsylvania

We have audited the accompanying consolidated statements of condition of ACNB Corporation (the "Corporation") as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the two years in the period ended December 31, 2014. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ACNB Corporation at December 31, 2014 and 2013, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), ACNB Corporation's internal control over financial reporting as of December 31, 2014, based on criteria established in the *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 6, 2015, expressed an unqualified opinion.

/s/ BDO USA, LLP

Harrisburg, Pennsylvania
March 6, 2015

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders
ACNB Corporation

We have audited the accompanying consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows of ACNB Corporation and Subsidiaries for the year ended December 31, 2012. ACNB Corporation's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated results of ACNB Corporation and Subsidiaries operations and their cash flows for the year ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

/s/ Baker Tilly Virchow Krause, LLP

Wilkes-Barre, Pennsylvania
March 15, 2013

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**ACNB CORPORATION**

**CONSOLIDATED STATEMENTS OF CONDITION**

| **Dollars in thousands, except per share data** | **December 31, 2014** | **December 31, 2013** |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | **$ 13,502** | $ 13,963 |
| Interest bearing deposits with banks | **6,171** | 4,153 |
| Total Cash and Cash Equivalents | **19,673** | 18,116 |
| Securities available for sale | **118,000** | 129,983 |
| Securities held to maturity, fair value $73,057; $92,082 | **73,346** | 94,373 |
| Loans held for sale | **1,623** | 496 |
| Loans, net of allowance for loan losses $15,172; $16,091 | **784,100** | 712,557 |
| Premises and equipment | **17,725** | 15,991 |
| Restricted investment in bank stocks | **4,216** | 6,861 |
| Investment in bank-owned life insurance | **37,942** | 32,237 |
| Investments in low-income housing partnerships | **3,793** | 4,687 |
| Goodwill | **6,308** | 6,308 |
| Intangible assets | **1,196** | 1,845 |
| Foreclosed assets held for resale | **1,617** | 1,762 |
| Other assets | **20,269** | 20,831 |
| **Total Assets** | **$ 1,089,808** | $ 1,046,047 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| **LIABILITIES** | | |
| Deposits: | | |
| Non-interest bearing | **$ 144,987** | $ 128,011 |
| Interest bearing | **699,889** | 672,632 |
| Total Deposits | **844,876** | 800,643 |
| Short-term borrowings | **45,699** | 49,052 |
| Long-term borrowings | **80,937** | 82,703 |
| Other liabilities | **8,274** | 6,847 |
| **Total Liabilities** | **979,786** | 939,245 |
| **STOCKHOLDERS' EQUITY** | | |
| Preferred stock, $2.50 par value; 20,000,000 shares authorized; no shares outstanding | | |
| Common stock, $2.50 par value; 20,000,000 shares authorized; 6,078,250 and 6,053,911 shares issued; 6,015,650 and 5,991,311 shares outstanding | **15,196** | 15,135 |
| Treasury stock, at cost (62,600 shares) | **(728)** | (728) |
| Additional paid-in capital | **9,948** | 9,628 |
| Retained earnings | **88,329** | 82,661 |
| Accumulated other comprehensive (loss) income | **(2,723)** | 106 |
| **Total Stockholders' Equity** | **110,022** | 106,802 |
| **Total Liabilities and Stockholders' Equity** | **$ 1,089,808** | $ 1,046,047 |

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

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**ACNB CORPORATION**

**CONSOLIDATED STATEMENTS OF INCOME**

| Dollars in thousands, except per share data | Years Ended December 31, 2014 | 2013 | 2012 |
|---|---|---|---|
| **INTEREST INCOME** | | | |
| Loans, including fees | **$ 32,573** | $ 32,084 | $ 33,990 |
| Securities: | | | |
| Taxable | **3,647** | 4,230 | 4,876 |
| Tax-exempt | **1,042** | 1,197 | 1,457 |
| Dividends | **194** | 22 | 27 |
| Other | **70** | 68 | 89 |
| **Total Interest Income** | **37,526** | 37,601 | 40,439 |
| **INTEREST EXPENSE** | | | |
| Deposits | **1,810** | 2,177 | 3,441 |
| Short-term borrowings | **63** | 61 | 76 |
| Long-term borrowings | **1,773** | 1,751 | 2,578 |
| **Total Interest Expense** | **3,646** | 3,989 | 6,095 |
| **Net Interest Income** | **33,880** | 33,612 | 34,344 |
| **PROVISION FOR LOAN LOSSES** | **150** | 1,450 | 4,675 |
| **Net Interest Income after Provision for Loan Losses** | **33,730** | 32,162 | 29,669 |
| **OTHER INCOME** | | | |
| Service charges on deposit accounts | **2,118** | 2,246 | 2,433 |
| Income from fiduciary activities | **1,418** | 1,299 | 1,224 |
| Earnings on investment in bank-owned life insurance | **1,099** | 975 | 981 |
| Gain on life insurance proceeds | | | 63 |
| Gains on sales or calls of securities | **62** | | 7 |
| Service charges on ATM and debit card transactions | **1,550** | 1,434 | 1,291 |
| Commissions from insurance sales | **4,839** | 4,671 | 4,835 |
| Other | **818** | 1,078 | 1,033 |
| **Total Other Income** | **11,904** | 11,703 | 11,867 |
| **OTHER EXPENSES** | | | |
| Salaries and employee benefits | **19,516** | 18,950 | 18,553 |
| Net occupancy | **2,050** | 1,957 | 1,952 |
| Equipment | **2,768** | 2,826 | 2,537 |
| Other tax | **737** | 901 | 833 |
| Professional services | **936** | 895 | 825 |
| Supplies and postage | **602** | 583 | 634 |
| Marketing and corporate relations | **587** | 396 | 372 |
| FDIC and regulatory | **748** | 768 | 843 |
| Intangible assets amortization | **649** | 641 | 641 |
| Foreclosed real estate expenses (income) | **346** | 576 | (119) |
| Other operating | **3,325** | 3,522 | 3,260 |
| **Total Other Expenses** | **32,264** | 32,015 | 30,331 |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Income Before Income Taxes** | | **13,370** | | 11,850 | | 11,205 |
| **PROVISION FOR INCOME TAXES** | | **3,080** | | 2,535 | | 2,319 |
| **Net Income** | **$** | **10,290** | $ | 9,315 | $ | 8,886 |
| **PER SHARE DATA** | | | | | | |
| Basic earnings | **$** | **1.71** | $ | 1.56 | $ | 1.49 |
| Cash dividends declared | **$** | **0.77** | $ | 0.76 | $ | 0.76 |

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

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**ACNB CORPORATION**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| | Years Ended December 31, | | |
|---|---|---|---|
| **In thousands** | **2014** | **2013** | **2012** |
| **NET INCOME** | **$ 10,290** | $ 9,315 | $ 8,886 |
| **OTHER COMPREHENSIVE (LOSS) INCOME** | | | |
| **SECURITIES** | | | |
| Unrealized gains (losses) arising during the period, net of income taxes of $22, $(1,567), and $(197), respectively | **42** | (3,042) | (377) |
| Reclassification adjustment for net gains included in net income, net of income taxes of $(21), $0, and $(2), respectively(A)(C) | **(41)** | | (5) |
| **PENSION** | | | |
| Amortization of pension net loss, transition liability, and prior service cost, net of income taxes of $(20), $236, and $226, respectively(B)(C) | **41** | 456 | 435 |
| Unrecognized net (loss) gain, net of income taxes of $(1,478), $1,496, and $(473), respectively | **(2,871)** | 2,904 | (920) |
| **TOTAL OTHER COMPREHENSIVE (LOSS) INCOME** | **(2,829)** | 318 | (867) |
| **TOTAL COMPREHENSIVE INCOME** | **$ 7,461** | $ 9,633 | $ 8,019 |

(A) Gross amounts are included in net gains on sales or calls of securities on the Consolidated Statements 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.

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

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**ACNB CORPORATION**

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

**Years Ended December 31, 2014, 2013 and 2012**

| Dollars in thousands | Common Stock | Treasury Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive (Loss) Income | Total Stockholders' Equity |
|---|---|---|---|---|---|---|
| **BALANCE January 1, 2012** | $ 15,021 | $ (728) | $ 9,000 | $ 73,526 | $ 655 | $ 97,474 |
| Net income | | | | 8,886 | | 8,886 |
| Other comprehensive loss, net of taxes | | | | | (867) | (867) |
| Common stock shares issued (19,559 shares) | 49 | | 246 | | | 295 |
| Cash dividends declared | | | | (4,524) | | (4,524) |
| **BALANCE December 31, 2012** | 15,070 | (728) | 9,246 | 77,888 | (212) | 101,264 |
| Net income | | | | 9,315 | | 9,315 |
| Other comprehensive income, net of taxes | | | | | 318 | 318 |
| Common stock shares issued (25,943 shares) | 65 | | 382 | | | 447 |
| Cash dividends declared | | | | (4,542) | | (4,542) |
| **BALANCE December 31, 2013** | 15,135 | (728) | 9,628 | 82,661 | 106 | 106,802 |
| Net income | | | | **10,290** | | **10,290** |
| Other comprehensive loss, net of taxes | | | | | **(2,829)** | **(2,829)** |
| Common stock shares issued (24,339 shares) | **61** | | **320** | | | **381** |
| Cash dividends declared | | | | **(4,622)** | | **(4,622)** |
| **BALANCE December 31, 2014** | **$ 15,196** | **$ (728)** | **$ 9,948** | **$ 88,329** | **$ (2,723)** | **$ 110,022** |

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

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**ACNB CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Years Ended December 31, | | |
|---|---|---|---|
| **In thousands** | **2014** | **2013** | **2012** |
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Net income | **$ 10,290** | $ 9,315 | $ 8,886 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Gain on sales of loans originated for sale | **(213)** | (430) | (296) |
| (Gain) loss on sales of foreclosed assets held for resale, including writedowns | **(36)** | 181 | (400) |
| Earnings on investment in bank-owned life insurance | **(1,099)** | (975) | (981) |
| Gain on sales or calls of securities | **(62)** | | (7) |
| Gain on life insurance proceeds | | | (63) |
| Depreciation and amortization | **2,063** | 1,993 | 2,041 |
| Provision for loan losses | **150** | 1,450 | 4,675 |
| Net amortization of investment securities premiums | **812** | 972 | 893 |
| Decrease in accrued interest receivable | **77** | 333 | 329 |
| Increase (decrease) in accrued interest payable | **92** | (433) | (315) |
| Mortgage loans originated for sale | **(15,824)** | (19,841) | (32,316) |
| Proceeds from sales of loans originated for sale | **14,910** | 26,462 | 26,262 |
| Decrease (increase) in other assets | **2,608** | (750) | 1,880 |
| Decrease in other liabilities | **(2,953)** | (291) | (1,285) |
| **Net Cash Provided by Operating Activities** | **10,815** | 17,986 | 9,303 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Proceeds from maturities of investment securities held to maturity | **20,555** | 8,970 | 2,399 |
| Proceeds from maturities of investment securities available for sale | **28,883** | 37,606 | 62,589 |
| Proceeds from sales of investment securities available for sale | **5,075** | | |
| Purchase of investment securities available for sale | **(22,252)** | (6,875) | (19,676) |
| Purchase of investments held to maturity | | (53,689) | (42,705) |
| Redemption (purchase) of restricted investment in bank stocks | **2,645** | (1,543) | 1,828 |
| Net increase in loans | **(72,828)** | (23,823) | (19,521) |
| Investment in low-income housing partnerships | | (249) | (2,106) |
| Proceeds from sale of low-income housing partnerships | **229** | 476 | |
| Purchase of bank-owned life insurance | **(4,606)** | (140) | (1,940) |
| Purchase of book of business | | (77) | |
| Proceeds from life insurance death benefits | | | 273 |
| Capital expenditures | **(3,148)** | (2,212) | (2,049) |
| Proceeds from sale of foreclosed real estate | **1,316** | 3,431 | 3,111 |
| **Net Cash Used in Investing Activities** | **(44,131)** | (38,125) | (17,797) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| Net increase in demand deposits | **16,976** | 8,714 | 7,050 |
| Net increase (decrease) in time certificates of deposits and interest bearing deposits | **27,257** | (42,247) | 44,331 |
| Net (decrease) increase in short-term borrowings | **(3,353)** | 1,749 | 1,341 |
| Proceeds from long-term borrowings | **27,500** | 37,000 | 10,000 |
| Repayments on long-term borrowings | **(29,266)** | (14,251) | (21,237) |
| Dividends paid | **(4,622)** | (4,542) | (4,524) |
| Common stock issued | **381** | 447 | 295 |
| **Net Cash Provided by (Used in) Financing Activities** | **34,873** | (13,130) | 37,256 |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | **1,557** | (33,269) | 28,762 |

| | | | | | | |
|---|---|---|---|---|---|---|
| **CASH AND CASH EQUIVALENTS BEGINNING** | | **18,116** | | 51,385 | | 22,623 |
| **CASH AND CASH EQUIVALENTS ENDING** | **$** | **19,673** | $ | 18,116 | $ | 51,385 |
| Interest paid | **$** | **3,554** | $ | 4,422 | $ | 6,410 |
| Income taxes paid | **$** | **2,260** | $ | 2,925 | $ | 725 |
| Loans transferred to foreclosed assets held for resale | **$** | **1,135** | $ | 1,127 | $ | 2,521 |

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

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**ACNB CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

## NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Nature of Operations

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 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 with a second location in Germantown, Maryland. The agency offers a broad range of property and casualty, life, and health insurance to both commercial and individual clients.

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.

### Basis of Financial Statements

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and include the accounts of the Corporation and its wholly-owned subsidiaries. All significant intercompany transactions have been eliminated.

Assets held by the Corporation's Trust Department in an agency or fiduciary capacity for its customers are excluded from the consolidated financial statements since they do not constitute assets of the Corporation. Assets held by the Trust Department amounted to $165,000,000 and $151,000,000 at December 31, 2014 and 2013, respectively. Income from fiduciary activities is recognized on the cash method, which approximates the accrual method.

The Corporation has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 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.

### Use of Estimates

Financial statements prepared in accordance with GAAP require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingencies at the date of the consolidated financial statements, and revenues and expenses during the reporting period. Actual results could differ from these estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the determination of other than temporary impairment on securities, and the potential impairment of goodwill.

### Significant Group Concentrations of Credit Risk

Most of the Corporation's activities are with customers located within southcentral Pennsylvania and northern Maryland. Note C discusses the types of securities in which the Corporation invests. Note D discusses the types of lending in which the Corporation engages. Included in commercial real estate loans are loans made to lessors of non-residential dwellings that total $123,422,000, or 15.4%, of

**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

total loans at December 31, 2014. These borrowers are geographically disbursed throughout ACNB's marketplace and are leasing commercial properties to a varied group of tenants including medical offices, retail space and recreational facilities. Because of the varied nature of the tenants in aggregate, management believes that these loans do not present any greater risk than commercial loans in general.

**Cash and Cash Equivalents**

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash on hand, balances due from banks, and federal funds sold, all of which mature within 90 days.

**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 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.

**Loans Held for Sale**

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by aggregate outstanding commitments from investors or current investor yield requirements. Net unrealized losses are recognized through a valuation allowance by charges to income.

Mortgage loans held for sale are sold with the mortgage servicing rights released to another financial institution through a correspondent relationship. The correspondent financial institution absorbs all of the risk related to rate lock commitments. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

**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 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

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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 uncollectability 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, 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.

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 each of these categories of loans, adjusted for qualitative factors. These qualitative risk factors include:

- lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices;

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

- 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,

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

and other specific factors involving the collateral. Once the updated valuation is completed, the collateral value is updated accordingly.

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

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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.

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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 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.

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.

Home equity lines of credit are secured by the borrower's primary residence with a maximum loan-to-value of 90% and a maximum term of 20 years. In underwriting home equity lines of credit, the Corporation evaluates both the value of the property securing the loan and the borrower's financial ability to repay the loan as agreed. The ability to repay is determined by the borrower's employment history, current financial condition, and credit background.

Home equity lines of credit generally present a moderate level of risk due primarily to general economic conditions, as well as a continued weak housing market.

Junior liens inherently have more credit risk by virtue of the fact that another financial institution may have a higher security position in the case of foreclosure liquidation of collateral to extinguish the debt. Generally, foreclosure actions could become more prevalent if the real estate market continues to be weak and property values deteriorate.

**Consumer Lending** The Corporation offers a variety of secured and unsecured consumer loans, including those for vehicles and mobile homes and loans secured by savings deposits. These loans originate primarily within the Corporation's market area or with customers primarily from the market area.

Consumer loan terms vary according to the type and value of collateral and the creditworthiness of the borrower. In underwriting consumer loans, a thorough analysis of the borrower's financial ability to

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

repay the loan as agreed is performed. The ability to repay is determined by the borrower's employment history, current financial condition, and credit background.

Consumer loans may entail greater credit risk than residential mortgage loans or home equity lines of credit, particularly in the case of consumer loans which are unsecured or are secured by rapidly depreciable assets such as automobiles or recreational equipment. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

**Premises and Equipment**

Land is carried at cost. Buildings, furniture, fixtures, equipment and leasehold improvements are carried at cost, less accumulated depreciation. Depreciation is computed principally by the straight-line method over the assets' estimated useful lives. Maintenance and normal repairs are charged to expense when incurred while major additions and improvements are capitalized. Gains and losses on disposals are reflected in current operations. Amortization of leasehold improvements is computed by straight line over the shorter of the assets' useful life or the related lease term.

**Restricted Investment in Bank Stocks**

Restricted investment in bank stocks, which represents required investments in the common stock of correspondent banks, is carried at cost as of December 31, 2014 and 2013, and consists of common stock in the Atlantic Central Bankers Bank and Federal Home Loan Bank (FHLB).

Management evaluates the restricted investment in bank stocks for impairment in accordance with Accounting Standard Codification (ASC) Topic 942, *Financial Services Depository and Lending*. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the correspondent bank as compared to the capital stock amount for the correspondent bank and the length of time this situation has persisted, (2) commitments by the correspondent bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of the correspondent bank, (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the correspondent bank, and (4) the liquidity position of the correspondent bank.

Management believes no impairment charge was necessary related to the restricted investment in bank stocks during 2014, 2013 or 2012. However, security impairment analysis is completed quarterly, and the determination that no impairment has occurred during those years is no assurance that impairment may not occur in future periods.

**Bank-Owned Life Insurance**

The Corporation's banking subsidiary maintains nonqualified compensation plans for selected senior officers. To fund the benefits under these plans, the Bank is the owner of single premium life insurance policies on participants in the nonqualified retirement plans. Investment in bank-owned life

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

insurance policies was used to finance the nonqualified compensation plans and provide tax-exempt income to the Corporation.

ASC Topic 715, *Compensation Retirement Benefits*, 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 incurred approximately $29,000, $47,000, and $28,000 of expense in 2014, 2013, and 2012, respectively, related to these benefits.

**Investments in Low-Income Housing Partnerships**

The Corporation's investments in low-income housing partnerships are accounted for using the "equity method" prescribed by ASC Topic 323, *Investments Equity Method*. In accordance with ASC Topic 740, *Income Taxes*, tax credits are recognized as they become available. Any residual loss is amortized as the tax credits are received.

**Goodwill and Intangible Assets**

The Corporation accounts for its acquisitions using the purchase accounting method required by ASC Topic 805, *Business Combinations.* Purchase accounting requires the total purchase price to be allocated to the estimated fair values of assets and liabilities acquired, including certain intangible assets that must be recognized. Generally, this results in a residual amount in excess of the net fair values, which is recorded as goodwill.

ASC Topic 350, *Intangibles Goodwill and Other,* requires that goodwill is not amortized to expense, but rather that it be assessed for impairment at least annually. If certain events occur which might indicate goodwill has been impaired, the goodwill is tested for impairment when such events occur. Impairment write-downs are charged to results of operations in the period in which the impairment is determined. During the quarter ended June 30, 2012, the Corporation changed its method of applying ASC 350, such that the annual goodwill impairment testing date was changed from December 31 to October 1. This new testing date is preferable in the circumstances, because it allowed the Corporation more time to accurately complete its impairment testing process in order to incorporate the results in the annual consolidated financial statements. The Corporation did not identify any impairment on its outstanding goodwill from its most recent testing, which was performed as of October 1, 2014. 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.

**Foreclosed Assets**

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value, less costs to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are adjusted to the fair value, less costs to sell as necessary. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Income Taxes**

The Corporation accounts for income taxes in accordance with income tax accounting guidance ASC Topic 740, *Income Taxes*.

Current income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Corporation determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are reduced by a valuation allowance if, based on the weight of the evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Corporation accounts for uncertain tax positions if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more-likely-than-not means a likelihood of more than 50%; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50% likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment.

The Corporation recognizes interest and penalties on income taxes, if any, as a component of income tax expense.

**Retirement Plan**

The compensation cost of an employee's pension benefit is recognized on the projected unit credit method over the employee's approximate service period. The aggregate cost method is utilized for funding purposes.

**Net Income per Share**

The Corporation has a simple capital structure. Basic earnings per share of common stock is computed based on 6,002,240, 5,976,960 and 5,953,723 weighted average shares of common stock outstanding for 2014, 2013 and 2012, respectively.

**Advertising Costs**

Costs of advertising, which are included in marketing expenses, are expensed when incurred.

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

In the ordinary course of business, the Corporation has entered into commitments to extend credit, including commitments under commercial lines of credit, and standby letters of credit. Such financial instruments are recorded when they are funded.

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

**Accumulated Other Comprehensive Income (Loss)**

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

| In thousands | Unrealized Gains on Securities | Pension Liability | Accumulated Other Comprehensive (Loss) Income |
|---|---|---|---|
| **BALANCE DECEMBER 31, 2014** | **$ 2,570** | **$ (5,293)** | **$ (2,723)** |
| BALANCE DECEMBER 31, 2013 | $ 2,572 | $ (2,466) | $ 106 |

**Segment Reporting**

The Bank acts as an independent community financial services provider, which offers traditional banking and related financial services to individual, business, and government customers. Through its branch and automated teller machine networks, the Bank offers a full array of commercial and retail financial services, including the taking of time, savings, and demand deposits; the making of commercial, consumer, and mortgage loans; and the providing of other financial services. Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial, retail and mortgage banking operations of the Bank. As such, discrete financial information for commercial, retail and mortgage banking operations is not available and segment reporting would not be meaningful. Please refer to Note S "Segment and Related Information" for a discussion of insurance operations.

**New Accounting Pronouncements**

**ASU 2014-01**

In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2014-01, *Investments Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force).*

The Low-Income Housing Tax Credit is a program designed to encourage investment of private capital for use in the construction and rehabilitation of low-income housing, which provides certain tax benefits to investors in those projects. The amendments in this Update permit a reporting entity that invests in qualified affordable housing projects to account for the investments using a proportional amortization method if certain conditions are met. If the Corporation elects the proportional amortization method, it will amortize the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognize the net investment performance in the income statement

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

as a component of income tax expense. Otherwise, the Corporation would apply either the equity method or the cost method, as appropriate.

The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. If adopted, the amendments should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments.

The Corporation is evaluating the effects this Update will have on its consolidated financial condition or results of operations.

**ASU 2014-04**

In January 2014, the FASB issued ASU 2014-04, *Receivables Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force).*

The Update clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement.

The amendments in this Update are effective for public business entities for annual periods and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. If adopted, an entity can elect to adopt the amendments in this Update using either a modified retrospective transition method or a prospective transition method.

The Corporation is evaluating the effects this Update will have on its consolidated financial condition or results of operations.

**ASU 2014-09**

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606).*

The amendments in this Update establish a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation.

The amendments in this Update are effective for public entities for annual periods beginning after December 15, 2016, including interim periods therein. Three basic transition methods are available full retrospective, retrospective with certain practical expedients, and a cumulative effect approach. Under the third alternative, an entity would apply the new revenue standard only to contracts that are

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

incomplete under legacy U.S. GAAP at the date of initial application (e.g. January 1, 2017) and recognize the cumulative effect of the new standard as an adjustment to the opening balance of retained earnings. That is, prior years would not be restated and additional disclosures would be required to enable users of the financial statements to understand the impact of adopting the new standard in the current year compared to prior years that are presented under legacy U.S. GAAP. Early adoption is prohibited under U.S. GAAP.

The Corporation is evaluating the effects this Update will have on its consolidated financial condition or results of operations.

**ASU 2014-11**

In June 2014, the FASB issued ASU 2014-11, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures.*

The amendments in this Update require two accounting changes. First, repurchase-to-maturity transactions will be accounted for as secured borrowing transactions on the balance sheet, rather than sales. Second, for repurchase financing arrangements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with (or in contemplation of) a repurchase agreement with the same counterparty, which also will generally result in secured borrowing accounting for the repurchase agreement. The ASU introduces new disclosures to increase transparency about the types of collateral pledged for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions that are accounted for as secured borrowings. The ASU also requires a transferor to disclose information about transactions accounted for as a sale in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets through an agreement with the transferee.

For public business entities, the accounting changes and disclosure for certain transactions accounted for as a sale are effective for the first interim or annual period beginning after December 15, 2014. The disclosure for transactions accounted for as secured borrowings is required for annual periods beginning after December 15, 2014, and for interim periods beginning after March 15, 2015. All entities are required to present changes in accounting for transactions outstanding on the effective date as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Earlier application for a public business entity is prohibited. The disclosures are not required to be presented for comparative periods before the effective date.

The Corporation is evaluating the effects this Update will have on its consolidated financial condition or results of operations.

**ASU 2014-14**

In August 2014, the FASB issued ASU 2014-14, *Receivables Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force).*

The amendments in this Update address a practice issue related to the classification of certain foreclosed residential and nonresidential mortgage loans that are either fully or partially guaranteed under government programs. Specifically, creditors should reclassify loans that meet certain conditions to "other receivables" upon foreclosure, rather than reclassifying them to other real estate owned (OREO). The separate other receivable recorded upon foreclosure is to be measured based on the amount of the loan balance (principal and interest) the creditor expects to recover from the guarantor.

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**NOTE A SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

The ASU is effective for public business entities for annual periods and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted, if the entity has already adopted ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.* Transition methods include a prospective method and a modified retrospective method; however, entities must apply the same transition method as elected under ASU 2014-04.

The Corporation is evaluating the effects this Update will have on its consolidated financial condition or results of operations.

**NOTE B RESTRICTIONS ON CASH AND DUE FROM BANKS**

In return for services obtained through correspondent banks, the Corporation is required to maintain non-interest bearing cash balances in those correspondent banks. At December 31, 2014 and 2013, compensating balances approximated $1,842,000 and $1,673,000, respectively. During 2014 and 2013, average compensating balances approximated $1,959,000 and $2,181,000, respectively. All compensating balances are met by vault cash.

**NOTE C SECURITIES**

Amortized cost and fair value at December 31, 2014 and 2013, were as follows:

| In thousands | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **SECURITIES AVAILABLE FOR SALE** | | | | |
| **December 31, 2014** | | | | |
| U.S. Government and agencies | **$ 16,980** | **$ 337** | **$** | **$ 17,317** |
| Mortgage-backed securities, residential | **51,076** | **2,187** | **1** | **53,262** |
| State and municipal | **34,378** | **1,072** | **5** | **35,445** |
| Corporate bonds | **10,001** | **82** | | **10,083** |
| CRA mutual fund | **1,044** | **14** | | **1,058** |
| Stock in other banks | **627** | **208** | | **835** |
| | **$ 114,106** | **$ 3,900** | **$ 6** | **$ 118,000** |
| **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** | | | | |
| **December 31, 2014** | | | | |
| U.S. Government and agencies | **$ 24,497** | **$ 11** | **$ 348** | **$ 24,160** |
| Mortgage-backed securities, residential | **48,849** | **305** | **257** | **48,897** |
| | **$ 73,346** | **$ 316** | **$ 605** | **$ 73,057** |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **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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**NOTE C SECURITIES (Continued)**

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 December 31, 2014 and 2013:

| In thousands | Less than 12 Months Fair Value | Less than 12 Months Unrealized Losses | 12 Months or More Fair Value | 12 Months or More Unrealized Losses | Total Fair Value | Total Unrealized Losses |
|---|---|---|---|---|---|---|
| **SECURITIES AVAILABLE FOR SALE** | | | | | | |
| **December 31, 2014** | | | | | | |
| Mortgage-backed securities, residential | **$ 2,038** | **$ 1** | **$** | **$** | **$ 2,038** | **$ 1** |
| State and municipal | | | **1,059** | **5** | **1,059** | **5** |
| | **$ 2,038** | **$ 1** | **$ 1,059** | **$ 5** | **$ 3,097** | **$ 6** |
| **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 bonds | 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** | | | | | | |
| **December 31, 2014** | | | | | | |
| U.S. Government and agencies | **$** | **$** | **$ 21,149** | **$ 348** | **$ 21,149** | **$ 348** |
| Mortgage-backed securities, residential | | | **21,666** | **257** | **21,666** | **257** |
| | **$** | **$** | **$ 42,815** | **$ 605** | **$ 42,815** | **$ 605** |
| **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 December 31, 2014, one available for sale residential mortgage-backed securities 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 security.

At December 31, 2014, three available for sale state and municipal securities had unrealized losses that individually did not exceed 1% 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.

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**NOTE C SECURITIES (Continued)**

At December 31, 2014, fourteen held to maturity U.S. Government and agency securities had unrealized losses that individually did not exceed 4% 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.

At December 31, 2014, sixteen held to maturity residential mortgage-backed securities had unrealized losses that individually did not exceed 2% 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 December 31, 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 December 31, 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.

| | Available for Sale | | Held to Maturity | |
|---|---|---|---|---|
| **In thousands** | **Amortized Cost** | **Fair Value** | **Amortized Cost** | **Fair Value** |
| 1 year or less | **$ 9,177** | **$ 9,274** | **$** | **$** |
| Over 1 year through 5 years | **27,875** | **28,732** | **19,045** | **18,787** |
| Over 5 years through 10 years | **22,094** | **22,545** | **5,452** | **5,373** |
| Over 10 years | **2,213** | **2,294** | | |
| Mortgage-backed securities, residential | **51,076** | **53,262** | **48,849** | **48,897** |
| CRA mutual fund | **1,044** | **1,058** | | |
| Stock in other banks | **627** | **835** | | |
| | **$ 114,106** | **$ 118,000** | **$ 73,346** | **$ 73,057** |

The Corporation realized gross gains of $72,000 during 2014, and $0 during 2013 and 2012 and gross losses of $10,000 during 2014, and $0 during 2013 and 2012 on sales of securities available for sale. There was $7,000 of gross gains realized on calls of securities available for sale during 2012.

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**NOTE C SECURITIES (Continued)**

At December 31, 2014 and 2013, securities with a carrying value of $128,710,000 and $139,966,000, respectively, were pledged as collateral as required by law on public and trust deposits, repurchase agreements, and for other purposes.

**NOTE D LOANS**

The Corporation grants commercial, residential, and consumer loans to customers primarily within southcentral Pennsylvania and northern Maryland and the surrounding area. A large portion of the loan portfolio is secured by real estate. Although the Bank has a diversified loan portfolio, its debtors' ability to honor their contracts is influenced by the region's economy.

The following tables present the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Corporation's internal risk rating system as of December 31, 2014 and 2013:

| In thousands | Pass | Special Mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| **December 31, 2014** | | | | | |
| Commercial and industrial | **$ 68,712** | **$ 2,412** | **$ 3,731** | **$** | **$ 74,855** |
| Commercial real estate | **238,820** | **26,214** | **16,548** | | **281,582** |
| Commercial real estate construction | **8,714** | **2,917** | **579** | | **12,210** |
| Residential mortgage | **352,283** | **4,507** | **2,585** | | **359,375** |
| Home equity lines of credit | **55,254** | **650** | **69** | | **55,973** |
| Consumer | **15,277** | | | | **15,277** |
| **Total** | **$ 739,060** | **$ 36,700** | **$ 23,512** | **$** | **$ 799,272** |
| | | | | | |
| **December 31, 2013** | | | | | |
| Commercial and industrial | $ 53,316 | $ 2,364 | $ 3,537 | $ | $ 59,217 |
| Commercial real estate | 193,162 | 29,655 | 16,369 | | 239,186 |
| Commercial real estate construction | 5,123 | 5,018 | 1,055 | | 11,196 |
| Residential mortgage | 344,847 | 2,551 | 3,611 | | 351,009 |
| Home equity lines of credit | 53,021 | 608 | 223 | | 53,852 |
| Consumer | 14,188 | | | | 14,188 |
| **Total** | $ 663,657 | $ 40,196 | $ 24,795 | $ | $ 728,648 |

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**NOTE D LOANS (Continued)**

The following table summarizes information relative to impaired loans by loan portfolio class as of December 31, 2014 and 2013:

| In thousands | Impaired Loans with Allowance | | | Impaired Loans with No Allowance | |
|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance |
| **December 31, 2014** | | | | | |
| Commercial and industrial | $ | $ | $ | $ 1,729 | $ 2,844 |
| Commercial real estate | | | | 9,999 | 10,209 |
| Commercial real estate construction | | | | 368 | 642 |
| Residential mortgage | 694 | 694 | 302 | 826 | 1,052 |
| **Total** | $ 694 | $ 694 | $ 302 | $ 12,922 | $ 14,747 |
| **December 31, 2013** | | | | | |
| Commercial and industrial | $ | $ | $ | $ 1,574 | $ 2,688 |
| Commercial real estate | | | | 11,197 | 11,758 |
| Commercial real estate construction | | | | 788 | 1,062 |
| Residential mortgage | 1,478 | 1,478 | 201 | 675 | 712 |
| **Total** | $ 1,478 | $ 1,478 | $ 201 | $ 14,234 | $ 16,220 |

The following table summarizes information in regards to average of impaired loans and related interest income by loan portfolio class:

| In thousands | Impaired Loans with Allowance | | Impaired Loans with No Allowance | |
|---|---|---|---|---|
| | Average Recorded Investment | Interest Income | Average Recorded Investment | Interest Income |
| **December 31, 2014** | | | | |
| Commercial and industrial | $ | $ | $ 1,351 | $ 2 |
| Commercial real estate | 144 | | 10,380 | 459 |
| Commercial real estate construction | | | 604 | |
| Residential mortgage | 1,027 | 9 | 576 | 16 |
| **Total** | $ 1,171 | $ 9 | $ 12,911 | $ 477 |
| **December 31, 2013** | | | | |
| Commercial and industrial | $ 58 | $ | $ 466 | $ |
| Commercial real estate | 95 | | 11,237 | 529 |
| Commercial real estate construction | | | 3,558 | 209 |
| Residential mortgage | 833 | | 1,119 | 10 |
| **Total** | $ 986 | $ | $ 16,380 | $ 748 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **December 31, 2012** | | | | | | | | |
| Commercial and industrial | $ | 431 | $ | | $ | 223 | $ | |
| Commercial real estate | | 691 | | | | 8,193 | | 11 |
| Commercial real estate construction | | 336 | | | | 1,242 | | |
| Residential mortgage | | 18 | | | | 1,390 | | |
| **Total** | $ | 1,476 | $ | | $ | 11,048 | $ | 11 |

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**NOTE D LOANS (Continued)**

No additional funds are committed to be advanced in connection with impaired loans.

If interest on all nonaccrual loans had been accrued at original contract rates, interest income would have increased by $570,000 in 2014, $704,000 in 2013, and $543,000 in 2012.

The following table presents nonaccrual loans by loan portfolio class as of December 31, 2014 and 2013:

| In thousands | 2014 | 2013 |
|---|---|---|
| Commercial and industrial | **$ 1,729** | $ 1,574 |
| Commercial real estate | **3,325** | 4,363 |
| Commercial real estate construction | **368** | 788 |
| Residential mortgage | **1,226** | 1,848 |
| **Total** | **$ 6,648** | $ 8,573 |

The following table summarizes information relative to troubled debt restructurings by loan portfolio class at December 31, 2014 and 2013:

| In thousands | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Recorded Investment at period end |
|---|---|---|---|
| **December 31, 2014** | | | |
| Nonaccruing troubled debt restructurings: | | | |
| Commercial and industrial | **$ 490** | **$ 485** | **$ 46** |
| Commercial real estate | **1,021** | **1,021** | **546** |
| Commercial real estate construction | **1,548** | **1,541** | **274** |
| Total nonaccruing troubled debt restructurings | **3,059** | **3,047** | **866** |
| Accruing troubled debt restructurings: | | | |
| Commercial real estate | **7,118** | **7,170** | **6,674** |
| Residential mortgage | **336** | **336** | **294** |
| Total accruing troubled debt restructurings | **7,454** | **7,506** | **6,968** |
| **Total Troubled Debt Restructurings** | **$ 10,513** | **$ 10,553** | **$ 7,834** |
| **December 31, 2013** | | | |
| Nonaccruing troubled debt restructurings: | | | |
| Commercial and industrial | $ 490 | $ 485 | $ 142 |
| Commercial real estate | 1,021 | 1,021 | 634 |
| Commercial real estate construction | 1,548 | 1,541 | 694 |
| Residential mortgage | 566 | 566 | 566 |
| Total nonaccruing troubled debt restructurings | 3,625 | 3,613 | 2,036 |
| Accruing troubled debt restructurings: | | | |
| Commercial real estate | 7,118 | 7,170 | 6,834 |
| Residential mortgage | 336 | 336 | 305 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total accruing troubled debt restructurings | | 7,454 | | 7,506 | | 7,139 |
| **Total Troubled Debt Restructurings** | $ | 11,079 | $ | 11,119 | $ | 9,175 |

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**NOTE D LOANS (Continued)**

All of the Corporation's troubled debt restructured loans are also impaired loans, of which some have resulted in a specific allocation and, subsequently, a charge-off as appropriate. There were no defaulted troubled debt restructured loans as of December 31, 2014. One troubled debt restructured loan paid in full during the second quarter of 2014. During the third quarter of 2013, one troubled debt restructured loan defaulted in the amount of $237,000 and was transferred to foreclosed assets held for resale, and all other troubled debt restructured loans were current with respect to their associated forbearance agreement. During 2013, there were charge-offs associated with troubled debt restructured loans while under a forbearance agreement which totaled $353,000. One forbearance agreement was negotiated during 2009 and modified during 2011, two were negotiated during 2010 and modified during 2013, three were negotiated during 2012, while one was negotiated during 2013.

There are forbearance agreements on all loans currently classified as troubled debt restructurings, except for two loans in which the forbearance agreement has expired and one loan in which a modification took place, all of which remain classified as troubled debt restructured loans. All of these troubled debt restructured loans have resulted in additional principal repayment. The terms of these troubled debt restructured loans vary whereby principal payments have been decreased, interest rates have been reduced, and/or the loan will be repaid as collateral is sold.

The following table summarizes loans whose terms have been modified resulting in troubled debt restructurings during the years ended December 31, 2014 and 2013:

| Dollars in thousands | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Recorded Investment at Period End |
|---|---|---|---|---|
| **2014** | | | | |
| Troubled debt restructurings | | $ | $ | $ |
| **2013** | | | | |
| Troubled debt restructurings: | | | | |
| Commercial real estate | 1 | $ 2,541 | $ 2,593 | $ 2,542 |
| Residential mortgage | 1 | 566 | 566 | 566 |

The performance and credit quality of the loan portfolio is also monitored by analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due.

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**NOTE D LOANS (Continued)**

The following table presents the classes of the loan portfolio summarized by the past due status as of December 31, 2014 and 2013:

| In thousands | 30-59 Days Past Due | 60-89 Days Past Due | >90 Days Past Due | Total Past Due | Current | Total Loans Receivable | Loans Receivable >90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| **December 31, 2014** | | | | | | | |
| Commercial and industrial | **$ 153** | **$** | **$ 1,729** | **$ 1,882** | **$ 72,973** | **$ 74,855** | **$** |
| Commercial real estate | **236** | **769** | **2,269** | **3,274** | **278,308** | **281,582** | **33** |
| Commercial real estate construction | | **17** | **368** | **385** | **11,825** | **12,210** | |
| Residential mortgage | **2,664** | **1,332** | **2,704** | **6,700** | **352,675** | **359,375** | **1,502** |
| Home equity lines of credit | **169** | | **101** | **270** | **55,703** | **55,973** | **101** |
| Consumer | **23** | **9** | | **32** | **15,245** | **15,277** | |
| **Total** | **$ 3,245** | **$ 2,127** | **$ 7,171** | **$ 12,543** | **$ 786,729** | **$ 799,272** | **$ 1,636** |
| **December 31, 2013** | | | | | | | |
| Commercial and industrial | $ 55 | $ 13 | $ 152 | $ 220 | $ 58,997 | $ 59,217 | $ 3 |
| Commercial real estate | 857 | 552 | 1,964 | 3,373 | 235,813 | 239,186 | |
| Commercial real estate construction | | | 788 | 788 | 10,408 | 11,196 | |
| Residential mortgage | 4,728 | 795 | 3,148 | 8,671 | 342,338 | 351,009 | 1,900 |
| Home equity lines of credit | 260 | 36 | 14 | 310 | 53,542 | 53,852 | 14 |
| Consumer | 22 | 15 | 9 | 46 | 14,142 | 14,188 | 9 |
| **Total** | $ 5,922 | $ 1,411 | $ 6,075 | $ 13,408 | $ 715,240 | $ 728,648 | $ 1,926 |

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**NOTE D LOANS (Continued)**

The following table summarizes the allowance for loan losses and recorded investment in loans:

| In thousands | Commercial and Industrial | Commercial Real Estate | Commercial Real Estate Construction | Residential Mortgage | Home Equity Lines of Credit | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| **December 31, 2014** | | | | | | | | |
| **Allowance for loan losses** | | | | | | | | |
| Beginning balance-January 1, 2014 | **$ 1,915** | **$ 5,819** | **$ 247** | **$ 4,013** | **$ 537** | **$ 947** | **$ 2,613** | **$ 16,091** |
| Charge-offs | **(132)** | **(121)** | | **(705)** | **(169)** | **(64)** | | **(1,191)** |
| Recoveries | **15** | | | **97** | | **10** | | **122** |
| Provisions | **250** | **174** | **(53)** | **440** | **189** | **157** | **(1,007)** | **150** |
| Ending balance-December 31, 2014 | **$ 2,048** | **$ 5,872** | **$ 194** | **$ 3,845** | **$ 557** | **$ 1,050** | **$ 1,606** | **$ 15,172** |
| Ending balance: individually evaluated for impairment | **$** | **$** | **$** | **$ 302** | **$** | **$** | **$** | **$ 302** |
| Ending balance: collectively evaluated for impairment | **$ 2,048** | **$ 5,872** | **$ 194** | **$ 3,543** | **$ 557** | **$ 1,050** | **$ 1,606** | **$ 14,870** |
| **Loans receivables** | | | | | | | | |
| Ending balance | **$ 74,855** | **$ 281,582** | **$ 12,210** | **$ 359,375** | **$ 55,973** | **$ 15,277** | **$** | **$ 799,272** |
| Ending balance: individually evaluated for impairment | **$ 1,729** | **$ 9,999** | **$ 368** | **$ 1,520** | **$** | **$** | **$** | **$ 13,616** |
| Ending balance: collectively evaluated for impairment | **$ 73,126** | **$ 271,583** | **$ 11,842** | **$ 357,855** | **$ 55,973** | **$ 15,277** | **$** | **$ 785,656** |
| **December 31, 2013** | | | | | | | | |
| **Allowance for loan losses** | | | | | | | | |
| Beginning balance-January 1, 2013 | $ 1,507 | $ 6,576 | $ 518 | $ 3,721 | $ 517 | $ 633 | $ 3,353 | $ 16,825 |
| Charge-offs | (178) | (996) | | (1,062) | | (191) | | (2,427) |
| Recoveries | 235 | | | 4 | | 4 | | 243 |
| Provisions | 351 | 239 | (271) | 1,350 | 20 | 501 | (740) | 1,450 |
| Ending balance-December 31, 2013 | $ 1,915 | $ 5,819 | $ 247 | $ 4,013 | $ 537 | $ 947 | $ 2,613 | $ 16,091 |
| Ending balance: individually evaluated for impairment | $ | $ | $ | $ 201 | $ | $ | $ | $ 201 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Ending balance: collectively evaluated for impairment | $ 1,915 | $ 5,819 | $ 247 | $ 3,812 | $ 537 | $ 947 | $ 2,613 | $ 15,890 |
| **Loans receivables** | | | | | | | | |
| Ending balance | $ 59,217 | $ 239,186 | $ 11,196 | $ 351,009 | $ 53,852 | $ 14,188 | $ | $ 728,648 |
| Ending balance: individually evaluated for impairment | $ 1,574 | $ 11,197 | $ 788 | $ 2,153 | $ | $ | $ | $ 15,712 |
| Ending balance: collectively evaluated for impairment | $ 57,643 | $ 227,989 | $ 10,408 | $ 348,856 | $ 53,852 | $ 14,188 | $ | $ 712,936 |
| **December 31, 2012** | | | | | | | | |
| **Allowance for loan losses** | | | | | | | | |
| Beginning balance-January 1, 2012 | $ 2,582 | $ 6,007 | $ 548 | $ 3,624 | $ 507 | $ 419 | $ 1,795 | $ 15,482 |
| Charge-offs | (2,180) | (417) | (538) | (500) | (51) | (71) | | (3,757) |
| Recoveries | 22 | 250 | 149 | 1 | | 3 | | 425 |
| Provisions | 1,083 | 736 | 359 | 596 | 61 | 282 | 1,558 | 4,675 |
| Ending balance-December 31, 2012 | $ 1,507 | $ 6,576 | $ 518 | $ 3,721 | $ 517 | $ 633 | $ 3,353 | $ 16,825 |
| Ending balance: individually evaluated for impairment | $ 29 | $ 7 | $ | $ | $ | $ | $ | $ 36 |
| Ending balance: collectively evaluated for impairment | $ 1,478 | $ 6,569 | $ 518 | $ 3,721 | $ 517 | $ 633 | $ 3,353 | $ 16,789 |
| **Loans receivables** | | | | | | | | |
| Ending balance | $ 49,004 | $ 243,019 | $ 19,154 | $ 328,836 | $ 53,130 | $ 14,993 | $ | $ 708,136 |
| Ending balance: individually evaluated for impairment | $ 341 | $ 9,009 | $ 854 | $ 938 | $ | $ | $ | $ 11,142 |
| Ending balance: collectively evaluated for impairment | $ 48,663 | $ 234,010 | $ 18,300 | $ 327,898 | $ 53,130 | $ 14,993 | $ | $ 696,994 |

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**NOTE D LOANS (Continued)**

The Bank has granted loans to certain of its executive officers, directors and their related interests. These loans were made on substantially the same basis, including interest rates and collateral as those prevailing for comparable transactions with other borrowers at the same time. The aggregate amount of these loans was $5,331,000 and $14,969,000 at December 31, 2014 and 2013, respectively. During 2014, repayments totaled $9,638,000, and there were no new loans or advances extended. None of these loans were past due, in nonaccrual status, or restructured at December 31, 2014.

**NOTE E PREMISES AND EQUIPMENT**

Premises and equipment at December 31 were as follows:

| In thousands | 2014 | 2013 |
|---|---|---|
| Land | **$ 2,591** | $ 2,591 |
| Buildings and improvements | **19,492** | 17,060 |
| Furniture and equipment | **14,843** | 12,946 |
| Construction in process | **139** | 1,959 |
| | **37,065** | 34,556 |
| Accumulated depreciation | **(19,340)** | (18,565) |
| | **$ 17,725** | $ 15,991 |

Depreciation expense was $1,414,000, $1,352,000 and $1,401,000 for the years ended December 31, 2014, 2013 and 2012, respectively.

**NOTE F INVESTMENTS IN LOW-INCOME HOUSING PARTNERSHIPS**

ACNB Corporation is a limited partner in three partnerships, whose purpose is to develop, manage and operate residential low-income properties. At December 31, 2014 and 2013, the carrying value of these investments was approximately $3,793,000 and $4,687,000, respectively.

**NOTE G DEPOSITS**

Deposits were comprised of the following as of December 31:

| In thousands | 2014 | 2013 |
|---|---|---|
| Non-interest bearing demand | **$ 144,987** | $ 128,011 |
| Interest bearing demand | **115,587** | 115,014 |
| Savings | **332,375** | 321,818 |
| Time certificates of deposit less than $100,000 | **162,246** | 165,491 |
| Time certificates of deposit greater than $100,000 | **89,681** | 70,309 |
| | **$ 844,876** | $ 800,643 |

Scheduled maturities of time certificates of deposit at December 31, 2014, were as follows:

| Years Ending | In thousands |
|---|---|
| 2015 | $ 156,329 |
| 2016 | 63,934 |
| 2017 | 24,689 |
| 2018 | 5,054 |

| | | |
|---|---|---|
| 2019 | | 1,921 |
| | $ | 251,927 |

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**NOTE H LEASE COMMITMENTS**

Certain branch offices and equipment are leased under agreements which expire at varying dates through 2024. Most leases contain renewal provisions at the Corporation's option. The total rental expense for all operating leases was $498,000, $468,000 and $424,000 for the years ended December 31, 2014, 2013 and 2012, respectively.

The following is a schedule by year of future minimum rental payments required under operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of December 31:

| Years Ending | In thousands |
|---|---|
| 2015 | $ 381 |
| 2016 | 229 |
| 2017 | 174 |
| 2018 | 153 |
| 2019 | 126 |
| Later years | 317 |
| | $ 1,380 |

ACNB leases space at several of its owned offices to other unrelated organizations under agreements that expired at varying dates in 2014. Total rental income for these properties was $132,000, $138,000 and $133,000 for the years ended December 31, 2014, 2013 and 2012, respectively.

**NOTE I BORROWINGS**

Short-term borrowings and weighted-average interest rates at December 31 are as follows:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Dollars in thousands** | **Amount** | **Rate** | **Amount** | **Rate** |
| FHLB overnight advance | **$** | **%** | $ 6,800 | 0.25% |
| Securities sold under repurchase agreements | **45,699** | **0.14%** | 42,252 | 0.12% |
| | **$ 45,699** | **0.14%** | $ 49,052 | 0.14% |

Under an agreement with the FHLB, the Bank has short-term borrowing capacity included within its maximum borrowing capacity. All FHLB advances are collateralized by a security agreement covering qualifying loans and unpledged U.S. Treasury, agency and mortgage-backed securities. In addition, all FHLB advances are secured by the FHLB capital stock owned by the Bank having a par value of $3,917,500 at December 31, 2014. The Corporation also has lines of credit that total $15,000,000 with correspondent banks for overnight federal funds borrowings. There were no advances on these lines at December 31, 2014 and 2013.

The Corporation enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Corporation may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Corporation to repurchase the assets. As a result, these repurchase agreements are accounted for as collateralized financing agreements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Corporation's consolidated statements of condition, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. In other words, there is no offsetting or netting of the investment securities assets with the repurchase agreement

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**NOTE I BORROWINGS (Continued)**

liabilities. In addition, as the Corporation does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements.

The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Corporation be in default (e.g., fails to make an interest payment to the counterparty). For private institution repurchase agreements, if the private institution counterparty were to default (e.g., declare bankruptcy), the Corporation could cancel the repurchase agreement (i.e., cease payment of principal and interest), and attempt collection on the amount of collateral value in excess of the repurchase agreement fair value. The collateral is held by a third-party financial institution in the counterparty's custodial account. The counterparty has the right to sell or repledge the investment securities. For government entity repurchase agreements, the collateral is held by the Corporation in a segregated custodial account under a tri-party agreement.

The following table presents the short-term borrowings subject to an enforceable master netting arrangement or repurchase agreement as of December 31, 2014 and 2013:

| | | | | Gross Amounts Not Offset in the Statements of Condition | | |
|---|---|---|---|---|---|---|
| **Dollars in thousands** | **Gross Amounts of Recognized Liabilities** | **Gross Amounts Offset in the Statements of Condition** | **Net Amounts of Liabilities Presented in the Statements of Condition** | **Financial Instruments** | **Cash Collateral Pledged** | **Net Amount** |
| **December 31, 2014** | | | | | | |
| Repurchase agreements | | | | | | |
| Commercial customers and government entities(a) | **$ 45,699** | **$** | **$ 45,699** | **$ (45,699)** | **$** | **$** |
| **December 31, 2013** | | | | | | |
| Repurchase agreements | | | | | | |
| Commercial customers and government entities(a) | $ 42,252 | $ | $ 42,252 | $ (42,252) | $ | $ |

(a) As of December 31, 2014 and 2013, the fair value of securities pledged in connection with repurchase agreements was $47,576,000 and $60,823,000, respectively.

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**NOTE I BORROWINGS (Continued)**

A summary of long-term debt as of December 31 is as follows:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Dollars in thousands** | **Amount** | **Rate** | **Amount** | **Rate** |
| FHLB fixed-rate advances maturing: | | | | |
| 2014 | $ | % | $ 29,000 | 1.51% |
| 2015 | **21,000** | **2.50%** | 21,000 | 2.50% |
| 2016 | **18,250** | **1.98%** | 15,000 | 2.19% |
| 2017 | **14,250** | **2.30%** | 6,000 | 3.76% |
| 2018 | **15,500** | **2.18%** | 10,000 | 2.48% |
| 2019 | **10,500** | **1.90%** | | % |
| Loan payable to local bank | **1,437** | **5.50%** | 1,703 | 5.50% |
| | **$ 80,937** | **2.26%** | $ 82,703 | 2.26% |

The FHLB advances are collateralized by the assets defined in security agreement and FHLB capital stock described previously. The Corporation can borrow a maximum of $456,258,000 from the FHLB, of which $376,758,000 was available at December 31, 2014.

The loan payable to a local bank is payable in monthly installments of $29,472 and matures in April 2016. The loan is unsecured.

**NOTE J REGULATORY RESTRICTIONS ON DIVIDENDS**

Dividend payments by the Bank to the Corporation are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from "accumulated net earnings" (generally, retained earnings). The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. As of December 31, 2014, $12,325,000 of undistributed earnings of the Bank, included in consolidated retained earnings, was available for distribution to the Corporation as dividends without prior regulatory approval. Additionally, dividends paid by the Bank to the Corporation would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements.

**NOTE K INCOME TAXES**

The components of income tax expense for the years ended December 31, 2014, 2013 and 2012, are as follows:

| **In thousands** | **2014** | **2013** | **2012** |
|---|---|---|---|
| Federal: | | | |
| Current | **$ 2,152** | $ 1,800 | $ 2,163 |
| Deferred | **875** | 693 | 108 |
| | **3,027** | 2,493 | 2,271 |
| State: | | | |
| Current | **53** | 42 | 48 |
| | **$ 3,080** | $ 2,535 | $ 2,319 |

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**NOTE K INCOME TAXES (Continued)**

Reconciliations of the statutory federal income tax at a rate of 34% to the income tax expense reported in the consolidated statements of income for the years ended December 31, 2014, 2013 and 2012, are as follows:

| | Percentage of Income before Income Taxes | | |
|---|---|---|---|
| | **2014** | **2013** | **2012** |
| Federal income tax at statutory rate | **34.0%** | 34.0% | 34.0% |
| State income taxes, net of federal benefit | **0.3%** | 0.2% | 0.2% |
| Tax-exempt income | **(3.5)%** | (4.6)% | (5.9)% |
| Earnings on investment in bank-owned life insurance | **(2.8)%** | (2.8)% | (3.0)% |
| Rehabilitation and low-income housing credits | **(5.1)%** | (5.7)% | (4.9)% |
| Other | **0.1%** | 0.3% | 0.3% |
| | **23.0%** | 21.4% | 20.7% |

The provision for federal income taxes includes $21,000, $0 and $2,000 of income taxes related to net gains on sales of securities in 2014, 2013 and 2012, respectively. Rehabilitation and low-income housing income tax credits were $678,000, $678,000, and $556,000 during 2014, 2013 and 2012, respectively. Projected credits are $299,000 in 2015, $287,000 in 2016, and $1,738,000 thereafter.

Components of deferred tax assets and liabilities at December 31 were as follows:

| **In thousands** | **2014** | **2013** |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan losses | **$ 5,159** | $ 5,471 |
| Accrued deferred compensation | **903** | 806 |
| Pension | **2,727** | 1,269 |
| Deferred loan fees | **67** | 5 |
| Other-than-temporary impairment | **178** | 178 |
| Low-income housing tax credit carryforward | | 287 |
| Nonaccrual interest | **176** | 191 |
| Deferred director fees | **496** | 419 |
| Other | **695** | 387 |
| | **10,401** | 9,013 |
| Deferred tax liabilities: | | |
| Available for sale securities | **1,324** | 1,323 |
| Prepaid pension benefit cost | **6,466** | 5,488 |
| Prepaid expenses | **168** | 237 |
| Accumulated depreciation | **188** | 358 |
| Goodwill/intangibles | **743** | 677 |
| | **8,889** | 8,083 |
| **Net Deferred Tax Asset** | **$ 1,512** | $ 930 |

The Corporation did not have any uncertain tax positions at December 31, 2014 and 2013. The Corporation's policy is to recognize interest and penalties on unrecognized tax benefits in income tax expense in the Consolidated Statements of Income.

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**NOTE K INCOME TAXES (Continued)**

Years that remain open for potential review by the Internal Revenue Service are 2011 through 2014.

**NOTE L FAIR VALUE MEASUREMENTS**

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

Fair value measurement and disclosure guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.

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

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

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

> Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
>
> Level 2: Quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability.
>
> Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

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

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**NOTE L FAIR VALUE MEASUREMENTS (Continued)**

For assets measured at fair value, the fair value measurements by level within the fair value hierarchy, and the basis of measurement used at December 31, 2014 and 2013, are as follows:

| | | Fair Value Measurements at December 31, 2014 | | | |
|---|---|---|---|---|---|
| **In thousands** | **Basis** | **Total** | **Level 1** | **Level 2** | **Level 3** |
| U.S. Government and agencies | | **$ 17,317** | **$** | **$ 17,317** | **$** |
| Mortgage-backed securities, residential | | **53,262** | | **53,262** | |
| State and municipal | | **35,445** | | **35,445** | |
| Corporate bonds | | **10,083** | | **10,083** | |
| CRA mutual fund | | **1,058** | **1,058** | | |
| Stock in other banks | | **835** | **835** | | |
| Total securities available for sale | **Recurring** | **$ 118,000** | **$ 1,893** | **$ 116,107** | **$** |
| Impaired loans | **Non-recurring** | **$ 5,785** | **$** | **$** | **$ 5,785** |
| Foreclosed assets held for resale | **Non-recurring** | **$ 383** | **$** | **$** | **$ 383** |

| | | Fair Value Measurements at December 31, 2013 | | | |
|---|---|---|---|---|---|
| **In thousands** | **Basis** | **Total** | **Level 1** | **Level 2** | **Level 3** |
| U.S. Government and agencies | | $ 21,651 | $ | $ 21,651 | $ |
| Mortgage-backed securities, residential | | 53,740 | | 53,740 | |
| State and municipal | | 41,522 | | 41,522 | |
| Corporate bonds | | 11,165 | | 11,165 | |
| CRA mutual fund | | 1,033 | 1,033 | | |
| Stock in other banks | | 872 | 872 | | |
| Total securities available for sale | Recurring | $ 129,983 | $ 1,905 | $ 128,078 | $ |
| Impaired loans | Non-recurring | $ 6,887 | $ | $ | $ 6,887 |
| Foreclosed assets held for resale | Non-recurring | $ 413 | $ | $ | $ 413 |

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis for which the Corporation has utilized Level 3 inputs to determine fair value:

**Quantitative Information about Level 3 Fair Value Measurements**

| Dollars in thousands | Fair Value Estimate | Valuation Technique | Unobservable Input | Range | Weighted Average |
|---|---|---|---|---|---|
| **December 31, 2014** | | | | | |
| Impaired loans | **$ 5,785** | **Appraisal of collateral(1)** | **Appraisal adjustments(2)** | **(10) - (50)%** | **(18)%** |
| Foreclosed assets held for resale | **$ 383** | **Appraisal of collateral(1)(3)** | **Appraisal adjustments(2)** | **(10) - (50)%** | **(44)%** |
| **December 31, 2013** | | | | | |
| Impaired loans | $ 6,887 | Appraisal of collateral(1) | Appraisal adjustments(2) | (10) - (50)% | (19)% |
| Foreclosed assets held for resale | $ 413 | Appraisal of collateral(1)(3) | Appraisal adjustments(2) | (10) - (50)% | (35)% |

(1) Fair value is generally determined through independent third-party appraisals of the underlying collateral, which generally includes various Level 3 inputs which are not observable.

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**NOTE L FAIR VALUE MEASUREMENTS (Continued)**

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range of liquidation expenses and other appraisal adjustments are presented as a percentage of the appraisal. Higher downward adjustments are caused by negative changes to the collateral or conditions in the real estate market, actual offers or sales contracts received, or age of the appraisal.

(3) Includes qualitative adjustments by management and estimated liquidation expenses.

The following information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of certain Corporation assets and liabilities at December 31, 2014 and 2013:

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

The carrying amounts reported in the consolidated statement of condition for cash and short-term instruments approximate those assets' fair value. U.S. currency is Level 1 and cash equivalents are Level 2.

**Securities**

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

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

The fair values of mortgage loans held for sale are determined based on amounts to be received at settlement by establishing the respective buyer requirement or market interest rates.

**Loans (Carried at Cost)**

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

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

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

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**NOTE L FAIR VALUE MEASUREMENTS (Continued)**

**Foreclosed Assets Held for Resale**

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

It is the policy of the Corporation to have the initial market value of a foreclosed asset held for resale determined by an independent third-party valuation. If the Corporation already has a valid appraisal on file for the property and that appraisal has been completed within the previous 12 months, another appraisal shall not be required when the Corporation acquires ownership of that real estate. Further, the Corporation shall update the market value of each foreclosed asset with an independent third-party valuation at least every 18 months, or more frequently if management believes that there is an indication that the fair value has declined. These valuations may be adjusted downward to account for specialized use of the property, change in the condition of the real estate, change in local market and economic conditions, and other specific factors involving the collateral.

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

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

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

The carrying amounts of accrued interest receivable and accrued interest payable approximate their fair value.

**Deposits (Carried at Cost)**

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

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

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

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

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

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

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

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**NOTE L FAIR VALUE MEASUREMENTS (Continued)**

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Corporation's financial instruments at December 31, 2014 and 2013:

| | December 31, 2014 | | | | |
|---|---|---|---|---|---|
| **In thousands** | **Carrying Amount** | **Fair Value** | **Level 1** | **Level 2** | **Level 3** |
| Financial assets: | | | | | |
| Cash and due from banks | **$ 13,502** | **$ 13,502** | **$ 7,200** | **$ 6,302** | **$** |
| Interest-bearing deposits in banks | **6,171** | **6,171** | **6,171** | | |
| Investment securities available for sale | **118,000** | **118,000** | **1,893** | **116,107** | |
| Investment securities held to maturity | **73,346** | **73,057** | | **73,057** | |
| Loans held for sale | **1,623** | **1,623** | | **1,623** | |
| Loans, less allowance for loan losses | **784,100** | **795,117** | | | **795,117** |
| Accrued interest receivable | **2,950** | **2,950** | | **2,950** | |
| Restricted investment in bank stocks | **4,216** | **4,216** | | **4,216** | |
| | | | | | |
| Financial liabilities: | | | | | |
| Deposits | **844,876** | **845,565** | | **845,565** | |
| Short-term borrowings | **45,699** | **45,699** | | **45,699** | |
| Long-term borrowings | **80,937** | **82,478** | | **82,478** | |
| Accrued interest payable | **773** | **773** | | **773** | |
| | | | | | |
| Off-balance sheet financial instruments | | | | | |

| | December 31, 2013 | | | | |
|---|---|---|---|---|---|
| **In thousands** | **Carrying Amount** | **Fair Value** | **Level 1** | **Level 2** | **Level 3** |
| Financial assets: | | | | | |
| Cash and due from banks | $ 13,963 | $ 13,963 | $ 7,755 | $ 6,208 | $ |
| Interest-bearing deposits in banks | 4,153 | 4,153 | 4,153 | | |
| Investment securities available for sale | 129,983 | 129,983 | 1,905 | 128,078 | |
| Investment securities held to maturity | 94,373 | 92,082 | | 92,082 | |
| Loans held for sale | 496 | 496 | | 496 | |
| Loans, less allowance for loan losses | 712,557 | 724,937 | | | 724,937 |
| Accrued interest receivable | 3,027 | 3,027 | | 3,027 | |
| Restricted investment in bank stocks | 6,861 | 6,861 | | 6,861 | |
| | | | | | |
| Financial liabilities: | | | | | |
| Deposits | 800,643 | 801,063 | | 801,063 | |
| Short-term borrowings | 49,052 | 49,052 | | 49,052 | |
| Long-term borrowings | 82,703 | 84,558 | | 84,558 | |
| Accrued interest payable | 681 | 681 | | 681 | |
| | | | | | |
| Off-balance sheet financial instruments | | | | | |

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**NOTE M RETIREMENT PLANS**

The Corporation's banking subsidiary has a non-contributory, defined benefit pension plan. Retirement benefits are a function of both years of service and compensation. The funding policy is to contribute annually the amount that is sufficient to meet the minimum funding requirements set forth in the Employee Retirement Income Security Act.

A measurement date of December 31 has been used for the fiscal year ending December 31, 2014 and 2013.

| In thousands | 2014 | 2013 |
|---|---|---|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | **$ 22,303** | $ 24,297 |
| Service cost | **689** | 774 |
| Interest cost | **1,035** | 894 |
| Change in assumptions | **4,087** | (2,725) |
| Benefits paid | **(949)** | (937) |
| Benefit obligation at end of year | **27,165** | 22,303 |
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | **34,711** | 29,418 |
| Actual return on plan assets | **2,050** | 3,631 |
| Employer contribution | **2,351** | 2,599 |
| Benefits paid | **(949)** | (937) |
| Fair value of plan assets at end of year | **38,163** | 34,711 |
| **Funded Status, included in other assets** | **$ 10,998** | $ 12,408 |

| | | |
|---|---|---|
| Amounts recognized in accumulated other comprehensive income: | | |
| Total net actuarial loss | **$ 7,995** | $ 3,667 |
| Prior service cost | **25** | 65 |
| **Total included in accumulated other comprehensive income (pretax)** | **$ 8,020** | $ 3,732 |

The estimated costs that will be amortized from accumulated other comprehensive income into net periodic pension cost during the next fiscal year are as follows:

| In thousands | |
|---|---|
| Net loss | $ 481 |
| Prior service cost | 24 |
| | $ 505 |

The accumulated benefit obligation totaled $26,172,000 and $21,713,000 at December 31, 2014 and 2013, respectively.

For the year ended December 31, 2013, the mortality assumptions were derived using the IRS 2013 Prescribed Mortality Optional Combined Table for Small Plans, male and female. For the year ended December 31, 2014, the mortality assumptions were derived using the mortality rates as of 2007 from SOA RP-2014 study. The impact on the benefit obligation for the mortality assumption change in 2014 was an increase of $1,106,000.

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**NOTE M RETIREMENT PLANS (Continued)**

The components of net periodic benefit costs (income) related to the non-contributory, defined benefit pension plan for the years ended December 31 are as follows:

| In thousands | 2014 | 2013 | 2012 |
|---|---|---|---|
| Components of net periodic benefit cost (income): | | | |
| Service cost | **$ 689** | $ 774 | $ 651 |
| Interest cost | **1,035** | 894 | 925 |
| Expected return on plan assets | **(2,311)** | (1,957) | (1,772) |
| Recognized net actuarial loss | **21** | 652 | 611 |
| Amortization of transition liability | | | 10 |
| Amortization of prior service cost | **40** | 40 | 40 |
| **Net Periodic Benefit (Income) Cost** | **(526)** | 403 | 465 |
| Net loss (gain) | **4,349** | (4,400) | 1,393 |
| Amortization of net loss | **(21)** | (652) | (611) |
| Amortization of transition liability | | | (10) |
| Amortization of prior service cost | **(40)** | (40) | (40) |
| **Total recognized in other comprehensive loss (income)** | **$ 4,288** | $ (5,092) | $ 732 |
| **Total recognized in net periodic benefit (income) cost and other comprehensive loss (income)** | **$ 3,762** | $ (4,689) | $ 1,197 |

For the years ended December 31, 2014, 2013 and 2012, the assumptions used to determine the benefit obligation are as follows:

| | 2014 | 2013 | 2012 |
|---|---|---|---|
| Discount rate | **3.90%** | 4.75% | 3.75% |
| Rate of compensation increase | **3.75%** | 3.75% | 3.75% |

For the years ended December 31, 2014, 2013 and 2012, the assumptions used to determine the net periodic benefit cost (income) are as follows:

| | 2014 | 2013 | 2012 |
|---|---|---|---|
| Discount rate | **4.75%** | 3.75% | 4.50% |
| Expected long-term rate of return on plan assets | **6.75%** | 6.75% | 7.00% |
| Rate of compensation increase | **3.75%** | 3.75% | 4.00% |

The Corporation's pension plan weighted-average assets' allocations at December 31, 2014 and 2013, are as follows:

| | 2014 | 2013 |
|---|---|---|
| Equity securities | **47%** | 46% |
| Debt securities | **47%** | 45% |
| Short-term fixed income | **1%** | 4% |
| Real estate | **5%** | 5% |
| | **100%** | 100% |

The Corporation's overall investment strategy is to achieve a mix of investments to meet the long-term rate of return assumption and near-term pension obligations with a diversification of assets types, fund strategies and fund managers. The mix of investments is adjusted periodically by retaining

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**NOTE M RETIREMENT PLANS (Continued)**

an advisory firm to recommend appropriate allocations after reviewing the Corporation's risk tolerance on contribution levels, funded status and plan expense, and any applicable regulatory requirements. The weighted-average assets' allocation in the above table represents the Corporation's conclusion on the appropriate mix of investments. The specific investment vehicles are institutional separate accounts from a variety of fund managers which are regularly reviewed by the Corporation for acceptable performance.

Equity securities included Corporation common stock in amounts of $1,412,000, or 4% of total plan assets, and $1,128,000, or 3% of total plan assets, at December 31, 2014 and 2013, respectively.

Fair value measurements at December 31, 2014, are as follows:

| In thousands | Total | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Equity securities | **$ 18,511** | **$ 1,412** | **$ 17,099** | **$** |
| Debt securities | **17,821** | | **17,821** | |
| Real estate | **1,831** | | **1,831** | |

Fair value measurements at December 31, 2013, are as follows:

| In thousands | Total | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Equity securities | $ 17,385 | $ 1,128 | $ 16,257 | $ |
| Debt securities | 15,754 | | 15,754 | |
| Real estate | 1,572 | | 1,572 | |

It has not yet been determined the amount that the Bank may contribute to the Plan in 2015. The Corporation reduced the future benefit accruals for the defined benefit pension plan effective January 1, 2010, in order to manage total benefit expense. The new formula is the earned benefit as of December 31, 2009, plus 0.75% of a participant's average monthly pay multiplied by years of benefit service earned on and after January 1, 2010, but not more than 25 years. The benefit formula percentage and maximum years of benefit service were both reduced. 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 379 active, vested terminated, and retired persons in the Plan.

Based on current data and assumptions, the following benefit payments, which reflect expected future service, as appropriate, are:

| Years Ending | In thousands |
|---|---|
| 2015 | $ 1,020 |
| 2016 | 1,060 |
| 2017 | 1,170 |
| 2018 | 1,260 |
| 2019 | 1,360 |
| 2020-2024 | 8,070 |

The Corporation's banking subsidiary maintains a 401(k) plan for the benefit of eligible employees. Employees may contribute up to 100% of their compensation subject to certain limits based on federal tax laws. The Bank makes matching contributions up to 100% of the first 4% of an employee's compensation contributed to the plan. Matching contributions vest immediately to the employee. Bank contributions to and expenses for the plan were $526,000, $500,000 and $486,000 for 2014, 2013 and 2012, respectively.

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**NOTE M RETIREMENT PLANS (Continued)**

RIG has a similar but separate 401(k) plan with the match of 6% for non-highly compensated employees and 3% match for highly compensated employees. RIG's contributions to and expenses for the plan were $63,000, $66,000 and $72,000 for 2014, 2013 and 2012, respectively.

The Corporation's banking subsidiary maintains nonqualified compensation plans for selected senior officers. The estimated present value of future benefits is accrued over the period from the effective date of the agreements until the expected retirement dates of the individuals. The balance accrued for these plans included in other liabilities as of December 31, 2014 and 2013, totaled $1,987,000 and $1,744,000, respectively. The annual expense included in salaries and benefits expense totaled $339,000, $321,000 and $297,000 during the years ended December 31, 2014, 2013 and 2012, respectively. To fund the benefits under these plans, the Bank is the owner of single premium life insurance policies on participants in the nonqualified retirement plans. At December 31, 2014 and 2013, the cash surrender value of these policies was $4,725,000 and $4,616,000, respectively.

**NOTE N REGULATORY MATTERS**

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

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios (set forth below) of Tier 1 capital to average assets and of Tier 1 and total capital (as defined in the regulations) to risk weighted assets. Management believes, as of December 31, 2014, that the Corporation and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2014, the most recent notification from the federal banking regulators categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

On May 5, 2009, stockholders approved and ratified the ACNB Corporation 2009 Restricted Stock Plan, which awards shall not exceed, in the aggregate, 200,000 shares of common stock. As of December 31, 2014, no shares have been issued under the plan. In January 2011, the Corporation offered stockholders the opportunity to participate in the ACNB Corporation Dividend Reinvestment and Stock Purchase Plan. The plan allows registered stockholders who have a minimal number of shares to participate and also provides for voluntary cash purchases of ACNB Corporation common stock. During 2014, 2013, and 2012, 24,339, 25,943, and 19,559 shares of common stock, respectively, were issued within the plan.

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**NOTE N REGULATORY MATTERS (Continued)**

The actual and required capital amounts and ratios were as follows:

| Dollars in thousands | Actual | | For Capital Adequacy Purposes | | To be Well Capitalized under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **CORPORATION** | | | | | | |
| **As of December 31, 2014** | | | | | | |
| Tier 1 leverage ratio (to average assets) | **$ 105,241** | **9.81%** | **$ ≥42,905** | **≥4.0%** | **N/A** | **N/A** |
| Tier 1 risk-based capital ratio (to risk-weighted assets) | **105,241** | **14.02** | **≥30,032** | **≥4.0** | **N/A** | **N/A** |
| Total risk-based capital ratio (to risk-weighted assets) | **114,798** | **15.29** | **≥60,064** | **≥8.0** | **N/A** | **N/A** |
| **As of December 31, 2013** | | | | | | |
| Tier 1 leverage ratio (to average assets) | $ 98,704 | 9.54% | $ ≥41,367 | ≥4.0% | N/A | N/A |
| Tier 1 risk-based capital ratio (to risk-weighted assets) | 98,704 | 14.09 | ≥28,014 | ≥4.0 | N/A | N/A |
| Total risk-based capital ratio (to risk-weighted assets) | 107,623 | 15.37 | ≥56,027 | ≥8.0 | N/A | N/A |
| **BANK** | | | | | | |
| **As of December 31, 2014** | | | | | | |
| Tier 1 leverage ratio (to average assets) | **$ 95,028** | **8.86%** | **$ ≥42,912** | **≥4.0%** | **$ ≥53,640** | **≥5.0%** |
| Tier 1 risk-based capital ratio (to risk-weighted assets) | **95,028** | **12.75** | **≥29,817** | **≥4.0** | **≥44,725** | **≥6.0** |
| Total risk-based capital ratio (to risk-weighted assets) | **104,425** | **14.01** | **≥59,633** | **≥8.0** | **≥74,542** | **≥10.0** |
| **As of December 31, 2013** | | | | | | |
| Tier 1 leverage ratio (to average assets) | $ 90,339 | 8.76% | $ ≥41,240 | ≥4.0% | $ ≥51,550 | ≥5.0% |
| Tier 1 risk-based capital ratio (to risk-weighted assets) | 90,339 | 12.99 | ≥27,808 | ≥4.0 | ≥41,712 | ≥6.0 |
| Total risk-based capital ratio (to risk-weighted assets) | 99,121 | 14.26 | ≥55,616 | ≥8.0 | ≥69,520 | ≥10.0 |

**NOTE O FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK**

The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist primarily of commitments to extend credit (typically mortgages and commercial loans) and, to a lesser extent, standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the consolidated balance sheet.

The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on balance sheet instruments. The Corporation does not anticipate any material losses from these commitments.

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**NOTE O FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (Continued)**

Commitments to extend credit, including commitments to grant loans and unfunded commitments under lines of credit, are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extensions of credit, is based on management's credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, property and equipment and income-producing commercial properties. On loans secured by real estate, the Corporation generally requires loan to value ratios of no greater than 80%.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements and similar transactions. The terms of the letters of credit vary and may have renewal features. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Corporation generally holds collateral and/or personal guarantees supporting those commitments for which collateral is deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral and the enforcement of guarantees would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of December 31, 2014 and 2013, for guarantees under standby letters of credit issued is not material.

In June 2013, ACNB Corporation executed a guaranty for a note related to a $500,000 commercial line of credit from an unaffiliated local bank, with normal terms and conditions for such a line, for Russell Insurance Group, Inc., the borrower and a wholly-owned subsidiary of ACNB Corporation. The commercial line of credit is for general working capital needs should they arise by the borrower. No liability is recorded for the guarantor's obligation as the guarantor would have full recourse from all assets of its wholly-owned subsidiary. No draws were taken on this commercial line of credit since its inception.

The Corporation has not been required to perform on any financial guarantees, and has not incurred any losses on its commitments, during the past three years.

A summary of the Corporation's commitments at December 31 were as follows:

| **In thousands** | **2014** | **2013** |
|---|---|---|
| Commitments to extend credit | **$ 217,837** | $ 156,135 |
| Standby letters of credit | **6,072** | 4,176 |

**NOTE P CONTINGENCIES**

The Corporation is subject to claims and lawsuits which arise primarily in the ordinary course of business. Based on information presently available and advice received from legal counsel representing the Corporation in connection with any such claims and lawsuits, it is the opinion of management that the disposition or ultimate determination of any such claims and lawsuits will not have a material adverse effect on the consolidated financial position, consolidated results of operations or liquidity of the Corporation.

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**NOTE Q ACNB CORPORATION (PARENT COMPANY ONLY) FINANCIAL INFORMATION**

**STATEMENTS OF CONDITION**

| | December 31, | |
|---|---|---|
| **In thousands** | **2014** | **2013** |
| **ASSETS** | | |