

FARMERS NATIONAL BANC CORP /OH/  
Form 10-Q  
May 09, 2013

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the**  
**Securities Exchange Act of 1934**

**For the Quarterly period ended March 31, 2013**

**Commission file number 001-35296**

**FARMERS NATIONAL BANC CORP.**

**(Exact name of registrant as specified in its charter)**

**OHIO**

**34-1371693**

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(State or other jurisdiction of

(I.R.S. Employer

incorporation or organization)

Identification No)

**20 South Broad Street Canfield, OH**

(Address of principal executive offices)

**44406**

(Zip Code)

**(330) 533-3341**

(Registrant's telephone number, including area code)

**Not applicable**

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer ☐ Accelerated filer ☒

Non-accelerated filer ☐ Smaller reporting company ☐

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

**Class**  
Common Stock, No Par Value

**Outstanding at April 30, 2013**  
18,795,048 shares

**PART I - FINANCIAL INFORMATION**

|        |                                                                                              |    |
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**10-Q Certifications**

**Section 906 Certifications**

**CONSOLIDATED BALANCE SHEETS****FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES****(Unaudited)**(In Thousands of Dollars)  
**March 31,**  
**2013**  
**December 31,**  
**2012****ASSETS**

|                              |           |           |
|------------------------------|-----------|-----------|
| Cash and due from banks      | \$ 14,013 | \$ 14,209 |
| Federal funds sold and other | 43,299    | 23,550    |

|                                 |        |        |
|---------------------------------|--------|--------|
| TOTAL CASH AND CASH EQUIVALENTS | 57,312 | 37,759 |
|---------------------------------|--------|--------|

|                                |         |         |
|--------------------------------|---------|---------|
| Securities available for sale  | 439,540 | 464,088 |
| Loans held for sale            | 4,330   | 3,624   |
| Loans                          | 592,520 | 586,592 |
| Less allowance for loan losses | 7,508   | 7,629   |

|           |         |         |
|-----------|---------|---------|
| NET LOANS | 585,012 | 578,963 |
|-----------|---------|---------|

|                             |        |        |
|-----------------------------|--------|--------|
| Premises and equipment, net | 18,143 | 18,429 |
| Goodwill                    | 3,709  | 3,709  |
| Other intangibles           | 2,225  | 2,323  |
| Bank owned life insurance   | 15,658 | 15,541 |
| Other assets                | 17,170 | 15,259 |

|              |              |              |
|--------------|--------------|--------------|
| TOTAL ASSETS | \$ 1,143,099 | \$ 1,139,695 |
|--------------|--------------|--------------|

**LIABILITIES AND STOCKHOLDERS EQUITY**

|                     |            |            |
|---------------------|------------|------------|
| Deposits:           |            |            |
| Noninterest-bearing | \$ 139,412 | \$ 132,016 |
| Interest-bearing    | 776,443    | 786,993    |

|                |         |         |
|----------------|---------|---------|
| TOTAL DEPOSITS | 915,855 | 919,009 |
|----------------|---------|---------|

|                       |        |        |
|-----------------------|--------|--------|
| Short-term borrowings | 91,302 | 79,886 |
| Long-term borrowings  | 10,357 | 10,423 |
| Other liabilities     | 5,009  | 9,585  |

|                   |           |           |
|-------------------|-----------|-----------|
| TOTAL LIABILITIES | 1,022,523 | 1,018,903 |
|-------------------|-----------|-----------|

**Commitments and contingent liabilities****Stockholders Equity:**

|                                                                                                                       |         |         |
|-----------------------------------------------------------------------------------------------------------------------|---------|---------|
| Common Stock - Authorized 35,000,000 shares in 2013 and 25,000,000 shares in 2012: issued 18,802,282 in 2013 and 2012 | 104,503 | 104,504 |
| Retained earnings                                                                                                     | 10,124  | 8,683   |
| Accumulated other comprehensive income                                                                                | 5,991   | 7,647   |
| Treasury stock, at cost; 7,234 shares in 2013 and 2012                                                                | (42)    | (42)    |

|                           |         |         |
|---------------------------|---------|---------|
| TOTAL STOCKHOLDERS EQUITY | 120,576 | 120,792 |
|---------------------------|---------|---------|

|                                           |              |              |
|-------------------------------------------|--------------|--------------|
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 1,143,099 | \$ 1,139,695 |
|-------------------------------------------|--------------|--------------|

See accompanying notes



**CONSOLIDATED STATEMENTS OF INCOME****FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES**

| (Unaudited)                                                                                                                                               | (In Thousands except Per Share Data)<br>For the Three Months Ended |                   |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------|-------------------|
|                                                                                                                                                           | March 31,<br>2013                                                  | March 31,<br>2012 |
| <b>INTEREST AND DIVIDEND INCOME</b>                                                                                                                       |                                                                    |                   |
| Loans, including fees                                                                                                                                     | 7,568                                                              | \$ 7,996          |
| Taxable securities                                                                                                                                        | 1,908                                                              | 2,106             |
| Tax exempt securities                                                                                                                                     | 727                                                                | 713               |
| Dividends                                                                                                                                                 | 53                                                                 | 50                |
| Federal funds sold and other interest income                                                                                                              | 10                                                                 | 21                |
| <b>TOTAL INTEREST AND DIVIDEND INCOME</b>                                                                                                                 | <b>10,266</b>                                                      | <b>10,886</b>     |
| <b>INTEREST EXPENSE</b>                                                                                                                                   |                                                                    |                   |
| Deposits                                                                                                                                                  | 1,187                                                              | 1,525             |
| Short-term borrowings                                                                                                                                     | 12                                                                 | 42                |
| Long-term borrowings                                                                                                                                      | 99                                                                 | 98                |
| <b>TOTAL INTEREST EXPENSE</b>                                                                                                                             | <b>1,298</b>                                                       | <b>1,665</b>      |
| <b>NET INTEREST INCOME</b>                                                                                                                                | <b>8,968</b>                                                       | <b>9,221</b>      |
| Provision for loan losses                                                                                                                                 | 255                                                                | 0                 |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>                                                                                                | <b>8,713</b>                                                       | <b>9,221</b>      |
| <b>NONINTEREST INCOME</b>                                                                                                                                 |                                                                    |                   |
| Service charges on deposit accounts                                                                                                                       | 491                                                                | 474               |
| Bank owned life insurance income                                                                                                                          | 117                                                                | 135               |
| Trust fees                                                                                                                                                | 1,346                                                              | 1,418             |
| Insurance agency commissions                                                                                                                              | 42                                                                 | 36                |
| Security gains (includes \$14 thousand accumulated other comprehensive income reclassification for unrealized net gains on available-for-sale securities) | 14                                                                 | 0                 |
| Investment commissions                                                                                                                                    | 262                                                                | 186               |
| Net gains on sale of loans                                                                                                                                | 114                                                                | 65                |
| Other operating income                                                                                                                                    | 489                                                                | 405               |
| <b>TOTAL NONINTEREST INCOME</b>                                                                                                                           | <b>2,875</b>                                                       | <b>2,719</b>      |
| <b>NONINTEREST EXPENSES</b>                                                                                                                               |                                                                    |                   |
| Salaries and employee benefits                                                                                                                            | 5,205                                                              | 4,729             |
| Occupancy and equipment                                                                                                                                   | 1,026                                                              | 961               |
| State and local taxes                                                                                                                                     | 329                                                                | 307               |
| Professional fees                                                                                                                                         | 484                                                                | 407               |
| Advertising                                                                                                                                               | 180                                                                | 248               |
| FDIC insurance                                                                                                                                            | 177                                                                | 186               |
| Intangible amortization                                                                                                                                   | 98                                                                 | 102               |
| Core processing charges                                                                                                                                   | 346                                                                | 388               |
| Other operating expenses                                                                                                                                  | 1,243                                                              | 1,302             |
| <b>TOTAL NONINTEREST EXPENSES</b>                                                                                                                         | <b>9,088</b>                                                       | <b>8,630</b>      |
| <b>INCOME BEFORE INCOME TAXES</b>                                                                                                                         | <b>2,500</b>                                                       | <b>3,310</b>      |

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|                                                                                     |          |          |
|-------------------------------------------------------------------------------------|----------|----------|
| INCOME TAXES (includes \$5 thousand income tax expense from reclassification items) | 495      | 790      |
| NET INCOME                                                                          | \$ 2,005 | \$ 2,520 |
| NET INCOME PER SHARE - basic and diluted                                            | \$ 0.11  | \$ 0.13  |

See accompanying notes

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES**

(Unaudited)

(In Thousands of Dollars)  
For the Three Months Ended  
**March 31, 2013**      **March 31, 2012**

|                                                                        |                 |                 |
|------------------------------------------------------------------------|-----------------|-----------------|
| <b>NET INCOME</b>                                                      | <b>\$ 2,005</b> | <b>\$ 2,520</b> |
| Other comprehensive income:                                            |                 |                 |
| Net unrealized holding gains (losses) on available for sale securities | (2,534)         | (856)           |
| Reclassification adjustment for (gains) losses realized in income      | (14)            | 0               |
| Net unrealized holding gains (losses)                                  | (2,548)         | (856)           |
| Income tax effect                                                      | 892             | 300             |
| Unrealized holding gains (losses), net of reclassification and tax     | (1,656)         | (556)           |
| <b>COMPREHENSIVE INCOME</b>                                            | <b>\$ 349</b>   | <b>\$ 1,964</b> |

See accompanying notes

**CONSOLIDATED STATEMENTS OF CASH FLOWS****FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES**

| (Unaudited)                                                                | (In Thousands of Dollars) |                 |
|----------------------------------------------------------------------------|---------------------------|-----------------|
|                                                                            | Three Months Ended        |                 |
|                                                                            | March 31,                 | March 31,       |
|                                                                            | 2013                      | 2012            |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                |                           |                 |
| Net income                                                                 | \$ 2,005                  | \$ 2,520        |
| Adjustments to reconcile net income to net cash from operating activities: |                           |                 |
| Provision for loan losses                                                  | 255                       | 0               |
| Depreciation and amortization                                              | 439                       | 413             |
| Net amortization of securities                                             | 660                       | 584             |
| Security gains                                                             | (14)                      | 0               |
| (Gain) Loss on sale of other real estate owned                             | 9                         | 0               |
| Increase in bank owned life insurance                                      | (117)                     | (134)           |
| Origination of loans held for sale                                         | (7,420)                   | (5,532)         |
| Proceeds from loans held for sale                                          | 6,828                     | 3,079           |
| Net gains on sale of loans                                                 | (114)                     | (65)            |
| Net change in other assets and liabilities                                 | (787)                     | (1,966)         |
| <b>NET CASH FROM OPERATING ACTIVITIES</b>                                  | <b>(1,744)</b>            | <b>(1,101)</b>  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                |                           |                 |
| Proceeds from maturities and repayments of securities available for sale   | 22,322                    | 15,684          |
| Proceeds from sales of securities available for sale                       | 32                        | 0               |
| Purchases and settlements of securities available for sale                 | (5,759)                   | (29,106)        |
| Loan originations and payments, net                                        | (6,407)                   | (5,210)         |
| Proceeds from sales of other real estate owned                             | 19                        | 56              |
| Additions to premises and equipment                                        | (30)                      | (852)           |
| <b>NET CASH FROM INVESTING ACTIVITIES</b>                                  | <b>10,177</b>             | <b>(19,428)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                |                           |                 |
| Net change in deposits                                                     | (3,154)                   | 46,468          |
| Net change in short-term borrowings                                        | 11,416                    | (8,170)         |
| Repayment of Federal Home Loan Bank borrowings and other debt              | (66)                      | (611)           |
| Cash dividends paid                                                        | (564)                     | (1,126)         |
| Proceeds from dividend reinvestment                                        | 0                         | 121             |
| <b>NET CASH FROM FINANCING ACTIVITIES</b>                                  | <b>7,632</b>              | <b>36,682</b>   |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                             | <b>19,553</b>             | <b>16,153</b>   |
| Beginning cash and cash equivalents                                        | 37,759                    | 52,422          |
| Ending cash and cash equivalents                                           | \$ 57,312                 | \$ 68,575       |
| <b>Supplemental cash flow information:</b>                                 |                           |                 |
| Interest paid                                                              | \$ 1,326                  | \$ 1,677        |
| Income taxes paid                                                          | \$ 0                      | \$ 0            |
| <b>Supplemental noncash disclosures:</b>                                   |                           |                 |
| Transfer of loans to other real estate                                     | \$ 103                    | \$ 15           |

See accompanying notes



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## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### Principles of Consolidation:

Farmers National Banc Corp. ( Company ) is a one-bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company provides full banking services through its nationally chartered subsidiary, The Farmers National Bank of Canfield ( Bank ). The Company provides trust services through its subsidiary, Farmers Trust Company ( Trust ), and insurance services through the Bank's subsidiary, Farmers National Insurance. The consolidated financial statements include the accounts of the Company, the Bank and its subsidiary and the Trust. All significant intercompany balances and transactions have been eliminated in the consolidation.

### Basis of Presentation:

The unaudited condensed consolidated financial statements have been prepared in conformity with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles ( U.S. GAAP ) for complete financial statements. The financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2012 Annual Report to Shareholders included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. The interim consolidated financial statements include all adjustments (consisting of only normal recurring items) that, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the periods presented. The results of operations for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year. Certain items included in the prior period financial statements were reclassified to conform to the current period presentation. There was no effect on net income or total stockholders' equity.

### Estimates:

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for loan losses, deferred tax assets, carrying amount of goodwill and fair values of financial instruments are particularly subject to change.

### Segments:

The Company provides a broad range of financial services to individuals and companies in northeastern Ohio. While the Company's chief decision makers monitor the revenue streams of the various products and services, operations are managed and financial performance is primarily aggregated and reported in two lines of business, the Bank segment and the Trust segment.

### Comprehensive Income:

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income consists of unrealized gains and losses on securities available for sale and changes in the funded status of the post retirement health plan, which are recognized as separate components of equity, net of tax effects. For the three-month period ended March 31, 2013, there was no change in the funded status of the plan.

### Recent Accounting Pronouncements

In February 2013, the FASB issued ASU 2013-02 with the primary objective of improving the reporting of reclassifications out of accumulated other comprehensive income (AOCI). For significant reclassifications that are required to be presented in their entirety in net income in the same reporting period by U.S. Generally Accepted Accounting Principles (U.S. GAAP), the ASU requires an entity to report the effect of these reclassifications out of AOCI on the respective line items of net income either on the face of the statement that reports net income or in the financial statement notes. For AOCI items that are not reclassified to net income in their entirety,

presentation in the financial statement notes is required. The Company adopted this ASU for the period ended March 31, 2013, by adding the additional disclosures to the consolidated statements of income.

### Securities:

The following table summarizes the amortized cost and fair value of the available-for-sale investment securities portfolio at March 31, 2013 and December 31, 2012 and the corresponding amounts of unrealized gains and losses recognized in accumulated other comprehensive income:

| (In Thousands of Dollars)                            | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value        |
|------------------------------------------------------|-------------------|------------------------------|-------------------------------|-------------------|
| <b>March 31, 2013</b>                                |                   |                              |                               |                   |
| U.S. Treasury and U.S. government sponsored entities | \$ 60,552         | \$ 1,402                     | \$ 0                          | \$ 61,954         |
| State and political subdivisions                     | 90,389            | 4,532                        | (488)                         | 94,433            |
| Corporate bonds                                      | 2,147             | 10                           | (5)                           | 2,152             |
| Mortgage-backed securities - residential             | 217,190           | 4,362                        | (853)                         | 220,699           |
| Collateralized mortgage obligations                  | 38,820            | 385                          | (568)                         | 38,637            |
| Small business administration                        | 21,234            | 5                            | (229)                         | 21,010            |
| Equity securities                                    | 121               | 537                          | (3)                           | 655               |
| <b>Totals</b>                                        | <b>\$ 430,453</b> | <b>\$ 11,233</b>             | <b>\$ (2,146)</b>             | <b>\$ 439,540</b> |

| (In Thousands of Dollars)                            | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value        |
|------------------------------------------------------|-------------------|------------------------------|-------------------------------|-------------------|
| <b>December 31, 2012</b>                             |                   |                              |                               |                   |
| U.S. Treasury and U.S. government sponsored entities | \$ 66,378         | \$ 1,601                     | \$ (1)                        | \$ 67,978         |
| State and political subdivisions                     | 90,466            | 5,067                        | (245)                         | 95,288            |
| Corporate bonds                                      | 2,123             | 12                           | (7)                           | 2,128             |
| Mortgage-backed securities - residential             | 231,582           | 5,112                        | (476)                         | 236,218           |
| Collateralized mortgage obligations                  | 40,333            | 336                          | (74)                          | 40,595            |
| Small business administration                        | 21,432            | 74                           | (62)                          | 21,444            |
| Equity securities                                    | 139               | 303                          | (5)                           | 437               |
| <b>Totals</b>                                        | <b>\$ 452,453</b> | <b>\$ 12,505</b>             | <b>\$ (870)</b>               | <b>\$ 464,088</b> |

Proceeds from the sale of equity securities were \$32 thousand during the three month period ended March 31, 2013. Gross gains of \$14 thousand were realized on these sales. There were no security sales during the three months ended March 31, 2012.

The amortized cost and fair value of the debt securities portfolio are shown by expected maturity. Expected maturities may differ from contractual maturities if issuers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

| (In Thousands of Dollars)               | March 31, 2013    |                   |
|-----------------------------------------|-------------------|-------------------|
|                                         | Amortized<br>Cost | Fair<br>Value     |
| <b>Maturity</b>                         |                   |                   |
| Within one year                         | \$ 13,761         | \$ 13,960         |
| One to five years                       | 77,217            | 79,989            |
| Five to ten years                       | 46,135            | 48,020            |
| Beyond ten years                        | 15,975            | 16,570            |
| Mortgage-backed, CMO and SBA securities | 277,244           | 280,346           |
| <b>Total</b>                            | <b>\$ 430,332</b> | <b>\$ 438,885</b> |

The following table summarizes the investment securities with unrealized losses at March 31, 2013 and December 31, 2012, aggregated by major security type and length of time in a continuous unrealized loss position. Unrealized losses for mortgage-backed securities – residential, rounded to less than \$1 thousand in 2012. In addition, small business administration securities had unrealized losses that rounded to less than \$1 thousand in 2013 and 2012.

| (In Thousands of Dollars)                | Less Than 12 Months |                      | 12 Months or Longer |                      | Total             |                      |
|------------------------------------------|---------------------|----------------------|---------------------|----------------------|-------------------|----------------------|
|                                          | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses |
| <b>March 31, 2013</b>                    |                     |                      |                     |                      |                   |                      |
| Available-for-sale                       |                     |                      |                     |                      |                   |                      |
| State and political subdivisions         | \$ 17,863           | \$ (488)             | \$ 0                | \$ 0                 | \$ 17,863         | \$ (488)             |
| Corporate bonds                          | 1,389               | (5)                  | 0                   | 0                    | 1,389             | (5)                  |
| Mortgage-backed securities – residential | 93,114              | (852)                | 38                  | (1)                  | 93,152            | (853)                |
| Collateralized mortgage obligations      | 23,344              | (568)                | 0                   | 0                    | 23,344            | (568)                |
| Small business administration            | 18,660              | (229)                | 35                  | 0                    | 18,695            | (229)                |
| Equity securities                        | 0                   | 0                    | 12                  | (3)                  | 12                | (3)                  |
| <b>Total</b>                             | <b>\$ 154,370</b>   | <b>\$ (2,142)</b>    | <b>\$ 85</b>        | <b>\$ (4)</b>        | <b>\$ 154,455</b> | <b>\$ (2,146)</b>    |

| (In Thousands of Dollars)                            | Less Than 12 Months |                      | 12 Months or Longer |                      | Total             |                      |
|------------------------------------------------------|---------------------|----------------------|---------------------|----------------------|-------------------|----------------------|
|                                                      | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses |
| <b>December 31, 2012</b>                             |                     |                      |                     |                      |                   |                      |
| Available-for-sale                                   |                     |                      |                     |                      |                   |                      |
| U.S. Treasury and U.S. government sponsored entities | \$ 5,490            | \$ (1)               | \$ 0                | \$ 0                 | \$ 5,490          | \$ (1)               |
| State and political subdivisions                     | 12,079              | (245)                | 0                   | 0                    | 12,079            | (245)                |
| Corporate bonds                                      | 887                 | (7)                  | 0                   | 0                    | 887               | (7)                  |
| Mortgage-backed securities – residential             | 97,598              | (476)                | 52                  | 0                    | 97,650            | (476)                |
| Collateralized mortgage obligations                  | 23,132              | (74)                 | 0                   | 0                    | 23,132            | (74)                 |
| Small business administration                        | 7,853               | (62)                 | 37                  | 0                    | 7,890             | (62)                 |
| Equity securities                                    | 0                   | 0                    | 8                   | (5)                  | 8                 | (5)                  |
| <b>Total</b>                                         | <b>\$ 147,039</b>   | <b>\$ (865)</b>      | <b>\$ 97</b>        | <b>\$ (5)</b>        | <b>\$ 147,136</b> | <b>\$ (870)</b>      |

*Other-Than-Temporary-Impairment*

Management evaluates securities for other-than-temporary impairment ( OTTI ) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Investment securities are generally evaluated for OTTI under Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) 320, *Investments Debt and Equity Securities*. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, whether the market decline was affected by macroeconomic conditions and whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. In analyzing an issuer's financial condition, the Company may consider whether the securities are issued by the federal government or its agencies, or U.S. government sponsored enterprises, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis. If an entity intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income or loss. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

As of March 31, 2013, the Company's security portfolio consisted of 405 securities, 60 of which were in an unrealized loss position. The majority of the unrealized losses on the Company's securities are related to its holdings of mortgage-backed securities as discussed below.

Unrealized losses on U.S. Treasury and U.S. government-sponsored entities have not been recognized into income because the securities are of high credit quality, management does not have the intent to sell these securities before their anticipated recovery and the decline in fair value is largely due to fluctuations in market interest rates and not credit quality. Consequently, the fair value of such debt securities is expected to recover as the securities approach their maturity date.

Unrealized losses on debt securities issued by state and political subdivisions have not been recognized into income. Generally these securities have maintained their investment grade ratings and management does not have the intent to sell these securities before their anticipated recovery. The fair value is expected to recover as the securities approach their maturity date.

All of the Company's holdings of collateralized mortgage obligations and mortgage-backed securities-residential were issued by U.S. government-sponsored entities. Unrealized losses on these securities- have not been recognized into income. Because the decline in fair value is attributable to changes in interest rates and illiquidity, and not credit quality, and because the Company does not have the intent to sell these mortgage-backed securities-residential and it is likely that it will not be required to sell the securities before their anticipated recovery, the Company does not consider these securities to be OTTI.

Management does not believe any unrealized losses on small business administration securities represent an other-than-temporary impairment. The securities are issued and backed by the full faith and credit of the U.S. Government and the Company does not have the intent to sell these securities before their anticipated recovery. The fair value of these securities is expected to recover as they approach their maturity.

The Company's equity securities are made up of local and regional bank holdings. The unrealized losses associated with these holdings have not been recognized into income. Generally these securities have suffered as most banking securities have suffered during the recent economic cycle. The fair value is expected to recover as the banking sector recovers. Management does not have the intent to sell these securities before their anticipated recovery.

**Loans:**

Loan balances were as follows:

| (In Thousands of Dollars)   | March 31,<br>2013 | December 31,<br>2012 |
|-----------------------------|-------------------|----------------------|
| Commercial real estate      |                   |                      |
| Owner occupied              | \$ 92,829         | \$ 95,208            |
| Non-owner occupied          | 94,807            | 83,405               |
| Other                       | 17,364            | 22,729               |
| Commercial                  | 99,593            | 97,112               |
| Residential real estate     |                   |                      |
| 1-4 family residential      | 130,609           | 132,665              |
| Home equity lines of credit | 25,524            | 24,110               |
| Consumer                    |                   |                      |
| Indirect                    | 117,309           | 116,471              |
| Direct                      | 10,614            | 11,160               |
| Other                       | 1,837             | 1,767                |
| Subtotal                    | 590,486           | 584,627              |
| Net deferred loan costs     | 2,034             | 1,965                |
| Allowance for loan losses   | (7,508)           | (7,629)              |
| Net loans                   | \$ 585,012        | \$ 578,963           |

The following tables present the activity in the allowance for loan losses by portfolio segment for the three months ended March 31, 2013 and 2012:

**Three Months Ended March 31, 2013**

| (In Thousands of Dollars) | Commercial<br>Real<br>Estate | Commercial | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---------------------------|------------------------------|------------|----------------------------|----------|-------------|----------|
| Allowance for loan losses |                              |            |                            |          |             |          |
| Beginning balance         | \$ 3,392                     | \$ 1,453   | \$ 1,569                   | \$ 951   | \$ 264      | \$ 7,629 |
| Provision for loan losses | (56)                         | 1          | 35                         | 250      | 25          | 255      |
| Loans charged off         | (81)                         | (80)       | (102)                      | (400)    | 0           | (663)    |
| Recoveries                | 102                          | 11         | 8                          | 166      | 0           | 287      |
| Ending balance            | \$ 3,357                     | \$ 1,385   | \$ 1,510                   | \$ 967   | \$ 289      | \$ 7,508 |

**Three Months Ended March 31, 2012**

| (In Thousands of Dollars)        | Commercial<br>Real Estate | Commercial      | Residential<br>Real Estate | Consumer        | Unallocated   | Total           |
|----------------------------------|---------------------------|-----------------|----------------------------|-----------------|---------------|-----------------|
| <b>Allowance for loan losses</b> |                           |                 |                            |                 |               |                 |
| Beginning balance                | \$ 4,880                  | \$ 1,529        | \$ 1,802                   | \$ 972          | \$ 637        | \$ 9,820        |
| Provision for loan losses        | 230                       | 13              | 72                         | 145             | (460)         | 0               |
| Loans charged off                | (85)                      | (42)            | (245)                      | (249)           | 0             | (621)           |
| Recoveries                       | 35                        | 18              | 13                         | 181             | 0             | 247             |
| <b>Ending balance</b>            | <b>\$ 5,060</b>           | <b>\$ 1,518</b> | <b>\$ 1,642</b>            | <b>\$ 1,049</b> | <b>\$ 177</b> | <b>\$ 9,446</b> |

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of March 31, 2013 and December 31, 2012. The recorded investment in loans includes the unpaid principal balance and unamortized loan origination fees and costs, but excludes accrued interest receivable, which is not considered to be material:

**March 31, 2013**

| (In Thousands of Dollars)                       | Commercial<br>Real Estate | Commercial       | Residential<br>Real Estate | Consumer          | Unallocated   | Total             |
|-------------------------------------------------|---------------------------|------------------|----------------------------|-------------------|---------------|-------------------|
| <b><u>Allowance for loan losses:</u></b>        |                           |                  |                            |                   |               |                   |
| Ending allowance balance attributable to loans: |                           |                  |                            |                   |               |                   |
| Individually evaluated for impairment           | \$ 168                    | \$ 31            | \$ 0                       | \$ 0              | \$ 0          | \$ 199            |
| Collectively evaluated for impairment           | 3,189                     | 1,354            | 1,510                      | 967               | 289           | 7,309             |
| <b>Total ending allowance balance</b>           | <b>\$ 3,357</b>           | <b>\$ 1,385</b>  | <b>\$ 1,510</b>            | <b>\$ 967</b>     | <b>\$ 289</b> | <b>\$ 7,508</b>   |
| <b><u>Loans:</u></b>                            |                           |                  |                            |                   |               |                   |
| Loans individually evaluated for impairment     | \$ 7,495                  | \$ 1,828         | \$ 1,112                   | \$ 0              | \$ 0          | \$ 10,435         |
| Loans collectively evaluated for impairment     | 196,791                   | 97,765           | 154,441                    | 133,088           | 0             | 582,085           |
| <b>Total ending loans balance</b>               | <b>\$ 204,286</b>         | <b>\$ 99,593</b> | <b>\$ 155,553</b>          | <b>\$ 133,088</b> | <b>\$ 0</b>   | <b>\$ 592,520</b> |

**December 31, 2012**

| (In Thousands of Dollars)                       | Commercial<br>Real Estate | Commercial       | Residential<br>Real Estate | Consumer          | Unallocated   | Total             |
|-------------------------------------------------|---------------------------|------------------|----------------------------|-------------------|---------------|-------------------|
| <b><u>Allowance for loan losses:</u></b>        |                           |                  |                            |                   |               |                   |
| Ending allowance balance attributable to loans: |                           |                  |                            |                   |               |                   |
| Individually evaluated for impairment           | \$ 129                    | \$ 51            | \$ 0                       | \$ 0              | \$ 0          | \$ 180            |
| Collectively evaluated for impairment           | 3,263                     | 1,402            | 1,569                      | 951               | 264           | 7,449             |
| <b>Total ending allowance balance</b>           | <b>\$ 3,392</b>           | <b>\$ 1,453</b>  | <b>\$ 1,569</b>            | <b>\$ 951</b>     | <b>\$ 264</b> | <b>\$ 7,629</b>   |
| <b><u>Loans:</u></b>                            |                           |                  |                            |                   |               |                   |
| Loans individually evaluated for impairment     | \$ 8,535                  | \$ 1,852         | \$ 989                     | \$ 0              | \$ 0          | \$ 11,376         |
| Loans collectively evaluated for impairment     | 192,116                   | 95,260           | 155,193                    | 132,647           | 0             | 575,216           |
| <b>Total ending loans balance</b>               | <b>\$ 200,651</b>         | <b>\$ 97,112</b> | <b>\$ 156,182</b>          | <b>\$ 132,647</b> | <b>\$ 0</b>   | <b>\$ 586,592</b> |



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The following tables present information related to impaired loans by class of loans as of March 31, 2013 and December 31, 2012:

| (In Thousands of Dollars)           | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance for<br>Loan Losses<br>Allocated |
|-------------------------------------|--------------------------------|------------------------|-------------------------------------------|
| <b>March 31, 2013</b>               |                                |                        |                                           |
| With no related allowance recorded: |                                |                        |                                           |
| Commercial real estate              |                                |                        |                                           |
| Owner occupied                      | \$ 2,521                       | \$ 2,393               | \$ 0                                      |
| Non-owner occupied                  | 546                            | 447                    | 0                                         |
| Commercial                          | 2,071                          | 1,669                  | 0                                         |
| Residential real estate             |                                |                        |                                           |
| 1-4 family residential              | 911                            | 937                    | 0                                         |
| Home equity lines of credit         | 183                            | 175                    | 0                                         |
| Subtotal                            | 6,232                          | 5,621                  | 0                                         |
| With an allowance recorded:         |                                |                        |                                           |
| Commercial real estate              |                                |                        |                                           |
| Owner occupied                      | 2,767                          | 2,744                  | 126                                       |
| Non-owner occupied                  | 2,050                          | 1,911                  | 42                                        |
| Commercial                          | 159                            | 159                    | 31                                        |
| Subtotal                            | 4,976                          | 4,814                  | 199                                       |
| Total                               | \$ 11,208                      | \$ 10,435              | \$ 199                                    |

| (In Thousands of Dollars)           | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance for<br>Loan Losses<br>Allocated |
|-------------------------------------|--------------------------------|------------------------|-------------------------------------------|
| <b>December 31, 2012</b>            |                                |                        |                                           |
| With no related allowance recorded: |                                |                        |                                           |
| Commercial real estate              |                                |                        |                                           |
| Owner occupied                      | \$ 3,916                       | \$ 3,481               | \$ 0                                      |
| Non-owner occupied                  | 560                            | 461                    | 0                                         |
| Commercial                          | 1,250                          | 1,192                  | 0                                         |
| Residential real estate             |                                |                        |                                           |
| 1-4 family residential              | 971                            | 989                    | 0                                         |
| Subtotal                            | 6,697                          | 6,123                  | 0                                         |
| With an allowance recorded:         |                                |                        |                                           |
| Commercial real estate              |                                |                        |                                           |
| Owner occupied                      | 2,207                          | 2,169                  | 59                                        |
| Non-owner occupied                  | 2,560                          | 2,424                  | 70                                        |
| Commercial                          | 948                            | 660                    | 51                                        |
| Subtotal                            | 5,715                          | 5,253                  | 180                                       |
| Total                               | \$ 12,412                      | \$ 11,376              | \$ 180                                    |

The following table presents the average recorded investment by class for the three month periods ended March 31, 2013 and 2012:

| (In Thousands of Dollars)                  | Average Recorded Investment for<br>Three Months Ended March 31, |           |
|--------------------------------------------|-----------------------------------------------------------------|-----------|
|                                            | 2013                                                            | 2012      |
| <b>With no related allowance recorded:</b> |                                                                 |           |
| Commercial real estate                     |                                                                 |           |
| Owner occupied                             | \$ 2,692                                                        | \$ 339    |
| Non-owner occupied                         | 453                                                             | 328       |
| Other                                      | 0                                                               | 200       |
| Commercial                                 | 1,384                                                           | 1,004     |
| Residential real estate                    |                                                                 |           |
| 1-4 family residential                     | 940                                                             | 677       |
| Home equity lines of credit                | 175                                                             | 0         |
| Subtotal                                   | 5,644                                                           | 2,548     |
| <b>With an allowance recorded:</b>         |                                                                 |           |
| Commercial real estate                     |                                                                 |           |
| Owner occupied                             | 2,770                                                           | 4,559     |
| Non-owner occupied                         | 2,029                                                           | 2,661     |
| Other                                      | 0                                                               | 279       |
| Commercial                                 | 496                                                             | 270       |
| Subtotal                                   | 5,295                                                           | 7,769     |
| Total                                      | \$ 10,939                                                       | \$ 10,317 |

Interest income recognized during impairment for both periods was immaterial.

Nonaccrual loans and loans past due 90 days or more still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. The following table presents the recorded investment in nonaccrual and loans past due 90 days or more still on accrual by class of loans as of March 31, 2013 and December 31, 2012:

| (In Thousands of Dollars)   | March 31, 2013 |                                               | December 31, 2012 |                                               |
|-----------------------------|----------------|-----------------------------------------------|-------------------|-----------------------------------------------|
|                             | Nonaccrual     | Loans Past Due 90 Days or More Still Accruing | Nonaccrual        | Loans Past Due 90 Days or More Still Accruing |
| Commercial real estate      |                |                                               |                   |                                               |
| Owner occupied              | \$ 2,736       | \$ 0                                          | \$ 3,116          | \$ 0                                          |
| Non-owner occupied          | 670            | 0                                             | 799               | 0                                             |
| Other                       | 0              | 0                                             | 0                 | 0                                             |
| Commercial                  | 1,014          | 0                                             | 1,081             | 0                                             |
| Residential real estate     |                |                                               |                   |                                               |
| 1-4 family residential      | 2,282          | 170                                           | 2,342             | 197                                           |
| Home equity lines of credit | 299            | 86                                            | 294               | 236                                           |
| Consumer                    |                |                                               |                   |                                               |
| Indirect                    | 0              | 123                                           | 0                 | 143                                           |
| Direct                      | 0              | 13                                            | 0                 | 19                                            |
| Other                       | 0              | 2                                             | 0                 | 1                                             |
| Total                       | \$ 7,001       | \$ 394                                        | \$ 7,632          | \$ 596                                        |



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The following table presents the aging of the recorded investment in past due loans as of March 31, 2013 and December 31, 2012 by class of loans:

| (In Thousands of Dollars)   | 30-59<br>Days Past<br>Due | 60-89<br>Days<br>Past Due | 90 Days or<br>More Past<br>Due and<br>Nonaccrual | Total Past<br>Due | Loans Not<br>Past Due | Total      |
|-----------------------------|---------------------------|---------------------------|--------------------------------------------------|-------------------|-----------------------|------------|
| <b>March 31, 2013</b>       |                           |                           |                                                  |                   |                       |            |
| Commercial real estate      |                           |                           |                                                  |                   |                       |            |
| Owner occupied              | \$ 238                    | \$ 0                      | \$ 2,736                                         | \$ 2,974          | \$ 89,532             | \$ 92,506  |
| Non-owner occupied          | 0                         | 0                         | 670                                              | 670               | 93,807                | 94,477     |
| Other                       | 458                       | 0                         | 0                                                | 458               | 16,845                | 17,303     |
| Commercial                  | 43                        | 72                        | 1,014                                            | 1,129             | 98,464                | 99,593     |
| Residential real estate     |                           |                           |                                                  |                   |                       |            |
| 1-4 family residential      | 732                       | 265                       | 2,452                                            | 3,449             | 126,580               | 130,029    |
| Home equity lines of credit | 61                        | 96                        | 385                                              | 542               | 24,982                | 25,524     |
| Consumer                    |                           |                           |                                                  |                   |                       |            |
| Indirect                    | 1,203                     | 241                       | 123                                              | 1,567             | 119,070               | 120,637    |
| Direct                      | 136                       | 16                        | 13                                               | 165               | 10,449                | 10,614     |
| Other                       | 12                        | 2                         | 2                                                | 16                | 1,821                 | 1,837      |
| Total                       | \$ 2,883                  | \$ 692                    | \$ 7,395                                         | \$ 10,970         | \$ 581,550            | \$ 592,520 |

| (In Thousands of Dollars)   | 30-59<br>Days Past<br>Due | 60-89<br>Days<br>Past Due | 90 Days<br>or<br>More Past<br>Due and<br>Nonaccrual | Total Past<br>Due | Loans Not<br>Past Due | Total      |
|-----------------------------|---------------------------|---------------------------|-----------------------------------------------------|-------------------|-----------------------|------------|
| <b>December 31, 2012</b>    |                           |                           |                                                     |                   |                       |            |
| Commercial real estate      |                           |                           |                                                     |                   |                       |            |
| Owner occupied              | \$ 259                    | \$ 0                      | \$ 3,116                                            | \$ 3,375          | \$ 91,506             | \$ 94,881  |
| Non-owner occupied          | 0                         | 0                         | 799                                                 | 799               | 82,320                | 83,119     |
| Other                       | 0                         | 0                         | 0                                                   | 0                 | 22,651                | 22,651     |
| Commercial                  | 233                       | 15                        | 1,081                                               | 1,329             | 95,783                | 97,112     |
| Residential real estate     |                           |                           |                                                     |                   |                       |            |
| 1-4 family residential      | 718                       | 352                       | 2,539                                               | 3,609             | 128,463               | 132,072    |
| Home equity lines of credit | 183                       | 82                        | 530                                                 | 795               | 23,315                | 24,110     |
| Consumer                    |                           |                           |                                                     |                   |                       |            |
| Indirect                    | 1,351                     | 319                       | 143                                                 | 1,813             | 117,907               | 119,720    |
| Direct                      | 144                       | 18                        | 19                                                  | 181               | 10,979                | 11,160     |
| Other                       | 15                        | 13                        | 1                                                   | 29                | 1,738                 | 1,767      |
| Total                       | \$ 2,903                  | \$ 799                    | \$ 8,228                                            | \$ 11,930         | \$ 574,662            | \$ 586,592 |

### Troubled Debt Restructurings:

Total troubled debt restructurings were \$7.8 million and \$7.6 million at March 31, 2013 and December 31, 2012, respectively. The Company has allocated \$118 thousand and \$155 thousand of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of March 31, 2013 and December 31, 2012. There are \$44 thousand in commitments to lend additional amounts to borrowers with loans that are classified as troubled debt restructurings at March 31, 2013. There were no commitments at December 31, 2012.

During the three month periods ended March 31, 2013 and 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; a permanent reduction of the recorded investment in the loan; a permanent increase of the recorded investment in the loan due to a protective advance to pay delinquent real estate taxes or advance new monies; or a deferral of principal payments.

Troubled debt restructuring modifications involved a change in the notes stated interest rate in the range of and increase of .25% to a reduction of 1.75%. There were also extensions of the maturity dates on these and other troubled debt restructurings in the range of 3 months to 102 months.

The following table presents loans by class modified as troubled debt restructurings that occurred during the period ended March 31, 2013:

|                                      | Number of<br>Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
|--------------------------------------|--------------------|--------------------------------------------------------|---------------------------------------------------------|
| <b>Troubled Debt Restructurings:</b> |                    |                                                        |                                                         |
| Commercial real estate               |                    |                                                        |                                                         |
| Owner occupied                       | 2                  | \$ 226                                                 | \$ 239                                                  |
| Commercial                           | 4                  | 486                                                    | 519                                                     |
| Residential real estate              |                    |                                                        |                                                         |
| HELOC                                | 2                  | 133                                                    | 133                                                     |
| <b>Total</b>                         | <b>8</b>           | <b>\$ 845</b>                                          | <b>\$ 891</b>                                           |

There were \$16 thousand in charge offs and a \$3 thousand increase in the allowance for loan losses as a result of the allowance adjustment due to the troubled debt restructurings described above at March 31, 2013.

There was one loan that was modified as a troubled debt restructuring for which there was a payment default within twelve months following the modification during the three month period ended March 31, 2013.

During the three month period ended March 31, 2012 there was one troubled debt restructuring that involved the reduction of the stated interest rate on a commercial and industrial loan. There were no modifications involving an extension of the maturity date. The pre-modification outstanding recorded investment for this loan was \$462 thousand and the post-modification outstanding recorded investment was \$467 thousand.

The troubled debt restructuring described above had an immaterial affect on the allowance for loan losses at March 31, 2012. There were no charge offs as a result of the allowance adjustment.

There was one residential real estate loan modified as troubled debt restructurings for which there was a payment default during the twelve months following the modification during the period ended March 31, 2012. The loan was past due 33 days at March 31, 2012. There was no additional provision or any impact to the allowance for losses associated with this loan. A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

#### Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company establishes a risk rating at origination for all commercial loan and commercial real estate relationships. For relationships over \$300 thousand management monitors the loans on an ongoing basis for any changes in the borrower's ability to service their debt. Management also affirms the risk ratings for the loans and leases in their respective portfolios on an annual basis. The Company uses the following definitions for risk ratings:

**Special Mention.** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

**Substandard.** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard loans are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. As of March 31, 2013 and December 31, 2012, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

(In Thousands of Dollars)

|                        | Pass       | Special<br>Mention | Sub-<br>standard | Doubtful | Not Rated | Total      |
|------------------------|------------|--------------------|------------------|----------|-----------|------------|
| <b>March 31, 2013</b>  |            |                    |                  |          |           |            |
| Commercial real estate |            |                    |                  |          |           |            |
| Owner occupied         | \$ 76,397  | \$ 5,968           | \$ 10,141        | \$ 0     | \$ 0      | \$ 92,506  |
| Non-owner occupied     | 81,052     | 9,773              | 3,652            | 0        | 0         | 94,477     |
| Other                  | 15,886     | 1,059              | 358              | 0        | 0         | 17,303     |
| Commercial             | 92,416     | 3,457              | 3,720            | 0        | 0         | 99,593     |
| Total                  | \$ 265,751 | \$ 20,257          | \$ 17,871        | \$ 0     | \$ 0      | \$ 303,879 |

| (In Thousands of Dollars) | Pass              | Special<br>Mention | Sub-<br>standard | Doubtful    | Not Rated   | Total             |
|---------------------------|-------------------|--------------------|------------------|-------------|-------------|-------------------|
| <b>December 31, 2012</b>  |                   |                    |                  |             |             |                   |
| Commercial real estate    |                   |                    |                  |             |             |                   |
| Owner occupied            | \$ 78,327         | \$ 5,954           | \$ 10,600        | \$ 0        | \$ 0        | \$ 94,881         |
| Non-owner occupied        | 72,270            | 6,519              | 4,330            | 0           | 0           | 83,119            |
| Other                     | 17,855            | 4,433              | 363              | 0           | 0           | 22,651            |
| Commercial                | 89,312            | 3,891              | 3,909            | 0           | 0           | 97,112            |
| <b>Total</b>              | <b>\$ 257,764</b> | <b>\$ 20,797</b>   | <b>\$ 19,202</b> | <b>\$ 0</b> | <b>\$ 0</b> | <b>\$ 297,763</b> |

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential, consumer indirect and direct loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in residential, consumer indirect and direct auto loans based on payment activity as of March 31, 2013 and December 31, 2012. Nonperforming loans are loans past due 90 days or more and still accruing interest and nonaccrual loans.

| (In Thousands of Dollars) | Residential Real Estate<br>1-4 Family<br>Residential | Home<br>Equity Lines<br>of Credit | Indirect          | Consumer<br>Direct | Other           |
|---------------------------|------------------------------------------------------|-----------------------------------|-------------------|--------------------|-----------------|
| <b>March 31, 2013</b>     |                                                      |                                   |                   |                    |                 |
| Performing                | \$ 127,577                                           | \$ 25,139                         | \$ 120,514        | \$ 10,601          | \$ 1,835        |
| Nonperforming             | 2,452                                                | 385                               | 123               | 13                 | 2               |
| <b>Total</b>              | <b>\$ 130,029</b>                                    | <b>\$ 25,524</b>                  | <b>\$ 120,637</b> | <b>\$ 10,614</b>   | <b>\$ 1,837</b> |

| (In Thousands of Dollars) | Residential Real Estate<br>1-4 Family<br>Residential | Home<br>Equity Lines<br>of Credit | Indirect          | Consumer<br>Direct | Other           |
|---------------------------|------------------------------------------------------|-----------------------------------|-------------------|--------------------|-----------------|
| <b>December 31, 2012</b>  |                                                      |                                   |                   |                    |                 |
| Performing                | \$ 129,533                                           | \$ 23,580                         | \$ 119,577        | \$ 11,141          | \$ 1,766        |
| Nonperforming             | 2,539                                                | 530                               | 143               | 19                 | 1               |
| <b>Total</b>              | <b>\$ 132,072</b>                                    | <b>\$ 24,110</b>                  | <b>\$ 119,720</b> | <b>\$ 11,160</b>   | <b>\$ 1,767</b> |

### Interest Rate Swaps

During 2012, the Company began using a program that utilizes interest-rate swaps as part of its asset/liability management strategy. The interest-rate swaps are used to help manage the Company's interest rate risk position and not as derivatives for trading purposes. The notional amount of the interest-rate swaps does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest-rate swap agreements.

The objective of the interest-rate swaps is to protect the related fixed rate commercial real estate loans from changes in fair value due to changes in interest rates. The Company has a program whereby it lends to its borrowers at a fixed rate with the loan agreement containing a two-way yield maintenance provision, which will be invoked in the event of prepayment of the loan, and is expected to exactly offset the fair value of unwinding the swap. The yield maintenance provision represents an embedded derivative which is bifurcated from the host loan contract and, as such, the swaps and embedded derivatives are not designed as hedges. Accordingly, both instruments are carried at fair value and changes in fair value are reported in current period earnings.

Summary information about these interest-rate swaps at periods ended March 31, 2013 and December 31, 2012 is as follows:

|                                                      | March 31, 2013 | December 31, 2012 |
|------------------------------------------------------|----------------|-------------------|
| Notional amounts                                     | \$ 13,542      | \$ 7,060          |
| Weighted average pay rate on interest-rate swaps     | 4.23%          | 4.07%             |
| Weighted average receive rate on interest-rate swaps | 3.12%          | 2.99%             |
| Weighted average maturity (years)                    | 4.7            | 5.8               |
| Fair value of combined interest-rate swaps           | \$ 207         | \$ 120            |

The fair value of the yield maintenance provisions and interest-rate swaps is recorded in other assets and other liabilities, respectively, in the consolidated balance sheet. Changes in the fair value of the yield maintenance provisions and interest-rate swaps are reported in earnings, as other noninterest income in the consolidated income statements. For the period ended March 31, 2013 the gross fair value adjustment recorded was \$181 thousand with a net zero gain recognized in earnings. The Company had no interest-rate swaps recorded at March 31, 2012.

**Earnings Per Share:**

The computation of basic and diluted earnings per share is shown in the following table:

| (In Thousands, except Share and Per Share Data)         |                                                                  | Three Months Ended<br>March 31, |            |
|---------------------------------------------------------|------------------------------------------------------------------|---------------------------------|------------|
|                                                         |                                                                  | 2013                            | 2012       |
| <b>Basic EPS computation</b>                            |                                                                  |                                 |            |
| Numerator                                               | Net income                                                       | \$ 2,005                        | \$ 2,520   |
| Denominator                                             | Weighted average shares outstanding                              | 18,795,048                      | 18,765,814 |
| <b>Basic earnings per share</b>                         |                                                                  | \$ .11                          | \$ .13     |
| <b>Diluted EPS computation</b>                          |                                                                  |                                 |            |
| Numerator                                               | Net income                                                       | \$ 2,005                        | \$ 2,520   |
| Denominator                                             | Weighted average shares outstanding for basic earnings per share | 18,795,048                      | 18,765,814 |
| Effect of Stock Options                                 |                                                                  | 0                               | 0          |
| Weighted averages shares for diluted earnings per share |                                                                  | 18,795,048                      | 18,765,814 |
| <b>Diluted earnings per share</b>                       |                                                                  | \$ .11                          | \$ .13     |

Stock options for 5,000 shares were not considered in the computing of diluted earnings per share for the three months ended March 31, 2013 and 2012, respectively, because they were antidilutive.

On April 25, 2013, at the annual meeting of stockholders, a vote to authorize an additional 10 million shares for future issuance was approved. The date of record for the action was March 6, 2013.

**Stock Based Compensation:**

During 2012, the Company, with the approval of shareholders, created a Restricted Stock Award Plan. The Plan permits the award of up to 500 thousand shares to its directors and employees based on performance. The Company believes that such awards better align the interests of its employees with those of its shareholders. No share awards were issued during the period ended March 31, 2013 or 2012 under the Plan.

The Company's Stock Option Plan, which was shareholder-approved and has since expired, permitted the grant of share options to its directors, officers and employees for up to 375 thousand shares of common stock. Option awards were granted with an exercise price equal to the market price of the Company's common stock at the date of grant; those option awards have vesting periods of 5 years and have 10-year contractual terms. Option exercises are expected to be satisfied with either newly issued shares or treasury shares. At March 31, 2013 there were 5,000 outstanding options of which 4,000 were fully vested and exercisable. The fair value of the Company's stock at March 31, 2013 was less than the fair value option exercise price; therefore the outstanding and exercisable options had no intrinsic value.

The fair value of each option award is estimated on the date of grant using a Black-Scholes model. Total compensation cost charged against income for the stock option plan for the three month period ended March 31, 2013 was not material. No related income tax benefit was recorded.

## Fair Value

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

**Level 1** Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

**Level 2** Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

**Level 3** Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

**Investment Securities:** The Company used a third party service to estimate fair value on available for sale securities on a monthly basis. This service provider is considered a leading evaluation pricing service for U.S. domestic fixed income securities. They subscribe to multiple third-party pricing vendors, and supplement that information with matrix pricing methods. The fair values for investment securities are determined by quoted market prices in active markets, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on quoted prices for similar assets in active markets, quoted prices for similar assets in markets that are not active or inputs other than quoted prices, which provide a reasonable basis for fair value determination. Such inputs may include interest rates and yield curves, volatilities, prepayment speeds, credit risks and default rates. Inputs used are derived principally from observable market data (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). The fair values of Level 3 investment securities are determined by using unobservable inputs to measure fair value of assets for which there is little, if any market activity at the measurement date, using reasonable inputs and assumptions based on the best information at the time, to the extent that inputs are available without undue cost and effort by the Company's Chief Financial Officer and Controller. For the period ended March 31, 2013 and for the year ended December 31, 2012 the fair value of Level 3 investment securities was immaterial.

**Derivative Instruments:** The fair values of derivative instruments are based on valuation models using observable market data as of the measurement date (Level 2).

**Impaired Loans:** At the time loans are considered impaired, collateral dependent impaired loans are valued at the lower of cost or fair value and non-collateral dependent loans are valued based on discounted cash flows. Impaired loans carried at fair value generally receive specific allocations of the allowance for loan losses. For collateral dependent loans fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

**Other Real Estate Owned:** Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair values are commonly based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal

process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial and commercial real estate properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of the Appraisal Department reviews the assumptions and approaches utilized in the appraisal as well as the overall resulting fair value in comparison with via independent data sources such as recent market data or industry-wide statistics. On an annual basis, the Company compares the actual selling price of collateral that has been sold to the most recent appraised value to determine what adjustments should be made to appraisals to arrive at fair value.

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Assets measured at fair value on a recurring basis, including financial assets for which the Company has elected the fair value option, are summarized below:

|                                                      |            | Fair Value Measurements at<br>March 31, 2013 Using:                                 |                                                           |                                                    |
|------------------------------------------------------|------------|-------------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                                                      |            | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (In Thousands of Dollars)                            |            | Carrying<br>Value                                                                   |                                                           |                                                    |
| <b>Financial Assets</b>                              |            |                                                                                     |                                                           |                                                    |
| Investment securities available-for sale             |            |                                                                                     |                                                           |                                                    |
| U.S. Treasury and U.S. government sponsored entities | \$ 61,954  | \$ 0                                                                                | \$ 61,954                                                 | \$ 0                                               |
| State and political subdivisions                     | 94,433     | 0                                                                                   | 94,433                                                    | 0                                                  |
| Corporate bonds                                      | 2,152      | 0                                                                                   | 2,152                                                     | 0                                                  |
| Mortgage-backed securities-residential               | 220,699    | 0                                                                                   | 220,688                                                   | 11                                                 |
| Collateralized mortgage obligations                  | 38,637     | 0                                                                                   | 38,637                                                    | 0                                                  |
| Small business administration                        | 21,010     | 0                                                                                   | 21,010                                                    | 0                                                  |
| Equity securities                                    | 655        | 655                                                                                 | 0                                                         | 0                                                  |
| Total investment securities                          | \$ 439,540 | \$ 655                                                                              | \$ 438,874                                                | \$ 11                                              |
| Yield maintenance provisions                         | \$ 207     | \$ 0                                                                                | \$ 207                                                    | \$ 0                                               |
| <b>Financial Liabilities</b>                         |            |                                                                                     |                                                           |                                                    |
| Interest rate swaps                                  | \$ 207     | \$ 0                                                                                | \$ 207                                                    | \$ 0                                               |

|                                                      |            | Fair Value Measurements at<br>December 31, 2012 Using:                              |                                                           |                                                    |
|------------------------------------------------------|------------|-------------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                                                      |            | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (In Thousands of Dollars)                            |            | Carrying<br>Value                                                                   |                                                           |                                                    |
| <b>Financial Assets</b>                              |            |                                                                                     |                                                           |                                                    |
| Investment securities available-for sale             |            |                                                                                     |                                                           |                                                    |
| U.S. Treasury and U.S. government sponsored entities | \$ 67,978  | \$ 0                                                                                | \$ 67,978                                                 | \$ 0                                               |
| State and political subdivisions                     | 95,288     | 0                                                                                   | 95,288                                                    | 0                                                  |
| Corporate bonds                                      | 2,128      | 0                                                                                   | 2,128                                                     | 0                                                  |
| Mortgage-backed securities-residential               | 236,218    | 0                                                                                   | 236,207                                                   | 11                                                 |
| Collateralized mortgage obligations                  | 40,595     | 0                                                                                   | 40,595                                                    | 0                                                  |
| Small business administration                        | 21,444     | 0                                                                                   | 21,444                                                    | 0                                                  |
| Equity securities                                    | 437        | 437                                                                                 | 0                                                         | 0                                                  |
| Total investment securities                          | \$ 464,088 | \$ 437                                                                              | \$ 463,640                                                | \$ 11                                              |
| Yield maintenance provisions                         | \$ 120     | \$ 0                                                                                | \$ 120                                                    | \$ 0                                               |
| <b>Financial Liabilities</b>                         |            |                                                                                     |                                                           |                                                    |

|                     |    |     |    |   |    |     |    |   |
|---------------------|----|-----|----|---|----|-----|----|---|
| Interest rate swaps | \$ | 120 | \$ | 0 | \$ | 120 | \$ | 0 |
|---------------------|----|-----|----|---|----|-----|----|---|

There were no significant transfers between Level 1 and Level 2 during the three month periods ended March 31, 2013 and 2012.

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3):

| (In Thousands of Dollars)                      | Investment Securities<br>Available-for-sale<br>(Level 3) |       |
|------------------------------------------------|----------------------------------------------------------|-------|
|                                                | Three Months Ended March 31,<br>2013                     | 2012  |
| Beginning balance                              | \$ 11                                                    | \$ 12 |
| Total unrealized gains or losses:              |                                                          |       |
| Included in other comprehensive income or loss | 0                                                        | 0     |
| Repayments                                     | 0                                                        | 0     |
| Transfer in and/or out of Level 3              | 0                                                        | 0     |
| Ending balance                                 | \$ 11                                                    | \$ 12 |

Assets measured at fair value on a non-recurring basis are summarized below:

| (In Thousands of Dollars) | Carrying Value | Fair Value Measurements<br>at March 31, 2013 Using:                        |                                                           |                                                    |
|---------------------------|----------------|----------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                           |                | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial assets:         |                |                                                                            |                                                           |                                                    |
| Impaired loans            |                |                                                                            |                                                           |                                                    |
| Commercial real estate    |                |                                                                            |                                                           |                                                    |
| Owner occupied            | \$ 980         | \$ 0                                                                       | \$ 0                                                      | \$ 980                                             |
| Non-owner occupied        | 606            | 0                                                                          | 0                                                         | 606                                                |
| Commercial                | 891            | 0                                                                          | 0                                                         | 891                                                |
| 1 4 family residential    | 42             | 0                                                                          | 0                                                         | 42                                                 |
| Other real estate owned   |                |                                                                            |                                                           |                                                    |
| 1 4 family residential    | 45             | 0                                                                          | 0                                                         | 45                                                 |

| (In Thousands of Dollars)      |                | Fair Value Measurements<br>at December 31, 2012 Using:                        |                                                           |                                                    |
|--------------------------------|----------------|-------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                                |                | Quoted<br>Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|                                | Carrying Value |                                                                               |                                                           |                                                    |
| <b>Financial assets:</b>       |                |                                                                               |                                                           |                                                    |
| <b>Impaired loans</b>          |                |                                                                               |                                                           |                                                    |
| <b>Commercial real estate</b>  |                |                                                                               |                                                           |                                                    |
| Owner occupied                 | \$ 928         | \$ 0                                                                          | \$ 0                                                      | \$ 928                                             |
| Non-owner occupied             | 775            | 0                                                                             | 0                                                         | 775                                                |
| Commercial                     | 869            | 0                                                                             | 0                                                         | 869                                                |
| 1 4 family residential         | 43             | 0                                                                             | 0                                                         | 43                                                 |
| <b>Other real estate owned</b> |                |                                                                               |                                                           |                                                    |
| 1 4 family residential         | 57             | 0                                                                             | 0                                                         | 57                                                 |

Impaired loans that are measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal balance of \$2.6 million with a valuation allowance of \$84 thousand at March 31, 2013, resulting in an additional provision for loan losses of \$180 thousand for the three month period. At December 31, 2012, impaired loans had a principal balance of \$2.6 million, with a valuation allowance of \$25 thousand. For loans carried at fair value the additional provision for loan losses, for the three month period ended March 31, 2012, was \$81 thousand. Excluded from the fair value of impaired loans, at March 31, 2013 and December 31, 2012, discussed above are \$4.0 million and \$4.3 million of loans classified as troubled debt restructurings, which are not carried at fair value.

Impaired commercial real estate loans, both owner occupied and non-owner occupied are valued by independent external appraisals. These external appraisals are prepared using the sales comparison approach and income approach valuation techniques. Management makes subsequent unobservable adjustments to the impaired loan appraisals. Impaired loans other than commercial real estate and other real estate owned are not considered material.

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at period ended March 31, 2013 and December 31, 2012:

| March 31, 2013                | Fair value | Valuation<br>Technique(s) | Unobservable Input(s)                                     | Range<br>(Weighted Average)   |
|-------------------------------|------------|---------------------------|-----------------------------------------------------------|-------------------------------|
| <b>Impaired loans</b>         |            |                           |                                                           |                               |
| <b>Commercial real estate</b> |            |                           |                                                           |                               |
|                               | \$ 1,586   | Sales<br>comparison       | Adjustment for<br>differences between<br>comparable sales | -11.30% - 14.12%<br>(-4.85%)  |
| <b>Commercial</b>             |            |                           |                                                           |                               |
|                               | 891        | Sales<br>comparison       | Adjustment for<br>differences between<br>comparable sales | -45.19% - 20.19%<br>(-27.05%) |
| <b>Residential</b>            |            |                           |                                                           |                               |
|                               | 42         | Sales<br>comparison       | Adjustment for<br>differences between<br>comparable sales | 46.81% - 23.45%<br>(-36.40)   |

|                        |            | Valuation        | Unobservable Input(s)                               | Range              |
|------------------------|------------|------------------|-----------------------------------------------------|--------------------|
| December 31, 2012      | Fair value | Technique(s)     |                                                     | (Weighted Average) |
| Impaired loans         |            |                  |                                                     |                    |
| Commercial real estate |            |                  | Adjustment for differences between comparable sales | -11.30% - 14.12%   |
|                        | \$ 1,548   | Sales comparison |                                                     | (-4.38%)           |
|                        |            |                  | Adjustment for differences in net operating income  | -28.36% - 19.40%   |
|                        | 155        | Income approach  |                                                     | (-5.47%)           |
| Commercial             |            |                  | Adjustment for differences between comparable sales | -45.19% - 20.19%   |
|                        | 869        | Sales comparison |                                                     | (-27.05%)          |
| Residential            |            |                  | Adjustment for differences between comparable sales | -46.81% - 23.45%   |
|                        | 43         | Sales comparison |                                                     | (-36.40%)          |

The carrying amounts and estimated fair values of financial instruments not previously disclosed at March 31, 2013 and December 31, 2012 are as follows:

| (In Thousands of Dollars)   | Carrying Amount | Fair Value Measurements at March 31, 2013 Using: |           |         |           |
|-----------------------------|-----------------|--------------------------------------------------|-----------|---------|-----------|
|                             |                 | Level 1                                          | Level 2   | Level 3 | Total     |
| Financial assets            |                 |                                                  |           |         |           |
| Cash and cash equivalents   | \$ 57,312       | \$ 14,013                                        | \$ 43,299 | \$ 0    | \$ 57,312 |
| Restricted stock            | 4,224           | n/a                                              | n/a       | n/a     | n/a       |
| Loans held for sale         | 4,330           | 0                                                | 4,421     | 0       | 4,421     |
| Loans, net                  | 585,012         | 0                                                | 0         | 591,116 | 591,116   |
| Accrued interest receivable | 3,890           | 0                                                | 2,184     | 1,706   | 3,890     |
| Financial liabilities       |                 |                                                  |           |         |           |
| Deposits                    | 915,855         | 685,885                                          | 234,739   | 0       | 920,624   |
| Short-term borrowings       | 91,302          | 0                                                | 91,302    | 0       | 91,302    |
| Long-term borrowings        | 10,357          | 0                                                | 11,534    | 0       | 11,534    |
| Accrued interest payable    | 449             | 6                                                | 443       | 0       | 449       |

| (In Thousands of Dollars)   | Carrying Amount | Fair Value Measurements at December 31, 2012 Using: |           |         |           |
|-----------------------------|-----------------|-----------------------------------------------------|-----------|---------|-----------|
|                             |                 | Level 1                                             | Level 2   | Level 3 | Total     |
| Financial assets            |                 |                                                     |           |         |           |
| Cash and cash equivalents   | \$ 37,759       | \$ 14,209                                           | \$ 23,550 | \$ 0    | \$ 37,759 |
| Restricted stock            | 4,224           | n/a                                                 | n/a       | n/a     | n/a       |
| Loans held for sale         | 3,624           | 0                                                   | 3,691     | 0       | 3,691     |
| Loans, net                  | 578,963         | 0                                                   | 0         | 586,359 | 586,359   |
| Accrued interest receivable | 3,679           | 0                                                   | 2,051     | 1,628   | 3,679     |
| Financial liabilities       |                 |                                                     |           |         |           |
| Deposits                    | 919,009         | 683,660                                             | 240,830   | 0       | 924,490   |
| Short-term borrowings       | 79,886          | 0                                                   | 79,886    | 0       | 79,886    |
| Long-term borrowings        | 10,423          | 0                                                   | 11,690    | 0       | 11,690    |
| Accrued interest payable    | 479             | 2                                                   | 477       | 0       | 479       |

The methods and assumptions used to estimate fair value, not previously described, are described as follows:

*Cash and Cash Equivalents:* The carrying amounts of cash and short-term instruments approximate fair values and are classified as either Level 1 or Level 2. The Company has determined that cash on hand and non-interest bearing due from bank accounts are Level 1 whereas interest bearing federal funds sold and other are Level 2.

*Restricted Stock:* It is not practical to determine the fair value of restricted stock due to restrictions placed on its transferability.

*Loans:* Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

*Loans held for sale:* The fair value of loans held for sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

*Accrued Interest Receivable/Payable:* The carrying amounts of accrued interest receivable and payable approximate fair value resulting in a Level 2 or Level 3 classification. The classification is the result of the association with securities, loans and deposits.

*Deposits:* The fair values disclosed for demand deposits – interest and non-interest checking, passbook savings, and money market accounts - are, by definition, equal to the amount payable on demand at the reporting date resulting in a Level 1 classification. The carrying amounts of variable rate certificates of deposit approximate their fair values at the reporting date resulting Level 2 classification. Fair value for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

*Short-term Borrowings:* The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings, generally maturing within ninety days, approximate their fair values resulting in a Level 2 classification.

*Long-term Borrowings:* The fair values of the Company's long-term borrowings are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

*Off-balance Sheet Instruments:* The fair value of commitments is not considered material.

### **Segment Information**

The reportable segments are determined by the products and services offered, primarily distinguished between banking and trust operations. They are also distinguished by the level of information provided to the chief operating decision makers in the Company, who use such information to review performance of various components of the business, which are then aggregated. Loans, investments, and deposits provide the revenues in the banking operation, and trust service fees provide the revenue in trust operations. All operations are domestic.

Significant segment totals are reconciled to the financial statements as follows:

| (In Thousands of Dollars)                  | Trust<br>Segment | Bank<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
|--------------------------------------------|------------------|-----------------|----------------------------|------------------------|
| <b>March 31, 2013</b>                      |                  |                 |                            |                        |
| Assets                                     |                  |                 |                            |                        |
| Cash and cash equivalents                  | \$ 651           | \$ 56,746       | \$ (85)                    | \$ 57,312              |
| Securities available for sale              | 4,967            | 434,433         | 140                        | 439,540                |
| Loans held for sale                        | 0                | 4,330           | 0                          | 4,330                  |
| Net loans                                  | 0                | 585,012         | 0                          | 585,012                |
| Premises and equipment, net                | 95               | 18,048          | 0                          | 18,143                 |
| Goodwill and other intangibles             | 5,934            | 0               | 0                          | 5,934                  |
| Other assets                               | 885              | 31,338          | 605                        | 32,828                 |
| Total Assets                               | \$ 12,532        | \$ 1,129,907    | \$ 660                     | \$ 1,143,099           |
| Liabilities and Stockholders' Equity       |                  |                 |                            |                        |
| Deposits, borrowings and other liabilities | \$ 703           | \$ 1,025,837    | \$ (4,017)                 | \$ 1,022,523           |
| Stockholders' equity                       | 11,829           | 104,070         | 4,677                      | 120,576                |
| Total Liabilities and Stockholders' Equity | \$ 12,532        | \$ 1,129,907    | \$ 660                     | \$ 1,143,099           |

| (In Thousands of Dollars)                  | Trust<br>Segment | Bank<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
|--------------------------------------------|------------------|-----------------|----------------------------|------------------------|
| <b>December 31, 2012</b>                   |                  |                 |                            |                        |
| Assets                                     |                  |                 |                            |                        |
| Cash and cash equivalents                  | \$ 636           | \$ 37,191       | \$ (68)                    | \$ 37,759              |
| Securities available for sale              | 4,695            | 459,246         | 147                        | 464,088                |
| Loans held for sale                        | 0                | 3,624           | 0                          | 3,624                  |
| Net loans                                  | 0                | 578,963         | 0                          | 578,963                |
| Premises and equipment, net                | 100              | 18,329          | 0                          | 18,429                 |
| Goodwill and other intangibles             | 6,032            | 0               | 0                          | 6,032                  |
| Other assets                               | 546              | 29,758          | 496                        | 30,800                 |
| Total Assets                               | \$ 12,009        | \$ 1,127,111    | \$ 575                     | \$ 1,139,695           |
| Liabilities and Stockholders' Equity       |                  |                 |                            |                        |
| Deposits, borrowings and other liabilities | \$ 302           | \$ 1,022,092    | \$ (3,491)                 | \$ 1,018,903           |
| Stockholders' equity                       | 11,707           | 105,019         | 4,066                      | 120,792                |
| Total Liabilities and Stockholders' Equity | \$ 12,009        | \$ 1,127,111    | \$ 575                     | \$ 1,139,695           |

| (In Thousands of Dollars)                                 | Trust<br>Segment | Bank<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
|-----------------------------------------------------------|------------------|-----------------|----------------------------|------------------------|
| <b>For the Three Months Ended March 31, 2013</b>          |                  |                 |                            |                        |
| Net interest income                                       | \$ 12            | \$ 8,959        | \$ (3)                     | \$ 8,968               |
| Provision for loan losses                                 | 0                | 255             | 0                          | 255                    |
| Service fees, security gains and other noninterest income | 1,365            | 1,560           | (50)                       | 2,875                  |
| Noninterest expense                                       | 1,190            | 7,684           | 214                        | 9,088                  |
| Income before taxes                                       | 187              | 2,580           | (267)                      | 2,500                  |
| Income taxes                                              | 65               | 521             | (91)                       | 495                    |

|            |    |     |    |       |    |       |    |       |
|------------|----|-----|----|-------|----|-------|----|-------|
| Net Income | \$ | 122 | \$ | 2,059 | \$ | (176) | \$ | 2,005 |
|------------|----|-----|----|-------|----|-------|----|-------|

| (In Thousands of Dollars)                                 |                  |                 |                            |                        |
|-----------------------------------------------------------|------------------|-----------------|----------------------------|------------------------|
|                                                           | Trust<br>Segment | Bank<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
| <b>For the Three Months Ended March 31, 2012</b>          |                  |                 |                            |                        |
| Net interest income                                       | \$ 10            | \$ 9,223        | \$ (12)                    | \$ 9,221               |
| Provision for loan losses                                 | 0                | 0               | 0                          | 0                      |
| Service fees, security gains and other noninterest income | 1,437            | 1,326           | (44)                       | 2,719                  |
| Noninterest expense                                       | 1,264            | 7,213           | 153                        | 8,630                  |
| Income before taxes                                       | 183              | 3,336           | (209)                      | 3,310                  |
| Income taxes                                              | 63               | 798             | (71)                       | 790                    |
| Net Income                                                | \$ 120           | \$ 2,538        | \$ (138)                   | \$ 2,520               |

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Forward Looking Statements**

Discussions in this report that are not statements of historical fact (including statements that include terms such as will, may, should, believe, expect, anticipate, estimate, project, intend, and plan) are forward-looking statements that involve risks and uncertainties. Any forward-looking statement is not a guarantee of future performance and actual future results could differ materially from those contained in forward-looking information. Factors that could cause or contribute to such differences include, without limitation, risks and uncertainties detailed from time to time in the Company's filings with the Securities and Exchange Commission, including without limitation, the risk factors disclosed in Item 1A, Risk Factors, in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Many of these factors are beyond the Company's ability to control or predict, and readers are cautioned not to put undue reliance on those forward-looking statements. The following list, which is not intended to be an all-encompassing list of risks and uncertainties affecting the Company, summarizes several factors that could cause the Company's actual results to differ materially from those anticipated or expected in these forward-looking statements:

general economic conditions in market areas where we conduct business, which could materially impact credit quality trends;

business conditions in the banking industry;

the regulatory environment;

fluctuations in interest rates;

demand for loans in the market areas where we conduct business;

rapidly changing technology and evolving banking industry standards;

competitive factors, including increased competition with regional and national financial institutions;

new service and product offerings by competitors and price pressures; and other like items.

Other factors not currently anticipated may also materially and adversely affect the Company's results of operations, cash flows and financial position. There can be no assurance that future results will meet expectations. While the Company believes that the forward-looking statements in this report are reasonable, the reader should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. The Company does not undertake, and expressly disclaims, any obligation to update or alter any statements whether as a result of new information, future events or otherwise, except as may be required by applicable law.

**Overview**

Net income for the three months ended March 31, 2013 was \$2.0 million, compared to \$2.5 million for the same three month period in 2012. On a per share basis, net income for the first quarter ended March 31, 2013 was \$0.11 per diluted share, compared to \$0.13 for the first quarter ended March 31, 2012. The tangible book value decreased to \$6.10 per share at March 31, 2013, compared to \$6.11 per share at December 31, 2012. Farmers reported \$1.14 billion in total assets at March 31, 2013 and December 31, 2012.

Net loans increased \$6.0 million between December 31, 2012 and March 31, 2013. Most of the loan growth in the past three months has occurred in the commercial real estate and commercial and industrial loan portfolio. Net loans were reported at \$585.0 million at March 31, 2013, which compares to \$579.0 million at December 31, 2012. Deposits decreased from \$919.0 million at December 31, 2012 to \$915.9 million at March 31, 2013. At March 31, 2013, core deposits—savings and money market accounts, time deposits less than \$100 thousand, demand

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deposits and interest bearing demand deposits represent approximately 91% of total deposits.

Stockholders' equity totaled \$120.6 million, or 10.6% of total assets, at March 31, 2013, a slight decrease of \$200 thousand from \$120.8 million at December 31, 2012. The decrease is mainly the result of net income, offset by the reduction in accumulated other comprehensive income during the past three months. Shareholders received a \$0.03 per share cash dividend paid during the first quarter of 2013. Book value per share decreased \$6.43 per share at December 31, 2012 to \$6.42 per share at March 31, 2013.

## Results of Operations

The following is a comparison of selected financial ratios and other results at or for the three months ended March 31, 2013 and 2012:

| (In Thousands, except Per Share Data)   | At or for the Three Months<br>Ended March 31, |              |
|-----------------------------------------|-----------------------------------------------|--------------|
|                                         | 2013                                          | 2012         |
| Total Assets                            | \$ 1,143,099                                  | \$ 1,106,445 |
| Net Income                              | \$ 2,005                                      | \$ 2,520     |
| Basic and Diluted Earnings Per Share    | \$ 0.11                                       | \$ .13       |
| Return on Average Assets (Annualized)   | 0.72%                                         | 0.94%        |
| Return on Average Equity (Annualized)   | 6.70%                                         | 8.82%        |
| Efficiency Ratio (tax equivalent basis) | 72.57%                                        | 68.40%       |
| Equity to Asset Ratio                   | 10.55%                                        | 10.43%       |
| Tangible Common Equity Ratio *          | 10.08%                                        | 9.91%        |
| Dividends to Net Income                 | 28.13%                                        | 44.68%       |
| Net Loans to Assets                     | 51.18%                                        | 51.26%       |
| Loans to Deposits                       | 64.70%                                        | 65.04%       |

\*The tangible common equity ratio is calculated by dividing total common stockholders' equity by total assets, after reducing both amounts by intangible assets. The tangible common equity ratio is not required by U.S.GAAP or by applicable bank regulatory requirements, but is a metric used by management to evaluate the adequacy of the Company's capital levels. Since there is no authoritative requirement to calculate the tangible common equity ratio, the Company's tangible common equity ratio is not necessarily comparable to similar capital measures disclosed or used by other companies in the financial services industry. Tangible common equity and tangible assets are non-U.S.GAAP financial measures and should be considered in addition to, not as a substitute for or superior to, financial measures determined in accordance with U.S.GAAP. With respect to the calculation of the actual unaudited tangible common equity ratio as of March 31, 2013 and 2012, reconciliations of tangible common equity to U.S.GAAP total common stockholders' equity and tangible assets to U.S.GAAP total assets are set forth below:

| (In Thousands of Dollars)                                               | March 31,<br>2013 | December 31,<br>2012 | March 31,<br>2012 |
|-------------------------------------------------------------------------|-------------------|----------------------|-------------------|
| Reconciliation of Common Stockholders' Equity to Tangible Common Equity |                   |                      |                   |
| Stockholders' Equity                                                    | \$ 120,576        | \$ 120,792           | \$ 115,404        |
| Less Goodwill and other intangibles                                     | 5,934             | 6,032                | 6,339             |
| Tangible Common Equity                                                  | \$ 114,642        | \$ 114,760           | \$ 109,065        |

| (In Thousands of Dollars)                         | March 31,<br>2013 | December 31,<br>2012 | March 31,<br>2012 |
|---------------------------------------------------|-------------------|----------------------|-------------------|
| Reconciliation of Total Assets to Tangible Assets |                   |                      |                   |
| Total Assets                                      | \$ 1,143,099      | \$ 1,139,695         | \$ 1,106,445      |
| Less Goodwill and other intangibles               | 5,934             | 6,032                | 6,339             |
| Tangible Assets                                   | \$ 1,137,165      | \$ 1,133,663         | \$ 1,100,106      |

**Net Interest Income.** The following schedules detail the various components of net interest income for the periods indicated. All asset yields are calculated on a tax-equivalent basis where applicable. Security yields are based on amortized cost.

## Average Balance Sheets and Related Yields and Rates

(Dollar Amounts in Thousands)

|                                                                 | Three Months Ended<br>March 31, 2013 |          |          | Three Months Ended<br>March 31, 2012 |          |          |
|-----------------------------------------------------------------|--------------------------------------|----------|----------|--------------------------------------|----------|----------|
|                                                                 | AVERAGE<br>BALANCE                   | INTEREST | RATE (1) | AVERAGE<br>BALANCE                   | INTEREST | RATE (1) |
| <b>EARNING ASSETS</b>                                           |                                      |          |          |                                      |          |          |
| Loans (3) (5) (6)                                               | \$ 576,627                           | \$ 7,681 | 5.40%    | \$ 563,175                           | \$ 8,077 | 5.78%    |
| Taxable securities (4)                                          | 360,971                              | 1,908    | 2.14     | 312,909                              | 2,106    | 2.71     |
| Tax-exempt securities (4) (6)                                   | 81,706                               | 1,107    | 5.49     | 74,061                               | 1,084    | 5.89     |
| Equity securities (2) (6)                                       | 4,360                                | 53       | 4.93     | 4,363                                | 50       | 4.61     |
| Federal funds sold and other                                    | 18,427                               | 10       | 0.22     | 43,500                               | 21       | 0.19     |
| Total earning assets                                            | 1,042,091                            | 10,759   | 4.19     | 998,008                              | 11,338   | 4.57     |
| <b>NONEARNING ASSETS</b>                                        |                                      |          |          |                                      |          |          |
| Cash and due from banks                                         | 20,485                               |          |          | 22,599                               |          |          |
| Premises and equipment                                          | 18,331                               |          |          | 16,790                               |          |          |
| Allowance for loan losses                                       | (7,546)                              |          |          | (9,684)                              |          |          |
| Unrealized gains (losses) on securities                         | 10,526                               |          |          | 13,050                               |          |          |
| Other assets (3)                                                | 44,204                               |          |          | 42,705                               |          |          |
| Total assets                                                    | \$ 1,128,091                         |          |          | \$ 1,083,468                         |          |          |
| <b>INTEREST-BEARING LIABILITIES</b>                             |                                      |          |          |                                      |          |          |
| Time deposits                                                   | \$ 232,907                           | \$ 993   | 1.73%    | \$ 257,074                           | \$ 1,216 | 1.90%    |
| Savings deposits                                                | 413,899                              | 185      | 0.18     | 391,860                              | 298      | 0.31     |
| Demand deposits                                                 | 125,147                              | 9        | 0.03     | 112,886                              | 11       | 0.04     |
| Short term borrowings                                           | 81,256                               | 12       | 0.06     | 90,281                               | 42       | 0.19     |
| Long term borrowings                                            | 18,557                               | 99       | 2.16     | 10,690                               | 98       | 3.69     |
| Total interest-bearing liabilities                              | 871,766                              | 1,298    | 0.60     | 862,791                              | 1,665    | 0.78     |
| <b>NONINTEREST-BEARING LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                                      |          |          |                                      |          |          |
| Demand deposits                                                 | 130,051                              |          |          | 102,029                              |          |          |
| Other liabilities                                               | 4,940                                |          |          | 3,709                                |          |          |
| Stockholders' equity                                            | 121,334                              |          |          | 114,939                              |          |          |
| Total liabilities and stockholders' equity                      | \$ 1,128,091                         |          |          | \$ 1,083,468                         |          |          |
| Net interest income and interest rate spread                    |                                      | \$ 9,461 | 3.59%    |                                      | \$ 9,673 | 3.79%    |
| Net interest margin                                             |                                      |          | 3.68%    |                                      |          | 3.90%    |

- (1) Rates are calculated on an annualized basis.
- (2) Equity securities include restricted stock, which is included in other assets on the consolidated balance sheets.
- (3) Non-accrual loans and overdraft deposits are included in other assets.
- (4) Includes unamortized discounts and premiums. Average balance and yield are computed using the average historical amortized cost.
- (5) Interest on loans includes fee income of \$526 thousand and \$504 thousand for 2013 and 2012 respectively and is reduced by amortization of \$489 thousand and \$471 thousand for 2013 and 2012 respectively.
- (6) For 2013, adjustments of \$113 thousand and \$380 thousand respectively are made to tax equate income on tax exempt loans and tax exempt securities. For 2012, adjustments of \$81 thousand and \$371 thousand respectively are made to tax equate income on tax exempt loans and tax exempt securities. These adjustments are based on a marginal federal income tax rate of 35%, less disallowances.

Net interest income. Net interest income was \$9.0 million for the first quarter of 2013, which compared to \$9.2 million in the first quarter of 2012. The net interest margin to average earning assets on a fully taxable equivalent basis decreased 22 basis points to 3.68% for the three months ended March 31, 2013, compared to 3.90% for the same period in the prior year. The decrease in net interest margin is largely a result of the change in the mix of interest earning assets and a decrease in earning asset yields. Loans, which yield more than securities, comprised a smaller level of interest-earning assets in the current period. At March 31, 2013, loans were 55% of average earning assets, compared to 56% at March 31, 2012. In comparing the quarters ending March 31, 2013 and 2012, yields on earning assets decreased 38 basis points, while the cost of interest bearing liabilities decreased 18 basis points. It is important to note that the current quarter net interest margin of 3.68% is a 1 basis point improvement over the 3.67% reported for the fourth quarter of 2012.

Noninterest Income. Noninterest income was \$2.9 million for the first quarter of 2013, increasing 5.7% from \$2.7 million compared to the same quarter of 2012. The increase was primarily the result of a few key revenue sources. Investment commissions increased from \$186 thousand in the first quarter of 2012 to \$262 thousand in the first quarter of 2013, representing an increase of \$76 thousand or 41%. Income from the sale of residential real estate loans also increased from \$65 thousand in the first quarter of 2012 to \$114

thousand in the first quarter of 2013 as the Company continues to develop its secondary mortgage operations. Other operating income also increased \$84 thousand over the prior year's same quarter mainly as a result of fee income earned on loan-level interest rate swaps, which amounted to \$66 thousand. The interest rate swaps are used to help manage the Company's interest rate risk position and not as derivatives for trading purposes.

**Noninterest Expense.** Noninterest expense totaled \$9.1 million for the first quarter of 2013, which is \$458 thousand more than the \$8.6 million reported in the same quarter in 2012. Most of this increase is the result of a 10% increase in salaries and employee benefits, due to a higher number of employees in the current quarter. The higher employee count is attributed primarily to our expanded branch network and lending support function. Occupancy and equipment expense also increased \$65 thousand as a result of depreciation expense and maintenance costs related to new facilities.

Farmers' tax equivalent efficiency ratio for the three month period ended March 31, 2013 was 72.57% compared to 68.4% for the same period in 2012. The decrease in the efficiency ratio was primarily driven by the lower level of net interest income and higher noninterest expenses as explained in the preceding paragraphs.

**Income Taxes.** Income tax expense totaled \$495 thousand for the quarter ended March 31, 2013 and \$790 thousand for the quarter ended March 31, 2012. The decrease in the current quarter tax expense can be attributed to both the \$810 thousand decrease in income before taxes and a larger percentage of tax exempt municipal securities. The effective tax rate for the first three months of 2013 was 19.8%, compared to 23.9% for the same period in 2012. The effective tax rate decrease over the same period in 2012 was primarily due to the increase in tax exempt income mentioned above.

**Other Comprehensive Income.** For the quarter ended March 31, 2013, the change in net unrealized gains on securities, net of reclassifications, resulted in an unrealized loss, net of tax, of \$1.7 million, compared to an unrealized loss of \$556 thousand for the same period in 2012. Management believes the decrease in fair value for the three month period ended March 31, 2013 is the result of the low interest rate environment accelerating the pay back rates on certain mortgage backed securities, which causes amortization to be recorded at a faster rate than expected.

## Financial Condition

**Cash and cash equivalents.** Cash and cash equivalents increased \$19.6 million during the first three months of 2013. The Company expects these levels to decrease over the next few months. The increase is largely due to the scarcity of viable investment options that produce a reasonably yield for the risk and management's effort to maintain a larger balance at the Federal Reserve Bank for future liquidity needs.

**Securities.** Securities available-for-sale decreased by \$24.5 million since December 31, 2012. Additional securities will be purchased in an effort to increase returns on some of the cash available from the additional core deposit account balances and repurchase agreements sold during the period.

**Loans.** Gross loans increased \$5.9 million, or 1.0%, since December 31, 2012. Most of the loan growth occurred in the commercial real estate and commercial loan portfolio. The increase in loans is related to the economic growth being experienced in the Mahoning Valley. The demand experience for the Bank's business and consumer credit is consistent with the experience of other banks in the Federal Reserve's Fourth District and banks nationally per the Federal Reserve Beige Book. The increase in loan balances wasn't enough to overcome the low interest rate environment that caused a lower level of loan income for the current quarter compared to the same quarter in 2012. On a fully tax equivalent basis, loans contributed \$7.7 million of total interest income for the three months ended March 31, 2013 and \$8.1 million during the same period in 2012.

**Allowance for Loan Losses.** The following table indicates key asset quality ratios that management evaluates on an ongoing basis. The unpaid principal balance of non-performing loans and non-performing assets was used in the calculation of amounts and ratios on the table below.

### Asset Quality History

(In Thousands of Dollars)

|                                                             | 3/31/13  | 12/31/12 | 9/30/12  | 6/30/12   | 3/31/12   |
|-------------------------------------------------------------|----------|----------|----------|-----------|-----------|
| Nonperforming loans                                         | \$ 7,368 | \$ 8,228 | \$ 8,662 | \$ 9,900  | \$ 11,030 |
| Nonperforming loans as a % of total loans                   | 1.24%    | 1.40%    | 1.51%    | 1.73%     | 1.91%     |
| Loans delinquent 30-89 days                                 | \$ 3,536 | \$ 3,702 | \$ 3,173 | \$ 2,778  | \$ 2,890  |
| Loans delinquent 30-89 days as a % of total loans           | 0.60%    | 0.62%    | 0.55%    | 0.49%     | 0.50%     |
| Allowance for loan losses                                   | \$ 7,508 | \$ 7,629 | \$ 8,625 | \$ 9,048  | \$ 9,446  |
| Allowance for loan losses as a % of loans                   | 1.27%    | 1.30%    | 1.51%    | 1.58%     | 1.64%     |
| Allowance for loan losses as a % of nonperforming loans     | 101.90%  | 93.01%   | 99.57%   | 91.39%    | 85.64%    |
| Annualized net charge-offs to average net loans outstanding | .26%     | 0.71%    | 0.54%    | 0.57%     | 0.27%     |
| Non-performing assets                                       | \$ 7,778 | \$ 8,536 | \$ 8,833 | \$ 10,312 | \$ 11,574 |
| Non-performing assets as a % of total assets                | 0.68%    | 0.75%    | 0.78%    | 0.92%     | 1.05%     |
| Net charge-offs for the quarter                             | \$ 376   | \$ 995   | \$ 748   | \$ 798    | \$ 374    |

For the three months ended March 31, 2013, management recorded \$255 thousand of loss provision to the allowance for loan losses, compared to providing none over the same three month period in the prior year. The provision for 2013 was primarily a result of an increase in total loans of 1.0% in the quarter. The growth in total loans outpaced the provision for the quarter due to improved asset quality metrics, most notably the decline in nonperforming loans during the three month period ended March 31, 2013 from \$8.2 million to \$7.4 million. As a result, the ratio of allowance for loan losses to gross loans declined from 1.30% to 1.27%. Net charge-offs for the quarter ended March 31, 2013 were \$376 thousand, compared to \$374 thousand for the first quarter of 2012. The net charge-offs outpaced the provision mainly as a result of the lower level of non-performing loans as explained above. The level of charge-offs and a lower level of delinquencies from the year ago period, are factors considered in management's quarterly estimate of loan loss provisions and the adequacy of the allowance for loan losses.

Non-performing loans equaled 1.2% of total loans at March 31, 2013 compared to 1.4% at December 31, 2012. Loans 30-89 days delinquent decreased \$166 thousand, or 4.5%, to \$3.5 million since December 31, 2012. On March 31, 2013, the ratio of the allowance for loan losses (ALLL) to non-performing loans was 101.9%, compared to 93.0% at December 31, 2012. The increase in this ratio over the last three months is mainly the result of the asset quality metrics and improving net charge-off levels.

Based on the evaluation of the adequacy of the allowance for loan losses, management believes that the allowance for loan losses at March 31, 2013 to be adequate and reflects probable incurred losses in the portfolio. The provision for loan losses is based on management's judgment after taking into consideration all factors connected with the collectability of the existing loan portfolio. Management evaluates the loan portfolio in light of economic conditions, changes in the nature and volume of the loan portfolio, industry standards and other relevant factors. Specific factors considered by management in determining the amounts charged to operating expenses include previous credit loss experience, the status of past due interest and principal payments, the quality of financial information supplied by loan customers and the general condition of the industries in the community to which loans have been made.

**Deposits.** Total deposits decreased \$3.2 million, or 0.3%, since December 31, 2012. Balances in the Company's non-interest bearing deposits increased \$7.4 million, or 5.6%, between December 31, 2012 and March 31, 2013. Money market accounts decreased \$11.0 million between December 31, 2012 and March 31, 2013. Savings and other interest bearing demand deposits decreased \$5.9 million

between December 31, 2012 and March 31, 2013. The Company's continued focus is on core deposit growth and will price deposit rates to remain competitive within the market and to retain customers. At March 31, 2013, core deposits—savings and money market accounts, time deposits less than \$100 thousand and demand deposits—represented approximately 91% of total deposits.

**Borrowings.** Total borrowings increased \$11.4 million, or 12.6%, since December 31, 2012. The increase in borrowings is the result of a \$11.4 million increase in securities sold under repurchase agreements. The increase in repurchase agreements is mainly due to semi-annual tax collections for public funds depositors.

**Capital Resources.** Total stockholders' equity decreased from \$120.8 million at December 31, 2012 to \$120.6 million at March 31, 2013. The decrease is mainly the result of net income, offset by the reduction in accumulated other comprehensive income during the past three months. Shareholders received a \$0.03 per share cash dividend paid during the first quarter of 2013. Book value per share decreased from \$6.43 per share at December 31, 2012 to \$6.42 per share at March 31, 2013.

The capital management function is a regular process that consists of providing capital for both the current financial position and the anticipated future growth of the Company. As of March 31, 2013 the Company's total risk-based capital ratio stood at 17.48%, and the Tier I risk-based capital ratio and Tier I leverage ratio were at 16.31% and 9.77%, respectively. Management believes that the Company and the Bank meet all capital adequacy requirements to which they are subject, as of March 31, 2013.

### **Critical Accounting Policies**

The Company follows financial accounting and reporting policies that are in accordance with U.S. GAAP. These policies are presented in Note 1 of the consolidated audited financial statements in the Company's Annual Report to Shareholders included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. Critical accounting policies are those policies that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. The Company has identified two accounting policies that are critical accounting policies and an understanding of these policies is necessary to understand the Company's financial statements. These policies relate to determining the adequacy of the allowance for loan losses and other-than-temporary impairment of securities. Additional information regarding these policies is included in the notes to the aforementioned 2012 consolidated financial statements, Note 1 (Summary of Significant Accounting Policies), Note 2 (Securities), Note 3 (Loans), and the sections captioned "Loan Portfolio" and "Investment Securities".

Management believes that the accounting for goodwill and other intangible assets also involves a higher degree of judgment than most other significant accounting policies. U.S. GAAP establishes standards for the amortization of acquired intangible assets and the impairment assessment of goodwill. Goodwill arising from business combinations represents the value attributable to unidentifiable intangible assets in the business acquired. The Company's goodwill relates to the value inherent in the banking industry and that value is dependent upon the ability of the Company's trust subsidiary to provide quality, cost-effective trust services in a competitive marketplace. The goodwill value is supported by revenue that is in part driven by the volume of business transacted. A decrease in earnings resulting from a decline in the customer base or the inability to deliver cost-effective services over sustained periods can lead to impairment of goodwill that could adversely impact earnings in future periods. U.S. GAAP requires an annual evaluation of goodwill for impairment, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The fair value of the goodwill, which resides on the books of the Trust, is estimated by reviewing the past and projected operating results for the subsidiary and trust banking industry comparable information.

### **Liquidity**

The Company maintains, in the opinion of management, liquidity sufficient to satisfy depositors' requirements and meet the credit needs of customers. The Company depends on its ability to maintain its market share of deposits as well as acquiring new funds. The Company's ability to attract deposits and borrow funds depends in large measure on its profitability, capitalization and overall financial condition. The Company's objective in liquidity management is to maintain the ability to meet loan commitments, purchase securities or to repay deposits and other liabilities in accordance with their terms without an adverse impact on current or future

earnings. Principal sources of liquidity for the Company include assets considered relatively liquid, such as federal funds sold, cash and due from banks, as well as cash flows from maturities and repayments of loans, and securities.

Along with its liquid assets, the Bank has additional sources of liquidity available which help to ensure that adequate funds are available as needed. These other sources include, but are not limited to, loan repayments, the ability to obtain deposits through the adjustment of interest rates and the purchasing of federal funds and borrowings on approved lines of credit at major domestic banks. At March 31, 2013, these lines of credit totaled \$24.5 million and the Bank had not borrowed against these lines. In addition, the Company has a \$1.5 million revolving line of credit with a correspondent bank. The outstanding balance at March 31, 2013 was \$350 thousand. Management feels that its liquidity position is adequate and continues to monitor the position on a monthly basis. As of March 31, 2013, the Bank had outstanding balances with the Federal Home Loan Bank of Cincinnati ( FHLB ) of \$10.3 million with additional borrowing capacity of approximately \$89.8 million with the FHLB as well as access to the Federal Reserve Discount Window, which provides an additional source of funds. The Bank views its membership in the FHLB as a solid source of liquidity.

The primary investing activities of the Company are originating loans and purchasing securities. During the first three months of 2013, net cash provided by investing activities amounted to \$10.2 million, compared to \$19.4 million used in investing activities for the same period in 2012. Proceeds from maturities and repayments of securities available for sale provided \$22.3 million in the first quarter of 2013 and only provided \$15.7 million during the same three month period in 2012. Purchases and settlements of securities amounted to \$5.8 million used during the first three months of 2013 compared to \$29.1 million used during the same period in 2012. There was \$6.4 million used for loan originations and payments during the first three months of 2013, compared to \$5.2 million in net cash provided by loan originations and payments during the same period in 2012. The cash used by lending activities during this year's first three month period can be attributed to the activity in the commercial portfolio.

The primary financing activities of the Company are obtaining deposits, repurchase agreements and other borrowings. Net cash provided by financing activities amounted to \$7.6 million for the first three months of 2013, compared to \$36.7 million provided by financing activities for the same period in 2012. The majority of this change can be attributed to the change in deposits. Deposits provided \$46.5 million during the first three months of 2012 and used \$3.2 million during the first three months of 2013.

#### **Off-Balance Sheet Arrangements**

In the normal course of business, to meet the financial needs of our customers, we are a party to financial instruments with off-balance sheet risk. These financial instruments generally include commitments to originate mortgage, commercial and consumer loans, and involve to varying degrees, elements of credit and interest rate risk in excess of amounts recognized in the Consolidated Balance Sheets. The Bank's maximum exposure to credit loss in the event of nonperformance by the borrower is represented by the contractual amount of those instruments. Because some commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The same credit policies are used in making commitments as are used for on-balance sheet instruments. Collateral is required in instances where deemed necessary. Undisbursed balances of loans closed include funds not disbursed but committed for construction projects. Unused lines of credit include funds not disbursed, but committed for, home equity, commercial and consumer lines of credit. Financial standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Those guarantees are primarily used to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Total unused commitments were \$108 million at March 31, 2013 and \$95.4 million at December 31, 2012.

#### **Recent Market and Regulatory Developments**

In response to the current national and international economic recession, and in an effort to stabilize and strengthen the financial markets and banking industries, the United States Congress and governmental agencies have taken a number of significant actions over the past several years, including the passage of legislation and the implementation of a number of programs. The most recent of these actions was the passage into law, on July 21, 2010, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The Dodd-Frank Act is the most comprehensive change to banking laws and the financial regulatory environment since the Great Depression of the 1930s. The Dodd-Frank Act affects almost every aspect of the nation's financial services industry.

and mandates change in several key areas, including regulation and compliance, securities regulation, executive compensation, regulation of derivatives, corporate governance, and consumer protection.

The extent to which the Dodd-Frank Act and initiatives thereunder will succeed in addressing the credit markets or otherwise result in an improvement in the national economy is uncertain. In addition, because many aspects of this legislation still remain subject to intensive agency rulemaking and subsequent public comment prior to implementation, it is difficult to predict at this time the ultimate effect of the Dodd-Frank Act on the Company. It is likely, however, that the Company's expenses will increase as a result of new compliance requirements.

Various legislation affecting financial institutions and the financial industry will likely continue to be introduced in Congress, and such legislation may further change banking statutes and the operating environment of the Company in substantial and unpredictable ways, and could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance depending upon whether any of this potential legislation will be enacted, and if enacted, the effect that it or any implementing regulations, would have on the financial condition or results of operations of the Company or any of its subsidiaries. With the enactment of the Dodd-Frank Act, the nature and extent of future legislative and regulatory changes affecting financial institutions remains very unpredictable at this time.

Also, such statutes, regulations and policies are continually under review by Congress and state legislatures and federal and state regulatory agencies and are subject to change at any time, particularly in the current economic and regulatory environment. Any such change in statutes, regulations or regulatory policies applicable to the Company could have a material effect on the business of the Company.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company's ability to maximize net income is dependent, in part, on management's ability to plan and control net interest income through management of the pricing and mix of assets and liabilities. Because a large portion of assets and liabilities of the Company are monetary in nature, changes in interest rates and monetary or fiscal policy affect its financial condition and can have significant impact on the net income of the Company. Additionally, the Company's balance sheet is currently liability sensitive and in the low interest rate environment that exists today, the Company's net interest margin should maintain current levels throughout the near future.

The Company considers the primary market exposure to be interest rate risk. Simulation analysis is used to monitor the Company's exposure to changes in interest rates, and the effect of the change to net interest income. The following table shows the effect on net interest income and the net present value of equity in the event of a sudden and sustained 300 basis point increase or 100 basis decrease in market interest rates:

| Changes In Interest Rate   | March 31,<br>2013<br>Result | December 31,<br>2012<br>Result | ALCO<br>Guidelines |
|----------------------------|-----------------------------|--------------------------------|--------------------|
| (basis points)             |                             |                                |                    |
| Net Interest Income Change |                             |                                |                    |
| +300                       | 1.9%                        | -0.6%                          | 15.00%             |
| +200                       | 1.2%                        | -0.1%                          | 10.00%             |
| +100                       | 1.2%                        | 0.1%                           | 5.00%              |
| -100                       | -3.9%                       | -3.4%                          | 5.00%              |
| Net Present Value          |                             |                                |                    |
| Of Equity Change           |                             |                                |                    |
| +300                       | 2.5%                        | 3.3%                           | 20.00%             |
| +200                       | 4.9%                        | 5.7%                           | 15.00%             |
| +100                       | 4.5%                        | 4.4%                           | 10.00%             |
| -100                       | -16.8%                      | -16.8%                         | 10.00%             |

The results of the simulation indicate that in an environment where interest rates rise 100, 200 and 300 basis points or fall 100 basis points over a 12 month period, using March 31, 2013 amounts as a base case, and considering the increase in deposit liabilities, and the volatile financial markets. It should be noted that the change in the net present value of equity exceeded policy when the simulation model assumed a sudden decrease in rates of 100 basis points. This was primarily because the positive impact on the fair value of assets would not be as great as the negative impact on the fair value of certain liabilities. Specifically, because core deposits typically bear relatively low interest rates, their fair value would be negatively impacted as the rates could not be adjusted by the full extent of the sudden decrease in rates. Management does not believe that a 100 basis rate decline is realistic in the current interest rate environment. The remaining results of this analysis comply with internal limits established by the Company. A report on interest rate risk is presented to the Board of Directors and the Asset/Liability Committee on a quarterly basis. The Company has no market risk sensitive instruments held for trading purposes, nor does it hold derivative financial instruments, and does not plan to purchase these instruments in the near future.

#### Item 4. Controls and Procedures

Based on their evaluation, as of the end of the period covered by this Quarterly Report on Form 10-Q, the Company's Chief Executive Officer and Chief Financial Officer have concluded the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) are effective. There were no changes in the Company's internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the fiscal quarter ended March 31, 2013, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II - OTHER INFORMATION

#### Item 1. Legal Proceedings

In the opinion of management there are no outstanding legal actions that will have a material adverse effect on the Company's financial condition or results of operations.

#### Item 1A. Risk Factors

There have been no material changes to the Company's risk factors from those disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Not applicable

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Mine Safety Disclosures**

Not applicable

**Item 5. Other Information**

Not applicable.

**Item 6. Exhibits**

The following exhibits are filed or incorporated by reference as part of this report:

- 3.1 Articles of Incorporation of Farmers National Banc Corp., as amended (incorporated by reference from Exhibit 4.1 to the Company's Registration Statement on Form S-3 filed with the SEC on October 3, 2001 (File No. 333-70806).
  - 3.2 Amended Code of Regulations of Farmers National Banc Corp. (incorporated by reference from Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2011 filed with the SEC on August 9, 2011).
  - 31.1 Rule 13a-14(a)/15d-14(a) Certification of John S. Gulas, President and Chief Executive Officer of the Company (filed herewith).
  - 31.2 Rule 13a-14(a)/15d-14(a) Certification of Carl D. Culp, Executive Vice President, Chief Financial Officer and Treasurer of the Company (filed herewith).
  - 32.1 Certification pursuant to 18 U.S.C. Section 1350 of John S. Gulas, President and Chief Executive Officer of the Company (filed herewith).
  - 32.2 Certification pursuant to 18 U.S.C. Section 1350 of Carl D. Culp, Executive Vice President, Chief Financial Officer and Treasurer of the Company (filed herewith).
  - 101\* The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2013, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income (iii) the Consolidated Statements of Comprehensive Income; (iv) the Consolidated Statements of Cash Flows; and (v) Notes to Unaudited Consolidated Financial Statements, tagged as blocks of text.
- \* As provided in Rule 406T of Regulation S-T, this information shall not be deemed filed for purposes of Section 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934 or otherwise subject to liability under those sections.

SIGNATURES

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

FARMERS NATIONAL BANC CORP.

Dated: May 8, 2013

/s/ John S. Gulas  
John S. Gulas

President and Chief Executive Officer  
Dated: May 8, 2013

/s/ Carl D. Culp  
Carl D. Culp

Executive Vice President

and Treasurer