

FARMERS NATIONAL BANC CORP /OH/  
Form 10-Q  
November 08, 2012

**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 September 30, 2012**

**Commission file number 001-35296**

**FARMERS NATIONAL BANC CORP.**

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

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

**34-1371693**  
**(I.R.S. Employer**  
**Identification No)**

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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                      | Outstanding at October 31, 2012 |
|----------------------------|---------------------------------|
| Common Stock, No Par Value | 18,802,269 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) |                      |
|---|---------------------------|----------------------|
|   | September 30,<br>2012     | December 31,<br>2011 |
| <b>ASSETS</b>   |                           |                      |
| Cash and due from banks   | \$ 15,927                 | \$ 14,161            |
| Federal funds sold and other  | 63,567                    | 38,261               |
| <b>TOTAL CASH AND CASH EQUIVALENTS</b>  | <b>79,494</b>             | <b>52,422</b>        |
| Securities available for sale   | 429,845                   | 400,029              |
| Loans held for sale   | 4,574                     | 677                  |
| Loans   | 572,903                   | 571,806              |
| Less allowance for loan losses  | 8,625                     | 9,820                |
| <b>NET LOANS</b>  | <b>564,278</b>            | <b>561,986</b>       |
| Premises and equipment, net   | 18,216                    | 16,461               |
| Goodwill  | 3,709                     | 3,709                |
| Other intangibles   | 2,425                     | 2,732                |
| Bank owned life insurance   | 15,404                    | 15,015               |
| Other assets  | 14,801                    | 14,840               |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,132,746</b>       | <b>\$ 1,067,871</b>  |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                           |                      |
| Deposits:   |                           |                      |
| Noninterest-bearing   | \$ 117,108                | \$ 96,117            |
| Interest-bearing  | 783,030                   | 744,008              |
| <b>TOTAL DEPOSITS</b>   | <b>900,138</b>            | <b>840,125</b>       |
| Short-term borrowings   | 96,870                    | 98,088               |
| Long-term borrowings  | 10,488                    | 11,263               |
| Other liabilities   | 4,242                     | 3,950                |
| <b>TOTAL LIABILITIES</b>  | <b>1,011,738</b>          | <b>953,426</b>       |
| Commitments and contingent liabilities  |                           |                      |
| Stockholders Equity:  |                           |                      |
| Common Stock - Authorized 25,000,000 shares; issued 18,802,282 in 2012 and 18,757,437 in 2011 | 104,504                   | 104,261              |
| Retained earnings   | 7,175                     | 2,133                |
| Accumulated other comprehensive income  | 9,329                     | 8,051                |
| Treasury stock, at cost; 13 shares in 2012 and 2011   | 0                         | 0                    |
| <b>TOTAL STOCKHOLDERS EQUITY</b>  | <b>121,008</b>            | <b>114,445</b>       |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>  | <b>\$ 1,132,746</b>       | <b>\$ 1,067,871</b>  |

See accompanying notes

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

|  | (In Thousands except Per Share Data) |                  |                           |                  |
|--|--------------------------------------|------------------|---------------------------|------------------|
|  | For the Three Months Ended           |                  | For the Nine Months Ended |                  |
|  | Sept 30,<br>2012                     | Sept 30,<br>2011 | Sept 30,<br>2012          | Sept 30,<br>2011 |
| <b>INTEREST AND DIVIDEND INCOME</b>                            |                                      |                  |                           |                  |
| Loans, including fees  | \$ 7,945                             | \$ 8,303         | \$ 23,928                 | \$ 25,123        |
| Taxable securities   | 1,901                                | 2,121            | 6,135                     | 6,038            |
| Tax exempt securities  | 705                                  | 725              | 2,124                     | 2,193            |
| Dividends  | 50                                   | 48               | 152                       | 147              |
| Federal funds sold and other interest income                   | 29                                   | 21               | 80                        | 40               |
| <b>TOTAL INTEREST AND DIVIDEND INCOME</b>                      | <b>10,630</b>                        | <b>11,218</b>    | <b>32,419</b>             | <b>33,541</b>    |
| <b>INTEREST EXPENSE</b>  |                                      |                  |                           |                  |
| Deposits   | 1,409                                | 1,660            | 4,394                     | 5,042            |
| Short-term borrowings  | 22                                   | 75               | 89                        | 276              |
| Long-term borrowings   | 98                                   | 248              | 294                       | 748              |
| <b>TOTAL INTEREST EXPENSE</b>                                  | <b>1,529</b>                         | <b>1,983</b>     | <b>4,777</b>              | <b>6,066</b>     |
| <b>NET INTEREST INCOME</b>                                     | <b>9,101</b>                         | <b>9,235</b>     | <b>27,642</b>             | <b>27,475</b>    |
| Provision for loan losses                                      | 325                                  | 700              | 725                       | 3,650            |
| <b>NET INTEREST INCOME AFTER<br/>PROVISION FOR LOAN LOSSES</b> | <b>8,776</b>                         | <b>8,535</b>     | <b>26,917</b>             | <b>23,825</b>    |
| <b>NONINTEREST INCOME</b>                                      |                                      |                  |                           |                  |
| Service charges on deposit accounts                            | 540                                  | 562              | 1,499                     | 1,535            |
| Bank owned life insurance income, including death benefits     | 129                                  | 143              | 389                       | 421              |
| Trust fees   | 1,328                                | 1,354            | 4,111                     | 4,057            |
| Security gains   | 473                                  | 0                | 473                       | 0                |
| Impairment of equity securities                                | 0                                    | (11)             | 0                         | (11)             |
| Insurance agency commissions                                   | 28                                   | 28               | 89                        | 120              |
| Investment commissions   | 210                                  | 215              | 645                       | 669              |
| Net gains on sale of loans                                     | 204                                  | 0                | 407                       | 0                |
| Other operating income   | 387                                  | 405              | 1,339                     | 1,216            |
| <b>TOTAL NONINTEREST INCOME</b>                                | <b>3,299</b>                         | <b>2,696</b>     | <b>8,952</b>              | <b>8,007</b>     |
| <b>NONINTEREST EXPENSES</b>                                    |                                      |                  |                           |                  |
| Salaries and employee benefits                                 | 4,808                                | 4,184            | 14,476                    | 12,855           |
| Occupancy and equipment  | 1,083                                | 944              | 3,134                     | 2,649            |
| State and local taxes  | 293                                  | 233              | 904                       | 718              |
| Professional fees  | 490                                  | 516              | 1,353                     | 1,326            |
| Advertising  | 210                                  | 265              | 668                       | 621              |
| FDIC insurance   | 166                                  | 171              | 535                       | 763              |
| Intangible amortization  | 102                                  | 112              | 307                       | 367              |
| Core processing charges  | 303                                  | 338              | 1,023                     | 962              |
| Other operating expenses                                       | 1,373                                | 1,414            | 3,944                     | 3,822            |

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|  |          |          |          |          |
|--|----------|----------|----------|----------|
| TOTAL NONINTEREST EXPENSES               | 8,828    | 8,177    | 26,344   | 24,083   |
| INCOME BEFORE INCOME TAXES               | 3,247    | 3,054    | 9,525    | 7,749    |
| INCOME TAXES                             | 758      | 683      | 2,230    | 1,571    |
| NET INCOME                               | \$ 2,489 | \$ 2,371 | \$ 7,295 | \$ 6,178 |
| NET INCOME PER SHARE - basic and diluted | \$ 0.13  | \$ 0.13  | \$ 0.39  | \$ 0.34  |

See accompanying notes

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES****(Unaudited)**

|  | (In Thousands except Per Share Data) |                  |                           |                  |
|--|--------------------------------------|------------------|---------------------------|------------------|
|  | For the Three Months Ended           |                  | For the Nine Months Ended |                  |
|  | Sept<br>30,<br>2012                  | Sept 30,<br>2011 | Sept 30,<br>2012          | Sept 30,<br>2011 |
| <b>NET INCOME</b>  | \$ 2,489                             | \$ 2,371         | \$ 7,295                  | \$ 6,178         |
| Other comprehensive income:  |                                      |                  |                           |                  |
| Net unrealized holding gains (losses) on available for sale securities | 695                                  | 5,140            | 2,438                     | 11,003           |
| Reclassification adjustment for (gains) losses realized in income      | (473)                                | 11               | (473)                     | 11               |
| Net unrealized holding gains (losses)                                  | 222                                  | 5,151            | 1,965                     | 11,014           |
| Income tax effect  | (77)                                 | (1,803)          | (687)                     | (3,854)          |
| Other comprehensive income (loss), net of tax                          | 145                                  | 3,348            | 1,278                     | 7,160            |
| <b>TOTAL COMPREHENSIVE INCOME</b>                                      | <b>\$ 2,634</b>                      | <b>\$ 5,719</b>  | <b>\$ 8,573</b>           | <b>\$ 13,338</b> |

See accompanying notes



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

|  | (In Thousands of Dollars)<br>Nine Months Ended |                  |
|--|--|------------------|
|  | Sept 30,<br>2012                               | Sept 30,<br>2011 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                |  |                  |
| Net income   | \$ 7,295                                       | \$ 6,178         |
| Adjustments to reconcile net income to net cash from operating activities: |  |                  |
| Provision for loan losses  | 725  | 3,650            |
| Depreciation and amortization  | 1,250  | 1,210            |
| Net amortization of securities   | 1,996  | 1,022            |
| Security gains   | (473)  | 0                |
| Impairment of equity securities  | 0  | 11               |
| (Gain) loss on sale of other real estate owned                             | (56)   | 132              |
| Increase in bank owned life insurance                                      | (389)  | (421)            |
| Origination of loans held for sale   | (25,217)                                       | 0                |
| Proceeds from loans held for sale  | 21,727   | 0                |
| Net gains on sale of loans   | (407)  | 0                |
| Net change in other assets and liabilities                                 | (844)  | (1,149)          |
| <b>NET CASH FROM OPERATING ACTIVITIES</b>                                  | <b>5,607</b>                                   | <b>10,633</b>    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                |  |                  |
| Proceeds from maturities and repayments of securities available for sale   | 62,216   | 30,511           |
| Proceeds from sales of securities available for sale                       | 56,463   | 3,361            |
| Purchases of securities available for sale                                 | (148,054)                                      | (92,397)         |
| Loan originations and payments, net  | (4,361)  | 19,885           |
| Proceeds from sale of other real estate owned                              | 1,814  | 345              |
| Purchase of bank owned life insurance                                      | 0  | (3,000)          |
| Proceeds from BOLI death benefit   | 0  | 108              |
| Additions to premises and equipment  | (2,623)  | (1,500)          |
| <b>NET CASH FROM INVESTING ACTIVITIES</b>                                  | <b>(34,545)</b>                                | <b>(42,687)</b>  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                |  |                  |
| Net change in deposits   | 60,013   | 45,148           |
| Net change in short-term borrowings  | (1,218)  | 33,450           |
| Repayment of Federal Home Loan Bank borrowings and other debt              | (775)  | (1,431)          |
| Cash dividends paid  | (2,253)  | (1,681)          |
| Proceeds from dividend reinvestment  | 243  | 380              |
| Net proceeds from issuance of common shares                                | 0  | 13,772           |
| <b>NET CASH FROM FINANCING ACTIVITIES</b>                                  | <b>56,010</b>                                  | <b>89,638</b>    |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                             | <b>27,072</b>                                  | <b>57,584</b>    |
| Beginning cash and cash equivalents  | 52,422   | 37,305           |
| Ending cash and cash equivalents   | \$ 79,494                                      | \$ 94,889        |
| <b>Supplemental cash flow information:</b>                                 |  |                  |
| Interest paid  | \$ 4,809                                       | \$ 6,127         |
| Income taxes paid  | \$ 1,455                                       | \$ 3,065         |

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Supplemental noncash disclosures:

|  |    |       |    |     |
|--|----|-------|----|-----|
| Transfer of loans to other real estate | \$ | 1,344 | \$ | 514 |
|--|----|-------|----|-----|

See accompanying notes

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**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**Principles of Consolidation:**

Farmers National Banc Corp. (the 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 (the Bank). The Company provides trust services through its subsidiary, Farmers Trust Company (the 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 2011 Annual Report to Shareholders included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. 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 other intangibles and fair values of financial instruments are particularly subject to change.

**Allowance for Loan Losses:**

The Company changed its methodology for estimating the valuation allowance for probable incurred loan losses for the three and nine month periods ended September 30, 2012. During the most recent period end, management computed the historical loss percentage based upon the loss history of the past 12 quarters. In previous years, management used a historical loss percentage based on the past 8 quarters. Using a 12 quarter loss history resulted in a larger historical loss ratio than what would have been computed using an 8 quarter history. The primary factor for the change was the lower historical loss percentage applied to homogeneous and pass rated loans due to recent lower levels of net charge-offs. This new 12 quarter history methodology resulted in a \$325 thousand and \$725 thousand loan loss provision for the three and nine month periods ended September 30, 2012. Under the previous eight quarter method the unallocated portion of the allowance for loan losses would have increased during those same three and nine month periods.

**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 or loss. Other comprehensive income or loss consists solely of the change in net unrealized gains and losses on securities available for sale, net of reclassification for gains or losses recognized in income.

**Recent Accounting Pronouncements**

In May 2011, the FASB issued an amendment to achieve common fair value measurement and disclosure requirements between U.S. and International accounting principles. Overall, the guidance is consistent with existing U.S. accounting principles; however, there are some amendments that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The amendments in this guidance are effective for interim and annual reporting periods beginning after December 15, 2011. The effect of adopting this standard did not have a material effect on the Company's operating results or financial condition, but the additional disclosures are included in the Fair Value footnote.

In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. The amendments in this guidance are effective as of the beginning of a fiscal reporting year, and interim periods within that year, that begins after December 15, 2011. The Company adopted this amendment for the year ended December 31, 2011, by presenting comprehensive income in new Consolidated Statements of Comprehensive Income. The new statements follow 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 September 30, 2012 and December 31, 2011 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>September 30, 2012</b>                            |                   |                              |                               |                   |
| U.S. Treasury and U.S. government sponsored entities | \$ 70,465         | \$ 1,830                     | \$ (15)                       | \$ 72,280         |
| State and political subdivisions                     | 78,643            | 5,357                        | (9)                           | 83,991            |
| Corporate bonds                                      | 1,232             | 17                           | 0                             | 1,249             |
| Mortgage-backed securities - residential             | 247,330           | 6,829                        | 0                             | 254,159           |
| Collateralized mortgage obligations                  | 17,504            | 209                          | 0                             | 17,713            |
| Small business administration                        | 179               | 1                            | 0                             | 180               |
| Equity securities                                    | 140               | 138                          | (5)                           | 273               |
| <b>Totals</b>  | <b>\$ 415,493</b> | <b>\$ 14,381</b>             | <b>\$ (29)</b>                | <b>\$ 429,845</b> |

| (In Thousands of Dollars)                            | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value        |
|--|-------------------|------------------------------|-------------------------------|-------------------|
| <b>December 31, 2011</b>                             |                   |                              |                               |                   |
| U.S. Treasury and U.S. government sponsored entities | \$ 53,689         | \$ 2,300                     | \$ (1)                        | \$ 55,988         |
| State and political subdivisions                     | 78,288            | 4,446                        | (44)                          | 82,690            |
| Corporate bonds                                      | 758               | 11                           | 0                             | 769               |
| Mortgage-backed securities - residential             | 217,644           | 5,384                        | (310)                         | 222,718           |
| Collateralized mortgage obligations                  | 36,806            | 416                          | 0                             | 37,222            |
| Small business administration                        | 318               | 1                            | (4)                           | 315               |
| Equity securities                                    | 139               | 194                          | (6)                           | 327               |
| <b>Totals</b>  | <b>\$ 387,642</b> | <b>\$ 12,752</b>             | <b>\$ (365)</b>               | <b>\$ 400,029</b> |



Proceeds from the sales of investment securities were \$56.5 million during the three and nine month periods ended September 30, 2012. Gross gains of \$671 thousand and gross losses of \$198 thousand were realized on these sales during 2012. There were no security sales during the three months ended September 30, 2011 and only one security sale during the nine month period ended September 30, 2011. Proceeds from the sale were \$3.4 million with no gain or loss recognized.

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. Mortgage-backed, CMO and SBA securities are not due at a single maturity date and are shown separately.

| (In Thousands of Dollars)               | September 30, 2012 |                   |
|---|--------------------|-------------------|
|   | Amortized Cost     | Fair Value        |
| <b>Maturity</b>                         |                    |                   |
| Within one year                         | \$ 15,967          | \$ 16,224         |
| One to five years                       | 75,340             | 78,725            |
| Five to ten years                       | 45,853             | 48,539            |
| Beyond ten years                        | 13,180             | 14,032            |
| Mortgage-backed, CMO and SBA securities | 265,013            | 272,052           |
| <b>Total</b>                            | <b>\$ 415,353</b>  | <b>\$ 429,572</b> |

The following table summarizes the investment securities with unrealized losses at September 30, 2012 and December 31, 2011, aggregated by major security type and length of time in a continuous unrealized loss position. Unrealized losses for Mortgage-backed securities residential and Small business administration securities for the period ended September 30, 2012 and Corporate bonds for the period ended December 31, 2011, rounded to less than \$1 thousand.

| (In Thousands of Dollars)                            | Less Than 12 Months |                   | 12 Months or Longer |                   | Total            |                   |
|--|---------------------|-------------------|---------------------|-------------------|------------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value       | Unrealized Losses |
| <b>September 30, 2012</b>                            |                     |                   |                     |                   |                  |                   |
| Available-for-sale                                   |                     |                   |                     |                   |                  |                   |
| U.S. Treasury and U.S. government sponsored entities | \$ 10,712           | \$ (15)           | \$ 0                | \$ 0              | \$ 10,712        | \$ (15)           |
| State and political subdivisions                     | 1,316               | (9)               | 0                   | 0                 | 1,316            | (9)               |
| Mortgage-backed securities residential               | 9                   | 0                 | 53                  | 0                 | 62               | 0                 |
| Small business administration                        | 0                   | 0                 | 39                  | 0                 | 39               | 0                 |
| Equity securities                                    | 0                   | 0                 | 8                   | (5)               | 8                | (5)               |
| <b>Total</b>   | <b>\$ 12,037</b>    | <b>\$ (24)</b>    | <b>\$ 100</b>       | <b>\$ (5)</b>     | <b>\$ 12,137</b> | <b>\$ (29)</b>    |

| (In Thousands of Dollars)                            | Less Than 12 Months |                   | 12 Months or Longer |                   | Total            |                   |
|--|---------------------|-------------------|---------------------|-------------------|------------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value       | Unrealized Losses |
| <b>December 31, 2011</b>                             |                     |                   |                     |                   |                  |                   |
| Available-for-sale                                   |                     |                   |                     |                   |                  |                   |
| U.S. Treasury and U.S. government sponsored entities | \$ 249              | \$ (1)            | \$ 0                | \$ 0              | \$ 249           | \$ (1)            |
| State and political subdivisions                     | 0                   | 0                 | 2,420               | (44)              | 2,420            | (44)              |
| Corporate bonds                                      | 507                 | 0                 | 0                   | 0                 | 507              | 0                 |
| Mortgage-backed securities residential               | 43,426              | (203)             | 9,652               | (107)             | 53,078           | (310)             |
| Small business administration                        | 0                   | 0                 | 233                 | (4)               | 233              | (4)               |
| Equity securities                                    | 0                   | 0                 | 7                   | (6)               | 7                | (6)               |
| <b>Total</b>   | <b>\$ 44,182</b>    | <b>\$ (204)</b>   | <b>\$ 12,312</b>    | <b>\$ (161)</b>   | <b>\$ 56,494</b> | <b>\$ (365)</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 September 30, 2012, the Company's security portfolio consisted of 403 securities, 19 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 U.S. Treasury and U.S mortgage-backed securities as discussed below.

Unrealized losses on debt securities issued by 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.

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)      | September 30,<br>2012 | December 31,<br>2011 |
|--------------------------------|-----------------------|----------------------|
| <b>Commercial real estate</b>  |                       |                      |
| Owner occupied                 | \$ 92,710             | \$ 100,710           |
| Non-owner occupied             | 84,579                | 80,585               |
| Other                          | 21,487                | 17,394               |
| <b>Commercial</b>              | <b>83,795</b>         | <b>74,875</b>        |
| <b>Residential real estate</b> |                       |                      |
| 1-4 family residential         | 136,485               | 145,743              |
| Home equity lines of credit    | 23,551                | 21,943               |
| <b>Consumer</b>                |                       |                      |
| Indirect                       | 115,447               | 115,681              |
| Direct                         | 11,417                | 11,596               |
| Other                          | 1,491                 | 1,520                |
| <b>Subtotal</b>                | <b>570,962</b>        | <b>570,047</b>       |
| Net deferred loan costs        | 1,941                 | 1,759                |
| Allowance for loan losses      | (8,625)               | (9,820)              |
| <b>Net loans</b>               | <b>\$ 564,278</b>     | <b>\$ 561,986</b>    |

The following tables present the activity in the allowance for loan losses by portfolio segment for the three and nine months ended September 30, 2012 and 2011:

**Three Months Ended September 30, 2012**

| (In Thousands of Dollars)        | Commercial<br>Real<br>Estate | Commercial      | Residential<br>Real Estate | Consumer        | Unallocated   | Total           |
|----------------------------------|------------------------------|-----------------|----------------------------|-----------------|---------------|-----------------|
| <b>Allowance for loan losses</b> |                              |                 |                            |                 |               |                 |
| Beginning balance                | \$ 4,626                     | \$ 1,752        | \$ 1,607                   | \$ 1,020        | \$ 43         | \$ 9,048        |
| Provision for loan losses        | (142)                        | 205             | 33                         | 99              | 130           | 325             |
| Loans charged off                | (446)                        | (187)           | (49)                       | (256)           | 0             | (938)           |
| Recoveries                       | 23                           | 9               | 21                         | 137             | 0             | 190             |
| <b>Ending balance</b>            | <b>\$ 4,061</b>              | <b>\$ 1,779</b> | <b>\$ 1,612</b>            | <b>\$ 1,000</b> | <b>\$ 173</b> | <b>\$ 8,625</b> |



**Nine Months Ended September 30, 2012**

| (In Thousands of Dollars) | Commercial<br>Real<br>Estate | Commercial | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---------------------------|------------------------------|------------|----------------------------|----------|-------------|----------|
| Allowance for loan losses |                              |            |                            |          |             |          |
| Beginning balance         | \$ 4,880                     | \$ 1,529   | \$ 1,802                   | \$ 972   | \$ 637      | \$ 9,820 |
| Provision for loan losses | (87)                         | 610        | 414                        | 252      | (464)       | 725      |
| Loans charged off         | (814)                        | (400)      | (657)                      | (703)    | 0           | (2,574)  |
| Recoveries                | 82                           | 40         | 53                         | 479      | 0           | 654      |
| Ending balance            | \$ 4,061                     | \$ 1,779   | \$ 1,612                   | \$ 1,000 | \$ 173      | \$ 8,625 |

**Three Months Ended September 30, 2011**

| (In Thousands of Dollars) | Commercial<br>Real<br>Estate | Commercial | Residential<br>Real Estate | Consumer | Unallocated | Total     |
|---------------------------|------------------------------|------------|----------------------------|----------|-------------|-----------|
| Allowance for loan losses |                              |            |                            |          |             |           |
| Beginning balance         | \$ 6,053                     | \$ 1,886   | \$ 1,542                   | \$ 1,123 | \$ 272      | \$ 10,876 |
| Provision for loan losses | 13                           | 79         | 263                        | 38       | 307         | 700       |
| Loans charged off         | (296)                        | (32)       | (190)                      | (312)    | 0           | (830)     |
| Recoveries                | 3                            | 2          | 7                          | 226      | 0           | 238       |
| Ending balance            | \$ 5,773                     | \$ 1,935   | \$ 1,622                   | \$ 1,075 | \$ 579      | \$ 10,984 |

**Nine Months Ended September 30, 2011**

| (In Thousands of Dollars) | Commercial<br>Real<br>Estate | Commercial | Residential<br>Real Estate | Consumer | Unallocated | Total     |
|---------------------------|------------------------------|------------|----------------------------|----------|-------------|-----------|
| Allowance for loan losses |                              |            |                            |          |             |           |
| Beginning balance         | \$ 5,780                     | \$ 1,707   | \$ 881                     | \$ 875   | \$ 64       | \$ 9,307  |
| Provision for loan losses | 918                          | 413        | 1,417                      | 387      | 515         | 3,650     |
| Loans charged off         | (936)                        | (221)      | (1,086)                    | (881)    | 0           | (3,124)   |
| Recoveries                | 11                           | 36         | 410                        | 694      | 0           | 1,151     |
| Ending balance            | \$ 5,773                     | \$ 1,935   | \$ 1,622                   | \$ 1,075 | \$ 579      | \$ 10,984 |

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 September 30, 2012 and December 31, 2011. 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:

**September 30, 2012**

| (In Thousands of Dollars)                       | Commercial<br>Real Estate | Commercial | Residential<br>Real Estate | Consumer | Unallocated | Total |
|---|---------------------------|------------|----------------------------|----------|-------------|-------|
| <u>Allowance for loan losses:</u>               |                           |            |                            |          |             |       |
| Ending allowance balance attributable to loans: |                           |            |                            |          |             |       |

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|                                       |                 |                 |                 |                 |               |                 |
|---------------------------------------|-----------------|-----------------|-----------------|-----------------|---------------|-----------------|
| Individually evaluated for impairment | \$ 372          | \$ 264          | \$ 0            | \$ 0            | \$ 0          | \$ 636          |
| Collectively evaluated for impairment | 3,689           | 1,515           | 1,612           | 1,000           | 173           | 7,989           |
| <b>Total ending allowance balance</b> | <b>\$ 4,061</b> | <b>\$ 1,779</b> | <b>\$ 1,612</b> | <b>\$ 1,000</b> | <b>\$ 173</b> | <b>\$ 8,625</b> |

Loans:

|   |                   |                  |                   |                   |             |                   |
|---|-------------------|------------------|-------------------|-------------------|-------------|-------------------|
| Loans individually evaluated for impairment | \$ 8,708          | \$ 2,136         | \$ 860            | \$ 0              | \$ 0        | \$ 11,704         |
| Loans collectively evaluated for impairment | 189,417           | 81,659           | 158,576           | 131,547           | 0           | 561,199           |
| <b>Total ending loans balance</b>           | <b>\$ 198,125</b> | <b>\$ 83,795</b> | <b>\$ 159,436</b> | <b>\$ 131,547</b> | <b>\$ 0</b> | <b>\$ 572,903</b> |

**December 31, 2011**

| (In Thousands of Dollars)                       | Commercial<br>Real Estate | Commercial      | Residential<br>Real Estate | Consumer      | Unallocated   | Total           |
|---|---------------------------|-----------------|----------------------------|---------------|---------------|-----------------|
| <u>Allowance for loan losses:</u>               |                           |                 |                            |               |               |                 |
| Ending allowance balance attributable to loans: |                           |                 |                            |               |               |                 |
| Individually evaluated for impairment           | \$ 748                    | \$ 237          | \$ 0                       | \$ 0          | \$ 0          | \$ 985          |
| Collectively evaluated for impairment           | 4,132                     | 1,292           | 1,802                      | 972           | 637           | 8,835           |
| <b>Total ending allowance balance</b>           | <b>\$ 4,880</b>           | <b>\$ 1,529</b> | <b>\$ 1,802</b>            | <b>\$ 972</b> | <b>\$ 637</b> | <b>\$ 9,820</b> |

Loans:

|   |                   |                  |                   |                   |             |                   |
|---|-------------------|------------------|-------------------|-------------------|-------------|-------------------|
| Loans individually evaluated for impairment | \$ 8,317          | \$ 1,341         | \$ 697            | \$ 0              | \$ 0        | \$ 10,355         |
| Loans collectively evaluated for impairment | 189,724           | 73,534           | 166,334           | 131,859           | 0           | 561,451           |
| <b>Total ending loans balance</b>           | <b>\$ 198,041</b> | <b>\$ 74,875</b> | <b>\$ 167,031</b> | <b>\$ 131,859</b> | <b>\$ 0</b> | <b>\$ 571,806</b> |

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The following tables present information related to impaired loans by class of loans as of September 30, 2012 and December 31, 2011:

| (In Thousands of Dollars)           | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance for<br>Loan Losses<br>Allocated |
|-------------------------------------|--------------------------------|------------------------|---|
| <b>September 30, 2012</b>           |                                |                        |   |
| With no related allowance recorded: |                                |                        |   |
| Commercial real estate              |                                |                        |   |
| Owner occupied                      | \$ 2,630                       | \$ 1,901               | \$ 0                                      |
| Non-owner occupied                  | 183                            | 91                     | 0   |
| Commercial                          | 1,119                          | 1,069                  | 0   |
| Residential real estate             |                                |                        |   |
| 1-4 family residential              | 857                            | 860                    | 0   |
| <b>Subtotal</b>                     | <b>4,789</b>                   | <b>3,921</b>           | <b>0</b>                                  |
| With an allowance recorded:         |                                |                        |   |
| Commercial real estate              |                                |                        |   |
| Owner occupied                      | 3,948                          | 3,881                  | 214                                       |
| Non-owner occupied                  | 3,049                          | 2,835                  | 158                                       |
| Commercial                          | 1,067                          | 1,067                  | 264                                       |
| <b>Subtotal</b>                     | <b>8,064</b>                   | <b>7,783</b>           | <b>636</b>                                |
| <b>Total</b>                        | <b>\$ 12,853</b>               | <b>\$ 11,704</b>       | <b>\$ 636</b>                             |

| (In Thousands of Dollars)           | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance for<br>Loan Losses<br>Allocated |
|-------------------------------------|--------------------------------|------------------------|---|
| <b>December 31, 2011</b>            |                                |                        |   |
| With no related allowance recorded: |                                |                        |   |
| Commercial real estate              |                                |                        |   |
| Owner occupied                      | \$ 884                         | \$ 762                 | \$ 0                                      |
| Non-owner occupied                  | 430                            | 340                    | 0   |
| Other                               | 800                            | 590                    | 0   |
| Commercial                          | 1,122                          | 1,063                  | 0   |
| Residential real estate             |                                |                        |   |
| 1-4 family residential              | 695                            | 697                    | 0   |
| <b>Subtotal</b>                     | <b>3,931</b>                   | <b>3,452</b>           | <b>0</b>                                  |
| With an allowance recorded:         |                                |                        |   |
| Commercial real estate              |                                |                        |   |
| Owner occupied                      | 4,653                          | 4,169                  | 309                                       |
| Non-owner occupied                  | 2,455                          | 2,456                  | 439                                       |
| Other                               | 0                              | 0                      | 0   |
| Commercial                          | 278                            | 278                    | 237                                       |
| <b>Subtotal</b>                     | <b>7,386</b>                   | <b>6,903</b>           | <b>985</b>                                |
| <b>Total</b>                        | <b>\$ 11,317</b>               | <b>\$ 10,355</b>       | <b>\$ 985</b>                             |



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The following table presents the average recorded investment in impaired loans by class for the three and nine month periods ended September 30, 2012 and 2011:

| (In Thousands of Dollars)                  | Average Recorded<br>Investment for Three Months<br>Ended September 30, |                 | Average Recorded<br>Investment for Nine Months<br>Ended September 30, |                  |
|--|--|-----------------|---|------------------|
|  | 2012   | 2011            | 2012  | 2011             |
| <b>With no related allowance recorded:</b> |  |                 |   |                  |
| <b>Commercial real estate</b>              |  |                 |   |                  |
| Owner occupied                             | \$ 1,558   | \$ 1,092        | \$ 974  | \$ 1,130         |
| Non-owner occupied                         | 219  | 387             | 458   | 477              |
| Other                                      | 0  | 765             | 152   | 796              |
| Commercial                                 | 934  | 615             | 960   | 652              |
| <b>Residential real estate</b>             |  |                 |   |                  |
| 1-4 family residential                     | 769  | 609             | 718   | 607              |
| <b>Subtotal</b>                            | <b>3,480</b>   | <b>3,468</b>    | <b>3,262</b>  | <b>3,662</b>     |
| <b>With an allowance recorded:</b>         |  |                 |   |                  |
| <b>Commercial real estate</b>              |  |                 |   |                  |
| Owner occupied                             | 4,241  | 2,837           | 4,391   | 2,960            |
| Non-owner occupied                         | 2,717  | 2,904           | 2,384   | 2,991            |
| Other                                      | 0  | 0               | 91  | 0                |
| Commercial                                 | 688  | 764             | 495   | 746              |
| <b>Subtotal</b>                            | <b>7,646</b>   | <b>6,505</b>    | <b>7,361</b>  | <b>6,697</b>     |
| <b>Total</b>                               | <b>\$ 11,126</b>   | <b>\$ 9,973</b> | <b>\$ 10,623</b>  | <b>\$ 10,359</b> |

Interest income recognized during impairment for the three and nine month 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 September 30, 2012 and December 31, 2011:

| (In Thousands of Dollars)      | September 30, 2012 |  | December 31, 2011 |  |
|--------------------------------|--------------------|--|-------------------|--|
|                                | Nonaccrual         | Loans Past<br>Due 90 Days<br>or More Still<br>Accruing | Nonaccrual        | Loans Past<br>Due 90 Days<br>or More Still<br>Accruing |
| <b>Commercial real estate</b>  |                    |  |                   |  |
| Owner occupied                 | \$ 3,151           | \$ 0   | \$ 2,640          | \$ 0   |
| Non-owner occupied             | 833                | 0  | 2,795             | 0  |
| Other                          | 0                  | 0  | 590               | 0  |
| Commercial                     | 1,602              | 0  | 527               | 0  |
| <b>Residential real estate</b> |                    |  |                   |  |
| 1-4 family residential         | 2,351              | 355  | 3,897             | 121  |
| Home equity lines of credit    | 284                | 95   | 299               | 0  |
| <b>Consumer</b>                |                    |  |                   |  |
| Indirect                       | 0                  | 13   | 12                | 114  |
| Direct                         | 0                  | 0  | 0                 | 13   |
| Other                          | 0                  | 2  | 0                 | 2  |
| <b>Total</b>                   | <b>\$ 8,221</b>    | <b>\$ 465</b>  | <b>\$ 10,760</b>  | <b>\$ 250</b>  |



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The following table presents the aging of the recorded investment in past due loans as of September 30, 2012 and December 31, 2011 by class of loans:

| (In Thousands of Dollars)   | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days<br>or<br>More Past<br>Due and<br>Nonaccrual | Total<br>Past Due | Loans Not<br>Past Due | Total      |
|-----------------------------|---------------------------|---------------------------|---|-------------------|-----------------------|------------|
| <b>September 30, 2012</b>   |                           |                           |   |                   |                       |            |
| Commercial real estate      |                           |                           |   |                   |                       |            |
| Owner occupied              | \$ 19                     | \$ 0                      | \$ 3,151  | \$ 3,170          | \$ 89,236             | \$ 92,406  |
| Non-owner occupied          | 0                         | 0                         | 833   | 833               | 83,469                | 84,302     |
| Other                       | 0                         | 0                         | 0   | 0                 | 21,417                | 21,417     |
| Commercial                  | 50                        | 44                        | 1,602   | 1,696             | 82,099                | 83,795     |
| Residential real estate     |                           |                           |   |                   |                       |            |
| 1-4 family residential      | 988                       | 116                       | 2,706   | 3,810             | 132,075               | 135,885    |
| Home equity lines of credit | 231                       | 0                         | 379   | 610               | 22,941                | 23,551     |
| Consumer                    |                           |                           |   |                   |                       |            |
| Indirect                    | 1,246                     | 294                       | 13  | 1,553             | 117,087               | 118,640    |
| Direct                      | 165                       | 28                        | 0   | 193               | 11,224                | 11,417     |
| Other                       | 21                        | 10                        | 2   | 33                | 1,457                 | 1,490      |
| Total                       | \$ 2,720                  | \$ 492                    | \$ 8,686  | \$ 11,898         | \$ 561,005            | \$ 572,903 |

| (In Thousands of Dollars)   | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days or<br>More Past<br>Due and<br>Nonaccrual | Total<br>Past Due | Loans Not<br>Past Due | Total      |
|-----------------------------|---------------------------|---------------------------|--|-------------------|-----------------------|------------|
| <b>December 31, 2011</b>    |                           |                           |  |                   |                       |            |
| Commercial real estate      |                           |                           |  |                   |                       |            |
| Owner occupied              | \$ 111                    | \$ 0                      | \$ 2,640   | \$ 2,751          | \$ 97,630             | \$ 100,381 |
| Non-owner occupied          | 13                        | 0                         | 2,795  | 2,808             | 77,515                | 80,323     |
| Other                       | 0                         | 0                         | 590  | 590               | 16,747                | 17,337     |
| Commercial                  | 26                        | 0                         | 527  | 553               | 74,322                | 74,875     |
| Residential real estate     |                           |                           |  |                   |                       |            |
| 1-4 family residential      | 973                       | 361                       | 4,018  | 5,352             | 139,736               | 145,088    |
| Home equity lines of credit | 128                       | 0                         | 299  | 427               | 21,516                | 21,943     |
| Consumer                    |                           |                           |  |                   |                       |            |
| Indirect                    | 1,458                     | 218                       | 126  | 1,802             | 116,941               | 118,743    |
| Direct                      | 120                       | 41                        | 13   | 174               | 11,422                | 11,596     |
| Other                       | 19                        | 3                         | 2  | 24                | 1,496                 | 1,520      |
| Total                       | \$ 2,848                  | \$ 623                    | \$ 11,010  | \$ 14,481         | \$ 557,325            | \$ 571,806 |

**Troubled Debt Restructurings:**

Total troubled debt restructurings were \$6.9 million and \$4.3 million at September 30, 2012 and December 31, 2011, respectively. The Company has allocated \$297 thousand and \$48 thousand of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2012 and December 31, 2011. There are no commitments to lend additional amounts to borrowers with loans that are classified as troubled debt restructurings at September 30, 2012 and December 31, 2011.

During the three and nine month periods ended September 30, 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 reduction of the notes stated interest rate in the range of 1% and 3.6% on loans with maturity periods ranging from 5 months to 41 months. One loan involved an extension of the maturity date by 5 years.

The following table presents loans by class modified as troubled debt restructurings that occurred during the nine month period ended September 30, 2012:

| (In Thousands of Dollars)           | Number<br>of Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|-------------------------------------|--------------------|--|--|
| <b>Troubled debt restructurings</b> |                    |  |  |
| Commercial real estate              |                    |  |  |
| Owner occupied                      | 3                  | \$ 1,143   | \$ 1,166   |
| Non-owner occupied                  | 3                  | 2,376  | 2,419  |
| Commercial                          | 1                  | 74   | 100  |
| Residential real estate             |                    |  |  |
| 1-4 family residential              | 4                  | 286  | 286  |
| <b>Total</b>                        | <b>11</b>          | <b>\$ 3,879</b>  | <b>\$ 3,971</b>  |

The troubled debt restructurings described above decreased the allowance for loan losses by \$161 thousand during the nine month period ended September 30, 2012. There were no charge offs as a result of the allowance adjustments.

There was one residential real estate loan modified as troubled debt restructurings for which there was a payment default within the previous twelve months, for the period ended September 30, 2012. The loan was not past due at September 30, 2012. There was no additional provision or any impact to the allowance for losses associated with these loans. 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 September 30, 2012 and December 31, 2011, 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>September 30, 2012</b> |                   |                    |                  |             |             |                   |
| Commercial real estate    |                   |                    |                  |             |             |                   |
| Owner occupied            | \$ 76,749         | \$ 4,352           | \$ 11,305        | \$ 0        | \$ 0        | \$ 92,406         |
| Non-owner occupied        | 73,465            | 6,102              | 4,735            | 0           | 0           | 84,302            |
| Other                     | 19,177            | 1,868              | 372              | 0           | 0           | 21,417            |
| Commercial                | 74,342            | 4,676              | 4,777            | 0           | 0           | 83,795            |
| <b>Total</b>              | <b>\$ 243,733</b> | <b>\$ 16,998</b>   | <b>\$ 21,189</b> | <b>\$ 0</b> | <b>\$ 0</b> | <b>\$ 281,920</b> |

| (In Thousands of Dollars) | Pass              | Special<br>Mention | Sub-<br>standard | Doubtful      | Not Rated   | Total             |
|---------------------------|-------------------|--------------------|------------------|---------------|-------------|-------------------|
| <b>December 31, 2011</b>  |                   |                    |                  |               |             |                   |
| Commercial real estate    |                   |                    |                  |               |             |                   |
| Owner occupied            | \$ 80,770         | \$ 6,359           | \$ 13,201        | \$ 51         | \$ 0        | \$ 100,381        |
| Non-owner occupied        | 68,806            | 2,575              | 8,942            | 0             | 0           | 80,323            |
| Other                     | 14,491            | 301                | 2,545            | 0             | 0           | 17,337            |
| Commercial                | 65,198            | 5,963              | 3,454            | 260           | 0           | 74,875            |
| <b>Total</b>              | <b>\$ 229,265</b> | <b>\$ 15,198</b>   | <b>\$ 28,142</b> | <b>\$ 311</b> | <b>\$ 0</b> | <b>\$ 272,916</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 September 30, 2012 and December 31, 2011. 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>Home |                           |                   | Consumer         |                 |
|---------------------------|---------------------------------|---------------------------|-------------------|------------------|-----------------|
|                           | 1-4 Family<br>Residential       | Equity Lines<br>of Credit | Indirect          | Direct           | Other           |
| <b>September 30, 2012</b> |                                 |                           |                   |                  |                 |
| Performing                | \$ 133,179                      | \$ 23,172                 | \$ 118,627        | \$ 11,417        | \$ 1,488        |
| Nonperforming             | 2,706                           | 379                       | 13                | 0                | 2               |
| <b>Total</b>              | <b>\$ 135,885</b>               | <b>\$ 23,551</b>          | <b>\$ 118,640</b> | <b>\$ 11,417</b> | <b>\$ 1,490</b> |

| (In Thousands of Dollars) | Residential Real Estate<br>Home |                           |          | Consumer |       |
|---------------------------|---------------------------------|---------------------------|----------|----------|-------|
|                           | 1-4 Family<br>Residential       | Equity Lines<br>of Credit | Indirect | Direct   | Other |

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**December 31, 2011**

|               |            |           |            |           |          |
|---------------|------------|-----------|------------|-----------|----------|
| Performing    | \$ 141,070 | \$ 21,644 | \$ 118,617 | \$ 11,583 | \$ 1,518 |
| Nonperforming | 4,018      | 299       | 126        | 13        | 2        |
| Total         | \$ 145,088 | \$ 21,943 | \$ 118,743 | \$ 11,596 | \$ 1,520 |

**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>September 30, |            | Nine Months Ended<br>September 30, |            |
|--|-------------------------------------|------------|------------------------------------|------------|
|  | 2012                                | 2011       | 2012                               | 2011       |
| <b>Basic EPS computation</b>   |                                     |            |                                    |            |
| Numerator Net income   | \$ 2,489                            | \$ 2,371   | \$ 7,295                           | \$ 6,178   |
| Denominator Weighted average shares outstanding                              | 18,802,269                          | 18,700,771 | 18,789,449                         | 18,116,985 |
| <b>Basic earnings per share</b>  | \$ .13                              | \$ .13     | \$ .39                             | \$ .34     |
| <b>Diluted EPS computation</b>   |                                     |            |                                    |            |
| Numerator Net income   | \$ 2,489                            | \$ 2,371   | \$ 7,295                           | \$ 6,178   |
| Denominator Weighted average shares outstanding for basic earnings per share | 18,802,269                          | 18,700,771 | 18,789,449                         | 18,116,985 |
| Effect of Stock Options  | 0                                   | 0          | 0                                  | 0          |
| Weighted averages shares for diluted earnings per share                      | 18,802,269                          | 18,700,771 | 18,789,449                         | 18,116,985 |
| <b>Diluted earnings per share</b>  | \$ .13                              | \$ .13     | \$ .39                             | \$ .34     |

Stock options for 5,000 and 28,500 shares were not considered in the computing of diluted earnings per share for the three and nine months ended September 30, 2012 and 2011, respectively, because they were antidilutive.

**Stock Based Compensation:**

The Company's Stock Option Plan (the Plan), permitted the grant of share options to its directors, officers and employees. Under the terms of the Plan no additional shares can be issued. Option awards were granted with an exercise price equal to the market price of the Company's common shares at the date of grant, with a vesting period of 5 years and have 10-year contractual terms. At September 30, 2012 there were 5,000 outstanding options of which 4,000 were fully vested and exercisable.

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 and nine month periods ended September 30, 2012 was not material. No related income tax benefit was recorded.

The Company's 2012 Equity Incentive Plan, as adopted by the Board of Directors and approved by shareholders on April 26, 2012 (Equity Plan), authorizes the issuance of up to 500,000 shares in awards of restricted stock, stock units and other share-based awards. At September 30, 2012, no shares were awarded under the Equity Plan.

## 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:

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. Finally, 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 September 30, 2012 the fair value of Level 3 investment securities was immaterial.

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.

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:

| (In Thousands of Dollars)                            | Carrying Value    | Fair Value Measurements at September 30, 2012 Using:           |   |   |
|--|-------------------|--|---|---|
|  |                   | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets</b>                              |                   |  |   |   |
| Investment securities available-for sale             |                   |  |   |   |
| U.S. Treasury and U.S. government sponsored entities | \$ 72,280         | \$ 0   | \$ 72,280                                     | \$ 0                                      |
| State and political subdivisions                     | 83,991            | 0  | 83,991  | 0   |
| Corporate bonds                                      | 1,249             | 0  | 1,249   | 0   |
| Mortgage-backed securities-residential               | 254,159           | 0  | 254,148                                       | 11  |
| Collateralized mortgage obligations                  | 17,713            | 0  | 17,713  | 0   |
| Small business administration                        | 180               | 0  | 180   | 0   |
| Equity securities                                    | 273               | 273  | 0   | 0   |
| <b>Total investment securities</b>                   | <b>\$ 429,845</b> | <b>\$ 273</b>  | <b>\$ 429,561</b>                             | <b>\$ 11</b>                              |

| (In Thousands of Dollars)                            | Carrying Value    | Fair Value Measurements at December 31, 2011 Using:            |   |   |
|--|-------------------|--|---|---|
|  |                   | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets</b>                              |                   |  |   |   |
| Investment securities available-for sale             |                   |  |   |   |
| U.S. Treasury and U.S. government sponsored entities | \$ 55,988         | \$ 0   | \$ 55,988                                     | \$ 0                                      |
| State and political subdivisions                     | 82,690            | 0  | 82,690  | 0   |
| Corporate bonds                                      | 769               | 0  | 769   | 0   |
| Mortgage-backed securities-residential               | 222,718           | 0  | 222,706                                       | 12  |
| Collateralized mortgage obligations                  | 37,222            | 0  | 37,222  | 0   |
| Small business administration                        | 315               | 0  | 315   | 0   |
| Equity securities                                    | 327               | 327  | 0   | 0   |
| <b>Total investment securities</b>                   | <b>\$ 400,029</b> | <b>\$ 327</b>  | <b>\$ 399,690</b>                             | <b>\$ 12</b>                              |

There were no significant transfers between Level 1 and Level 2 during the three and nine month periods ended September 30, 2012 and 2011.

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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               |       |                                    |       |
|--|-------------------------------------|-------|------------------------------------|-------|
|  | Available-for-sale<br>(Level 3)     |       |                                    |       |
|  | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |       |
|  | 2012                                | 2011  | 2012                               | 2011  |
| Beginning balance                              | \$ 11                               | \$ 12 | \$ 12                              | \$ 12 |
| Total unrealized gains or losses:              |                                     |       |                                    |       |
| Included in other comprehensive income or loss | 0                                   | 0     | 0                                  | 0     |
| Repayments                                     | 0                                   | 0     | (1)                                | 0     |
| Transfer in and/or out of Level 3              | 0                                   | 0     | 0                                  | 0     |
| Ending balance                                 | \$ 11                               | \$ 12 | \$ 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 September 30, 2012 Using:                    |  |  |
|---------------------------|----------------|--|--|--|
|                           |                | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial assets:         |                |  |  |  |
| Impaired loans            |                |  |  |  |
| Commercial real estate    |                |  |  |  |
| Owner occupied            | \$ 1,957       | \$ 0   | \$ 0   | \$ 1,957   |
| Non-owner occupied        | 728            | 0  | 0  | 728  |
| Other                     | 0              | 0  | 0  | 0  |
| Commercial                | 937            | 0  | 0  | 937  |
| Other real estate owned   |                |  |  |  |
| Commercial real estate    | 0              | 0  | 0  | 0  |
| 1-4 family residential    | 57             | 0  | 0  | 57   |

| (In Thousands of Dollars) | Carrying Value | Fair Value Measurements<br>at December 31, 2011 Using:                     |  |  |
|---------------------------|----------------|--|--|--|
|                           |                | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial assets:         |                |  |  |  |
| Impaired loans            |                |  |  |  |
| Commercial real estate    |                |  |  |  |
| Owner occupied            | \$ 1,606       | \$ 0   | \$ 0   | \$ 1,606   |
| Non-owner occupied        | 2,017          | 0  | 0  | 2,017  |
| Other                     | 0              | 0  | 0  | 0  |
| Commercial                | 41             | 0  | 0  | 41   |
| Other real estate owned   |                |  |  |  |

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|                        |     |   |   |     |
|------------------------|-----|---|---|-----|
| Commercial real estate | 270 | 0 | 0 | 270 |
| 1-4 family residential | 76  | 0 | 0 | 76  |

Impaired loans that are measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal balance of \$3.0 million with a valuation allowance of \$340 thousand at September 30, 2012, resulting in an additional provision for loan losses of \$246 thousand and \$665 thousand for the three and nine month periods ended September 30, 2012. At December 31, 2011, impaired loans had a principal balance of \$4.6 million, with a valuation allowance of \$936 thousand. The additional provision for loan losses was \$745 thousand for the three months ended September 30, 2011 and \$1.1 million for the nine months ended September 30, 2011, for loans carried at fair value. Excluded from the fair value of impaired loans, at September 30, 2012 and December 31, 2011, discussed above are \$4.4 million and \$2.3 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 September 30, 2012:

| (In Thousands of Dollars) | Fair value | Valuation Technique(s) | Unobservable Input(s)                               | Range(Weighted Average) |
|---------------------------|------------|------------------------|---|-------------------------|
| <b>Impaired loans</b>     |            |                        |   |                         |
| Commercial real estate    | \$ 2,074   | Sales comparison       | Adjustment for differences between comparable sales | -44.2% - 70.0% (-9.6%)  |
|                           | 611        | Income approach        | Adjustment for differences in net operating income  | -28.4% - 19.4% (-5.5%)  |
| Commercial                | 937        | Sales comparison       | Adjustment for differences between comparable sales | -17.3% - 15.1% (11.4%)  |

Other real estate owned measured at fair value less costs to sell, had a net carrying amount of \$57 thousand at September 30, 2012. The Company sold thirteen other real estate owned properties during the nine month period ended September 30, 2012. The Company recorded \$73 thousand in write downs on four other real estate owned properties during the nine month period ended September 30, 2012. At December 31, 2011, other real estate owned had a net carrying amount of \$346 thousand. During the year ended December 31, 2011 five properties were charged down reflecting updated appraisals which resulted in a write-down of \$115 thousand.

The carrying amounts and estimated fair values of financial instruments, at September 30, 2012 and December 31, 2011 are as follows:

| (In Thousands of Dollars)     | Carrying Amount | Fair Value Measurements at September 30, 2012 Using: |           |         |           |
|-------------------------------|-----------------|--|-----------|---------|-----------|
|                               |                 | Level 1  | Level 2   | Level 3 | Total     |
| <b>Financial assets</b>       |                 |  |           |         |           |
| Cash and cash equivalents     | \$ 79,494       | \$ 15,927  | \$ 63,567 | \$ 0    | \$ 79,494 |
| Securities available-for-sale | 429,845         | 273  | 429,561   | 11      | 429,845   |
| Restricted stock              | 4,224           | n/a  | n/a       | n/a     | n/a       |
| Loans held for sale           | 4,574           | 0  | 4,660     | 0       | 4,660     |
| Loans, net                    | 564,278         | 0  | 0         | 576,637 | 576,637   |
| Accrued interest receivable   | 3,886           | 0  | 1,296     | 2,590   | 3,886     |
| <b>Financial liabilities</b>  |                 |  |           |         |           |
| Deposits                      | 900,138         | 659,599  | 241,910   | 0       | 901,509   |
| Short-term borrowings         | 96,870          | 0  | 96,870    | 0       | 96,870    |
| Long-term borrowings          | 10,488          | 0  | 11,859    | 0       | 11,859    |
| Accrued interest payable      | 553             | 7  | 546       | 0       | 553       |





| (In Thousands of Dollars)     | Carrying Amount | Fair Value |
|-------------------------------|-----------------|------------|
| <b>December 31, 2011</b>      |                 |            |
| Financial assets              |                 |            |
| Cash and cash equivalents     | \$ 52,422       | \$ 52,422  |
| Securities available-for-sale | 400,029         | 400,029    |
| Restricted stock              | 4,224           | n/a        |
| Loans held for sale           | 677             | 677        |
| Loans, net                    | 561,986         | 574,391    |
| Accrued interest receivable   | 3,794           | 3,794      |
| Financial liabilities         |                 |            |
| Deposits                      | 840,125         | 846,412    |
| Short-term borrowings         | 98,088          | 98,088     |
| Long-term borrowings          | 11,263          | 12,719     |
| Accrued interest payable      | 585             | 585        |

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.

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*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 Segment    | Bank Segment        | Eliminations and Others | Consolidated Totals |
|---|------------------|---------------------|-------------------------|---------------------|
| <b>September 30, 2012</b>                         |                  |                     |                         |                     |
| <b>Assets</b>                                     |                  |                     |                         |                     |
| Cash and cash equivalents                         | \$ 1,598         | \$ 77,994           | \$ (98)                 | \$ 79,494           |
| Securities available for sale                     | 3,816            | 425,862             | 167                     | 429,845             |
| Loans held for sale                               | 0                | 4,574               | 0                       | 4,574               |
| Net loans   | 0                | 564,278             | 0                       | 564,278             |
| Premises and equipment, net                       | 104              | 18,112              | 0                       | 18,216              |
| Goodwill and other intangibles                    | 6,134            | 0                   | 0                       | 6,134               |
| Other assets                                      | 496              | 29,321              | 388                     | 30,205              |
| <b>Total Assets</b>                               | <b>\$ 12,148</b> | <b>\$ 1,120,141</b> | <b>\$ 457</b>           | <b>\$ 1,132,746</b> |
| <b>Liabilities and Stockholders' Equity</b>       |                  |                     |                         |                     |
| Deposits, borrowings and other liabilities        | \$ 591           | \$ 1,015,325        | \$ (4,178)              | \$ 1,011,738        |
| Stockholders' equity                              | 11,557           | 104,816             | 4,635                   | 121,008             |
| <b>Total Liabilities and Stockholders' Equity</b> | <b>\$ 12,148</b> | <b>\$ 1,120,141</b> | <b>\$ 457</b>           | <b>\$ 1,132,746</b> |

| (In Thousands of Dollars)                   | Trust Segment    | Bank Segment        | Eliminations and Others | Consolidated Totals |
|---|------------------|---------------------|-------------------------|---------------------|
| <b>December 31, 2011</b>                    |                  |                     |                         |                     |
| <b>Assets</b>                               |                  |                     |                         |                     |
| Cash and cash equivalents                   | \$ 2,208         | \$ 50,327           | \$ (113)                | \$ 52,422           |
| Securities available for sale               | 2,388            | 397,513             | 128                     | 400,029             |
| Loans held for sale                         | 0                | 677                 | 0                       | 677                 |
| Net loans                                   | 0                | 561,986             | 0                       | 561,986             |
| Premises and equipment, net                 | 101              | 16,360              | 0                       | 16,461              |
| Goodwill and other intangibles              | 6,441            | 0                   | 0                       | 6,441               |
| Other assets                                | 463              | 28,904              | 488                     | 29,855              |
| <b>Total Assets</b>                         | <b>\$ 11,601</b> | <b>\$ 1,055,767</b> | <b>\$ 503</b>           | <b>\$ 1,067,871</b> |
| <b>Liabilities and Stockholders' Equity</b> |                  |                     |                         |                     |
| Deposits, borrowings and other liabilities  | \$ 345           | \$ 957,780          | \$ (4,699)              | \$ 953,426          |

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|   |           |              |        |              |
|---|-----------|--------------|--------|--------------|
| Stockholders equity                       | 11,256    | 97,987       | 5,202  | 114,445      |
| Total Liabilities and Stockholders Equity | \$ 11,601 | \$ 1,055,767 | \$ 503 | \$ 1,067,871 |

| (In Thousands of Dollars)                                 | Trust Segment | Bank Segment | Eliminations and Others | Consolidated Totals |
|---|---------------|--------------|-------------------------|---------------------|
| <b>For the Three Months Ended September 30, 2012</b>      |               |              |                         |                     |
| Net interest income                                       | \$ 13         | \$ 9,091     | \$ (3)                  | \$ 9,101            |
| Provision for loan losses                                 | 0             | 325          | 0                       | 325                 |
| Service fees, security gains and other noninterest income | 1,347         | 2,025        | (73)                    | 3,299               |
| Noninterest expense                                       | 1,215         | 7,427        | 186                     | 8,828               |
| Income before taxes                                       | 145           | 3,364        | (262)                   | 3,247               |
| Income taxes  | 51            | 797          | (90)                    | 758                 |
| Net Income  | \$ 94         | \$ 2,567     | \$ (172)                | \$ 2,489            |

| (In Thousands of Dollars)                                 | Trust Segment | Bank Segment | Eliminations and Others | Consolidated Totals |
|---|---------------|--------------|-------------------------|---------------------|
| <b>For the Nine Months Ended September 30, 2012</b>       |               |              |                         |                     |
| Net interest income                                       | \$ 35         | \$ 27,624    | \$ (17)                 | \$ 27,642           |
| Provision for loan losses                                 | 0             | 725          | 0                       | 725                 |
| Service fees, security gains and other noninterest income | 4,166         | 4,996        | (210)                   | 8,952               |
| Noninterest expense                                       | 3,742         | 22,063       | 539                     | 26,344              |
| Income before taxes                                       | 459           | 9,832        | (766)                   | 9,525               |
| Income taxes  | 161           | 2,330        | (261)                   | 2,230               |
| Net Income  | \$ 298        | \$ 7,502     | \$ (505)                | \$ 7,295            |

| (In Thousands of Dollars)                                 | Trust Segment | Bank Segment | Eliminations and Others | Consolidated Totals |
|---|---------------|--------------|-------------------------|---------------------|
| <b>For the Three Months Ended September 30, 2011</b>      |               |              |                         |                     |
| Net interest income                                       | \$ 10         | \$ 9,237     | \$ (12)                 | \$ 9,235            |
| Provision for loan losses                                 | 0             | 700          | 0                       | 700                 |
| Service fees, security gains and other noninterest income | 1,379         | 1,379        | (62)                    | 2,696               |
| Noninterest expense                                       | 1,175         | 6,809        | 193                     | 8,177               |
| Income before taxes                                       | 214           | 3,107        | (267)                   | 3,054               |
| Income taxes  | 74            | 700          | (91)                    | 683                 |
| Net Income  | \$ 140        | \$ 2,407     | \$ (176)                | \$ 2,371            |

| (In Thousands of Dollars)                                 | Trust Segment | Bank Segment | Eliminations and Others | Consolidated Totals |
|---|---------------|--------------|-------------------------|---------------------|
| <b>For the Nine Months Ended September 30, 2011</b>       |               |              |                         |                     |
| Net interest income                                       | \$ 32         | \$ 27,480    | \$ (37)                 | \$ 27,475           |
| Provision for loan losses                                 | 0             | 3,650        | 0                       | 3,650               |
| Service fees, security gains and other noninterest income | 4,106         | 4,040        | (139)                   | 8,007               |

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|                     |        |          |          |          |
|---------------------|--------|----------|----------|----------|
| Noninterest expense | 3,524  | 20,064   | 495      | 24,083   |
| Income before taxes | 614    | 7,806    | (671)    | 7,749    |
| Income taxes        | 211    | 1,588    | (228)    | 1,571    |
| Net Income          | \$ 403 | \$ 6,218 | \$ (443) | \$ 6,178 |

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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, 2011.

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 September 30, 2012 was \$2.5 million, compared to \$2.4 million for the same three month period in 2011. On a per share basis, net income for the third quarter ended September 30, 2012 was \$0.13 per diluted share, compared to \$0.13 for the third quarter ended September 30, 2011. Net income for the nine months ended September 30, 2012 was \$7.3 million, compared to \$6.2 million for the same nine month period in 2011. On a per share basis, net income for the nine months ended September 30, 2012 was \$0.39, an increase of 14.7% compared to the same nine month period in 2011. The tangible common equity ratio increased to 10.20% at September 30, 2012, compared to 9.94% at September 30, 2011, mainly as a result of retained net income. Farmers' total assets reported at September 30, 2012 were \$1.13 billion, representing a 6.1% increase compared to \$1.07 billion in total assets recorded at December 31, 2011.





Net income increased to \$2.5 million for the three months ended September 30, 2012, which represents a 5% increase over the \$2.4 million reported for the same period in 2011. Noninterest income increased 22.4% during the same three month period compared to prior year, which is consistent with the strategy to diversify revenue. Asset quality continues to improve, evidenced by the reduction in the provision for loan losses from \$700 thousand for the three month period ended September 30, 2011 to \$325 thousand for the three months ended September 30, 2012. Non-performing loans declined from \$10.9 million at September 30, 2011 to \$8.7 million at September 30, 2012.

Net loans increased \$2.3 million in comparing the September 30, 2012 balance to the December 31, 2011. Most of the loan growth in the nine month period has occurred in the commercial and industrial loan portfolio. Net loans were reported at \$564.3 million at September 30, 2012, which compares to \$562.0 million at December 31, 2011. Deposits increased \$60.0 million from \$840.1 million at December 31, 2011 to \$900.1 million at September 30, 2012, as customers continue to seek the safety and security of FDIC insured deposit accounts. The Company's deposits are also being affected positively by the recent development of the Marcellus and Utica shale activity within the local region. At September 30, 2012, the Company had deposits totaling approximately \$50.3 million that customers have received from energy exploration companies from the leasing or sale of mineral rights.

Stockholders' equity totaled \$121.0 million, or 10.7% of total assets, at September 30, 2012, an increase of \$6.6 million, or 5.7%, compared to \$114.4 million at December 31, 2011. The increase is mainly the result of net income, offset by cash dividends paid to shareholders during the period. Shareholders received a total of \$0.15 per share in cash dividends paid in the past four quarters, including a special \$0.03 cash dividend on February 28, 2012. Book value per share increased 5.6% from \$6.10 per share at December 31, 2011 to \$6.44 per share at September 30, 2012. Farmers' tangible book value per share also increased 6.1% from \$5.76 per share at December 31, 2011 to \$6.11 per share at September 30, 2012.

## Results of Operations

The following is a comparison of selected financial ratios and other results at or for the three and nine months ended September 30, 2012 and 2011:

| (In Thousands, except Per Share Data)   | At or for the Three Months<br>Ended September 30, |              | At or for the Nine Months<br>Ended September 30, |              |
|---|---|--------------|--|--------------|
|   | 2012  | 2011         | 2012   | 2011         |
| Total Assets                            | \$ 1,132,746                                      | \$ 1,086,405 | \$ 1,132,746                                     | \$ 1,086,405 |
| Net Income                              | \$ 2,489  | \$ 2,371     | \$ 7,295   | \$ 6,178     |
| Basic and Diluted Earnings Per Share    | \$ .13  | \$ .13       | \$ .39   | \$ .34       |
| Return on Average Assets (Annualized)   | .88%  | .90%         | .88%   | .81%         |
| Return on Average Equity (Annualized)   | 8.22%   | 8.56%        | 8.28%  | 8.01%        |
| Efficiency Ratio (tax equivalent basis) | 70.07%  | 64.64%       | 69.01%   | 63.89%       |
| Equity to Asset Ratio                   | 10.68%  | 10.48%       | 10.68%   | 10.48%       |
| Tangible Common Equity Ratio *          | 10.20%  | 9.94%        | 10.20%   | 9.94%        |
| Dividends to Net Income                 | 22.66%  | 23.66%       | 30.90%   | 27.21%       |
| Net Loans to Assets                     | 49.82%  | 51.27%       | 49.82%   | 51.27%       |
| Loans to Deposits                       | 63.65%  | 70.45%       | 63.65%   | 70.45%       |

\* 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 September 30, 2012 and 2011, 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)  | September 30,<br>2012 | September 30,<br>2011 |
|--|-----------------------|-----------------------|
| <b>Reconciliation of Common Stockholders' Equity to Tangible Common Equity</b> |                       |                       |
| Stockholders' Equity   | \$ 121,008            | \$ 113,858            |
| Less Goodwill and other intangibles  | 6,134                 | 6,553                 |
| <br>Tangible Common Equity   | <br>\$ 114,874        | <br>\$ 107,305        |
| <br><b>Reconciliation of Total Assets to Tangible Assets</b>                   |                       |                       |
| Total Assets   | \$ 1,132,746          | \$ 1,086,405          |
| Less Goodwill and other intangibles  | 6,134                 | 6,553                 |
| <br>Tangible Assets  | <br>\$ 1,126,612      | <br>\$ 1,079,852      |

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>September 30, 2012 |                 |              | Three Months Ended<br>September 30, 2011 |                 |              |
|--|--|-----------------|--------------|--|-----------------|--------------|
|  | AVERAGE<br>BALANCE                       | INTEREST        | RATE (1)     | AVERAGE<br>BALANCE                       | INTEREST        | RATE (1)     |
| <b>EARNING ASSETS</b>  |  |                 |              |  |                 |              |
| Loans (3) (5) (6)  | \$ 566,382                               | \$ 8,067        | 5.67%        | \$ 557,084                               | \$ 8,386        | 5.97%        |
| Taxable securities (4)   | 333,909                                  | 1,901           | 2.26         | 279,609                                  | 2,121           | 3.01         |
| Tax-exempt securities (4) (6)                                  | 73,452                                   | 1,074           | 5.82         | 75,396                                   | 1,103           | 5.80         |
| Equity securities (2) (6)                                      | 4,363                                    | 50              | 4.56         | 4,373                                    | 48              | 4.35         |
| Federal funds sold and other                                   | 61,084                                   | 29              | 0.19         | 53,066                                   | 21              | 0.16         |
| <b>Total earning assets</b>                                    | <b>1,039,190</b>                         | <b>11,121</b>   | <b>4.26</b>  | <b>969,528</b>                           | <b>11,679</b>   | <b>4.78</b>  |
| <b>NONEARNING ASSETS</b>                                       |  |                 |              |  |                 |              |
| Cash and due from banks  | 22,185                                   |                 |              | 16,755                                   |                 |              |
| Premises and equipment   | 18,044                                   |                 |              | 14,709                                   |                 |              |
| Allowance for loan losses                                      | (8,945)                                  |                 |              | (10,987)                                 |                 |              |
| Unrealized gains (losses) on securities                        | 14,680                                   |                 |              | 11,105                                   |                 |              |
| Other assets (3)   | 45,081                                   |                 |              | 42,582                                   |                 |              |
| <b>Total assets</b>  | <b>\$ 1,130,235</b>                      |                 |              | <b>\$ 1,043,692</b>                      |                 |              |
| <b>INTEREST-BEARING LIABILITIES</b>                            |  |                 |              |  |                 |              |
| Time deposits  | \$ 242,025                               | \$ 1,171        | 1.92%        | \$ 250,505                               | \$ 1,266        | 2.01%        |
| Savings deposits   | 422,899                                  | 229             | 0.22         | 343,981                                  | 377             | 0.43         |
| Demand deposits  | 117,045                                  | 9               | 0.03         | 108,528                                  | 17              | 0.06         |
| Short term borrowings  | 95,681                                   | 22              | 0.09         | 116,501                                  | 75              | 0.26         |
| Long term borrowings   | 10,532                                   | 98              | 3.70         | 23,412                                   | 248             | 4.20         |
| <b>Total interest-bearing liabilities</b>                      | <b>888,182</b>                           | <b>1,529</b>    | <b>0.68</b>  | <b>842,927</b>                           | <b>1,983</b>    | <b>0.93</b>  |
| <b>NONINTEREST-BEARING LIABILITIES AND STOCKHOLDERS EQUITY</b> |  |                 |              |  |                 |              |
| Demand deposits  | 117,096                                  |                 |              | 87,380                                   |                 |              |
| Other liabilities  | 4,497                                    |                 |              | 3,496                                    |                 |              |
| Stockholders equity  | 120,460                                  |                 |              | 109,889                                  |                 |              |
| <b>Total liabilities and stockholders equity</b>               | <b>\$ 1,130,235</b>                      |                 |              | <b>\$ 1,043,692</b>                      |                 |              |
| <b>Net interest income and interest rate spread</b>            |  | <b>\$ 9,592</b> | <b>3.58%</b> |  | <b>\$ 9,696</b> | <b>3.85%</b> |
| <b>Net interest margin</b>                                     |  |                 | <b>3.67%</b> |  |                 | <b>3.97%</b> |

(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 \$562 thousand and \$440 thousand for 2012 and 2011 respectively and is reduced by amortization of \$483 thousand and \$455 thousand for 2012 and 2011 respectively.

(6)

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For 2012, adjustments of \$122 thousand and \$369 thousand respectively are made to tax equate income on tax exempt loans and tax exempt securities. For 2011, adjustments of \$83 thousand and \$378 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.

## Average Balance Sheets and Related Yields and Rates

(Dollar Amounts in Thousands)

|  | Nine Months Ended<br>September 30, 2012 |                  |              | Nine Months Ended<br>September 30, 2011 |                  |              |
|--|---|------------------|--------------|---|------------------|--------------|
|  | AVERAGE<br>BALANCE                      | INTEREST         | RATE (1)     | AVERAGE<br>BALANCE                      | INTEREST         | RATE (1)     |
| <b>EARNING ASSETS</b>  |   |                  |              |   |                  |              |
| Loans (3) (5) (6)  | \$ 563,642                              | \$ 24,195        | 5.73%        | \$ 564,066                              | \$ 25,384        | 6.02%        |
| Taxable securities (4)   | 325,958                                 | 6,135            | 2.51         | 256,755                                 | 6,038            | 3.14         |
| Tax-exempt securities (4) (6)                                  | 73,612                                  | 3,232            | 5.86         | 76,166                                  | 3,338            | 5.86         |
| Equity securities (2) (6)                                      | 4,363                                   | 152              | 4.65         | 4,282                                   | 147              | 4.59         |
| Federal funds sold and other                                   | 54,293                                  | 80               | 0.20         | 46,257                                  | 40               | 0.12         |
| <b>Total earning assets</b>                                    | <b>1,021,868</b>                        | <b>33,794</b>    | <b>4.42</b>  | <b>947,526</b>                          | <b>34,947</b>    | <b>4.93</b>  |
| <b>NONEARNING ASSETS</b>                                       |   |                  |              |   |                  |              |
| Cash and due from banks  | 21,376                                  |                  |              | 20,578                                  |                  |              |
| Premises and equipment   | 17,417                                  |                  |              | 14,133                                  |                  |              |
| Allowance for loan losses                                      | (9,289)                                 |                  |              | (10,375)                                |                  |              |
| Unrealized gains (losses) on securities                        | 13,663                                  |                  |              | 6,958                                   |                  |              |
| Other assets (3)   | 44,891                                  |                  |              | 42,621                                  |                  |              |
| <b>Total assets</b>  | <b>\$ 1,109,926</b>                     |                  |              | <b>\$ 1,021,441</b>                     |                  |              |
| <b>INTEREST-BEARING LIABILITIES</b>                            |   |                  |              |   |                  |              |
| Time deposits  | \$ 249,596                              | \$ 3,583         | 1.92%        | \$ 250,708                              | \$ 3,854         | 2.06%        |
| Savings deposits   | 408,918                                 | 779              | 0.25         | 333,478                                 | 1,134            | 0.45         |
| Demand deposits  | 115,143                                 | 32               | 0.04         | 109,815                                 | 54               | 0.07         |
| Short term borrowings  | 94,720                                  | 89               | 0.13         | 113,243                                 | 276              | 0.33         |
| Long term borrowings   | 10,609                                  | 294              | 3.70         | 23,681                                  | 748              | 4.22         |
| <b>Total interest-bearing liabilities</b>                      | <b>878,986</b>                          | <b>4,777</b>     | <b>0.73</b>  | <b>830,925</b>                          | <b>6,066</b>     | <b>0.98</b>  |
| <b>NONINTEREST-BEARING LIABILITIES AND STOCKHOLDERS EQUITY</b> |   |                  |              |   |                  |              |
| Demand deposits  | 109,411                                 |                  |              | 83,967                                  |                  |              |
| Other liabilities  | 3,827                                   |                  |              | 3,403                                   |                  |              |
| Stockholders equity  | 117,702                                 |                  |              | 103,146                                 |                  |              |
| <b>Total liabilities and stockholders equity</b>               | <b>\$ 1,109,926</b>                     |                  |              | <b>\$ 1,021,441</b>                     |                  |              |
| <b>Net interest income and interest rate spread</b>            |   | <b>\$ 29,017</b> | <b>3.69%</b> |   | <b>\$ 28,881</b> | <b>3.95%</b> |
| <b>Net interest margin</b>                                     |   |                  | <b>3.80%</b> |   |                  | <b>4.08%</b> |

(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 \$1.7 million and \$1.3 million for 2012 and 2011 respectively and is reduced by amortization of \$1.4 million and \$1.3 million for 2012 and 2011 respectively.

(6)

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For 2012, adjustments of \$267 thousand and \$1.1 million respectively are made to tax equate income on tax exempt loans and tax exempt securities. For 2011, adjustments of \$261 thousand and \$1.1 million 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 \$9.1 million for the third quarter of 2012, which compared to \$9.2 million in the third quarter of 2011. The net interest margin to average earning assets on a fully taxable equivalent basis decreased 30 basis points to 3.67% for the three months ended September 30, 2012, compared to 3.97% 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 year. At September 30, 2012, loans were 54% of average earning assets, compared to 57% at September 30, 2011. In comparing the quarters ended September 30, 2012 and 2011, yields on earning assets decreased 52 basis points, while the cost of interest bearing liabilities decreased 25 basis points.

On a year-to-date basis, net interest income improved to \$27.6 million for the nine month period ended September 30 2012, compared to \$27.5 million in the same period in 2011. The annualized net interest margin to average earning assets on a fully taxable equivalent basis was 3.80% for the nine months ended September 30, 2012, compared to 4.08% for the same period in the prior year.

**Noninterest Income.** Noninterest income was \$3.3 million for the third quarter of 2012, increasing 22.4% from \$2.7 million compared to the same quarter of 2011. Income from the sale of residential real estate loans increased from none in the third quarter of 2011 to \$204 thousand in the third quarter of 2012 as the Company continues to develop its secondary mortgage operations. Security gains also were \$473 thousand in the third quarter of 2012 compared to none in the same quarter of 2011 as the Company sold mortgage-backed securities and reinvested the proceeds into similar mortgage-backed securities with slightly longer durations to improve asset yields.

Noninterest income for the nine months ended September 30 2012 was \$9.0 million, compared to \$8.0 million for the same period in 2011. The increase in noninterest income is primarily due to income from the sale of loans, increasing from none for the nine months ended September 30, 2011 to \$407 thousand for the same nine month period in 2012. Security gains were also \$473 thousand higher in 2012.

**Noninterest Expense.** Noninterest expense totaled \$8.8 million for the third quarter of 2012, which is \$651 thousand more than the \$8.2 million in the same quarter in 2011. Most of this increase is a result of a \$624 thousand or 14.9% 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 Secondary Mortgage project expansion. Additionally, employee health insurance costs increased \$178 thousand as a result of a higher level of claims. Occupancy and equipment expense also increased \$139 thousand as a result of depreciation expense and small equipment costs related to new facilities.

Noninterest expenses for the nine months ended September 30, 2012 was \$26.3 million, compared to \$24.1 million for the same period in 2011, representing an increase of \$2.3 million, or 9.4%. The increase is mainly the result of the previously mentioned increase in salaries and employee benefits, resulting from a higher number of employees in the current year and a \$509 thousand or 44% increase in health insurance costs, and a \$485 thousand increase in occupancy and equipment expense related to new facilities.

Farmers' tax equivalent efficiency ratio for the three month period ended September 30, 2012 was 70.1% compared to 64.6% for the same period in 2011. The change in the efficiency ratio was the result of the \$651 thousand increase in noninterest expenses as explained in the previous paragraph.

The Company's tax equivalent efficiency ratio for the nine month period ended September 30, 2012 was 69.0%, compared to 63.9% for the prior year's same nine month period. The change in the efficiency ratio was the result of a \$2.3 million increase in noninterest expense, partially offset by the \$1.1 million increase in net interest income and noninterest income.

**Income Taxes.** Income tax expense totaled \$758 thousand for the quarter ended September 30, 2012 and \$683 thousand for the quarter ended September 30, 2011. The increase in the current quarter tax expense can be mainly attributed to the \$193 thousand increase in income before taxes. The effective tax rate for the three month period ended September 30, 2012 was 23.3%, compared to 22.4% for the same period in 2011. The effective tax rate increase over the same period in 2011 was primarily due to the reduction in the amount of tax exempt municipal securities income as a percentage of total income for the period.

Income tax expense was \$2.2 million for the first nine months of 2012 and \$1.6 million for the first nine months of 2011. The effective tax rate for the nine month period of 2012 was 23.4%, compared to 20.3% for the same period in 2011. The effective tax rate increase over the same period in 2011 was due to the reduction of tax exempt municipal securities income as mentioned in the quarter discussion from above.

**Other Comprehensive Income.** For the quarter ended September 30, 2012, the change in net unrealized gains on securities, net of reclassifications, resulted in an unrealized gain, net of tax, of \$145 thousand, compared to an unrealized gain of \$3.3 million for the same period in 2011. For the first nine months of 2012, the change in net unrealized gains on securities, net of reclassifications, resulted in an unrealized gain, net of tax, of \$1.3 million, compared to an unrealized gain of \$7.2 million for the same period in 2011. Management believes the smaller increase in fair value for the three and nine month periods ended September 30, 2012 compared to the same periods in 2011 is the result of the interest rate environment stabilizing in the debt securities market.

### **Financial Condition**

**Cash and cash equivalents.** Cash and cash equivalents increased \$27.1 million during the first nine months of 2012. The increase is largely due to the scarcity of viable investment options that produce a reasonable yield for the risk and management's effort to maintain a larger balance at the Federal Reserve Bank for future liquidity needs. The Company expects these deposit levels to remain steady over the next few months.

**Securities.** Securities available-for-sale increased by \$29.8 million since December 31, 2011. Securities were 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 \$1.1 million since December 31, 2011. Most of the loan growth occurred in the commercial and industrial loan portfolio. The increase in loans is related to the subtle 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 was not 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 2011. On a fully tax equivalent basis, loans contributed 71.6% of total interest income for the nine months ended September 30, 2012 and 72.6% for the same period in 2011.



**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)

|   | 9/30/12  | 6/30/12   | 3/31/12   | 12/31/11  | 9/30/11   |
|---|----------|-----------|-----------|-----------|-----------|
| Nonperforming loans   | \$ 8,662 | \$ 9,900  | \$ 11,030 | \$ 10,984 | \$ 10,884 |
| Nonperforming loans as a % of total loans                   | 1.51%    | 1.73%     | 1.91%     | 1.92%     | 1.92%     |
| Loans delinquent 30-89 days                                 | \$ 3,173 | \$ 2,778  | \$ 2,890  | \$ 3,431  | \$ 3,386  |
| Loans delinquent 30-89 days as a % of total loans           | 0.55%    | 0.49%     | 0.50%     | 0.60%     | 0.60%     |
| Allowance for loan losses                                   | \$ 8,625 | \$ 9,048  | \$ 9,446  | \$ 9,820  | \$ 10,984 |
| Allowance for loan losses as a % of loans                   | 1.51%    | 1.58%     | 1.64%     | 1.72%     | 1.93%     |
| Allowance for loan losses as a % of nonperforming loans     | 99.57%   | 91.39%    | 85.64%    | 89.40%    | 100.92%   |
| Annualized net charge-offs to average net loans outstanding | 0.54%    | 0.57%     | 0.27%     | 0.84%     | 0.43%     |
| Non-performing assets                                       | \$ 8,833 | \$ 10,312 | \$ 11,574 | \$ 11,569 | \$ 11,453 |
| Non-performing assets as a % of total assets                | 0.78%    | 0.92%     | 1.05%     | 1.08%     | 1.05%     |
| Net charge-offs for the quarter                             | \$ 748   | \$ 798    | \$ 374    | \$ 1,165  | \$ 591    |

For the three months ended September 30, 2012, management recorded a \$325 thousand provision to the allowance for loan losses, compared to providing \$700 thousand over the same three month period in the prior year. Non-performing loans equaled 1.51% of total loans at September 30, 2012, lower than the 1.92% reported at the same time in 2011. Loans 30-89 days delinquent decreased \$258 thousand to \$3.2 million during the first nine months of 2012. Non-performing loans totaled \$8.7 million at September 30, 2012, a decrease of \$2.3 million or 21.1% compared to the December 31, 2011 balance. On September 30, 2012, the ratio of the allowance for loan losses (ALLL) to non-performing loans was 99.6%, compared to 89.4% at December 31, 2011. At September 30, 2012, the ALLL/total loan ratio was 1.51%, compared to 1.72% at December 31, 2011. For the three months ended September 30, 2012, management recorded a \$325 thousand provision to the allowance for loan losses, compared to a \$400 thousand provision in the preceding quarter and a \$700 thousand provision in the same three month period in the prior year. Net charge-offs were \$748 thousand for the quarter ended September 30, 2012 representing a \$50 thousand decrease compared to the preceding quarter, but \$157 thousand higher than the same quarter in the prior year. Most of the charge-offs in the current quarter were related to the commercial real estate and commercial and industrial loan portfolios. In determining the estimate of the allowance for loan losses, management computes the historical loss percentage based upon the loss history of the past 12 quarters. In periods previous to the first quarter of 2012, management used a historical loss percentage based on the past 8 quarters. The Company believes that using a loss history of the previous 12 quarters will help mitigate quarterly volatility in the loan portfolio.

For the nine months ended September 30, 2012, management provided \$725 thousand to the allowance for loan losses, a decrease of \$2.9 million, or 80.1%, over the same nine month period in the prior year. This decrease is primarily due to a lower historical loss ratio, compared to the year ago period, and to lower levels of specific allocations on impaired loans. Net charge-offs for the first nine months of 2012 exceeded the provision for loan losses by \$1.2 million, however the Company has experienced improvement in certain measures of asset quality that led to the reduction in its reserve for loan losses. The recorded investment balance of impaired loans at September 30, 2012 was \$11.7 million with an allocated allowance for loan losses of \$636 thousand compared to \$10.4 million and \$985 thousand at December 31, 2011, respectively. In addition, credit quality factors have improved as the Company has lower levels of 30-89 day delinquent loans, nonperforming loans and substandard classified loans compared to December 31, 2011 and September 30, 2011. Substandard and doubtful loans have declined from \$20.2 million at December 31, 2011 to \$13.4 million at September 30, 2012. The allocated portion of the allowance for loan losses at September 30, 2012 was \$1.5 million down from \$2.0 million at December 31, 2011. Net charge-offs declined from \$2.0 million for the first nine months of 2011 to \$1.9 million for the current nine month period.

Based on the evaluation of the adequacy of the allowance for loan losses, management believes that the allowance for loan losses at September 30, 2012 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 increased \$60.0 million, or 7.1%, since December 31, 2011. Balances in the Company's non-interest bearing deposits increased \$21.0 million, or 21.8%, between December 31, 2011 and September 30, 2012. Money market accounts also increased \$34.5 million between year-end 2011 and September 30, 2012. Savings and other interest bearing demand deposits increased \$19.2 million between December 31, 2011 and September 30, 2012. The Company's deposits are also being affected positively by the recent development of the Marcellus and Utica shale activity within the local region. At September 30, 2012 the Company had deposits totaling approximately \$50.3 million that customers have received from energy exploration companies from the leasing or sale of mineral rights. The Company's focus continues to be on core deposit growth and the Company will price deposit rates to remain competitive within the market and to retain customers. At September 30, 2012, core deposits—savings and money market accounts, time deposits less than \$100,000 and demand deposits represented approximately 90.4% of total deposits.

Borrowings. Total borrowings decreased \$2.0 million, or 1.8%, since December 31, 2011. The decrease in borrowings is the result of an \$468 thousand and \$727 thousand decrease in securities sold under repurchase agreements and federal home loan bank advances, respectively. The decrease in repurchase agreements is due to public funds deposits moving to money market deposit accounts in an effort to maximize interest rate return. The reduction of federal home loan bank advances is the result of scheduled advance pay down.

Capital Resources. Total stockholders' equity increased from \$114.4 million at December 31, 2011 to \$121.0 million at September 30, 2012. The increase is the result of net income and fair value adjustments in the Company's investment securities and partially offset by cash dividends paid to shareholders during the past nine months. Shareholders received a \$0.12 per share cash dividend during the first nine months of 2012 which included a one-time special \$0.03 dividend. Book value per share increased 5.6% from \$6.10 per share at December 31, 2011 to \$6.44 per share at September 30, 2012. This increase is mainly the result of net income from the nine month period ended September 30, 2012.

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 September 30, 2012 the Company's total risk-based capital ratio stood at 17.68%, and the Tier I risk-based capital ratio and Tier I leverage ratio were at 16.42% and 9.51%, respectively. Management believes that the Company and the Bank meet all capital adequacy requirements to which they are subject, as of September 30, 2012.

Due to the continuing growth in the Bank's business and the higher levels of its allowance for loan losses associated with current economic conditions, senior management and the Board have determined that higher levels of capital are appropriate. The Office of the Comptroller of the Currency (the OCC) concurred in the Board's view that additional capital would be beneficial in supporting its continued growth and operations. As a result, effective February 2, 2010, the OCC proposed and the Bank accepted the following individual minimum capital requirements for the Bank: Tier I Capital to Adjusted Total Assets of 7.20% and Total Capital to Risk-Weighted Assets of 11.00%. At September 30, 2012, the Bank is in compliance with these minimum capital requirements.

### **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, 2011. 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. The change in methodology for historical loss experience used in calculating the unallocated portion of the allowance for loan losses from 8 previous quarters to now using the 12 previous quarters was previously discussed. Additional information regarding these policies is included in the notes to the aforementioned 2011 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 September 30, 2012, 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 September 30, 2012 was \$350 thousand. Management feels that its liquidity position is adequate and continues to monitor the position on a monthly basis. As of

September 30, 2012, the Bank had outstanding balances with the Federal Home Loan Bank of Cincinnati ( FHLB ) of \$10.4 million with additional borrowing capacity of approximately \$86.4 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 nine months of 2012, net cash used by investing activities amounted to \$34.5 million, compared to \$42.7 million used by investing activities for the same period in 2011. Proceeds from maturities and repayments of securities was \$62.2 million for the nine month period ended September 30, 2012 compared to \$30.5 million provided in the same prior year period. Proceeds from the sales of securities available for sale increased from \$3.4 million for the nine month period ended September 30, 2011 to \$56.5 million during the same period in the current year. Purchases of securities amounted to \$148.1 million used during the first nine months of 2012 compared to \$92.4 million used during the same period in 2011. This increased activity in the current nine month period was driven by management's decision to sell mortgage-backed securities and reinvest the proceeds into similar mortgage-backed securities with slightly longer durations to improve asset yields. There was \$4.4 million used for loan originations and payments during the first nine months of 2012, compared to \$19.9 million in net cash provided by loan originations and payments during the same period in 2011. The cash used by lending activities during this year's first nine month period can be attributed to the activity in the commercial real estate and the commercial and industrial loan portfolios.

The primary financing activities of the Company are obtaining deposits, repurchase agreements and other borrowings. Net cash provided by financing activities amounted to \$56.0 million for the first nine months of 2012, compared to \$89.6 million provided by financing activities for the same period in 2011. The majority of this change was in the net change in deposits and net change in short term borrowings. During the first nine months of 2012 cash provided by deposits was \$60.0 million while during the same period in 2011 the cash provided amounted to \$45.1 million. Net short term borrowings used \$1.2 million in the nine month period ended September 30, 2012 compared to \$33.5 million being provided in the same period in 2011. The Company's common and treasury shares public offering during the first quarter of 2011 provided \$13.8 million and \$0 during 2012.

#### **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 \$100.3 million at September 30, 2012 and \$86.4 million at December 31, 2011.

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

In response to the recent 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 over the next several months, 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 increase or decrease in market interest rates:

| Changes In Interest Rate<br>(basis points) | September 30,<br>2012<br>Result | December 31,<br>2011<br>Result | ALCO<br>Guidelines |
|--|---------------------------------|--------------------------------|--------------------|
| Net Interest Income Change                 |                                 |                                |                    |
| +300                                       | 0.52%                           | -4.40%                         | 15.00%             |
| +200                                       | 1.07%                           | -2.58%                         | 10.00%             |
| +100                                       | 1.03%                           | -1.05%                         | 5.00%              |
| -100                                       | -3.01%                          | -2.32%                         | 5.00%              |
| Net Present Value Of Equity Change         |                                 |                                |                    |
| +300                                       | 8.06%                           | -1.42%                         | 20.00%             |
| +200                                       | 8.99%                           | 2.51%                          | 15.00%             |
| +100                                       | 5.97%                           | 2.66%                          | 10.00%             |
| -100                                       | -17.22%                         | 16.81%                         | 10.00%             |

The simulation provides probable results that could be expected in an environment where interest rates rise 100, 200 and 300 basis points or fall 100 basis points over a 12 month period, using September 30, 2012 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 September 30, 2012, 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, 2011.

**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).
- 4 Agreement to furnish instruments and agreements defining rights of holders of long-term debt (incorporated by reference from Exhibit 4 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2012 filed with the SEC on May 9, 2012).
- 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 September 30, 2012, formatted in XBRL (Extensible Business Reporting Language): (i) the Unaudited Consolidated Balance Sheets; (ii) the Unaudited Consolidated Statements of Income (iii) the Unaudited Consolidated Statements of Comprehensive Income; (iv) the Unaudited 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: November 7, 2012

/s/ John S. Gulas  
John S. Gulas  
President and Chief Executive Officer  
Dated: November 7, 2012

/s/ Carl D. Culp  
Carl D. Culp  
Executive Vice President and Treasurer