

FARMERS NATIONAL BANC CORP /OH/  
Form 10-Q  
November 07, 2013

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

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934  
For the Quarterly period ended September 30, 2013  
Commission file number 001-35296

FARMERS NATIONAL BANC CORP.  
(Exact name of registrant as specified in its charter)

|  |  |
|--|--|
| OHIO<br>(State or other jurisdiction of<br>incorporation or organization)                        | 34-1371693<br>(I.R.S. Employer<br>Identification No) |
| 20 South Broad Street Canfield, OH<br>(Address of principal executive offices)<br>(330) 533-3341 | 44406<br>(Zip Code)                                  |

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(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, 2013 |
|----------------------------|---------------------------------|
| Common Stock, No Par Value | 18,775,980 shares               |



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## CONSOLIDATED BALANCE SHEETS

## FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES

| (Unaudited)   | (In Thousands of Dollars) |                      |
|---|---------------------------|----------------------|
|   | September 30,<br>2013     | December 31,<br>2012 |
| <b>ASSETS</b>   |                           |                      |
| Cash and due from banks   | \$ 13,690                 | \$ 14,209            |
| Federal funds sold and other  | 26,613                    | 23,550               |
| <b>TOTAL CASH AND CASH EQUIVALENTS</b>  | <b>40,303</b>             | <b>37,759</b>        |
| Securities available for sale   | 438,127                   | 464,088              |
| Loans held for sale   | 1,016                     | 3,624                |
| Loans   | 611,349                   | 586,592              |
| Less allowance for loan losses  | 7,369                     | 7,629                |
| <b>NET LOANS</b>  | <b>603,980</b>            | <b>578,963</b>       |
| Premises and equipment, net   | 17,567                    | 18,429               |
| Goodwill  | 6,343                     | 3,709                |
| Other intangibles   | 4,203                     | 2,323                |
| Bank owned life insurance   | 15,783                    | 15,541               |
| Other assets  | 20,797                    | 15,259               |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,148,119</b>       | <b>\$ 1,139,695</b>  |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                           |                      |
| Deposits:   |                           |                      |
| Noninterest-bearing   | \$ 139,705                | \$ 132,016           |
| Interest-bearing  | 763,705                   | 786,993              |
| <b>TOTAL DEPOSITS</b>   | <b>903,410</b>            | <b>919,009</b>       |
| Short-term borrowings   | 98,243                    | 79,886               |
| Long-term borrowings  | 20,079                    | 10,423               |
| Other liabilities   | 13,863                    | 9,585                |
| <b>TOTAL LIABILITIES</b>  | <b>1,035,595</b>          | <b>1,018,903</b>     |
| Commitments and contingent liabilities  |                           |                      |
| Stockholders Equity:  |                           |                      |
| Common Stock Authorized 35,000,000 shares in 2013 and 25,000,000 shares in 2012: issued 19,031,059 in 2013 and 18,802,282 in 2012 | 105,905                   | 104,504              |
| Retained earnings   | 12,484                    | 8,683                |
| Accumulated other comprehensive income (loss)   | (4,217)                   | 7,647                |
| Treasury stock, at cost; 255,079 shares in 2013 and 7,234 shares in 2012  | (1,648)                   | (42)                 |
| <b>TOTAL STOCKHOLDERS EQUITY</b>  | <b>112,524</b>            | <b>120,792</b>       |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>  | <b>\$ 1,148,119</b>       | <b>\$ 1,139,695</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 |               |
|  | September 30,                        | September 30, | September 30,             | September 30, |
|  | 2013                                 | 2012          | 2013                      | 2012          |
| <b>INTEREST AND DIVIDEND INCOME</b>                        |                                      |               |                           |               |
| Loans, including fees                                      | \$ 7,724                             | \$ 7,945      | \$ 23,031                 | \$ 23,928     |
| Taxable securities   | 1,598                                | 1,901         | 5,240                     | 6,135         |
| Tax exempt securities                                      | 742                                  | 705           | 2,213                     | 2,124         |
| Dividends  | 47                                   | 50            | 148                       | 152           |
| Federal funds sold and other interest income               | 11                                   | 29            | 29                        | 80            |
| <b>TOTAL INTEREST AND DIVIDEND INCOME</b>                  | <b>10,122</b>                        | <b>10,630</b> | <b>30,661</b>             | <b>32,419</b> |
| <b>INTEREST EXPENSE</b>                                    |                                      |               |                           |               |
| Deposits   | 1,136                                | 1,409         | 3,450                     | 4,394         |
| Short-term borrowings                                      | 13                                   | 22            | 38                        | 89            |
| Long-term borrowings                                       | 125                                  | 98            | 318                       | 294           |
| <b>TOTAL INTEREST EXPENSE</b>                              | <b>1,274</b>                         | <b>1,529</b>  | <b>3,806</b>              | <b>4,777</b>  |
| <b>NET INTEREST INCOME</b>                                 | <b>8,848</b>                         | <b>9,101</b>  | <b>26,855</b>             | <b>27,642</b> |
| Provision for loan losses                                  | 340                                  | 325           | 765                       | 725           |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b> | <b>8,508</b>                         | <b>8,776</b>  | <b>26,090</b>             | <b>26,917</b> |
| <b>NONINTEREST INCOME</b>                                  |                                      |               |                           |               |
| Service charges on deposit accounts                        | 633                                  | 540           | 1,648                     | 1,499         |
| Bank owned life insurance income, including death benefits | 337                                  | 129           | 570                       | 389           |
| Trust fees   | 1,368                                | 1,328         | 4,105                     | 4,111         |
| Insurance agency commissions                               | 56                                   | 28            | 139                       | 89            |
| Security gains   | 597                                  | 473           | 853                       | 473           |
| Retirement plan consulting fees                            | 205                                  | 0             | 205                       | 0             |
| Investment commissions                                     | 173                                  | 210           | 686                       | 645           |
| Net gains on sale of loans                                 | 146                                  | 204           | 448                       | 407           |
| Other operating income                                     | 658                                  | 455           | 1,619                     | 1,339         |
| <b>TOTAL NONINTEREST INCOME</b>                            | <b>4,173</b>                         | <b>3,367</b>  | <b>10,273</b>             | <b>8,952</b>  |
| <b>NONINTEREST EXPENSES</b>                                |                                      |               |                           |               |
| Salaries and employee benefits                             | 6,475                                | 4,808         | 17,080                    | 14,476        |
| Occupancy and equipment                                    | 1,053                                | 1,060         | 3,167                     | 3,089         |
| State and local taxes                                      | 327                                  | 293           | 984                       | 904           |
| Professional fees  | 742                                  | 490           | 1,691                     | 1,353         |
| Merger related costs                                       | 9                                    | 0             | 270                       | 0             |
| Advertising  | 225                                  | 210           | 638                       | 668           |
| FDIC insurance   | 181                                  | 166           | 538                       | 535           |
| Intangible amortization                                    | 214                                  | 102           | 410                       | 307           |
| Core processing charges                                    | 353                                  | 303           | 1,035                     | 1,023         |



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|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Other operating expenses               | 1,347    | 1,464    | 4,023    | 3,989    |
| TOTAL NONINTEREST EXPENSES             | 10,926   | 8,896    | 29,836   | 26,344   |
| INCOME BEFORE INCOME TAXES             | 1,755    | 3,247    | 6,527    | 9,525    |
| INCOME TAXES                           | 143      | 758      | 1,042    | 2,230    |
| NET INCOME                             | \$ 1,612 | \$ 2,489 | \$ 5,485 | \$ 7,295 |
| NET INCOME PER SHARE basic and diluted | \$ 0.09  | \$ 0.13  | \$ 0.29  | \$ 0.39  |

See accompanying notes

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

## FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES

| (Unaudited)  | (In Thousands of Dollars)  |                    |                           |                    |
|--|----------------------------|--------------------|---------------------------|--------------------|
|  | For the Three Months Ended |                    | For the Nine Months Ended |                    |
|  | September 30, 2013         | September 30, 2012 | September 30, 2013        | September 30, 2012 |
| NET INCOME   | \$ 1,612                   | \$ 2,489           | \$ 5,485                  | \$ 7,295           |
| Other comprehensive income (loss):                                     |                            |                    |                           |                    |
| Net unrealized holding gains (losses) on available for sale securities | (5,939)                    | 695                | (17,399)                  | 2,438              |
| Reclassification adjustment for (gains) losses realized in income      | (597)                      | (473)              | (853)                     | (473)              |
| Net unrealized holding gains (losses)                                  | (6,536)                    | 222                | (18,252)                  | 1,965              |
| Income tax effect  | 2,286                      | (77)               | 6,388                     | (687)              |
| Other comprehensive income (loss)                                      | (4,250)                    | 145                | (11,864)                  | 1,278              |
| COMPREHENSIVE INCOME (LOSS)  | \$ (2,638)                 | \$ 2,634           | \$ (6,379)                | \$ 8,573           |

See accompanying notes

## CONSOLIDATED STATEMENTS OF CASH FLOWS

## FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES

| (Unaudited)  | (In Thousands of Dollars) |                          |
|--|---------------------------|--------------------------|
|  | Nine Months Ended         |                          |
|  | September 30,<br>2013     | September<br>30,<br>2012 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                |                           |                          |
| Net income   | \$ 5,485                  | \$ 7,295                 |
| Adjustments to reconcile net income to net cash from operating activities: |                           |                          |
| Provision for loan losses  | 765                       | 725                      |
| Depreciation and amortization  | 1,410                     | 1,250                    |
| Net amortization of securities   | 2,216                     | 1,996                    |
| Security gains   | (853)                     | (473)                    |
| (Gain) loss on sale of other real estate owned                             | 30                        | (56)                     |
| Earnings on bank owned life insurance                                      | (353)                     | (389)                    |
| Income recognized from death benefit on bank owned life insurance          | (217)                     | 0                        |
| Origination of loans held for sale   | (22,350)                  | (25,217)                 |
| Proceeds from sale of loans held for sale                                  | 25,406                    | 21,727                   |
| Net gains on sale of loans   | (448)                     | (407)                    |
| Net change in other assets and liabilities                                 | 3,505                     | (844)                    |
| <b>NET CASH FROM OPERATING ACTIVITIES</b>                                  | <b>14,596</b>             | <b>5,607</b>             |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                |                           |                          |
| Proceeds from maturities and repayments of securities available for sale   | 62,427                    | 62,216                   |
| Proceeds from sales of securities available for sale                       | 55,614                    | 56,463                   |
| Purchases and settlements of securities available for sale                 | (111,696)                 | (148,054)                |
| Loan originations and payments, net  | (25,885)                  | (4,361)                  |
| Proceeds from sales of other real estate owned                             | 199                       | 1,814                    |
| Proceeds from BOLI death benefit   | 328                       | 0                        |
| Proceeds from sale of real estate  | 118                       | 0                        |
| Additions to premises and equipment  | (181)                     | (2,623)                  |
| Investment in National Associates Inc., net                                | (2,100)                   | 0                        |
| <b>NET CASH FROM INVESTING ACTIVITIES</b>                                  | <b>(21,176)</b>           | <b>(34,545)</b>          |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                |                           |                          |
| Net change in deposits   | (15,599)                  | 60,013                   |
| Net change in short-term borrowings  | 18,357                    | (1,218)                  |
| Repayment of Federal Home Loan Bank borrowings and other debt              | (344)                     | (775)                    |
| New Federal Home Loan Bank advance borrowings                              | 10,000                    | 0                        |
| Cash dividends paid  | (1,684)                   | (2,253)                  |
| Proceeds from dividend reinvestment  | 0                         | 243                      |
| Acquisition of treasury stock  | (1,606)                   | 0                        |
| <b>NET CASH FROM FINANCING ACTIVITIES</b>                                  | <b>9,124</b>              | <b>56,010</b>            |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                             | <b>2,544</b>              | <b>27,072</b>            |

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|   |           |           |
|---|-----------|-----------|
| Beginning cash and cash equivalents         | 37,759    | 52,422    |
| Ending cash and cash equivalents            | \$ 40,303 | \$ 79,494 |
| Supplemental cash flow information:         |           |           |
| Interest paid                               | \$ 3,829  | \$ 4,809  |
| Income taxes paid                           | \$ 1,130  | \$ 1,455  |
| Supplemental noncash disclosures:           |           |           |
| Transfer of loans to other real estate      | \$ 103    | \$ 1,344  |
| Issuance of stock for NAI acquisition       | \$ 1,400  | \$ 0      |
| Contigent consideration for NAI acquisition | \$ 920    | \$ 0      |
| Security purchases not settled              | \$ 6,606  | \$ 0      |

See accompanying notes

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### Principles of Consolidation:

Farmers National Banc Corp. ( Company ) is a one-bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company provides full banking services through its nationally chartered subsidiary, The Farmers National Bank of Canfield ( Bank ). The Company provides trust services through its subsidiary, Farmers Trust Company ( Trust ), and insurance services through the Bank's subsidiary, Farmers National Insurance. On July 1, 2013 the Company acquired National Associates, Inc. ( NAI ), a retirement plan consulting firm located in Cleveland, Ohio. Therefore the Company now provides retirement consulting services through NAI. The consolidated financial statements include the accounts of the Company, the Bank and its subsidiary, along with the Trust and NAI. All significant intercompany balances and transactions have been eliminated in the consolidation.

### Basis of Presentation:

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

### Estimates:

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

### Segments:

The Company provides a broad range of financial services to individuals and companies in northeastern Ohio. While the Company's chief decision makers monitor the revenue streams of the various products and services, operations are managed and financial performance is primarily aggregated and reported in two lines of business, the Bank segment and the Trust segment. The NAI segment was not considered material at September 30, 2013 and was therefore not

presented as a separate segment.

Comprehensive Income (Loss):

Comprehensive income (loss) consists of net income and other comprehensive income (loss). Other comprehensive income (loss) consists of unrealized gains and losses on securities available for sale and changes in the funded status of the post-retirement health plan, which are recognized as separate components of equity, net of tax effects. For the three and nine month periods ended September 30, 2013, there was no change in the funded status of the plan.

Recent Accounting Pronouncements:

In February 2013, the Fair Accounting Standards Board ( FASB ) issued Accounting Standards Update 2013-02 (the ASU ) with the primary objective of improving the reporting of reclassifications out of accumulated other comprehensive income ( AOCI ). For significant reclassifications that are required to be presented in their entirety in net income in the same reporting period by U.S. Generally Accepted Accounting Principles (U.S. GAAP), the ASU requires an entity to report the effect of these reclassifications out of AOCI on the respective line items of net income either on the face of the statement that reports net income or in the financial statement notes. For AOCI items that are not reclassified to net income in their entirety, presentation in the financial statement notes is required. The Company has adopted this ASU beginning with periods ended March 31, 2013, by adding an additional footnote disclosure to the consolidated financial statements.

## Securities:

The following table summarizes the amortized cost and fair value of the available-for-sale investment securities portfolio at September 30, 2013 and December 31, 2012 and the corresponding amounts of unrealized gains and losses recognized in accumulated other comprehensive income:

| (In Thousands of Dollars)                            | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2013                                   |                   |                              |                               |               |
| U.S. Treasury and U.S. government sponsored entities | \$ 54,751         | \$ 889                       | \$ (404)                      | \$ 55,236     |
| State and political subdivisions                     | 106,937           | 1,889                        | (2,551)                       | 106,275       |
| Corporate bonds                                      | 1,541             | 1                            | (17)                          | 1,525         |
| Mortgage-backed securities residential               | 223,966           | 1,591                        | (4,437)                       | 221,120       |
| Collateralized mortgage obligations                  | 31,336            | 156                          | (1,864)                       | 29,628        |
| Small business administration                        | 26,153            | 2                            | (1,933)                       | 24,222        |
| Equity securities                                    | 60                | 64                           | (3)                           | 121           |
| Totals   | \$ 444,744        | \$ 4,592                     | \$ (11,209)                   | \$ 438,127    |

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

Proceeds from the sale of portfolio securities were \$54.7 million and \$55.6 million during the three and nine-month periods ended September 30, 2013. Gross gains of \$738 thousand and \$994 thousand along with gross losses of \$141 thousand were realized on these sales during the three and nine month periods ended September 30, 2013. 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 the three and nine month periods ended September 30, 2012.

The amortized cost and fair value of the debt securities portfolio are shown by expected maturity. Expected maturities may differ from contractual maturities if issuers have the right to call or prepay obligations with or without call or

prepayment penalties. Securities not due at a single maturity date are shown separately.

| (In Thousands of Dollars)               | September 30, 2013 |                   |
|---|--------------------|-------------------|
|   | Amortized<br>Cost  | Fair<br>Value     |
| <b>Maturity</b>                         |                    |                   |
| Within one year                         | \$ 13,179          | \$ 13,303         |
| One to five years                       | 79,638             | 80,478            |
| Five to ten years                       | 50,514             | 49,774            |
| Beyond ten years                        | 19,898             | 19,481            |
| Mortgage-backed, CMO and SBA securities | 281,455            | 274,970           |
| <b>Total</b>                            | <b>\$ 444,684</b>  | <b>\$ 438,006</b> |



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The following table summarizes the investment securities with unrealized losses at September 30, 2013 and December 31, 2012, aggregated by major security type and length of time in a continuous unrealized loss position. Unrealized losses for small business administration securities rounded to less than \$1 thousand in 2013 and 2012. In addition, unrealized losses for mortgage-backed securities residential, rounded to less than \$1 thousand in 2012.

| (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 |
| September 30, 2013                                   |                     |                   |                     |                   |            |                   |
| Available-for-sale                                   |                     |                   |                     |                   |            |                   |
| U.S. Treasury and U.S. government sponsored entities | \$ 21,226           | \$ (404)          | \$ 0                | \$ 0              | \$ 21,226  | \$ (404)          |
| State and political subdivisions                     | 36,377              | (2,551)           | 0                   | 0                 | 36,377     | (2,551)           |
| Corporate bonds                                      | 1,275               | (17)              | 0                   | 0                 | 1,275      | (17)              |
| Mortgage-backed securities residential               | 95,361              | (3,005)           | 31,293              | (1,432)           | 126,654    | (4,437)           |
| Collateralized mortgage obligations                  | 21,306              | (1,864)           | 0                   | 0                 | 21,306     | (1,864)           |
| Small business administration                        | 24,121              | (1,933)           | 8                   | 0                 | 24,129     | (1,933)           |
| Equity securities                                    | 0                   | 0                 | 9                   | (3)               | 9          | (3)               |
| Total  | \$ 199,666          | \$ (9,774)        | \$ 31,310           | \$ (1,435)        | \$ 230,976 | \$ (11,209)       |

| (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 |
| December 31, 2012                                    |                     |                   |                     |                   |            |                   |
| Available-for-sale                                   |                     |                   |                     |                   |            |                   |
| U.S. Treasury and U.S. government sponsored entities | \$ 5,490            | \$ (1)            | \$ 0                | \$ 0              | \$ 5,490   | \$ (1)            |
| State and political subdivisions                     | 12,079              | (245)             | 0                   | 0                 | 12,079     | (245)             |
| Corporate bonds                                      | 887                 | (7)               | 0                   | 0                 | 887        | (7)               |
| Mortgage-backed securities residential               | 97,598              | (476)             | 52                  | 0                 | 97,650     | (476)             |
| Collateralized mortgage obligations                  | 23,132              | (74)              | 0                   | 0                 | 23,132     | (74)              |
| Small business administration                        | 7,853               | (62)              | 37                  | 0                 | 7,890      | (62)              |

|                   |            |          |       |        |            |          |
|-------------------|------------|----------|-------|--------|------------|----------|
| Equity securities | 0          | 0        | 8     | (5)    | 8          | (5)      |
| Total             | \$ 147,039 | \$ (865) | \$ 97 | \$ (5) | \$ 147,136 | \$ (870) |

#### 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 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, 2013, the Company's security portfolio consisted of 389 securities, 103 of which were in an unrealized loss position. The majority of the unrealized losses on the Company's securities are related to its holdings of mortgage-backed securities and state and political subdivision securities as discussed below.

Unrealized losses on U.S. Treasury and U.S. government-sponsored entities have not been recognized into income because the securities are of high credit quality, management does not have the intent to sell these securities before their anticipated recovery and the decline in fair value is largely due to fluctuations in market interest rates and not credit quality. Consequently, the fair value of such debt securities is expected to recover as the securities approach their maturity date. Unrealized losses on debt securities issued by state and political subdivisions have not been recognized into income. A security-level assessment is performed on each security, and assessments are based on the nature of the securities, the financial condition of the issuer, the extent and duration of the securities, the extent and duration of the loss and whether management intends to sell or it is more likely than not that it will be required to sell a security before recovery of its amortized cost basis. These securities have maintained their investment grade ratings and management does not have the intent to sell these securities before their anticipated recovery. The fair value is expected to recover as the securities approach their maturity date.

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

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

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

Loans:

Loan balances were as follows:

| (In Thousands of Dollars) | September 30,<br>2013 | December 31,<br>2012 |
|---------------------------|-----------------------|----------------------|
| Commercial real estate    |                       |                      |
| Owner occupied            | \$ 84,484             | \$ 95,208            |
| Non-owner occupied        | 96,630                | 83,405               |
| Other                     | 19,888                | 22,729               |
| Commercial                | 108,758               | 97,112               |

|                             |         |         |         |         |
|-----------------------------|---------|---------|---------|---------|
| Residential real estate     |         |         |         |         |
| 1-4 family residential      | 139,581 |         | 132,665 |         |
| Home equity lines of credit | 26,151  |         | 24,110  |         |
| Consumer                    |         |         |         |         |
| Indirect                    | 120,607 |         | 116,471 |         |
| Direct                      | 10,526  |         | 11,160  |         |
| Other                       | 2,606   |         | 1,767   |         |
| Subtotal                    | 609,231 |         | 584,627 |         |
| Net deferred loan costs     | 2,118   |         | 1,965   |         |
| Allowance for loan losses   | (7,369) |         | (7,629) |         |
| Net loans                   | \$      | 603,980 | \$      | 578,963 |

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The following tables present the activity in the allowance for loan losses by portfolio segment for the three and nine month periods ended September 30, 2013 and 2012:

Three Months Ended September 30, 2013

| (In Thousands of Dollars) | Commercial<br>Real Estate | Commercial | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---------------------------|---------------------------|------------|----------------------------|----------|-------------|----------|
| Allowance for loan losses |                           |            |                            |          |             |          |
| Beginning balance         | \$ 3,050                  | \$ 1,431   | \$ 1,751                   | \$ 1,180 | \$ 178      | \$ 7,590 |
| Provision for loan losses | (213)                     | (14)       | 171                        | 398      | (2)         | 340      |
| Loans charged off         | (219)                     | 0          | (135)                      | (561)    | 0           | (915)    |
| Recoveries                | 33                        | 38         | 26                         | 257      | 0           | 354      |
| Ending balance            | \$ 2,651                  | \$ 1,455   | \$ 1,813                   | \$ 1,274 | \$ 176      | \$ 7,369 |

Nine Months Ended September 30, 2013

| (In Thousands of Dollars) | Commercial<br>Real Estate | Commercial | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---------------------------|---------------------------|------------|----------------------------|----------|-------------|----------|
| Allowance for loan losses |                           |            |                            |          |             |          |
| Beginning balance         | \$ 3,392                  | \$ 1,453   | \$ 1,569                   | \$ 951   | \$ 264      | \$ 7,629 |
| Provision for loan losses | (606)                     | (87)       | 508                        | 1,038    | (88)        | 765      |
| Loans charged off         | (300)                     | (80)       | (303)                      | (1,351)  | 0           | (2,034)  |
| Recoveries                | 165                       | 169        | 39                         | 636      | 0           | 1,009    |
| Ending balance            | \$ 2,651                  | \$ 1,455   | \$ 1,813                   | \$ 1,274 | \$ 176      | \$ 7,369 |

Three Months Ended September 30, 2012

| (In Thousands of Dollars) | Commercial<br>Real Estate | Commercial | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---------------------------|---------------------------|------------|----------------------------|----------|-------------|----------|
| Allowance for loan losses |                           |            |                            |          |             |          |
| 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      |
| Ending balance            | \$ 4,061                  | \$ 1,779   | \$ 1,612                   | \$ 1,000 | \$ 173      | \$ 8,625 |

Nine Months Ended September 30, 2012

| (In Thousands of Dollars) | Commercial<br>Real 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 |

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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, 2013 and December 31, 2012. The recorded investment in loans includes the unpaid principal balance and unamortized loan origination fees and costs, but excludes accrued interest receivable, which is not considered to be material:

September 30, 2013

| (In Thousands of Dollars)                       | Commercial<br>Real Estate | Commercial | Residential<br>Real Estate | Consumer   | Unallocated | Total      |
|---|---------------------------|------------|----------------------------|------------|-------------|------------|
| Allowance for loan losses:                      |                           |            |                            |            |             |            |
| Ending allowance balance attributable to loans: |                           |            |                            |            |             |            |
| Individually evaluated for impairment           | \$ 245                    | \$ 279     | \$ 0                       | \$ 0       | \$ 0        | \$ 524     |
| Collectively evaluated for impairment           | 2,406                     | 1,176      | 1,813                      | 1,274      | 176         | 6,845      |
| Total ending allowance balance                  | \$ 2,651                  | \$ 1,455   | \$ 1,813                   | \$ 1,274   | \$ 176      | \$ 7,369   |
| Loans:  |                           |            |                            |            |             |            |
| Loans individually evaluated for impairment     | \$ 7,173                  | \$ 2,625   | \$ 2,398                   | \$ 0       | \$ 0        | \$ 12,196  |
| Loans collectively evaluated for impairment     | 192,999                   | 106,133    | 162,804                    | 137,217    | 0           | 599,153    |
| Total ending loans balance                      | \$ 200,172                | \$ 108,758 | \$ 165,202                 | \$ 137,217 | \$ 0        | \$ 611,349 |

December 31, 2012

| (In Thousands of Dollars)                       | Commercial<br>Real Estate | Commercial | Residential<br>Real Estate | Consumer | Unallocated | Total     |
|---|---------------------------|------------|----------------------------|----------|-------------|-----------|
| Allowance for loan losses:                      |                           |            |                            |          |             |           |
| Ending allowance balance attributable to loans: |                           |            |                            |          |             |           |
| Individually evaluated for impairment           | \$ 129                    | \$ 51      | \$ 0                       | \$ 0     | \$ 0        | \$ 180    |
| Collectively evaluated for impairment           | 3,263                     | 1,402      | 1,569                      | 951      | 264         | 7,449     |
| Total ending allowance balance                  | \$ 3,392                  | \$ 1,453   | \$ 1,569                   | \$ 951   | \$ 264      | \$ 7,629  |
| Loans:  |                           |            |                            |          |             |           |
|   | \$ 8,535                  | \$ 1,852   | \$ 989                     | \$ 0     | \$ 0        | \$ 11,376 |

|   |            |           |            |            |      |            |
|---|------------|-----------|------------|------------|------|------------|
| Loans individually evaluated for impairment |            |           |            |            |      |            |
| Loans collectively evaluated for impairment | 192,116    | 95,260    | 155,193    | 132,647    | 0    | 575,216    |
| Total ending loans balance                  | \$ 200,651 | \$ 97,112 | \$ 156,182 | \$ 132,647 | \$ 0 | \$ 586,592 |

The following tables present information related to impaired loans by class of loans as of September 30, 2013 and December 31, 2012:

| (In Thousands of Dollars)           | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated |
|-------------------------------------|--------------------------|---------------------|-------------------------------------|
| September 30, 2013                  |                          |                     |                                     |
| With no related allowance recorded: |                          |                     |                                     |
| Commercial real estate              |                          |                     |                                     |
| Owner occupied                      | \$ 2,554                 | \$ 2,423            | \$ 0                                |
| Non-owner occupied                  | 518                      | 418                 | 0                                   |
| Commercial                          | 2,091                    | 2,057               | 0                                   |
| Residential real estate             |                          |                     |                                     |
| 1-4 family residential              | 2,261                    | 2,147               | 0                                   |
| Home equity lines of credit         | 261                      | 251                 | 0                                   |
| Subtotal                            | 7,685                    | 7,296               | 0                                   |
| With an allowance recorded:         |                          |                     |                                     |
| Commercial real estate              |                          |                     |                                     |
| Owner occupied                      | 2,963                    | 2,727               | 220                                 |
| Non-owner occupied                  | 1,605                    | 1,605               | 25                                  |
| Commercial                          | 568                      | 568                 | 279                                 |
| Subtotal                            | 5,136                    | 4,900               | 524                                 |
| Total                               | \$ 12,821                | \$ 12,196           | \$ 524                              |



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

The following table presents the average recorded investment in impaired loans by class for the three and nine month periods ended September 30, 2013 and 2012:

| (In Thousands of Dollars)           | Average Recorded Investment for<br>Three Months Ended September 30, |          | Average Recorded Investment for<br>Nine Months Ended September 30, |        |
|-------------------------------------|---|----------|--|--------|
|                                     | 2013  | 2012     | 2013   | 2012   |
| With no related allowance recorded: |   |          |  |        |
| Commercial real estate              |   |          |  |        |
| Owner occupied                      | \$ 2,557  | \$ 1,558 | \$ 2,533   | \$ 974 |
| Non-owner occupied                  | 421   | 219      | 454  | 458    |
| Other                               | 0   | 0        | 0  | 152    |
| Commercial                          | 1,597   | 934      | 1,485  | 960    |
| Residential real estate             |   |          |  |        |
| 1-4 family residential              | 2,125   | 769      | 1,349  | 718    |
| Home equity lines of credit         | 215   | 0        | 192  | 0      |
| Subtotal                            | 6,915   | 3,480    | 6,013  | 3,262  |
| With an allowance recorded:         |   |          |  |        |
| Commercial real estate              |   |          |  |        |
| Owner occupied                      | 2,498   | 4,241    | 2,714  | 4,391  |
| Non-owner occupied                  | 1,612   | 2,717    | 1,816  | 2,384  |
| Other                               | 0   | 0        | 0  | 91     |

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|            |           |           |           |           |
|------------|-----------|-----------|-----------|-----------|
| Commercial | 253       | 688       | 295       | 495       |
| Subtotal   | 4,363     | 7,646     | 4,825     | 7,361     |
| Total      | \$ 11,278 | \$ 11,126 | \$ 10,838 | \$ 10,623 |

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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, 2013 and December 31, 2012:

| (In Thousands of Dollars)      | September 30, 2013 |   | December 31, 2012 |   |
|--------------------------------|--------------------|---|-------------------|---|
|                                | Nonaccrual         | Loans Past Due 90 Days or More Still Accruing | Nonaccrual        | Loans Past Due 90 Days or More Still Accruing |
| <b>Commercial real estate</b>  |                    |   |                   |   |
| Owner occupied                 | \$ 2,933           | \$ 0  | \$ 3,116          | \$ 0  |
| Non-owner occupied             | 416                | 0   | 799               | 0   |
| Other                          | 0                  | 0   | 0                 | 0   |
| <b>Commercial</b>              | <b>2,143</b>       | <b>0</b>                                      | <b>1,081</b>      | <b>0</b>                                      |
| <b>Residential real estate</b> |                    |   |                   |   |
| 1-4 family residential         | 2,607              | 618   | 2,342             | 197   |
| Home equity lines of credit    | 286                | 0   | 294               | 236   |
| <b>Consumer</b>                |                    |   |                   |   |
| Indirect                       | 0                  | 82  | 0                 | 143   |
| Direct                         | 0                  | 14  | 0                 | 19  |
| Other                          | 0                  | 7   | 0                 | 1   |
| <b>Total</b>                   | <b>\$ 8,385</b>    | <b>\$ 721</b>                                 | <b>\$ 7,632</b>   | <b>\$ 596</b>                                 |

The following table presents the aging of the recorded investment in past due loans as of September 30, 2013 and December 31, 2012 by class of loans:

| (In Thousands of Dollars)      | 30-59         | 60-89         | 90 Days or                   | Total Past   | Loans Not      | Total          |
|--------------------------------|---------------|---------------|------------------------------|--------------|----------------|----------------|
|                                | Days Past Due | Days Past Due | More Past Due and Nonaccrual |              |                |                |
| <b>September 30, 2013</b>      |               |               |                              |              |                |                |
| <b>Commercial real estate</b>  |               |               |                              |              |                |                |
| Owner occupied                 | \$ 48         | \$ 8          | \$ 2,933                     | \$ 2,989     | \$ 81,146      | \$ 84,135      |
| Non-owner occupied             | 17            | 0             | 416                          | 433          | 95,798         | 96,231         |
| Other                          | 0             | 0             | 0                            | 0            | 19,806         | 19,806         |
| <b>Commercial</b>              | <b>0</b>      | <b>50</b>     | <b>2,143</b>                 | <b>2,193</b> | <b>106,565</b> | <b>108,758</b> |
| <b>Residential real estate</b> |               |               |                              |              |                |                |
| 1-4 family residential         | 206           | 0             | 3,225                        | 3,431        | 135,620        | 139,051        |
| Home equity lines of credit    | 26            | 0             | 286                          | 312          | 25,839         | 26,151         |
| <b>Consumer</b>                |               |               |                              |              |                |                |

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|          |          |        |          |           |            |            |
|----------|----------|--------|----------|-----------|------------|------------|
| Indirect | 1,376    | 248    | 82       | 1,706     | 122,379    | 124,085    |
| Direct   | 109      | 17     | 14       | 140       | 10,386     | 10,526     |
| Other    | 26       | 12     | 7        | 45        | 2,561      | 2,606      |
| Total    | \$ 1,808 | \$ 335 | \$ 9,106 | \$ 11,249 | \$ 600,100 | \$ 611,349 |

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

#### Troubled Debt Restructurings:

Total troubled debt restructurings were \$8.3 million and \$7.6 million at September 30, 2013 and December 31, 2012, respectively. The Company has allocated \$187 thousand and \$155 thousand of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2013 and December 31, 2012, respectively. There are \$16 thousand in commitments to lend additional amounts to borrowers with loans that were classified as troubled debt restructurings at September 30, 2013. There were no commitments at December 31, 2012.

During the three and nine month periods ended September 30, 2013 and 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; a permanent reduction of the recorded investment in the loan; a permanent increase of the recorded investment in the loan due to a protective advance to pay delinquent real estate taxes or advance new monies; a deferral of principal payments; or a legal concession.

Troubled debt restructuring modifications involved a change in the notes stated interest rate in the range of an increase of 0.25% to a reduction of 3.25%. There were also extensions of the maturity dates on these and other troubled debt restructurings in the range of three months to 126 months.

The following table presents loans by class modified as troubled debt restructurings that occurred during the three and nine month periods ended September 30, 2013 and 2012:

#### Three Months Ended September 30, 2013

(In Thousands of Dollars)

|                                      | Number of<br>Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
|--------------------------------------|--------------------|--|---|
| <b>Troubled Debt Restructurings:</b> |                    |  |   |
| Residential real estate              |                    |  |   |
| 1-4 family residential               | 1                  | \$ 10  | \$ 10   |
| HELOC                                | 1                  | 56   | 56  |
| <b>Total</b>                         | <b>2</b>           | <b>\$ 66</b>   | <b>\$ 66</b>  |

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Nine Months Ended September 30, 2013

|                                      | Number of<br>Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
|--------------------------------------|--------------------|--|---|
| <b>Troubled Debt Restructurings:</b> |                    |  |   |
| Commercial real estate               |                    |  |   |
| Owner occupied                       | 2                  | \$ 226   | \$ 239  |
| Commercial                           | 5                  | 649  | 682   |
| Residential real estate              |                    |  |   |
| 1-4 family residential               | 2                  | 18   | 18  |
| HELOC                                | 5                  | 214  | 214   |
| Total                                | 14                 | \$ 1,107   | \$ 1,153  |

Three Months Ended September 30, 2012

|                                      | Number of<br>Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
|--------------------------------------|--------------------|--|---|
| <b>Troubled Debt Restructurings:</b> |                    |  |   |
| Commercial real estate               |                    |  |   |
| Owner occupied                       | 1                  | \$ 356   | \$ 374  |
| Commercial                           | 1                  | 74   | 100   |
| Residential real estate              |                    |  |   |
| 1-4 family residential               | 3                  | 234  | 234   |
| Total                                | 5                  | \$ 664   | \$ 708  |

Nine Months Ended September 30, 2012

|                                      | Number of<br>Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
|--------------------------------------|--------------------|--|---|
| <b>Troubled Debt Restructurings:</b> |                    |  |   |
| Commercial real estate               |                    |  |   |
| Owner occupied                       | 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   |
| Total                                | 11                 | \$ 3,879   | \$ 3,971  |

There were \$1 thousand in charge offs during the three month period and \$17 thousand in charge offs during the nine month period ended September 30, 2013 as a result of troubled debt restructurings. During these periods ended September 30, 2013, the charge offs did not cause an increase in the allowance for loan losses. There was a loan discussed in prior periods that resulted in a \$3 thousand increase in the allowance of loan losses as a result of the allowance adjustment due to the troubled debt restructurings described above that no longer has an impairment reserve due to the increase in the fair market value of the collateral. The troubled debt restructuring decreased the allowance for loan losses by \$161 thousand during the three and nine month periods ended September 30, 2012. There were no charge offs as a result of the allowance adjustment.

There were two commercial loans and one commercial real estate loan modified as troubled debt restructuring for which there were payment defaults within twelve months following the modification during the three and nine month periods ended September 30, 2013. Two of the three loans were past due at September 30, 2013. There were two residential real estate loans modified as troubled debt restructurings for which there were payment defaults within twelve months following the modification during the period ended September 30, 2012. The loans were 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, 2013 and December 31, 2012, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| (In Thousands of Dollars) | Pass       | Special Mention | Sub-standard | Doubtful | Not Rated | Total      |
|---------------------------|------------|-----------------|--------------|----------|-----------|------------|
| September 30, 2013        |            |                 |              |          |           |            |
| Commercial real estate    |            |                 |              |          |           |            |
| Owner occupied            | \$ 70,512  | \$ 7,419        | \$ 6,204     | \$ 0     | \$ 0      | \$ 84,135  |
| Non-owner occupied        | 87,290     | 5,993           | 2,948        | 0        | 0         | 96,231     |
| Other                     | 19,459     | 0               | 347          | 0        | 0         | 19,806     |
| Commercial                | 102,417    | 2,363           | 3,978        | 0        | 0         | 108,758    |
| Total                     | \$ 279,678 | \$ 15,775       | \$ 13,477    | \$ 0     | \$ 0      | \$ 308,930 |

|      |          |           |       |
|------|----------|-----------|-------|
| Pass | Doubtful | Not Rated | Total |
|------|----------|-----------|-------|

| (In Thousands of Dollars) |            | Special Mention | Sub-standard |      |      |            |
|---------------------------|------------|-----------------|--------------|------|------|------------|
| December 31, 2012         |            |                 |              |      |      |            |
| Commercial real estate    |            |                 |              |      |      |            |
| Owner occupied            | \$ 78,327  | \$ 5,954        | \$ 10,600    | \$ 0 | \$ 0 | \$ 94,881  |
| Non-owner occupied        | 72,270     | 6,519           | 4,330        | 0    | 0    | 83,119     |
| Other                     | 17,855     | 4,433           | 363          | 0    | 0    | 22,651     |
| Commercial                | 89,312     | 3,891           | 3,909        | 0    | 0    | 97,112     |
| Total                     | \$ 257,764 | \$ 20,797       | \$ 19,202    | \$ 0 | \$ 0 | \$ 297,763 |

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, 2013 and December 31, 2012. Nonperforming loans are loans past due 90 days or more and still accruing interest and nonaccrual loans.

| (In Thousands of Dollars) | Residential Real Estate      |                                   |            | Consumer  |          |
|---------------------------|------------------------------|-----------------------------------|------------|-----------|----------|
|                           | 1-4<br>Family<br>Residential | Home<br>Equity Lines<br>of Credit | Indirect   | Direct    | Other    |
| September 30, 2013        |                              |                                   |            |           |          |
| Performing                | \$ 135,826                   | \$ 25,865                         | \$ 124,003 | \$ 10,512 | \$ 2,599 |
| Nonperforming             | 3,225                        | 286                               | 82         | 14        | 7        |
| Total                     | \$ 139,051                   | \$ 26,151                         | \$ 124,085 | \$ 10,526 | \$ 2,606 |

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

#### Interest Rate Swaps:

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

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

Summary information about these interest-rate swaps at periods ended September 30, 2013 and December 31, 2012 is as follows:

| (In Thousands of Dollars)                                     | September 30, 2013 | December 31, 2012 |
|---|--------------------|-------------------|
| Notional amounts  | \$ 16,548          | \$ 7,060          |
| Weighted average fixed pay rate on interest-rate swaps        | 4.19%              | 4.07%             |
| Weighted average variable receive rate on interest-rate swaps | 3.08%              | 2.99%             |
| Weighted average maturity (years)                             | 4.3                | 5.8               |
| Fair value of combined interest-rate swaps                    | \$ 160             | \$ 120            |

The fair value of the yield maintenance provisions and interest-rate swaps is recorded in other assets and other liabilities, respectively, in the consolidated balance sheets. Changes in the fair value of the yield maintenance provisions and interest-rate swaps are reported in earnings, as other noninterest income in the consolidated statements of income. For the three and nine month periods ended September 30, 2013 there was no net gain or loss recognized in earnings. The Company had no interest-rate swaps recorded at September 30, 2012.

## Earnings Per Share:

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

| (In Thousands, except Share and Per Share Data)                              | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|--|-------------------------------------|------------|------------------------------------|------------|
|  | 2013                                | 2012       | 2013                               | 2012       |
| <b>Basic EPS computation</b>   |                                     |            |                                    |            |
| Numerator Net income   | \$ 1,612                            | \$ 2,489   | \$ 5,485                           | \$ 7,295   |
| Denominator Weighted average shares outstanding                              | 18,775,980                          | 18,802,269 | 18,772,664                         | 18,789,449 |
| Basic earnings per share   | \$ .09                              | \$ .13     | \$ .29                             | \$ .39     |
| <b>Diluted EPS computation</b>   |                                     |            |                                    |            |
| Numerator Net income   | \$ 1,612                            | \$ 2,489   | \$ 5,485                           | \$ 7,295   |
| Denominator Weighted average shares outstanding for basic earnings per share | 18,775,980                          | 18,802,269 | 18,772,664                         | 18,789,449 |
| Effect of Stock Options  | 0                                   | 0          | 0                                  | 0          |
| Weighted averages shares for diluted earnings per share                      | 18,775,980                          | 18,802,269 | 18,772,664                         | 18,789,449 |
| Diluted earnings per share   | \$ .09                              | \$ .13     | \$ .29                             | \$ .39     |

Stock options for 5,000 shares were not considered in the computing of diluted earnings per share for the three and nine months ended September 30, 2013 and 2012, respectively, because they were antidilutive.

## Stock Based Compensation:

During 2012, the Company, with the approval of shareholders, created the 2012 Equity Incentive Plan (the Plan). The Plan permits the award of up to 500 thousand shares to the Company's directors and employees to promote the Company's long-term financial success by motivating performance through long-term incentive compensation and to better align the interests of its employees with those of its shareholders. No share awards were issued during the periods ended September 30, 2013 and 2012 under the Plan.

The Company's Stock Option Plan, which was shareholder-approved and has since expired, permitted the grant of share options to its directors, officers and employees for up to 375 thousand shares of common stock. Option awards were granted with an exercise price equal to the market price of the Company's common stock at the date of grant; those option awards have vesting periods of 5 years and have 10-year contractual terms. Option exercises are expected to be satisfied with either newly issued shares or treasury shares. At September 30, 2013 there remained only 5,000 outstanding options that were fully vested and exercisable. The fair value of the Company's stock at September 30, 2013 was less than the fair value option exercise price; therefore the outstanding and exercisable options had no intrinsic value.

The fair value of each option award is estimated on the date of grant using a Black-Scholes model. Total compensation cost charged against income for the stock option plan for the three and nine month period ended September 30, 2013 was not material. No related income tax benefit was recorded.

Other Comprehensive Income (Loss):

The following table represents the detail of other comprehensive income (loss) for the three and nine month periods ended September 30, 2013 and 2012.

| (In Thousands of Dollars)  | Three months ended<br>September 30, 2013 |          |            |
|--|--|----------|------------|
|  | Pre-tax                                  | Tax      | After-tax  |
| Unrealized holding losses on available-for-sale securities during the period | \$ (5,939)                               | \$ 2,077 | \$ (3,862) |
| Reclassification adjustment for (gains) losses included in net income (1)    | (597)                                    | 209      | (388)      |
| Net unrealized losses on available-for-sale securities                       | \$ (6,536)                               | \$ 2,286 | \$ (4,250) |

| (In Thousands of Dollars)  | Nine months ended September 30,<br>2013 |          |             |
|--|---|----------|-------------|
|  | Pre-tax                                 | Tax      | After-tax   |
| Unrealized holding losses on available-for-sale securities during the period | \$ (17,399)                             | \$ 6,090 | \$ (11,309) |
| Reclassification adjustment for (gains) losses included in net income (1)    | (853)                                   | 298      | (555)       |
| Net unrealized losses on available-for-sale securities                       | \$ (18,252)                             | \$ 6,388 | \$ (11,864) |

| (In Thousands of Dollars)   | Three months ended<br>September 30, 2012 |          |           |
|---|--|----------|-----------|
|   | Pre-tax                                  | Tax      | After-tax |
| Unrealized holding gains on available-for-sale securities during the period | \$ 695                                   | \$ (243) | \$ 452    |
| Reclassification adjustment for (gains) losses included in net income (1)   | (473)                                    | 166      | (307)     |
| Net unrealized gains on available-for-sale securities                       | \$ 222                                   | \$ (77)  | \$ 145    |

| (In Thousands of Dollars) | Nine months ended<br>September 30, 2012 |     |           |
|---------------------------|---|-----|-----------|
|                           | Pre-tax                                 | Tax | After-tax |

|   |          |          |          |
|---|----------|----------|----------|
| Unrealized holding gains on available-for-sale securities during the period | \$ 2,438 | \$ (853) | \$ 1,585 |
| Reclassification adjustment for (gains) losses included in net income (1)   | (473)    | 166      | (307)    |
| Net unrealized gains on available-for-sale securities                       | \$ 1,965 | \$ (687) | \$ 1,278 |

(1) Pre-tax reclassification adjustments relating to available-for-sale securities are reported in security gains and the tax impact is included in income tax expense on the consolidated statements of income.

Fair Value:

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

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

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

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

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

Investment Securities: The Company used a third party service to estimate fair value on available for sale securities on a monthly basis. This service provider is considered a leading evaluation pricing service for U.S. domestic fixed income securities. They subscribe to multiple third-party pricing vendors, and supplement that information with matrix pricing methods. The fair values for



investment securities are determined by quoted market prices in active markets, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on quoted prices for similar assets in active markets, quoted prices for similar assets in markets that are not active or inputs other than quoted prices, which provide a reasonable basis for fair value determination. Such inputs may include interest rates and yield curves, volatilities, prepayment speeds, credit risks and default rates. Inputs used are derived principally from observable market data (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). The fair values of Level 3 investment securities are determined by using unobservable inputs to measure fair value of assets for which there is little, if any market activity at the measurement date, using reasonable inputs and assumptions based on the best information at the time, to the extent that inputs are available without undue cost and effort by the Company's Chief Financial Officer and Controller. For the period ended September 30, 2013 and for the year ended December 31, 2012, the fair value of Level 3 investment securities was immaterial.

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

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

**Other Real Estate Owned:** Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair values are commonly based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

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



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

| Fair Value Measurements at                           |                   |   |   |  |
|--|-------------------|---|---|--|
| September 30, 2013 Using:                            |                   |   |   |  |
| (In Thousands of Dollars)                            | Carrying<br>Value | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Financial Assets</b>                              |                   |   |   |  |
| Investment securities available-for sale             |                   |   |   |  |
| U.S. Treasury and U.S. government sponsored entities | \$ 55,236         | \$ 0  | \$ 55,236   | \$ 0   |
| State and political subdivisions                     | 106,275           | 0   | 106,275   | 0  |
| Corporate bonds                                      | 1,525             | 0   | 1,525   | 0  |
| Mortgage-backed securities-residential               | 221,120           | 0   | 221,109   | 11   |
| Collateralized mortgage obligations                  | 29,628            | 0   | 29,628  | 0  |
| Small business administration                        | 24,222            | 0   | 24,222  | 0  |
| Equity securities                                    | 121               | 121   | 0   | 0  |
| Total investment securities                          | \$ 438,127        | \$ 121  | \$ 437,995  | \$ 11  |
| Yield maintenance provisions                         | \$ 160            | \$ 0  | \$ 160  | \$ 0   |
| <b>Financial Liabilities</b>                         |                   |   |   |  |
| Interest rate swaps                                  | \$ 160            | \$ 0  | \$ 160  | \$ 0   |

| Fair Value Measurements at                           |                   |   |   |  |
|--|-------------------|---|---|--|
| December 31, 2012 Using:                             |                   |   |   |  |
| (In Thousands of Dollars)                            | Carrying<br>Value | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Financial Assets</b>                              |                   |   |   |  |
| Investment securities available-for sale             |                   |   |   |  |
| U.S. Treasury and U.S. government sponsored entities | \$ 67,978         | \$ 0  | \$ 67,978   | \$ 0   |

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|  |            |        |            |       |
|--|------------|--------|------------|-------|
| State and political subdivisions       | 95,288     | 0      | 95,288     | 0     |
| Corporate bonds                        | 2,128      | 0      | 2,128      | 0     |
| Mortgage-backed securities-residential | 236,218    | 0      | 236,207    | 11    |
| Collateralized mortgage obligations    | 40,595     | 0      | 40,595     | 0     |
| Small business administration          | 21,444     | 0      | 21,444     | 0     |
| Equity securities                      | 437        | 437    | 0          | 0     |
| Total investment securities            | \$ 464,088 | \$ 437 | \$ 463,640 | \$ 11 |
| Yield maintenance provisions           | \$ 120     | \$ 0   | \$ 120     | \$ 0  |
| Financial Liabilities                  |            |        |            |       |
| Interest rate swaps                    | \$ 120     | \$ 0   | \$ 120     | \$ 0  |

There were no significant transfers between Level 1 and Level 2 during the three and nine month periods ended September 30, 2013 and 2012.

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

| (In Thousands of Dollars)                      | Investment Securities<br>Available-for-sale<br>(Level 3) |       |                                    |       |
|--|--|-------|------------------------------------|-------|
|  | Three Months Ended<br>September<br>30,                   |       | Nine Months Ended<br>September 30, |       |
|  | 2013   | 2012  | 2013                               | 2012  |
|  | Beginning balance  | \$ 11 | \$ 11                              | \$ 11 |
| Total unrealized gains or losses:              |  |       |                                    |       |
| Included in other comprehensive income or loss | 0  | 0     | 0                                  | 0     |
| Repayments                                     | 0  | 0     | 0                                  | (1)   |
| Transfer in and/or out of Level 3              | 0  | 0     | 0                                  | 0     |
| Ending balance                                 | \$ 11  | \$ 11 | \$ 11                              | \$ 11 |

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

| Fair Value Measurements      |                |                  |             |              |
|------------------------------|----------------|------------------|-------------|--------------|
| at September 30, 2013 Using: |                |                  |             |              |
| (In Thousands of Dollars)    | Carrying Value | Quoted Prices    | Significant | Significant  |
|                              |                | in Active        | Other       | Unobservable |
|                              |                | Markets for      | Observable  | Inputs       |
|                              |                | Identical Assets | Inputs      | (Level 3)    |
|                              |                | (Level 1)        | (Level 2)   | (Level 3)    |
| <b>Financial assets:</b>     |                |                  |             |              |
| Impaired loans               |                |                  |             |              |
| Commercial real estate       |                |                  |             |              |
| Owner occupied               | \$ 2,370       | \$ 0             | \$ 0        | \$ 2,370     |
| Non-owner occupied           | 418            | 0                | 0           | 418          |
| Commercial                   | 703            | 0                | 0           | 703          |
| 1 4 family residential       | 409            | 0                | 0           | 409          |
| HELOC                        | 96             | 0                | 0           | 96           |
| Other real estate owned      |                |                  |             |              |
| 1 4 family residential       | 33             | 0                | 0           | 33           |

Fair Value Measurements

at December 31, 2012 Using:

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

Impaired loans that are measured for impairment using the fair value of the collateral for collateral dependent loans, had a principal balance of \$4.4 million with a valuation allowance of \$450 thousand at September 30, 2013, resulting in an additional provision for loan losses of \$431 thousand and \$714 thousand for the three and nine month periods. At December 31, 2012, impaired loans had a principal balance of \$2.6 million, with a valuation allowance of \$25 thousand. For loans carried at fair value the additional provision for loan losses, for the three and nine month periods ended September 30, 2012, was \$246 thousand and \$665 thousand, respectively. Excluded from the fair value of impaired loans, at September 30, 2013 and December 31, 2012, discussed above are \$2.3 million and \$4.3 million of loans classified as troubled debt restructurings, which are not carried at fair value.

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

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at period ended September 30, 2013 and December 31, 2012:

(In Thousands of Dollars)

| September 30, 2013     | Fair value | Valuation Technique(s) | Unobservable Input(s)                               | Range (Weighted Average)     |
|------------------------|------------|------------------------|---|------------------------------|
| <b>Impaired loans</b>  |            |                        |   |                              |
| Commercial real estate | \$ 2,585   | Sales comparison       | Adjustment for differences between comparable sales | -42.96% - 47.57%<br>(-3.43%) |
|                        | 203        | Income approach        | Adjustment for differences in net operating income  | -13.64% - 12.93%<br>(-5.96%) |
| Commercial             | 703        | Sales comparison       | Adjustment for differences between comparable sales | -25.56% - 33.03%<br>(21.49%) |
| Residential            | 505        | Sales comparison       | Adjustment for differences between comparable sales | -46.81% - 23.45%<br>(-9.75%) |

(In Thousands of Dollars)

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

The carrying amounts and estimated fair values of financial instruments not previously disclosed at September 30, 2013 and December 31, 2012 are as follows:

| (In Thousands of Dollars)    | Fair Value Measurements at<br>September 30, 2013 Using: |           |           |         |           |
|------------------------------|---|-----------|-----------|---------|-----------|
|                              | Carrying<br>Amount                                      | Level 1   | Level 2   | Level 3 | Total     |
| <b>Financial assets</b>      |   |           |           |         |           |
| Cash and cash equivalents    | \$ 40,303   | \$ 13,690 | \$ 26,613 | \$ 0    | \$ 40,303 |
| Restricted stock             | 4,224   | n/a       | n/a       | n/a     | n/a       |
| Loans held for sale          | 1,016   | 0         | 1,034     | 0       | 1,034     |
| Loans, net                   | 603,980   | 0         | 0         | 610,718 | 610,718   |
| Accrued interest receivable  | 3,783   | 0         | 2,173     | 1,610   | 3,783     |
| <b>Financial liabilities</b> |   |           |           |         |           |
| Deposits                     | 903,410   | 675,349   | 229,627   | 0       | 904,976   |
| Short-term borrowings        | 98,243  | 0         | 98,243    | 0       | 98,243    |
| Long-term borrowings         | 20,079  | 0         | 20,872    | 0       | 20,872    |
| Accrued interest payable     | 455   | 2         | 453       | 0       | 455       |



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

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

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

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

**Loans:** Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that repriced 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 in a Level 2 classification. Fair value for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

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

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

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

## Segment Information:

The reportable segments are determined by the products and services offered, primarily distinguished between banking and trust operations. They are also distinguished by the level of information provided to the chief operating decision makers in the Company, who use such information to review performance of various components of the business, which are then aggregated. Loans, investments, and deposits provide the revenues in the banking operation, and trust service fees provide the revenue in trust operations. NAI is included in others. 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 |
|--|---------------|--------------|-------------------------|---------------------|
| September 30, 2013                         |               |              |                         |                     |
| Assets                                     |               |              |                         |                     |
| Cash and cash equivalents                  | \$ 591        | \$ 39,627    | \$ 85                   | \$ 40,303           |
| Securities available for sale              | 4,675         | 433,330      | 122                     | 438,127             |
| Loans held for sale                        | 0             | 1,016        | 0                       | 1,016               |
| Net loans                                  | 0             | 603,980      | 0                       | 603,980             |
| Premises and equipment, net                | 97            | 17,400       | 70                      | 17,567              |
| Goodwill and other intangibles             | 5,738         | 0            | 4,808                   | 10,546              |
| Other assets                               | 562           | 35,293       | 725                     | 36,580              |
| Total Assets                               | \$ 11,663     | \$ 1,130,646 | \$ 5,810                | \$ 1,148,119        |
| Liabilities and Stockholders Equity        |               |              |                         |                     |
| Deposits, borrowings and other liabilities | \$ 640        | \$ 1,034,674 | \$ 281                  | \$ 1,035,595        |
| Stockholders equity                        | 11,023        | 95,972       | 5,529                   | 112,524             |
| Total Liabilities and Stockholders Equity  | \$ 11,663     | \$ 1,130,646 | \$ 5,810                | \$ 1,148,119        |

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

|   |           |              |        |              |
|---|-----------|--------------|--------|--------------|
| Total Liabilities and Stockholders Equity | \$ 12,009 | \$ 1,127,111 | \$ 575 | \$ 1,139,695 |
|---|-----------|--------------|--------|--------------|

| (In Thousands of Dollars)<br>For the Three Months Ended September 30, 2013 | Trust<br>Segment | Bank<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
|--|------------------|-----------------|----------------------------|------------------------|
| Net interest income  | \$ 11            | \$ 8,840        | \$ (3)                     | \$ 8,848               |
| Provision for loan losses  | 0                | 340             | 0                          | 340                    |
| Service fees, security gains and other noninterest income                  | 1,389            | 2,489           | 295                        | 4,173                  |
| Noninterest expense  | 1,213            | 8,774           | 939                        | 10,926                 |
| Income before taxes  | 187              | 2,215           | (647)                      | 1,755                  |
| Income taxes   | 65               | 298             | (220)                      | 143                    |
| Net Income   | \$ 122           | \$ 1,917        | \$ (427)                   | \$ 1,612               |

| (In Thousands of Dollars)                                 | Trust Segment | Bank Segment | Eliminations and Others | Consolidated Totals |
|---|---------------|--------------|-------------------------|---------------------|
| For the Nine Months Ended September 30, 2013              |               |              |                         |                     |
| Net interest income                                       | \$ 34         | \$ 26,831    | \$ (10)                 | \$ 26,855           |
| Provision for loan losses                                 | 0             | 765          | 0                       | 765                 |
| Service fees, security gains and other noninterest income | 4,167         | 5,781        | 325                     | 10,273              |
| Noninterest expense                                       | 3,711         | 24,406       | 1,719                   | 29,836              |
| Income before taxes                                       | 490           | 7,441        | (1,404)                 | 6,527               |
| Income taxes  | 170           | 1,349        | (477)                   | 1,042               |
| Net Income  | \$ 320        | \$ 6,092     | \$ (927)                | \$ 5,485            |

| (In Thousands of Dollars)                                 | Trust Segment | Bank Segment | Eliminations and Others | Consolidated Totals |
|---|---------------|--------------|-------------------------|---------------------|
| For the Three Months Ended September 30, 2012             |               |              |                         |                     |
| 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         | 1,973        | 47                      | 3,367               |
| Noninterest expense                                       | 1,215         | 7,373        | 308                     | 8,896               |
| Income before taxes                                       | 145           | 3,366        | (264)                   | 3,247               |
| Income taxes  | 51            | 797          | (90)                    | 758                 |
| Net Income  | \$ 94         | \$ 2,569     | \$ (174)                | \$ 2,489            |

| (In Thousands of Dollars)                                 | Trust Segment | Bank Segment | Eliminations and Others | Consolidated Totals |
|---|---------------|--------------|-------------------------|---------------------|
| For the Nine Months Ended September 30, 2012              |               |              |                         |                     |
| 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         | 4,728        | 58                      | 8,952               |
| Noninterest expense                                       | 3,742         | 21,793       | 809                     | 26,344              |
| Income before taxes                                       | 459           | 9,834        | (768)                   | 9,525               |
| Income taxes  | 161           | 2,330        | (261)                   | 2,230               |
| Net Income  | \$ 298        | \$ 7,504     | \$ (507)                | \$ 7,295            |

#### Business Combination:

On July 1, 2013, the Company completed the acquisition of all outstanding stock of the retirement planning consultancy National Associates, Inc. of Cleveland, Ohio. The transaction involved both cash and stock totaling \$4.4 million, including up to \$1.5 million of future payments, contingent upon NAI meeting income performance targets, with an estimated fair value at the acquisition date of \$920,000. The fair market value of the contingent consideration

was determined using the Monte Carlo Simulation. The simulation's key assumptions included a two year period with an estimated volatility of 20%. Expected EBITDA had a base of 6% with a maximum 12% and a discount rate of 11.9%. The acquisition is part of the Company's plan to increase the levels of noninterest income and to complement the existing retirement services currently being offered. Acquisition-related costs of \$9 thousand and \$270 thousand are included in the Company's consolidated income statements for the three and nine month periods ended September 30, 2013.

Goodwill of \$2.6 million, which is recorded on the balance sheet of NAI, arising from the acquisition consisted largely of synergies and the cost savings resulting from the combining of the operations of the companies. The goodwill is not expected to be deductible for income tax purposes. The fair value of other intangible assets of \$2.3 million is related to client relationships, company name and noncompetition agreements. The following table summarizes the consideration paid for NAI and the amounts of the assets acquired and liabilities assumed. All amounts are subject to certain adjustments contained in the purchase agreement.

| (In Thousands of Dollars)                              |          |
|--|----------|
| <b>Consideration</b>                                   |          |
| Cash   | \$ 2,100 |
| Stock  | 1,400    |
| Contingent consideration                               | 920      |
| Fair value of total consideration transferred          | 4,420    |
| <b>Assets acquired and liabilities assumed</b>         |          |
| Cash   | 28       |
| Accounts receivable                                    | 300      |
| Premises and equipment                                 | 50       |
| Other assets   | 1        |
| Total assets acquired                                  | 379      |
| Liabilities assumed                                    | 81       |
| Net assets acquired                                    | \$ 298   |
| <b>Assets and liabilities arising from acquisition</b> |          |
| Identified intangible assets                           | 2,290    |
| Deferred tax liability                                 | (802)    |
| Goodwill   | 2,634    |
| Net assets acquired from acquisition                   | \$ 4,420 |

NAI contributed \$279 thousand of gross revenues to the Company with a resulting net loss of \$98 thousand during the three month period ended September 30, 2013. Net income of the Company would not have been materially affected if the acquisition occurred at the beginning of the nine month period ended September 30, 2013.

#### Subsequent Event:

Management of the Company has focused on increasing the levels of noninterest income and reducing the level of noninterest expenses. In addition to the acquisition of NAI, another step in this process was the decision to close two retail branch locations in Leetonia and Warren, Ohio. With declining branch transaction counts and banking trends driving customers towards online banking, the two branches were underutilized. Management is evaluating the financial statement impact of the closures but does not expect losses, if any, to be material. Efficiencies will be gained as these branches sit in close proximity to other branch locations. The two branches were closed on October 1, 2013.





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 and involve risks and uncertainties. Any forward-looking statement is not a guarantee of future performance and actual future results could differ materially from those contained in forward-looking information. Factors that could cause or contribute to such differences include, without limitation, risks and uncertainties detailed from time to time in the Company's filings with the Securities and Exchange Commission, including without limitation, the risk factors disclosed in Item 1A, Risk Factors, in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

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

- general economic conditions in market areas where we conduct business, which could materially impact credit quality trends;
- business conditions in the banking industry;
- the regulatory environment;
- fluctuations in interest rates;
- demand for loans in the market areas where we conduct business;
- rapidly changing technology and evolving banking industry standards;
- competitive factors, including increased competition with regional and national financial institutions;
- new service and product offerings by competitors and price pressures; and other like items.

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

## Overview

Net income for the three months ended September 30, 2013 was \$1.6 million, compared to \$2.5 million for the same period last year. On a per share basis, net income for the third quarter ended September 30, 2013 was \$0.09 per diluted share, compared to \$0.13 for the third quarter ended September 30, 2012 and \$0.10 for the second quarter ended June 30, 2013. During the third quarter ended September 30, 2013, the Company recorded charges of \$1.3 million related to severance costs for terminated employees. Excluding these severance expenses, net income for the quarter would have been \$2.4 million, or \$0.13 per share.

Net income for the nine months ended September 30, 2013 was \$5.5 million, compared to \$7.3 million for the same nine month period in 2012. On a per share basis, net income for the nine months ended September 30, 2013 was \$0.29, a decrease of 25.6% compared to the same nine month period in 2012. For the nine month period ended September 30, 2013, net income excluding the severance expenses was \$6.3 million, or \$0.34 per share.

Net loans increased \$39.7 million in comparing the third quarter of 2013 to the same quarter of 2012. Net loans were \$604.0 million at September 30, 2013, compared to \$564.3 million at the same time in 2012. Deposits increased \$3.3 million, from \$900.1 million at September 30, 2012 to \$903.4 million at September 30, 2013, as customers continue to seek the safety and security of FDIC insured deposit accounts. At September 30, 2013, core deposits savings and money market accounts, time deposits less than \$100 thousand, demand deposits and interest bearing demand deposits represented approximately 90% of total deposits.

Stockholders equity totaled \$112.5 million, or 9.8% of total assets, at September 30, 2013, a decrease of \$8.5 million, or 7%, compared to \$121.0 million at September 30, 2012. Contributing to the decrease are mark to market adjustments in securities available for sale due to increases in long-term interest rates, partially offset by retained net income. Another contributing factor is the issuance of \$1.4 million in shares and the related goodwill associated with the acquisition of NAI, which closed at the beginning of the

third quarter. 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 paid on December 31, 2012. Book value per share decreased from \$6.44 per share at September 30, 2012 to \$5.99 per share at September 30, 2013. The Company's tangible book value per share also decreased from \$6.11 per share at September 30, 2012 to \$5.43 per share at September 30, 2013. The decreases in book value and tangible book value per share were also the result of the mark to market adjustments in securities available for sale and the issuance of shares and related goodwill from the acquisition of NAI.

### 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, 2013 and 2012:

| (In Thousands, except Per Share Data)   | At or for the Three<br>Months<br>Ended September 30, |              | At or for the Nine Months<br>Ended September 30, |              |
|---|--|--------------|--|--------------|
|   | 2013   | 2012         | 2013   | 2012         |
| Total Assets                            | \$ 1,148,119   | \$ 1,132,746 | \$ 1,148,119                                     | \$ 1,132,746 |
| Net Income                              | \$ 1,612   | \$ 2,489     | \$ 5,485   | \$ 7,295     |
| Basic and Diluted Earnings Per Share    | \$ 0.09  | \$ 0.13      | \$ 0.29  | \$ 0.39      |
| Return on Average Assets (Annualized)   | 0.56%  | 0.88%        | 0.64%  | 0.88%        |
| Return on Average Equity (Annualized)   | 5.60%  | 8.22%        | 6.26%  | 8.28%        |
| Efficiency Ratio (tax equivalent basis) | 81.64%   | 70.12%       | 77.21%   | 69.01%       |
| Equity to Asset Ratio                   | 9.80%  | 10.68%       | 9.80%  | 10.68%       |
| Tangible Common Equity Ratio *          | 8.96%  | 10.20%       | 8.96%  | 10.20%       |
| Dividends to Net Income                 | 34.93%   | 22.66%       | 30.70%   | 30.90%       |
| Net Loans to Assets                     | 52.61%   | 49.82%       | 52.61%   | 49.82%       |
| Loans to Deposits                       | 67.67%   | 63.65%       | 67.67%   | 63.65%       |

\*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, 2013 and 2012, reconciliations of tangible common equity to U.S. GAAP total common stockholders' equity and tangible assets to U.S. GAAP total assets are set forth below:

| (In Thousands of Dollars)   | September 30,<br>2013 | December 31,<br>2012 | September 30,<br>2012 |
|---|-----------------------|----------------------|-----------------------|
| Reconciliation of Common Stockholders' Equity to Tangible Common Equity |                       |                      |                       |
| Stockholders' Equity  | \$ 112,524            | \$ 120,792           | \$ 121,008            |

|                                     |            |            |            |
|-------------------------------------|------------|------------|------------|
| Less Goodwill and other intangibles | 10,546     | 6,032      | 6,134      |
| Tangible Common Equity              | \$ 101,978 | \$ 114,760 | \$ 114,874 |

| (In Thousands of Dollars)                                | September 30,<br>2013 | December 31,<br>2012 | September 30,<br>2012 |
|--|-----------------------|----------------------|-----------------------|
| <b>Reconciliation of Total Assets to Tangible Assets</b> |                       |                      |                       |
| Total Assets   | \$ 1,148,119          | \$ 1,139,695         | \$ 1,132,746          |
| Less Goodwill and other intangibles                      | 10,546                | 6,032                | 6,134                 |
| Tangible Assets  | \$ 1,137,573          | \$ 1,133,663         | \$ 1,126,612          |

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.

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Average Balance Sheets and Related Yields and Rates

(Dollar Amounts in Thousands)

|  | Three Months Ended |          |          | Three Months Ended |          |          |
|--|--------------------|----------|----------|--------------------|----------|----------|
|  | September 30, 2013 |          |          | September 30, 2012 |          |          |
|  | AVERAGE<br>BALANCE | INTEREST | RATE (1) | AVERAGE<br>BALANCE | INTEREST | RATE (1) |
| <b>EARNING ASSETS</b>  |                    |          |          |                    |          |          |
| Loans (3) (5) (6)  | \$ 597,839         | \$ 7,851 | 5.21%    | \$ 566,382         | \$ 8,067 | 5.67%    |
| Taxable securities (4)   | 352,213            | 1,598    | 1.80     | 333,909            | 1,901    | 2.26     |
| Tax-exempt securities<br>(4) (6)   | 86,985             | 1,128    | 5.14     | 73,452             | 1,074    | 5.82     |
| Equity securities (2)  | 4,307              | 47       | 4.33     | 4,363              | 50       | 4.56     |
| Federal funds sold and other   | 29,596             | 11       | 0.15     | 61,084             | 29       | 0.19     |
| Total earning assets   | 1,070,940          | 10,635   | 3.94     | 1,039,190          | 11,121   | 4.26     |
| <b>NONEARNING ASSETS</b>   |                    |          |          |                    |          |          |
| Cash and due from banks  | 19,532             | 0        | 0        | 22,185             | 0        | 0        |
| Premises and equipment   | 17,797             | 0        | 0        | 18,044             | 0        | 0        |
| Allowance for loan losses  | (7,364)            | 0        | 0        | (8,945)            | 0        | 0        |
| Unrealized gains (losses) on<br>securities                                 | (4,703)            | 0        | 0        | 14,680             | 0        | 0        |
| Other assets (3)   | 52,538             | 0        | 0        | 45,081             | 0        | 0        |
| Total assets   | \$ 1,148,740       | 0        | 0        | \$ 1,130,235       | 0        | 0        |
| <b>INTEREST-BEARING<br/>LIABILITIES</b>                                    |                    |          |          |                    |          |          |
| Time deposits  | \$ 229,675         | \$ 960   | 1.66%    | \$ 242,025         | \$ 1,171 | 1.92%    |
| Savings deposits   | 417,083            | 166      | 0.16     | 422,899            | 229      | 0.22     |
| Demand deposits  | 124,168            | 10       | 0.03     | 117,045            | 9        | 0.03     |
| Short term borrowings  | 99,517             | 13       | 0.05     | 95,681             | 22       | 0.09     |
| Long term borrowings   | 17,654             | 125      | 2.81     | 10,532             | 98       | 3.70     |
| Total interest-bearing<br>liabilities                                      | 888,097            | 1,274    | 0.57     | 888,182            | 1,529    | 0.68     |
| <b>NONINTEREST-BEARING<br/>LIABILITIES AND<br/>STOCKHOLDERS<br/>EQUITY</b> |                    |          |          |                    |          |          |
| Demand deposits  | 139,263            | 0        | 0        | 117,096            | 0        | 0        |
| Other liabilities  | 7,254              | 0        | 0        | 4,497              | 0        | 0        |

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|  |              |          |       |              |          |       |
|--|--------------|----------|-------|--------------|----------|-------|
| Stockholders equity                          | 114,126      | 0        | 0     | 120,460      | 0        | 0     |
| Total liabilities and stockholders equity    | \$ 1,148,740 | 0        | 0     | \$ 1,130,235 | 0        | 0     |
| Net interest income and interest rate spread |              | \$ 9,361 | 3.37% |              | \$ 9,592 | 3.58% |
| Net interest margin                          |              |          | 3.47% |              |          | 3.67% |

(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 \$677 thousand and \$562 thousand for 2013 and 2012, respectively, and is reduced by amortization of \$561 thousand and \$483 thousand for 2013 and 2012, respectively.

(6) For 2013, adjustments of \$127 thousand and \$386 thousand, respectively, are made to tax equate income on tax exempt loans and tax exempt securities. For 2012, adjustments of \$122 thousand and \$369 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  |           |          | Nine Months Ended  |           |          |
|--|--------------------|-----------|----------|--------------------|-----------|----------|
|  | September 30, 2013 |           |          | September 30, 2012 |           |          |
|  | AVERAGE<br>BALANCE | INTEREST  | RATE (1) | AVERAGE<br>BALANCE | INTEREST  | RATE (1) |
| <b>EARNING ASSETS</b>  |                    |           |          |                    |           |          |
| Loans (3) (5) (6)  | \$ 588,712         | \$ 23,399 | 5.31%    | \$ 563,642         | \$ 24,195 | 5.73%    |
| Taxable securities (4)   | 354,885            | 5,240     | 1.97     | 325,958            | 6,135     | 2.51     |
| Tax-exempt securities<br>(4) (6)   | 85,063             | 3,366     | 5.29     | 73,612             | 3,232     | 5.86     |
| Equity securities (2)  | 4,335              | 148       | 4.56     | 4,363              | 152       | 4.65     |
| Federal funds sold and other   | 23,557             | 29        | 0.16     | 54,293             | 80        | 0.20     |
| Total earning assets   | 1,056,552          | 32,182    | 4.07     | 1,021,868          | 33,794    | 4.42     |
| <b>NONEARNING ASSETS</b>   |                    |           |          |                    |           |          |
| Cash and due from banks  | 19,864             | 0         | 0        | 21,376             | 0         | 0        |
| Premises and equipment   | 18,056             | 0         | 0        | 17,417             | 0         | 0        |
| Allowance for loan losses  | (7,486)            | 0         | 0        | (9,289)            | 0         | 0        |
| Unrealized gains (losses) on<br>securities                                 | 5,050              | 0         | 0        | 13,663             | 0         | 0        |
| Other assets (3)   | 47,118             | 0         | 0        | 44,891             | 0         | 0        |
| Total assets   | \$ 1,139,154       | 0         | 0        | \$ 1,109,926       | 0         | 0        |
| <b>INTEREST-BEARING<br/>LIABILITIES</b>                                    |                    |           |          |                    |           |          |
| Time deposits  | \$ 231,027         | \$ 2,905  | 1.68%    | \$ 249,596         | \$ 3,583  | 1.92%    |
| Savings deposits   | 416,520            | 516       | 0.17     | 408,918            | 779       | 0.25     |
| Demand deposits  | 124,723            | 29        | 0.03     | 115,143            | 32        | 0.04     |
| Short term borrowings  | 92,153             | 38        | 0.06     | 94,720             | 89        | 0.13     |
| Long term borrowings   | 15,482             | 318       | 2.75     | 10,609             | 294       | 3.70     |
| Total interest-bearing<br>liabilities                                      | 879,905            | 3,806     | 0.58     | 878,986            | 4,777     | 0.73     |
| <b>NONINTEREST-BEARING<br/>LIABILITIES AND<br/>STOCKHOLDERS<br/>EQUITY</b> |                    |           |          |                    |           |          |
| Demand deposits  | 136,319            | 0         | 0        | 109,411            | 0         | 0        |
| Other liabilities  | 5,768              | 0         | 0        | 3,827              | 0         | 0        |

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|  |              |           |       |              |           |       |
|--|--------------|-----------|-------|--------------|-----------|-------|
| Stockholders equity                          | 117,162      | 0         | 0     | 117,702      | 0         | 0     |
| Total liabilities and stockholders equity    | \$ 1,139,154 | 0         | 0     | \$ 1,109,926 | 0         | 0     |
| Net interest income and interest rate spread |              | \$ 28,376 | 3.49% |              | \$ 29,017 | 3.69% |
| Net interest margin                          |              |           | 3.59% |              |           | 3.80% |

(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 \$1.8 million and \$1.7 million for 2013 and 2012, respectively, and is reduced by amortization of \$1.6 million and \$1.4 million for 2013 and 2012, respectively.

(6) For 2013, adjustments of \$368 thousand and \$1.2 million, respectively, are made to tax equate income on tax exempt loans and tax exempt securities. 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. These adjustments are based on a marginal federal income tax rate of 35%, less disallowances.



Net interest income. Net interest income was \$8.8 million for the third quarter of 2013, compared to \$9.1 million in the third quarter of 2012. The net interest margin to average earning assets on a fully taxable equivalent basis decreased 20 basis points to 3.47% for the three months ended September 30, 2013, compared to 3.67% for the same period in the prior year. The decrease in net interest margin is largely a result of interest-earning assets repricing at lower rates. Also contributing to the decrease was the amortization of premiums related to the Company's holdings of mortgage-backed securities during the first month of the quarter, as the Company received significant prepayments of principal on these securities. Prepayments on mortgage-backed securities slowed in the latter half of the quarter. In comparing the quarters ending September 30, 2013 and 2012, yields on earning assets decreased 31 basis points, while the cost of interest bearing liabilities decreased 11 basis points.

Net interest income decreased to \$26.9 million for the nine month period ended September 30 2013, compared to \$27.6 million in the same period in 2012. The annualized net interest margin to average earning assets on a fully taxable equivalent basis was 3.59% for the nine months ended September 30, 2013, compared to 3.80% for the same period in the prior year. The decline is primarily a result of factors similar to the three months results previously stated.

Noninterest Income. Noninterest income was \$4.2 million for the third quarter of 2013, increasing 23.9% from \$3.4 million compared to the same quarter of 2012. Security gains were \$597 thousand in the third quarter of 2013 compared to \$473 thousand in 2012, as the Company sold shares of Fannie Mae preferred stock during the third quarter of 2013. Service charges on deposit accounts increased \$93 thousand or 17%, and retirement plan consulting fees increased to \$205 thousand compared to none in the third quarter of 2012, reflecting the income earned from the newly acquired entity, NAI. Insurance agency commissions increased from \$28 thousand in the third quarter of 2012 to \$56 thousand in the third quarter of 2013, and trust fees also increased \$40 thousand to \$1.4 million in comparing the same time periods. Bank owned life insurance increased \$208 thousand as the Company received tax free death benefits, which are included in income. Other operating income also increased \$271 thousand, which is primarily the result of a gain on the sale of land that was owned by the Company.

Noninterest income for the nine months ended September 30, 2013 was \$10.3 million, compared to \$9.0 million for the same period in 2012. The increase in noninterest income is due to security gains of \$853 thousand in 2013 compared to \$473 thousand in 2012 and retirement plan consulting fees increasing to \$205 thousand compared to none in 2012. Other operating income increased \$280 thousand as a result of the gain on sale of land as explained in the preceding paragraph. Bank owned life insurance increased \$181 thousand or 47%, and service charges on deposit accounts increased \$149 thousand or 10%.

Noninterest Expense. Noninterest expense totaled \$10.9 million for the third quarter of 2013, which is \$2.0 million more than the \$8.9 million in the same quarter in 2012. Most of this increase is a result of a \$1.7 million or 34.7% increase in salaries and employee benefits, mainly due to \$1.3 million recorded in severance costs. Professional fees increased \$252 thousand, mainly as a result of consulting fees. Other operating expenses decreased \$117 thousand.

Noninterest expenses for the nine months ended September 30, 2013 was \$29.8 million, compared to \$26.3 million for the same period in 2012, representing an increase of \$3.5 million, or 13.3%. The increase is mainly the result of the previously mentioned increase in salaries and employee benefits resulting from severance costs in the current year, an increase in merger related costs of \$270 thousand and a \$34 thousand increase in other operating expenses.

The Company's tax equivalent efficiency ratio for the nine month period ended September 30, 2013 was 77.2% compared to 69.0% for the same period in 2012. The change in the efficiency ratio was the result of the \$3.5 million increase in noninterest expenses as explained in the previous paragraph. Management has focused on increasing the levels of noninterest income and reducing the level of noninterest expenses. One of the steps implemented in this process was the decision to close two retail branch locations in Warren and Leetonia, Ohio. With declining branch transaction counts and banking trends driving our customers towards online banking offerings, the two branches were underutilized. Efficiencies will be gained as these branches sat in close proximity to other branch locations. The branches were closed on October 1, 2013.

Income Taxes. Income tax expense totaled \$143 thousand for the quarter ended September 30, 2013 and \$758 thousand for the quarter ended September 30, 2012. The decrease in the current quarter tax expense can be attributed to the \$1.5 million decrease in income before taxes, a larger percentage of tax exempt municipal securities and an increase in BOLI income from death benefits. The effective tax rate for the three month period ended September 30, 2013 was 8.1%, compared to 23.3% for the same period in 2012. The effective tax rate decrease compared to the same period in 2012 was primarily due to the increase in tax exempt income, as a percentage of total income, from both tax exempt municipal securities and loans to municipalities.

Income tax expense was \$1.0 million for the nine months of 2013 and \$2.2 million for the nine months of 2012. The effective tax rate for the nine month period of 2013 was 16.0%, compared to 23.4% for the same period in 2012. The effective tax rate decrease over the same period in 2012 was due to the increase in income from tax exempt municipal securities and loans and BOLI death benefits as mentioned in the quarter discussion above.

Other Comprehensive Income. For the quarter ended September 30, 2013, the change in net unrealized gains or losses on securities, net of reclassifications, resulted in an unrealized loss, net of tax, of \$4.2 million, compared to an unrealized gain of \$145 thousand for the same period in 2012. For the nine months of 2013, the change in net unrealized gains on securities, net of reclassifications, resulted in an unrealized loss, net of tax, of \$11.9 million, compared to an unrealized gain of \$1.3 million for the same period in 2012. The decrease in fair value for the three and nine month periods ended September 30, 2013 is the result of the increase in long term interest rates.

#### Financial Condition

Cash and cash equivalents. Cash and cash equivalents increased \$2.5 million during the nine months of 2013. The Company expects these levels to remain steady over the next few months.

Securities. Securities available-for-sale decreased by \$26.0 million since December 31, 2012. As securities matured and were paid down, the proceeds were used to fund increases in the loan portfolio as well as withdrawals on deposit accounts.

Loans. Gross loans increased \$25.0 million, or 4.2%, since December 31, 2012. Most of the loan growth occurred in the commercial and the indirect loan portfolios. The increase in loans is related to the modest 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 nine months of 2013 compared to the same period in 2012. On a fully tax equivalent basis, loans contributed \$23.4 million of total interest income for the nine months ended September 30, 2013 compared to \$24.2 million during the same period in 2012.

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

#### Asset Quality History

(In Thousands of Dollars)

|   | 9/30/13  | 6/30/13  | 3/31/13  | 12/31/12 | 9/30/12  |
|---|----------|----------|----------|----------|----------|
| Nonperforming loans, unpaid principal balance               | \$ 9,124 | \$ 8,079 | \$ 7,368 | \$ 8,202 | \$ 8,662 |
| Nonperforming loans as a % of total loans                   | 1.49%    | 1.35%    | 1.24%    | 1.40%    | 1.51%    |
| Loans delinquent 30-89 days                                 | \$ 2,348 | \$ 2,497 | \$ 3,536 | \$ 3,702 | \$ 3,173 |
| Loans delinquent 30-89 days as a % of total loans           | 0.38%    | 0.42%    | 0.60%    | 0.62%    | 0.55%    |
| Allowance for loan losses                                   | \$ 7,369 | \$ 7,590 | \$ 7,508 | \$ 7,629 | \$ 8,625 |
| Allowance for loan losses as a % of loans                   | 1.21%    | 1.27%    | 1.27%    | 1.30%    | 1.51%    |
| Allowance for loan losses as a % of nonperforming loans     | 80.77%   | 93.95%   | 101.90%  | 93.01%   | 99.57%   |
| Annualized net charge-offs to average net loans outstanding | 0.38%    | 0.06%    | 0.26%    | 0.71%    | 0.54%    |
| Non-performing assets                                       | \$ 9,332 | \$ 8,374 | \$ 7,778 | \$ 8,536 | \$ 8,833 |

|  |        |       |        |        |        |
|--|--------|-------|--------|--------|--------|
| Non-performing assets as a % of total assets | 0.81%  | 0.75% | 0.68%  | 0.75%  | 0.78%  |
| Net charge-offs for the quarter              | \$ 561 | \$ 88 | \$ 376 | \$ 995 | \$ 748 |

For the three months ended September 30, 2013, management recorded \$340 thousand of loss provision to the allowance for loan losses, compared to providing \$325 thousand over the same three month period in the prior year. The provision for the three month period ended September 30, 2013 was primarily a result of an increase in total loans of 2.4% over the current three month period and the \$561 thousand net charge-offs recorded during the quarter. Net charge-offs were \$748 thousand for the quarter ended September 30, 2012. The growth in total loans outpaced the provision for the three month period ended September 30, 2013, due to improved asset quality metrics, most notably a decrease in net charge-offs and a 7.0% decrease in classified loans, and improved historical loss factors. As a result, the ratio of allowance for loan losses to gross loans declined from 1.51% at September 30, 2012 to 1.21% at September 30, 2013. The level of charge-offs and a lower level of delinquencies from the previous year, are factors considered in management's quarterly estimate of loan loss provisions and the adequacy of the allowance for loan losses.

For the nine month period ended September 30, 2013, a \$765 thousand provision was recorded compared to \$725 thousand for the nine months of 2012. The slightly larger provision for the nine month period ended September 30, 2013 was primarily a result of a \$25.0 million increase in total loans compared to December 31, 2012. The unallocated portion of the allowance for loan losses was

\$264 thousand at December 31, 2012, compared to an unallocated portion of the allowance for loan losses of \$176 thousand at September 30, 2013. The decrease to the unallocated portion in the nine months of 2013 was primarily due to an increase in the allocated portion for environmental factors. Additionally, charge offs exceeded the provision during the nine month period ended September 30, 2013. Non-performing loans increased from \$8.2 million at December 31, 2012 to \$9.1 million at September 30, 2013. Loans 30 - 89 days delinquent decreased \$1.3 million, or 35.8%, to \$2.3 million since December 31, 2012.

Based on the evaluation of the adequacy of the allowance for loan losses, management believes that the allowance for loan losses at September 30, 2013 is adequate and reflects probable incurred losses in the portfolio. The provision for loan losses is based on management's judgment after taking into consideration all factors connected with the collectability of the existing loan portfolio. Management evaluates the loan portfolio in light of economic conditions, changes in the nature and volume of the loan portfolio, industry standards and other relevant factors. Specific factors considered by management in determining the amounts charged to operating expenses include previous credit loss experience, the status of past due interest and principal payments, the quality of financial information supplied by loan customers and the general condition of the industries in the community to which loans have been made.

Deposits. Total deposits decreased \$15.6 million, or 1.7%, since December 31, 2012. Money market accounts decreased \$17.0 million between December 31, 2012 and September 30, 2013. This large decrease in money market accounts was offset slightly by an increase of \$8.0 million in savings and non-interest bearing demand deposits between December 31, 2012 and September 30, 2013. The Company's strategy is to maintain deposit balances while pricing deposit rates to remain competitive within the market. At September 30, 2013, core deposits - savings and money market accounts, time deposits less than \$100 thousand and demand deposits - represented approximately 90% of total deposits.

Borrowings. Total borrowings increased \$28.0 million, or 31.0%, since December 31, 2012. The increase in borrowings is the result of a \$16.2 million increase in securities sold under repurchase agreements and a \$10 million increase in FHLB advances. The increase in repurchase agreements is mainly due to the public funds movement between securities sold under repurchase agreements and money market accounts in an effort to maximize interest rate returns.

Capital Resources. Total stockholders' equity decreased from \$120.8 million at December 31, 2012 to \$112.5 million at September 30, 2013. The decrease is mainly the result of mark to market adjustments in securities available for sale due to increases in long term interest rates, offset by retained net income and the issuance of \$1.4 million in stock and the related goodwill associated with the acquisition of National Associates, which closed at the beginning of the third quarter. Shareholders received a \$0.09 per share cash dividend paid during the nine months of 2013. Book value per share decreased from \$6.43 per share at December 31, 2012 to \$5.99 per share at September 30, 2013.

The capital management function is a regular process that consists of providing capital for both the current financial position and the anticipated future growth of the Company. As of September 30, 2013 the Company's total risk-based capital ratio stood at 16.28%, and the Tier I risk-based capital ratio and Tier I leverage ratio were at 15.22% and 9.29%, respectively. Management believes that the Company and the Bank meet all capital adequacy requirements to which they are subject, as of September 30, 2013.

#### Critical Accounting Policies

The Company follows financial accounting and reporting policies that are in accordance with U.S. GAAP. These policies are presented in Note 1 of the consolidated audited financial statements in the Company's Annual Report to Shareholders included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. Critical accounting policies are those policies that require management's most difficult, subjective or complex judgments, often

as a result of the need to make estimates about the effect of matters that are inherently uncertain. The Company has identified two accounting policies that are critical accounting policies and an understanding of these policies is necessary to understand the Company's financial statements. These policies relate to determining the adequacy of the allowance for loan losses and other-than-temporary impairment of securities. Additional information regarding these policies is included in the notes to the aforementioned 2012 consolidated financial statements, Note 1 (Summary of Significant Accounting Policies), Note 2 (Securities), Note 3 (Loans), and the sections captioned Investment Securities and Loan Portfolio.

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, 2013, these lines of credit totaled \$24.5 million and the Bank had not borrowed against these lines. In addition, the Company has a \$1.5 million revolving line of credit with a correspondent bank. The outstanding balance at September 30, 2013 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, 2013, the Bank had outstanding balances with the Federal Home Loan Bank of Cincinnati (FHLB) of \$20.1 million with additional borrowing capacity of approximately \$79.6 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 nine months of 2013, net cash used by investing activities amounted to \$23.7 million, compared to \$34.5 million used in investing activities for the same period in 2012. Purchases and settlements of securities amounted to \$111.7 million used during the nine months of 2013 compared to \$148.1 million used during the same period in 2012. There was \$25.9 million used for loan originations and payments during the nine months of 2013, compared to \$4.4 million in net cash used by loan originations and payments during the same period in 2012. The cash used by lending activities during this year's first nine month period can be attributed to the activity in the commercial and indirect loan portfolios. There was \$2.1 million used to purchase National Associates Inc. during the nine month period ended September 30, 2013.

The primary financing activities of the Company are obtaining deposits, repurchase agreements and other borrowings. Net cash provided by financing activities amounted to \$9.1 million for the nine months of 2013, compared to \$56.0 million provided by financing activities for the same period in 2012. The majority of this change can be attributed to the change in deposits. Deposits provided \$60.0 million during the nine months of 2012 and used \$15.6 million during the nine months of 2013. This increase in funds used was offset by the net change in both short and long-term borrowings. During the nine month period ended September 30, 2013 cash provided by short-term borrowings was \$18.4 million compared to \$1.2 million used during the same nine month period in 2012. There was \$10 million in new long-term advances during the nine month period ended September 30, 2013 compared to none last year. The Company used \$1.6 million for the acquisition of treasury shares during the nine month period ended September 30, 2013 compared to none in 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 \$121 million at September 30, 2013 and \$95.4 million at December 31, 2012. Additionally, the Company has committed up to a \$3 million subscription in a Small Business Investment Company fund (SBIC). At September 30, 2013 the Company had invested \$458 thousand in this fund.



## Recent Market and Regulatory Developments

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

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

In July 2013, the Federal banking regulators approved a final rule to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and to address relevant provisions of the Dodd-Frank Act. The final rule strengthens the definition of regulatory capital, increases risk-based capital requirements, makes selected changes to the calculation of risk-weighted assets, and adjusts the prompt corrective action thresholds. Community banking organizations, such as the Company and the Bank, become subject to the new rule on January 1, 2015 and certain provisions of the new rule will be phased in over the period of 2015 through 2019.

The final rule:

- Permits banking organizations that had less than \$15 billion in total consolidated assets as of December 31, 2009 to include in Tier 1 capital trust preferred securities and cumulative perpetual preferred stock that were issued and included in Tier 1 capital prior to May 19, 2010, subject to a limit of 25% of Tier 1 capital elements, excluding any non-qualifying capital instruments and after all regulatory capital deductions and adjustments have been applied to Tier 1 capital.
- Establishes new qualifying criteria for regulatory capital, including new limitations on the inclusion of deferred tax assets and mortgage servicing rights.
- Requires a minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5%.

- Increases the minimum Tier 1 capital to risk-weighted assets ratio requirement from 4% to 6%.
  
- Retains the minimum total capital to risk-weighted assets ratio requirement of 8%.
  
- Establishes a minimum leverage ratio requirement of 4%.
  
- Retains the existing regulatory capital framework for 1-4 family residential mortgage exposures.
  
- Permits banking organizations that are not subject to the advanced approaches rule, such as the Company and the Bank, to retain, through a one-time election, the existing treatment for most accumulated other comprehensive income, such that unrealized gains and losses on securities available for sale will not affect regulatory capital amounts and ratios.
  
- Implements a new capital conservation buffer requirement for a banking organization to maintain a common equity capital ratio more than 2.5% above the minimum common equity Tier 1 capital, Tier 1 capital and total risk-based capital ratios in order to avoid limitations on capital distributions, including dividend payments, and certain discretionary bonus payments. The capital conservation buffer requirement will be phased in beginning on January 1, 2016 at 0.625% and will be fully phased in at 2.50% by January 1, 2019. A banking organization with a buffer of less than the required amount would be subject to increasingly stringent limitations on such distributions and payments as the buffer approaches zero. The new rule also generally prohibits a banking organization from making such distributions or payments during any quarter if its eligible retained income is negative and its capital conservation buffer ratio was 2.5% or less at the end of the previous quarter. The eligible retained income of a banking organization is defined as its net income for the four calendar quarters preceding the current calendar quarter, based on the organization's quarterly regulatory reports, net of any distributions and associated tax effects not already reflected in net income.
  
- Increases capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term commitments and securitization exposures.

- Expands the recognition of collateral and guarantors in determining risk-weighted assets.
- Removes references to credit ratings consistent with the Dodd Frank Act and establishes due diligence requirements for securitization exposures.

The Company's management is currently evaluating the provisions of the final rule and their expected impact on the Company.

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

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

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

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

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

| Changes In Interest Rate<br>(basis points)    | September 30,<br>2013<br>Result | December 31,<br>2012<br>Result | ALCO<br>Guidelines |
|---|---------------------------------|--------------------------------|--------------------|
| <b>Net Interest Income Change</b>             |                                 |                                |                    |
| +300  | -2.2%                           | -0.6%                          | 15.00%             |
| +200  | -1.2%                           | -0.1%                          | 10.00%             |
| +100  | -0.5%                           | 0.1%                           | 5.00%              |
| -100  | -2.7%                           | -3.4%                          | 5.00%              |
| <b>Net Present Value<br/>Of Equity Change</b> |                                 |                                |                    |
| +300  | -2.5%                           | 3.3%                           | 20.00%             |
| +200  | 0.6%                            | 5.7%                           | 15.00%             |
| +100  | 1.5%                            | 4.4%                           | 10.00%             |
| -100  | -13.8%                          | -16.8%                         | 10.00%             |

The results of the simulation indicate that in an environment where interest rates rise 100, 200 and 300 basis points or fall 100 basis points over a 12 month period, using September 30, 2013 amounts as a base case, and considering the increase in deposit liabilities, and the volatile financial markets. It should be noted that the change in the net present value of equity exceeded policy when the simulation model assumed a sudden decrease in rates of 100 basis points. This was primarily because the positive impact on the fair value of assets would not be as great as the negative impact on the fair value of certain liabilities. Specifically, because core deposits typically bear relatively low interest rates, their fair value would be negatively impacted as the rates could not be adjusted by the full extent of the sudden decrease in rates. Management does not believe that a 100 basis rate decline is realistic in the current interest rate environment. The remaining results of this analysis comply with internal limits established by the Company. A report on interest rate risk is presented to the Board of Directors and the Asset/Liability Committee on a quarterly basis. The Company has no market risk sensitive instruments held for trading purposes, nor does it hold derivative financial instruments, and does not plan to purchase these instruments in the near future.

### Item 4. Controls and Procedures

Based on their evaluation, as of the end of the period covered by this Quarterly Report on Form 10-Q, the Company's Interim 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, 2013, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

Purchases of equity securities by the issuer.

On September 28, 2012, the Company announced that its Board of Directors approved a stock repurchase program that authorizes the repurchase of up to 920,000 shares of its outstanding common stock in the open market or in privately negotiated transactions. No shares were purchased during the three months ended September 30, 2013.

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 Amendment to Articles of Incorporation of Farmers National Banc Corp., as amended (incorporated by reference from Exhibit 3.1 to the Company's Current Report on Form 8-K filed with the SEC on May 1, 2013).
- 3.3 Amended Code of Regulations of Farmers National Banc Corp. (incorporated by reference from Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2011 filed with the SEC on August 9, 2011).
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Kevin J. Helmick, Interim 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 Kevin J. Helmick, Interim 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, 2013, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income (iii) the Consolidated Statements of Comprehensive Income (Loss); (iv) the Consolidated Statements of Cash Flows; and (v) Notes to Unaudited Consolidated Financial Statements, tagged as blocks of text.

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, 2013

/s/ Kevin J. Helmick

Kevin J. Helmick

Interim President and Chief Executive Officer

Dated: November 7, 2013

/s/ Carl D. Culp

Carl D. Culp

Executive Vice President and Treasurer