7421877

# *Embracing the* FUTURE *for 120 years*

1887 2007

## FARMERS NATIONAL BANC CORP.

2007 ANNUAL REPORT

Filings Services
March 3, 2008
SNL Financial, LC
1-800-969-4121

Since 1887

# Corporate Profile

Farmers National Banc Corp. (the "Corporation") is a one-bank holding company formed under the Bank Holding Company Act of 1956, as amended, operating under regulations of the Board of Governors of the Federal Reserve System. Its principal subsidiary is The Farmers National Bank of Canfield, which was acquired March 31, 1983. Presently, the Corporation and its subsidiary operate in one industry, domestic banking and the corporate offices are located at 20 South Broad Street, Canfield, Ohio.

The Farmers National Bank of Canfield, chartered in 1887 as a national bank, is a full-service financial services company engaged in commercial and retail banking with the exception of trust services. The bank's main office is located at 20 South Broad Street, Canfield, Ohio. Business is conducted at a total of seventeen (17) offices located in the counties of Mahoning, Columbiana and Trumbull. In addition, the bank provides 24-hour access to a network of Automated Teller Machines and offers Internet and telephone banking services. As a national banking association, the Bank is a member of the Federal Reserve System, subject to supervision and regulation of the Comptroller of the Currency, and deposits are insured by the Federal Deposit Insurance Corporation to the extent provided by law. The Bank is affected also by the monetary and fiscal policy of the United States and of various regulatory agencies.

The Bank competes with state and national banks located in Mahoning, Columbiana and Trumbull counties. The bank also competes with a large number of other financial institutions, such as thrifts, insurance companies, consumer finance companies, credit unions and commercial finance leasing companies for deposits, loans and other financial service business. The principal methods of competition are the rates of interest charged for loans, the rates paid for funds, the fees charged for services and the availability of services.

# Corporate Mission Statement

Farmers National Bank is an independently owned community bank with offices located in Northeastern Ohio and beyond. We are staffed and managed by dedicated professionals who are committed to be community partners working to maximize mutual opportunities for success. We offer a comprehensive selection of financial products and services specifically designed to support the needs of consumers, businesses, and other organizations. We set the standard in our communities for excellence in financial service products and their delivery, and do so with the highest level of integrity, security, personal service, and convenience. All decisions are made locally in a very timely manner. We are flexible and highly responsive to our customers' diverse needs. We pay attention to detail and offer the personal touch of a small bank with the capabilities and resources of a larger financial institution. Through a balance of our unparalleled customer service and solid financial performance, we earn the loyalty and confidence of generations of customers and shareholders.

# Table Of Contents


Financial Highlights ..... 1

Letter To Our Shareholders ..... 2-3

Investor Information ..... 4

Selected Financial Data ..... 5-6

Management's Discussion & Analysis ..... 7-15

Report Of Independent Auditors ..... 18

Consolidated Financial Statements & Notes ..... 19-34

Board Of Directors & Officers ..... 35

Branch Locations ..... 36


**ANNUAL MEETING NOTICE**

The annual meeting of Shareholders will be held at Kenneth F. McMahon Hall at the Mill Creek MetroParks Experimental & Educational Building at 7574 Columbiana-Canfield Rd., Canfield, OH 44406, at 3:30 p.m. local time, on Thursday, March 27, 2008.

# Financial Highlights

(Dollar Amounts in Thousands Except for Per Share Data)

| For the Year | 2007 | 2006 | 2005 |
|---|---|---|---|
| Net Income | $ 5,925 | $ 7,215 | $ 8,060 |
| Return on Average Assets | 0.74% | 0.88% | 0.97% |
| Return on Average Equity | 7.95% | 9.60% | 10.40% |
| **Per Share** | | | |
| Net Income (Basic) | $ 0.46 | $ 0.55 | $ 0.62 |
| Net Income (Diluted) | 0.46 | 0.55 | 0.62 |
| Book Value | 5.67 | 5.83 | 5.82 |
| **Balances at Year-End** | | | |
| Total Assets | $ 798,236 | $ 821,584 | $ 827,069 |
| Earning Assets | 745,482 | 778,719 | 776,300 |
| Total Deposits | 593,428 | 619,747 | 630,800 |
| Net Loans | 508,647 | 502,594 | 506,054 |
| Total Stockholders' Equity | 73,920 | 76,223 | 75,864 |
| Cash Dividends | 8,309 | 8,307 | 8,309 |
| Common Shares Outstanding | 13,028 | 13,073 | 13,043 |

# Embracing the FUTURE for 120 years

Frank L. Paden
Farmers National Bank
President & CEO

On behalf of the employees and directors of Farmers National Banc Corp., it is my pleasure to present our Annual Report to Shareholders for 2007. We believe it is appropriate that the theme of this year's report is ***"Embracing the Future for 120 Years"*** as it clearly reflects both our enduring philosophy and our efforts in 2007.

In sum, we are celebrating twelve decades of community banking because we have always looked forward, and embraced a willingness to respond and adapt to change.

This year we recognized a significant milestone in our history, but more importantly, our focus and resources are designed to implement strategic steps to establish and enhance the bank's future for several generations.

According to the Independent Community Bankers of America, community banks are independent, locally owned and operated institutions with assets ranging from less than $10 million to multi-billion dollar institutions. There are approximately 8,600 community banks with total assets less than $1 Billion, which represents approximately 92% of the total number of banks in the United States.

Chartered in 1887 as a community bank with the founding principles of placing customer and community first, Farmers National Bank truly fits the definition of a community bank as described above. We are a local, independent community bank with a mission to advance this company through a balance of unparalleled customer service and solid financial performance, supported with the loyalty and confidence of generations of customers and shareholders.

Whether operating within a booming market, or during a downturn, there are three critical considerations that keep us on track:

- remain focused on the fundamentals;
- follow the proven path of great performers;
- effectively differentiate our institution from the competition and consistently communicate that unique value.

In 2007, we embarked on a number of initiatives to position our company to build the stamina and flexibility to effectively compete in an ever-changing business environment and under a variety of market conditions.

## Strategic Initiatives for 2007

***Growth and Retention Initiative.*** In accordance with strategic planning decisions made in late 2006, the bank engaged the services of a third party firm to implement the tools, processes and strategies to improve profitability and implement a long term growth and retention strategy through a comprehensive customer relationship management project. This state-of-the-industry system provides the tools for management to quantify relationships per household and analyze profitability at the account, product, officer and branch levels.

In addition, management will have access to customer behavior patterns that will assist in managing attrition risk, targeted marketing campaigns and create workflow efficiencies. Installation and training is complete and our project team is expected to have this system in production by the end of the first quarter 2008.

As part of this initiative, management is also implementing a profitability enhancement tool that gives our management team a structured means of continually developing conclusions toward profit enhancement. They will be able to quickly identify strengths and weaknesses to pinpoint opportunities to:

- enhance profitability;
- quantify the bottom-line estimates for profitability;
- rank those opportunities meriting internal and external resources;
- propose specific solutions for the top priorities.

***Brand and Name Recognition Initiative.*** A second initiative that our management team completed during 2007 included a market research study with the objective of providing a comprehensive and acute understanding of the Farmers National Bank brand and the reasons why the bank is or isn't attracting new customers as well as the reasons why the bank is retaining customers.

The Optimization Group, from Ann Arbor, Michigan conducted this research study. This firm utilized a proprietary online brainstorming tool designed to solicit a wide range of inputs and identify the strongest, based on importance and relevance. Two analytical subgroups of respondents were identified – customers and non-customers. The response was overwhelming, exceeding industry standards when conducting this type of survey. The data collected gave management priceless feedback about our bank, how we are perceived in regard to customer service, our pricing of products and services and our role in the local communities we serve. As with any survey, we received suggestions and recommendations, which we have accepted and will further evaluate in order to determine what it takes to get better at what we do.

***Investment in Human Capital Initiative***. This particular initiative started in late 2006. As I reported earlier, this was a two-year project plan that has a series of objectives to be accomplished in stages. Our senior management team has spent countless hours analyzing our staff capacity, evaluating skill levels, and developing performance metrics and other human capital resource tools to

lead this company into the future. I am very excited about the group of young executives and associates we have on our team and have high expectations for them. We plan to allocate time and resources to challenge this group and give them opportunities to grow and become leaders in our company for the future.

***Investment in Technology Initiative.*** During 2007, we installed and integrated a new teller platform at all our locations that converts all over-the-counter transactions to electronic images and transmits these images to a central processing site to interface with other technology upgrades we made in our core processing system. This technology will give more timely credit of funds to customer accounts and balances throughout the banking network.

## 2007 Performance

The primary source of Farmers National Bank's revenue is net interest income from the combination of income earned on loans and investments less interest paid for deposits and other borrowings. Business volumes tend to be influenced by overall economic factors, including market interest rates, business spending, and consumer confidence, as well as competitive conditions within the marketplace.

Despite a challenging interest rate environment, slower economic growth conditions in our markets and the current industry challenges related to home mortgage lending, we accomplished our primary objective for 2007, which was to stabilize and manage our net interest margin. On a tax-equivalent basis, our margin increased during 2007 from 3.29% in 2006 up to 3.33% for 2007.

In 2007, total revenues for Farmers National Banc Corp., which includes net interest income plus non-interest income, was $28.1 million. Net income after taxes was $5.9 million, or $0.46 per share. Included in those results and adversely affecting net income was a non-cash after-tax impairment charge of $567 thousand, representing $0.04 per share. The other-than-temporary impairment charge was recognized in the fourth quarter of 2007 and was caused by the sudden drop in value of preferred stock holdings of Fannie Mae, and uncertainty of future market conditions surrounding the U.S. Government sponsored enterprise.

We ended 2007 with total assets of $798 million compared to $822 million in 2006. Overall growth in total loans was modest, but we continued to diversify our loan portfolio with an emphasis on commercial loans and commercial real estate loans. During 2007, we experienced a 7.76% increase in those particular types of loans, but that increase was offset with a reduction in consumer loans of 9.75% over the same twelve-month period. Total deposits were $593 million, down from $619 million from the previous year. The lower balances were a result of our disciplined pricing strategy on volatile non-core deposits.

Shareholders' Equity was $74 million at year-end equating to a book value of $5.67 per share. Our common stock traded at a high of $10.85 and a low of $7.31 during 2007. Our price had stabilized during the first eight months of the year, but then in September, following industry announcements of additional sub-prime mortgage issues and the foreclosure crisis, stock prices and market values of most companies in the financial services industry generally decreased across the board and remain at low levels.

We continued our current cash dividend policy, paying $0.64 per share. Our Dividend Reinvestment Program also remained unchanged during 2007. Our Board of Directors did re-authorize our Share Repurchase Program in June 2007, which afforded us the opportunity to repurchase approximately 398,000 shares of common stock during the past calendar year.

Our industry is currently faced with two related issues that have drawn media attention on both the local and national levels. The first issue is the sub-prime mortgage loan crisis and fallout that is causing mortgage loan defaults and the increase in the number of foreclosures. The second issue has to deal with overall asset quality in the bank's loan portfolios that has prompted high loan loss provisions and increased levels of non-performing assets.

During 2007, many of our peers made substantial provisions to their allowance for loan loss accounts. For the year, our provision for loan losses totaled $570 thousand in 2007, up from $200 thousand in 2006. Net chargeoffs were $705 thousand, or .14% of average net loans.

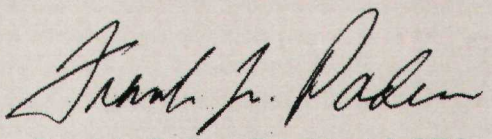
At year-end, total loans were $514.1 million and we had $5.5 million in our allowance for loan loss reserve account. This represents 1.06% of total loans, and 231% of non-performing loans. Non-performing loans, which are loans delinquent 90 days or more plus non-accrual loans were $2.4 million, or .46% of total loans and .30% of total assets. It is important to note that all these ratios are comparable to our historical results over a period of years. Historically, we have been able to manage these special assets in a very efficient manner. The primary objective of our loan officers and loan review staff is to continue to focus on quality loan growth and manage risk with a long-term focus.

I encourage you to take the opportunity to review this Annual Report along with the Report of our Independent Registered Public Accounting Firm. The Management's Discussion section included within this report details more results of performance during 2007.

Looking forward to 2008 and beyond, our strategy is to provide sustainable, long-term growth of assets, earnings and value to our shareholders utilizing prudent risk management practices.

We want to thank our customers, shareholders, and our team of over 280 associates who have supported the Farmers National Banc Corp. Performance with integrity and a commitment to our communities, customers and shareholders are at the core of who we are and the keys to our success.

Sincerely,



Frank L. Paden, President & CEO

# INVESTOR INFORMATION

**CORPORATE HEADQUARTERS:**
Farmers National Banc Corp., 20 South Broad Street, P.O. Box 555, Canfield, OH 44406. Phone 330-533-3341 or Toll Free 1-888-988-3276.

**WEBSITE:** www.fnbcanfield.com

**DIVIDEND PAYMENTS:**
Subject to the approval of the Board of Directors, quarterly cash dividends are customarily payable on or about the 30th day of March, June, September and December.

**DIVIDEND REINVESTMENT PLAN (DRIP):**
Registered shareholders can purchase additional shares of Farmers' common stock through Farmers Dividend Reinvestment Plan. Participation is voluntary and allows for automatic reinvestment of cash dividends, supplemental cash contributions not to exceed $1,000 per quarter and the safekeeping of stock certificates. To obtain our Plan prospectus, contact Susan Better at the bank or email: exec@fnbcanfield.com.

**DIRECT DEPOSIT OF CASH DIVIDENDS:**
The direct deposit program, which is offered at no charge, provides for automatic deposit of quarterly dividends directly to a checking or savings account. For information regarding this program, please contact the bank.

**STOCK TRANSFER AGENT:**
The Farmers National Bank of Canfield
Attention: Susan Better, AVP, Corporate Services
Administration, P.O. Box 555, Canfield, OH 44406

**FORM 10-K:**
A copy of the Annual Report filed with the Securities and Exchange Commission will be provided to any shareholder on request to the Corporation, to the attention:
Mr. Carl D. Culp, Treasurer, Farmers National Banc Corp.
20 South Broad Street, P.O. Box 555, Canfield, OH 44406

**COMMON STOCK LISTING AND INFORMATION AS TO STOCK PRICES AND DIVIDENDS:**
The common stock of the Corporation trades on the OTC Bulletin Board under the symbol FMNB.OB. There are approximately thirteen local and/or regional brokerage firms that are known to be relatively active in trading the Corporation's common stock. Set forth in the accompanying table are per share prices at which common stock of the Corporation has actually been purchased and sold in transactions during the periods indicated, to the knowledge of the Corporation. Also included in the table are dividends per share paid on the outstanding common stock and any stock dividends paid. As of December 31, 2007, there were 13,028,376 shares outstanding and 3,878 shareholders of record of common stock.

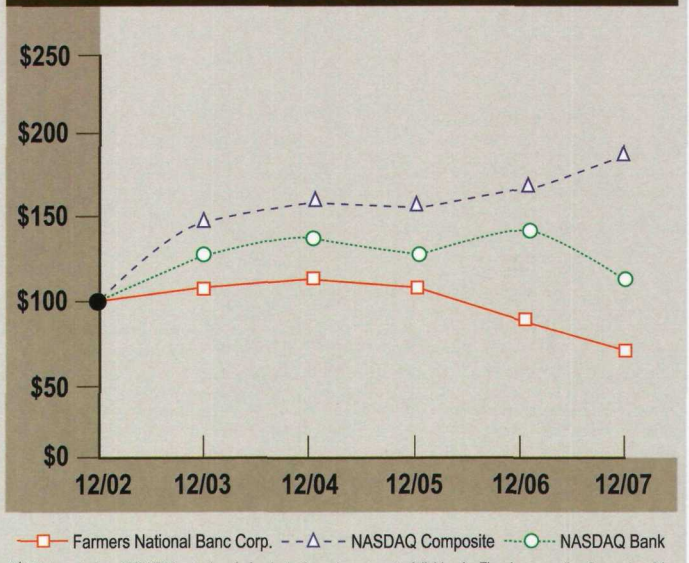
**MARKET AND DIVIDEND SUMMARY**

| Dividend Date | High | Low | Dividend |
|---|---|---|---|
| March 2006 | $12.55 | $11.55 | $0.16 |
| June 2006 | $11.85 | $10.50 | $0.16 |
| September 2006 | $11.20 | $10.50 | $0.16 |
| December 2006 | $10.80 | $10.50 | $0.16 |
| March 2007 | $10.80 | $10.50 | $0.16 |
| June 2007 | $10.80 | $10.49 | $0.16 |
| September 2007 | $10.85 | $ 8.99 | $0.16 |
| December 2007 | $ 9.45 | $ 7.31 | $0.16 |

## PERFORMANCE GRAPH

The Securities and Exchange Commission requires a line graph presentation comparing cumulative, five-year shareholder returns on an indexed basis with a broad equity market index and either a nationally recognized industry standard or an index of peer companies selected by the Corporation. The Corporation has selected the NASDAQ Composite Index and the NASDAQ Bank Index for purposes of this performance comparison. The Performance Graph set forth below, assumes an investment of $100 on December 31, 2002, and compares year-end totals, shareholder returns, assuming dividends are reinvested, for a five-year period ending December 31, 2007.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN***
Among Farmers National Banc Corp., The NASDAQ Composite Index And The NASDAQ Bank Index




* $100 invested on 12/31/02 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

| | 12/02 | 12/03 | 12/04 | 12/05 | 12/06 | 12/07 |
|---|---|---|---|---|---|---|
| Farmers National Banc Corp. | 100.00 | 115.46 | 124.25 | 103.64 | 90.90 | 70.93 |
| NASDAQ Composite | 100.00 | 149.75 | 164.64 | 168.60 | 187.83 | 205.22 |
| NASDAQ Bank | 100.00 | 130.51 | 144.96 | 141.92 | 159.42 | 125.80 |

# SELECTED FINANCIAL DATA

(Table Dollar Amounts In Thousands except Per Share Data)

| For the Years Ending December 31, | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|---|---|---|---|---|
| **Summary of Earnings** | | | | | |
| Total Interest Income (including fees on loans) | **$ 45,538** | $ 44,098 | $ 42,481 | $ 41,772 | $ 43,673 |
| Total Interest Expense | **21,893** | 20,199 | 15,236 | 12,772 | 13,934 |
| Net Interest Income | **23,645** | 23,899 | 27,245 | 29,000 | 29,739 |
| Provision for Loan Losses | **570** | 200 | 649 | 915 | 870 |
| Noninterest Income (1) | **4,408** | 5,134 | 4,386 | 537 | 2,978 |
| Noninterest Expense | **20,382** | 19,619 | 20,212 | 18,947 | 18,372 |
| Income Before Income Taxes | **7,101** | 9,214 | 10,770 | 9,675 | 13,475 |
| Income Taxes | **1,176** | 1,999 | 2,710 | 2,494 | 3,960 |
| NET INCOME | **$ 5,925** | $ 7,215 | $ 8,060 | $ 7,181 | $ 9,515 |
| **Per Share Data** | | | | | |
| Basic earnings per share | **$ 0.46** | $ 0.55 | $ 0.62 | $ 0.56 | $ 0.74 |
| Diluted earnings per share | **0.46** | 0.55 | 0.62 | 0.55 | 0.74 |
| Cash Dividends Paid | **0.64** | 0.64 | 0.64 | 0.63 | 0.59 |
| Book Value at Year-End | **5.67** | 5.83 | 5.82 | 6.06 | 6.19 |
| **Balances at Year-End** | | | | | |
| Total Assets | **$ 798,236** | $ 821,584 | $ 827,069 | $ 817,839 | $ 812,815 |
| Earning Assets | **745,482** | 778,719 | 776,300 | 771,513 | 767,137 |
| Total Deposits | **593,428** | 619,747 | 630,800 | 622,224 | 625,615 |
| Short-Term Borrowings | **74,174** | 77,792 | 76,963 | 76,728 | 58,599 |
| Long-Term Borrowings | **52,455** | 41,602 | 39,508 | 37,495 | 44,324 |
| Net Loans | **508,647** | 502,594 | 506,054 | 479,535 | 475,898 |
| Total Stockholders' Equity | **73,920** | 76,223 | 75,864 | 78,654 | 80,214 |
| **Average Balances** | | | | | |
| Total Assets | **$ 804,968** | $ 818,549 | $ 828,180 | $ 811,951 | $ 790,725 |
| Total Stockholders' Equity | **74,615** | 75,143 | 77,475 | 79,186 | 80,875 |
| **Significant Ratios** | | | | | |
| Return on Average Assets (ROA) | **0.74 %** | 0.88 % | 0.97 % | 0.88 % | 1.20 % |
| Return on Average Equity (ROE) | **7.95** | 9.60 | 10.40 | 9.07 | 11.77 |
| Average Earning Assets/Average Assets | **94.86** | 94.98 | 94.59 | 94.49 | 94.23 |
| Average Equity/Average Assets | **9.26** | 9.18 | 9.35 | 9.75 | 10.23 |
| Net Loans/Deposits | **85.71** | 81.10 | 80.22 | 77.07 | 76.07 |
| Allowance for Loan Losses/Total Loans | **1.06** | 1.10 | 1.14 | 1.27 | 1.38 |
| Allowance for Loan Losses/Nonperforming Loans | **231.22** | 324.85 | 290.57 | 461.29 | 435.34 |
| Efficiency Ratio (On tax equivalent basis) | **68.00** | 65.04 | 61.54 | 55.75 | 54.40 |
| Net Interest Margin | **3.33** | 3.31 | 3.67 | 3.94 | 4.13 |
| Dividend Payout Rate | **140.24** | 115.14 | 103.08 | 113.33 | 79.89 |

(1) Noninterest income includes a securities impairment charge of $873 thousand and $3.225 million respectively for the years ended December 31, 2007 and 2004.

# AVERAGE BALANCE SHEETS AND RELATED YIELDS AND RATES

(Table Dollar Amounts In Thousands except Per Share Data)

| Years Ended December 31, | 2007 | | | 2006 | | | 2005 | | |
|---|---|---|---|---|---|---|---|---|---|
| | AVERAGE BALANCE | INTEREST | RATE | AVERAGE BALANCE | INTEREST | RATE | AVERAGE BALANCE | INTEREST | RATE |
| **EARNING ASSETS** | | | | | | | | | |
| Loans (1)(3)(5) | **$508,812** | **$ 35,203** | **6.92 %** | $508,645 | $33,519 | 6.59 % | $496,266 | $ 31,739 | 6.40 % |
| Taxable securities (2) | **168,074** | **7,017** | **4.17** | 186,341 | 7,423 | 3.98 | 213,519 | 8,216 | 3.85 |
| Tax-exempt securities (2)(5) | **70,413** | **4,112** | **5.84** | 62,525 | 3,703 | 5.92 | 52,495 | 3,197 | 6.09 |
| Equity securities (4)(5) | **9,360** | **664** | **7.09** | 11,429 | 732 | 6.40 | 12,733 | 477 | 3.75 |
| Federal funds sold | **6,970** | **342** | **4.91** | 8,534 | 431 | 5.05 | 8,383 | 266 | 3.17 |
| Total earning assets | **763,629** | **47,338** | **6.20** | 777,474 | 45,808 | 5.89 | 783,396 | 43,895 | 5.60 |
| **NONEARNING ASSETS** | | | | | | | | | |
| Cash and due from banks | **21,774** | | | 23,975 | | | 26,929 | | |
| Premises and equipment | **14,630** | | | 14,924 | | | 15,397 | | |
| Allowance for Loan Losses | **( 5,597 )** | | | ( 5,845 ) | | | ( 6,136 ) | | |
| Other assets (1) | **10,532** | | | 8,021 | | | 8,594 | | |
| Total Assets | **$804,968** | | | $818,549 | | | $828,180 | | |
| **INTEREST-BEARING LIABILITIES** | | | | | | | | | |
| Time deposits | **$270,269** | **$12,675** | **4.69 %** | $279,196 | $ 11,423 | 4.09 % | $272,049 | $ 8,981 | 3.30 % |
| Savings deposits | **166,840** | **3,334** | **2.00** | 167,062 | 3,271 | 1.96 | 169,881 | 1,549 | 0.91 |
| Demand deposits | **97,362** | **547** | **0.56** | 110,812 | 831 | 0.75 | 131,859 | 1,170 | 0.89 |
| Repurchase agreements | **77,770** | **2,826** | **3.63** | 77,377 | 2,579 | 3.33 | 77,677 | 1,809 | 2.33 |
| Other borrowings | **52,940** | **2,511** | **4.74** | 45,776 | 2,095 | 4.57 | 39,396 | 1,727 | 4.38 |
| Total Interest-Bearing Liabilities | **665,181** | **21,893** | **3.29** | 680,223 | 20,199 | 2.97 | 690,862 | 15,236 | 2.21 |
| **NONINTEREST-BEARING LIABILITIES AND STOCKHOLDERS' EQUITY** | | | | | | | | | |
| Demand deposits | **60,632** | | | 57,755 | | | 55,848 | | |
| Other Liabilities | **4,540** | | | 5,428 | | | 3,995 | | |
| Stockholders' equity | **74,615** | | | 75,143 | | | 77,475 | | |
| Total Liabilities and Stockholders' Equity | **$804,968** | | | $818,549 | | | $828,180 | | |
| Net interest income and interest rate spread | | **$ 25,445** | **2.91%** | | $ 25,609 | 2.92 % | | $ 28,659 | 3.39 % |
| Net interest margin | | | **3.33 %** | | | 3.29 % | | | 3.66 % |

(1) Non-accrual loans and overdraft deposits are included in other assets.

(2) Includes unamortized discounts and premiums. Average balance and yield are computed using the historical amortized cost.

(3) Interest on loans includes fee income of $1.68 million, $1.61 million and $1.98 million for 2007, 2006 and 2005 respectively.

(4) Equity securities include restricted stock, which is included in other assets on the consolidated balance sheets.

(5) For 2007, adjustments of $350 thousand, $1.37 million, and $83 thousand respectively are made to tax equate income on tax exempt loans, tax exempt securities and to reflect a dividends received deduction on equity securities. For 2006, adjustments of $357 thousand, $1.24 million, and $112 thousand respectively are made to tax equate income on tax exempt loans, tax exempt securities and to reflect a dividends received deduction on equity securities. For 2005, adjustments of $286 thousand, $1.07 million, and $56 thousand respectively are made to tax equate income on tax exempt loans, tax exempt securities and to reflect a dividends received deduction on equity securities. These adjustments are based on a marginal federal income tax rate of 35%, less disallowances.

## RATE AND VOLUME ANALYSIS

(Table Dollar Amounts In Thousands except Per Share Data)

The following table analyzes by rate and volume the dollar amount of changes in the components of the interest differential:

| | 2007 change from 2006 | | | 2006 change from 2005 | | |
|---|---|---|---|---|---|---|
| | Net Change | Change Due To Volume | Change Due To Rate | Net Change | Change Due To Volume | Change Due To Rate |
| **Tax Equivalent Interest Income** | | | | | | |
| Loans | $ 1,684 | $ 11 | $ 1,673 | $ 1,780 | $ 792 | $ 988 |
| Taxable securities | ( 406 ) | ( 728 ) | 322 | ( 793 ) | ( 1,046 ) | 253 |
| Tax-exempt securities | 409 | 467 | ( 58 ) | 506 | 611 | ( 105 ) |
| Equity securities | ( 68 ) | ( 133 ) | 65 | 255 | ( 49 ) | 304 |
| Federal funds sold | ( 89 ) | ( 79 ) | ( 10 ) | 165 | 5 | 160 |
| Total interest income | $ 1,530 | $ ( 462 ) | $ 1,992 | $ 1,913 | $ 313 | $ 1,600 |
| **Interest Expense** | | | | | | |
| Time deposits | $ 1,252 | $ ( 365 ) | $ 1,617 | $ 2,442 | $ 236 | $ 2,206 |
| Savings deposits | 63 | ( 4 ) | 67 | 1,722 | ( 26 ) | 1,748 |
| Demand deposits | ( 284 ) | ( 101 ) | ( 183 ) | ( 339 ) | ( 187 ) | ( 152 ) |
| Repurchase agreements | 247 | 13 | 234 | 770 | ( 7 ) | 777 |
| Borrowings | 416 | 328 | 88 | 368 | 281 | 87 |
| Total interest expense | $ 1,694 | $ ( 129 ) | $ 1,823 | $ 4,963 | $ 297 | $ 4,666 |
| Increase (decrease) in tax equivalent net interest income | $ ( 164 ) | $ ( 333 ) | $ 169 | $( 3,050 ) | $ 16 | $( 3,066 ) |

The amount of change not solely due to rate or volume changes was allocated between the change due to rate and the change due to volume based on the relative size of the rate and volume changes.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's discussion and analysis represents a review of the Corporation's consolidated financial condition and results of operations. This review should be read in conjunction with the consolidated financial statements and footnotes.

### Forward Looking Statements

When used in this annual report, or in future filings with the Securities and Exchange Commission, in press releases or other public or shareholder communications, or in oral statements made with the approval of an authorized executive officer, the words or phrases "will likely result", "are expected to", "will continue", "is anticipated", "estimate", "project", or similar expressions are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause the Corporation's actual results to be materially different from those indicated. Such statements are subject to certain risks and uncertainties including changes in economic conditions in the market areas the Corporation conducts business, which could materially impact credit quality trends, changes in policies by regulatory agencies, fluctuations in interest rates, demand for loans in the market areas the Corporation conducts business, and competition, that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Corporation wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. The Corporation undertakes no obligation to publicly release the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

### Overview:

#### *Earnings, Margins, Average Earning Assets/Liabilities*

Net income for 2007 was $5.9 million, or $0.46 basic and diluted earnings per share compared to $7.2 million, or $0.55 diluted earnings per share in 2006, decreases of 17.88% and 16.36% respectively. The results for 2007 included a non-operating after-tax charge of $576 thousand representing a reclassification and recognition of an other-than-temporary impairment of securities.

The net interest margin increased from 3.29% at December 31, 2006 to 3.33% for 2007, or 4 basis points. Total average earning assets decreased 1.78% and the yields on those average-earning assets increased 31 basis points from 5.89% in 2006 to 6.20% in 2007. Total interest bearing liabilities decreased 2.21%, and the cost on the average interest-bearing liabilities increased from 2.97% in 2006 to 3.29% in 2007 or 32 basis points. This increase was the result of depositors opting to invest in higher rate time deposit products. The increase in net interest margin offset by a lower level of earning assets resulted in a slight decrease in net interest income from the previous year.

# MANAGEMENT'S DISCUSSION

(Table Dollar Amounts In Thousands except Per Share Data)

## Deposits

Average deposits decreased during the past year. Given the modest loan demand and the keen competition for time deposits, efforts have been concentrated to better manage the margin rather than grow the balance sheet in the current interest rate environment. The Corporation prices deposit rates to remain competitive within the market to retain customers. The average balance of Securities sold under Repurchase Agreements increased slightly, however the cost of those particular borrowings increased 30 basis points. The effect of higher short-term interest rates in the first half of the year and a shift in deposit types resulted in interest expense increasing $1.694 million in 2007.

Strategies for 2008 include plans to strategically price rates on time deposit products and money market accounts; continued efforts to increase our level of noninterest-bearing deposits; and remain focused on lowering our overall cost of funds.

## Loans

Net loans increased 1.2% during 2007. A strategy the Corporation adopted a few years ago was to diversify the loan portfolio and employ a more balanced loan portfolio management model between commercial loans, commercial real estate loans, residential real estate loans and consumer loans. At year-end, we have approximately 9% of the loan portfolio in commercial loans, 38% in commercial real estate loans, 33% in residential real estate loans and 20% in consumer loans. Our lending staff has accomplished another year of solid growth in the commercial real estate portfolio, stressing local economic development, encouraging growth and expansion within our communities and building on long-term customer relationships.

Asset quality remains a high-priority in our overall business plan as it relates to our long-term asset growth projections. During 2007, our net charge-offs increased by $239 thousand compared to 2006. Two key ratios to monitor asset quality performance are the net charge-offs/average loans and the allowance for loan losses/non-performing loans. At year-end 2007, these ratios were .14% and 231% respectively compared to .09% and 325% in 2006. Approximately 60% of net charge-offs experienced in 2007 were related to a single commercial relationship.

Loan strategies for 2008 include to responsibly grow the balances in our loan portfolios while continuing to maintain our underwriting standards and focus on maintaining yields in a declining interest rate environment.

## Stockholders Equity

During 2007, we maintained our annual cash dividend plan and paid $0.64 per share. Total cash dividends declared were $8.3 million in 2007 and 2006. During the past twelve months, we have seen the market price of our stock fluctuate from $10.55 at the end of 2006 to $7.31 at the end of 2007. The Corporation remains committed to utilization of the stock repurchase plan, having repurchased approximately 398,000 shares during 2007.

Equity strategies for 2008 include three initiatives: increase earnings to support the current cash dividend plan; continued evaluation of the current features of our Dividend Reinvestment Plan to determine its impact on the goals and objectives for future capital planning; and continue to remain active with our Stock Repurchase Program.

## Results of Operations

***Comparison of Operating Results for the Years Ended December 31, 2007 and 2006.***

The Corporation's net income totaled $5.925 million during 2007, compared to $7.215 million for 2006. On a per share basis, diluted earnings per share were $.46 as compared to $.55 diluted earnings per share for 2006. Common comparative ratios for results of operations include the return on average assets and return on average stockholders' equity. For 2007 the return on average equity was 7.95% compared to 9.60% for 2006. The return on average assets was .74% for 2007 and .88% for 2006.

The results for 2007 included an after-tax charge of $576 thousand representing a reclassification and recognition of an other-than-temporary impairment of securities. During the past year, the Corporation has made progress in improving on the rate spread between interest income and interest expense. Margins have improved despite the challenges faced in the current interest rate and the economic environment. However, with the lack of any growth, the Corporation's performance ratios and total dollars of net income are less than what we reported from the previous year. The Corporation will continue to monitor pricing policies and remain competitive for new loans and deposits. Strategically, the management team is working very diligently to focus on efficiency, controlling expenses and exploring other sources of non-interest income.

Net interest income, the principal source of the Corporation's earnings, represents the difference between interest income on interest-earning assets and interest expense on interest-bearing liabilities. For 2007, taxable equivalent net interest income decreased $164 thousand or .64% from 2006. Interest-earning assets averaged $763.629 million during 2007 decreasing $13.845 million or 1.78% compared to 2006. The Corporation's interest-bearing liabilities decreased 2.21% from $680.223 million in 2006 to $665.181 million in 2007.

The Corporation finances its earning assets with a combination of interest-bearing and interest-free funds. The interest-bearing funds are composed of deposits, short-term borrowings and long-term debt. Interest paid for the use of these funds is the second factor in the net interest income equation. Interest-free funds, such as demand deposits and stockholders' equity, require no interest expense and, therefore, contribute significantly to net interest income.

The profit margin, or spread, on invested funds is a key performance measure. The Corporation monitors two key performance indicators - net interest spread and net interest margin. The net interest spread represents the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities. The net interest margin represents the overall profit margin: net interest income as a percentage of total interest-earning assets. This performance indicator gives effect to interest earned for all investable funds including the substantial volume of interest-free funds. For 2007 the net interest margin, measured on a fully taxable equivalent basis increased to 3.33%, compared to 3.29% in 2006.

Total taxable equivalent interest income was $47.338 million for 2007, which is $1.53 million more than the $45.808 million reported in 2006. This moderate increase is primarily the result of increases in the yields on average earning

# MANAGEMENT'S DISCUSSION

(Table Dollar Amounts In Thousands except Per Share Data)

assets. Average loans were slightly higher in 2007, and the yields increased from 6.59% in 2006 to 6.92% in 2007. Income from securities and federal funds was slightly lower in 2007, but the Corporation saw its yields on these assets increase from 4.57% in 2006 to 4.76% in 2007. However, the average balances of investment securities and federal funds sold decreased 5.21% in 2007, mainly due to decreases in customer deposits.

Total interest expense amounted to $21.893 million for 2007, an 8.39% increase from $20.199 million reported in 2006. The increase in 2007 is the result of higher rates of interest paid on a lower level of interest-bearing deposits and repurchase agreements. The cost of interest-bearing liabilities increased from 2.97% in 2006 to 3.29% in 2007.

Management will continue to evaluate future changes in interest rates and the shape of the treasury yield curve so that assets and liabilities may be priced accordingly to minimize the impact on the net interest margin.

## Other Income

Total other income, excluding the $873 thousand pre-tax impairment charge discussed on page 8, increased by $147 thousand in 2007. This increase is primarily due to a $221 thousand increase in security gains, and a $97 thousand increase in other operating income. Management continues to explore new products and nontraditional banking services that could increase other income in future years.

## Other Expenses

Total other expenses for 2007 increased 3.89% or $763 thousand from 2006. Most of this increase resulted from higher occupancy and equipment expense, as well as other operating expenses, which increased 9.37% and 8.88% respectively. Salaries and employee benefits increased just $147 thousand or 1.27%. The Corporation's tax equivalent efficiency ratio increased from 65.04% in 2006 to 68.00% in 2007. The efficiency ratio was adversely impacted by the $763 thousand increase in other expenses and the $164 thousand decline in tax equivalent net interest income. The efficiency ratio is calculated as follows: non-interest expense divided by the sum of tax equivalent net interest income plus non-interest income, excluding security gains and losses. This ratio is a measure of the expense incurred to generate a dollar of revenue. Management will continue to closely monitor and keep the increases in other expenses to a minimum.

## Income Taxes

Income tax expense totaled $1.176 million for 2007 and $1.999 million for 2006. Income taxes are computed using the appropriate effective tax rates for each period. The effective tax rates are less than the statutory tax rate primarily due to nontaxable interest and dividend income. The effective income tax rate was 17% and 22% for the periods ending 2007 and 2006, respectively. Refer to Note L to the consolidated financial statements for additional information regarding the effective tax rate.

## *Comparison of Operating Results for the Years Ended December 31, 2006 and 2005.*

The Corporation's net income totaled $7.2 million during 2006 compared to $8.1 million for 2005. On a per share basis, diluted earnings per share was $.55 for 2006 as compared to $.62 for 2005. For 2006, the return on average equity was 9.60% as compared to 10.40% for 2005. The return on average assets was .88% for 2006 and .97% for 2005. For 2006, taxable equivalent net interest income decreased $3.05 million or 10.64% less than 2005. Interest-earning assets averaged $777.474 million during 2006 decreasing slightly compared to 2005. For 2006 the net interest margin, measured on a fully taxable equivalent basis was 3.29% in comparison to 3.66% for 2005.

Total taxable equivalent interest income was $45.808 million for 2006 which was $1.913 million more than the $43.895 million reported in 2005. This increase was primarily the result of higher yields on earning assets. Average loan balances increased 2.49%, and the yields increased from 6.40% in 2005 to 6.59% in 2006. Income from securities and federal funds sold increased $133 thousand or 1.09%, as the Corporation saw its yields on these assets increase from 4.23% in 2005 to 4.57% in 2006. The average balances of investment securities and federal funds sold decreased 6.37% in 2006, mainly due to increases in customer deposits.

Total interest expense amounted to $20.199 million for 2006, a 32.57% increase from $15.236 million reported in 2005. The increase in 2006 is the result of higher rates of interest paid on a slightly lower level of interest-bearing liabilities. The cost of interest-bearing liabilities increased from 2.21% in 2005 to 2.97% in 2006.

## Other Income

Total other income in 2006 amounted to $5.134 million, an increase of 17.05% over $4.386 million in 2005. This increase is primarily due to a $250 thousand increase in overdrafts and return check charges, a $260 thousand increase in security gains and a $100 thousand increase in brokerage income.

## Other Expenses

Total other expenses for 2006 decreased 2.93% or $593 thousand from 2005. Salaries and employee benefits decreased $109 thousand or .93%. The Corporation's tax-equivalent efficiency ratio increased from 61.71% in 2005 to 65.04% in 2006. The efficiency ratio was adversely impacted by the $3.05 million decline in net interest income.

## Income Taxes

Income tax expense totaled $1.99 million for 2006 and $2.71 million for 2005. The effective income tax rate was 22% and 25% for the periods ending 2006 and 2005, respectively.

## Market Risk

Important considerations in asset/liability management are liquidity, the balance between interest rate sensitive assets and liabilities and the adequacy of capital. Interest rate sensitive assets and liabilities are those which have yields on rates subject to change within a future time period due to maturity of the instrument or changes in market rates. While liquidity management involves meeting the funds flow requirements of the Corporation, the management of interest rate sensitivity focuses on the structure of these assets and liabilities

# MANAGEMENT'S DISCUSSION

(Table Dollar Amounts In Thousands except Per Share Data)

with respect to maturity and repricing characteristics. Balancing interest rate sensitive assets and liabilities provides a means of tempering fluctuating interest rates and maintaining net interest margins through periods of changing interest rates. The Corporation monitors interest rate sensitive assets and liabilities to determine the overall interest rate position over various time frames.

The Corporation considers the primary market exposure to be interest rate risk. Simulation analysis is used to monitor the Corporation'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 200 basis point increase or decrease in market interest rates:

| Changes In Interest Rate (basis points) | 2007 Result | 2006 Result | ALCO Guidelines |
|---|---|---|---|
| Net Interest Income Change | | | |
| +200 | **-6.16%** | -12.99% | 15.00% |
| -200 | **-5.26%** | 3.52% | 15.00% |
| Net Present Value Of Equity Change | | | |
| +200 | **.01%** | -5.28% | 20.00% |
| -200 | **-22.47%** | -8.20% | 20.00% |

It should be noted that the change in the net present value of equity slightly exceeded policy when the simulation model assumed a sudden decrease in rates of 200 basis points (2%). This is because the positive impact on the fair value of assets would not be as great as the same 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. The remaining results of this analysis comply with internal limits established by the Corporation. A report on interest rate risk is presented to the Board of Directors and the Asset/Liability Committee on a quarterly basis. The Corporation 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.

With the largest amount of interest sensitive assets and liabilities maturing within twelve months, the Corporation monitors this area most closely. Early withdrawal of deposits, prepayments of loans and loan delinquencies are some of the factors that could have such an effect. In addition, changes in rates on interest sensitive assets and liabilities may not be equal, which could result in a change in net margin.

Interest rate sensitivity management provides some degree of protection against net interest income volatility. It is not possible or necessarily desirable to attempt to eliminate this risk completely by matching interest sensitive assets and liabilities. Other factors, such as market demand, interest rate outlook, regulatory restraint and strategic planning also have an effect on the desired balance sheet structure.

## Liquidity

The Corporation maintains, in the opinion of management, liquidity sufficient to satisfy depositors' requirements and meet the credit needs of customers. The Corporation depends on its ability to maintain its market share of deposits as well as acquiring new funds. The Corporation's ability to attract deposits and borrow funds depends in large measure on its profitability, capitalization and overall financial condition.

Principal sources of liquidity for the Corporation include assets considered relatively liquid such as short-term investment securities, federal funds sold and cash and due from banks.

Along with its liquid assets, the Corporation has additional sources of liquidity available which help to insure 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 three major domestic banks. At December 31, 2007, the Corporation had not borrowed against these lines of credit. Management feels that its liquidity position is more than adequate and will continue to monitor the position on a monthly basis. The Corporation also has additional borrowing capacity with the Federal Home Loan Bank of Cincinnati, as well as access to the Federal Reserve Discount Window, which provides an additional source of funds. Advances outstanding from the Federal Home Loan Bank at December 31, 2007 amounted to $52.111 million.

The primary investing activities of the Corporation are originating loans and purchasing securities. During 2007, net cash from investing activities amounted to $18.96 million compared to $7.94 million in 2006. Net increases in loans were $6.623 million in 2007 compared to net decreases of $3.234 million in 2006. Purchases of securities available were only $17.107 million in 2007 compared to $61.565 million in 2006. The Corporation used cash to purchase $10 million of bank owned life insurance in 2007 compared to none purchased in 2006. Proceeds from maturities and sales of securities available for sale were $53.362 million in 2007 compared to $66.751 million in 2006.

The primary financing activities of the Corporation are obtaining deposits, repurchase agreements and other borrowings. Net cash used by financing activities amounted to $28.103 million for 2007 compared to $16.124 million in 2006. Most of this change is a result of the net decrease in deposits. Deposits decreased $26.319 million in 2007 compared to $11.053 million in 2006. Short-term borrowings decreased $3.618 million in 2007 compared to a $829 thousand increase in 2006.

## Financial Condition

Total Assets declined $23.348 million or 2.84% since December 31, 2006. Average earning assets decreased similarly by $13.845 million since 2006. This decline in assets is mainly the result of decreases in deposit balances. Total Liabilities decreased $21.045 million or 2.82% since December 31, 2006. Average interest-bearing liabilities also decreased $15.042 million from 2006 to 2007. Capital ratios remain strong, as shown by the ratio of equity to total assets at December 31, 2007 of 9.26%.

# MANAGEMENT'S DISCUSSION

(Table Dollar Amounts In Thousands except Per Share Data)

## Loan Portfolio

### *Maturities and Sensitivities of Loans to Interest Rates*

The following schedule shows the composition of loans and the percentage of loans in each category at the dates indicated:

| Years Ended December 31, | 2007 | | 2006 | | 2005 | | 2004 | | 2003 | |
|---|---|---|---|---|---|---|---|---|---|---|
| Commercial, Financial and Agricultural .. | **$ 45,844** | **8.9%** | $ 40,698 | 8.0% | $ 38,722 | 7.6% | $ 32,838 | 6.8% | $ 29,143 | 6.0% |
| Commercial Real Estate ..... | **193,187** | **37.6** | 181,128 | 35.6 | 164,936 | 32.2 | 142,148 | 29.3 | 126,833 | 26.3 |
| Residential Real Estate ..... | **170,006** | **33.1** | 169,937 | 33.5 | 165,386 | 32.3 | 165,819 | 34.1 | 168,681 | 35.0 |
| Installment Loans to Individuals ..... | **105,069** | **20.4** | 116,425 | 22.9 | 142,870 | 27.9 | 144,874 | 29.8 | 157,880 | 32.7 |
| Total Loans ..... | **$514,106** | **100.0%** | $508,188 | 100.0% | $511,914 | 100.0% | $485,679 | 100.0% | $482,537 | 100.0% |

The following schedule sets forth maturities based on remaining scheduled repayments of principal for commercial, financial and agricultural loans listed above as of December 31, 2007:

| Types of Loans | 1 Year or less | 1 to 5 Years | Over 5 Years |
|---|---|---|---|
| Commercial, Financial and Agricultural ..... | $ 13,345 | $ 14,370 | $ 18,129 |

The amounts of commercial, financial and agricultural loans as of December 31, 2007, based on remaining scheduled repayments of principal, are shown in the following table:

| Loan Sensitivities | 1 Year or less | Over 1 Year | Total |
|---|---|---|---|
| Floating or Adjustable Rates of Interest ..... | $ 11,231 | $ 5,383 | $ 16,614 |
| Fixed Rates of Interest ..... | 2,114 | 27,116 | 29,230 |
| Total Loans ..... | $ 13,345 | $ 32,499 | $ 45,844 |

Total loans were $514.106 million at year-end 2007 compared to $508.188 million at year-end 2006. This represents an increase of 1.16%. Loans comprised 66.6% of the Bank's average earning assets in 2007, compared to 65.4% in 2006. The product mix in the Loan Portfolio includes Commercial Loans comprising 8.9%, Residential Real Estate Loans 33.1%, Commercial Real Estate Loans 37.6% and Consumer Loans 20.4% at December 31, 2007 compared with 8%, 33.5%, 35.6% and 22.9%, respectively, at December 31, 2006.

Loans contributed 74.37% of total taxable equivalent interest income in 2007 and 73.2% in 2006. Loan yield was 6.92% in 2007, 72 basis points greater than the average rate for total earning assets. Management recognizes that while the Loan Portfolio holds some of the Bank's highest yielding assets, it is inherently the most risky portfolio. Accordingly, management attempts to balance credit risk versus return with conservative credit standards. Management has developed and maintains comprehensive underwriting guidelines and a loan review function that monitors credits during and after the approval process. To minimize risks associated with changes in the borrower's future repayment capacity, the Bank generally requires scheduled periodic principal and interest payments on all types of loans and normally requires collateral.

Consumer Loans decreased from $116.425 million on December 31, 2006 to $105.069 million on December 31, 2007 representing a 9.75% decrease. Management continues to target the automobile dealer network to purchase indirect Installment Loans. Dealer paper was purchased using strict underwriting guidelines with an emphasis on quality. Indirect Loans comprise 87.5% of the Installment Loan Portfolio. Net loan losses on the Installment Loan portfolio have decreased to $213 thousand in 2007 as compared to $283 thousand in 2006.

Residential Real Estate Mortgage Loans increased slightly to $170.006 million at December 31, 2007, compared to $169.937 million in 2006. Commercial Real Estate Loans increased from $181.128 million in 2006 to $193.187 million in 2007. The Corporation originated both fixed rate and adjustable rate mortgages during 2007. Fixed rate terms are generally limited to fifteen year terms while adjustable rate products are offered with maturities up to thirty years.

Commercial Loans at December 31, 2007 increased 12.64% from year-end 2006 with outstanding balances of $45.844 million. The Bank's commercial loans are granted to customers within the immediate trade area of the Bank. The mix is diverse, covering a wide range of borrowers and business types. The Bank monitors and controls concentrations within a particular industry or segment of the economy. These loans are made for purposes such as equipment purchases, capital and leasehold improvements, the purchase of inventory, general working capital purposes and small business lines of credit.

# MANAGEMENT'S DISCUSSION

(Table Dollar Amounts In Thousands except Per Share Data)

## Summary of Loan Loss Experience

The following is an analysis of the allowance for loan losses for the periods indicated:

| Years Ended December 31, | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|---|---|---|---|---|
| Balance at Beginning of Year | $ 5,594 | $ 5,860 | $ 6,144 | $ 6,639 | $ 6,779 |
| Charge-Offs: | | | | | |
| Commercial, Financial and Agricultural | ( 48 ) | ( 19 ) | ( 25 ) | ( 41 ) | ( 12 ) |
| Commercial Real Estate | ( 385 ) | ( 9 ) | ( 78 ) | ( 78 ) | ( 80 ) |
| Residential Real Estate | ( 67 ) | ( 181 ) | ( 25 ) | ( 80 ) | ( 26 ) |
| Installment Loans to Individuals | ( 612 ) | ( 850 ) | ( 1,631 ) | ( 1,655 ) | ( 1,257 ) |
| Total Charge-Offs | ( 1,112 ) | ( 1,059 ) | ( 1,759 ) | ( 1,854 ) | ( 1,375 ) |
| Recoveries on Previous Charge-Offs: | | | | | |
| Commercial, Financial and Agricultural | 3 | 24 | 276 | 4 | 1 |
| Commercial Real Estate | 0 | 2 | 0 | 0 | 0 |
| Residential Real Estate | 5 | 0 | 0 | 15 | 0 |
| Installment Loans to Individuals | 399 | 567 | 550 | 425 | 364 |
| Total Recoveries | 407 | 593 | 826 | 444 | 365 |
| Net Charge-Offs | ( 705 ) | ( 466 ) | ( 933 ) | ( 1,410 ) | ( 1,010 ) |
| Provision for Loan Losses (1) | 570 | 200 | 649 | 915 | 870 |
| Balance at End of Year | $ 5,459 | $ 5,594 | $ 5,860 | $ 6,144 | $ 6,639 |
| Ratio of Net Charge-Offs to Average Net Loans Outstanding | 0.14 % | 0.09 % | 0.19 % | 0.30 % | 0.22 % |

(1) The provision for loan losses charged to operating expense is based on management's judgment after taking into consideration all factors connected with the collectibility 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 charge-off 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.

Provisions charged to operations amounted to $570 thousand in 2007 compared to $200 thousand in 2006. The balance in the allowance for loan losses is $5.459 million or 1.06% of loans at December 31, 2007. This ratio has decreased slightly from the 1.10% reported at December 31, 2006. Net charge-offs as a percentage of average net loans outstanding increased from .09% for 2006 to .14% for 2007. The allowance for loan losses as a percentage of nonperforming loans remains strong, although decreasing from 324.85% at December 31, 2006 to 231.22% in 2007.

The allowance for loan losses decreased slightly during the year. Historically, the majority of our net losses in the loan portfolio have been in the consumer loan category. Over the past two years, that loss experience has improved significantly. Approximately 60% of net charge-offs during 2007 related to a single commercial relationship. The commercial real estate portfolio otherwise continues to perform very strongly. The decrease in the overall allowance for loan losses reflects the improved performance of the consumer portfolio and the continued strong performance of the commercial real estate portfolio. The recorded reserve reflects management's judgments about the state of the local economy and its impact on the loan portfolio.

Nonaccrual loans are commercial and real estate loans which are 90 days past due and with respect to which, in management's opinion, collection of interest is doubtful. These loans no longer accrue interest and are accounted for on a cash basis. Loans which are 90 days or more past due but continue to accrue interest are loans which, in management's opinion, are well secured and are in the process of collection.

# MANAGEMENT'S DISCUSSION

(Table Dollar Amounts In Thousands except Per Share Data)

The allowance is allocated among the loan categories based upon the consistent, quarterly procedures determined by management. However, the entire allowance for loan losses is available to absorb future losses in any loan category. The following table details the allocation of the allowance for loan losses at December 31:

| December 31, | 2007 | | 2006 | | 2005 | | 2004 | | 2003 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Amount | Loans to Total Loans | Amount | Loans to Total Loans | Amount | Loans to Total Loans | Amount | Loans to Total Loans | Amount | Loans to Total Loans |
| Commercial, Financial and Agricultural | **$ 506** | **8.9%** | $ 302 | 8.0% | $ 439 | 7.6% | $ 297 | 6.8% | $ 225 | 6.0% |
| Residential Real Estate | **1,026** | **33.1%** | 1,084 | 33.5% | 1,528 | 32.3% | 1,639 | 34.1% | 1,925 | 35.0% |
| Commercial Real Estate | **2,956** | **37.6%** | 2,910 | 35.6% | 1,660 | 32.2% | 1,783 | 29.3% | 1,521 | 26.3% |
| Installment Loans to Individuals | **971** | **20.4%** | 1,298 | 22.9% | 2,233 | 27.9% | 2,425 | 29.8% | 2,968 | 32.7% |
| | **$5,459** | **100.0%** | $5,594 | 100.0% | $5,860 | 100.0% | $6,144 | 100.0% | $6,639 | 100.0% |

The allowance allocated to each of the four loan categories should not be interpreted as an indication that charge-offs in 2008 will occur in the same proportions or that the allocation indicates future charge-off trends. The allowance allocated to the one-to-four family real estate loan category and the consumer loan category is based upon the Corporation's allowance methodology for homogeneous loans, and increases and decreases in the balances of those portfolios. In the current and previous years, the indirect loan category has historically represented the largest percentage of loan losses. The one-to-four family real estate loan category represents approximately 33.1% of total loans, but historically has a small loss history. For the commercial loan category, which represents only 8.9% of the total loan portfolio, management relies on the Bank's internal loan review procedures and allocates accordingly based on loan classifications. The commercial real estate loan category represents 37.6% of the total loan portfolio and management feels it to be prudent to list this category's allocation separately. The allocation amounts in this category are determined through management's quarterly assessment of classified loans. Each of these allocation categories includes an amount to include current environmental factors that may have an impact on future loan losses.

## Loan Commitments and Lines of Credit

In the normal course of business, the Bank has extended various commitments for credit. Commitments for mortgages, revolving lines of credit and letters of credit generally are extended for a period of one month up to one year. Normally no fees are charged on any unused portion. Normally, an annual fee of two percent is charged for the issuance of a letter of credit.

As of December 31, 2007, there were no concentrations of loans exceeding 25% of total loans that are not disclosed as a category of loans. As of that date also, there were no other interest-earning assets that are either nonaccrual, past due, restructured or non-performing.

## Investment Securities

The investment securities portfolio decreased $35.648 million in 2007. As securities matured and paydowns were received on mortgage-backed securities, management used the proceeds to fund decreases in deposit balances. The Company also sold $10.865 million in securities in 2007, resulting in net security gains of $771 thousand.

Our objective in managing the investment portfolio is to preserve and enhance corporate liquidity through investment in short and intermediate term securities which are readily marketable and of the highest credit quality. In general, investment in securities is limited to those funds the Bank feels it has in excess of funds used to satisfy loan demand and operating considerations.

During 2007, the Corporation recorded a $576 thousand after-tax impairment of securities charge after concluding that a Fannie Mae Series F preferred equity security was other-than-temporarily impaired. Management's decision to recognize the other-than-temporary impairment charge was due to the following circumstances: In mid November, Fannie Mae went to the markets and offered two new preferred share offerings carrying higher dividend rates that appear to have caused the market prices of the other Fannie Mae preferred stock issues, including the issue we hold, to decrease in current market value. Due to this sudden drop in value, and the lack of recovery in value in this security since the end of the year, and uncertainty of future market conditions surrounding Fannie Mae, management has determined that this decrease is other-than-temporary and felt it is prudent to recognize the non-cash after-tax charge of $576 thousand in the fourth quarter of 2007.

Mortgage-backed securities are created by the pooling of mortgages and issuance of a security. Mortgage-backed securities typically represent a participation interest in a pool of single-family or multi-family mortgages. Investments in mortgage-backed securities involve a risk that actual principal prepayments will be greater than estimated prepayments over the life of the security. Prepayment estimates for mortgage-backed securities are performed at purchase to ensure that prepayment assumptions are reasonable considering the underlying collateral for the mortgage-backed securities at issue and current mortgage interest rates and to determine the yield and estimated maturity of the mortgage-backed security portfolio. Prepayments that are faster than anticipated may shorten the life of the security and may result in faster amortization of any premiums paid and thereby reduce the net yield on such securities. During periods of declining mortgage interest rates, refinancing generally increases and accelerates the prepayment of the underlying mortgages and the related security.

# MANAGEMENT'S DISCUSSION

(Table Dollar Amounts In Thousands except Per Share Data)

The following table shows the book value of investment securities by type of obligation at the dates indicated:

## Type

| December 31, | 2007 | 2006 | 2005 |
|---|---|---|---|
| U.S. Treasury Securities | $ 800 | $ 800 | $ 800 |
| U.S. Government sponsored enterprise debt securities | 56,076 | 75,131 | 77,499 |
| Mortgage-backed securities | 88,825 | 102,586 | 110,725 |
| Obligations of States and Political Subdivisons | 71,395 | 68,967 | 59,710 |
| Other Securities | 3,055 | 8,315 | 10,751 |
| | $220,151 | $255,799 | $259,485 |

A summary of debt securities held at December 31, 2007, classified according to maturity and including weighted average yield for each range of maturities is set forth below:

| Type and Maturity Grouping | December 31, 2007 Fair Value | Weighted Average Yield (1) |
|---|---|---|
| U.S. Treasury Securities | | |
| Maturing Within One Year | $ 800 | 4.81 % |
| U.S. Government Sponsored Enterprise Debt Securities | | |
| Maturing Within One Year | $ 29,942 | 3.90 % |
| Maturing After One Year But Within Five Years | 25,467 | 4.51 % |
| Maturing After Five Years But Within Ten Years | 368 | 6.45 % |
| Maturing After Ten Years | 299 | 5.45 % |
| Total U.S. Government Sponsored Enterprise Debt Securities | $ 56,076 | 4.20 % |
| Mortgage-Backed Securities (2) | | |
| Maturing Within One Year | $ 3,246 | 3.47 % |
| Maturing After One Year But Within Five Years | 38,269 | 4.18 % |
| Maturing After Five Years But Within Ten Years | 18,603 | 4.38 % |
| Maturing After Ten Years | 28,707 | 4.84 % |
| Total Mortgage-Backed Securities: | $ 88,825 | 4.41 % |
| Obligations of States and Political Subdivisions | | |
| Maturing Within One Year | $ 890 | 5.73 % |
| Maturing After One Year But Within Five Years | 9,897 | 5.32 % |
| Maturing After Five Years But Within Ten Years | 24,403 | 5.74 % |
| Maturing After Ten Years | 36,205 | 6.21 % |
| Total Obligations of States and Political Subdivisions | $ 71,395 | 5.92 % |

(1) The weighted average yield has been computed by dividing the total contractual interest income adjusted for amortization of premium or accretion of discount over the life of the security by the par value of the securities outstanding. The weighted average yield of tax-exempt obligations of states and political subdivisions has been calculated on a fully taxable equivalent basis. The amounts of adjustments to interest which are based on the statutory tax rate of 35% were $18 thousand, $183 thousand, $487 thousand and $798 thousand for the four ranges of maturities.

(2) Payments based on contractual maturity.

## Bank Owned Life Insurance

The Corporation purchased bank owned life insurance policies on the lives of certain members of management. The purpose of this transaction is to help fund the costs of employee benefit plans. The cash surrender value of these policies is $10.490 million at December 31, 2007 compared to $425 thousand at December 31, 2006.

## Deposits

Deposits represent the Corporation's principal source of funds. The deposit base consists of demand deposits, savings and money market accounts and other time deposits. During the year, the Corporation's average total deposits decreased from $614.825 million in 2006 to $595.103 million in 2007. Money market accounts decreased $10.68 million since December 31, 2006. Total time deposits have also decreased $5.86 million since 2006. Given the modest loan demand and the keen competition for time deposits, efforts have been concentrated to better manage the margin rather than grow the balance sheet in the current interest rate environment. The Company prices deposit rates to remain competitive within the market and to retain customers.

## Borrowings

Total borrowings increased $7.236 million or 6.06% since December 31, 2006. Most of this increase resulted from growth in securities sold under repurchase agreements of $6.32 million, or 9.44%. Long-term Federal Home Loan Bank advances increased $10.899 million, but a short-term advance of $10 million outstanding in 2006 was repaid in 2007.

## Contractual Obligations, Commitments, Contingent Liabilities and Off-Balance Sheet Arrangements

The following table presents, as of December 31, 2007, the Corporation's significant fixed and determinable contractual obligations by payment date. The payment amounts represent those amounts contractually due to the recipient and do not include any unamortized premiums or discounts or other similar carrying value adjustments. Further discussion of the nature of each obligation is included in referenced note to the consolidated financial statements.

| | Note Ref. | 2008 | 2009 | 2010 | 2011 | 2012 | There-after |
|---|---|---|---|---|---|---|---|
| Deposits without maturity | - | $318,942 | - | - | - | - | - |
| Certificates of deposit | E | 219,360 | 37,479 | 10,348 | 3,697 | 1,474 | 2,128 |
| Other borrowed funds | G | 965 | 52 | 56 | 60 | 65 | 64 |
| Repurchase agreements | F | 73,257 | - | - | - | - | - |
| Federal Home Loan Bank advances | G | 11,196 | 3,475 | 11,453 | 6,229 | 2,322 | 17,436 |
| Operating leases | D | 54 | 55 | 61 | 61 | 61 | 110 |

Note H to the consolidated financial statements discusses in greater detail other commitments and contingencies and the various obligations that exists under those agreements. Examples of these commitments and contingencies include commitments to extend credit and standby letters of credit.

# MANAGEMENT'S DISCUSSION

(Table Dollar Amounts In Thousands except Per Share Data)

At December 31, 2007 the Corporation had no unconsolidated, related special purpose entities, nor did the Corporation engage in derivatives and hedging contracts, such as interest rate swaps, that may expose the Corporation to liabilities greater than the amounts recorded on the consolidated balance sheet. Management's policy is to not engage in derivatives contracts for speculative trading purposes.

## Capital Resources

Total Stockholders' Equity decreased 3.02% from $76.223 million at December 31, 2006 to $73.920 million in 2007. The Corporation continues to utilize the stock repurchase program, repurchasing approximately 398,000 shares during 2007 at an average price of $10.01 per share. Shares repurchased by the Corporation are for general corporate purposes. During the year, the Corporation issued 354,000 shares through the dividend reinvestment program.

The Bank, as a national bank, is subject to the dividend restrictions set forth by the Comptroller of the Currency. The Comptroller of the Currency must approve declaration of any dividends in excess of the sum of profits for the current year and retained net profits for the preceding two years (as defined). The Bank and the Corporation are required to maintain minimum amounts of capital to total "risk weighted" assets, as defined by the banking regulators. At December 31, 2007, the Bank and the Corporation are required to have a minimum Tier 1 and Total Capital ratios of 4.00% and 8.00%, respectively. The Bank and the Corporation had capital ratios above the minimum levels at December 31, 2007 and 2006. At year-end 2007 and 2006, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

## Critical Accounting Policies

The Corporation follows financial accounting and reporting policies that are in accordance with generally accepted accounting principles in the United States of America and conform to general practices within the banking industry. Some of these accounting policies are considered to be critical accounting policies. 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 Corporation has identified two accounting policies that are critical accounting policies and an understanding of these policies is necessary to understand our 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 consolidated financial statements, Note A (Summary of Significant Accounting Policies), Note B (Securities), Note C (Loans), and the sections above captioned "Loan Portfolio" and "Investment Securities". Management believes that the judgments, estimates and assumptions used in the preparation of the consolidated financial statements are appropriate given the factual circumstances at the time.

The Corporation maintains an allowance for loan losses. The allowance for loan losses is presented as a reserve against loans on the balance sheets. Loan losses are charged-off against the allowance for loan losses, while recoveries of amounts previously charged-off are credited to the allowance for loan losses. A provision for loan losses is charged to operations based on management's periodic evaluation of adequacy of the allowance. The provision for credit losses provides for probable losses on loans.

Estimating the amount of the allowance for loan losses requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio represents the largest asset category on the consolidated balance sheets. Management's assessment of the adequacy of the allowance for loan losses considers individually impaired loans, pools of homogeneous loans with similar risk characteristics and other environmental risk factors.

Pools of homogeneous loans with similar risk characteristics are assessed for probable losses. Probable losses are estimated through application of historical loss experience. Historical loss experience data used to establish loss estimates may not precisely correspond to the current portfolio. As a result, the historical loss experience used in the allowance analysis may not be representative of actual unrealized losses inherent in the portfolio.

Management also evaluates the impact of environmental factors which pose additional risks that may not adequately be addressed in the analyses described above. Such environmental factors could include: levels of, and trends in, delinquencies and impaired loans, charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in lending policies and procedures including those for underwriting, collection, charge-off, and recovery; experience, ability, and depth of lending management and staff; national and local economic trends and conditions; industry and geographic conditions; concentrations of credit such as, but not limited to, local industries, their employees, suppliers; or any other common risk factor that might affect loss experience across one or more components of the portfolio. The determination of this component of the allowance requires considerable management judgment. To the extent actual outcomes differ from management estimates, additional provision for credit losses could be required that could adversely affect earnings or financial position in future periods. The "Loan Portfolio" section of this financial review includes a discussion of the factors driving changes in the allowance for loan losses during the current period.

Other-than-temporary impairment of securities is the second critical accounting policy. Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: (1) the length of time, extent, and reasons that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

## Recent Accounting Pronouncements and Developments

Note A to the consolidated financial statements discusses new accounting policies adopted by the Corporation during 2007 and the expected impact of accounting policies recently issued or proposed, but not yet required to be adopted. To the extent the adoption of new accounting standards materially affects financial condition, results of operations, or liquidity, the impacts are discussed in the applicable section(s) of this financial review and notes to the consolidated financial statements.

# MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

February 18, 2008

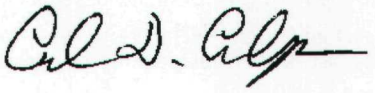
The management of Farmers National Banc Corp. (the Company) is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities and Exchange Act of 1934. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

The Company's internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on our assessment and those criteria, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2007.

Frank L. Paden
President and Secretary



Carl D. Culp
Executive Vice President and Treasurer

Crowe

**Crowe Chizek and Company LLC**
Member Horwath International

Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting

Board of Directors and Shareholders
Farmers National Banc Corp.
Canfield, Ohio

We have audited Farmers National Banc Corp's internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Farmers National Banc Corp.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Farmers National Banc Corp. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Farmers National Banc Corp. as of December 31, 2007 and 2006 and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2007 and our report dated February 18, 2008 expressed an unqualified opinion on those consolidated financial statements.

Crowe Chizek and Company LLC

Crowe Chizek and Company LLC

Columbus, Ohio
February 18, 2008

**Crowe Chizek and Company LLC**
Member Horwath International

Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements

Board of Directors and Shareholders
Farmers National Banc Corp.
Canfield, Ohio

We have audited the accompanying consolidated balance sheets of Farmers National Banc Corp. as of December 31, 2007 and 2006, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Farmers National Banc Corp.'s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report, dated February 18, 2008, expressed an unqualified opinion thereon.

Crowe Chizek and Company LLC

Crowe Chizek and Company LLC

Columbus, Ohio
February 18, 2008

# CONSOLIDATED BALANCE SHEETS

(Table Dollar Amounts In Thousands except Per Share Data)

| December 31, | 2007 | 2006 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | $ 25,022 | $ 24,447 |
| Federal funds sold | 6,083 | 9,591 |
| TOTAL CASH AND CASH EQUIVALENTS | 31,105 | 34,038 |
| Securities available for sale | 220,151 | 255,799 |
| Loans | 514,106 | 508,188 |
| Less allowance for loan losses | 5,459 | 5,594 |
| NET LOANS | 508,647 | 502,594 |
| Premises and equipment, net | 14,516 | 14,744 |
| Bank owned life insurance | 10,490 | 425 |
| Other assets | 13,327 | 13,984 |
| TOTAL ASSETS | $ 798,236 | $ 821,584 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Deposits: | | |
| Noninterest-bearing | $ 61,574 | $ 66,003 |
| Interest-bearing | 531,854 | 553,744 |
| TOTAL DEPOSITS | 593,428 | 619,747 |
| Short-term borrowings | 74,174 | 77,792 |
| Long-term borrowings | 52,455 | 41,601 |
| Other liabilities | 4,259 | 6,221 |
| TOTAL LIABILITIES | 724,316 | 745,361 |
| Commitments and contingent liabilities | | |
| Stockholders' Equity | | |
| Common Stock - Authorized 25,000,000 shares; issued 14,921,106 in 2007 and 14,567,280 in 2006 | 91,741 | 88,366 |
| Retained earnings | 7,233 | 9,617 |
| Accumulated other comprehensive income (loss) | ( 653 ) | ( 1,345 ) |
| Treasury stock, at cost; 1,892,730 shares in 2007 and 1,494,525 shares in 2006 | ( 24,401 ) | ( 20,415 ) |
| TOTAL STOCKHOLDERS' EQUITY | 73,920 | 76,223 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 798,236 | $ 821,584 |

See accompanying notes.

# CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(Table Dollar Amounts In Thousands except Per Share Data)

| Years ended December 31, | 2007 | 2006 | 2005 |
|---|---|---|---|
| **INTEREST AND DIVIDEND INCOME** | | | |
| Loans, including fees | **$ 34,853** | $ 33,162 | $ 31,453 |
| Taxable securities | **7,017** | 7,423 | 8,216 |
| Tax exempt securities | **2,745** | 2,462 | 2,125 |
| Dividends | **581** | 620 | 421 |
| Federal funds sold | **342** | 431 | 266 |
| TOTAL INTEREST AND DIVIDEND INCOME | **45,538** | 44,098 | 42,481 |
| **INTEREST EXPENSE** | | | |
| Deposits | **16,556** | 15,525 | 11,700 |
| Short-term borrowings | **2,957** | 2,623 | 1,833 |
| Long-term borrowings | **2,380** | 2,051 | 1,703 |
| TOTAL INTEREST EXPENSE | **21,893** | 20,199 | 15,236 |
| NET INTEREST INCOME | **23,645** | 23,899 | 27,245 |
| Provision for loan losses | **570** | 200 | 649 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | **23,075** | 23,699 | 26,596 |
| **NONINTEREST INCOME** | | | |
| Service charges on deposit accounts | **2,823** | 2,994 | 2,758 |
| Security gains | **771** | 550 | 290 |
| Impairment of securities | **( 873 )** | 0 | 0 |
| Other operating income | **1,687** | 1,590 | 1,338 |
| TOTAL NONINTEREST INCOME | **4,408** | 5,134 | 4,386 |
| **NONINTEREST EXPENSE** | | | |
| Salaries and employee benefits | **11,732** | 11,585 | 11,694 |
| Occupancy and equipment | **2,709** | 2,477 | 2,700 |
| State and local taxes | **904** | 895 | 911 |
| Professional fees | **586** | 574 | 589 |
| Other operating expenses | **4,451** | 4,088 | 4,318 |
| TOTAL NONINTEREST EXPENSE | **20,382** | 19,619 | 20,212 |
| INCOME BEFORE INCOME TAXES | **7,101** | 9,214 | 10,770 |
| **INCOME TAXES** | **1,176** | 1,999 | 2,710 |
| NET INCOME | **5,925** | 7,215 | 8,060 |
| **OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:** | | | |
| Change in net unrealized gains (losses) on securities, net of reclassifications | **692** | 1,191 | ( 3,429 ) |
| COMPREHENSIVE INCOME | **$ 6,617** | $ 8,406 | $ 4,631 |
| **EARNINGS PER SHARE:** | | | |
| Basic | **$ 0.46** | $ 0.55 | $ 0.62 |
| Diluted | **$ 0.46** | $ 0.55 | $ 0.62 |

See accompanying notes.

# CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(Table Dollar Amounts In Thousands except Per Share Data)

| Years ended December 31, | 2007 | 2006 | 2005 |
|---|---|---|---|
| **COMMON STOCK** | | | |
| Balance at beginning of year | **$ 88,366** | $ 84,595 | $ 80,200 |
| Stock option expense | **0** | 23 | 0 |
| 353,826 shares issued from dividend reinvestment in 2007, 339,742 in 2006 and 315,023 in 2005 | **3,375** | 3,748 | 4,395 |
| Balance at end of year | **91,741** | 88,366 | 84,595 |
| **RETAINED EARNINGS** | | | |
| Balance at beginning of year | **9,617** | 10,709 | 10,958 |
| Net income | **5,925** | 7,215 | 8,060 |
| Dividends declared: $.64 cash dividends per share in 2007, $.64 in 2006 and $.64 in 2005 | **( 8,309 )** | ( 8,307 ) | ( 8,309 ) |
| Balance at end of year | **7,233** | 9,617 | 10,709 |
| **ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)** | | | |
| Balance at beginning of year | **( 1,345 )** | ( 2,536 ) | 893 |
| Change in net unrealized gains (losses) on securities, net of reclassifications | **692** | 1,191 | ( 3,429 ) |
| Balance at end of year | **( 653 )** | ( 1,345 ) | ( 2,536 ) |
| **TREASURY STOCK, AT COST** | | | |
| Balance at beginning of year | **( 20,415 )** | ( 16,904 ) | ( 13,397 ) |
| Purchase of 398,205 shares in 2007, 310,210 in 2006 and 251,274 in 2005 | **( 3,986 )** | ( 3,511 ) | ( 3,507 ) |
| Balance at end of year | **( 24,401 )** | ( 20,415 ) | ( 16,904 ) |
| TOTAL STOCKHOLDERS' EQUITY AT END OF YEAR | **$ 73,920** | $ 76,223 | $ 75,864 |

See accompanying notes.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

(Table Dollar Amounts In Thousands except Per Share Data)

| Years ended December 31, | 2007 | 2006 | 2005 |
|---|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Net income | $ 5,925 | $ 7,215 | $ 8,060 |
| Adjustments to reconcile net income to net cash from operating activities: | | | |
| Provision for loan losses | 570 | 200 | 649 |
| Depreciation and amortization | 1,042 | 1,015 | 1,088 |
| Net amortization of securities | 355 | 882 | 829 |
| Security gains | ( 771 ) | ( 550 ) | ( 290 ) |
| Impairment of securities | 873 | 0 | 0 |
| Federal Home Loan Bank dividends | 0 | ( 240 ) | ( 197 ) |
| Stock based compensation | 0 | 23 | 0 |
| Increase in bank owned life insurance | ( 65 ) | ( 19 ) | ( 26 ) |
| Net change in other assets and liabilities | ( 1,718 ) | 2,083 | 327 |
| NET CASH FROM OPERATING ACTIVITIES | 6,211 | 10,609 | 10,440 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Proceeds from maturities and repayments of securities available for sale | 42,497 | 48,489 | 57,668 |
| Proceeds from sales of securities available for sale | 10,865 | 18,262 | 19,657 |
| Proceeds from sales of other real estate owned | 0 | 24 | 162 |
| Purchase of securities available for sale | ( 17,107 ) | ( 61,565 ) | ( 65,546 ) |
| Loan originations and payments, net | ( 6,623 ) | 3,234 | ( 27,238 ) |
| Additions to premises and equipment | ( 673 ) | ( 505 ) | ( 479 ) |
| Purchase of bank owned life insurance | ( 10,000 ) | 0 | 0 |
| NET CASH FROM INVESTING ACTIVITIES | 18,959 | 7,939 | ( 15,776 ) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| Net change in deposits | ( 26,319 ) | ( 11,053 ) | 8,576 |
| Net change in short-term borrowings | ( 3,618 ) | 829 | 5,240 |
| Proceeds from Federal Home Loan Bank borrowings and other debt | 20,000 | 10,000 | 7,294 |
| Repayment of Federal Home Loan Bank borrowings and other debt | ( 9,146 ) | ( 7,906 ) | ( 10,280 ) |
| Repurchase of common stock | ( 3,986 ) | ( 3,511 ) | ( 3,507 ) |
| Cash dividends paid | ( 8,409 ) | ( 8,231 ) | ( 8,338 ) |
| Proceeds from dividend reinvestment | 3,375 | 3,748 | 4,395 |
| NET CASH FROM FINANCING ACTIVITIES | ( 28,103 ) | ( 16,124 ) | 3,380 |
| NET CHANGE IN CASH AND CASH EQUIVALENTS | ( 2,933 ) | 2,424 | ( 1,956 ) |
| Beginning cash and cash equivalents | 34,038 | 31,614 | 33,570 |
| Ending cash and cash equivalents | $ 31,105 | $ 34,038 | $ 31,614 |
| Supplemental cash flow information: | | | |
| Interest paid | $ 21,910 | $ 19,705 | $ 15,017 |
| Income taxes paid | 1,220 | 2,175 | 3,030 |
| Supplemental noncash disclosures: | | | |
| Investment in Ohio Equity Fund with issuance of note payable | $ 0 | $ 0 | $ 1,000 |
| Transfer of loans to other real estate | $ 0 | $ 26 | $ 70 |

See accompanying notes.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

## NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Principles of Consolidation:

The consolidated financial statements include the accounts of Farmers National Banc Corp. (the Corporation) and its wholly-owned subsidiary, The Farmers National Bank of Canfield (the Bank). All significant intercompany balances and transactions have been eliminated.

### Nature of Operations:

The Corporation's wholly owned subsidiary, The Farmers National Bank of Canfield, operates under a national bank charter and provides full banking services. As a national bank, the Bank is subject to regulation of the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. The area served by the Bank is the northeastern region of Ohio and service is provided at seventeen (17) locations.

### Estimates:

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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. The allowance for loan losses, fair values of financial instruments, and judgements about other-than-temporary impairment of securities are particularly subject to change. Actual results could differ from those estimates.

### Cash Flows:

Cash and cash equivalents include cash on hand, due from banks and federal funds sold. Generally, federal funds are purchased and sold for one-day periods. Net cash flows are reported for loan and deposit transactions, short term borrowings, and other assets and liabilities.

### Securities Available for Sale:

Debt securities are classified as available for sale when they might be sold before maturity. Equity securities with readily determinable fair values are classified as available for sale. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method. Purchases and sales are recognized on the trade date.

Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: the length of time, extent and reasons that fair value has been less than cost, the financial condition and near term prospects of the issuer, and the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

### Loans:

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs, and an allowance for loan losses. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and commercial and residential real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. There are no significant concentrations of loans to any one industry or customer. However, the customers' ability to repay their loans is dependent on the real estate values and general economic conditions in the area.

Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level yield method without anticipating prepayments. The accrual of interest income is ordinarily discontinued when a loan becomes 90 days past due as to principal or interest; however, management may elect to continue the accrual when the estimated value of collateral is sufficient to cover the principal balance and the accrued interest and the loan is in process of collection. Consumer and credit card loans are typically charged off no later than 120 days past due.

When interest accruals are discontinued, interest credited to income in the current year is reversed. Interest on such loans is thereafter recorded on a cash basis and is included in earnings only when actually received in cash and when full payment of principal is no longer doubtful. When the loan is determined to be uncollectible, interest accrued in prior years and the principal are charged to the allowance for loan losses. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

### Allowance for Loan Losses:

The allowance for loan losses is a valuation allowance for probable incurred loan losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. The allowance is based on management's judgment taking into consideration past loss experience, reviews of individual loans, current economic conditions and other factors considered relevant by management at the financial statement date. While management uses the best information available to establish the allowance, future adjustments to the allowance may be necessary, which may be material, if economic conditions differ substantially from the assumptions used in estimating the allowance. If additions to the original estimate of the allowance for loan losses are deemed necessary, they will be reported in earnings in the period in which they become reasonably estimable. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers loans not individually classified as impaired and is based on historical loss experience adjusted for current factors.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

A loan is considered impaired when, based on the current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and commercial real estate loans over $25 thousand by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures.

## Foreclosed Assets:

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. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

## Premises and Equipment:

Land is carried at cost. Premises and equipment are stated at cost, less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 5 to 40 years. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 10 years.

## Restricted Stock:

The Bank is a member of the Federal Home Loan Bank (FHLB) system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security included in other assets, and periodically evaluated for impairment based on ultimate recovery of par value. The Bank is also a member of and owns stock in the Federal Reserve Bank. Both cash and stock dividends are reported as income.

## Bank Owned Life Insurance:

The Company has purchased life insurance policies on certain key officers. Upon adoption of EITF 06-5, which is discussed further below, Company owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement. Prior to adoption of EITF 06-5, the Company recorded owned life insurance at its cash surrender value. In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-5, *Accounting for Purchases of Life Insurance - Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 (Accounting for Purchases of Life Insurance)*. This Issue requires that a policyholder consider contractual terms of a life insurance policy in determining the amount that could be realized under the insurance contract. It also requires that if the contract provides for a greater surrender value if all individual policies in a group are surrendered at the same time, that the surrender value be determined based on the assumption that policies will be surrendered on an individual basis. Lastly, the Issue requires disclosure when there are contractual restrictions on the Company's ability to surrender a policy. The adoption of EITF 06-5 on January 1, 2007, had no impact on the Company's financial condition or results of operations.

## Long-term Assets:

Premises and equipment and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

## Loan Commitments and Related Financial Instruments:

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

## Stock-Based Compensation:

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 123(R), *Share-based Payment*, using the modified prospective transition method. Accordingly, the Company has recorded stock-based compensation cost using the fair value method starting in 2006.

Prior to January 1, 2006, employee compensation expense under stock options was reported using the intrinsic value method; therefore, no stock-based compensation cost is reflected in net income for the year ended December 31, 2005, as all options granted had an exercise price equal to or greater than the market price of the underlying common stock at date of grant.

The following table illustrates the effect on net income and earnings per share if expense was measured using the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock Based Compensation*, for the year ended December 31, 2005:

| | 2005 |
|---|---|
| Net income as reported | $ 8,060 |
| Deduct: Stock-based compensation expense determined under fair value based method | ( 27 ) |
| Pro forma net income | $ 8,033 |
| Basic earnings per share as reported | $ 0.62 |
| Pro forma basic earnings per share | $ 0.62 |
| Diluted earnings per share as reported | $ 0.62 |
| Pro forma diluted earnings per share | $ 0.62 |

## Income Taxes:

Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

The Company adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), as of January 1, 2007. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The adoption had no effect on the Company's financial statements.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

## Earnings Per Share:

Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements.

## Comprehensive Income:

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income consists solely of unrealized gains and losses on securities available for sale and is recognized as a separate component of equity.

## Loss Contingencies:

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there are such matters that will have a material effect on the financial statements.

In the ordinary course of business, Farmers National Bank was named a defendant in a lawsuit filed in September 2005. The plaintiff in the lawsuit alleges that Farmers National Bank is indebted to the plaintiff for withdrawals from the plaintiff's account by the plaintiff's former agent, which the plaintiff claims were unauthorized. The plaintiff was seeking damages in excess of $423,000. During January 2008, the plaintiff dismissed the case without prejudice.

## Dividend Restriction:

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the holding company or by the holding company to shareholders.

## Restrictions on Cash:

Cash on hand or on deposit with the Federal Reserve Bank of $4.826 million and $4.633 million was required to meet regulatory reserve and clearing requirements at year end 2007 and 2006. These balances do not earn interest.

## Fair Value of Financial Instruments:

Fair value of financial instruments is estimated using relevant market information and other assumptions as more fully disclosed in Note M. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

## Operating Segments:

While the chief decision-makers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Operating segments are aggregated into one, as operating results for all segments are similar. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

## Reclassifications:

Certain items in the prior year financial statements were reclassified to conform to the current presentation.

## Adoption of New Accounting Standards:

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments* (SFAS No. 155), which permits fair value remeasurement for hybrid financial instruments that contain an embedded derivative that otherwise would require bifurcation. Additionally, SFAS No. 155 clarifies the accounting guidance for beneficial interests in securitizations. Under SFAS No. 155, all beneficial interests in a securitization will require an assessment in accordance with SFAS No. 133 to determine if an embedded derivative exists within the instrument. In January 2007, the FASB issued Derivatives Implementation Group Issue B40, *Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets* (DIG Issue B40). DIG Issue B40 provides an exemption from the embedded derivative test of paragraph 13(b) of SFAS No. 133 for instruments that would otherwise require bifurcation if the test is met solely because of a prepayment feature included within the securitized interest and prepayment is not controlled by the security holder. SFAS No. 155 and DIG Issue B40 are effective for fiscal years beginning after September 15, 2006. The adoption of SFAS No. 155 and DIG Issue B40 did not have a material impact on the Company's consolidated financial position or results of operations.

## Effect of Newly Issued But Not Yet Effective Accounting Standards:

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard is effective for fiscal years beginning after November 15, 2007. The impact of adoption was not material.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new standard is effective for the Company on January 1, 2008. The Company did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This issue requires that a liability be recorded during the service period when a split-dollar life insurance

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. This issue is effective for the Corporation on January 1, 2008. There will be no impact on the Company's financial statements as a result of adoption of this issue.

On November 5, 2007, the SEC issued Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value through Earnings* ("SAB 109"). Previously, SAB 105, *Application of Accounting Principles to Loan Commitments*, stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 is effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The Company does not expect the impact of this standard to be material.

## NOTE B - SECURITIES AVAILABLE FOR SALE

The fair value of available for sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

| 2007 | Fair Value | Gross Unrealized Gains | Gross Unrealized Losses |
|---|---|---|---|
| U.S. Treasury and U.S. Government sponsored enterprises | $ 56,876 | $ 352 | $( 88 ) |
| Mortgage-backed securities | 88,825 | 106 | (1,249 ) |
| Obligations of states and political subdivisions | 71,395 | 303 | ( 451 ) |
| Total debt securities | 217,096 | 761 | (1,788 ) |
| Equity securities | 3,055 | 66 | ( 44 ) |
| TOTALS | $220,151 | $ 827 | $(1,832 ) |

| 2006 | Fair Value | Gross Unrealized Gains | Gross Unrealized Losses |
|---|---|---|---|
| U.S. Treasury and U.S. Government sponsored enterprises | $ 75,931 | $ 105 | $( 843 ) |
| Corporate debt securities | 1,000 | 0 | ( 1 ) |
| Mortgage-backed securities | 102,586 | 72 | (2,610 ) |
| Obligations of states and political subdivisions | 68,967 | 296 | ( 345 ) |
| Total debt securities | 248,484 | 473 | (3,799 ) |
| Equity securities | 7,315 | 1,257 | 0 |
| TOTALS | $255,799 | $ 1,730 | $(3,799 ) |

| Sales of available for sale securities were as follows: | 2007 | 2006 | 2005 |
|---|---|---|---|
| Proceeds | $ 10,865 | $ 18,262 | $19,657 |
| Gross gains | 771 | 550 | 290 |

During 2007, the Company concluded that the Fannie Mae Series F preferred stock held in the Securities portfolio was other-than-temporarily impaired. The impairment charge against income was $873 thousand and the related tax benefit was $297 thousand.

The fair value of debt securities available for sale by contractual maturities at December 31, 2007 are summarized below. Mortgage-backed securities are not due at a single maturity date and are shown separately.

| Available for sale - Debt securities | FAIR VALUE |
|---|---|
| Due in 1 year or less | $ 31,632 |
| Due after one year through five years | 35,364 |
| Due after five years through ten years | 24,771 |
| Due after ten years | 36,504 |
| Mortgage-backed securities | 88,825 |
| TOTALS | $217,096 |

Certain of the Bank's investments in obligations of states and political subdivisions contain call provisions that would allow the issuer to repay the obligation before the stated maturity.

Securities with a carrying amount of $101 million at December 31, 2007 and $99 million at December 31, 2006 were pledged to secure public deposits in accordance with federal and state requirements.

At year end 2007, significant holdings of securities issued by the U.S. Treasury and U.S. Government sponsored enterprises included $24.5 million of unsecured debentures issued by the FHLB, $21.3 million of debentures issued by the Federal National Mortgage Association (FNMA or Fannie Mae), and $9.3 million of debentures issued by the Federal Home Loan Mortgage Corp (FHLMC or Freddie Mac).

At year end 2006, significant holdings of securities issued by the U.S. Treasury and U.S. Government sponsored enterprises included $38.6 million of unsecured debentures issued by the FHLB, $21.5 million of debentures issued by the Federal National Mortgage Association (FNMA or Fannie Mae), and $12.5 million of debentures issued by the Federal Home Loan Mortgage Corp (FHLMC or Freddie Mac).

All of the Company's holdings of mortgage-backed securities at year end 2007 and 2006 were issued by U.S. Government sponsored enterprises.

In each year, there were no holdings of any other issuer that exceeded 10% of shareholders' equity.

Securities with unrealized losses at year-end 2007 and 2006, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

**2007**

| Description of Securities | Less than 12 Months Fair Value | Less than 12 Months Unrealized Loss | 12 Months or More Fair Value | 12 Months or More Unrealized Loss | Total Fair Value | Total Unrealized Loss |
|---|---|---|---|---|---|---|
| U.S. Treasury and U.S. Government sponsored enterprises | $ 3,222 | $( 7 ) | $ 24,372 | $( 81 ) | $ 27,594 | $( 88 ) |
| Mortgage-backed securities | 9,585 | ( 67 ) | 62,874 | (1,182 ) | 72,459 | (1,249 ) |
| Obligations of states and political subdivisions | 20,423 | ( 181 ) | 19,186 | ( 270 ) | 39,609 | ( 451 ) |
| Equity securities | 133 | ( 38 ) | 6 | ( 6 ) | 139 | ( 44 ) |
| Total temporarily impaired | $33,363 | $( 293 ) | $106,438 | $(1,539 ) | $139,801 | $(1,832 ) |

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

**2006**

| Description of Securities | Less than 12 Months Fair Value | Less than 12 Months Unrealized Loss | 12 Months or More Fair Value | 12 Months or More Unrealized Loss | Total Fair Value | Total Unrealized Loss |
|---|---|---|---|---|---|---|
| U.S. Treasury and U.S. Government sponsored enterprises | $10,008 | $( 26 ) | $ 50,783 | $( 817 ) | $ 60,791 | $( 843 ) |
| Mortgage-backed securities | 2,289 | ( 15 ) | 89,254 | (2,595 ) | 91,543 | (2,610 ) |
| Obligations of states and political subdivisions | 23,481 | ( 164 ) | 11,270 | ( 181 ) | 34,751 | ( 345 ) |
| Corporate debt security | 1,000 | ( 1 ) | 0 | 0 | 1,000 | ( 1 ) |
| Total temporarily impaired | $36,778 | $( 206 ) | $151,307 | $(3,593 ) | $188,085 | $(3,799 ) |

The Corporation evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. 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, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. 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.

Unrealized losses on debt securities issued by the U.S. Treasury, U.S. Government agencies, or U.S. Government sponsored enterprises have not been recognized into income because the securities are of high credit quality, management has the intent and ability to hold these securities for the foreseeable future and the decline in fair value is largely due to changes in market interest rates. The fair value is expected to recover as the securities approach their maturity date. Unrealized losses on mortgage-backed securities have not been recognized into income because timely repayment of principal and interest is guaranteed by their highly rated issuers and because management has the intent and ability to hold these securities for the forseeable future. The fair value of these securities is expected to recover as principal payments are received.

## NOTE C - LOANS

Loans at year end were as follows:

| | 2007 | 2006 |
|---|---|---|
| Residential Real Estate | **$170,006** | $169,937 |
| Commercial Real Estate | **193,187** | 181,128 |
| Consumer | **105,069** | 116,425 |
| Commercial | **45,844** | 40,698 |
| Subtotal | **514,106** | 508,188 |
| Allowance for loan losses | **( 5,459 )** | ( 5,594 ) |
| NET LOANS | **$508,647** | **$502,594** |

Activity in the allowance for loan losses was as follows:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Balance at beginning of year | **$5,594** | $5,860 | $6,144 |
| Provision for loan losses | **570** | 200 | 649 |
| Recoveries | **407** | 593 | 826 |
| Loans charged off | **( 1,112 )** | ( 1,059 ) | ( 1,759 ) |
| Balance at end of year | **$5,459** | $5,594 | $5,860 |

Individually impaired loans were as follows:

| | 2007 |
|---|---|
| Year-end loans with no allocated allowance for loan losses | **$ 141** |
| Year-end loans with allocated allowance for loan losses | **834** |
| | **$ 975** |
| Amount of the allowance for loan losses allocated | **$ 834** |

At year end 2006, loans individually identified as impaired and the amount of allowance for loan losses allocated for these loans were immaterial.

The average of individually impaired loans during the year was $1.33 million and immaterial for years 2006 and 2005.

Nonperforming loans were as follows:

| | 2007 | 2006 |
|---|---|---|
| Loans past due over 90 days still on accrual | **$ 334** | $ 437 |
| Nonaccrual loans | **2,027** | 1,285 |

Nonperforming loans includes both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

Certain directors, executive officers and associates of such persons were loan customers during 2007. A summary of related party loan activity is as follows:

| | |
|---|---|
| Total loans at December 31, 2006 | $7,494 |
| New loans | 815 |
| Repayments | (2,233) |
| Total loans at December 31, 2007 | $6,076 |

## NOTE D - PREMISES AND EQUIPMENT

Year-end premises and equipment were as follows:

| | 2007 | 2006 |
|---|---|---|
| Land | **$ 2,747** | $ 2,747 |
| Premises | **15,531** | 15,437 |
| Equipment | **9,313** | 8,734 |
| Leasehold Improvements | **198** | 198 |
| | **27,789** | 27,116 |
| Less accumulated depreciation | **( 13,273 )** | ( 12,372 ) |
| NET BOOK VALUE | **$ 14,516** | $ 14,744 |

Depreciation expense was $901 thousand for the year ended December 31, 2007, $904 thousand for 2006 and $991 thousand for 2005.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

The Bank leases a branch location under a noncancelable operating lease extending to 2014. Rental expense charged to operations totaled $61 thousand for 2007 and $62 thousand for 2006 and 2005. In addition to rental expense, under the lease, common area maintenance is paid and the amount can fluctuate according to the costs incurred.

Following is a summary of future minimum rental payments under the lease:

| | |
|---|---|
| 2008 | $ 54 |
| 2009 | 55 |
| 2010 | 61 |
| 2011 | 61 |
| 2012 | 61 |
| Thereafter | 110 |
| TOTAL | $ 402 |

## NOTE E - INTEREST-BEARING DEPOSITS

Following is a summary of scheduled maturities of certificates of deposit during the years following December 31, 2007:

| | |
|---|---|
| 2008 | $ 219,360 |
| 2009 | 37,479 |
| 2010 | 10,348 |
| 2011 | 3,697 |
| 2012 | 1,474 |
| Thereafter | 2,128 |
| TOTAL | $ 274,486 |

Following is a summary of certificates of deposit of $100 thousand or more by remaining maturities:

| | 2007 | 2006 |
|---|---|---|
| Three months or less | **$ 30,322** | $ 37,944 |
| Three to six months | **18,370** | 24,174 |
| Six to twelve months | **30,744** | 14,579 |
| Over twelve months | **11,231** | 10,406 |
| TOTAL | **$ 90,667** | $ 87,103 |

Following is a summary of year-end interest-bearing deposits:

| | 2007 | 2006 |
|---|---|---|
| Demand | **$ 96,744** | $ 97,696 |
| Money Market | **92,685** | 103,367 |
| Savings | **67,939** | 72,335 |
| Certificates of Deposit | **274,486** | 280,346 |
| TOTAL | **$531,854** | $553,744 |

## NOTE F - SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Securities sold under repurchase agreements are secured by the Bank's holdings of debt securities issued by U.S. Government Agencies and U.S. Government sponsored enterprises with a carrying amount of $79.1 million and $75.3 million at year-end 2007 and 2006.

Repurchase agreements are financing arrangements that mature within 89 days. Under the agreements, customers agree to maintain funds on deposit with the Bank and in return acquire an interest in a pool of securities pledged as collateral against the funds. The securities are held in a segregated safekeeping account at the Federal Reserve Bank. Information concerning securities sold under agreements to repurchase is summarized as follows:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Average balance during the year | **$77,770** | $77,377 | $77,677 |
| Average interest rate during the year | **3.63 %** | 3.33 % | 2.33 % |
| Maximum month end balance during the year | **$90,643** | $85,929 | $85,902 |
| Average year end interest rate | **3.48 %** | 3.53 % | 2.66 % |

## NOTE G - FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS

### Short-term borrowings:

The Bank has a short-term U.S. Treasury interest-bearing demand note with a balance of $917 thousand at December 31, 2007 and $853 thousand at December 31, 2006. The demand note carried an interest rate of 3.59% at December 31, 2007 and 5.04% at December 31, 2006.

The Bank has access to lines of credit amounting to $21 million at three major domestic banks that are below prime rate. These lines and terms are periodically reviewed by the banks and are generally subject to withdrawal at their discretion. At December 31, 2007, the Bank had no borrowings from these lines.

### *Long-term borrowings:*

At year end, long-term advances from the Federal Home Loan Bank were as follows:

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | Amount | Weighted Average Rate | Amount | Weighted Average Rate |
| Fixed-rate interest only advances, at rates from 4.66% to 5.00% | **$16,400** | **4.89 %** | $22,475 | 5.06 % |
| Fixed-rate constant payment advances, at rates from 2.07% to 7.05% | **15,711** | **4.71 %** | 13,737 | 3.95 % |
| Convertible and putable fixed-rate advances, at rates from 4.32% to 4.90% | **20,000** | **4.64 %** | 5,000 | 4.32 % |
| Total advances | **$52,111** | **4.74 %** | $41,212 | 4.60 % |

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

At year end 2007 and 2006, $5 million of the FHLB fixed-rate advances are convertible to a floating rate advance on or after certain specific dates at the option of the FHLB. Should the FHLB elect to convert, the Bank has the right to prepay any or all of the borrowing at the time of conversion and on any interest payment due date, thereafter, without penalty.

At year end 2007 and 2006, $15 million and $0 of the FHLB fixed-rate advances are putable on or after certain specific dates at the option of the FHLB. Should the FHLB elect the put, the Bank is required to pay the advance off on that date without penalty.

Federal Home Loan Bank advances are secured by a blanket pledge of residential mortgage loans totaling $70.3 million and $69.1 million at year end 2007 and 2006. Based on this collateral and the Company's holdings of FHLB stock, the Bank is eligible to borrow up to $60.8 million at year end 2007. Each advance is subject to a prepayment penalty if paid prior to its maturity date. Scheduled repayments of long-term FHLB advances are as follows:

| Maturing in: | |
|---|---|
| 2008 | $ 11,196 |
| 2009 | 3,475 |
| 2010 | 11,453 |
| 2011 | 6,229 |
| 2012 | 2,322 |
| Later years | 17,436 |
| TOTAL | $ 52,111 |

The Bank has notes payable secured by real estate totaling $344 thousand in 2007 and $389 thousand in 2006. These notes carried a fixed interest rate of 7.50%. Scheduled repayments of notes payable are as follows:

| Maturing in: | |
|---|---|
| 2008 | $ 48 |
| 2009 | 52 |
| 2010 | 56 |
| 2011 | 60 |
| 2012 | 64 |
| Later years | 64 |
| TOTAL | $ 344 |

## NOTE H - COMMITMENTS AND CONTINGENT LIABILITIES

Some financial instruments, such as loan commitments, credit lines, letters of credit and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance-sheet risk at year end were as follows:

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | Fixed Rate | Variable Rate | Fixed Rate | Variable Rate |
| Commitments to make loans | **$ 4,586** | **$10,154** | $ 3,612 | $12,623 |
| Unused lines of credit | **$36,291** | **$15,071** | $25,796 | $19,958 |

Commitments to make loans are generally made for periods of 30 days or less. The fixed rate loan commitments have interest rates ranging from 5.50% to 8.75% and maturities ranging from 9 months to 30 years.

Standby letters of credit are considered financial guarantees under FASB Interpretation 45. The standby letters of credit have a contractual value of $1.376 million in 2007 and $1.186 million in 2006. The carrying amount of these items on the balance sheet is not material.

## NOTE I - STOCK OPTIONS

The Company's Stock Option Plan, which is shareholder-approved, permits the grant of share options to its directors, officers and employees for up to 375,000 shares of common stock. Option awards are generally 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. All options outstanding were granted in 2001 and became fully vested in 2006. Option exercises are expected to be satisfied with either newly issued shares or treasury shares. The fair value of the Company's stock at December 31, 2007 is less than the fair value option exercise price, therefore the outstanding and exercisable options had no intrinsic value.

A summary of the activity in the plan for 2007 is as follows:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life |
|---|---|---|---|
| Outstanding at beginning of year | 48,000 | $ 11 | |
| Granted | 0 | | |
| Exercised | 0 | | |
| Forfeited or expired | ( 1,500 ) | 11 | |
| Outstanding at end of year | 46,500 | $ 11 | 3.9 |
| Exercisable at end of year | 46,500 | $ 11 | 3.9 |

As of December 31, 2007, there was no unrecognized compensation cost related to stock options granted under the Plan.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

## NOTE J - REGULATORY MATTERS

The Bank, as a national bank, is subject to the dividend restrictions set forth by the Comptroller of the Currency. The Comptroller of the Currency must approve declaration of any dividends in excess of the sum of profits for the current year and retained net profits for the preceding two years (as defined). In 2007, the Bank received approval from the Comptroller of the Currency to distribute $10 million to the Corporation, which exceeded the amount otherwise available for distribution by $8.5 million. The Bank's 2007 earnings subsequent to this distribution totaled $1.4 million. In 2008, the Bank could, without prior approval, distribute this amount, plus any net profits retained to the date of the dividend declaration.

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

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year-end 2007 and 2006, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's category.

The following table reflects various measures of capital at year-end:

| | | Actual | | Requirement For Capital Adequacy Purposes: | | To be Well Capitalized Under Prompt Corrective Action Provisions: | |
|---|---|---|---|---|---|---|---|
| | | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **2007** | | | | | | | |
| Total Capital to risk weighted assets | Consolidated..... | $80,042 | 14.95 % | $42,820 | 8.00 % | N/A | N/A |
| | Bank..... | $72,463 | 13.55 % | $42,785 | 8.00 % | $53,484 | 10.00 % |
| Tier I Capital to risk weighted assets | Consolidated..... | $74,573 | 13.93 % | $21,410 | 4.00 % | N/A | N/A |
| | Bank..... | $67,003 | 12.53 % | $21,394 | 4.00 % | $32,091 | 6.00 % |
| Tier I Capital to average assets | Consolidated..... | $74,573 | 9.20 % | $32,432 | 4.00 % | N/A | N/A |
| | Bank..... | $67,003 | 8.28 % | $32,373 | 4.00 % | $40,467 | 5.00 % |
| **2006** | | | | | | | |
| Total Capital to risk weighted assets | Consolidated..... | $83,631 | 15.84 % | $42,227 | 8.00 % | N/A | N/A |
| | Bank..... | $81,333 | 15.42 % | $42,193 | 8.00 % | $52,742 | 10.00 % |
| Tier I Capital to risk weighted assets | Consolidated..... | $77,472 | 14.68 % | $21,114 | 4.00 % | N/A | N/A |
| | Bank..... | $75,259 | 14.27 % | $21,097 | 4.00 % | $31,645 | 6.00 % |
| Tier I Capital to average assets | Consolidated..... | $77,472 | 9.51 % | $32,599 | 4.00 % | N/A | N/A |
| | Bank..... | $75,259 | 9.25 % | $32,533 | 4.00 % | $40,667 | 5.00 % |

## NOTE K - EMPLOYEE BENEFIT PLANS

The Bank has a qualified 401(k) deferred compensation Retirement Savings Plan. All employees of the Bank who have completed at least one year of service and meet certain other eligibility requirements are eligible to participate in the Plan. Under the terms of the Plan, employees may voluntarily defer a portion of their annual compensation pursuant to section 401(k) of the Internal Revenue Code. The Bank matches a percentage of the participants' voluntary contributions up to 6% of gross wages. In addition, at the discretion of the Board of Directors, the Bank may make an additional profit sharing contribution to the Plan. Total expense was $194 thousand, $276 thousand and $290 thousand for the years ended December 31, 2007, 2006 and 2005, respectively.

The Corporation maintains a deferred compensation plan for certain existing employees and retirees. Expense under the plan was $29 thousand, $33 thousand and $77 thousand for the years ended December 31, 2007, 2006 and 2005, respectively. The liability under the Plan at December 31, 2007 and 2006 was $427 thousand and $454 thousand, respectively.

The Corporation also has a postretirement benefit plan covering individuals retired from the Corporation that have met certain service and age requirements and certain other active employees that have met similar service requirements. The postretirement health care plan includes a limit on the Corporation's share of costs for recent and future retirees. Expense under this plan for 2007, 2006, and 2005 was not material. The accrued postretirement benefit liability under this plan is also not material. Due to the immateriality of the plan, the disclosures required under U.S. generally accepted accounting principles have been omitted.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

## NOTE L - INCOME TAXES

The provision for income taxes (credit) consists of the following:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Current expense | **$1,389** | $1,778 | $2,790 |
| Deferred expense | **( 213 )** | 221 | ( 80 ) |
| TOTALS | **$1,176** | $1,999 | $2,710 |

Following is a reconciliation between income taxes at statutory rates and actual taxes based on income before income taxes:

| | 2007 | | 2006 | | 2005 | |
|---|---|---|---|---|---|---|
| | Amount | Percent of Pretax Income | Amount | Percent of Pretax Income | Amount | Percent of Pretax Income |
| Statutory tax | **$2,485** | **35.0 %** | $3,225 | 35.0 % | $3,770 | 35.0 % |
| Effect of nontaxable interest | **(1,039 )** | **-14.6 %** | ( 968 ) | -10.5 % | ( 851 ) | -7.9 % |
| Bank owned life insurance, net | **( 8 )** | **-0.1 %** | 8 | 0.1 % | 6 | 0.1 % |
| Other | **( 262 )** | **-3.7 %** | ( 266 ) | -2.9 % | ( 215 ) | -2.0 % |
| ACTUAL TAX | **$1,176** | **16.6 %** | $1,999 | 21.7 % | $2,710 | 25.2 % |

Deferred tax assets (liabilities) are comprised of the following:

| | 2007 | 2006 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for credit losses | **$ 1,911** | $ 1,958 |
| Net unrealized loss on securities available for sale | **352** | 724 |
| Security valuation | **796** | 785 |
| Deferred compensation | **242** | 255 |
| Deferred loan fees and costs | **433** | 319 |
| Capital loss carryover | **247** | 149 |
| Post-retirement benefits | **140** | 117 |
| Other | **85** | 78 |
| Gross deferred tax assets | **$ 4,206** | $ 4,385 |
| Deferred tax liabilities: | | |
| Depreciation | **$( 578 )** | $( 673 ) |
| Federal Home Loan Bank dividends | **( 674 )** | ( 674 ) |
| Prepaid expenditures | **( 140 )** | ( 114 ) |
| Other | **( 161 )** | ( 112 ) |
| Gross deferred tax liabilities | **(1,553 )** | ( 1,573 ) |
| NET DEFERRED TAX ASSET | **$ 2,653** | $ 2,812 |

No valuation allowance for deferred tax assets was recorded at December 31, 2007 and 2006. Income taxes applicable to realized investment securities gains in 2007, 2006 and 2005 were $270 thousand, $192 thousand and $101 thousand, respectively. The capital loss carryover of $706 thousand, which can be used to offset future capital gain income, expires as follows: $155 thousand by December 31, 2010, $271 thousand by December 31, 2011 and $280 thousand by December 31, 2012.

The adoption of FIN 48 at January 1, 2007 had no impact on the Corporation's financial statements. At January 1, 2007 and December 31, 2007, the Corporation had no unrecognized tax benefits recorded. The Corporation does not expect the amount of unrecognized tax benefits to significantly change within the next twelve months.

The Corporation is subject to U.S. federal income tax. The Corporation is no longer subject to examination by the federal taxing authority for years prior to 2004. The tax years 2004 - 2006 remain open to examination by the U.S. taxing authority.

## NOTE M - DISCLOSURE ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used to estimate the fair value of each class of financial instruments at December 31, 2007 and 2006:

### Cash and cash equivalents:

The carrying amounts in the consolidated balance sheets of cash and cash equivalents approximates their fair value.

### Securities available for sale:

The fair value of securities available for sale equals quoted market price, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

### Loans:

The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

### Deposits:

The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

### Securities sold under repurchase agreements:

The carrying amount for securities sold under repurchase agreements approximates their fair value.

### Federal Home Loan Bank advances:

The fair values of the advances are estimated using discounted cash flow analyses based on the current incremental borrowing rates for similar types of borrowing arrangements.

### Accrued interest:

The carrying amounts of accrued interest approximate fair value.

### Off-balance sheet commitments:

The fair value of commitments is nominal.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

The estimated fair values of the company's financial instruments at year end were as follows:

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | CARRYING AMOUNT | FAIR VALUE | CARRYING AMOUNT | FAIR VALUE |
| Financial assets: | | | | |
| Cash and cash equivalents | $ 31,105 | $ 31,105 | $ 34,038 | $ 34,038 |
| Securities available for sale | 220,151 | 220,151 | 255,799 | 255,799 |
| Loans - Net | 508,647 | 507,290 | 502,594 | 496,708 |
| Accrued interest receivable | 3,765 | 3,765 | 4,050 | 4,050 |
| Financial liabilities: | | | | |
| Deposits | $593,429 | $594,461 | $619,747 | $618,168 |
| Short-term borrowings | 74,174 | 74,174 | 77,793 | 77,793 |
| Long-term borrowings | 52,455 | 52,804 | 41,601 | 40,929 |
| Accrued interest payable | 1,557 | 1,557 | 1,574 | 1,574 |

## NOTE N - EARNINGS PER SHARE

The factors used in the earnings per share computation follow:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| **Basic EPS** | | | |
| Net income | $ 5,925 | $ 7,215 | $ 8,060 |
| Weighted average shares outstanding | 13,004,593 | 13,006,042 | 13,004,739 |
| **Basic earnings per share** | $ .46 | $ .55 | $ .62 |
| **Diluted EPS** | | | |
| Net income | $ $5,925 | $ 7,215 | $ 8,060 |
| Weighted average shares outstanding for basic earnings per share | 13,004,593 | 13,006,042 | 13,004,739 |
| Effect of Stock Options | 0 | 518 | 10,635 |
| Weighted average shares for diluted earnings per share | 13,004,593 | 13,006,560 | 13,015,374 |
| **Diluted earnings per share** | $ .46 | $ .55 | $ .62 |

Stock options for 46,500 shares of common stock were not considered in the computing diluted earnings per share for 2007 because they were antidilutive.

## NOTE O - OTHER COMPREHENSIVE INCOME (LOSS)

Other comprehensive income (loss) components and related tax effects were as follows:

| | 2007 | 2006 | 2005 |
|---|---|---|---|
| Net unrealized holding gains (losses) on available for sale securities | $ 962 | $ 2,383 | $( 4,985 ) |
| Reclassification adjustment for (gains) losses realized in income | 102 | ( 550 ) | ( 291 ) |
| Net unrealized gains (losses) | $ 1,064 | $ 1,833 | $( 5,276 ) |
| Tax effect | ( 372 ) | ( 642 ) | 1,847 |
| Net-of-tax amount | $ 692 | $ 1,191 | $( 3,429 ) |

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

## NOTE P - QUARTERLY FINANCIAL DATA (UNAUDITED)

| Quarter Ended 2007 | March 31 | June 30 | September 30 | December 31 |
|---|---|---|---|---|
| Total interest income | $ 11,071 | $ 11,332 | $ 11,543 | $ 11,592 |
| Total interest expense | 5,354 | 5,358 | 5,548 | 5,633 |
| Net interest income | 5,717 | 5,974 | 5,995 | 5,959 |
| Provision for loan losses | 60 | 55 | 70 | 385 |
| Other income | 1,597 | 1,140 | 1,155 | 516 |
| Other expense | 5,118 | 5,171 | 5,015 | 5,078 |
| Income before income taxes | 2,136 | 1,888 | 2,065 | 1,012 |
| Income taxes | 327 | 368 | 432 | 49 |
| Net income | $ 1,809 | $ 1,520 | $ 1,633 | $ 963 |
| Earnings per share - basic and diluted | $ 0.14 | $ 0.12 | $ 0.13 | $ 0.07 |

| Quarter Ended 2006 | March 31 | June 30 | September 30 | December 31 |
|---|---|---|---|---|
| Total interest income | $ 10,636 | $ 11,026 | $ 11,171 | $ 11,265 |
| Total interest expense | 4,482 | 4,987 | 5,255 | 5,475 |
| Net interest income | 6,154 | 6,039 | 5,916 | 5,790 |
| Provision for loan losses | 110 | 60 | 30 | 0 |
| Other income | 1,293 | 1,331 | 1,336 | 1,173 |
| Other expense | 4,763 | 4,889 | 5,017 | 4,949 |
| Income before income taxes | 2,574 | 2,421 | 2,205 | 2,014 |
| Income taxes | 612 | 533 | 454 | 400 |
| Net income | $ 1,962 | $ 1,888 | $ 1,751 | $ 1,614 |
| Earnings per share - basic and diluted | $ 0.15 | $ 0.15 | $ 0.13 | $ 0.12 |

## NOTE Q - PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION

Below is condensed financial information of Farmers National Banc Corp. (parent company only). In this information, the parent's investment in the Bank is stated at cost plus equity in undistributed earnings of the subsidiary since acquisition. This information should be read in conjunction with the consolidated financial statements and related notes.

| | Dec. 31, 2007 | Dec. 31, 2006 |
|---|---|---|
| **BALANCE SHEETS** | | |
| Assets: | | |
| Cash | $ 6,796 | $ 1,553 |
| Investment in bank subsidiary | 66,337 | 73,886 |
| Securities available for sale | 1,130 | 1,291 |
| Other | 47 | 38 |
| TOTAL ASSETS | $ 74,310 | $ 76,768 |
| Liabilities: | | |
| Dividends payable | $ 345 | $ 445 |
| Other accounts payable | 45 | 100 |
| TOTAL LIABILITIES | 390 | 545 |
| Stockholders' equity: | | |
| Common stock | 91,741 | 88,366 |
| Retained earnings | 7,233 | 9,617 |
| Accumulated other comprehensive income (loss) | ( 653 ) | ( 1,345 ) |
| Treasury stock, at cost; 1,892,730 shares in 2007 and 1,494,525 shares in 2006 | ( 24,401 ) | ( 20,415 ) |
| TOTAL STOCKHOLDERS' EQUITY | 73,920 | 76,223 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 74,310 | $ 76,768 |

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Table Dollar Amounts In Thousands except Per Share Data)

## STATEMENTS OF INCOME

| Years ended December 31, | 2007 | 2006 | 2005 |
|---|---|---|---|
| Income: | | | |
| Dividends from subsidiary bank | $ 14,339 | $ 8,677 | $ 5,423 |
| Interest and dividends on securities | 68 | 64 | 59 |
| Security gains | 9 | 33 | 68 |
| TOTAL INCOME | 14,416 | 8,774 | 5,550 |
| Other expenses | ( 172 ) | ( 190 ) | ( 190 ) |
| Income before income tax benefit and undistributed subsidiary income | 14,244 | 8,584 | 5,360 |
| Income tax benefit | 32 | 32 | 21 |
| Equity in undistributed net income of subsidiary (dividends in excess of net income) | ( 8,351 ) | ( 1,401 ) | 2,679 |
| NET INCOME | $ 5,925 | $ 7,215 | $ 8,060 |

## STATEMENTS OF CASH FLOWS

| Years ended December 31, | 2007 | 2006 | 2005 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income | $ 5,925 | $ 7,215 | $ 8,060 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Security gains | ( 9 ) | ( 33 ) | ( 68 ) |
| Dividends in excess of net income (Equity in undistributed net income of subsidiary) | 8,351 | 1,401 | ( 2,679 ) |
| Other | ( 44 ) | ( 52 ) | ( 6 ) |
| NET CASH FROM OPERATING ACTIVITIES | 14,223 | 8,531 | 5,307 |
| Cash flows from investing activities: | | | |
| Proceeds from maturities of investment securities available for sale | 1,600 | 1,600 | 3,400 |
| Proceeds from sales of securities available for sale | 9 | 77 | 108 |
| Purchases of securities available for sale | ( 1,569 ) | ( 1,570 ) | ( 2,472 ) |
| NET CASH FROM INVESTING ACTIVITIES | 40 | 107 | 1,036 |
| Cash flows from financing activities: | | | |
| Purchase of treasury stock | ( 3,986 ) | ( 3,511 ) | ( 3,507 ) |
| Dividends paid | ( 8,409 ) | ( 8,231 ) | ( 8,338 ) |
| Proceeds from dividend reinvestment | 3,375 | 3,748 | 4,395 |
| NET CASH FROM FINANCING ACTIVITIES | ( 9,020 ) | ( 7,994 ) | ( 7,450 ) |
| NET CHANGE IN CASH AND CASH EQUIVALENTS | 5,243 | 644 | ( 1,107 ) |
| Beginning cash and cash equivalents | 1,553 | 909 | 2,016 |
| Ending cash and cash equivalents | $ 6,796 | $ 1,553 | $ 909 |

## Board Of Directors

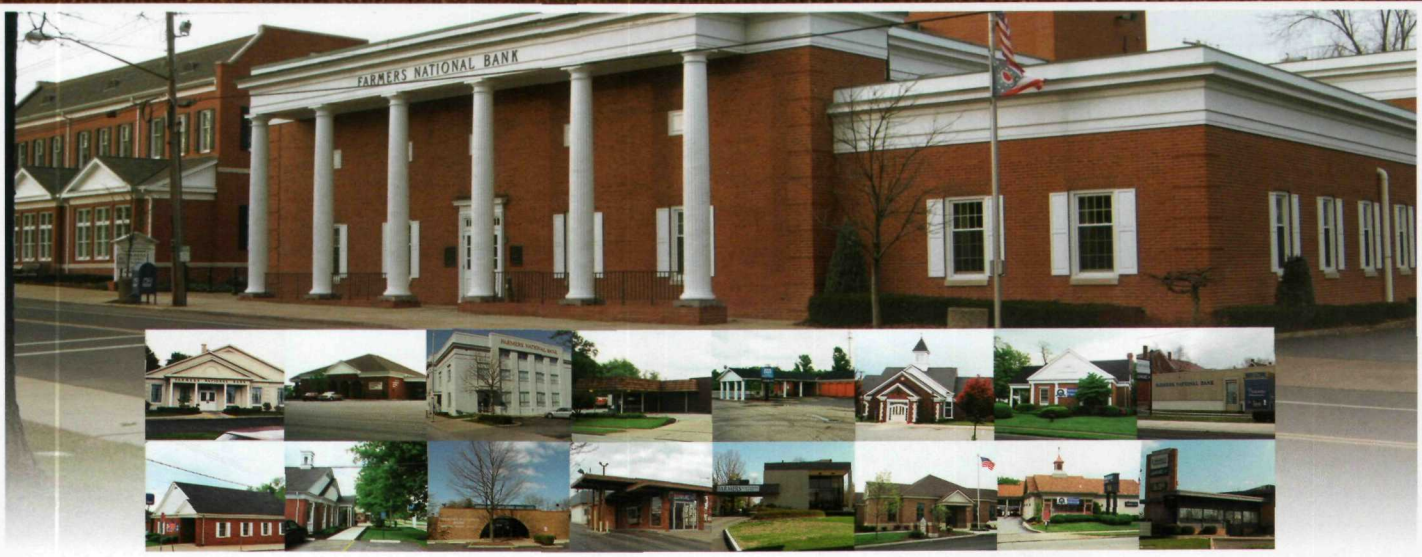
From left to right: Frank L. Paden, Joseph D. Lane, Ronald V. Wertz, Earl R. Scott, Anne Frederick Crawford, Benjamin R. Brown, Ralph D. Macali, James R. Fisher

### Farmers National Banc Corp. Officers

Frank L. Paden, President & Secretary
Carl D. Culp, Executive Vice President & Treasurer
Donald F. Lukas, Senior Vice President

### Farmers National Bank Officers

Frank L. Paden, President & CEO
Carl D. Culp, Executive Vice President, Cashier & CFO
Donald F. Lukas, Senior Vice President Bank Systems
Mark L. Graham, Senior Vice President and Senior Loan Officer
Bradley S. Henderson, Vice President Branch Adm. & Security
Anthony F. Peluso, Vice President Human Resources
Barbara C. Fisher, Vice President Deposit Operations & Marketing
Daniel G. Cerroni, Vice President Canfield Loans
Joseph E. Chapman, Vice President Niles Collections
Kevin J. Helmick, Vice President Investment Services
Frederick M. Kotheimer, Vice President Loan Review
Kevin T. Lamar, Vice President Niles
Alfred F. Ridel, Vice President Consumer Loans
James G. Swift, Vice President Niles Operations Center
Susan E. Better, Assistant Vice President Corporate Services Administration
Raymond Calcagni, Assistant Vice President Commercial Loans
Gregory Ensley, Assistant Vice President Canfield Loans
Keith A. Leonard, Assistant Vice President Canfield Loans
Richard R. Lytle, Assistant Vice President Youngstown Rd.
Mary Jane Naples, Assistant Vice President Niles Operations Center
Jon Schmied, Assistant Vice President Canfield Loans
Thomas Supko, Assistant Vice President Compliance and CRA
Phyllis A. Welton, Assistant Vice President Niles Operations Center
Joseph W. Sabat, Controller
Clare Baldwin, Assistant Cashier Cornersburg
Pamela J. Cleghorn, Assistant Cashier Canfield
Janine M. Cox, Assistant Cashier Credit Administration
Daniel A. Cvercko, Assistant Cashier Investment Services
Charlene K. Daugherty, Assistant Cashier Human Resources
David E. Enterline, Assistant Cashier Network Administrator
Rhonda R. Frantz, Assistant Cashier Electronic Banking
Merle C. Garritano, Assistant Cashier Canfield Loans
Geraldine J. Gbur Polas, Assistant Cashier Columbiana
Lynnita J. Himes, Assistant Cashier Western Reserve
Diane C. King, Assistant Cashier Canfield Loans
Rob Leonard, Assistant Cashier Indirect Loans
Jennifer McCon, Assistant Cashier Lake Milton
Joanie F. Orr, Assistant Cashier Accounting
Ernest A. Ramsey, Assistant Cashier Business Client Services
Linda Robertson, Assistant Cashier Mineral Ridge
Carl Romeo, Assistant Cashier Salem
Patricia C. Rosko, Assistant Cashier Austintown
Jennifer L. Scharf, Assistant Cashier Credit Department
Barbara J. Sitler, Assistant Cashier Canfield Main
Deborah N. Testa, Assistant Cashier Eastwood
Dennis S. Vitt, Assistant Cashier Poland




# Branch Locations

**Website- www.fnbcanfield.com**

| | | |
|---|---|---|
| Austintown | 22 North Niles-Canfield Road • Youngstown, OH 44515 | 792-1411 |
| Boardman | 102 West Western Reserve Road • Boardman, OH 44514 | 726-8896 |
| Canfield | Main Office 20 South Broad Street • Canfield, OH 44406 | 533-3341 |
| Colonial Plaza | 401 East Main Street • Canfield, OH 44406 | 533-2686 |
| Columbiana | 340 State Rt. 14 • Columbiana, OH 44408 | 482-1974 |
| Cornersburg | 3619 S. Meridian Road • Youngstown, OH 44511 | 793-3971 |
| Damascus | 29053 State Rt. 62 • Damascus, OH 44619 | 537-4004 |
| Girard | 121 North State Street • Girard, OH 44420 | 545-9791 |
| Lake Milton | 17817 Mahoning Avenue • Lake Milton, OH 44429 | 654-3351 |
| Leetonia | 16 Walnut Street • Leetonia, OH 44431 | 427-2436 |
| Mineral Ridge | 3826 South Main Street • Mineral Ridge, OH 44440 | 544-7430 |
| Niles | 1 South Main Street • Niles, OH 44446 | 544-7400 |
| Niles Drive Up | 170 East State Street • Niles, OH 44446 | 544-7420 |
| Niles Ops. Center | 51 South Main Street • Niles, OH 44446 | 544-7400 |
| Niles | 5845 Youngstown-Warren Road • Niles, OH 44446 | 544-7410 |
| Poland | 106 McKinley Way West • Poland, OH 44514 | 757-7508 |
| Salem | 1858 East State Street • Salem, OH 44460 | 332-1558 |
| Warren | 2910 Youngstown-Warren Road • Warren, OH 44484 | 369-5400 |

# Professional Services

Professional services offered by PrimeVest Financial Services located at Farmers National Bank

Kevin Helmick

Annette Kushner

Daniel Cvercko

Angie Mikesell

Vince Dobransky

Lynn Bowers

- Portfolio Strategy
- Insurance Needs
- Asset Allocation
- Mutual Funds
- Retirement Planning
- College Funding
- Tax-Favored Investing
- Health Care Concerns
- Business Owner Needs
- Estate Issues*

Our Investment and Insurance Professionals will be glad to take the time to discuss your needs and aspirations.

Whether you are seeking to create or revise a comprehensive financial plan, or are interested in a specific product, we have the experience to assist you.

We can help you determine which products and services make the most sense for you. Our Investment and Insurance Professionals bring a wealth of common sense, experience and objectivity to your financial planning.

PrimeVest Financial Services, Inc., is an independent registered broker/dealer. Securities and insurance products offered by PrimeVest Financial Services located at Farmers National Bank:

- Not FDIC Insured
- May go down in value
- Not Financial Institution guaranteed
- Not a deposit
- Not insured by any federal government agency

*Please note that neither PrimeVest nor any of its representatives may give legal or tax advice.

PV

PRIMEVEST℠

FINANCIAL SERVICES

Member NASD/SIPC

PrimeVest Investment and Insurance Professionals

# *Embracing the* FUTURE *for 120 years*

How do you embrace the future?

First, by spending more time moving forward than you do looking back.

More specifically, by possessing an attitude that is open to needed change, especially in the form of new business practices and advanced technologies.

The essential reason that Farmers National Bank is in a position to celebrate its 120th Anniversary is due to our historical willingness to adapt. So, in 2007, we determined that the best way to honor our history was to focus on pursuing initiatives that will meet the evolving needs of our customers.

The cover of this annual report makes clear the changes in our main buildings over the years. The more significant changes are those that have and are taking place inside your company, changes designed to help us meet the expectations of shareholders for generations to come.

FARMERS NATIONAL BANC CORP.

20 SOUTH BROAD STREET
P.O. BOX 555
CANFIELD, OHIO 44406