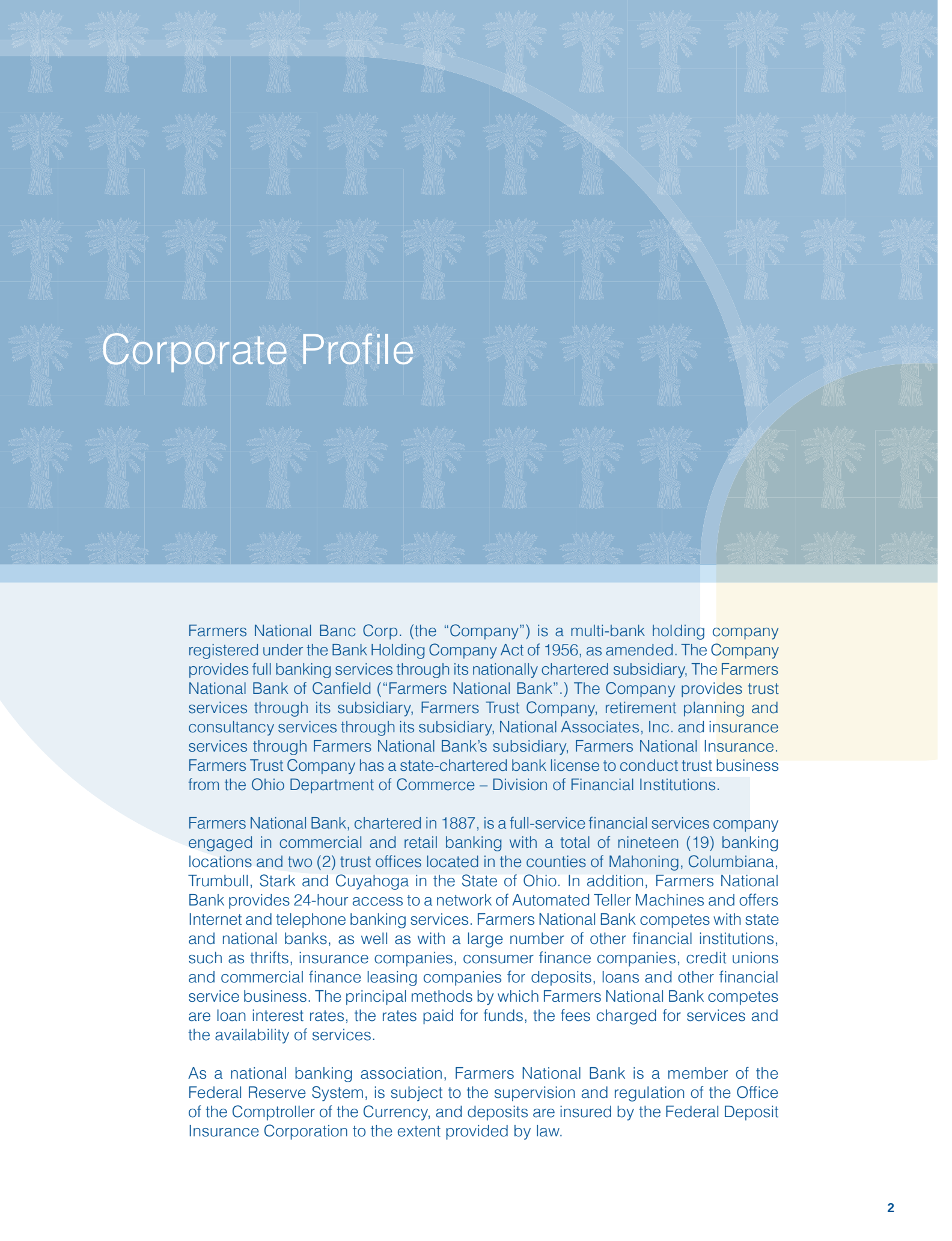




Growing the  
**health of  
our wealth**

Farmers National Banc Corp.  
2013 Annual Report



# Corporate Profile

Farmers National Banc Corp. (the “Company”) is a multi-bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company provides full banking services through its nationally chartered subsidiary, The Farmers National Bank of Canfield (“Farmers National Bank”). The Company provides trust services through its subsidiary, Farmers Trust Company, retirement planning and consultancy services through its subsidiary, National Associates, Inc. and insurance services through Farmers National Bank’s subsidiary, Farmers National Insurance. Farmers Trust Company has a state-chartered bank license to conduct trust business from the Ohio Department of Commerce – Division of Financial Institutions.

Farmers National Bank, chartered in 1887, is a full-service financial services company engaged in commercial and retail banking with a total of nineteen (19) banking locations and two (2) trust offices located in the counties of Mahoning, Columbiana, Trumbull, Stark and Cuyahoga in the State of Ohio. In addition, Farmers National Bank provides 24-hour access to a network of Automated Teller Machines and offers Internet and telephone banking services. Farmers National Bank competes with state and national banks, as well as 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 by which Farmers National Bank competes are loan interest rates, the rates paid for funds, the fees charged for services and the availability of services.

As a national banking association, Farmers National Bank is a member of the Federal Reserve System, is subject to the supervision and regulation of the Office of the Comptroller of the Currency, and deposits are insured by the Federal Deposit Insurance Corporation to the extent provided by law.

# Financial Highlights

*(Dollar Amounts in Thousands Except for Per Share Data)*

| For the Year               | 2013        | 2012        | 2011        |
|----------------------------|-------------|-------------|-------------|
| Net Income                 | \$7,780     | \$9,932     | \$9,218     |
| Return on Average Assets   | 0.68%       | 0.89%       | 0.89%       |
| Return on Average Equity   | 6.66%       | 8.42%       | 8.76%       |
| Per Share                  |             |             |             |
| Net Income (Basic)         | \$0.41      | \$0.53      | \$0.50      |
| Net Income (Diluted)       | 0.41        | 0.53        | 0.50        |
| Book Value                 | 6.02        | 6.43        | 6.10        |
| Balances at Year-End       |             |             |             |
| Total Assets               | \$1,137,326 | \$1,139,695 | \$1,067,871 |
| Earning Assets             | 1,076,222   | 1,082,078   | 1,014,997   |
| Total Deposits             | 915,216     | 919,009     | 840,125     |
| Net Loans                  | 623,116     | 578,963     | 561,986     |
| Total Stockholders' Equity | 113,007     | 120,792     | 114,445     |
| Cash Dividends             | 2,248       | 3,382       | 2,241       |
| Common Shares Outstanding  | 18,776      | 18,795      | 18,757      |

## Annual Meeting Notice

*The Annual Meeting of Shareholders will be held at the Joyce E. Brooks Center at the Mahoning County Career and Technical Center (MCCTC) at 7300 North Palmyra Road, Canfield, OH 44406 at 3:30pm EST, on Thursday, April 24, 2014.*

“We successfully managed the health of our Company’s wealth in the steady fashion that earned us our longevity.”

**Kevin J. Helmick**  
*President & Chief Executive Officer*



Fellow  
Shareholders,

The modern age of our storied Bank has been a very interesting time.

After many years of maintaining a steady and solid presence in our original Mahoning Valley marketplace, Farmers has spent the last few years expanding its northeast Ohio regional footprint, acquiring new offices and developing new service lines. What started as a horse and buggy journey 126 years ago has transformed into a legacy of calculated growth and expansion.

As we look back at 2013, we can all take note of a new era in our Bank’s history. On November 6th, I was very pleased to accept the position of President and CEO of Farmers and thank our Company’s Board of Directors for their trust and confidence. As many of you know, I am not new to Farmers and, in fact, have worked for our Bank in various capacities during my entire adult career. Still, I am humbled by the fact that I am one of only nine presidents in our Bank’s 126 year long history, and I respect the fact that I must be a dedicated steward of a proud legacy as we advance our Company’s future.

And so, for this, my first report to you as our Bank’s President and CEO, I’d like to review the highlights of the previous year and share with you my vision for the years to come. This past year was a good business year. We successfully managed the health of our Company’s wealth in the steady fashion that earned us our longevity.

#### **NAI Acquisition**

Prior to June, Farmers had been a Mahoning Valley-based business with an additional presence in Canton. However, in June, we acquired National Associates Inc. (NAI) in the Cleveland suburb of Rocky River. This strategic initiative extends Farmers’ marketplace to Cuyahoga County and gives us a platform to broaden our community bank footprint.

From an operations perspective, the NAI acquisition is very exciting. Farmers’ business plan has been to develop a truly comprehensive slate of financial services for our customers, which consists of one-source solutions for individuals, families and businesses. NAI is a nationally recognized provider of retirement planning services and fits nicely into Farmers’ wealth management offering. NAI maintains a robust business in actuarial, plan design,

compliance and administrative services and has \$505 million in assets under administration. Since the acquisition, we have on-boarded highly qualified associates to provide commercial banking and private client services from that location. By year’s end this site will be a fully functional Farmers’ branch to include mortgage services, investments and universal banking.

#### **National Recognition**

We have grown accustomed to earning positive reviews in national publications and 2013 provided more of the same. Once again, Bank Director Magazine, a nationally respected publication for the banking and financial services industry, named Farmers as one of the best banks in America.

When we analyzed the article’s findings, we discovered Farmers was ranked 69th in the top one hundred list of banks between \$1 billion and \$5 billion in assets. Ours was one of only three banks in Ohio to earn this recognition.

#### **Farmers Trust Company**

In December, Jim Sisek made the decision to assume the titles of Chairman and

Chief Legal Counsel and leave the day-to-day management of the trust company to a highly-respected trust officer, Joe DePascale. As such, Farmers and the trust company continue to benefit from Jim's knowledge and expertise. This is something I value a great deal.

Jim founded the trust company in 1995 and he grew it into the thriving business it is today. Through his considerable effort, the Valley gained a locally managed company for a variety of retirement planning and trust services. As it grew, Farmers Trust Company adopted the role of chief philanthropist of greater Youngstown. Today, dozens of schools and nonprofit organizations owe their very existence to the funds granted them by the trust company and its clients. This apparatus – which lifts up this Valley in too many ways to enumerate – would not exist if not for Jim Sisek.

On a personal note, I wish to acknowledge how important Jim's support has been to me during my time at Farmers, but particularly through the transition to my current position. I know you join me in my appreciation for Jim's continued leadership and dedication to Farmers.

### **Maintaining the Health of our Wealth**

The theme of this year's annual report is

the "Health of our Wealth." Perhaps you've heard this phrase in some of our recent television commercials. The line itself is meant to be clever and "ear catching" because of its rhyme. But you can be assured Farmers' commitment to faithful stewardship of our customers' assets and financial planning is serious and unwavering.

Reflecting on this commitment has reaffirmed my belief that we must continue to focus on the fundamental metrics of banking. Farmers has an established culture that values business discipline, which yields the company higher net income and meaningful returns for our shareholders. We will also focus on refining and perfecting the complement of services Farmers now offers and on continually improving the performance of our stock. Again, these are the fundamentals of good banking.

Many of our future achievements will be fostered by our established sales culture model that moves the organization in one cohesive direction maximizing revenues and strengthening customer relationships. The self-branded model, appropriately named F.A.S.T., is an acronym for Farmers Associates Stand Together. This powerful tool allows our specialized workforce to analyze and gather data in order to develop and implement a relationship-

based plan. What comes next is the facet for which Farmers has been known over the two decades I've been associated with the Company...and that is our best-in-class customer service. We monitor the relationship through a variety of touch points only dreamt about in the late 1800's when Farmers was in its infancy to ensure a complete customer experience.

As you can see by this brief review of 2013, we have had some big ideas that came to fruition last year. We look forward to capitalizing on even bigger ideas in 2014 and beyond. As we continue into one of the most challenging eras in American business history, that includes continued regulatory scrutiny, unpredictable technological advances and a very competitive landscape, I am optimistic about the value Farmers will continue to create for our shareholders, the opportunity we will give our employees, the service we will give our customers and the care we will give our communities.

I think we have just begun to realize the potential of Farmers National Banc Corp. We are well positioned to achieve great things and I thank you for being a part of that effort.



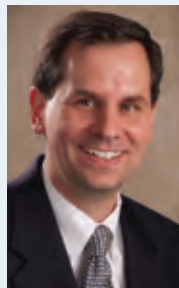
**Kevin J. Helmick**  
*President & Chief Executive Officer*

**"Farmers' commitment to faithful stewardship of our customers' assets and financial planning is serious and unwavering."**

“We expect to continue to adapt, execute and improve as a company and look forward to continued growth in 2014.”



**James H. Sisek, Esq.**  
*Chairman & Chief  
Legal Counsel*



**Joseph J. DePascale,**  
*CPA, CFP®, AIFA®, CMFS,  
President*



**William Hanshaw, Esq.**  
*Executive V.P. & Secretary*

Dear Fellow Shareholders,

We are happy to report that Farmers Trust Company, with our new offices in Boardman and Howland, enjoyed 16% growth in net income compared to 2012. Trust assets stood at \$1.1 billion at December 31, 2013 having grown from \$972 million last year. We attribute the growth to members of the community recognizing that they can have professional asset management and local service. The Trust Company provides fiduciary and estate services, employee retirement plan services, as well as a professional investment management process. As a fiduciary, Farmers Trust Company prides itself on being local and independent with no conflicts of interest and no proprietary mutual funds.

Our highly qualified staff of 28 includes five attorneys, two CFA charter holders, two employees with advanced fiduciary designations, a Certified Public Accountant and enrolled agent, two Certified Trust Financial Advisors, as well as two Certified Financial Planners® and multiple staff members with advanced degrees. Recent changes in management saw CEO and President, James H. Sisek, Esq., transition to Chairman of the Board and Chief Legal Counsel. Joseph J. DePascale, CPA was named President and William Hanshaw, Esq. continues as Executive Vice President and Chief Operating Officer. Mr. Sisek continues to manage certain accounts, heads the Charitable Trust Division and the Executive Committee.

The Investment Department has been led by Chief Investment Officer Joseph J. DePascale, CPA, and Chief Investment Strategist David A. Dastoli. John D. Stewart was added to the staff this year after running a Registered Investment Advisory Firm for several years. The Department accomplished several initiatives last year including an automated system of managing mutual funds within portfolios, reduced its commission costs on equity trades and implemented an enhanced bond trading platform that ensured best execution pricing for our clients. William F. Moss III and John P. Zimomra round out this highly qualified investment team.

The Administration Team is led by Attorney Hanshaw along with Gary L. Pilcher, Esq., Kimberly A. Tomlinson, Esq., Margaret S. Adams, Esq. and Kathleen Brown, CTFA. Henry J. Bilyk heads the Employee Benefits Division, Rebecca A. Mottram continues to lead the Operations group, and the Tax Department is headed by Barbara L. Repasky. All functions (Operations, Pension Administration, Tax, etc.) are performed locally with no major function being outsourced as some larger competitors have elected to do.

The Charitable Division of the Trust Company continued its record growth throughout the year. Individuals, private foundations, and charitable trusts contributed in excess of \$6 million to

beneficiaries throughout the community, funding college scholarships, early childhood intervention programs, area hospitals and community charities. Kathy Brown is lead relationship manager for many of these accounts.

A state-chartered bank, Farmers Trust is overseen by the Ohio Division of Financial Institutions and the Federal Reserve Bank of Cleveland. During these difficult financial times, the Trust Company has maintained an exemplary record. While the economy and the markets may present challenges, we expect to continue to adapt, execute and improve as a Company and look forward to continued growth in 2014.

With the market at an all-time high, this is the time to plan the financial affairs of your family with qualified experts. We look forward to the challenges presented in 2014 with many new projects, and view them as enhanced opportunities for continued growth. We extend our thanks and our appreciation to our loyal clients, shareholders, officers and employees. As always, we welcome and value your support.



**James H. Sisek, Esq.**  
*Chairman & Chief Legal Counsel*

“Farmers has recorded 124 consecutive quarters of positive earnings.”



**CARL D. CULP**  
*Executive Vice President & CFO*

To Our  
Stockholders,



We are pleased to report our 2013 financial results for your Company. The following

paragraphs provide a brief overview of relevant information regarding your Company's financial performance in 2013.

We are proud to report that Farmers has recorded 124 consecutive quarters of positive earnings. Net income for 2013 was \$7.8 million compared to \$9.9 million in 2012. On a per share basis, net income for 2013 was \$0.41 per diluted share, compared to \$0.53 in 2012. The results for 2013 included severance expenses of \$1.3 million. Excluding these severance expenses, net income for 2013 would have been \$8.6 million or \$0.46 per share. As a result of management actions that took place in the third quarter of this year, net income per diluted share for the fourth quarter of 2013 improved to \$0.12, which represents our best quarter of the year in terms of profitability.

The net interest margin decreased slightly from 3.76% for the year ended December 31, 2012 to 3.58% for 2013, or 18 basis points. Total average earning assets increased 3% while the yields on those average-earning assets decreased 31 basis points from 4.36% in 2012 to 4.05% in 2013. Total average interest bearing liabilities decreased 0.3%, while the cost of the average interest-bearing liabilities decreased from 0.70% in 2012 to 0.58% in 2013, or 12 basis points. The decrease in cost was the result of lower rates of interest paid on interest-bearing deposits and repurchase agreements.

Noninterest income excluding security gains and losses increased by \$1.5 million in 2013, primarily as a result of increases

of \$327 thousand from service charges on deposit accounts, \$119 thousand from insurance agency commissions and \$86 thousand in trust income. We also added \$477 thousand in retirement plan consulting fees as a result of the income earned from the newly acquired entity, National Associates, Inc. Management continues to focus on the diversification and enhancement of income streams.

Noninterest expenses for 2013 increased \$3.3 million to \$39.1 million in 2013. It is important to note that the Company underwent a cost reduction program during the year that resulted in the closure of two retail branch locations and the elimination of several full time positions. In addition to the cost saving initiatives, the Company also made adjustments to the fee structure for its retail and commercial banking products and services. As a result of these actions, the Company's efficiency ratio improved to 67.96% for the quarter ended December 31, 2013, which compares favorably to the 72.48% reported in the fourth quarter in 2012.

#### Loans

Total loans increased 7.5% during 2013. The modest improvement in the local economy is the primary factor for the increase in loans. Increases were realized in the commercial real estate, residential real estate and indirect automobile loan portfolios. The Company maintains a diverse loan portfolio comprised of approximately 16.7% in commercial loans, 34.4% in commercial real estate loans, 27.0% in residential real estate loans and 21.9% in consumer loans. Our team of experienced loan officers remains focused on increasing our portfolio by building long-term customer relationships.

Your Company continues to maintain strong asset quality. Net loan charge-offs decreased from \$2.9 million in 2012 to \$1.4 million in 2013. Most of the improvement occurred in the commercial and commercial real estate loan portfolios. Non-performing assets to total assets remain low, currently at 0.81% at the end of 2013. Early stage delinquencies also remain at low levels, down slightly to \$3.6 million at December 31, 2013. Management remains diligent in monitoring local economic conditions and the impact that it may have on our loan portfolio.

#### Stockholders' Equity

At the end of the year, the Bank is considered “well capitalized” under regulatory guidelines. Stockholders received a total of \$0.12 per share in cash dividends in 2013. Total Stockholders' Equity decreased 6.4% during 2013, mainly as a result of a \$13.1 million decrease in accumulated comprehensive income and treasury share repurchases that amounted to \$1.6 million.

With our improved financial results reported for the fourth quarter of 2013, we look forward to the continued positive trends in our local economy, and the opportunities that come with those trends to help us in our efforts to increase profitability and enhance shareholder value.



*Carl D. Culp*

**CARL D. CULP**  
*Executive Vice President & CFO*



TRUST · INVESTMENTS · INSURANCE  
PRIVATE CLIENT SERVICES  
RETIREMENT SERVICES

## Farmers Wealth Management

Banking is no longer the same business it was at our founding over 125 years ago. Today's Farmers National Bank recognizes the necessity of diversification. Our Company now provides a broad array of wealth management services. From a business perspective, new business lines provide reliable revenue that strengthen our Company and give it a solid foundation for future growth. For our valued customers, Farmers' comprehensive wealth management offerings provide expert services that are backed by the trusted Farmers brand name.

## Farmers Trust Company

Farmers Trust Company is the Mahoning Valley's leading trust company and currently has \$1.1 billion in assets under management. Trust customers can access several distinct service lines within Farmers Trust, including investment management, tax and estate planning, employee benefit plans, pension plans, estate settlement, living trusts and charitable trusts and endowments. Farmers Trust Company was acquired by Farmers National Banc Corp. in 2009 and operates from two offices in Boardman and Howland.

*Please read more about Farmers Trust Company in a dedicated section of this annual report found on page 6.*

## Farmers Private Client Services

In 2012, Farmers National Bank introduced a new business line to service wealth management clients with various financial needs such as investment, retirement and estate planning; as well as insurance, and trust services.

Customers will find Private Client Services the ultimate in convenience by having one liaison provide a comprehensive financial array of services to meet all financial requirements. Private Client Relationship

Managers have the ability to manage a broad range of deposit accounts, arrange for loans and mortgages and perform other various financial transactions.

Farmers Private Client Services' offices are located in Howland at 1625 Niles-Cortland Road, in Boardman at 42 McClurg Road, in Canton at 4518 Fulton Drive NW and in Rocky River at 20325 Center Ridge Road.

## Farmers National Investments

Farmers National Investments embodies the optimum convergence of industry leading professionalism, deep knowledge of investment options, thorough understanding of marketplace conditions and superior customer service.

When customers meet with a Farmers Investment Representative, they have the full attention of a professional who will help them develop and understand their financial goals, work on a detailed plan for meeting or exceeding those goals and be on notice for any changes that require a prudent adjustment in the plan they created together.

Farmers National Investments offers a comprehensive array of services, including:

- Portfolio strategy
- Retirement planning
- College funding
- Estate conversion management
- Business owner needs

Cetera Investment Services LLC is a registered broker/dealer, member FINRA/SIPC. Securities and insurance products offered by Cetera Investment Service are: Not FDIC insured. May go down in value. Not Financial Institution guaranteed. Not a deposit. Not insured by any federal government agency.

## National Associates, Inc.

In June 2013, Farmers acquired National Associates Inc. (NAI) in the Cleveland suburb of Rocky River, Ohio. NAI is an excellent addition to our wealth management division. The company is a leading independent consultant to retirement plans and offers actuarial, plan design, compliance and administrative services. As a third party administrator, NAI provides services to 401(k), Defined

Benefit, Profit Sharing, Flexible Spending, 403(b), ESOP and other plans.

NAI has 17 employees and administers over 200 retirement plans with assets under administration of approximately \$505 million. The majority of NAI's business comes from Northeast Ohio and the firm maintains strong relationships with its clients, as evidenced by the fact many of them have been clients of NAI for over 30 years.

NAI integrates well into Farmers' growing slate of financial services and we continue to strengthen our ability to provide comprehensive, one-stop solutions to our valued customers.

## Farmers National Insurance

Since March 2010, Farmers National Bank customers have enjoyed the convenience and cost-savings of Farmers National Insurance.

In its brief history, Farmers National Insurance has become a trusted provider of financial security for individuals and businesses alike. We offer a wide range of competitively-priced policies including:

- Auto
- Homeowner
- Rental/Condo
- Personal Liability
- Business
- Life
- Disability
- Individual/Group Health and Dental
- Medicare Supplements
- Worksite Benefits

Insurance products are not deposits of Farmers National Bank and are not protected by the FDIC. They are not guaranteed by Farmers National Bank and may be subject to risk. Any insurance required as a condition of an extension of credit by Farmers National Bank need not be purchased from Farmers National Insurance LLC, and may be purchased from an agent or an insurance company of the customer's choice. Farmers National Insurance LLC, is a subsidiary of Farmers National Bank. Business conducted with Farmers National Insurance LLC, is separate and distinct from any business conducted with Farmers National Bank.



# Board Of Directors



From Left to Right  
 Top Row: Ralph D. Macali, Gregg Strollo, Anne Frederick Crawford, Gregory C. Bestic  
 Bottom Row: David Z. Paull, Lance J. Cirolì, Ronald V. Wertz, Earl R. Scott  
 Also pictured in the top row, third from left, is Kevin J. Helmick, President & Chief Executive Officer.

## **Lance J. Cirolì** <sup>2,4</sup>

*Chairman of the Board  
 Co-founder of NBE Bank Consulting  
 Services. Retired Assistant Deputy  
 Comptroller in the Cleveland/Detroit  
 Field Office, Office of the Comptroller  
 of the Currency*

## **Gregory C. Bestic** <sup>1,3</sup>

*CPA, CGMA, Certified Forensic  
 Accountant, DABFA, FACFEI  
 Principal with Schroedel, Scullin  
 & Bestic, LLC - Certified Public  
 Accountants and Strategic Advisors*

## **Anne Frederick Crawford** <sup>2,3</sup>

*Attorney-at-Law  
 Self-employed/Sole Proprietor*

## **Ralph D. Macali** <sup>1,4</sup>

*Vice President of Palmer J. Macali, Inc.  
 Partner in P.M.R.P. Partnership*

## **David Z. Paull** <sup>1,2</sup>

*Vice President, Human Resources  
 Operations and Labor Relations, RTI  
 International Metals, Inc.*

## **Earl R. Scott** <sup>1,4</sup>

*Certified Public Accountant (CPA) and  
 President, Realì, Giampetro & Scott*

## **Gregg Strollo** <sup>2,3</sup>

*Partner, Architect and President, Strollo  
 Architects*

## **Ronald V. Wertz** <sup>3,4</sup>

*Retired President and Chief Executive  
 Officer, Boyer Insurance, Inc.  
 Retired Risk Management Consultant,  
 Wells Fargo Insurance Services*

- 1 Audit Committee
- 2 Compensation Committee
- 3 Corporate Governance and Nominating Committee
- 4 Risk Management Committee

## Farmers National Banc Corp. Officers

**Kevin J. Helmick,**  
*President and Chief Executive Officer*

**Carl D. Culp,**  
*Executive Vice President & Treasurer*

## Farmers National Bank Officers



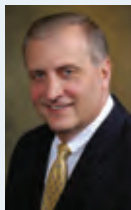
**Kevin J. Helmick,**  
*President and Chief Executive Officer*



**Carl D. Culp,**  
*Executive Vice President, Cashier & Chief Financial Officer*



**Mark L. Graham,**  
*Executive Vice President, Chief Credit Officer*



**Joseph Gerzina,**  
*Senior Vice President, Chief Lending Officer, Community President West Region*



**Brian E. Jackson,**  
*Senior Vice President, Chief Information Officer*



**Mark Nicastro,**  
*Senior Vice President, Director of Human Resources*



**Amber Wallace,**  
*Senior Vice President, Chief Retail and Marketing Officer*



**Timothy Shaffer,**  
*Vice President, Director of Commercial Banking and Private Client Services, Mahoning Valley*



**Dale Sturdevant,**  
*Vice President, Chief Risk Officer*

## Vice Presidents

Breen Bannon  
Daniel Bryan  
Daniel A. Cvercko  
Gregory L. Ensley  
Ted G. Grabowski  
Roberta L. Harding  
Bradley S. Henderson  
William Holland  
James D. Horvath  
Robert J. Leonard  
Rebecca Lonteen  
Peter J. Noll  
Thomas W. Ogg  
Kerry R. Pizzulo  
David Roberts  
Joseph W. Sabat  
Stacie W. Salyard  
Jennifer L. Scharf  
Jon R. Schmied  
David E. Simko  
Barbara J. Sitler  
James G. Swift  
Christopher Willoughby

## Assistant Vice Presidents

Rochelle L. Baer  
Richard Bunyoff  
Randall S. Colian  
David E. Enterline  
Stephen Fisher  
Lynn J. Himes  
Iris Irwin  
Diane C. King  
Philip L. Lammers  
Marla Pieton  
Geraldine J. Polas  
Amber Richards  
Racheal L. Solida  
Michael Taylor  
John Zoppelt

## Banking Officers

Peggy Bailey  
Clare F. Baldwin  
Michael Brenner  
Christine Byrd  
Pamela J. Cleghorn  
Bradley C. Daugherty  
Cynthia A. Doran  
Francis Gallagher  
Jennifer Gavalier  
Kristin Glasser  
Jane E. Goddard  
Mel Gretta  
Cathy Grimm  
Raymond R. Harsch  
Anita L. Jarvis  
Jeanette Kocher  
Kenneth C. Kondas  
Kenneth Kraft  
Rhonda R. Learn  
Maria Martinez  
Jennifer C. McCon  
Marita Miklos  
Desirae Monaco  
Richard Palmer  
Sandra Penezich  
Gina Price  
Linda L. Robertson  
Carl P. Romeo  
G. Scott Rowley  
Kimberley A. Stoffer  
Deborah N. Testa  
Carol Tsvetkoff  
Christopher Wentz

## Farmers Trust Company Officers



**James H. Sisek, Esq.,**  
*Chairman and Chief Legal Counsel*



**Joseph J. DePascale,**  
*CPA, CFP®, AIFA®, CMFS, President*



**William Hanshaw, Esq.,**  
*Executive V.P. & Secretary*

## Senior Vice Presidents

Henry J. Bilyk  
David A. Dastoli, CFA  
Gary L. Pilcher, Esq.

## Vice Presidents

Kathleen Brown, CTFA  
Rebecca A. Mottram  
Jill A. Pegg  
Barbara L. Repasky  
John D. Stewart, CFA  
Kimberly A. Tomlinson, Esq.  
John P. Zimomra

## Assistant Vice President

Margaret S. Adams, Esq.

## Trust Officers

Amy L. Jones  
William F. Moss III, AFIM®  
Linda A. Russell

## Assistant Trust Officer

Michelle Schenker

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

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**FORM 10-K**

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(Mark One)

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

For the fiscal year ended December 31, 2013

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-35296

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**Farmers National Banc Corp.**

(Exact name of registrant as specified in its charter)

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Ohio  
(State or other jurisdiction of  
incorporation or organization)

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

20 South Broad Street, Canfield, Ohio  
(Address of principal executive offices)

44406  
(Zip Code)

Registrant's telephone number, including area code: 330-533-3341

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

| Title of each class         | Name of each exchange on which registered |
|-----------------------------|-------------------------------------------|
| Common Shares, no par value | The NASDAQ Stock Market LLC               |

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

None  
(Title of Class)

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

|                                                                                              |                                                       |
|----------------------------------------------------------------------------------------------|-------------------------------------------------------|
| Large accelerated filer <input type="checkbox"/>                                             | Accelerated filer <input checked="" type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company <input type="checkbox"/>    |

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

As of June 30, 2013, the estimated aggregate market value of the registrant's common shares, no par value (the only common equity of the registrant), held by non-affiliates of the registrant was approximately \$116.5 million based upon the last sales price as of June 30, 2013 reported on NASDAQ. (The exclusion from such amount of the market value of the common shares owned by any person shall not be deemed an admission by the registrant that such person is an affiliate of the registrant).

As of March 5, 2014, the registrant had outstanding 18,780,980 common shares, no par value.

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**FARMERS NATIONAL BANC CORP.**  
**ANNUAL REPORT ON FORM 10-K**  
**FOR THE FISCAL YEAR ENDED DECEMBER 31, 2013**

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**SIGNATURES**

## **PART I**

### **Item 1. Business.**

#### **General**

##### ***Farmers National Banc Corp.***

Farmers National Banc Corp. (the “Company,” “Farmers,” “we,” “our” or “us”), is a one-bank holding company organized in 1983 under the laws of the State of Ohio and registered under the Bank Holding Company Act of 1956, as amended (the “BHCA”). The Company operates principally through its wholly-owned subsidiaries, The Farmers National Bank of Canfield (the “Bank” or “Farmers Bank”), Farmers Trust Company (“Trust” or “Farmers Trust”) and National Associates, Inc. (“NAI”). Farmers National Insurance, LLC (“Insurance” or “Farmers Insurance”) is a wholly-owned subsidiary of the Bank. The Company and its subsidiaries operate in the domestic banking, trust, retirement consulting, insurance and financial management industries.

The Company’s principal business consists of owning and supervising its subsidiaries. Although Farmers’ directs the overall policies of its subsidiaries, including lending practices and financial resources, most day-to-day affairs are managed by their respective officers. Farmers and its subsidiaries had 328 full-time equivalent employees at December 31, 2013.

The Company’s principal executive offices are located at 20 South Broad Street, Canfield, Ohio 44406, and its telephone number is (330) 533-3341. Farmers’ common shares, no par value, are listed on the NASDAQ Capital Market (the “NASDAQ”) under the symbol “FMNB.” Farmers’ business activities are managed and financial performance is primarily aggregated and reported in three lines of business, the Bank segment, the Trust segment and NAI segment. For a discussion of Farmers’ financial performance for the fiscal year ended December 31, 2013, see the Consolidated Financial Statements and Notes to the Consolidated Financial Statements found in Item 8 of this Annual Report on Form 10-K.

##### ***The Farmers National Bank of Canfield***

The Bank is a full-service national banking association engaged in commercial and retail banking in Mahoning, Trumbull, Columbiana and Stark Counties in Ohio. The Bank’s commercial and retail banking services include checking accounts, savings accounts, time deposit accounts, commercial, mortgage and installment loans, home equity loans, home equity lines of credit, night depository, safe deposit boxes, money orders, bank checks, automated teller machines, internet banking, travel cards, “E” Bond transactions, MasterCard and Visa credit cards, brokerage services and other miscellaneous services normally offered by commercial banks.

A discussion of the general development of the Bank’s business and information regarding its financial performance throughout 2013, is discussed in Item 7. Management Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K.

The Bank faces significant competition in offering financial services to customers. Ohio has a high density of financial services providers, many of which are significantly larger institutions that have greater financial resources than the Bank, and all of which are competitors to varying degrees. Competition for loans comes principally from savings banks, savings and loan associations, commercial banks, mortgage banking companies, credit unions, insurance companies and other financial service companies. The most direct competition for deposits has historically come from savings and loan associations, savings banks, commercial banks and credit unions. Additional competition for deposits comes from non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies.

##### ***Farmers Trust Company***

During 2009, the Company acquired 100% of the capital stock of Butler Wick Trust Company, a wholly-owned subsidiary of Butler Wick Corporation for approximately \$12.1 million and renamed the entity Farmers Trust Company. Farmers Trust offers a full complement of personal and corporate trust services in the areas of estate settlement, trust administration and employee benefit plans. Farmers Trust operates two offices located in Boardman and Howland, Ohio.

##### ***National Associates, Inc.***

During 2013, the Company completed the acquisition of all outstanding stock of the retirement planning consultancy National Associates, Inc. of Cleveland, Ohio. The transaction involved both cash and stock totaling \$4.4 million, including up to \$1.5 million of future payments, contingent upon NAI meeting income performance targets. The acquisition is part of the Company’s plan to increase the levels of noninterest income and to complement the existing retirement service currently being offered. NAI operates from its office located in Rocky River, Ohio.

## ***Farmers National Insurance, LLC***

Farmers Insurance was formed during 2009 and offers a variety of insurance products through licensed representatives. Farmers Insurance is a subsidiary of Farmers Bank and does not account for a material portion of the revenue and, therefore, will not be discussed individually, but as part of the Bank.

## ***Investor Relations***

The Company maintains an Internet site at <http://www.farmersbankgroup.com>, which contains an Investor Relations section that provides access to the Company's filings with the Securities and Exchange Commission (the "Commission") Farmers makes available free of charge on or through its website the Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to such documents filed or furnished pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act") as soon as reasonably practicable after the Company has filed these documents with the Commission. In addition, the Company's filings with the Commission may be read and copied at the Commission's Public Reference Room at 100 F Street, NE, Washington, DC 20549. Information on the operation of the Public Reference Room may be obtained by calling 1-800-SEC-0330. These filings are also available on the Commission's web-site at <http://www.sec.gov> free of charge as soon as reasonably practicable after the Company has filed the above referenced reports.

## ***Supervision and Regulation***

### ***Introduction***

The Company and its subsidiaries are subject to extensive regulation by federal and state regulatory agencies. The regulation of bank holding companies and their subsidiaries is intended primarily for the protection of consumers, depositors, borrowers, the Deposit Insurance Fund and the banking system as a whole and not for the protection of shareholders. This intensive regulatory environment, among other things, may restrict the Company's ability to diversify into certain areas of financial services, acquire depository institutions in certain markets or pay dividends on its common shares. It also may require the Company to provide financial support to its banking and other subsidiaries, maintain capital balances in excess of those desired by management and pay higher deposit insurance premiums as a result of the deterioration in the financial condition of depository institutions in general.

Significant aspects of the laws and regulations that have, or could have a material impact on Farmers and its subsidiaries are described below. These descriptions are qualified in their entirety by reference to the full text of the applicable statutes, legislation, regulations and policies, as they may be amended or revised by the U.S. Congress or state legislatures and federal or state regulatory agencies, as the case may be. Changes in these statutes, legislation, regulations and policies may have a material adverse effect on the Company and its business, financial condition or results of operations.

### ***Regulatory Agencies***

**Bank Holding Company.** As a bank holding company, Farmers is subject to regulation under the BHCA and to inspection, examination and supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"). The Federal Reserve Board has extensive enforcement authority over bank holding companies and may initiate enforcement actions for violations of laws and regulations and unsafe or unsound practices. The Federal Reserve Board may assess civil money penalties, issue cease and desist or removal orders and may require that a bank holding company divest subsidiaries, including subsidiary banks. Farmers is also required to file reports and other information with the Federal Reserve Board regarding its business operations and those of its subsidiaries.

**Subsidiary Bank.** The Bank is subject to regulation and examination primarily by the Office of the Comptroller of the Currency (the "OCC") and secondarily by the Federal Deposit Insurance Corporation (the "FDIC"). OCC regulations govern permissible activities, capital requirements, dividend limitations, investments, loans and other matters. The OCC has extensive enforcement authority over Farmers Bank and may impose sanctions on Farmers Bank and, under certain circumstances, may place Farmers Bank into receivership.

Farmers Bank is also subject to certain restrictions imposed by the Federal Reserve Act and Federal Reserve Board regulations regarding such matters as the maintenance of reserves against deposits, extensions of credit to Farmers or any of its subsidiaries, investments in the stock or other securities of Farmers or its subsidiaries and the taking of such stock or securities as collateral for loans to any borrower.

*Non-Banking Subsidiaries.* Farmers' non-banking subsidiaries are also subject to regulation by the Federal Reserve Board and other applicable federal and state agencies. In particular, Farmers National Insurance is subject to regulation by the Ohio Department of Insurance, which requires, amongst other things, the education and licensing of agencies and individual agents and imposes business conduct rules.

*Securities and Exchange Commission and The NASDAQ Stock Market LLC.* The Company is also under the regulation and supervision of the Commission and certain state securities commissions for matters relating to the offering and sale of its securities. The Company is subject to disclosure and regulatory requirements of the Securities Act of 1933, as amended (the "Securities Act"), and the Exchange Act, and the regulations promulgated there under. Farmers common shares are listed on the NASDAQ under the symbol "FMNB" and the Company is subject to the rules for NASDAQ listed companies.

*Federal Home Loan Bank.* Farmers Bank is a member of the Federal Home Loan Bank of Cincinnati (the "FHLB"), which provides credit to its members in the form of advances. As a member of the FHLB, the Bank must maintain an investment in the capital stock of the FHLB in a specified amount. Upon the origination or renewal of a loan or advance, the FHLB is required by law to obtain and maintain a security interest in certain types of collateral. The FHLB is required to establish standards of community investment or service that its members must maintain for continued access to long-term advances from the FHLB. The standards take into account a member's performance under the Community Reinvestment Act of 1977 (the "CRA") and its record of lending to first-time home buyers.

*The Federal Deposit Insurance Corporation.* The FDIC is an independent federal agency that insures the deposits, up to prescribed statutory limits, of federally-insured banks and savings associations and safeguards the safety and soundness of the financial institution industry. The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund of the FDIC and subject to deposit insurance assessments to maintain the Deposit Insurance Fund.

The FDIC may terminate insurance coverage upon a finding that an insured depository institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition, or has violated any applicable law, regulation, rule, order or condition enacted or imposed by the institution's regulatory agency.

### ***Dodd-Frank Act***

Federal regulators continue to implement many provisions of the Dodd-Frank Act, which was signed into law by President Obama on July 21, 2010. The Dodd-Frank Act created many new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions. Many provisions of the Dodd-Frank Act still have not been implemented and will require interpretation and rule making by federal regulators, including banking regulators and the Securities and Exchange Commission. In addition, the Consumer Financial Protection Bureau has only recently begun to implement its authority, and there is significant uncertainty as to how its regulations and other authority will affect the Company's business. Farmers continues to closely monitor all relevant sections of the Dodd-Frank Act to ensure continued compliance with these regulatory requirements. The following discussion summarizes significant aspects of the Dodd-Frank Act that have and may continue to affect Farmers and Farmers Bank:

- the Consumer Financial Protection Bureau has been established and empowered to exercise broad regulatory, supervisory and enforcement authority with respect to both new and existing consumer financial protection laws;
- the Dodd-Frank Act restricts the preemption of state law by federal law and disallows subsidiaries and affiliates of national banks from availing themselves of such preemption;
- the deposit insurance assessment base for federal deposit insurance has been expanded from domestic deposits to average assets minus average tangible equity;
- the Dodd-Frank Act instructs appropriate federal banking agencies to make the capital requirements for banks and savings and loan holding companies and insured depository institutions countercyclical so that the amount of capital required to be maintained increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness;
- the prohibition on the payment of interest on demand deposits has been repealed, effective July 21, 2011, thereby permitting depository institutions to pay interest on business transaction and other accounts;
- the standard maximum amount of deposit insurance per customer has been permanently increased to \$250,000 and non-interest-bearing transaction accounts had unlimited deposit insurance through January 1, 2013;
- bank holding companies, such as Farmers, are required to be well capitalized and well managed and must continue to be both well capitalized and well managed in order to acquire banks located outside their home state;

- the Dodd-Frank Act extended the application to most bank holding companies of the same leverage and risk-based capital requirements that apply to insured depository institutions, which, among other things, will disallow treatment of trust preferred securities as Tier 1 capital under certain circumstances;
- new corporate governance requirements, which are generally applicable to most larger public companies, now require new compensation practices, including, but not limited to, providing shareholders the opportunity to cast a non-binding vote on executive compensation, to consider the independence of compensation advisors and new executive compensation disclosure requirements;
- the Dodd-Frank Act amended the Electronic Fund Transfer Act to, among other things, give the Federal Reserve Board the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over \$10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer; and
- the authority of the Federal Reserve Board to examine bank holding companies and their non-bank subsidiaries was expanded.

Community banking organizations, such as the Company and the Bank, become subject to the new rule capital requirements on January 1, 2015 and certain provisions of the new rule will be phased in over the period of 2015 through 2019 as described further below under Capital Adequacy.

### **Bank Holding Company Regulation**

As a bank holding company, Farmers' activities are subject to extensive regulation by the Federal Reserve Board under the BHCA. Generally, the BHCA limits the business of bank holding companies to banking, managing or controlling banks and other activities that the Federal Reserve Board has determined to be closely related to banking as to be a proper incident thereto. Under Federal Reserve Board policy, a bank holding company is expected to serve as a source of financial and managerial strength to each subsidiary bank and to commit resources to support those subsidiary banks. Under this policy, the Federal Reserve Board may require a bank holding company to contribute additional capital to an undercapitalized subsidiary bank and may disapprove of the payment of dividends to the holding company's shareholders if the Federal Reserve Board believes the payment of such dividends would be an unsafe or unsound practice. The Dodd-Frank Act codified this policy as a statutory requirement.

The BHCA requires prior approval by the Federal Reserve Board for a bank holding company to directly or indirectly acquire more than a 5.0% voting interest in any bank or its parent holding company. Factors taken into consideration in making such a determination include the effect of the acquisition on competition, the public benefits expected to be received from the acquisition, the projected capital ratios and levels on a post-acquisition basis, and the acquiring institution's record of addressing the credit needs of the communities it serves.

The BHCA also governs interstate banking and restricts Farmers' nonbanking activities to those determined by the Federal Reserve Board to be financial in nature, or incidental or complementary to such financial activity, without regard to territorial restrictions. Transactions among the Bank and its affiliates are also subject to certain limitations and restrictions of the Federal Reserve Board, as described more fully under the caption "Dividends and Transactions with Affiliates" In this Item 1.

The Gramm-Leach-Bliley Act of 1999 permits a qualifying bank holding company to elect to become a financial holding company and thereby affiliate with securities firms and insurance companies and engage in other activities that are financial in nature and not otherwise permissible for a bank holding company. Farmers has not elected to seek financial holding company status.

### **Regulation of Nationally-Chartered Banks**

As a national banking association, Farmers Bank is subject to regulation under the National Banking Act and is periodically examined by the OCC. OCC regulations govern permissible activities, capital requirements, dividend limitations, investments, loans and other matters. Furthermore, Farmers Bank is subject, as a member bank, to certain rules and regulations of the Federal Reserve Board, many of which restrict activities and prescribe documentation to protect consumers. Under the Bank Merger Act, the prior approval of the OCC is required for a national bank to merge with, or purchase the assets or assume the deposits of, another bank. In reviewing applications to approve merger and other acquisition transactions, the OCC and other bank regulatory authorities may include among their considerations the competitive effect and public benefits of the transactions, the capital position of the combined organization, the applicant's performance under the CRA, and fair housing laws, and the effectiveness of the entities in restricting money laundering activities. In addition, the establishment of branches by Farmers Bank is subject to the prior approval of the OCC. The OCC has the authority to impose sanctions on the Bank and, under certain circumstances, may place Farmers Bank into receivership.

The Bank is also an insured institution as a member of the Deposit Insurance Fund. As a result, it is subject to regulation and deposit insurance assessments by the FDIC.

### **Dividends and Transactions with Affiliates**

The Company is a legal entity separate and distinct from the Bank and its other subsidiaries. The Company's principal source of funds to pay dividends on its common shares and service its debt is dividends from Farmers Bank and its other subsidiaries. Various federal and state statutory provisions and regulations limit the amount of dividends that Farmers Bank may pay to Farmers without regulatory approval. Farmers Bank generally may not, without prior regulatory approval, pay a dividend in an amount greater than its undivided profits after deducting statutory bad debt in excess of the bank's allowance for loan losses. In addition, prior approval of the OCC is required for the payment of a dividend if the total of all dividends declared in a calendar year would exceed the total of Farmers Bank's net income for the year combined with its retained net income for the two preceding years.

In addition, Farmers and Farmers Bank are subject to other regulatory policies and requirements relating to the payment of dividends, including requirements to maintain adequate capital above regulatory minimums. The federal banking agencies are authorized to determine under certain circumstances that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof. The federal banking agencies have stated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice and that banking organizations should generally pay dividends only out of current operating earnings. In addition, in the current financial and economic environment, the Federal Reserve Board has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels, unless both asset quality and capital are very strong. Thus, the ability of Farmers to pay dividends in the future is currently influenced, and could be further influenced, by bank regulatory policies and capital guidelines.

The Bank is subject to restrictions under federal law that limit the transfer of funds or other items of value to the Company and its nonbanking subsidiaries and affiliates, whether in the form of loans and other extensions of credit, investments and asset purchases, or other transactions involving the transfer of value from a subsidiary to an affiliate or for the benefit of an affiliate. These regulations limit the types and amounts of transactions (including loans due and extensions of credit) that may take place and generally require those transactions to be on an arm's-length basis. In general, these regulations require that any "covered transaction" by Farmers Bank with an affiliate must be secured by designated amounts of specified collateral and must be limited, as to any one of Farmers or its non-bank subsidiaries, to 10% of Farmers Bank's capital stock and surplus, and, as to Farmers and all such non-bank subsidiaries in the aggregate, to 20% of Farmers Bank's capital stock and surplus. The Dodd-Frank Act significantly expanded the coverage and scope of the limitations on affiliate transactions within a banking organization including, for example, the requirement that the 10% of capital limit on covered transactions apply to financial subsidiaries. "Covered transactions" are defined by statute to include a loan or extension of credit, as well as a purchase of securities issued by an affiliate, a purchase of assets (unless otherwise exempted by the Federal Reserve Board) from the affiliate, certain derivative transactions that create a credit exposure to an affiliate, the acceptance of securities issued by the affiliate as collateral for a loan, and the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

Capital loans from the Company to the Bank are subordinate in right of payment to deposits and certain other indebtedness of the Bank. In the event of Farmers' bankruptcy, any commitment by Farmers to a federal bank regulatory agency to maintain the capital of Farmers Bank will be assumed by the bankruptcy trustee and entitled to a priority of payment.

The Federal Deposit Insurance Act of 1950, as amended, provides that, in the event of the "liquidation or other resolution" of an insured depository institution such as the Bank, the insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, nondeposit creditors, including the Company, with respect to any extensions of credit they have made to such insured depository institution.

### **Capital Adequacy**

Both Farmers and Farmers Bank are subject to risk-based capital requirements imposed by their respective primary federal banking regulator. These capital guidelines are based on the "International Convergence of Capital Measurement and Capital Standards" (Basel I), published by the Basel Committee on Banking Supervision (the "Basel Committee") in 1988. The guidelines provide a systematic analytical framework for evaluating capital levels and make regulatory capital requirements sensitive to differences in risk profiles among banking organizations, takes off-balance sheet exposures expressly into account in evaluating capital adequacy and minimizes disincentives to holding liquid, low-risk assets. Capital levels as measured by these standards are also used to categorize financial institutions for purposes of certain prompt corrective action regulatory provisions.

Under the guidelines, the minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet items such as standby letters of credit) is 8.0%. At least half of the minimum total risk-based capital ratio (4.0%) must be composed of “Tier 1” capital, which consists of: (i) common shareholders’ equity; (ii) minority interests in certain equity accounts of consolidated subsidiaries; and (iii) a limited amount of qualifying preferred stock and qualified trust preferred securities (although the Tier 1 capital treatment of trust preferred securities will be phased out under the Dodd-Frank Act in certain circumstances), less goodwill and certain other intangible assets, including unrealized net gains and losses, after applicable taxes, on available-for-sale securities carried at fair value. The remainder of total risk-based capital (“Tier 2” risk-based capital) may consist of certain amounts of hybrid capital instruments, mandatory convertible debt, subordinated debt, preferred stock not qualifying as Tier 1 capital, loan and lease loss allowance and net unrealized gains on certain available-for-sale equity securities, all subject to limitations established by the guidelines.

Under the guidelines, capital is compared to the relative risk on Farmers and Farmers Bank’s balance sheet. To derive the risk included in the balance sheet, one of four risk weights (0.0%, 20.0%, 50.0% and 100.0%) is applied to different balance sheet and off-balance sheet assets, primarily based on the relative credit risk of the counterparty. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The Federal Reserve Board has also established minimum leverage ratio guidelines for bank holding companies. The Federal Reserve Board guidelines provide for a minimum ratio of Tier 1 capital to average assets (excluding the loan and lease loss allowance, goodwill and certain other intangibles), or “leverage ratio,” of 3.0% for bank holding companies that meet certain criteria, including having the highest regulatory rating, and 4.0% for all other bank holding companies. The guidelines further provide that bank holding companies experiencing growth through acquisitions or otherwise, or under other warranted circumstances, will be expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. The OCC and the FDIC have each also adopted minimum leverage ratio guidelines for national banks and for state non-member banks, respectively.

The Federal Reserve Board’s review of certain bank holding company transactions is affected by whether the applying bank holding company is “well-capitalized.” To be deemed “well-capitalized,” the bank holding company must have a Tier 1 risk-based capital ratio of at least 6.0%, a leverage ratio of at least 5.0%, and a total risk-based capital ratio of at least 10.0%, and must not be subject to any written agreement, order, capital directive or prompt corrective action directive issued by the Federal Reserve Board to meet and maintain a specific capital level for any capital measure.

In 2004, the Basel Committee published a new, more risk-sensitive capital adequacy framework (Basel II) for large, internationally active banking organizations. In December 2007, the federal banking agencies issued final rules making the implementation of certain parts of Basel II mandatory for any bank that has consolidated total assets of at least \$250 billion (excluding certain assets) or has consolidated on-balance sheet foreign exposure of at least \$10 billion, and making it voluntary for other banks. The Dodd-Frank Act requires the Federal Reserve Board, the OCC and the FDIC to adopt regulations imposing minimum Basel I-based capital requirements in cases where the Basel II-based capital requirements and any changes in capital regulations resulting from Basel III (discussed below) otherwise would permit lower requirements. In June 2011, the federal banking agencies adopted a rule applicable to only large, internationally active banks requiring their risk-based capital to meet the higher of the minimum requirements under Basel III or under the risk-based capital rules generally applicable to United States banks.

In December 2010 and January 2011, the Basel Committee released its framework for strengthening international capital and liquidity regulation (Basel III). Basel III, when implemented by the U.S. banking agencies and fully phased-in, will require bank holding companies and their bank subsidiaries to maintain substantially more capital, with a greater emphasis on common equity.

The Basel III final capital framework, among other things, (i) introduces as a new capital measure of “Common Equity Tier 1” (“CET1”), (ii) specifies that Tier 1 capital consist of CET1 and “Additional Tier 1 capital” instruments meeting specified requirements, (iii) defines CET1 narrowly by requiring that most adjustments to regulatory capital measures be made to CET1 and not to the other components of capital, and (iv) expands the scope of the adjustments as compared to existing regulations.

When fully phased in on January 1, 2019, Basel III will require banks to maintain: (i) as a newly adopted international standard, a minimum ratio of CET1 to risk-weighted assets of 4.5%, plus a 2.5% “capital conservation buffer” (which is added to the 4.5% CET1 ratio as that buffer is phased in, which will effectively result in a minimum ratio of CET1 to risk-weighted assets of 7.0%); (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% on full implementation); (iii) a minimum ratio of Total (Tier 1 plus Tier 2) capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation); and (iv) as a newly adopted international standard, a minimum leverage ratio of 3.0%, calculated as the ratio of Tier 1 capital to balance sheet exposures plus certain off-balance sheet exposures (computed as the average for each quarter of the month-end ratios for the quarter).

Basel III also provides for a “countercyclical capital buffer,” generally imposed when federal banking agencies determine that excess aggregate credit growth becomes associated with a buildup of systemic risk, that would be in addition to the capital conservation buffer in the range of 0.0% to 2.5% when fully implemented, potentially resulting in total buffers of 2.5% to 5.0%. The countercyclical capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum, but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when applicable) will have constraints imposed on their dividends, equity repurchases and compensation, based on the amount of the shortfall.

The implementation of the Basel III capital framework was initially scheduled to commence on January 1, 2013, but had previously been delayed. Community banking organizations such as Farmers and Merchants Bank will now begin transitioning to new capital rules on January 1, 2015. The new minimum capital requirements are effective on January 1, 2015, whereas a new capital conservation buffer and deductions from common equity capital phase in from January 1, 2016, through January 1, 2019, and most deductions from common equity tier 1 capital will phase in from January 1, 2015, through January 1, 2019. Banking institutions will be required to maintain 3.5% CET1 to risk weighted assets, 4.5% Tier 1 capital to risk weighted assets and 8.0% total capital to risk-weighted assets.

The Basel III final framework provides for a number of new deductions from and adjustments to CET1, including the deduction of mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities if any one such category exceeds 10.0% of CET1 or if all such categories in the aggregate exceed 15.0% of CET1.

The following is a summary of the other major changes from the current general risk-based capital rule:

- replacement of the external credit ratings approach to standards of creditworthiness with a simplified supervisory formula approach;
- stricter limitations on the extent to which mortgage servicing assets, deferred tax assets and significant investments in unconsolidated financial institutions may be included in common equity tier 1 capital and the risk weight to be assigned to any amounts of such assets not deducted; and
- increased risk weights for past-due loans, certain commercial real estate loans and some equity exposures, and selected other changes in risk weights and credit conversion factors.

Notwithstanding its release of the Basel III framework as a final framework, the Basel Committee is considering further amendments to Basel III, including imposition of additional capital surcharges on globally systemically important financial institutions. In addition to Basel III, the Dodd-Frank Act requires or permits federal banking agencies to adopt regulations affecting capital requirements in a number of respects, including potentially more stringent capital requirements for systemically important financial institutions. Accordingly, the regulations ultimately applicable to the Company may differ substantially from the currently published final Basel III framework. Requirements of higher capital levels or higher levels of liquid assets could adversely impact the Company’s net income and return on equity.

### **Volcker Rule**

In December 2013, five federal agencies adopted a final regulation implementing the Volcker Rule provision of the Dodd-Frank Act (the “Volcker Rule”). The Volcker Rule places limits on the trading activity of insured depository institutions and entities affiliated with a depository institution, subject to certain exceptions. The trading activity includes a purchase or sale as principal of a security, derivative, commodity future or option on any such instrument in order to benefit from short-term price movements or to realize short-term profits. The Volcker Rule exempts specified U.S. Government, agency and/or municipal obligations, and it excepts trading conducted in certain capacities, including as a broker or other agent, through a deferred compensation or pension plan, as a fiduciary on behalf of customers, to satisfy a debt previously contracted, repurchase and securities lending agreements and risk-mitigating hedging activities.

The Volcker Rule also prohibits a banking entity from having an ownership interest in, or certain relationships with, a hedge fund or private equity fund, with a number of exceptions.

The Bank does not engage in any of the trading activities or own any of the types of funds regulated by the Volcker Rule.

## **Prompt Corrective Action**

The federal banking agencies have established a system of prompt corrective action to resolve certain of the problems of undercapitalized institutions. This system is based on five capital level categories for insured depository institutions: “well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized.”

The federal banking agencies may (or in some cases must) take certain supervisory actions depending upon a bank’s capital level. For example, the banking agencies must appoint a receiver or conservator for a bank within 90 days after it becomes “critically undercapitalized” unless the bank’s primary regulator determines, with the concurrence of the FDIC, that other action would better achieve regulatory purposes. Banking operations otherwise may be significantly affected depending on a bank’s capital category. For example, a bank that is not “well capitalized” generally is prohibited from accepting brokered deposits and offering interest rates on deposits higher than the prevailing rate in its market, and the holding company of any undercapitalized depository institution must guarantee, in part, specific aspects of the bank’s capital plan for the plan to be acceptable.

Federal law permits the OCC to order the pro rata assessment of shareholders of a national bank whose capital stock has become impaired, by losses or otherwise, to relieve a deficiency in such national bank’s capital stock. This statute also provides for the enforcement of any such pro rata assessment of shareholders of such national bank to cover such impairment of capital stock by sale, to the extent necessary, of the capital stock owned by any assessed shareholder failing to pay the assessment. As the sole shareholder of Farmers Bank, the Company is subject to such provisions.

## **Deposit Insurance**

Substantially all of the deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund of the FDIC, and Farmers Bank is assessed deposit insurance premiums to maintain the Deposit Insurance Fund. Insurance premiums for each insured institution are determined based upon the institution’s capital level and supervisory rating provided to the FDIC by the institution’s primary federal regulator and other information deemed by the FDIC to be relevant to the risk posed to the Deposit Insurance Fund by the institution. The assessment rate is then applied to the amount of the institution’s deposits to determine the institution’s insurance premium.

On February 7, 2011, the FDIC approved a final rule that changed the deposit insurance assessment base, as required by the Dodd-Frank Act. As adopted, the final rule changed the deposit insurance assessment base from domestic deposits to average assets minus average tangible equity. In addition, the final rule also adopted a new large-bank pricing assessment scheme and established a target size for the Deposit Insurance Fund. Specifically, the final rule set a target size for the Deposit Insurance Fund at 2 percent of insured deposits and implements a lower assessment rate schedule when the fund reaches 1.15 percent and, in lieu of dividends, provides for a lower rate schedule when the reserve ratio reaches 2 percent and 2.5 percent. The final rule also created a scorecard-based assessment system for banks with more than \$10 billion in assets. The final rule went into effect beginning with the second quarter of 2011.

As insurer, the FDIC is authorized to conduct examinations of and to require reporting by federally-insured institutions. It also may prohibit any federally-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the Deposit Insurance Fund. The FDIC also has the authority to take enforcement actions against insured institutions. Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged or is engaging in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or written agreement entered into with the FDIC. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

## **Fiscal and Monetary Policies**

The Company’s business and earnings are affected significantly by the fiscal and monetary policies of the federal government and its agencies. The Company is particularly affected by the policies of the Federal Reserve Board, which regulates the supply of money and credit in the United States in order to influence general economic conditions, primarily through open market operations in U.S. government securities, changes in the discount rate on bank borrowings and changes in the reserve requirements against depository institutions’ deposits. These policies and regulations significantly affect the overall growth and distribution of loans, investments and deposits, as well as interest rates charged on loans and paid on deposits.

The monetary policies of the Federal Reserve board have had a significant effect on operations and results of financial institutions in the past and are expected to have significant effects in the future. In view of the changing conditions in the economy, the money markets and activities of monetary and fiscal authorities, Farmers can make no predictions as to future changes in interest rates, credit availability or deposit levels.

## **Community Reinvestment Act**

The CRA requires depository institutions to assist in meeting the credit needs of their market areas consistent with safe and sound banking practice. Under the CRA, each depository institution is required to help meet the credit needs of its market areas by, among other things, providing credit to low- and moderate-income individuals and communities. Depository institutions are periodically examined for compliance with the CRA and are assigned ratings. In order for a bank holding company to commence any new activity permitted by the BHCA, or to acquire any company engaged in any new activity permitted by the BHCA, each insured depository institution subsidiary of the bank holding company must have received a rating of at least “satisfactory” in its most recent examination under the CRA. Furthermore, banking regulators take into account CRA ratings when considering approval of a proposed transaction. Farmers received a rating of “satisfactory” in its most recent CRA examination.

## **Customer Privacy**

Farmers Bank is subject to regulations limiting the ability of financial institutions to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow customers to prevent disclosure of certain personal information to a nonaffiliated third party. These regulations affect how consumer information is transmitted and conveyed to outside vendors.

## **Anti-Money Laundering and the USA Patriot Act**

The Uniting and Strengthening of America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA Patriot Act”) and its related regulations require insured depository institutions, broker-dealers and certain other financial institutions to have policies, procedures, and controls to detect, prevent, and report money laundering and terrorist financing. The USA Patriot Act and its regulations also provide for information sharing, subject to conditions, between federal law enforcement agencies and financial institutions, as well as among financial institutions, for counter-terrorism purposes. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution. In addition, federal banking agencies are required, when reviewing bank holding company acquisition and bank merger applications, to take into account the effectiveness of the anti-money laundering policies, procedures and controls of the applicants.

## **Corporate Governance**

The Sarbanes-Oxley Act of 2002 effected broad reforms to areas of corporate governance and financial reporting for public companies under the jurisdiction of the Commission. The Company’s corporate governance policies include an Audit Committee Charter, a Compensation Committee Charter, Corporate Governance and Nominating Committee Charter, and Code of Business Conduct and Ethics. The Board of Directors reviews the Company’s corporate governance practices on a continuing basis. These and other corporate governance policies have been provided previously to shareholders and are available, along with other information on Farmers’ corporate governance practices, on the Company’s website at [www.farmersbankgroup.com](http://www.farmersbankgroup.com).

As directed by Section 302(a) of the Sarbanes-Oxley Act, the Company’s chief executive officer and chief financial officer are each required to certify that the Company’s Quarterly and Annual Reports do not contain any untrue statement of a material fact. The rules have several requirements, including having these officers certify that: they are responsible for establishing, maintaining, and regularly evaluating the effectiveness of the Company’s internal controls, they have made certain disclosures about the Company’s internal controls to its auditors and the audit committee of the Board of Directors, and they have included information in the Company’s Quarterly and Annual Reports about their evaluation and whether there have been significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

## **Executive and Incentive Compensation**

In June 2010, the Federal Reserve Board, OCC and FDIC issued joint interagency guidance on incentive compensation policies (the “Joint Guidance”) intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. This principles-based guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization’s incentive compensation arrangements should: (i) provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks; (ii) be compatible with effective internal controls and risk management; and (iii) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.

Pursuant to the Joint Guidance, the Federal Reserve Board will review as part of a regular, risk-focused examination process, the incentive compensation arrangements of financial institutions such as Farmers. Such reviews will be tailored to each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination and deficiencies will be incorporated into the institution's supervisory ratings, which can affect the institution's ability to make acquisitions and take other actions. Enforcement actions may be taken against an institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization's safety and soundness and prompt and effective measures are not being taken to correct the deficiencies.

On February 7, 2011, the federal banking agencies jointly issued proposed rules on incentive-based compensation arrangements under applicable provisions of the Dodd-Frank Act (the "Proposed Rules"). The Proposed Rules generally apply to financial institutions with \$1.0 billion or more in assets that maintain incentive-based compensation arrangements for certain covered employees. The Proposed Rules: (i) prohibit covered financial institutions from maintaining incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risk by providing the covered person with "excessive" compensation; (ii) prohibit covered financial institutions from establishing or maintaining incentive-based compensation arrangements for covered persons that encourage inappropriate risks that could lead to a material financial loss; (iii) require covered financial institutions to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance with the Proposed Rules; and (iv) require covered financial institutions to provide enhanced disclosure to regulators regarding their incentive-based compensation arrangements for covered persons within 90 days following the end of the fiscal year.

Public companies will also be required, once stock exchanges impose additional listing requirements under the Dodd-Frank Act, to implement "clawback" procedures for incentive compensation payments and to disclose the details of the procedures which allow recovery of incentive compensation that was paid on the basis of erroneous financial information necessitating a restatement due to material noncompliance with financial reporting requirements. This clawback policy is intended to apply to compensation paid within a three year look-back window of the restatement and would cover all executives who received incentive awards.

The Dodd-Frank Act also provides shareholders the opportunity to cast a non-binding vote on executive compensation practices, imposes new executive compensation disclosure requirements, and contains additional considerations of the independence of compensation advisors.

### **Future Legislation**

Various and significant legislation affecting financial institutions and the financial industry is from time to time introduced in the U.S. Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change the operating environment for Farmers and its subsidiaries in substantial and unpredictable ways and could significantly increase or decrease the costs of doing business, limit or expand permissible activities or affect the competitive balance among financial institutions. With the enactment of the Dodd-Frank Act and the continuing implementation of final rules and regulations thereunder, the nature and extent of future legislative and regulatory changes affecting financial institutions remains very unpredictable. Farmers cannot predict the scope and timing of any such future legislation and, if enacted, the effect that it could have on its business, financial condition or results of operations.

### **Summary**

To the extent that the foregoing information describes statutory and regulatory provisions applicable to the Company or its subsidiaries, it is qualified in its entirety by reference to the full text of those provisions or agreements. Also, such statutes, regulations and policies are continually under review by the U.S. Congress and state legislatures as well as federal and state regulatory agencies and are subject to change at any time, particularly in the current economic and regulatory environment. Any such change in applicable statutes, regulations or regulatory policies could have a material effect on Farmers and its business, financial condition or results of operations.

### **Item 1A. Risk Factors.**

The following are certain risk factors that could materially and negatively affect our business, results of operations, cash flows or financial condition. These risk factors should be considered in connection with evaluating the forward-looking statements contained in this Annual Report on Form 10-K because these factors could cause our actual results or financial condition to differ materially from those projected in forward-looking statements. The risks that are discussed below are not the only ones we face. If any of the following risks occur, our business, financial condition or results of operations could be negatively affected. Additional risks that are not presently known or that we presently deem to be immaterial could also have a material, adverse impact on our business, financial condition or results of operations.

## **Risks Relating to Economic and Market Conditions**

### ***Difficult market conditions and economic trends have adversely affected our industry and our business.***

Beginning in the latter half of 2007 through 2009, the U.S. economy was in recession and business activity across a wide range of industries and regions in the U. S. was greatly reduced. Although economic conditions have improved, certain sectors, such as real estate and manufacturing, remain weak and unemployment remains high. It is also possible that recent improvements may be reversed if current economic turmoil in Europe becomes global or the United States Congress fails to resolve certain critical fiscal policies it is now facing, including the automatic budget cuts contemplated in the sequester arrangement and raising the federal government's debt ceiling in time to avoid a default. In addition, many local governments and many businesses are still in serious difficulty due to depressed consumer spending and continued decreased liquidity in the credit markets.

Market conditions have also led to poor financial performance resulting in the failure and merger of a number of financial institutions. These failures, as well as possible future failures, have had a significant negative impact on the capitalization levels and of the Deposit Insurance Fund, which has led to a significant increase in deposit insurance premiums paid by financial institutions.

Our success depends, to a certain extent, upon economic and political conditions, local and national, as well as governmental monetary policies. Conditions such as inflation, recession, unemployment, changes in interest rates, money supply, governmental fiscal policies, and other factors beyond our control may adversely affect our asset quality, deposit levels and loan demand and, therefore, our earnings. Because we have a significant amount of real estate loans, additional decreases in real estate values could adversely affect the value of property used as collateral and our ability to sell the collateral upon foreclosure. Adverse changes in the economy may also have a negative effect on the ability of our borrowers to make timely repayments of their loans, which would have an adverse impact on our earnings. If during a period of reduced real estate values we are required to liquidate the collateral securing loans to satisfy the debt or to increase our allowance for loan losses, it could materially reduce our profitability and adversely affect our financial condition. Moreover, the Financial Accounting Standards Board may change its requirements for establishing the loan loss allowance. The substantial majority of our loans are to individuals and businesses in the Mahoning Valley and Stark County (the "Valley"). Consequently, further significant declines in the economy in the Valley could have a material adverse effect on our business, financial condition or results of operations. It is uncertain when the negative credit trends in our market will reverse, and, therefore, future earnings are susceptible to further declining credit conditions in the market in which we operate.

### ***Changes in interest rates could adversely affect income and financial condition.***

Our earnings and cash flow are dependent upon our net interest income. Net interest income is the difference between the interest income generated by our interest-earning assets (consisting primarily of loans and, to a lesser extent, securities) and the interest expense generated by our interest-bearing liabilities (consisting primarily of deposits and wholesale borrowings). Our level of net interest income is primarily a function of the average balance of our interest-earning assets, the average balance of our interest-bearing liabilities and the spread between the yield on such assets and the cost of such liabilities. These factors are influenced by both the pricing and mix of our interest-earning assets and our interest-bearing liabilities which, in turn, are impacted by external factors, such as the local economy, competition for loans and deposits, the monetary policy of the Federal Reserve Board and market interest rates.

Interest rates are beyond our control, and they fluctuate in response to general economic conditions and the policies of various governmental and regulatory agencies, in particular, the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, will influence the origination of loans, the purchase of investments, the generation of deposits and the rates received on loans and investment securities and paid on deposits. While we have taken measures intended to manage the risks of operating in a changing interest rate environment, there can be no assurance that such measures will be effective in avoiding undue interest rate risk. See additional interest rate risk discussion under the Market Risk section found in Item 7A of this Annual Report on Form 10-K.

### ***Defaults by another larger financial institution could adversely affect financial markets generally.***

The commercial soundness of many financial institutions may be closely interrelated as a result of credit, trading, clearing or other relationships between institutions. As a result, concerns about, or a default or threatened default by, one institution could lead to significant market-wide liquidity and credit problems, losses or defaults by other institutions. This is sometimes referred to as "systemic risk" and may adversely affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges, with which we and our subsidiaries interact on a daily basis, and therefore could adversely affect our business, financial condition or results of operations.

## **Risks Related to Our Business**

***We extend credit to a variety of customers based on internally set standards and judgment. We manage credit risk through a program of underwriting standards, the review of certain credit decisions and an on-going process of assessment of the quality of credit already extended. Our credit standards and on-going process of credit assessment might not protect us from significant credit losses.***

We take credit risk by virtue of making loans, extending loan commitments and letters of credit and, to a lesser degree, purchasing non-governmental securities. Our exposure to credit risk is managed through the use of consistent underwriting standards that emphasize “in-market” lending, while avoiding highly leveraged transactions as well as excessive industry and other concentrations. Our credit administration function employs risk management techniques to ensure that loans adhere to corporate policy and problem loans are promptly identified. While these procedures are designed to provide us with the information needed to implement policy adjustments where necessary, and to take proactive corrective actions, there can be no assurance that such measures will be effective in avoiding undue credit risk.

***We have significant exposure to risks associated with commercial real estate and residential real estate.***

As of December 31, 2013, approximately 61.4% of our loan portfolio consisted of commercial real estate and residential real estate loans, including real estate development, construction and residential and commercial mortgage loans. Consequently, real estate-related credit risks are a significant concern for us. The adverse consequences from real estate-related credit risks tend to be cyclical and are often driven by national economic developments that are not controllable or entirely foreseeable by us or our borrowers. General difficulties in our real estate markets have recently contributed to increases in our non-performing loans, charge-offs, and decreases in our income.

Our business depends significantly on general economic conditions in Ohio. Accordingly, the ability of our borrowers to repay their loans, and the value of the collateral securing such loans, may be significantly affected by economic conditions in the regions we serve or by changes in the local real estate markets. A significant decline in general economic conditions caused by inflation, recession, unemployment, acts of terrorism, or other factors beyond our control could therefore have an adverse effect on our business, financial condition or results of operations.

***Our indirect lending exposes us to increased credit risks.***

A portion of our current lending involves the purchase of consumer automobile installment sales contracts from automobile dealers located in Northeastern Ohio. These loans are for the purchase of new or late model used cars. We serve customers over a broad range of creditworthiness, and the required terms and rates are reflective of those risk profiles. While these loans have higher yields than many of our other loans, such loans involve significant risks in addition to normal credit risk. Potential risk elements associated with indirect lending include the limited personal contact with the borrower as a result of indirect lending through dealers, the absence of assured continued employment of the borrower, the varying general creditworthiness of the borrower, changes in the local economy, and difficulty in monitoring collateral. While indirect automobile loans are secured, such loans are secured by depreciating assets and characterized by loan to value ratios that could result in us not recovering the full value of an outstanding loan upon default by the borrower. Due to the economic slowdown in our primary market area, we currently are experiencing higher delinquencies, charge-offs and repossessions of vehicles in this portfolio. If the economy continues to contract, we may continue to experience higher levels of delinquencies, repossessions and charge-offs.

***Commercial and industrial loans may expose us to greater financial and credit risk than other loans.***

As of December 31, 2013, approximately 16.7% of our loan portfolio consisted of commercial and industrial loans. Commercial and industrial loans generally carry larger loan balances and can involve a greater degree of financial and credit risk than other loans. Any significant failure to pay on time by our customers would hurt our earnings and cause a significant increase in non-performing loans. The increased financial and credit risk associated with these types of loans are a result of several factors, including the concentration of principal in a limited number of loans and borrowers, the size of loan balances, the effects of general economic conditions on income-producing properties and the increased difficulty of evaluating and monitoring these types of loans. In addition, when underwriting a commercial or industrial loan, we may take a security interest in commercial real estate, and, in some instances upon a default by the borrower, we may foreclose on and take title to the property, which may lead to potential financial risks. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on our business, financial condition or results of operations.

***Our allowance for loan loss may not be adequate to cover actual future losses.***

We maintain an allowance for loan losses to cover current, probable incurred loan losses. Every loan we make carries a certain risk of non-repayment, and we make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of loans. Through a periodic review and consideration of the loan portfolio, management determines the amount of the allowance for loan losses by considering general market conditions, credit quality of the loan portfolio, the collateral supporting the loans and performance of customers relative to their financial obligations with us. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, which may be beyond our control, and these losses may exceed current estimates. We cannot fully predict the amount or timing of losses or whether the loss allowance will be adequate in the future. If our assumptions prove to be incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, which will require additions to the allowance. Excessive loan losses and significant additions to our allowance for loan losses could have a material adverse impact on our business, financial condition or results of operations.

***We are subject to certain risks with respect to liquidity.***

“Liquidity” refers to our ability to generate sufficient cash flows to support our operations and to fulfill our obligations, including commitments to originate loans, to repay our wholesale borrowings and other liabilities and to satisfy the withdrawal of deposits by our customers. Our primary source of liquidity is our core deposit base, which is raised through our retail branch system. Core deposits – savings and money market accounts, time deposits less than \$100 thousand and demand deposits—comprised approximately 90.6% of total deposits at December 31, 2013. Additional available unused wholesale sources of liquidity include advances from the FHLB, issuances through dealers in the capital markets and access to certificates of deposit issued through brokers. Liquidity is further provided by unencumbered, or unpledged, investment securities that totaled \$268 million at December 31, 2013. An inability to raise funds through deposits, borrowings, the sale or pledging as collateral of loans and other assets could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities could be impaired by factors that affect us specifically or the financial services industry in general. Factors that could negatively affect our access to liquidity sources include a decrease in the level of our business activity due to a market downturn or negative regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as severe disruption of the financial markets or negative news and expectations about the prospects for the financial services industry as a whole, as evidenced by recent turmoil in the domestic and worldwide credit markets.

***Our business strategy includes continuing our growth plans. Our business, financial condition or results of operations could be negatively affected if we fail to grow or fail to manage our growth effectively.***

We intend to continue pursuing a profitable growth strategy both within our existing markets and in new markets. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in significant growth stages of development. We cannot assure that we will be able to expand our market presence in our existing markets or successfully enter new markets or that any such expansion will not adversely affect our results of operations. Failure to manage our growth effectively could have a material adverse effect on our business, future prospects, financial condition or results of operations and could adversely affect our ability to successfully implement our business strategy. Also, if we grow more slowly than anticipated, our operating results could be materially adversely affected.

***We may not be able to attract and retain skilled people.***

Our success depends, in large part, on our ability to attract and retain key people. Competition for the best people in most activities in which we engage can be intense, and we may not be able to retain or hire the people we want or need. In order to attract and retain qualified employees, we must compensate them at market levels. If we are unable to continue to attract and retain qualified employees, or do so at rates necessary to maintain our competitive position, our performance, including our competitive position, could suffer, and, in turn, adversely affect our business, financial condition or results of operations.

***Strong competition within the market in which we operate could reduce our ability to attract and retain business.***

In our market, we encounter significant competition from banks, savings and loan associations, credit unions, mortgage banks and other financial service companies. As a result of their size and ability to achieve economies of scale, some of our competitors offer a broader range of products and services than we can offer. In particular, the competition includes major financial companies whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous banking locations and mount extensive promotional and advertising campaigns. Our ability to maintain our history of strong financial performance and return on investment to shareholders will depend in part on our continued ability to compete successfully in our market. Financial performance and return on investment to shareholders will also depend on our ability to expand our scope of available financial services to our customers. In addition to other banks, competitors include securities dealers, brokers, investment advisors, and finance and insurance companies. The increasingly competitive environment is, in part, a result of changes in regulation, changes in technology and product delivery systems, and the accelerating pace of consolidation among financial service providers.

***Consumers may decide not to use banks to complete their financial transactions.***

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

***We are exposed to operational risk.***

Similar to any large organization, we are exposed to many types of operational risk, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees or operational errors, including clerical or record-keeping errors or those resulting from faulty or disabled computer or telecommunications systems.

Negative public opinion can result from our actual or alleged conduct in any number of activities, including lending practices, corporate governance and acquisitions and from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect our ability to attract and keep customers and can expose us to litigation and regulatory action.

Given the volume of transactions we process, certain errors may be repeated or compounded before they are discovered and successfully rectified. Our necessary dependence upon automated systems to record and process our transaction volume may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. We may also be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss of liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as we are) and to the risk that our (or our vendors') business continuity and data security systems prove to be inadequate.

***Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of our computer systems or otherwise, could severely harm our business.***

As part of our financial institution business, we collect, process and retain sensitive and confidential client and customer information on behalf of our subsidiaries and other third parties. Despite the security measures we have in place, our facilities and systems, and those of our third-party service providers, may be vulnerable to security breaches, acts of vandalism, computer viruses, misplaced or lost data, programming and/or human errors or other similar events. If information security is breached, information could be lost or misappropriated, resulting in financial loss or costs to us or damages to others. Any security breach involving the misappropriation, loss or other unauthorized disclosure of confidential customer information, whether by us or by our vendors, could severely damage our reputation, expose us to the risks of litigation and liability or disrupt our operations and have a material adverse effect on our business, financial condition or results of operations.

***We depend on our subsidiaries for dividends, distributions and other payments.***

As a bank holding company, we are a legal entity separate and distinct from our subsidiaries. Our principal source of funds to pay dividends on our common shares is dividends from these subsidiaries. Federal and state statutory provisions and regulations limit the amount of dividends that our banking and other subsidiaries may pay to us without regulatory approval. In the event our subsidiaries become unable to pay dividends to us, we may not be able to pay dividends on our outstanding common shares. Accordingly, our inability to receive dividends from our subsidiaries could also have a material adverse effect on our business, financial condition and results of operations. Further discussion of our ability to pay dividends can be found under the caption “Dividends and Transactions with Affiliates” in Item 1 of this Annual Report on Form 10-K.

***We may elect or be compelled to seek additional capital in the future, but that capital may not be available when it is needed.***

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. Federal banking agencies have proposed extensive changes to their capital requirements, including raising required amounts and eliminating the inclusion of certain instruments from the calculation of capital. The final form of such regulations and their impact on the Company is unknown at this time but may require us to raise additional capital. In addition, we may elect to raise capital to support our business or to finance acquisitions, if any, or for other anticipated reasons. Our ability to raise additional capital, if needed, will depend on financial performance, conditions in the capital markets, economic conditions and a number of other factors, including the satisfaction or release of preemptive rights in the event of a common share offering, many of which are outside our control. Therefore, there can be no assurance additional capital can be raised when needed or that capital can be raised on acceptable terms. The inability to raise capital may have a material adverse effect on our business, financial condition or results of operations.

***Impairment of investment securities, goodwill, other intangible assets, or deferred tax assets could require charges to earnings, which could result in a negative impact on our results of operations.***

In assessing the impairment of investment securities, we consider the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuers, whether the market decline was affected by macroeconomic conditions and whether we have the intent to sell the debt security or will be required to sell the debt security before its anticipated recovery. Under current accounting standards, goodwill and certain other intangible assets with indeterminate lives are no longer amortized but, instead, are assessed for impairment periodically or when impairment indicators are present. Assessment of goodwill and such other intangible assets could result in circumstances where the applicable intangible asset is deemed to be impaired for accounting purposes. Under such circumstances, the intangible asset’s impairment would be reflected as a charge to earnings in the period. Deferred tax assets are only recognized to the extent it is more likely than not they will be realized. Should management determine it is not more likely than not that the deferred tax assets will be realized, a valuation allowance with a charge to earnings would be reflected in the period.

**Risks Related to the Legal and Regulatory Environment**

***Increases in FDIC insurance premiums may have a material adverse effect on our earnings.***

The FDIC maintains the Deposit Insurance Fund to resolve the cost of bank failures. Since 2007, the number of bank failures has increased significantly, which dramatically increased resolution costs of the FDIC and depleted the Deposit Insurance Fund. Also during this period, the FDIC and the U.S. Congress have instituted a program to further insure customer deposits at FDIC-member banks: (i) deposit accounts are now insured up to \$250,000 per customer (up from \$100,000). This has placed additional stress on the Deposit Insurance Fund.

Since late 2008, the FDIC has taken various actions intended to maintain a strong funding position and restore reserve ratios of the Deposit Insurance Fund. These actions have included increasing assessment rates for all insured institutions, requiring riskier institutions to pay a larger share of premiums by factoring in rate adjustments based on secured liabilities and unsecured debt levels, imposing special assessments and requiring insured depository institutions to prepay their quarterly risk-based assessments for the fourth quarter of 2009 and full years 2010 through 2012. In addition, on February 7, 2011, the FDIC approved a final rule that changed the deposit insurance assessment base and assessment rate schedule, adopted a new large-bank pricing assessment scheme, and set a target size for the Deposit Insurance Fund. The rule, as mandated by the Dodd-Frank Act, finalized a target size for the Deposit Insurance Fund at 2 percent of insured deposits. The final rule went into effect beginning with the second quarter of 2011.

We have a limited ability to control the amount of premiums we are required to pay for FDIC insurance. If there are additional financial institution failures or other significant legislative or regulatory changes, the FDIC may be required to increase assessment rates or take actions similar to those taken during 2009. Increases in FDIC insurance assessment rates may materially adversely affect our results of operations and our ability to continue to pay dividends on our common shares at the current rate or at all.

***Legislative or regulatory changes or actions, or significant litigation, could adversely impact us or the businesses in which we are engaged.***

The financial services industry is extensively regulated. We are subject to extensive state and federal regulation, supervision and legislation that govern almost all aspects of our operations. Laws and regulations may change from time to time and are primarily intended for the protection of consumers, depositors and the Deposit Insurance Fund, and not to benefit our shareholders. The impact of any changes to laws and regulations or other actions by regulatory agencies may negatively impact us or our ability to increase the value of our business. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of an institution, the classification of assets by an institution and the adequacy of an institution's allowance for loan losses. Additionally, actions by regulatory agencies or significant litigation against us could cause us to devote significant time and resources to defending our business and may lead to penalties that materially affect us and our shareholders.

In addition to laws, regulations and actions directed at the operations of banks, proposals to reform the housing finance market consider winding down Fannie Mae and Freddie Mac, which could negatively affect our sales of loans.

***Continued regulatory changes implemented under the Dodd-Frank Act may adversely impact our business, financial condition or results of operations.***

On July 21, 2010, the Dodd-Frank Act was signed into law as an intended comprehensive overhaul of the financial services industry within the U.S. There are a number of reform provisions that are likely to significantly impact the ways in which banks and bank holding companies do business. A detailed discussion regarding the Dodd-Frank Act can be found under the caption "Dodd-Frank Act" in Item 1 of this Annual Report on Form 10-K.

While the ultimate effect of the changes effected and to be implemented under the Dodd-Frank Act cannot currently be determined, the law and its implementing rules and regulations are expected to result in increased compliance costs and fees paid to regulators, along with possible restrictions on our banking operations, all of which may have a material adverse affect on our business, financial condition or results of operations.

***Our results of operations, financial condition or liquidity may be adversely impacted by issues arising in foreclosure practices, including delays in the foreclosure process, related to certain industry deficiencies, as well as potential losses in connection with actual or projected repurchases and indemnification payments related to mortgages sold into the secondary market.***

Recent announcements of deficiencies in foreclosure documentation by several large seller/servicer financial institutions have raised various concerns relating to mortgage foreclosure practices. The integrity of the foreclosure process is important to our business, as an originator and servicer of residential mortgages. As a result of our continued focus of concentrating our lending efforts in our primary markets in Ohio, as well as servicing loans for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), we do not anticipate suspending any of our foreclosure activities. During 2010, we reviewed our foreclosure procedures and concluded they are generally conservative in nature and do not present the significant documentation deficiencies underlying other industry foreclosure problems. Nevertheless, we could face delays and challenges in the foreclosure process arising from claims relating to industry practices generally, which could adversely affect recoveries and our financial results, whether through increased expenses of litigation and property maintenance, deteriorating values of underlying mortgaged properties or unsuccessful litigation results generally.

In addition, in connection with the origination and sale of residential mortgages into the secondary market, we make certain representations and warranties, which, if breached, may require us to repurchase such loans, substitute other loans or indemnify the purchasers of such loans for actual losses incurred in respect of such loans. Although we believe that our mortgage documentation and procedures have been appropriate and are generally conservative in nature, it is possible that we will receive repurchase requests in the future and we may not be able to reach favorable settlements with respect to such requests. It is therefore possible that we may increase our reserves or may sustain losses associated with such loan repurchases and indemnification payments.

***Environmental liability associated with commercial lending could have a material adverse effect on our business, financial condition or results of operations.***

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. In addition, we own and operate certain properties that may be subject to similar environmental liability risks.

Environmental laws may require us to incur substantial expenses and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures requiring the performance of an environmental site assessment before initiating any foreclosure action on real property, these assessments may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our business, financial condition or results of operations.

***Changes in tax laws could adversely affect our performance.***

We are subject to extensive federal, state and local taxes, including income, excise, sales/use, payroll, franchise, withholding and ad valorem taxes. Changes to our taxes could have a material adverse effect on our results of operations. On January 1, 2014 the State of Ohio replaced the current franchise tax for financial institutions with the new Ohio Financial Institutions Tax. The Company has determined that this new tax will have a non-material positive effect on the Company. In addition, our customers are subject to a wide variety of federal, state and local taxes. Changes in taxes paid by our customers may adversely affect their ability to purchase homes or consumer products, which could adversely affect their demand for our loans and deposit products. In addition, such negative effects on our customers could result in defaults on the loans we have made and decrease the value of mortgage-backed securities in which we have invested.

***Changes to the healthcare laws in the United States may increase the number of employees who choose to participate in our healthcare plans, which may significantly increase our healthcare costs and negatively impact our financial results.***

We offer healthcare coverage to our eligible employees with part of the cost subsidized by the Company. With recent changes to the healthcare laws in the United States becoming effective in 2014, more of our employees may choose to participate in our health insurance plans, which could increase our costs for such coverage and material adversely impact our costs of operations.

***Anti-takeover provisions could delay or prevent an acquisition or change in control by a third party.***

Provisions of the Ohio General Corporation Law, our Articles of Incorporation, and our Amended Code of Regulations, including a staggered board and supermajority voting requirements, could make it more difficult for a third party to acquire control of us or could have the effect of discouraging a third party from attempting to acquire control of us.

***We may be a defendant from time to time in the future in a variety of litigation and other actions, which could have a material adverse effect on our business, financial condition or results of operations.***

We and our subsidiaries may be involved from time to time in the future in a variety of litigation arising out of our business. Our insurance may not cover all claims that may be asserted against us, and any claims asserted against us, regardless of merit or eventual outcome, may harm our reputation. Should the ultimate judgments or settlements in any litigation exceed our insurance coverage, they could have a material adverse effect on our business, financial condition or results of operations. In addition, we may not be able to obtain appropriate types or levels of insurance in the future, nor may we be able to obtain adequate replacement policies with acceptable terms, if at all.

**Item 1B. Unresolved Staff Comments.**

There are no matters of unresolved staff comments from the Commission staff.

**Item 2. Properties.**

***Farmers National Banc Corp.'s Properties***

The Company does not own any property. The Company's operations are conducted at Farmers Bank's main office, which is located at 20 and 30 South Broad Street, Canfield, Ohio.

### *Farmers National Bank Property*

The Bank's main office is located at 20 and 30 S. Broad Street, Canfield, Ohio. The other locations of Farmers Bank are:

|                        |                                              |
|------------------------|----------------------------------------------|
| Office Building        | 40 & 46 S. Broad St., Canfield, Ohio         |
| Austintown Office      | 22 N. Niles-Canfield Rd., Youngstown, Ohio   |
| Lake Milton Office     | 17817 Mahoning Avenue, Lake Milton, Ohio     |
| Cornersburg Office     | 3619 S. Meridian Rd., Youngstown, Ohio       |
| Colonial Plaza Office  | 401 E. Main St. Canfield, Ohio               |
| Western Reserve Office | 102 W. Western Reserve Rd., Youngstown, Ohio |
| Salem Office           | 1858 E. State Street, Salem, Ohio            |
| Columbiana Office      | 340 State Rt. 14, Columbiana, Ohio           |
| Damascus Office        | 29053 State Rt. 62 Damascus, Ohio            |
| Poland Office          | 106 McKinley Way West, Poland, Ohio          |
| Niles Office           | 1 South Main Street, Niles, Ohio             |
| Niles Drive Up         | 170 East State Street, Niles, Ohio           |
| Girard Office          | 121 North State Street, Girard, Ohio         |
| Eastwood Office        | 5845 Youngstown-Warren Rd, Niles, Ohio       |
| Mineral Ridge Office   | 3826 South Main Street, Mineral Ridge, Ohio  |
| Niles Operation Center | 51 South Main Street, Niles, Ohio            |
| Canton Office          | 4518 Fulton Dr., Canton, Ohio                |
| McClurg Road Office    | 42 McClurg Rd., Boardman, Ohio               |
| Howland Office         | 1625 Niles-Cortland Rd., Warren, Ohio        |

The Bank owns all locations except the Colonial Plaza and Canton offices, which are leased.

The Company purchased property located adjacent to its Canfield branch on South Broad Street in Canfield, Ohio. Plans have not been finalized for the future use of the property. Possession took place in January 2014.

### *Farmers Trust Company Property*

Farmers Trust Company operates from two locations owned by the Bank:

|                 |                                       |
|-----------------|---------------------------------------|
| Boardman Office | 42 McClurg Rd., Boardman, Ohio        |
| Howland Office  | 1625 Niles-Cortland Rd., Warren, Ohio |

### *Farmers National Insurance, LLC Property*

Farmers National Insurance operates from one location which is owned by the Bank:

|                 |                                |
|-----------------|--------------------------------|
| Boardman Office | 42 McClurg Rd., Boardman, Ohio |
|-----------------|--------------------------------|

### *National Associates, Inc. Property*

National Associates, Inc. operates from one location which is leased:

|                    |                                         |
|--------------------|-----------------------------------------|
| Rocky River Office | 20325 Center Ridge Rd., Cleveland, Ohio |
|--------------------|-----------------------------------------|

**Item 3. Legal Proceedings.**

In the normal course of business, the Company and its subsidiaries are at all times subject to pending and threatened legal actions, some for which the relief or damages sought are substantial. Although Farmers is not able to predict the outcome of such actions, after reviewing pending and threatened actions with counsel, management believes that based on the information currently available the outcome of such actions, individually or in the aggregate, will not have a material adverse effect on the results of operations or stockholders' equity of the Company. However, it is possible that the ultimate resolution of these matters, if unfavorable, may be material to the results of operations in a particular future period as the time and amount of any resolution of such actions and its relationship to the future results of operations are not known.

**Item 4. Mine Safety Disclosures**

Not applicable.

## Part II

### Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuers Purchases of Equity Securities

*Market Information regarding the Company's Common Shares.*

Farmers' common shares currently trade under the symbol "FMNB" on the Nasdaq Capital Market. Farmers had 18,780,980 common shares outstanding and approximately 3,395 holders of record of common shares at March 5, 2014. The following table sets forth price ranges and dividend information for Farmers' common shares for the calendar quarters indicated. Quotations reflect inter-dealer prices without retail mark-up, mark-down or commission, and may not represent actual transactions.

| <u>Quarter Ended</u>                | <u>March 31,<br/>2013</u> | <u>June 30,<br/>2013</u> | <u>September 30,<br/>2013</u> | <u>December 31,<br/>2013</u> |
|-------------------------------------|---------------------------|--------------------------|-------------------------------|------------------------------|
| High .....                          | \$ 6.90                   | \$ 6.70                  | \$ 6.58                       | \$ 6.59                      |
| Low .....                           | \$ 6.13                   | \$ 5.81                  | \$ 6.10                       | \$ 6.11                      |
| Cash dividends paid per share ..... | \$ 0.03                   | \$ 0.03                  | \$ 0.03                       | \$ 0.03                      |

| <u>Quarter Ended</u>                | <u>March 31,<br/>2012</u> | <u>June 30,<br/>2012</u> | <u>September 30,<br/>2012</u> | <u>December 31,<br/>2012</u> |
|-------------------------------------|---------------------------|--------------------------|-------------------------------|------------------------------|
| High .....                          | \$ 6.49                   | \$ 6.85                  | \$ 6.49                       | \$ 6.77                      |
| Low .....                           | \$ 4.85                   | \$ 6.03                  | \$ 5.50                       | \$ 5.71                      |
| Cash dividends paid per share ..... | \$ 0.06                   | \$ 0.03                  | \$ 0.03                       | \$ 0.06                      |

*Purchases of Common Shares by Farmers.*

On September 28, 2012, the Company announced that its Board of Directors approved a share repurchase program under which the Company was authorized to repurchase up to 920,000 shares of its common stock in the open market or in privately negotiated transactions, subject to market and other conditions (the "Program"). The Program may be modified, suspended or terminated by the Company at any time. During the course of 2013 and 2012 the Company repurchased 247,845 and 7,221 shares of its common shares.

## Item 6. Selected Financial Data.

### SELECTED FINANCIAL DATA (Table Dollar Amounts in Thousands except Per Share Data)

For the Years Ending December 31,

|                                                                    | 2013         | 2012         | 2011         | 2010         | 2009         |
|--------------------------------------------------------------------|--------------|--------------|--------------|--------------|--------------|
| <b>Summary of Earnings</b>                                         |              |              |              |              |              |
| Total Interest and Dividend Income (including fees on loans) ..... | \$ 40,959    | \$ 43,110    | \$ 44,434    | \$ 48,365    | \$ 49,775    |
| Total Interest Expense .....                                       | 5,063        | 6,212        | 7,837        | 10,998       | 16,547       |
| Net Interest Income .....                                          | 35,896       | 36,898       | 36,597       | 37,367       | 33,228       |
| Provision for Loan Losses .....                                    | 1,290        | 725          | 3,650        | 8,078        | 6,050        |
| Noninterest Income (1) .....                                       | 13,914       | 12,578       | 12,539       | 13,210       | 9,388        |
| Noninterest Expense .....                                          | 39,057       | 35,764       | 33,728       | 30,964       | 29,655       |
| Income Before Income Taxes .....                                   | 9,463        | 12,987       | 11,758       | 11,535       | 6,911        |
| Income Taxes .....                                                 | 1,683        | 3,055        | 2,540        | 2,544        | 1,069        |
| NET INCOME .....                                                   | \$ 7,780     | \$ 9,932     | \$ 9,218     | \$ 8,991     | \$ 5,842     |
| <b>Per Share Data</b>                                              |              |              |              |              |              |
| Basic earnings per share .....                                     | \$ 0.41      | \$ 0.53      | \$ 0.50      | \$ 0.66      | \$ 0.44      |
| Diluted earnings per share .....                                   | 0.41         | 0.53         | 0.50         | 0.66         | 0.44         |
| Cash Dividends Paid .....                                          | 0.12         | 0.18         | 0.12         | 0.12         | 0.36         |
| Book Value at Year-End .....                                       | 6.02         | 6.43         | 6.10         | 6.45         | 5.96         |
| Tangible Book Value (2) .....                                      | 5.47         | 6.11         | 5.76         | 5.95         | 5.41         |
| <b>Balances at Year-End</b>                                        |              |              |              |              |              |
| Total Assets .....                                                 | \$ 1,137,326 | \$ 1,139,695 | \$ 1,067,871 | \$ 982,751   | \$ 1,014,808 |
| Earning Assets .....                                               | 1,076,073    | 1,082,078    | 1,014,997    | 915,224      | 948,187      |
| Total Deposits .....                                               | 915,216      | 919,009      | 840,125      | 761,050      | 777,552      |
| Short-Term Borrowings .....                                        | 81,617       | 79,886       | 98,088       | 105,634      | 125,912      |
| Long-Term Borrowings .....                                         | 19,822       | 10,423       | 11,263       | 24,733       | 27,169       |
| Loans Held For Sale .....                                          | 158          | 3,624        | 677          | 0            | 0            |
| Net Loans .....                                                    | 623,116      | 578,963      | 561,986      | 581,060      | 601,995      |
| Total Stockholders' Equity .....                                   | 113,007      | 120,792      | 114,445      | 88,048       | 80,628       |
| <b>Average Balances</b>                                            |              |              |              |              |              |
| Total Assets .....                                                 | \$ 1,141,770 | \$ 1,118,322 | \$ 1,035,392 | \$ 1,030,516 | \$ 970,163   |
| Total Stockholders' Equity .....                                   | 116,735      | 118,011      | 105,276      | 85,968       | 79,775       |
| <b>Significant Ratios</b>                                          |              |              |              |              |              |
| Return on Average Assets (ROA) .....                               | 0.68%        | 0.89%        | 0.89%        | 0.87%        | 0.60%        |
| Return on Average Equity (ROE) .....                               | 6.66         | 8.42         | 8.76         | 10.46        | 7.32         |
| Average Earning Assets/Average Assets .....                        | 92.90        | 92.13        | 92.64        | 92.28        | 92.79        |
| Average Equity/Average Assets .....                                | 10.22        | 10.55        | 10.17        | 8.34         | 8.22         |
| Loans/Deposits .....                                               | 68.91        | 63.83        | 68.06        | 77.57        | 78.37        |
| Allowance for Loan Losses/Total Loans .....                        | 1.20         | 1.30         | 1.72         | 1.58         | 1.21         |
| Allowance for Loan Losses/Nonperforming Loans .....                | 83.25        | 93.01        | 89.19        | 104.56       | 73.25        |
| Efficiency Ratio (On tax equivalent basis) .....                   | 74.82        | 69.94        | 67.14        | 61.10        | 67.00        |
| Net Interest Margin .....                                          | 3.58         | 3.76         | 4.01         | 4.10         | 3.88         |
| Dividend Payout Rate .....                                         | 28.89        | 34.05        | 24.31        | 18.08        | 82.18        |
| Tangible Common Equity Ratio (3) .....                             | 9.11         | 10.12        | 10.18        | 8.31         | 7.26         |

- (1) Noninterest income includes a securities impairment charge of \$3 thousand, \$11 thousand and \$74 thousand respectively for the years ended December 31, 2013, 2011 and 2009.
- (2) Tangible book value per share is Total Stockholders' Equity minus goodwill and other intangible assets divided by the number of shares outstanding.

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

Reconciliation of Common Stockholders' Equity to Tangible Common Equity

| December 31,                             | 2013              | 2012              | 2011              | 2010             | 2009             |
|------------------------------------------|-------------------|-------------------|-------------------|------------------|------------------|
| Stockholders' Equity .....               | \$ 113,007        | \$ 120,792        | \$ 114,445        | \$ 88,048        | \$ 80,628        |
| Less Goodwill and other intangibles..... | 10,343            | 6,032             | 6,441             | 6,920            | 7,500            |
| Tangible Common Equity .....             | <u>\$ 102,664</u> | <u>\$ 114,760</u> | <u>\$ 108,004</u> | <u>\$ 81,128</u> | <u>\$ 73,128</u> |

Reconciliation of Total Assets to Tangible Assets

| December 31,                             | 2013                | 2012                | 2011                | 2010              | 2009                |
|------------------------------------------|---------------------|---------------------|---------------------|-------------------|---------------------|
| Total Assets.....                        | \$ 1,137,326        | \$ 1,139,695        | \$ 1,067,871        | \$ 982,751        | \$ 1,014,808        |
| Less Goodwill and other intangibles..... | 10,343              | 6,032               | 6,441               | 6,920             | 7,500               |
| Tangible Assets .....                    | <u>\$ 1,126,983</u> | <u>\$ 1,133,663</u> | <u>\$ 1,061,430</u> | <u>\$ 975,831</u> | <u>\$ 1,007,308</u> |

**Average Balance Sheets and Related Yields and Rates**  
(Table Dollar Amounts in Thousands except Per Share Data)

| Years ended December 31,                                        | 2013               |                  |              | 2012               |                  |              | 2011               |                  |              |
|-----------------------------------------------------------------|--------------------|------------------|--------------|--------------------|------------------|--------------|--------------------|------------------|--------------|
|                                                                 | AVERAGE<br>BALANCE | INTEREST         | RATE         | AVERAGE<br>BALANCE | INTEREST         | RATE         | AVERAGE<br>BALANCE | INTEREST         | RATE         |
| <b>EARNING ASSETS</b>                                           |                    |                  |              |                    |                  |              |                    |                  |              |
| Loans (1) (3) (5).....                                          | \$ 595,560         | \$ 31,211        | 5.24%        | \$ 564,952         | \$ 32,249        | 5.71%        | \$ 562,048         | \$ 33,534        | 5.97%        |
| Taxable securities (2).....                                     | 351,898            | 7,062            | 2.01         | 334,470            | 8,099            | 2.42         | 262,603            | 8,058            | 3.07         |
| Tax-exempt securities (2) (5) ..                                | 87,001             | 4,487            | 5.16         | 73,979             | 4,308            | 5.82         | 75,787             | 4,429            | 5.84         |
| Equity securities (4) (5).....                                  | 4,323              | 196              | 4.53         | 4,363              | 206              | 4.72         | 4,296              | 195              | 4.54         |
| Federal funds sold and other cash                               | 21,964             | 35               | 0.16         | 52,585             | 100              | 0.19         | 54,459             | 79               | 0.15         |
| Total earning assets .....                                      | 1,060,746          | 42,991           | 4.05         | 1,030,349          | 44,962           | 4.36         | 959,193            | 46,295           | 4.83         |
| <b>NONEARNING ASSETS</b>                                        |                    |                  |              |                    |                  |              |                    |                  |              |
| Cash and due from banks.....                                    | 20,085             |                  |              | 21,171             |                  |              | 21,230             |                  |              |
| Premises and equipment.....                                     | 17,912             |                  |              | 17,663             |                  |              | 14,419             |                  |              |
| Allowance for Loan Losses.....                                  | (7,451)            |                  |              | (9,017)            |                  |              | (10,508)           |                  |              |
| Unrealized gains on securities.                                 | 2,623              |                  |              | 13,766             |                  |              | 8,198              |                  |              |
| Other assets (1).....                                           | 47,855             |                  |              | 44,390             |                  |              | 42,860             |                  |              |
| Total Assets.....                                               | <u>\$1,141,770</u> |                  |              | <u>\$1,118,322</u> |                  |              | <u>\$1,035,392</u> |                  |              |
| <b>INTEREST-BEARING LIABILITIES</b>                             |                    |                  |              |                    |                  |              |                    |                  |              |
| Time deposits .....                                             | \$ 230,232         | \$ 3,858         | 1.68%        | \$ 247,428         | \$ 4,700         | 1.90%        | \$ 251,546         | \$ 5,083         | 2.02%        |
| Savings deposits .....                                          | 415,179            | 664              | 0.16         | 413,497            | 976              | 0.24         | 341,673            | 1,468            | 0.43         |
| Demand deposits .....                                           | 124,990            | 38               | 0.03         | 116,409            | 43               | 0.04         | 110,857            | 66               | 0.06         |
| Short term borrowings .....                                     | 91,653             | 51               | 0.06         | 93,730             | 103              | 0.11         | 114,391            | 325              | 0.28         |
| Long term borrowings.....                                       | 16,597             | 452              | 2.72         | 10,568             | 390              | 3.69         | 21,408             | 895              | 4.18         |
| Total Interest-Bearing Liabilities.....                         | 878,651            | 5,063            | 0.58         | 881,632            | 6,212            | 0.70         | 839,875            | 7,837            | 0.93         |
| <b>NONINTEREST-BEARING LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                    |                  |              |                    |                  |              |                    |                  |              |
| Demand deposits .....                                           | 140,111            |                  |              | 114,616            |                  |              | 86,764             |                  |              |
| Other Liabilities .....                                         | 6,273              |                  |              | 4,063              |                  |              | 3,477              |                  |              |
| Stockholders' equity .....                                      | 116,735            |                  |              | 118,011            |                  |              | 105,276            |                  |              |
| Total Liabilities and Stockholders' Equity .....                | <u>\$1,141,770</u> |                  |              | <u>\$1,118,322</u> |                  |              | <u>\$1,035,392</u> |                  |              |
| Net interest income and interest rate spread .....              |                    | <u>\$ 37,928</u> | <u>3.47%</u> |                    | <u>\$ 38,750</u> | <u>3.66%</u> |                    | <u>\$ 38,458</u> | <u>3.90%</u> |
| Net interest margin.....                                        |                    |                  | <u>3.58%</u> |                    |                  | <u>3.76%</u> |                    |                  | <u>4.01%</u> |

- (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 average historical amortized cost.
- (3) Interest on loans includes fee income of \$2.4 million, \$2.2 million and \$1.7 million for 2013, 2012 and 2011 respectively and is reduced by amortization of \$2.1 million, \$1.9 million and \$1.8 million for 2013, 2012 and 2011 respectively.
- (4) Equity securities include restricted stock, which is included in other assets on the consolidated balance sheets.
- (5) For 2013, adjustments of \$494 thousand and \$1.5 million were made to tax equate income on tax exempt loans and tax exempt securities. For 2012, adjustments of \$375 thousand and \$1.5 million were made to tax equate income on tax exempt loans and tax exempt securities. For 2011, adjustments of \$343 thousand and \$1.5 million were made to tax equate income on tax exempt loans and tax exempt securities. These adjustments are based on a marginal federal income tax rate of 35%, less disallowances.

**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:

|                                                                    | 2013 change from 2012 |                         |                       | 2012 change from 2011 |                         |                       |
|--------------------------------------------------------------------|-----------------------|-------------------------|-----------------------|-----------------------|-------------------------|-----------------------|
|                                                                    | Net<br>Change         | Change Due<br>To Volume | Change Due<br>To Rate | Net<br>Change         | Change Due<br>To Volume | Change Due<br>To Rate |
| <b>Tax Equivalent Interest Income</b>                              |                       |                         |                       |                       |                         |                       |
| Loans .....                                                        | \$ (1,038)            | \$ 1,747                | \$ (2,785)            | \$ (1,285)            | \$ 173                  | \$ (1,458)            |
| Taxable securities.....                                            | (1,037)               | 422                     | (1,459)               | 41                    | 2,205                   | (2,164)               |
| Tax-exempt securities .....                                        | 179                   | 758                     | (579)                 | (121)                 | (106)                   | (15)                  |
| Equity securities .....                                            | (10)                  | (2)                     | (8)                   | 11                    | 3                       | 8                     |
| Funds sold and other cash .....                                    | (65)                  | (58)                    | (7)                   | 21                    | (3)                     | 24                    |
| Total interest income .....                                        | <u>\$ (1,971)</u>     | <u>\$ 2,867</u>         | <u>\$ (4,838)</u>     | <u>\$ (1,333)</u>     | <u>\$ 2,272</u>         | <u>\$ (3,605)</u>     |
| <b>Interest Expense</b>                                            |                       |                         |                       |                       |                         |                       |
| Time deposits .....                                                | \$ (842)              | \$ (327)                | \$ (515)              | \$ (383)              | \$ (83)                 | \$ (300)              |
| Savings deposits .....                                             | (312)                 | 4                       | (316)                 | (492)                 | 309                     | (801)                 |
| Demand deposits .....                                              | (5)                   | 3                       | (8)                   | (23)                  | 3                       | (26)                  |
| Short term borrowings .....                                        | (52)                  | (2)                     | (50)                  | (222)                 | (59)                    | (163)                 |
| Long term borrowings.....                                          | 62                    | 222                     | (160)                 | (505)                 | (453)                   | (52)                  |
| Total interest expense .....                                       | <u>\$ (1,149)</u>     | <u>\$ (100)</u>         | <u>\$ (1,049)</u>     | <u>\$ (1,625)</u>     | <u>\$ (283)</u>         | <u>\$ (1,342)</u>     |
| Increase (decrease) in tax equivalent net<br>interest income ..... | <u>\$ (822)</u>       | <u>\$ 2,967</u>         | <u>\$ (3,789)</u>     | <u>\$ 292</u>         | <u>\$ 2,555</u>         | <u>\$ (2,263)</u>     |

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.

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following presents a discussion and analysis of Farmers' financial condition and results of operations by its management. The review highlights the principal factors affecting earnings and the significant changes in balance sheet items for the years 2013, 2012 and 2011. Financial information for prior years is presented when appropriate. The objective of this financial review is to enhance the reader's understanding of the accompanying tables and charts, the consolidated financial statements, notes to financial statements, and financial statistics appearing elsewhere in this Annual Report on Form 10-K. Where applicable, this discussion also reflects management's insights of known events and trends that have or may reasonably be expected to have a material effect on Farmers' business, financial condition or results of operations.

Cautionary Note Regarding Forward Looking Statements

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

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

- general economic conditions in market areas where Farmers conducts business, which could materially impact credit quality trends;
- business conditions in the banking industry;
- the regulatory environment;

- fluctuations in interest rates;
- demand for loans in the market areas where Farmers conducts business;
- rapidly changing technology and evolving banking industry standards;
- competitive factors, including increased competition with regional and national financial institutions;
- new service and product offerings by competitors and price pressures; and
- other similar items.

Other factors not currently anticipated may also materially and adversely affect Farmers' business, financial condition, results of operations or cash flows. There can be no assurance that future results will meet expectations. While the Company believes that the forward-looking statements in this Annual Report on Form 10-K are reasonable, the reader should not place undue reliance on any forward-looking statement. In addition, these statements speak only as of the date made. Farmers does not undertake, and expressly disclaims, any obligation to update or alter any statements whether as a result of new information, future events or otherwise, except as may be required by applicable law.

## Results of Operations

### *Comparison of Operating Results for the Years Ended December 31, 2013 and 2012.*

The Company's net income totaled \$7.8 million during 2013, compared to \$9.9 million for 2012. On a per share basis, diluted earnings per share were \$0.41 as compared to \$0.53 diluted earnings per share for 2012. Common comparative ratios for results of operations include the return on average assets and return on average stockholders' equity. For 2013, the return on average equity was 6.66%, compared to 8.42% for 2012. The return on average assets was 0.68% for 2013 and 0.89% for 2012.

The results for 2013 included \$863 thousand in gains on sales of securities, compared to \$1.1 million in 2012.

During 2013, the Company completed the acquisition of all outstanding stock of the retirement planning consultancy National Associates, Inc. of Cleveland, Ohio. The company is a leading independent consultant to retirement plans and offers actuarial, plan design, compliance and administrative services. As a third party administrator, NAI provides services to 401(k), defined benefit, profit sharing, flexible spending, 403(b), ESOP and other plans. In acquiring NAI, the Company assumes a professional staff that is highly qualified and credentialed. Synergies and the cost savings resulting from the combining of the operations of the companies will help drive an increase of non-interest income.

## **Net Interest Income**

Net interest income, the principal source of the Company's earnings, represents the difference between interest income on interest-earning assets and interest expense on interest-bearing liabilities. For 2013, taxable equivalent net interest income decreased \$822 thousand, or 2.12%, from 2012. Interest-earning assets averaged \$1.061 billion during 2013, increasing \$30.4 million, or 2.95%, compared to 2012. The Company's interest-bearing liabilities decreased 0.34% from \$881.6 million in 2012 to \$878.7 million in 2013.

The Company 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 Company 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 spread in 2013 was 3.47%, decreasing from 3.66% in 2012. 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 2013, the net interest margin, measured on a fully taxable equivalent basis, decreased to 3.58%, compared to 3.76% in 2012.

The decrease in net interest margin is largely a result of interest-earning assets repricing at lower rate. Total taxable equivalent interest income was \$43.0 million for 2013, which is \$2.0 million less than the \$45.0 million reported in 2012. In comparing the years ending December 31, 2013 and 2012, yields on earning assets decreased 31 basis points while the cost of interest bearing liabilities decreased 12 basis points. Average loans increased \$30.6 million, or 5.42%, in 2013, however the yields decreased from 5.71% in 2012 to 5.24% in 2013. Tax equated income from securities, federal funds and other decreased \$933 thousand, or 7.3%, in 2013,

Farmers saw its yields on these assets decreased from 2.73% in 2012 to 2.53% in 2013. The average balance of investment securities and federal funds sold decreased slightly from \$465.4 million in 2012 to \$465.2 million in 2013.

Total interest expense amounted to \$5.1 million for 2013, a 18.5% decrease from \$6.2 million reported in 2012. The decrease in 2013 is the result of lower rates of interest paid on interest-bearing deposits and repurchase agreements. The cost of interest-bearing liabilities decreased from 0.70% in 2012 to 0.58% in 2013.

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.

### **Noninterest Income**

Total noninterest income increased by \$1.3 million in 2013. The increase in noninterest income is due to several factors. Retirement plan consulting fees increased to \$477 thousand compared to none in 2012 reflecting the income earned from the newly acquired entity, National Associates, Inc. ("NAI"). Service charges on deposit accounts increased from \$2.0 million in 2012 to \$2.4 million in 2013 as the Company made adjustments to the service charge structure of its deposit accounts. Bank owned life insurance income increased \$170 thousand as the Company received tax free death benefits, which are included in income. Insurance agency commissions also increased \$119 thousand and trust fees increased \$86 thousand, as management continues to focus on diversifying revenue sources to decrease the reliance on net interest income as the main driver of revenue. Other operating income also increased \$406 thousand, which is primarily the result of a gain on the sale of land that was owned by the Company.

### **Noninterest Expenses**

Noninterest expense for 2013 was \$39.1 million, compared to \$35.8 million in 2012, representing an increase of \$3.3 million, or 9.2%. Most of the increase was a result of an 11.7% increase in salary and employee benefits, mainly due to \$1.3 million recorded in severance costs. The majority of the severance costs were associated with the departure of the Company's President and CEO in 2013. The Company underwent a cost reduction program in 2013 that included the closure of two retail branch locations and the elimination of several full time positions. The reduction in the number of employees in the bank was offset by the employees included in the acquisition of NAI. Including the 17 employees of NAI, we have 328 full time equivalent employees compared to 335 one year ago.

Professional fees increased 16% as a result of corporate legal and consulting fees related to compensation practices and other business advisory fees. Intangible amortization increased \$215 thousand as a result of the amortization of intangible assets related to the acquisition of NAI. Merger related costs also increased \$330 thousand, and other operating expenses increased \$193 thousand. State and local taxes also increased \$110 thousand or 9.1% as a result of an increase in intangible tax paid to the State of Ohio due to higher levels of stockholders' equity.

The Company's tax equivalent efficiency ratio for the twelve month period ended December 31, 2013 was 74.82%, compared to 69.94% for the same period in 2012. The main factor leading to the decline in the efficiency ratio was the increase in noninterest expenses as explained earlier in this section. 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 and intangible amortization. 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 \$1.7 million for 2013 and \$3.1 million in 2012. Income taxes are computed using the appropriate effective tax rates for each period. The decrease in the current year tax expense can be mainly attributed to the \$3.5 million decrease in income before taxes. 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 17.8% for 2013 and 23.5% for 2012. The effective tax rate decrease compared to the same period in 2012 was primarily due to an increase in tax exempt income from securities, loans and bank owned life insurance income. Refer to Note 14 to the consolidated financial statements for additional information regarding the effective tax rate.

### *Comparison of Operating Results for the Years Ended December 31, 2012 and 2011.*

The Company's net income totaled \$9.9 million during 2012, compared to \$9.2 million for 2011. On a per share basis, diluted earnings per share were \$0.53 for 2012, as compared to \$0.50 for 2011. For 2012, the return on average equity was 8.42%, as compared to 8.76% for 2011. The return on average assets was 0.89% for 2012 and 2011.

## **Net Interest Income**

For 2012, taxable equivalent net interest income increased \$292 thousand, or 0.8%, more than 2011. Interest-earning assets averaged \$1,030.3 million during 2012, increasing \$71.2 million, or 7.4%, compared to 2011. For 2012, the net interest margin, measured on a fully taxable equivalent basis, was 3.76%, in comparison to 4.01% for 2011.

Total taxable equivalent interest income was \$45.0 million for 2012, which was \$1.3 million less than the \$46.3 million reported in 2011. This decrease was primarily the result of a change in the mix of interest earning assets in 2012. For 2012, loans, which yield more than securities, were 54.8% of average earning assets, compared to 58.6% in 2011. Average loan balances increased \$3.1 million, or 0.55%, and the yields decreased from 5.97% in 2011 to 5.71% in 2012. Income from securities and federal funds sold decreased \$54 thousand, or 0.42%, in 2012, though Company saw its yields on these assets decrease from 3.21% in 2011 to 2.73% in 2012. The average balances of investment securities and federal funds sold increased 17.1% in 2012, mainly due to increases in customer deposits outpacing opportunities to grow loans.

Total interest expense amounted to \$6.2 million for 2012, a 20.7% decrease from \$7.8 million reported in 2011. The decrease in 2012 is the result of lower rates of interest paid on interest-bearing deposits and repurchase agreements. The cost of interest-bearing liabilities decreased from 0.93% in 2011 to 0.70% in 2012.

## **Noninterest Income**

Total noninterest income in 2012 increased by \$39 thousand. The increase in noninterest income is primarily due to income from the sale of loans, increasing from \$113 thousand for the twelve months ended December 31, 2011 to \$598 thousand for the same twelve month period in 2012. The Company decided to sell some of the residential real estate loans it originates in order to decrease interest rate risk, reduce liquidity risk and to diversify its revenue streams. The increase in loans sold income was offset by a decrease in security gains, which were \$745 thousand higher in 2011. Trust fees also increased \$142 thousand and investment commissions increased \$83 thousand, as management continues to focus on diversifying revenue sources to decrease the reliance on net interest income as the main driver of revenue.

## **Noninterest Expenses**

Noninterest expense for 2012 was \$35.8 million, compared to \$33.7 million in 2011, representing an increase of \$2.1 million, or 6.0%. Most of the increase was a result of a \$12.8% increase in salary and employee benefits, resulting from a higher number of employees in current year and a \$561 thousand or 34.6% increase in health insurance costs. The higher employee count is attributed primarily to our Secondary Mortgage project expansion. Occupancy and equipment expense also increased \$578 thousand as a result of depreciation expense and small equipment costs related to new facilities. Professional fees increased 10% as a result of corporate legal and consulting fees related to compensation practices and other business advisory fees. There was also an \$86 thousand or 1.6% decrease in other operating expenses in 2012 compared to 2011, mainly related to new facilities opened in 2012. These expense increases were offset by \$1.2 million in prepayment penalties paid to Federal Home Loan Bank of Cincinnati in the prior year, compared to none in 2012.

State and local taxes also increased \$248 thousand or 26.0% as a result of an increase in intangible tax paid to the State of Ohio due to higher levels of stockholders' equity. Core processing charges also increased \$126 thousand due to a higher number accounts and new banking products for our customers.

## **Income Taxes**

Income tax expense totaled \$3.1 million for 2012 and \$2.5 million for 2011. The effective income tax rate was 23.5% for 2012 and 21.6% for 2011.

## **Liquidity**

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

Principal sources of liquidity 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, Farmers 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 two major domestic banks. At December 31, 2013, Farmers had borrowed \$6 million 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 Company also has additional borrowing capacity with the FHLB, as well as access to the Federal Reserve Discount Window, which provides an additional source of funds. The Company views its membership in the FHLB as a solid source of liquidity. As of December 31, 2013, the Bank is eligible to borrow an additional \$84.6 million from the FHLB under various fixed rate and variable rate credit facilities. Advances outstanding from the FHLB at December 31, 2013 amounted to \$19.8 million.

Farmers' primary investing activities are originating loans and purchasing securities. During 2013, net cash used in investing activities amounted to \$28.0 million, compared to \$82.3 million in 2012. Net increases in loans were \$45.5 million in 2013, compared to \$19.3 in 2012. The cash used by lending activities during 2013 can be attributed to the activity in the commercial real estate, residential real estate and indirect loan portfolios. Purchases of securities available for sale were \$149.9 million in 2013, compared to \$237.4 million in 2012. Proceeds from maturities and sales of securities available for sale were \$169.0 million in 2013, compared to \$175.7 million in 2012. There was \$2.1 million used to purchase National Associates Inc. during the year ended December 31, 2013.

Farmers' primary financing activities are obtaining deposits, repurchase agreements and other borrowings. Net cash from financing activities amounted to \$3.5 million for 2013, compared to \$56.7 million in 2012. The majority of this change can be attributed to the change in deposits. Deposits provided \$78.9 million during 2012 and used \$3.8 million during 2013. Short-term borrowings increased \$1.7 million in 2013 compared to an \$18.2 million decrease in 2012. There was \$10 million in new Federal Home Loan Bank long-term advances during 2013 compared to none last year. The Company used \$1.6 million for the acquisition of treasury shares during 2013 compared to none in 2012.

#### 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. Balances include unamortized loan origination fees and costs.

| Years Ended December 31,      | 2013                    |                       | 2012             |               | 2011             |               | 2010             |               | 2009             |               |
|-------------------------------|-------------------------|-----------------------|------------------|---------------|------------------|---------------|------------------|---------------|------------------|---------------|
| Commercial Real Estate ....   | <b>\$217,362</b>        | <b>34.4 %</b>         | \$200,651        | 34.2%         | \$198,041        | 34.6%         | \$203,894        | 34.5%         | \$215,917        | 35.4%         |
| Commercial .....              | <b>105,023</b>          | <b>16.7</b>           | 97,112           | 16.6          | 74,875           | 13.1          | 76,635           | 13.0%         | 75,893           | 12.5          |
| Residential Real Estate ..... | <b>170,151</b>          | <b>27.0</b>           | 156,182          | 26.6          | 167,031          | 29.2          | 177,067          | 30.0%         | 180,877          | 29.7          |
| Consumer.....                 | <b>138,148</b>          | <b>21.9</b>           | 132,647          | 22.6          | 131,859          | 23.1          | 132,771          | 22.5%         | 136,708          | 22.4          |
| Total Loans.....              | <b><u>\$630,684</u></b> | <b><u>100.0 %</u></b> | <u>\$586,592</u> | <u>100.0%</u> | <u>\$571,806</u> | <u>100.0%</u> | <u>\$590,367</u> | <u>100.0%</u> | <u>\$609,395</u> | <u>100.0%</u> |

The following schedule sets forth maturities based on remaining scheduled repayments of principal for commercial and commercial real estate loans listed above as of December 31, 2013:

| Types of Loans               | 1 Year or less   | 1 to 5 Years      | Over 5 Years     |
|------------------------------|------------------|-------------------|------------------|
| Commercial .....             | <u>\$ 17,233</u> | <u>\$ 47,802</u>  | <u>\$ 39,988</u> |
| Commercial Real Estate ..... | <u>\$ 66,550</u> | <u>\$ 123,110</u> | <u>\$ 27,702</u> |

The amounts of commercial and commercial real estate loans as of December 31, 2012, 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 ..... | \$ 75,085        | \$ 117,607        | \$ 192,692        |
| Fixed Rates of Interest .....                  | 8,698            | 120,995           | 129,693           |
| Total Loans .....                              | <u>\$ 83,783</u> | <u>\$ 238,602</u> | <u>\$ 322,385</u> |

Total loans were \$630.7 million at year-end 2013, compared to \$586.6 million at year-end 2012. This represents an increase of 7.52%. The increase in loans has mainly occurred in the commercial real estate, residential real estate, and indirect loan portfolios. Loans comprised 56.1% of the Bank's average earning assets in 2013, compared to 54.8% in 2012. The product mix in the Loan Portfolio includes Commercial Loans comprising 16.7%, Residential Real Estate Loans 27.0%, Commercial Real Estate Loans 34.4% and Consumer Loans 21.9% at December 31, 2013 compared with 16.6%, 26.6%, 34.2% and 22.6%, respectively, at December 31, 2012.

Loans contributed 72.6% of total taxable equivalent interest income in 2013 and 71.7% in 2012. Loan yield was 5.24% in 2013, 119 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 increased from \$132.6 million on December 31, 2012 to \$138.1 million on December 31, 2013, representing a 4.1% increase. 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 90.4% of the Consumer Loan portfolio. Net charge-offs in the Consumer Loan portfolio increased to \$901 thousand in 2013, as compared to \$374 thousand in 2012.

Residential Real Estate Mortgage Loans increased 8.9% to \$170.2 million at December 31, 2013, compared to \$156.2 million in 2012. Farmers originated both fixed rate and adjustable rate mortgages during 2013. Fixed rate terms are generally limited to fifteen year terms while adjustable rate products are offered with maturities up to thirty years.

Commercial Real Estate loans increased from \$200.7 million at December 31, 2012 to \$217.4 million at December 31, 2013, an increase of 8.3%. The Company's commercial real estate loan portfolio includes loans for owner occupied and non-owner occupied real estate. These loans are made to finance properties such as office and industrial buildings, hotels and retail shopping centers. Commercial Loans at December 31, 2013 increased 8.1% from year-end 2012 with outstanding balances of \$105.0 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, business types and local municipalities. 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 and small business lines of credit.

The growth in the Commercial and Commercial Real Estate loan portfolios was consistent with the improvements in the local economy. Several new projects announced in the Mahoning Valley, along with decreased levels of unemployment have led small business owners to expand or make additional investments in their operations.

### Summary of Loan Loss Experience

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

| Years Ended December 31,                                      | 2013     | 2012     | 2011     | 2010     | 2009     |
|---------------------------------------------------------------|----------|----------|----------|----------|----------|
| Balance at Beginning of Year .....                            | \$ 7,629 | \$ 9,820 | \$ 9,307 | \$ 7,400 | \$ 5,553 |
| Charge-Offs:                                                  |          |          |          |          |          |
| Commercial Real Estate.....                                   | (505)    | (1,225)  | (1,246)  | (1,910)  | (2,389)  |
| Commercial, Financial and Agricultural .....                  | (99)     | (918)    | (414)    | (2,898)  | (911)    |
| Residential Real Estate .....                                 | (326)    | (806)    | (1,736)  | (760)    | (251)    |
| Consumer.....                                                 | (1,723)  | (1,002)  | (1,125)  | (1,177)  | (1,248)  |
| Total Charge-Offs .....                                       | (2,653)  | (3,951)  | (4,521)  | (6,745)  | (4,799)  |
| Recoveries on Previous Charge-Offs:                           |          |          |          |          |          |
| Commercial Real Estate.....                                   | 171      | 253      | 44       | 26       | 178      |
| Commercial, Financial and Agricultural .....                  | 262      | 50       | 39       | 8        | 2        |
| Residential Real Estate .....                                 | 47       | 104      | 452      | 2        | 1        |
| Consumer.....                                                 | 822      | 628      | 849      | 538      | 415      |
| Total Recoveries .....                                        | 1,302    | 1,035    | 1,384    | 574      | 596      |
| Net Charge-Offs .....                                         | (1,351)  | (2,916)  | (3,137)  | (6,171)  | (4,203)  |
| Provision For Loan Losses.....                                | 1,290    | 725      | 3,650    | 8,078    | 6,050    |
| Balance at End of Year.....                                   | \$ 7,568 | \$ 7,629 | \$ 9,820 | \$ 9,307 | \$ 7,400 |
| Ratio of Net Charge-Offs to Average<br>Loans Outstanding..... | 0.23%    | 0.52%    | 0.56%    | 1.02%    | 0.72%    |

Provisions charged to operations amounted to \$1.3 million in 2013, compared to \$725 thousand in 2012, an increase of \$565 thousand. This increase is primarily due to an increase in the level of non-performing loans, which is a factor considered in management's estimate of loan loss provisions and the adequacy of the allowance for loan losses. Nonperforming loans to total loans increased from 1.40% at December 31, 2012 to 1.44% at December 31, 2013. The change in this ratio was the result of a increase in nonperforming loans of \$849 thousand from December 31, 2012. Net charge-offs for the year ended December 31, 2013 were just \$61 thousand higher than the provision for loan losses. In determining the estimate of the allowance for loan losses, management computes the historical loss percentage based upon the loss history of the past 12 quarters. The Company believes that using a loss history of the previous 12 quarters helps mitigate volatility in the timing of charge-offs and better reflects probable incurred losses.

The provision for loan losses charged to operating expense is based on management's judgment after taking into consideration all factors connected with the collectability of the existing loan portfolio. Management evaluates the loan portfolio in light of economic conditions, changes in the nature and volume of the loan portfolio, industry standards and other relevant factors. Specific factors considered by management in determining the amounts charged to operating expenses include previous 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.

The allowance for loan losses decreased \$61 thousand during the year. Aside from the various credit quality metrics discussed above, another reason for the decrease in the current year allowance for loan losses was a decrease in the loan loss history used as a basis to evaluate probable incurred losses for loans collectively evaluated. At December 31, 2013, loans collectively evaluated for impairment totaled \$618.7 million with an allowance allocation of \$7.0 million. At the end of 2012, loans collectively evaluated for impairment were \$575.2 million with an allowance allocation of \$7.4 million. The commercial real estate and commercial loan portfolios experienced a negative provision of \$703 thousand, even though the portfolio's loan balances increased by 8.3% during 2013. This can be attributed to the reduction in substandard commercial real estate and commercial loans during the year. The residential real estate and consumer loan portfolio's allowance for loan losses had a provision of \$2.0 million as a result of an adjustment to the methodology of the impairment formula used for these portfolio segments during 2013. Impaired loans are carried at the fair value of the underlying collateral, less estimated disposition costs, if repayment of the loan is expected to be solely dependent on the sale of the collateral. Otherwise, impaired loans are carried at the present value of expected cash flows.

The valuation of collateral-dependent impaired loans is a challenging component of the financial reporting process due to the timing of when a loan is identified as impaired and the need to timely close Farmers' books for a given period. Typically, commercial and commercial real estate loans are identified as impaired when they become ninety days past due, or earlier if management believes it is probable that the Company will not collect all amounts due under the terms of the loan agreement. When Farmers identifies a loan as impaired and also concludes that the loan is collateral dependent, Farmers performs an internal collateral valuation as an interim measure. Farmers typically obtains an external appraisal to validate its internal collateral valuation as soon as is practical. To the extent that an external appraisal returns a value estimate that is materially different from the internally generated estimate before the release of interim or annual financial statements, Farmers adjusts the associated specific loss reserve and, if necessary, Farmers' consolidated financial statements for the difference.

The ratio of the allowance for loan losses to non-performing loans at December 31, 2013 was 83.25%, compared to 93.01% at December 31, 2012. The increase in non-performing loans is primarily related to the commercial, residential real estate and consumer loan portfolios. Balances in the three portfolios increased in similar fashion during 2013. The balance in the allowance for loan losses is \$7.6 million or 1.20% of loans at December 31, 2013. This ratio has decreased from the 1.30% reported at December 31, 2012.

#### Nonperforming Assets

December 31,

#### Nonaccrual loans:

|                                                                | 2013     | 2012     | 2011      | 2010     | 2009      |
|----------------------------------------------------------------|----------|----------|-----------|----------|-----------|
| Commercial Real Estate .....                                   | \$ 3,211 | \$ 3,915 | \$ 6,025  | \$ 3,972 | \$ 5,677  |
| Commercial, Financial and Agricultural .....                   | 1,993    | 1,081    | 527       | 400      | 1,504     |
| Residential Real Estate .....                                  | 2,864    | 2,636    | 4,196     | 4,177    | 2,281     |
| Consumer .....                                                 | 363      | 0        | 12        | 27       | 172       |
| Total Nonaccrual Loans .....                                   | \$ 8,431 | \$ 7,632 | \$ 10,760 | \$ 8,576 | \$ 9,634  |
| Loans Past Due 90 Days or More .....                           | 646      | 596      | 250       | 325      | 469       |
| Total Nonperforming Loans .....                                | \$ 9,077 | \$ 8,228 | \$ 11,010 | \$ 8,901 | \$ 10,103 |
| Other Real Estate Owned .....                                  | 171      | 334      | 585       | 532      | 374       |
| Total Nonperforming Assets .....                               | \$ 9,248 | \$ 8,562 | \$ 11,595 | \$ 9,433 | \$ 10,477 |
| Loans modified in troubled debt restructuring .....            | \$ 8,280 | \$ 7,642 | \$ 4,277  | \$ 2,974 | \$ 5,440  |
| TDRs included in Nonaccrual Loans .....                        | \$ 1,957 | \$ 818   | \$ 471    | \$ 0     | \$ 0      |
| Percentage of Nonperforming Loans to Loans .....               | 1.44%    | 1.40%    | 1.93%     | 1.51%    | 1.66%     |
| Percentage of Nonperforming Assets to Total Assets ..          | 0.81%    | 0.75%    | 1.09%     | 0.96%    | 1.03%     |
| Loans Delinquent 30-89 days .....                              | 3,658    | 3,702    | 3,471     | 7,924    | 9,212     |
| Percentage of Loans Delinquent 30-89 days to Total Loans ..... | 0.58%    | 0.63%    | 0.61%     | 1.34%    | 1.51%     |

The Company has forgone interest income of approximately \$93 thousand from nonaccrual loans as of December 31, 2013 that would have been earned during the year if all loans had performed in accordance with their original terms.

Net charge-offs as a percentage of average loans outstanding decreased from 0.52% for 2012 to 0.23% for 2013. The primary reason for the improvement was gross charge-offs in total decreased by \$1.3 million or 32.9% from 2012 to 2013. In addition all portfolios saw recoveries increase by \$267 thousand in total with the largest increase being in the commercial and industrial loan portfolio.

A significant allocation in the allowance for loan losses is for performing commercial and commercial real estate loans classified by the internal loan review as substandard. The loss experience on the average balance of this category of loans for the past three years has been approximately 4.20% of the principal balance of these loans, which is management's allocation for these loans. This equates to an allocation of approximately \$295 thousand at the end of 2013 compared to an allocation of \$935 thousand at the end of 2012. The allocation decreased due to decrease in the historical loss experience for the substandard loans as well as a decrease in the total balance of substandard loans. The actual loss experience may be more or less than the amount allocated. At December 31, 2013, the amount of substandard loans that continue to accrue interest is \$8.9 million. As always, management is working to address weaknesses in each of these specific loans that may result in loss.

| December 31,     | 2013            |                         | 2012            |                         | 2011            |                         | 2010            |                         | 2009            |                         |
|------------------|-----------------|-------------------------|-----------------|-------------------------|-----------------|-------------------------|-----------------|-------------------------|-----------------|-------------------------|
|                  | Amount          | Loans to<br>Total Loans | Amount          | Loans to<br>Total Loans | Amount          | Loans to<br>Total Loans | Amount          | Loans to<br>Total Loans | Amount          | Loans to<br>Total Loans |
| Commercial Real  |                 |                         |                 |                         |                 |                         |                 |                         |                 |                         |
| Estate.....      | \$ 2,752        | 34.4%                   | \$ 3,392        | 34.2%                   | \$ 4,880        | 34.6%                   | \$ 5,780        | 34.5%                   | \$ 4,111        | 35.4%                   |
| Commercial ..... | 1,219           | 16.7%                   | 1,453           | 16.6%                   | 1,529           | 13.1%                   | 1,707           | 13.0%                   | 1,738           | 12.5%                   |
| Residential Real |                 |                         |                 |                         |                 |                         |                 |                         |                 |                         |
| Estate.....      | 1,964           | 27.0%                   | 1,569           | 26.6%                   | 1,802           | 29.2%                   | 881             | 30.0%                   | 328             | 29.7%                   |
| Consumer.....    | 1,419           | 21.9%                   | 951             | 22.6%                   | 972             | 23.1%                   | 875             | 22.5%                   | 1,223           | 22.4%                   |
| Unallocated..... | 214             | 0                       | 264             | 0                       | 637             | 0                       | 64              | 0                       | 0               | 0                       |
|                  | <u>\$ 7,568</u> | <u>100.0%</u>           | <u>\$ 7,629</u> | <u>100.0%</u>           | <u>\$ 9,820</u> | <u>100.0%</u>           | <u>\$ 9,307</u> | <u>100.0%</u>           | <u>\$ 7,400</u> | <u>100.0%</u>           |

The allowance allocated to each of the four loan categories should not be interpreted as an indication that charge-offs in 2014 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 Company's allowance methodology for homogeneous loans, and increases and decreases in the balances of those portfolios. In previous years, the indirect installment loan category has represented the largest percentage of loan losses. The consumer loan category represents approximately 21.9% of total loans and in 2013, the net loan losses accounted for 66.7% of the losses of the entire loan portfolio. For the commercial loan category, which represents only 16.7% 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 34.4% of the total loan portfolio.

There were no loans other than those identified above, that management has known information about possible credit problems of borrowers and their ability to comply with the loan repayment terms. Management is actively monitoring certain borrowers' financial condition and loans which management wants to more closely monitor due to special circumstances. These loans and their potential loss exposure have been considered in management's analysis of the adequacy of the allowance for 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, 2013, there were no concentrations of loans exceeding 10% 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 \$41.1 million in 2013. Maturing security funds were used to fund loan portfolio growth. Excess balances of federal funds sold were strategically invested throughout the year. The Company's investment strategy is to maintain a diverse investment security portfolio with a higher concentration in mortgage-backed securities that are issued by U.S. Government sponsored enterprises and tax-free municipal securities. Farmers sold \$93.1 million in securities in 2013, resulting in net security gains of \$863 thousand. Farmers recognized market appreciation on faster paying mortgage-backed securities and lower rated municipal securities, and reinvested in new mortgage-backed securities and higher rated municipal securities to further diversify the securities portfolio.

Farmers' objective in managing the investment portfolio is to preserve and enhance corporate liquidity through investment in primarily 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.

Volcker Rule places limits on the trading activity of insured depository institutions and entities affiliated with a depository institution, subject to certain exceptions. The Bank does not engage in any of the trading activities or own any of the types of funds regulated by the Volcker Rule.

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. 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. All holdings of mortgage-backed securities were issued by U.S. Government sponsored enterprises.

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

#### Type

| December 31,                                                                         | 2013              | 2012              | 2011              |
|--------------------------------------------------------------------------------------|-------------------|-------------------|-------------------|
| U.S. Treasury Securities .....                                                       | \$ 100            | \$ 100            | \$ 350            |
| U.S. Government sponsored enterprise debt securities .....                           | 51,210            | 67,878            | 55,638            |
| Mortgage-backed securities—residential and collateralized mortgage obligations ..... | 251,656           | 276,813           | 259,940           |
| Small Business Administration .....                                                  | 23,573            | 21,444            | 315               |
| Obligations of States and Political Subdivisions .....                               | 94,734            | 95,288            | 82,690            |
| Equity securities .....                                                              | 187               | 437               | 327               |
| Corporate Bonds .....                                                                | 1,525             | 2,128             | 769               |
|                                                                                      | <u>\$ 422,985</u> | <u>\$ 464,088</u> | <u>\$ 400,029</u> |

A summary of debt securities held at December 31, 2013 classified according to maturity and including weighted average yield for each range of maturities is set forth below:

| Type and Maturity Grouping                                       | December 31, 2013 |                            |
|------------------------------------------------------------------|-------------------|----------------------------|
|                                                                  | Fair Value        | Weighted Average Yield (1) |
| U.S. Treasury Securities                                         |                   |                            |
| Maturing After One Year But Within Five Years .....              | \$ 100            | 0.36%                      |
| U.S. Government sponsored enterprise debt securities             |                   |                            |
| Maturing Within One Year .....                                   | \$ 11,671         | 2.75%                      |
| Maturing After One Year But Within Five Years .....              | 39,539            | 1.36%                      |
| Maturing After Five Years But Within Ten Years .....             | 0                 | 0%                         |
| Total U.S. Government Sponsored Enterprise Debt Securities ..... | \$ 51,210         | 1.68%                      |
| Mortgage-Backed Securities (2)                                   |                   |                            |
| Maturing Within One Year .....                                   | \$ 25,213         | 2.37%                      |
| Maturing After One Year But Within Five Years .....              | 76,885            | 2.29%                      |
| Maturing After Five Years But Within Ten Years .....             | 68,610            | 2.22%                      |
| Maturing After Ten Years .....                                   | 80,948            | 2.40%                      |
| Total Mortgage-Backed Securities: .....                          | \$ 251,656        | 2.31%                      |
| Small Business Administration                                    |                   |                            |
| Maturing Within One Year .....                                   | \$ 19             | 2.57%                      |
| Maturing After One Year But Within Five Years .....              | 83                | 2.57%                      |
| Maturing After Five Years But Within Ten Years .....             | 23,471            | 1.89%                      |
| Total Small Business Administration .....                        | \$ 23,573         | 1.89%                      |
| Obligations of States and Political Subdivisions                 |                   |                            |
| Maturing Within One Year .....                                   | \$ 2,003          | 5.49%                      |
| Maturing After One Year But Within Five Years .....              | 37,179            | 4.69%                      |
| Maturing After Five Years But Within Ten Years .....             | 45,225            | 3.94%                      |
| Maturing After Ten Years .....                                   | 10,327            | 5.28%                      |
| Total Obligations of States and Political Subdivisions .....     | \$ 94,734         | 4.42%                      |
| Corporate Bonds                                                  |                   |                            |
| Maturing Within One Year .....                                   | \$ 0              | 0%                         |
| Maturing After One Year But Within Five Years .....              | 1,352             | 1.12%                      |
| Maturing After Five Years But Within Ten Years .....             | 173               | 1.55%                      |
| Total Other Securities .....                                     | \$ 1,525          | 1.17%                      |

- (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 \$38 thousand, \$590 thousand, \$536 thousand and \$209 thousand for the four ranges of maturities.
- (2) Payments based on contractual maturity.

#### Premises and Equipment

Premises and equipment decreased \$1.2 million in 2013. The decrease was the result of normal depreciation and the decision to close two retail branch locations in Leetonia and Warren, Ohio. With declining branch transaction counts and banking trends driving customers towards online banking the decision was made to close the two branches in October 2013.

## Deposits

Deposits represent the Company'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 Company's average total deposits increased 12.8% from \$892.0 million in 2012 to \$910.5 million in 2013. Savings deposits increased \$6.5 million and noninterest bearing deposits increased \$23.5 million since December 31, 2012. The growth in savings and noninterest deposits were offset by a decrease of \$25.7 million in money market accounts. With interest rates continuing to be low, customers have little incentive to commit funds to term deposit accounts. Time deposits decreased \$8.6 million as customers moved deposit dollars from time deposits seeking liquidity. The Company's focus is on core deposit growth and Farmers will continue to price deposit rates to remain competitive within the market and to retain customers. At December 31, 2013, core deposits – savings and money market accounts, time deposits less than \$100 thousand, demand deposits and interest bearing demand deposits represented approximately 90.6% of total deposits. See Note 7 within Item 8 of this Annual report on Form 10-K for additional detail.

## Bank Owned Life Insurance

Farmers' owns 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 \$15.9 million at December 31, 2013 compared to \$15.5 million at December 31, 2012.

## Borrowings

Short-term borrowings increased \$1.7 million or 2.2% since December 31, 2012. Long-term borrowings increased \$9.4 million or 90.2%, as a result of a new \$10 million Federal Home Loan Bank advance. See Note 9 within Item 8 of this Annual report on Form 10-K for additional detail.

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

The following table presents, as of December 31, 2013, the Company'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 the referenced note to the consolidated financial statements.

|                                          | Note<br>Ref. | Commitments<br>12/31/2013 |        |        |        |        |            |
|------------------------------------------|--------------|---------------------------|--------|--------|--------|--------|------------|
|                                          |              | 2014                      | 2015   | 2016   | 2017   | 2018   | Thereafter |
| Deposits without maturity .....          |              | \$ 688,470                |        |        |        |        |            |
| Certificates of deposit .....            | 7            | 68,199                    | 84,689 | 34,517 | 16,148 | 12,448 | 10,745     |
| Repurchase agreements .....              | 8            | 75,267                    |        |        |        |        |            |
| Other short-term borrowed<br>funds ..... | 8            | 6,350                     |        |        |        |        |            |
| Federal Home Loan Bank<br>advances       | 9            | 1,544                     | 6,296  | 1,176  | 6,089  | 1,008  | 3,709      |
| Operating leases .....                   | 5            | 229                       | 166    | 102    | 110    | 114    | 380        |

Note 10 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.

At December 31, 2013, the Company had no unconsolidated, related special purpose entities, nor did the Company engage in derivatives and hedging contracts that may expose the Company 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. The Company does utilize interest-rate swaps as a way of helping manage interest rate risk and not as derivatives for trading purposes. See Note 19 within Item 8 of this Annual report on Form 10-K for additional detail.

## Capital Resources

Total Stockholders' Equity decreased 6.4% from \$120.8 million at December 31, 2012 to \$113.0 million in 2013. The decrease in equity was mainly the result of a \$13.1 million decrease in accumulated other comprehensive income. The change in accumulated other comprehensive income was mainly due to a swing from unrealized gains on the investment security portfolio in 2012 to unrealized losses in 2013. Additionally, the Company obtained \$1.6 million in treasury share repurchases in 2013. These decreases were offset by net income during the past twelve months. During the year, shareholders received a total of \$0.12 per share cash dividends paid in the past four quarters. Book value decreased 6.8% from \$6.43 per share at December 31, 2012 to \$6.02 per share at December 31, 2013. The Company's tangible book value also decreased 10.5% from \$6.11 per share at December 31, 2012 to \$5.47 per share at December 31, 2013.

The Bank, as a national chartered bank, is subject to the dividend restrictions set forth by the OCC. The OCC 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). Farmers and Farmers Bank are required to maintain minimum amounts of capital to total "risk weighted" assets, as defined by the banking regulators. At December 31, 2013, Farmers Bank and Farmers are required to have a minimum Tier 1 and Total Capital ratios of 4.00% and 8.00%, respectively. Farmers Bank and Farmers had capital ratios above the minimum levels at December 31, 2013 and 2012. At year-end 2013 and 2012, the most recent regulatory notifications categorized Farmers Bank as well capitalized under the regulatory framework for prompt corrective action.

## Critical Accounting Policies

The Company 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 Company has identified three accounting policies that are critical accounting policies and an understanding of these policies is necessary to understand the financial statements. These policies relate to determining the adequacy of the allowance for loan losses, if there are any securities that are other-than-temporarily impaired and if there is any impairment of goodwill and intangibles. Additional information regarding these policies is included in the notes to the consolidated financial statements, including Note 1 (Summary of Significant Accounting Policies), Note 2 (Securities) and Note 3 (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.

Farmers 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 allowances 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) whether Farmers has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery.

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

At December 31, 2013, on a consolidated basis, Farmers had intangibles of \$4.0 million subject to amortization and \$6.4 million of goodwill, which was not subject to periodic amortization.

#### Recent Accounting Pronouncements and Developments

Note 1 to the consolidated financial statements discusses new accounting policies adopted by Farmers during 2013 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 sections of this financial review and notes to the consolidated financial statements.

#### **Item 7A. Quantitative and Qualitative Disclosures About 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 Company, the management of interest rate sensitivity focuses on the structure of these assets and liabilities 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 Company monitors interest rate sensitive assets and liabilities to determine the overall interest rate position over various time frames.

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

| <b>Changes In<br/>Interest Rate<br/>(basis points)</b> | <b>2013<br/>Result</b> | <b>2012<br/>Result</b> | <b>ALCO<br/>Guidelines</b> |
|--------------------------------------------------------|------------------------|------------------------|----------------------------|
| Net Interest                                           |                        |                        |                            |
| Income Change                                          |                        |                        |                            |
| +300 .....                                             | -3.3%                  | -0.6%                  | 15%                        |
| +200 .....                                             | -1.9%                  | -0.1%                  | 10%                        |
| +100 .....                                             | -0.8%                  | 0.1%                   | 5%                         |
| -100 .....                                             | -2.8%                  | -3.4%                  | 5%                         |
| Net Present Value                                      |                        |                        |                            |
| Of Equity Change                                       |                        |                        |                            |
| +300 .....                                             | -8.7%                  | 3.3%                   | 20%                        |
| +200 .....                                             | -3.8%                  | 5.7%                   | 15%                        |
| +100 .....                                             | -0.5%                  | 4.4%                   | 10%                        |
| -100 .....                                             | -11.2%                 | -16.8%                 | 10%                        |

It should be noted that the change in the net present value of equity exceeded policy when the simulation model assumed a sudden decrease in rates of 100 basis points (1%). This is primarily because the positive impact on the fair value of assets would not be as great as the negative impact on the fair value of certain liabilities. Specifically, because core deposits typically bear relatively low interest rates, their fair value would be negatively impacted as the rates could not be adjusted by the full extent of the sudden decrease in rates. Management does not believe that a 100 basis rate decline is realistic in the current interest rate environment. The remaining results of this analysis comply with internal limits established by the Company. A report on interest rate risk is presented to the Board of Directors and the Asset/Liability Committee on a quarterly basis. The Company has no market risk sensitive instruments held for trading purposes.

With the largest amount of interest sensitive assets and liabilities maturing within twelve months, the Company monitors this area most closely. Early withdrawal of deposits, prepayments of loans and loan delinquencies are some of the factors that can impact actual results in comparison to our simulation analysis. In addition, changes in rates on interest sensitive assets and liabilities may not be equal, which could result in a change in net interest 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.

## Item 8. Financial Statements and Supplementary Data.

### MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Farmers National Banc Corp. (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(1) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of; our principal executive and principal financial officers and effected by the board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

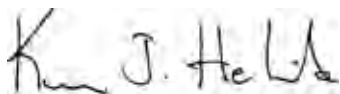
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our 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. 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 our internal control over financial reporting as of December 31, 2013. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in the 1992 Internal Control-Integrated Framework. Based on that assessment, we believe that, as of December 31, 2013, our internal control over financial reporting is effective based on those criteria.

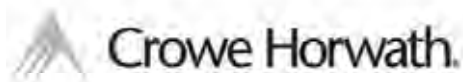
Crowe Horwath LLP has audited the effectiveness of the Company's internal control over financial reporting as of December 31, 2013, as stated in their report dated March 13, 2014.



Kevin J. Helmick  
President and Chief Executive Officer



Carl D. Culp  
Executive Vice President and Treasurer



Crowe Horwath LLP  
Independent Member Crowe Horwath International

## Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Farmers National Banc Corp. (the "Company") as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2013. We also have audited the Company's internal control over financial reporting as of December 31, 2013, based on criteria established in the 1992 Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, 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 these financial statements and an opinion on the company's internal control over financial reporting 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting 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. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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, the financial statements referred to above present fairly, in all material respects, the financial position of Farmers National Banc Corp. as of December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on criteria established in the 1992 Internal Control – Integrated Framework issued by COSO.

Crowe Horwath LLP

Cleveland, Ohio  
March 13, 2014

**CONSOLIDATED BALANCE SHEETS**  
(Table Dollar Amounts in Thousands except Per Share Data)

| December 31,                                                                                                                                 | 2013                | 2012                |
|----------------------------------------------------------------------------------------------------------------------------------------------|---------------------|---------------------|
| <b>ASSETS</b>                                                                                                                                |                     |                     |
| Cash and due from banks .....                                                                                                                | \$ 12,957           | \$ 14,209           |
| Federal funds sold and other .....                                                                                                           | 14,556              | 23,550              |
| <b>TOTAL CASH AND CASH EQUIVALENTS .....</b>                                                                                                 | <b>27,513</b>       | <b>37,759</b>       |
| Securities available for sale .....                                                                                                          | 422,985             | 464,088             |
| Loans held for sale .....                                                                                                                    | 158                 | 3,624               |
| Loans .....                                                                                                                                  | 630,684             | 586,592             |
| Less allowance for loan losses .....                                                                                                         | 7,568               | 7,629               |
| <b>NET LOANS .....</b>                                                                                                                       | <b>623,116</b>      | <b>578,963</b>      |
| Premises and equipment, net .....                                                                                                            | 17,187              | 18,429              |
| Goodwill .....                                                                                                                               | 6,354               | 3,709               |
| Other intangibles .....                                                                                                                      | 3,989               | 2,323               |
| Bank owned life insurance .....                                                                                                              | 15,908              | 15,541              |
| Other assets .....                                                                                                                           | 20,116              | 15,259              |
| <b>TOTAL ASSETS .....</b>                                                                                                                    | <b>\$ 1,137,326</b> | <b>\$ 1,139,695</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                  |                     |                     |
| Deposits:                                                                                                                                    |                     |                     |
| Noninterest-bearing .....                                                                                                                    | \$ 155,893          | \$ 132,016          |
| Interest-bearing .....                                                                                                                       | 759,323             | 786,993             |
| <b>TOTAL DEPOSITS .....</b>                                                                                                                  | <b>915,216</b>      | <b>919,009</b>      |
| Short-term borrowings .....                                                                                                                  | 81,617              | 79,886              |
| Long-term borrowings .....                                                                                                                   | 19,822              | 10,423              |
| Other liabilities .....                                                                                                                      | 7,664               | 9,585               |
| <b>TOTAL LIABILITIES .....</b>                                                                                                               | <b>1,024,319</b>    | <b>1,018,903</b>    |
| Commitments and contingent liabilities                                                                                                       |                     |                     |
| Stockholders' Equity                                                                                                                         |                     |                     |
| Common Stock - Authorized 35,000,000 shares in 2013 and 25,000,000 shares in 2012; issued<br>19,031,059 in 2013 and 18,802,282 in 2012 ..... | <b>105,905</b>      | 104,504             |
| Retained earnings .....                                                                                                                      | 14,215              | 8,683               |
| Accumulated other comprehensive income (loss) .....                                                                                          | (5,465)             | 7,647               |
| Treasury stock, at cost; 255,079 shares in 2013 and 7,234 shares in 2012 .....                                                               | (1,648)             | (42)                |
| <b>TOTAL STOCKHOLDERS' EQUITY .....</b>                                                                                                      | <b>113,007</b>      | <b>120,792</b>      |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY .....</b>                                                                                      | <b>\$ 1,137,326</b> | <b>\$ 1,139,695</b> |

See accompanying notes.

**CONSOLIDATED STATEMENTS OF INCOME**  
**(Table Dollar Amounts in Thousands except Per Share Data)**

| Years ended December 31,                                        | 2013            | 2012            | 2011            |
|-----------------------------------------------------------------|-----------------|-----------------|-----------------|
| <b>INTEREST AND DIVIDEND INCOME</b>                             |                 |                 |                 |
| Loans, including fees .....                                     | \$ 30,717       | \$ 31,874       | \$ 33,191       |
| Taxable securities.....                                         | 7,062           | 8,099           | 8,058           |
| Tax exempt securities.....                                      | 2,949           | 2,831           | 2,911           |
| Dividends .....                                                 | 196             | 206             | 195             |
| Federal funds sold and other interest income.....               | 35              | 100             | 79              |
| TOTAL INTEREST AND DIVIDEND INCOME .....                        | <u>40,959</u>   | <u>43,110</u>   | <u>44,434</u>   |
| <b>INTEREST EXPENSE</b>                                         |                 |                 |                 |
| Deposits.....                                                   | 4,560           | 5,719           | 6,617           |
| Short-term borrowings .....                                     | 51              | 103             | 325             |
| Long-term borrowings .....                                      | 452             | 390             | 895             |
| TOTAL INTEREST EXPENSE.....                                     | <u>5,063</u>    | <u>6,212</u>    | <u>7,837</u>    |
| NET INTEREST INCOME.....                                        | 35,896          | 36,898          | 36,597          |
| Provision for loan losses .....                                 | 1,290           | 725             | 3,650           |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN<br>LOSSES .....    | <u>34,606</u>   | <u>36,173</u>   | <u>32,947</u>   |
| <b>NONINTEREST INCOME</b>                                       |                 |                 |                 |
| Service charges on deposit accounts .....                       | 2,370           | 2,043           | 2,063           |
| Bank owned life insurance income, including death benefits..... | 696             | 526             | 594             |
| Trust fees .....                                                | 5,583           | 5,497           | 5,355           |
| Insurance agency commissions .....                              | 243             | 124             | 152             |
| Security gains .....                                            | 863             | 1,059           | 1,804           |
| Impairment of equity securities.....                            | (3)             | 0               | (11)            |
| Retirement plan consulting fees .....                           | 477             | 0               | 0               |
| Investment commissions .....                                    | 989             | 946             | 863             |
| Net gains on sale of loans.....                                 | 505             | 598             | 113             |
| Other operating income.....                                     | 2,191           | 1,785           | 1,606           |
| TOTAL NONINTEREST INCOME.....                                   | <u>13,914</u>   | <u>12,578</u>   | <u>12,539</u>   |
| <b>NONINTEREST EXPENSE</b>                                      |                 |                 |                 |
| Salaries and employee benefits .....                            | 22,054          | 19,746          | 17,504          |
| Occupancy and equipment .....                                   | 4,189           | 4,179           | 3,601           |
| State and local taxes .....                                     | 1,313           | 1,203           | 955             |
| Professional fees.....                                          | 2,212           | 1,967           | 1,791           |
| Merger related costs .....                                      | 330             | 0               | 0               |
| Advertising.....                                                | 911             | 973             | 835             |
| FDIC insurance .....                                            | 719             | 710             | 831             |
| Intangible amortization .....                                   | 624             | 409             | 479             |
| Core processing charges.....                                    | 1,354           | 1,419           | 1,293           |
| FHLB advance prepayment fee.....                                | 0               | 0               | 1,195           |
| Other operating expenses .....                                  | 5,351           | 5,158           | 5,244           |
| TOTAL NONINTEREST EXPENSE .....                                 | <u>39,057</u>   | <u>35,764</u>   | <u>33,728</u>   |
| INCOME BEFORE INCOME TAXES .....                                | 9,463           | 12,987          | 11,758          |
| <b>INCOME TAXES</b> .....                                       | <u>1,683</u>    | <u>3,055</u>    | <u>2,540</u>    |
| NET INCOME.....                                                 | <u>\$ 7,780</u> | <u>\$ 9,932</u> | <u>\$ 9,218</u> |
| <b>EARNINGS PER SHARE:</b> Basic and diluted                    | <u>\$ 0.41</u>  | <u>\$ 0.53</u>  | <u>\$ 0.50</u>  |

See accompanying notes.

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
**(Table Dollar Amounts in Thousands except Per Share Data)**

| Years ended December 31,                                                   | <u>2013</u>       | <u>2012</u>     | <u>2011</u>      |
|----------------------------------------------------------------------------|-------------------|-----------------|------------------|
| NET INCOME.....                                                            | \$ 7,780          | \$ 9,932        | \$ 9,218         |
| Other comprehensive income (loss):                                         |                   |                 |                  |
| Net unrealized holding gains (losses) on available for sale securities ... | (19,310)          | 307             | 9,707            |
| Reclassification adjustment for (gains) losses realized in income .....    | (860)             | (1,059)         | (1,793)          |
| Net unrealized holding gains (losses) .....                                | (20,170)          | (752)           | 7,914            |
| Income tax effect .....                                                    | 7,060             | 263             | (2,770)          |
| Unrealized holding gains (losses), net of reclassification and tax .....   | (13,110)          | (489)           | 5,144            |
| Change in funded status of post-retirement health plan.....                | (3)               | 131             | 0                |
| Income tax effect .....                                                    | 1                 | (46)            | 0                |
| Change in funded status of post-retirement health plan, net of tax .....   | (2)               | 85              | 0                |
| Other comprehensive income (loss), net of tax .....                        | (13,112)          | (404)           | 5,144            |
| TOTAL COMPREHENSIVE INCOME (LOSS) .....                                    | <u>\$ (5,332)</u> | <u>\$ 9,528</u> | <u>\$ 14,362</u> |

See accompanying notes.

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**(Table Dollar Amounts in Thousands except Per Share Data)**

| Years ended December 31,                                                                                                      | <u>2013</u>              | <u>2012</u>              | <u>2011</u>              |
|-------------------------------------------------------------------------------------------------------------------------------|--------------------------|--------------------------|--------------------------|
| <b>COMMON STOCK</b>                                                                                                           |                          |                          |                          |
| Balance at beginning of year.....                                                                                             | \$ 104,504               | \$ 104,261               | \$ 96,142                |
| Stock option expense (1).....                                                                                                 | 1                        | 0                        | 0                        |
| Issued 2,946,864 shares in public offering, net of offering costs of \$1,228 in 2011.....                                     | 0                        | 0                        | 7,615                    |
| Issued 44,845 shares from dividend reinvestment in 2012, 111,389 in 2011 .                                                    | 0                        | 243                      | 504                      |
| Issued 228,777 shares as part of the acquisition of National Associates, Inc. in 2013                                         | 1,400                    | 0                        | 0                        |
| Balance at end of year.....                                                                                                   | <u>105,905</u>           | <u>104,504</u>           | <u>104,261</u>           |
| <b>RETAINED EARNINGS</b>                                                                                                      |                          |                          |                          |
| Balance at beginning of year.....                                                                                             | 8,683                    | 2,133                    | 14,502                   |
| Net income .....                                                                                                              | 7,780                    | 9,932                    | 9,218                    |
| Reduction as a result of treasury shares reissued as part of public offering .....                                            | 0                        | 0                        | (19,346)                 |
| Dividends declared: \$0.12 cash dividends per share in 2013 and 2011, \$0.18 in 2012 .....                                    | (2,248)                  | (3,382)                  | (2,241)                  |
| Balance at end of year.....                                                                                                   | <u>14,215</u>            | <u>8,683</u>             | <u>2,133</u>             |
| <b>ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)</b>                                                                          |                          |                          |                          |
| Balance at beginning of year.....                                                                                             | 7,647                    | 8,051                    | 2,907                    |
| Other comprehensive income (loss), net of reclassifications and tax effects ...                                               | (13,112)                 | (404)                    | 5,144                    |
| Balance at end of year.....                                                                                                   | <u>(5,465)</u>           | <u>7,647</u>             | <u>8,051</u>             |
| <b>TREASURY STOCK, AT COST</b>                                                                                                |                          |                          |                          |
| Balance at beginning of year.....                                                                                             | (42)                     | 0                        | (25,503)                 |
| Purchased 247,845 shares in 2013 and 7,221 shares in 2012; reissued 2,053,136 shares in 2011 as part of public offering ..... | (1,606)                  | (42)                     | 25,503                   |
| Balance at end of year.....                                                                                                   | <u>(1,648)</u>           | <u>(42)</u>              | <u>0</u>                 |
| <b>TOTAL STOCKHOLDERS' EQUITY AT END OF YEAR .....</b>                                                                        | <u><b>\$ 113,007</b></u> | <u><b>\$ 120,792</b></u> | <u><b>\$ 114,445</b></u> |

(1) Stock option expense for 2012 and 2011 was less than \$1,000 and rounded to \$0.

See accompanying notes.

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Table Dollar Amounts in Thousands except Per Share Data)

| Years ended December 31,                                                       | 2013      | 2012      | 2011      |
|--------------------------------------------------------------------------------|-----------|-----------|-----------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                    |           |           |           |
| Net income .....                                                               | \$ 7,780  | \$ 9,932  | \$ 9,218  |
| Adjustments to reconcile net income to net cash from operating activities:     |           |           |           |
| Provision for loan losses .....                                                | 1,290     | 725       | 3,650     |
| Depreciation and amortization .....                                            | 1,945     | 1,738     | 1,647     |
| Net amortization of securities .....                                           | 2,646     | 2,711     | 1,469     |
| Security gains .....                                                           | (863)     | (1,059)   | (1,804)   |
| Impairment of equity securities .....                                          | 3         | 0         | 11        |
| (Gain) Loss on sale of other real estate owned .....                           | 75        | (61)      | 175       |
| Earnings on bank owned life insurance .....                                    | (478)     | (526)     | (548)     |
| Income recognized from death benefit on bank owned life insurance .....        | (218)     | 0         | (46)      |
| Origination of loans held for sale .....                                       | (25,085)  | (35,237)  | (5,969)   |
| Proceeds from loans held for sale .....                                        | 29,056    | 32,888    | 5,392     |
| Net gains on sale of loans .....                                               | (505)     | (598)     | (113)     |
| Net change in other assets and liabilities .....                               | (1,394)   | 457       | 912       |
| NET CASH FROM OPERATING ACTIVITIES .....                                       | 14,252    | 10,970    | 13,994    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                    |           |           |           |
| Proceeds from maturities and repayments of securities available for sale ..... | 75,015    | 84,490    | 43,122    |
| Proceeds from sales of securities available for sale .....                     | 94,016    | 91,197    | 50,952    |
| Purchases of securities available for sale .....                               | (149,886) | (237,393) | (171,517) |
| Purchase of Federal Reserve Bank Stock .....                                   | 0         | 0         | (247)     |
| Loan originations and payments, net .....                                      | (45,529)  | (19,278)  | 14,836    |
| Proceeds from sale of other real estate owned .....                            | 282       | 1,888     | 360       |
| Purchase of bank owned life insurance .....                                    | 0         | 0         | (3,000)   |
| Proceeds from BOLI death benefit .....                                         | 329       | 0         | 108       |
| Proceeds from sale of land .....                                               | 118       | 0         | 0         |
| Additions to premises and equipment .....                                      | (215)     | (3,198)   | (3,585)   |
| Purchase of National Associates Inc., net .....                                | (2,111)   | 0         | 0         |
| NET CASH FROM INVESTING ACTIVITIES .....                                       | (27,981)  | (82,294)  | (68,971)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                    |           |           |           |
| Net change in deposits .....                                                   | (3,793)   | 78,884    | 79,075    |
| Net change in short-term borrowings .....                                      | 1,731     | (18,202)  | (7,546)   |
| Repayment of Federal Home Loan Bank borrowings and other debt .....            | (601)     | (840)     | (13,470)  |
| New Federal Home Loan Bank advance borrowings .....                            | 10,000    | 0         | 0         |
| Cash dividends paid .....                                                      | (2,248)   | (3,382)   | (2,241)   |
| Proceeds from dividend reinvestment .....                                      | 0         | 243       | 504       |
| Net proceeds from issuance of common shares .....                              | 0         | 0         | 13,772    |
| Acquisition of treasury shares .....                                           | (1,606)   | (42)      | 0         |
| NET CASH FROM FINANCING ACTIVITIES .....                                       | 3,483     | 56,661    | 70,094    |
| NET CHANGE IN CASH AND CASH EQUIVALENTS .....                                  | (10,246)  | (14,663)  | 15,117    |
| Beginning cash and cash equivalents .....                                      | 37,759    | 52,422    | 37,305    |
| Ending cash and cash equivalents .....                                         | \$ 27,513 | \$ 37,759 | \$ 52,422 |
| Supplemental cash flow information:                                            |           |           |           |
| Interest paid .....                                                            | \$ 5,095  | \$ 6,318  | \$ 7,955  |
| Income taxes paid .....                                                        | \$ 1,130  | \$ 2,065  | \$ 3,895  |
| Supplemental noncash disclosures:                                              |           |           |           |
| Transfer of assets to other real estate owned .....                            | \$ 193    | \$ 1,576  | \$ 588    |
| Issuance of stock for NAI acquisition .....                                    | \$ 1,400  | \$ 0      | \$ 0      |
| Contingent consideration for NAI acquisition .....                             | \$ 920    | \$ 0      | \$ 0      |
| Security purchases not settled .....                                           | \$ 0      | \$ 4,758  | \$ 0      |

See accompanying notes.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Table Dollar Amounts In Thousands except Per Share Data)**

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation:** The consolidated financial statements include the accounts of Farmers National Banc Corp. and its wholly-owned subsidiaries, The Farmers National Bank ("Bank") of Canfield, Farmers Trust Company ("Trust") and National Associates, Inc. ("NAI"). The consolidated financial statements also include the accounts of the Farmers National Bank of Canfield's subsidiary, Farmers National Insurance. Together the entities are referred to as "the Company." All significant intercompany balances and transactions have been eliminated in consolidation.

**Nature of Operations:** The Company provides full banking services, including wealth management services and mortgage banking activity, through its nationally chartered subsidiary, The Farmers National Bank of Canfield. 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. On July 1, 2013 the Company acquired National Associates, Inc. ("NAI"), a retirement plan consulting firm located in Cleveland, Ohio. Therefore the Company now provides retirement consulting services through NAI. The Company provides trust services through its subsidiary, Farmers Trust Company, and insurance services through the Bank's subsidiary, Farmers National Insurance. Farmers Trust Company has a state-chartered bank license to conduct trust business from the Ohio Department of Commerce – Division of Financial Institutions.

**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. Actual results could differ from those estimates. The allowance for loan losses, deferred tax assets, carrying amount of goodwill and fair values of financial instruments are particularly subject to change.

**Cash Flows:** Cash and cash equivalents include cash on hand, deposits with other financial institutions 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 are recorded on the trade date.

Management evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market conditions warrant. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment (OTTI) related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

**Loans Held for Sale:** Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are charged to earnings.

Mortgage loans held for sale are generally sold with servicing rights released. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

**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.

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. Interest income on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Consumer loans are typically charged off no later than 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

For all classes of loans, when interest accruals are discontinued, interest accrued but not received for loans placed on non-accrual is reversed against interest income. Interest on such loans is thereafter recorded on a cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

**Derivatives:** Derivative financial instruments are recognized as assets or liabilities at fair value. The Company's derivatives are interest-rate swap agreements, which are used as part of its asset and liability management strategy to help manage its interest rate risk position. The Company does not use derivatives for trading or balance sheet hedging purposes. The derivative transactions are considered instruments with no hedging designation, otherwise known as stand-alone derivatives. Changes in the fair value of the derivatives are reported currently in earnings, as other noninterest income.

**Concentration of Credit Risk:** There are no significant concentrations of loans to any one industry or customer. However, most of the Company's business activity is with customers located within Mahoning, Trumbull, Columbiana, and Stark counties. Therefore, the Company's exposure to credit risk is significantly affected by changes in the economy of the four county area.

**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 and probable. 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. 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. Loans, for which the terms have been modified, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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 \$300 thousand, individually or in the aggregate, 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, such as consumer and residential real estate loans are collectively evaluated for impairment and accordingly, they are not separately identified for impairment disclosures. Non-real estate secured consumer loans in bankruptcy where debt has not been reaffirmed are considered troubled debt restructurings and are evaluated individually to ensure that accurate accounting treatment is in place.

The Company considers the guidance on troubled debt restructuring for individual consumer and residential loans when evaluating for impairment disclosure. Troubled debt restructurings are measured at the present value of estimated future cash flow using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Company determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced for the most recent twelve-quarters. The formula for calculating the allowance for loan losses requires that the historical loss percentage be applied to homogeneous and pass rated loans. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified:

**Commercial Loans.** Commercial credit is extended to commercial customers for use in normal business operations to finance working capital needs, equipment purchases, or other projects. The majority of these borrowers are customers doing business within our geographic regions. These loans are generally underwritten individually and secured with the assets of the company and the personal guarantee of the business owners. Commercial loans are made based primarily on the historical and projected cash flow of the borrower and the underlying collateral provided by the borrower.

**Commercial Real Estate Loans.** Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans. These loans are viewed primarily as cash flow loans and the repayment of these loans is largely dependent on the successful operation of the property. Loan performance may be adversely affected by factors impacting the general economy or conditions specific to the real estate market such as geographic location and property type.

**Consumer Loans.** Consumer loans are primarily comprised of loans made directly to consumers and indirectly through automobile dealerships. These loans have a specific matrix which consists of several factors including debt to income, type of collateral and loan to collateral value, credit history and relationship with the borrower. Consumer lending uses risk-based pricing in the underwriting process.

**Residential Mortgage Loans.** Residential mortgage loans represent loans to consumers for the purchase or refinance of a residence. These loans are generally financed up to 15 years, and in most cases, are extended to borrowers to finance their primary residence. Real estate market values at the time of origination directly affect the amount of credit extended and, in the event of default, subsequent changes in these values may impact the severity of losses.

**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. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating 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. The bank is also a member of and owns stock in the Federal Reserve Bank. These stocks are carried at cost, classified as restricted securities included in other assets, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income. Restricted stock is included in other assets in the consolidated balance sheets.

**Bank Owned Life Insurance:** The Company has purchased life insurance policies on certain key officers. Bank 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.

**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.

**Goodwill and Other Intangible Assets:** Goodwill resulting from a business combination is generally determined as the excess of the fair value of the consideration transferred over the fair value of the net assets acquired as of the acquisition date. Goodwill acquired in a purchase business combination and determined to have an indefinite useful life is not amortized, but tested for impairment at least annually. The Company has selected September 30 as the date to perform the annual impairment tests associated with the acquisition of the Trust and NAI. Intangible assets with definite useful lives are amortized over their estimated useful lives. Goodwill is the only intangible asset with an indefinite life on our balance sheet. Non-compete contracts are amortized on a straight line basis, over the term of the agreements. Customer relationship and trade name intangibles are amortized over an average of 13 years on an accelerated method.

**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:** Compensation cost is recognized for stock options issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

**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.

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

**Retirement Plans:** Employee 401(k) and profit sharing plan expense is the amount of matching contributions. Deferred compensation and supplemental retirement plan expense allocates the benefits over years of service.

**Earnings per Common 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 (Loss):** Comprehensive income (loss) consists of net income and other comprehensive income (loss). Other comprehensive income (loss) consists of unrealized gains and losses on securities available for sale and changes in the funded status of the post-retirement health plan, which are recognized as separate components of equity, net of tax effects.

**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.

**Restrictions on Cash:** Cash on hand or on deposit with the Federal Reserve Bank was required to meet regulatory reserve and clearing requirements.

**Equity:** As part of the NAI acquisition the Company issued 228,777 common shares during 2013. The Company successfully completed a rights and public offering of 5,000,000 common shares in January 2011, of which 2,053,136 shares were treasury stock that was reissued. Proceeds from the rights and public offering, net of offering costs of \$1.2 million, were \$13.8 million. Treasury stock is carried at cost.

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

**Fair Value of Financial Instruments:** Fair values of financial instruments are estimated using relevant market information and other assumptions as more fully disclosed in Note 4. 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 these 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 primarily aggregated and reported in three lines of business, the Bank, Trust and Retirement planning/consulting segments. The Company discloses segment information in Footnote 20.

**Reclassification:** Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior year net income or stockholders' equity.

**Adoption of New Accounting Standards:**

In February 2013, the Fair Accounting Standards Board ("FASB") issued Accounting Standards Update 2013-02 (the "ASU") with the primary objective of improving the reporting of reclassifications out of accumulated other comprehensive income ("AOCI"). For significant reclassifications that are required to be presented in their entirety in net income in the same reporting period by U.S. Generally Accepted Accounting Principles (U.S. GAAP), the ASU requires an entity to report the effect of these reclassifications out of AOCI on the respective line items of net income either on the face of the statement that reports net income or in the financial statement notes. For AOCI items that are not reclassified to net income in their entirety, presentation in the financial statement notes is required. The Company has adopted this ASU beginning with periods ended March 31, 2013, by adding an additional footnote disclosure, in Footnote 15 of the consolidated financial statements.

**NOTE 2 - SECURITIES AVAILABLE FOR SALE**

The following table summarizes the amortized cost and fair value of the available-for-sale securities portfolio at December 31, 2013 and 2012 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

|                                                           | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value        |
|-----------------------------------------------------------|-------------------|------------------------------|-------------------------------|-------------------|
| <b>2013</b>                                               |                   |                              |                               |                   |
| U.S. Treasury and U.S. government sponsored entities..... | \$ 50,942         | \$ 755                       | \$ (387)                      | \$ 51,310         |
| State and political subdivisions.....                     | 96,239            | 1,302                        | (2,807)                       | 94,734            |
| Corporate bonds .....                                     | 1,540             | 0                            | (15)                          | 1,525             |
| Mortgage-backed securities - residential .....            | 226,865           | 1,199                        | (5,084)                       | 222,980           |
| Collateralized mortgage obligations .....                 | 30,227            | 162                          | (1,713)                       | 28,676            |
| Small business administration.....                        | 25,592            | 1                            | (2,020)                       | 23,573            |
| Equity securities.....                                    | 117               | 70                           | 0                             | 187               |
| Totals .....                                              | <u>\$ 431,522</u> | <u>\$ 3,489</u>              | <u>\$ (12,026)</u>            | <u>\$ 422,985</u> |
| <b>2012</b>                                               |                   |                              |                               |                   |
| U.S. Treasury and U.S. government sponsored entities..... | \$ 66,378         | \$ 1,601                     | \$ (1)                        | \$ 67,978         |
| State and political subdivisions .....                    | 90,466            | 5,067                        | (245)                         | 95,288            |
| Corporate bonds .....                                     | 2,123             | 12                           | (7)                           | 2,128             |
| Mortgage-backed securities - residential.....             | 231,582           | 5,112                        | (476)                         | 236,218           |
| Collateralized mortgage obligations.....                  | 40,333            | 336                          | (74)                          | 40,595            |
| Small business administration .....                       | 21,432            | 74                           | (62)                          | 21,444            |
| Equity securities .....                                   | 139               | 303                          | (5)                           | 437               |
| Totals .....                                              | <u>\$ 452,453</u> | <u>\$ 12,505</u>             | <u>\$ (870)</u>               | <u>\$ 464,088</u> |

The proceeds from sales of available-for-sale securities and the associated gains and losses were as follows:

|                   | 2013      | 2012      | 2011      |
|-------------------|-----------|-----------|-----------|
| Proceeds .....    | \$ 94,016 | \$ 91,197 | \$ 50,952 |
| Gross gains.....  | 1,924     | 1,258     | 1,804     |
| Gross losses..... | (1,061)   | (199)     | 0         |

The tax provision related to these net realized gains was \$301 thousand, \$371 thousand and \$631 thousand respectively.

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

| Available for sale<br>Maturity                                                                             | December 31, 2013 |                   |
|------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
|                                                                                                            | Amortized<br>Cost | Fair Value        |
| Within one year .....                                                                                      | \$ 13,511         | \$ 13,674         |
| One to five years.....                                                                                     | 77,830            | 78,170            |
| Five to ten years.....                                                                                     | 46,459            | 45,398            |
| Beyond ten years .....                                                                                     | 10,921            | 10,327            |
| Mortgage-backed securities, collateralized mortgage obligations<br>and small business administration ..... | 282,684           | 275,229           |
| Totals.....                                                                                                | <u>\$ 431,405</u> | <u>\$ 422,798</u> |

Securities with a carrying amount of \$164 million at December 31, 2013 and \$169 million at December 31, 2012 were pledged to secure public deposits and repurchase agreements. The Trust company had securities, with a carrying amount of \$100 thousand, at year-end 2013, 2012 and 2011, pledged to qualify as a fiduciary in the State of Ohio.

In each year, there were no holdings of any other issuer that exceeded 10% of stockholders' equity, other than the U.S. Government, its agencies and its sponsored entities.

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

| 2013<br>Description of Securities                             | Less than 12 Months |                    | 12 Months or More |                    | Total             |                    |
|---------------------------------------------------------------|---------------------|--------------------|-------------------|--------------------|-------------------|--------------------|
|                                                               | Fair<br>Value       | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss |
| U.S. Treasury and U.S. government<br>sponsored entities ..... | \$ 20,776           | \$ (387)           | \$ 0              | \$ 0               | \$ 20,776         | \$ (387)           |
| State and political subdivisions .....                        | 34,851              | (1,855)            | 7,492             | (952)              | 42,343            | (2,807)            |
| Corporate bonds .....                                         | 1,052               | (2)                | 473               | (13)               | 1,525             | (15)               |
| Mortgage-backed securities -<br>residential .....             | 141,024             | (3,735)            | 27,026            | (1,349)            | 168,050           | (5,084)            |
| Collateralized mortgage obligations.....                      | 5,283               | (450)              | 15,726            | (1,263)            | 21,009            | (1,713)            |
| Small business administration.....                            | 6,927               | (491)              | 16,520            | (1,529)            | 23,447            | (2,020)            |
| Equity securities .....                                       | 7                   | 0                  | 0                 | 0                  | 7                 | 0                  |
| Total temporarily impaired.....                               | <u>\$ 209,920</u>   | <u>\$ (6,920)</u>  | <u>\$ 67,237</u>  | <u>\$ (5,106)</u>  | <u>\$ 277,157</u> | <u>\$ (12,026)</u> |

| 2012<br>Description of Securities                          | Less than 12 Months |                 | 12 Months or More |                 | Total             |                 |
|------------------------------------------------------------|---------------------|-----------------|-------------------|-----------------|-------------------|-----------------|
|                                                            | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value        | Unrealized Loss |
| U.S. Treasury and U.S. government sponsored entities ..... | \$ 5,490            | \$ (1)          | \$ 0              | \$ 0            | \$ 5,490          | \$ (1)          |
| State and political subdivisions .....                     | 12,079              | (245)           | 0                 | 0               | 12,079            | (245)           |
| Corporate bonds .....                                      | 887                 | (7)             | 0                 | 0               | 887               | (7)             |
| Mortgage-backed securities - residential .....             | 97,598              | (476)           | 52                | 0               | 97,650            | (476)           |
| Collateralized mortgage obligations.....                   | 23,132              | (74)            | 0                 | 0               | 23,132            | (74)            |
| Small business administration .....                        | 7,853               | (62)            | 37                | 0               | 7,890             | (62)            |
| Equity securities .....                                    | 0                   | 0               | 8                 | (5)             | 8                 | (5)             |
| Total temporarily impaired .....                           | <u>\$ 147,039</u>   | <u>\$ (865)</u> | <u>\$ 97</u>      | <u>\$ (5)</u>   | <u>\$ 147,136</u> | <u>\$ (870)</u> |

The Company's equity securities include local and regional bank holdings. During the year ended December 31, 2013 a \$3 thousand pre-tax charge was recognized for the other-than-temporary decline in fair value on these equity holdings. The Company recognized an other-than-temporary impairment that was less than \$1 thousand and rounded to zero for year ended December 31, 2012. The Company recognized an \$ 11 thousand other-than-temporary impairment for the year ended December 31, 2011. When a decline in fair value below cost is deemed to be other-than-temporary, the difference between the amortized cost basis of the equity security and its fair value must be recognized as a charge to earnings.

As of December 31, 2013, the Company's security portfolio consisted of 414 securities, 124 of which were in an unrealized loss position. The majority of unrealized losses are related to the Company's holdings in securities issued by state and political subdivisions, mortgage-backed securities—residential, collateralized mortgage obligations and small business administration, as discussed below:

#### Securities issued by State and Political subdivisions

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

#### Mortgage-backed securities—residential

All of the Company's holdings of mortgage-backed securities—residential at year end 2013 and 2012 were issued by U.S. Government sponsored enterprises. Unrealized losses on mortgage-backed securities—residential have not been recognized into income. Because the decline in fair value is attributable to changes in interest rates and illiquidity, and not credit quality, and because the Company does not have the intent to sell these mortgage-backed securities—residential and it is likely that it will not be required to sell the securities before their anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired at December 31, 2013.

#### Collateralized mortgage obligations

The Company's portfolio includes collateralized mortgage obligations issued by U.S. Government sponsored enterprises. The decline in fair value is attributable to changes in interest rates and illiquidity, and not credit quality. The Company does not have the intent to sell these collateralized mortgage obligations and it is likely that it will not be required to sell the securities before their anticipated recovery. The Company monitors all securities to insure adequate credit support and as of December 31, 2013, the Company believes there is no other-than-temporarily impairment.

#### Small business administration

The Company's holdings of small business administration securities are issued and backed by the full faith and credit of the U.S. Government. Unrealized losses on these small business administration securities have not been recognized into income. Because the decline in fair value is attributable to changes in interest rates and illiquidity, and not credit quality, and because the Company does not have the intent to sell these securities and it is likely that it will not be required to sell the securities before their anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired at December 31, 2013.

### NOTE 3 LOANS

Loans at year end were as follows:

|                                     | 2013              | 2012              |
|-------------------------------------|-------------------|-------------------|
| Commercial real estate              |                   |                   |
| Owner occupied.....                 | \$ 86,286         | \$ 95,208         |
| Non-owner occupied.....             | 107,625           | 83,405            |
| Other .....                         | 24,381            | 22,729            |
| Commercial .....                    | 105,023           | 97,112            |
| Residential real estate             |                   |                   |
| 1-4 family residential.....         | 144,225           | 132,665           |
| Home equity lines of credit .....   | 26,448            | 24,110            |
| Consumer                            |                   |                   |
| Indirect.....                       | 121,446           | 116,471           |
| Direct .....                        | 10,237            | 11,160            |
| Other .....                         | 3,031             | 1,767             |
| Subtotal .....                      | 628,702           | 584,627           |
| Net deferred loan (fees) costs..... | 1,982             | 1,965             |
| Allowance for loan losses .....     | (7,568)           | (7,629)           |
| Net loans .....                     | <u>\$ 623,116</u> | <u>\$ 578,963</u> |

The following table presents the activity in the allowance for loan losses by portfolio segment for years ended December 31, 2013, 2012 and 2011:

#### December 31, 2013

|                                     | Commercial<br>Real Estate | Commercial      | Residential<br>Real Estate | Consumer        | Unallocated   | Total           |
|-------------------------------------|---------------------------|-----------------|----------------------------|-----------------|---------------|-----------------|
| Allowance for loan losses           |                           |                 |                            |                 |               |                 |
| Beginning balance.....              | \$ 3,392                  | \$ 1,453        | \$ 1,569                   | \$ 951          | \$ 264        | \$ 7,629        |
| Provision for loan losses .....     | (306)                     | (397)           | 674                        | 1,369           | (50)          | 1,290           |
| Loans charged off.....              | (505)                     | (99)            | (326)                      | (1,723)         | 0             | (2,653)         |
| Recoveries .....                    | 171                       | 262             | 47                         | 822             | 0             | 1,302           |
| Total ending allowance balance..... | <u>\$ 2,752</u>           | <u>\$ 1,219</u> | <u>\$ 1,964</u>            | <u>\$ 1,419</u> | <u>\$ 214</u> | <u>\$ 7,568</u> |

#### December 31, 2012

|                                     | Commercial<br>Real Estate | Commercial      | Residential<br>Real Estate | Consumer      | Unallocated   | Total           |
|-------------------------------------|---------------------------|-----------------|----------------------------|---------------|---------------|-----------------|
| Allowance for loan losses           |                           |                 |                            |               |               |                 |
| Beginning balance .....             | \$ 4,880                  | \$ 1,529        | \$ 1,802                   | \$ 972        | \$ 637        | \$ 9,820        |
| Provision for loan losses .....     | (516)                     | 792             | 469                        | 353           | (373)         | 725             |
| Loans charged off.....              | (1,225)                   | (918)           | (806)                      | (1,002)       | 0             | (3,951)         |
| Recoveries .....                    | 253                       | 50              | 104                        | 628           | 0             | 1,035           |
| Total ending allowance balance..... | <u>\$ 3,392</u>           | <u>\$ 1,453</u> | <u>\$ 1,569</u>            | <u>\$ 951</u> | <u>\$ 264</u> | <u>\$ 7,629</u> |

#### December 31, 2011

|                                     | Commercial<br>Real Estate | Commercial      | Residential<br>Real Estate | Consumer      | Unallocated   | Total           |
|-------------------------------------|---------------------------|-----------------|----------------------------|---------------|---------------|-----------------|
| Allowance for loan losses           |                           |                 |                            |               |               |                 |
| Beginning balance .....             | \$ 5,780                  | \$ 1,707        | \$ 881                     | \$ 875        | \$ 64         | \$ 9,307        |
| Provision for loan losses .....     | 302                       | 197             | 2,205                      | 373           | 573           | 3,650           |
| Loans charged off.....              | (1,246)                   | (414)           | (1,736)                    | (1,125)       | 0             | (4,521)         |
| Recoveries .....                    | 44                        | 39              | 452                        | 849           | 0             | 1,384           |
| Total ending allowance balance..... | <u>\$ 4,880</u>           | <u>\$ 1,529</u> | <u>\$ 1,802</u>            | <u>\$ 972</u> | <u>\$ 637</u> | <u>\$ 9,820</u> |

The Company changed its methodology for estimating the allowance for probable incurred loan losses during 2012. Management computed the historical loss percentage based upon the loss history of the past 12 quarters. In previous years, management used a historical loss percentage based on the past 8 quarters. Using a 12 quarter loss history resulted in a larger historical loss ratio than what would have been computed using an 8 quarter history. The Company believes that using a 12 quarter loss history helps mitigate volatility in the timing of charge-offs and better reflects probable incurred losses.

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

#### December 31, 2013

|                                                   | Commercial<br>Real Estate | Commercial        | Residential<br>Real Estate | Consumer         | Unallocated   | Total            |
|---------------------------------------------------|---------------------------|-------------------|----------------------------|------------------|---------------|------------------|
| Allowance for loan losses:                        |                           |                   |                            |                  |               |                  |
| Ending allowance balance attributable to loans:   |                           |                   |                            |                  |               |                  |
| Individually evaluated for impairment .....       | \$ 166                    | \$ 110            | \$ 202                     | \$ 82            | \$ 0          | \$ 560           |
| Collectively evaluated for impairment .....       | 2,586                     | 1,109             | 1,762                      | 1,337            | 214           | 7,008            |
| Total ending allowance balance .....              | <u>\$ 2,752</u>           | <u>\$ 1,219</u>   | <u>\$ 1,964</u>            | <u>\$ 1,419</u>  | <u>\$ 214</u> | <u>\$ 7,568</u>  |
| Loans:                                            |                           |                   |                            |                  |               |                  |
| Loans individually evaluated for impairment ..... | \$ 6,623                  | \$ 2,430          | \$ 2,554                   | \$ 363           | \$ 0          | \$ 11,970        |
| Loans collectively evaluated for impairment ..... | 210,739                   | 102,593           | 167,597                    | 137,785          | 0             | 618,714          |
| Total ending loans balance .....                  | <u>\$ 217,362</u>         | <u>\$ 105,023</u> | <u>\$170,151</u>           | <u>\$138,148</u> | <u>\$ 0</u>   | <u>\$630,684</u> |

#### December 31, 2012

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

The following table presents information related to impaired loans by class of loans as of and for year ended December 31, 2013, 2012 and 2011. The recorded investment in loans excludes accrued interest receivable due to immateriality.

| <b>December 31, 2013</b>            | <u>Unpaid Principal<br/>Balance</u> | <u>Recorded<br/>Investment</u> | <u>Allowance for<br/>Loan Losses<br/>Allocated</u> | <u>Average<br/>Recorded<br/>Investment</u> | <u>Interest<br/>Income<br/>Recognized</u> |
|-------------------------------------|-------------------------------------|--------------------------------|----------------------------------------------------|--------------------------------------------|-------------------------------------------|
| With no related allowance recorded: |                                     |                                |                                                    |                                            |                                           |
| Commercial real estate .....        |                                     |                                |                                                    |                                            |                                           |
| Owner occupied .....                | \$ 4,302                            | \$ 3,762                       | \$ 0                                               | \$ 2,643                                   | \$ 137                                    |
| Non-owner occupied .....            | 491                                 | 389                            | 0                                                  | 438                                        | 0                                         |
| Other .....                         | 0                                   | 0                              | 0                                                  | 0                                          | 0                                         |
| Commercial .....                    | 1,007                               | 971                            | 0                                                  | 1,363                                      | 25                                        |
| Residential real estate .....       |                                     |                                |                                                    |                                            |                                           |
| 1-4 family residential .....        | 1,026                               | 961                            | 0                                                  | 1,462                                      | 51                                        |
| Home equity lines of credit .....   | 107                                 | 99                             |                                                    | 194                                        | 0                                         |
| Consumer .....                      | 111                                 | 112                            | 0                                                  | 9                                          | 0                                         |
| Subtotal .....                      | <u>7,044</u>                        | <u>6,294</u>                   | <u>0</u>                                           | <u>6,109</u>                               | <u>213</u>                                |
| With an allowance recorded:         |                                     |                                |                                                    |                                            |                                           |
| Commercial real estate .....        |                                     |                                |                                                    |                                            |                                           |
| Owner occupied .....                | 886                                 | 884                            | 91                                                 | 2,536                                      | 39                                        |
| Non-owner occupied .....            | 1,593                               | 1,588                          | 75                                                 | 1,975                                      | 87                                        |
| Other .....                         | 0                                   | 0                              | 0                                                  | 0                                          | 0                                         |
| Commercial .....                    | 1,462                               | 1,459                          | 110                                                | 594                                        | 5                                         |
| Residential real estate .....       |                                     |                                |                                                    |                                            |                                           |
| 1-4 family residential .....        | 1,458                               | 1,347                          | 190                                                | 112                                        | 48                                        |
| Home equity lines of credit .....   | 148                                 | 147                            | 12                                                 | 12                                         | 0                                         |
| Consumer .....                      | 247                                 | 251                            | 82                                                 | 21                                         | 0                                         |
| Subtotal .....                      | <u>5,794</u>                        | <u>5,676</u>                   | <u>560</u>                                         | <u>5,250</u>                               | <u>179</u>                                |
| Total                               | <u>\$ 12,838</u>                    | <u>\$ 11,970</u>               | <u>\$ 560</u>                                      | <u>\$ 11,359</u>                           | <u>\$ 392</u>                             |

During 2013 the Company, for the first time, began considering consumer loans individually for impairment. Interest income recognized and cash basis interest recognized was not materially different for 2013.

| <b>December 31, 2012</b>            | <u>Unpaid Principal<br/>Balance</u> | <u>Recorded<br/>Investment</u> | <u>Allowance for<br/>Loan Losses<br/>Allocated</u> | <u>Average<br/>Recorded<br/>Investment</u> |
|-------------------------------------|-------------------------------------|--------------------------------|----------------------------------------------------|--------------------------------------------|
| With no related allowance recorded: |                                     |                                |                                                    |                                            |
| Commercial real estate .....        |                                     |                                |                                                    |                                            |
| Owner occupied .....                | \$ 3,916                            | \$ 3,481                       | \$ 0                                               | \$ 1,490                                   |
| Non-owner occupied .....            | 560                                 | 461                            | 0                                                  | 483                                        |
| Other .....                         | 0                                   | 0                              | 0                                                  | 114                                        |
| Commercial .....                    | 1,250                               | 1,192                          | 0                                                  | 1,075                                      |
| Residential real estate .....       |                                     |                                |                                                    |                                            |
| 1-4 family residential .....        | 971                                 | 989                            | 0                                                  | 747                                        |
| Subtotal .....                      | <u>6,697</u>                        | <u>6,123</u>                   | <u>0</u>                                           | <u>3,909</u>                               |
| With an allowance recorded:         |                                     |                                |                                                    |                                            |
| Commercial real estate .....        |                                     |                                |                                                    |                                            |
| Owner occupied .....                | 2,207                               | 2,169                          | 59                                                 | 3,859                                      |
| Non-owner occupied .....            | 2,560                               | 2,424                          | 70                                                 | 2,402                                      |
| Other .....                         | 0                                   | 0                              | 0                                                  | 119                                        |
| Commercial .....                    | 948                                 | 660                            | 51                                                 | 478                                        |
| Subtotal .....                      | <u>5,715</u>                        | <u>5,253</u>                   | <u>180</u>                                         | <u>6,858</u>                               |
| Total .....                         | <u>\$ 12,412</u>                    | <u>\$ 11,376</u>               | <u>\$ 180</u>                                      | <u>\$ 10,767</u>                           |

| December 31, 2011                           | Unpaid Principal<br>Balance | Recorded<br>Investment | Allowance for<br>Loan Losses<br>Allocated | Average<br>Recorded<br>Investment |
|---------------------------------------------|-----------------------------|------------------------|-------------------------------------------|-----------------------------------|
| With no related allowance recorded:         |                             |                        |                                           |                                   |
| Commercial real estate Owner occupied ..... | \$ 884                      | \$ 762                 | \$ 0                                      | \$ 844                            |
| Non-owner occupied .....                    | 430                         | 340                    | 0                                         | 443                               |
| Other .....                                 | 800                         | 590                    | 0                                         | 767                               |
| Commercial .....                            | 1,122                       | 1,063                  | 0                                         | 1,203                             |
| Residential real estate .....               |                             |                        |                                           |                                   |
| 1-4 family residential .....                | 695                         | 697                    | 0                                         | 697                               |
| Subtotal .....                              | 3,931                       | 3,452                  | 0                                         | 3,954                             |
| With an allowance recorded:                 |                             |                        |                                           |                                   |
| Commercial real estate Owner occupied ..... | 4,721                       | 4,169                  | 309                                       | 4,316                             |
| Non-owner occupied .....                    | 2,455                       | 2,456                  | 439                                       | 2,883                             |
| Commercial .....                            | 278                         | 278                    | 237                                       | 296                               |
| Subtotal .....                              | 7,454                       | 6,903                  | 985                                       | 7,495                             |
| Total .....                                 | <u>\$ 11,385</u>            | <u>\$ 10,355</u>       | <u>\$ 985</u>                             | <u>\$ 11,449</u>                  |

Interest income recognized during impairment for both 2012 and 2011 periods was immaterial.

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

|                                   | Nonaccrual      |                 | Loans Past Due over 90 Days<br>Still Accruing |               |
|-----------------------------------|-----------------|-----------------|-----------------------------------------------|---------------|
|                                   | 2013            | 2012            | 2013                                          | 2012          |
| Commercial real estate            |                 |                 |                                               |               |
| Owner occupied .....              | \$ 2,806        | \$ 3,116        | \$ 0                                          | \$ 0          |
| Non-owner occupied .....          | 405             | 799             | 0                                             | 0             |
| Other .....                       | 0               | 0               | 0                                             | 0             |
| Commercial .....                  | 1,993           | 1,081           | 13                                            | 0             |
| Residential real estate           |                 |                 |                                               |               |
| 1-4 family residential .....      | 2,584           | 2,342           | 526                                           | 197           |
| Home equity lines of credit ..... | 280             | 294             | 0                                             | 236           |
| Consumer                          |                 |                 |                                               |               |
| Indirect .....                    | 308             | 0               | 94                                            | 143           |
| Direct .....                      | 55              | 0               | 3                                             | 19            |
| Other .....                       | 0               | 0               | 10                                            | 1             |
| Total .....                       | <u>\$ 8,431</u> | <u>\$ 7,632</u> | <u>\$ 646</u>                                 | <u>\$ 596</u> |

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

|                                   | 30-59<br>Days Past<br>Due | 60-89<br>Days Past<br>Due | Greater<br>than 90<br>Days Past<br>Due and<br>Nonaccrual | Total Past<br>Due | Loans Not<br>Past Due | Total            |
|-----------------------------------|---------------------------|---------------------------|----------------------------------------------------------|-------------------|-----------------------|------------------|
| <b>December 31, 2013</b>          |                           |                           |                                                          |                   |                       |                  |
| Commercial real estate            |                           |                           |                                                          |                   |                       |                  |
| Owner occupied.....               | \$ 48                     | \$ 0                      | \$ 2,806                                                 | \$ 2,854          | \$ 83,065             | \$ 85,919        |
| Non-owner occupied .....          | 0                         | 0                         | 405                                                      | 405               | 106,762               | 107,167          |
| Other.....                        | 0                         | 0                         | 0                                                        | 0                 | 24,276                | 24,276           |
| Commercial.....                   | 14                        | 0                         | 2,006                                                    | 2,020             | 103,003               | 105,023          |
| Residential real estate           |                           |                           |                                                          |                   |                       |                  |
| 1-4 family residential .....      | 573                       | 141                       | 3,110                                                    | 3,824             | 139,879               | 143,703          |
| Home equity lines of credit ..... | 35                        | 0                         | 280                                                      | 315               | 26,133                | 26,448           |
| Consumer                          |                           |                           |                                                          |                   |                       |                  |
| Indirect .....                    | 2,004                     | 539                       | 402                                                      | 2,945             | 121,935               | 124,880          |
| Direct.....                       | 204                       | 31                        | 58                                                       | 293               | 9,944                 | 10,237           |
| Other.....                        | 63                        | 6                         | 10                                                       | 79                | 2,952                 | 3,031            |
| Total.....                        | <u>\$ 2,941</u>           | <u>\$ 717</u>             | <u>\$ 9,077</u>                                          | <u>\$ 12,735</u>  | <u>\$617,949</u>      | <u>\$630,684</u> |
|                                   |                           |                           |                                                          |                   |                       |                  |
|                                   | 30-59<br>Days Past<br>Due | 60-89<br>Days Past<br>Due | Greater<br>than 90<br>Days Past<br>Due and<br>Nonaccrual | Total Past<br>Due | Loans Not<br>Past Due | Total            |
| <b>December 31, 2012</b>          |                           |                           |                                                          |                   |                       |                  |
| Commercial real estate            |                           |                           |                                                          |                   |                       |                  |
| Owner occupied .....              | \$ 259                    | \$ 0                      | \$ 3,116                                                 | \$ 3,375          | \$ 91,506             | \$ 94,881        |
| Non-owner occupied .....          | 0                         | 0                         | 799                                                      | 799               | 82,320                | 83,119           |
| Other.....                        | 0                         | 0                         | 0                                                        | 0                 | 22,651                | 22,651           |
| Commercial.....                   | 233                       | 15                        | 1,081                                                    | 1,329             | 95,783                | 97,112           |
| Residential real estate           |                           |                           |                                                          |                   |                       |                  |
| 1-4 family residential .....      | 718                       | 352                       | 2,539                                                    | 3,609             | 128,463               | 132,072          |
| Home equity lines of credit ..... | 183                       | 82                        | 530                                                      | 795               | 23,315                | 24,110           |
| Consumer                          |                           |                           |                                                          |                   |                       |                  |
| Indirect .....                    | 1,351                     | 319                       | 143                                                      | 1,813             | 117,907               | 119,720          |
| Direct.....                       | 144                       | 18                        | 19                                                       | 181               | 10,979                | 11,160           |
| Other.....                        | 15                        | 13                        | 1                                                        | 29                | 1,738                 | 1,767            |
| Total.....                        | <u>\$ 2,903</u>           | <u>\$ 799</u>             | <u>\$ 8,228</u>                                          | <u>\$ 11,930</u>  | <u>\$574,662</u>      | <u>\$586,592</u> |

#### Troubled Debt Restructurings:

Total troubled debt restructurings were \$8.3 million and \$7.6 million at December 31, 2013 and 2012 respectively. The Company has allocated \$397 thousand and \$155 thousand of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2013 and 2012. There are \$16 thousand in commitments to lend additional amounts to borrowers with loans that were classified as troubled debt restructurings at December 31, 2013. There were no commitments at December 31, 2012.

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

Troubled debt restructuring modifications involved a reduction of the notes stated interest rate in the range of .025% and 3.25%. There were also extensions of the maturity dates on these and other troubled debt restructurings in the range of three months to 126 months.

The following table presents loans by class modified as troubled debt restructurings that occurred during the year ending December 31, 2013:

|                                   | Number of<br>Loans | Pre-<br>Modification Outstanding<br>Recorded Investment | Post-<br>Modification Outstanding<br>Recorded Investment |
|-----------------------------------|--------------------|---------------------------------------------------------|----------------------------------------------------------|
| Troubled Debt Restructurings:     |                    |                                                         |                                                          |
| Commercial real estate .....      |                    |                                                         |                                                          |
| Owner occupied .....              | 2                  | \$ 226                                                  | \$ 239                                                   |
| Non-owner occupied .....          | 0                  | 0                                                       | 0                                                        |
| Commercial .....                  | 5                  | 649                                                     | 682                                                      |
| Residential real estate           |                    |                                                         |                                                          |
| 1-4 family residential .....      | 4                  | 131                                                     | 98                                                       |
| Home equity lines of credit ..... | 5                  | 214                                                     | 214                                                      |
| Indirect .....                    | 24                 | 188                                                     | 188                                                      |
| Consumer .....                    | 1                  | 1                                                       | 1                                                        |
| Total .....                       | <u>41</u>          | <u>\$ 1,409</u>                                         | <u>\$ 1,422</u>                                          |

The following table presents loans by class modified as troubled debt restructurings that occurred during the year ending December 31, 2012:

|                               | Number of<br>Loans | Pre-<br>Modification Outstanding<br>Recorded Investment | Post-<br>Modification Outstanding<br>Recorded Investment |
|-------------------------------|--------------------|---------------------------------------------------------|----------------------------------------------------------|
| Troubled Debt Restructurings: |                    |                                                         |                                                          |
| Commercial real estate .....  |                    |                                                         |                                                          |
| Owner occupied .....          | 3                  | \$ 1,143                                                | \$ 1,166                                                 |
| Non-owner occupied .....      | 3                  | 2,376                                                   | 2,419                                                    |
| Commercial .....              | 3                  | 1,072                                                   | 1,098                                                    |
| Residential real estate ..... |                    |                                                         |                                                          |
| 1-4 family residential .....  | 7                  | 508                                                     | 540                                                      |
| Total .....                   | <u>16</u>          | <u>\$ 5,099</u>                                         | <u>\$ 5,223</u>                                          |

There were \$50 thousand and \$418 thousand in charge offs and a \$66 thousand increase and \$306 thousand decrease in the allowance for loan losses as a result of the allowance adjustment due to the troubled debt restructurings described above at December 31, 2013 and December 31, 2012, respectively.

There were two commercial loans for \$204 thousand, one commercial real estate loan for \$205 thousand and one residential real estate loan for \$35 thousand modified as troubled debt restructuring for which there were payment defaults within twelve months following the modification during the year ending December 31, 2013. All four loans were past due at December 31, 2013. There was one indirect loan modified as troubled debt restructuring for which there were payment defaults within twelve months following the modification during the year ending December 31, 2013. The loan was not past due at December 31, 2013. There was no additional provision or any impact to the allowance for losses associated with these loans. A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

There were no loans that were modified as troubled debt restructuring for which there was a payment default within twelve months following the modification during the year ending December 31, 2012.

## Credit Quality Indicators:

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

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

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

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

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

Based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| December 31, 2013        | Pass             | Special<br>Mention | Sub-<br>standard | Doubtful    | Not Rated   | Total            |
|--------------------------|------------------|--------------------|------------------|-------------|-------------|------------------|
| Commercial real estate   |                  |                    |                  |             |             |                  |
| Owner occupied .....     | \$ 72,398        | \$ 7,312           | \$ 6,209         | \$ 0        | \$ 0        | \$ 85,919        |
| Non-owner occupied ..... | 96,065           | 7,877              | 3,225            | 0           | 0           | 107,167          |
| Other .....              | 23,935           | 0                  | 341              | 0           | 0           | 24,276           |
| Commercial .....         | 99,022           | 2,313              | 3,688            | 0           | 0           | 105,023          |
| Total .....              | <u>\$291,420</u> | <u>\$ 17,502</u>   | <u>\$ 13,463</u> | <u>\$ 0</u> | <u>\$ 0</u> | <u>\$322,385</u> |

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

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

| December 31, 2013   | Residential Real Estate   |                                | Consumer          |                  |                 |
|---------------------|---------------------------|--------------------------------|-------------------|------------------|-----------------|
|                     | 1-4 Family<br>Residential | Home Equity<br>Lines of Credit | Indirect          | Direct           | Other           |
| Performing .....    | \$ 140,593                | \$ 26,168                      | \$ 124,478        | \$ 10,179        | \$ 3,021        |
| Nonperforming ..... | 3,110                     | 280                            | 402               | 58               | 10              |
| Total .....         | <u>\$ 143,703</u>         | <u>\$ 26,448</u>               | <u>\$ 124,880</u> | <u>\$ 10,237</u> | <u>\$ 3,031</u> |

December 31, 2012

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

#### NOTE 4 - FAIR VALUE

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

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

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

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

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

##### Investment Securities

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

##### Derivative Instruments

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

##### Impaired Loans

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

## Other Real Estate Owned

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

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

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

| Fair Value Measurements at<br>December 31, 2013 Using:         |                |                                                                            |                                                        |                                                    |
|----------------------------------------------------------------|----------------|----------------------------------------------------------------------------|--------------------------------------------------------|----------------------------------------------------|
|                                                                | Carrying Value | Quoted Prices<br>in Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Financial Assets</b>                                        |                |                                                                            |                                                        |                                                    |
| <b>Investment securities available-for sale</b>                |                |                                                                            |                                                        |                                                    |
| U.S Treasury and U.S. government sponsored entities...         | \$ 51,310      | \$ 0                                                                       | \$ 51,310                                              | \$ 0                                               |
| State and political subdivisions .....                         | 94,734         | 0                                                                          | 94,734                                                 | 0                                                  |
| Corporate bonds .....                                          | 1,525          | 0                                                                          | 1,525                                                  | 0                                                  |
| Mortgage-backed securities-residential .....                   | 222,980        | 0                                                                          | 222,970                                                | 10                                                 |
| Collateralized mortgage obligations .....                      | 28,676         | 0                                                                          | 28,676                                                 | 0                                                  |
| Small business administration .....                            | 23,573         | 0                                                                          | 23,573                                                 | 0                                                  |
| Equity securities .....                                        | 187            | 187                                                                        | 0                                                      | 0                                                  |
| Total investment securities .....                              | \$ 422,985     | \$ 187                                                                     | \$ 422,788                                             | \$ 10                                              |
| Yield maintenance provisions .....                             | \$ 275         | \$ 0                                                                       | \$ 275                                                 | \$ 0                                               |
| <b>Financial Liabilities</b>                                   |                |                                                                            |                                                        |                                                    |
| Interest rate swaps .....                                      | \$ 275         | \$ 0                                                                       | \$ 275                                                 | \$ 0                                               |
| <b>Fair Value Measurements at<br/>December 31, 2012 Using:</b> |                |                                                                            |                                                        |                                                    |
|                                                                | Carrying Value | Quoted Prices<br>in Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Financial Assets</b>                                        |                |                                                                            |                                                        |                                                    |
| <b>Investment securities available-for sale</b>                |                |                                                                            |                                                        |                                                    |
| U.S Treasury and U.S. government sponsored entities...         | \$ 67,978      | \$ 0                                                                       | \$ 67,978                                              | \$ 0                                               |
| State and political subdivisions .....                         | 95,288         | 0                                                                          | 95,288                                                 | 0                                                  |
| Corporate bonds .....                                          | 2,128          | 0                                                                          | 2,128                                                  | 0                                                  |
| Mortgage-backed securities-residential .....                   | 236,218        | 0                                                                          | 236,207                                                | 11                                                 |
| Collateralized mortgage obligations .....                      | 40,595         | 0                                                                          | 40,595                                                 | 0                                                  |
| Small business administration .....                            | 21,444         | 0                                                                          | 21,444                                                 | 0                                                  |
| Equity securities .....                                        | 437            | 437                                                                        | 0                                                      | 0                                                  |
| Total investment securities .....                              | \$ 464,088     | \$ 437                                                                     | \$ 463,640                                             | \$ 11                                              |
| Yield maintenance provisions .....                             | \$ 120         | \$ 0                                                                       | \$ 120                                                 | \$ 0                                               |
| <b>Financial Liabilities</b>                                   |                |                                                                            |                                                        |                                                    |
| Interest rate swaps .....                                      | \$ 120         | \$ 0                                                                       | \$ 120                                                 | \$ 0                                               |

There were no significant transfers between Level 1 and Level 2 during 2013 or 2012.

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period ended December 31:

|                                                         | Mortgage-Backed<br>Securities - Residential<br>(Level 3) |              |              |
|---------------------------------------------------------|----------------------------------------------------------|--------------|--------------|
|                                                         | 2013                                                     | 2012         | 2011         |
| Balance of recurring Level 3 assets at January 1.....   | \$ 11                                                    | \$ 12        | \$ 12        |
| Total unrealized gains or losses:                       |                                                          |              |              |
| Included in other comprehensive income.....             | 0                                                        | 0            | 0            |
| Repayments .....                                        | (1)                                                      | (1)          | 0            |
| Transfers in and/or out of Level 3.....                 | 0                                                        | 0            | 0            |
| Balance of recurring Level 3 assets at December 31..... | <u>\$ 10</u>                                             | <u>\$ 11</u> | <u>\$ 12</u> |

There is no impact to earnings as a result of fair value measurements on items valued on a recurring basis, using level 3 inputs.

### Assets Measured on a Non-Recurring Basis

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

|                                   | Carrying Value | Fair Value Measurements at<br>December 31, 2013 Using:                     |                                                        |                                                    |
|-----------------------------------|----------------|----------------------------------------------------------------------------|--------------------------------------------------------|----------------------------------------------------|
|                                   |                | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial Assets                  |                |                                                                            |                                                        |                                                    |
| Impaired loans                    |                |                                                                            |                                                        |                                                    |
| Commercial real estate            |                |                                                                            |                                                        |                                                    |
| Owner occupied .....              | \$ 962         | \$ 0                                                                       | \$ 0                                                   | \$ 962                                             |
| Non-owner occupied.....           | 391            | 0                                                                          | 0                                                      | 391                                                |
| Other .....                       | 0              | 0                                                                          | 0                                                      | 0                                                  |
| Commercial .....                  | 1,575          | 0                                                                          | 0                                                      | 1,575                                              |
| 1-4 family residential .....      | 577            | 0                                                                          | 0                                                      | 577                                                |
| Home equity lines of credit ..... | 174            | 0                                                                          | 0                                                      | 174                                                |
| Consumer indirect .....           | 142            | 0                                                                          | 0                                                      | 142                                                |
| Consumer direct .....             | 22             | 0                                                                          | 0                                                      | 22                                                 |
| Other real estate owned           |                |                                                                            |                                                        |                                                    |
| 1-4 family residential .....      | 33             | 0                                                                          | 0                                                      | 33                                                 |

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

Impaired loans carried at fair value that are measured for impairment using the fair value of the collateral had a principal balance of \$4.2 million, with a valuation allowance of \$363 thousand at December 31, 2013, resulting in an additional provision for loan losses of \$916 thousand for the year ending December 31, 2013. At December 31, 2012, impaired loans had a carrying amount of \$2.6 million, with a valuation allowance of \$25 thousand. Loans measured at fair value throughout the year resulted in an additional provision for loan losses of \$997 thousand for the year ending December 31, 2012. Excluded from the fair value of impaired loans, at December 31, 2013 and 2012, discussed above are \$3.0 million and \$4.3 million of loans with specific allowance amounts allocated and classified as troubled debt restructurings and measured using the present value of discounted cash flows, which are not carried at fair value.

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

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

| <b>December 31, 2013</b>     | <u>Fair value</u> | <u>Valuation Technique(s)</u> | <u>Unobservable Input(s)</u>                        | <u>Range (Weighted Average)</u> |
|------------------------------|-------------------|-------------------------------|-----------------------------------------------------|---------------------------------|
| Impaired loans               |                   |                               |                                                     |                                 |
| Commercial real estate ..... | \$ 1,237          | Sales comparison              | Adjustment for differences between comparable sales | -41.59% - 77.25% (-7.82%)       |
|                              | 116               | Income approach               | Adjustment for differences in net operating income  | -13.64% - 12.93% (-5.96%)       |
| Commercial .....             | 1,575             | Sales comparison              | Adjustment for differences between comparable sales | -25.56% - 33.03% (17.42%)       |
| Residential .....            | 751               | Sales comparison              | Adjustment for differences between comparable sales | -46.81% - 23.45% (-7.00%)       |
| Consumer.....                | 164               | Sales comparison              | Adjustment for differences between comparable sales | -29.00% - 29.00% (0.00%)        |
| <b>December 31, 2012</b>     | <u>Fair value</u> | <u>Valuation Technique(s)</u> | <u>Unobservable Input(s)</u>                        | <u>Range (Weighted Average)</u> |
| Impaired loans               |                   |                               |                                                     |                                 |
| Commercial real estate ..... | \$ 1,548          | Sales comparison              | Adjustment for differences between comparable sales | -11.30% - 14.12% (-4.38%)       |
|                              | 155               | Income approach               | Adjustment for differences in net operating income  | -28.36% - 19.40% (-5.47%)       |
| Commercial .....             | 869               | Sales comparison              | Adjustment for differences between comparable sales | -45.19% - 20.19% (27.05%)       |
| Residential .....            | 43                | Sales comparison              | Adjustment for differences between comparable sales | -46.81% - 23.45% (-36.40%)      |

Other real estate owned measured at fair value less costs to sell, had a net carrying amount of \$33 thousand at December 31, 2013. The Company sold six other real estate owned properties during the year ended December 31, 2013. The Company recorded \$21 thousand in write downs on three other real estate owned properties during the year ended December 31, 2013. At December 31, 2012, other real estate owned had a net carrying amount of \$57 thousand. During the year ended December 31, 2012 five properties were charged down reflecting updated appraisals which resulted in a write-down of \$97 thousand.

## Fair Value of Financial Instruments

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

|                                   |                    | Fair Value Measurements at December 31, 2013 Using: |           |         |           |
|-----------------------------------|--------------------|-----------------------------------------------------|-----------|---------|-----------|
|                                   | Carrying<br>Amount | Level 1                                             | Level 2   | Level 3 | Total     |
| Financial assets                  |                    |                                                     |           |         |           |
| Cash and cash equivalents .....   | \$ 27,513          | \$ 12,957                                           | \$ 14,556 | \$ 0    | \$ 27,513 |
| Restricted stock .....            | 4,224              | n/a                                                 | n/a       | n/a     | n/a       |
| Loans held for sale .....         | 158                | 0                                                   | 161       | 0       | 161       |
| Loans, net .....                  | 623,116            | 0                                                   | 0         | 623,875 | 623,875   |
| Accrued interest receivable ..... | 3,399              | 0                                                   | 1,844     | 1,555   | 3,399     |
| Financial liabilities             |                    |                                                     |           |         |           |
| Deposits .....                    | 915,216            | 688,470                                             | 228,116   | 0       | 916,586   |
| Short-term borrowings .....       | 81,617             | 0                                                   | 81,617    | 0       | 81,617    |
| Long-term borrowings .....        | 19,822             | 0                                                   | 20,526    | 0       | 20,526    |
| Accrued interest payable .....    | 447                | 2                                                   | 445       | 0       | 447       |
|                                   |                    | Fair Value Measurements at December 31, 2012 Using: |           |         |           |
|                                   | Carrying<br>Amount | Level 1                                             | Level 2   | Level 3 | Total     |
| Financial assets                  |                    |                                                     |           |         |           |
| Cash and cash equivalents .....   | \$ 37,759          | \$ 14,209                                           | \$ 23,550 | \$ 0    | \$ 37,759 |
| Restricted stock .....            | 4,224              | n/a                                                 | n/a       | n/a     | n/a       |
| Loans held for sale .....         | 3,624              | 0                                                   | 3,691     | 0       | 3,691     |
| Loans, net .....                  | 578,963            | 0                                                   | 0         | 586,359 | 586,359   |
| Accrued interest receivable ..... | 3,679              | 0                                                   | 2,051     | 1,628   | 3,679     |
| Financial liabilities             |                    |                                                     |           |         |           |
| Deposits .....                    | 919,009            | 683,660                                             | 240,830   | 0       | 924,490   |
| Short-term borrowings .....       | 79,886             | 0                                                   | 79,886    | 0       | 79,886    |
| Long-term borrowings .....        | 10,423             | 0                                                   | 11,690    | 0       | 11,690    |
| Accrued interest payable .....    | 479                | 2                                                   | 477       | 0       | 479       |

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

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

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

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

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

**Accrued Interest Receivable/Payable:** The carrying amounts of accrued interest receivable and payable approximate fair value resulting in a Level 1, Level 2, or Level 3 classification. The classification is the result of the association with securities, loans and deposits.

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

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

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

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

## **NOTE 5—PREMISES AND EQUIPMENT**

Year-end premises and equipment were as follows:

|                                        | 2013             | 2012             |
|----------------------------------------|------------------|------------------|
| Land .....                             | \$ 3,086         | \$ 3,223         |
| Buildings .....                        | 20,293           | 20,457           |
| Furniture, fixtures and equipment..... | 11,294           | 11,314           |
| Leasehold Improvements .....           | 254              | 248              |
|                                        | <u>34,927</u>    | <u>35,242</u>    |
| Less accumulated depreciation .....    | (17,740)         | (16,813)         |
| NET BOOK VALUE .....                   | <u>\$ 17,187</u> | <u>\$ 18,429</u> |

Depreciation expense was \$1.2 million for year ended December 31, 2013, \$1.2 million for year ended December 31, 2012, and \$1.1 million for the year ended December 31, 2011.

The Company purchased property located adjacent to its Canfield branch on South Broad Street in Canfield, for \$395 thousand. Management's plans for the property are to house some investment, insurance and mortgage lending activities. Possession took place in January 2014.

With declining branch transaction counts and banking trends driving customers towards online banking the decision was made to close two retail branch locations in Leetonia and Warren, Ohio. The two branches were closed on October 1, 2013. One property, valued at \$90 thousand, has been moved to Other Real Estate Owned while the other is still providing ATM service and remains in service as part of premises and equipment. The Company plans to actively market the properties for sale in the near future.

The Company leases certain branch properties under operating leases. Rent expense was \$302, \$265, and \$283 thousand for 2013, 2012 and 2011. In addition to rent expense, under the leases, common area maintenance and property taxes are paid and the amount can fluctuate according to the costs incurred. Rent commitments, before considering renewal options that generally are present, were as follows:

|                 |                 |
|-----------------|-----------------|
| 2014 .....      | \$ 229          |
| 2015 .....      | 166             |
| 2016 .....      | 102             |
| 2017 .....      | 110             |
| 2018 .....      | 114             |
| Thereafter..... | 380             |
| TOTAL.....      | <u>\$ 1,101</u> |

## NOTE 6—GOODWILL AND INTANGIBLE ASSETS

Goodwill associated with the Company's purchase of National Associates, Inc. in July of 2013 and Farmers Trust Company in 2009 totaled \$6.4 million at December 31, 2013 and \$3.7 million at December 31, 2012. The NAI acquisition is more fully described in Note 16. Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value, which is determined through a two-step impairment test. Step 1 includes the determination of the carrying value of the reporting units, including the existing goodwill and intangible assets, and estimating the fair value of the reporting units. The Company determined the fair value of the reporting units exceeded their carrying amount. If the carrying amount of a reporting unit exceeds its fair value, a second step to the impairment test is required.

### Acquired Intangible Assets

Acquired intangible assets were as follows at year end:

|                                        | 2013                        |                             | 2012                        |                             |
|----------------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                                        | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |
| Amortized intangible assets:           |                             |                             |                             |                             |
| Customer relationship intangibles..... | \$ 5,970                    | \$ (2,262)                  | \$ 3,990                    | \$ (1,667)                  |
| Non-compete contracts .....            | 370                         | (265)                       | 250                         | (250)                       |
| Trade name.....                        | 190                         | (14)                        | 0                           | 0                           |
| Total.....                             | <u>\$ 6,530</u>             | <u>\$ (2,541)</u>           | <u>\$ 4,240</u>             | <u>\$ (1,917)</u>           |

Aggregate amortization expense was \$624 thousand, \$409 thousand, and \$479 thousand for 2013, 2012, and 2011.

Estimated amortization expense for each of the next five years:

|                 |                 |
|-----------------|-----------------|
| 2014 .....      | \$ 767          |
| 2015 .....      | 667             |
| 2016 .....      | 580             |
| 2017 .....      | 494             |
| 2018 .....      | 410             |
| Thereafter..... | 1,071           |
| TOTAL.....      | <u>\$ 3,989</u> |

## NOTE 7 - INTEREST BEARING DEPOSITS

Time deposits of \$100 thousand or more were \$85.7 million and \$86.6 million at year-end 2013 and 2012.

Following is a summary of scheduled maturities of certificates of deposit during the years following December 31, 2013:

|                  |                   |
|------------------|-------------------|
| 2014.....        | 68,199            |
| 2015.....        | 84,689            |
| 2016.....        | 34,517            |
| 2017.....        | 16,148            |
| 2018.....        | 12,448            |
| Thereafter ..... | 10,745            |
| TOTAL .....      | <u>\$ 226,746</u> |

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

|                               | 2013              | 2012              |
|-------------------------------|-------------------|-------------------|
| Demand .....                  | \$ 124,660        | \$ 124,466        |
| Money Market.....             | 285,464           | 311,174           |
| Savings.....                  | 122,453           | 116,004           |
| Certificates of Deposit ..... | 226,746           | 235,349           |
| TOTAL .....                   | <u>\$ 759,323</u> | <u>\$ 786,993</u> |

#### **NOTE 8 - SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND OTHER SHORT-TERM BORROWINGS**

Securities sold under repurchase agreements are secured by the Bank's holdings of debt securities issued by U.S. government sponsored entities and agencies with a carrying amount of \$152.4 million and \$162.0 million at year ended 2013 and 2012.

Repurchase agreements are financing arrangements that mature within 89 days and usually overnight. 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 segregated safekeeping accounts at the Federal Reserve Bank and Farmers Trust Company. Information concerning securities sold under agreements to repurchase is summarized as follows:

|                                                | 2013       | 2012      | 2011       |
|------------------------------------------------|------------|-----------|------------|
| Average balance during the year .....          | \$ 90,951  | \$ 93,149 | \$ 112,635 |
| Average interest rate during the year.....     | 0.04%      | 0.08%     | 0.24%      |
| Maximum month-end balance during the year..... | \$ 100,462 | \$ 98,531 | \$ 137,234 |
| Weighted average year-end interest rate .....  | 0.06%      | 0.07%     | 0.23%      |
| Balance at year-end .....                      | \$ 75,267  | \$ 79,536 | \$ 96,988  |

The Bank has access to lines of credit amounting to \$24.5 million at two major domestic banks that are below prime rate. The lines and terms are periodically reviewed by the banks and are generally subject to withdrawal at their discretion. At December 31, 2013 the Bank had drawn \$6 million against these lines. The \$6 million was repaid during January of 2014. There were no borrowings under this line at December 31, 2012.

Farmers National Banc Corp has an unsecured \$1.5 million revolving line of credit. The line can be renewed annually. The outstanding balance was \$350 thousand at December 31, 2013 and 2012. The interest rate is prime with a floor of 4.5%. The interest rate at December 31, 2013 and 2012 was 4.5%.

#### **NOTE 9 - FEDERAL HOME LOAN BANK ADVANCES AND OTHER LONG-TERM BORROWINGS**

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

|                                                                                                                  | 2013             |                             | 2012             |                             |
|------------------------------------------------------------------------------------------------------------------|------------------|-----------------------------|------------------|-----------------------------|
|                                                                                                                  | Amount           | Weighted<br>Average<br>Rate | Amount           | Weighted<br>Average<br>Rate |
| Fixed-rate constant payment advances, at rates from 1.70% to 4.88%<br>for 2013 and 3.16% to 4.88% for 2012 ..... | \$ 9,822         | 1.74%                       | \$ 359           | 4.29%                       |
| Convertible and putable fixed-rate advances, at rates from 2.82% to<br>4.45% for 2013 and 2012 .....             | 10,000           | 3.64%                       | 10,000           | 3.64%                       |
| Total advances .....                                                                                             | <u>\$ 19,822</u> | <u>2.70%</u>                | <u>\$ 10,359</u> | <u>3.66%</u>                |

During 2013, the Bank received a fixed-rate FHLB advance in the amount of \$10 million with an annual 5% principal prepayment. At December 31, 2013, the Bank retains \$10 million of putable FHLB fixed-rate advances. The balance of these putable FHLB fixed-rate advances was also \$10 million at December 31, 2012. Should the FHLB elect the put, the Bank is required to repay the advance on that date without penalty.

Federal Home Loan Bank advances are secured by a blanket pledge of residential mortgage loans totaling \$104.4 million and \$95.2 million at year end 2013 and 2012. Based on this collateral the Bank is eligible to borrow an additional \$84.6 million at year end 2013. 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:     |                  |
| 2014.....        | \$ 1,544         |
| 2015.....        | 6,296            |
| 2016.....        | 1,176            |
| 2017.....        | 6,089            |
| 2018.....        | 1,007            |
| Thereafter ..... | 3,710            |
| TOTAL .....      | <u>\$ 19,822</u> |

During 2013 the Bank made the final payment on a note payable secured by real estate totaling \$64 thousand at December 31, 2012. This note carried a fixed interest rate of 7.50%.

#### NOTE 10 - 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 amounts of financial instruments with off-balance-sheet risk at year end were as follows:

|                                 | 2013          |                  | 2012          |                  |
|---------------------------------|---------------|------------------|---------------|------------------|
|                                 | Fixed<br>Rate | Variable<br>Rate | Fixed<br>Rate | Variable<br>Rate |
| Commitments to make loans ..... | \$ 4,373      | \$ 8,722         | \$ 1,172      | \$ 1,890         |
| Unused lines of credit.....     | \$ 87,562     | \$ 33,351        | \$ 33,258     | \$ 59,049        |

Commitments to make loans are generally made for periods of 30 days or less. The fixed rate loan commitments for 2013 have interest rates of 4.50% and mature between ten and twelve years. The fixed rate commitments for 2012 have interest rates ranging from 2.88% to 4.50% and all mature between ten and thirty years. Fixed rate unused lines of credit have interest rates ranging from 2.16% to 13.50% at December 31, 2013 and 3.25% to 18.00% at December 31, 2012.

Standby letters of credit are considered financial guarantees. The standby letters of credit have a contractual value of \$4.9 million in 2013 and \$3.8 million in 2012. The carrying amount of these items on the balance sheet is not material.

#### NOTE 11 - STOCK BASED COMPENSATION

During 2012, the Company, with the approval of shareholders, created the 2012 Equity Incentive Plan (the "Plan"). The Plan permits the award of up to 500 thousand shares to the Company's directors and employees to promote the Company's long-term financial success by motivating performance through long-term incentive compensation and to better align the interests of its employees with those of its shareholders. No share awards were issued during the years ended December 31, 2013 and 2012 under the Plan.

The Company's Stock Option Plan, which was shareholder-approved and has since expired, permitted the grant of share options to its directors, officers and employees for up to 375 thousand shares of common stock. Option awards were granted with an exercise price equal to the market price of the Company's common stock at the date of grant; those option awards have vesting periods of 5 years and have 10-year contractual terms. Option exercises are expected to be satisfied with either newly issued shares or treasury shares. The fair value of the Company's stock at December 31, 2013 and 2012 was less than or equal to the fair value option exercise price, therefore the outstanding and exercisable options had no intrinsic value.

The fair value of each option award is estimated on the date of grant using a closed form option valuation Black-Scholes model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Company's common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

There were no options granted or exercised under the Stock Option Plan during 2013, 2012 or 2011.

A summary of the stock option plan for year end 2013 is as follows:

|                                  | Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life |
|----------------------------------|--------|------------------------------------------|---------------------------------------------------------|
| Outstanding at end of year ..... | 5,000  | \$ 6.55                                  | 0.1                                                     |
| Exercisable at end of year ..... | 5,000  | \$ 6.55                                  | 0.1                                                     |

The weighted average remaining contractual life changed from 5.5 years at December 31, 2012 to 0.1 years at December 31, 2013 because the employee holding the 5,000 options was terminated in November 2013. Per the Stock Option Plan employees have three months after the date of separation to exercise their options.

As of December 31, 2013, the total unrecognized compensation cost related to non-vested stock options granted under the Plan was immaterial.

#### NOTE 12 - REGULATORY MATTERS

Banks and bank holding companies are subject to various regulatory capital requirements administered by the federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action by regulators that, if undertaken, could have a direct material effect on the financial statements. Management believes as of December 31, 2013, the Company and Bank meet all capital adequacy requirements to which they are subject.

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 only 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 2013 and 2012, 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.

**Dividend Restrictions:** The Corporation's principal source of funds for dividend payments is dividends received from the Bank and Trust. The Bank and Trust are subject to the dividend restrictions set forth by the Comptroller of the Currency and Ohio Department of Commerce – Division of Financial Institutions, respectively. The respective regulatory agency 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. During 2014, the Bank could, without prior approval, declare dividends of approximately \$11.6 million plus any 2014 net profits retained to the date of the dividend declaration. In order to practice trust powers, Trust must maintain a minimum capital of \$3 million. The Trust could, without prior approval, declare dividends of \$7 thousand plus any net profits retained to the date of the dividend declaration in 2014.

Actual and required capital amounts and ratios are presented below at year-end:

|                                        | Actual     |        | Requirement For<br>Capital<br>Adequacy<br>Purposes: |       | To be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Provisions: |        |
|----------------------------------------|------------|--------|-----------------------------------------------------|-------|----------------------------------------------------------------------------|--------|
|                                        | Amount     | Ratio  | Amount                                              | Ratio | Amount                                                                     | Ratio  |
| <b>2013</b>                            |            |        |                                                     |       |                                                                            |        |
| Total Capital to risk weighted assets  |            |        |                                                     |       |                                                                            |        |
| Consolidated .....                     | \$ 115,730 | 16.26% | \$56,950                                            | 8.00% | N/A                                                                        | N/A    |
| Bank .....                             | 109,154    | 15.42% | 56,638                                              | 8.00% | \$70,798                                                                   | 10.00% |
| Tier I Capital to risk weighted assets |            |        |                                                     |       |                                                                            |        |
| Consolidated .....                     | 108,130    | 15.19% | 28,475                                              | 4.00% | N/A                                                                        | N/A    |
| Bank .....                             | 101,586    | 14.35% | 28,319                                              | 4.00% | 42,479                                                                     | 6.00%  |
| Tier I Capital to average assets       |            |        |                                                     |       |                                                                            |        |
| Consolidated .....                     | 108,130    | 9.36%  | 46,185                                              | 4.00% | N/A                                                                        | N/A    |
| Bank .....                             | 101,586    | 8.93%  | 45,478                                              | 4.00% | 56,848                                                                     | 5.00%  |
| <b>2012</b>                            |            |        |                                                     |       |                                                                            |        |
| Total Capital to risk weighted assets  |            |        |                                                     |       |                                                                            |        |
| Consolidated .....                     | \$ 114,876 | 17.35% | \$52,967                                            | 8.00% | N/A                                                                        | N/A    |
| Bank .....                             | 105,160    | 15.97% | 52,667                                              | 8.00% | \$65,834                                                                   | 10.00% |
| Tier I Capital to risk weighted assets |            |        |                                                     |       |                                                                            |        |
| Consolidated .....                     | 107,113    | 16.18% | 26,483                                              | 4.00% | N/A                                                                        | N/A    |
| Bank .....                             | 97,424     | 14.80% | 26,334                                              | 4.00% | 39,501                                                                     | 6.00%  |
| Tier I Capital to average assets       |            |        |                                                     |       |                                                                            |        |
| Consolidated .....                     | 107,113    | 9.54%  | 44,931                                              | 4.00% | N/A                                                                        | N/A    |
| Bank .....                             | 97,424     | 8.72%  | 44,681                                              | 4.00% | 55,851                                                                     | 5.00%  |

#### NOTE 13 - EMPLOYEE BENEFIT PLANS

The Company has a qualified 401(k) deferred compensation Retirement Savings Plan. All employees of the Company who have completed at least 90 days 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 Company 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 Company may make an additional profit sharing contribution to the Plan. Total expense was \$336 thousand, \$334 thousand and \$300 thousand for the years ended December 31, 2013, 2012 and 2011, respectively.

The Company maintains a deferred compensation plan for certain retirees. Expense under the Plan was \$10 thousand and \$13 thousand for the years ended December 31, 2013 and 2012. Due to the early retirement of a participant in the Plan, future monthly benefits were reduced which resulted in a benefit of \$26 thousand being recorded in 2011. The liability under the Plan at December 31, 2013 was \$163 thousand and \$170 thousand at December 31, 2012.

The Company also has a postretirement health care benefit Plan covering individuals retired from the Company 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 Company's share of costs for recent and future retirees. Expense under this Plan for 2013, 2012, and 2011 was \$13 thousand, \$34 thousand and \$15 thousand. The accrued postretirement benefit liability under this Plan was \$370 thousand and \$375 thousand at December 31, 2013 and 2012. Due to the immateriality of the Plan, the disclosures required under U.S. generally accepted accounting principles have been omitted.

#### NOTE 14 - INCOME TAXES

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

|                                  | 2013            | 2012            | 2011            |
|----------------------------------|-----------------|-----------------|-----------------|
| Current expense .....            | \$ 874          | \$ 2,042        | \$ 2,925        |
| Deferred expense (benefit) ..... | 809             | 1,013           | (385)           |
| TOTALS .....                     | <u>\$ 1,683</u> | <u>\$ 3,055</u> | <u>\$ 2,540</u> |

Effective tax rates differ from federal statutory rate of 35% applied to income before income taxes due to the following:

|                                                          | 2013            | 2012            | 2011            |
|----------------------------------------------------------|-----------------|-----------------|-----------------|
| Statutory tax.....                                       | \$ 3,312        | \$ 4,545        | \$ 4,115        |
| Effect of nontaxable interest.....                       | (1,325)         | (1,203)         | (1,198)         |
| Bank owned life insurance, net.....                      | (123)           | (179)           | (183)           |
| Effect of nontaxable life insurance death proceeds ..... | (115)           | 0               | (16)            |
| Other .....                                              | (66)            | (108)           | (178)           |
| ACTUAL TAX .....                                         | <u>\$ 1,683</u> | <u>\$ 3,055</u> | <u>\$ 2,540</u> |

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

|                                                            | 2013            | 2012            |
|------------------------------------------------------------|-----------------|-----------------|
| Deferred tax assets:                                       |                 |                 |
| Allowance for credit losses .....                          | \$ 2,649        | \$ 2,670        |
| Net unrealized loss on securities available for sale ..... | 3,005           | 0               |
| Security valuation.....                                    | 41              | 1,772           |
| Deferred and accrued compensation .....                    | 874             | 516             |
| Deferred loan fees and costs.....                          | 511             | 455             |
| Capital loss carryover.....                                | 0               | 15              |
| Post-retirement benefits.....                              | 174             | 132             |
| AMT credit carryforward .....                              | 367             | 0               |
| Other.....                                                 | 217             | 259             |
| Gross deferred tax assets .....                            | <u>\$ 7,838</u> | <u>\$ 5,819</u> |
| Deferred tax liabilities:                                  |                 |                 |
| Depreciation .....                                         | \$ (1,766)      | \$ (1,089)      |
| Net unrealized gain on securities available for sale ..... | 0               | (4,073)         |
| Federal Home Loan Bank dividends .....                     | (482)           | (482)           |
| Prepaid expenditures .....                                 | (37)            | (79)            |
| Other.....                                                 | (12)            | (22)            |
| Gross deferred tax liabilities .....                       | <u>(2,297)</u>  | <u>(5,745)</u>  |
| NET DEFERRED TAX ASSET .....                               | <u>\$ 5,541</u> | <u>\$ 74</u>    |

No valuation allowance for deferred tax assets was recorded at December 31, 2013 and 2012. There was a \$42 thousand capital loss carryover, all of which was used to offset capital gain income in 2013.

At December 31, 2013 and December 31, 2012, the Company had no unrecognized tax benefits recorded. The Company does not expect the amount of unrecognized tax benefits to significantly change within the next twelve months.

The Company paid a \$12 thousand penalty for the year ended December 31, 2013. There were no amounts accrued for penalties or interest as of December 31, 2013 and 2012.

The Company is subject to U.S. federal income tax. The Company is no longer subject to examination by the federal taxing authority for years prior to 2010. The tax years 2010—2012 remain open to examination by the U.S. taxing authority.

## NOTE 15 – OTHER COMPREHENSIVE INCOME (LOSS)

The following table represents the detail of other comprehensive income (loss) for the years ended December 31, 2013, 2012 and 2011.

| (In Thousands of Dollars)                                                          | 2013               |                 |                    |
|------------------------------------------------------------------------------------|--------------------|-----------------|--------------------|
|                                                                                    | Pre-tax            | Tax             | After-tax          |
| Unrealized holding losses on available-for-sale securities during the period ..... | \$ (19,310)        | \$ 6,759        | \$ (12,551)        |
| Reclassification adjustment for (gains) losses included in net income (1) .....    | (860)              | 301             | (559)              |
| Net unrealized losses on available-for-sale securities .....                       | (20,170)           | 7,060           | (13,110)           |
| Change in funded status of post-retirement health plan .....                       | (3)                | 1               | (2)                |
| Net other comprehensive income (loss) .....                                        | <u>\$ (20,173)</u> | <u>\$ 7,061</u> | <u>\$ (13,112)</u> |

| (In Thousands of Dollars)                                                          | 2012            |               |                 |
|------------------------------------------------------------------------------------|-----------------|---------------|-----------------|
|                                                                                    | Pre-tax         | Tax           | After-tax       |
| Unrealized holding losses on available-for-sale securities during the period ..... | \$ 307          | \$ (107)      | \$ 200          |
| Reclassification adjustment for (gains) losses included in net income (1) .....    | (1,059)         | 370           | (689)           |
| Net unrealized losses on available-for-sale securities .....                       | (752)           | 263           | (489)           |
| Change in funded status of post-retirement health plan .....                       | 131             | (46)          | 85              |
| Net other comprehensive income (loss) .....                                        | <u>\$ (621)</u> | <u>\$ 217</u> | <u>\$ (404)</u> |

| (In Thousands of Dollars)                                                         | 2011              |                   |                 |
|-----------------------------------------------------------------------------------|-------------------|-------------------|-----------------|
|                                                                                   | Pre-tax           | Tax               | After-tax       |
| Unrealized holding gains on available-for-sale securities during the period ..... | \$ 9,707          | \$ (3,397)        | \$ 6,310        |
| Reclassification adjustment for (gains) losses included in net income (1) .....   | (1,793)           | 627               | (1,166)         |
| Net unrealized losses on available-for-sale securities .....                      | 7,914             | (2,770)           | 5,144           |
| Change in funded status of post-retirement health plan .....                      | 0                 | 0                 | 0               |
| Net other comprehensive income (loss) .....                                       | <u>\$ (7,914)</u> | <u>\$ (2,770)</u> | <u>\$ 5,144</u> |

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

## NOTE 16 - BUSINESS COMBINATION

On July 1, 2013, the Company completed the acquisition of all outstanding stock of the retirement planning consultancy National Associates, Inc. of Cleveland, Ohio. The transaction involved both cash and stock totaling \$4.4 million, including up to \$1.5 million of future payments, contingent upon NAI meeting income performance targets, with an estimated fair value at the acquisition date of \$920,000. The fair market value of the contingent consideration was determined using the Monte Carlo Simulation. The simulation's key assumptions included a two year period with an estimated volatility of 20%. Expected EBITDA had a base of 6% with a maximum 12% and a discount rate of 11.9%. The acquisition is part of the Company's plan to increase the levels of noninterest income and to complement the existing retirement services currently being offered. Acquisition-related costs of \$270 thousand are included in the Company's consolidated statements of income for the year ended December 31, 2013.

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

(In Thousands of Dollars)

Consideration

|                                                    |                 |
|----------------------------------------------------|-----------------|
| Cash.....                                          | \$ 2,111        |
| Stock.....                                         | 1,400           |
| Contingent consideration .....                     | 920             |
| Fair value of total consideration transferred..... | <u>\$ 4,431</u> |

Assets acquired and liabilities assumed

|                             |          |
|-----------------------------|----------|
| Cash.....                   | \$ 28    |
| Accounts receivable .....   | 300      |
| Premises and equipment..... | 50       |
| Other assets .....          | <u>1</u> |
| Total assets acquired.....  | 379      |

|                           |               |
|---------------------------|---------------|
| Liabilities assumed.....  | 81            |
| Net assets acquired ..... | <u>\$ 298</u> |

Assets and liabilities arising from acquisition

|                                           |                 |
|-------------------------------------------|-----------------|
| Identified intangible assets .....        | 2,290           |
| Deferred tax liability .....              | (802)           |
| Goodwill.....                             | 2,645           |
| Net assets acquired from acquisition..... | <u>\$ 4,431</u> |

NAI contributed \$627 thousand of gross revenues to the Company with a resulting net loss of \$156 thousand during the six month period ended December 31, 2013.

The following table presents pro forma information as if the acquisition had occurred at the beginning of 2012. The pro forma information includes adjustments for amortization of intangibles arising from the transaction and the related income tax effects. The pro forma financial information is not necessarily indicative of the results of operations that would have occurred had the transactions been effected on the assumed dates.

(In Thousands of Dollars except per share results)

|                                            | 2013             | 2012             |
|--------------------------------------------|------------------|------------------|
| Noninterest income.....                    | <u>\$ 15,080</u> | <u>\$ 14,577</u> |
| Net income.....                            | <u>\$ 7,665</u>  | <u>\$ 9,883</u>  |
| Basic and diluted earnings per share ..... | <u>\$ 0.41</u>   | <u>\$ 0.53</u>   |

**NOTE 17 - RELATED PARTY TRANSACTIONS**

Loans to principal officers, directors, and their affiliates during 2013 were as follows:

|                                                           |               |
|-----------------------------------------------------------|---------------|
| Total loans at December 31, 2012.....                     | \$ 825        |
| New loans .....                                           | 32            |
| Effect of changes in composition of related parties ..... | (5)           |
| Repayments .....                                          | <u>(279)</u>  |
| Total loans at December 31, 2013.....                     | <u>\$ 573</u> |

Deposits from principal officers, directors, and their affiliates at year-end 2013 and 2012 were \$1.6 million and \$1.1 million.

## NOTE 18 – EARNINGS PER SHARE

The factors used in the earnings per share computation follow:

|                                                                       | 2013                 | 2012                 | 2011                 |
|-----------------------------------------------------------------------|----------------------|----------------------|----------------------|
| <b>Basic EPS</b>                                                      |                      |                      |                      |
| Net income .....                                                      | <u>\$ 7,780</u>      | <u>\$ 9,932</u>      | <u>\$ 9,218</u>      |
| Weighted average shares outstanding .....                             | <u>18,773,491</u>    | <u>18,791,843</u>    | <u>18,271,580</u>    |
| <b>Basic earnings per share .....</b>                                 | <b><u>\$ .41</u></b> | <b><u>\$ .53</u></b> | <b><u>\$ .50</u></b> |
| <b>Diluted EPS</b>                                                    |                      |                      |                      |
| Net income .....                                                      | <u>\$ 7,780</u>      | <u>\$ 9,932</u>      | <u>\$ 9,218</u>      |
| Weighted average shares out-standing for basic earnings per share ... | <u>18,773,491</u>    | <u>18,791,843</u>    | <u>18,271,580</u>    |
| Effect of Stock Options .....                                         | <u>0</u>             | <u>0</u>             | <u>0</u>             |
| Weighted average shares for diluted earnings per share .....          | <u>18,773,491</u>    | <u>18,791,843</u>    | <u>18,271,580</u>    |
| <b>Diluted earnings per share.....</b>                                | <b><u>\$ .41</u></b> | <b><u>\$ .53</u></b> | <b><u>\$ .50</u></b> |

Stock options for 5,000 shares of common stock for 2013, 2012 and 2011 were not considered in computing diluted earnings per share because they were antidilutive.

## NOTE 19 – INTEREST RATE SWAPS

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

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

Summary information about these interest-rate swaps as of year ended December 31, 2013 and 2012 is as follows:

|                                                           | 2013      | 2012     |
|-----------------------------------------------------------|-----------|----------|
| Notional amounts.....                                     | \$ 25,195 | \$ 7,060 |
| Weighted average pay rate on interest-rate swaps .....    | 4.28%     | 4.07%    |
| Weighted average receive rate on interest-rate swaps..... | 2.82%     | 2.99%    |
| Weighted average maturity (years) .....                   | 6.3       | 5.8      |
| Fair value of combined interest-rate swaps .....          | \$ 275    | \$ 120   |

The fair value of the yield maintenance provisions and interest-rate swaps is recorded in other assets and other liabilities, respectively, in the consolidated balance sheet. Changes in the fair value of the yield maintenance provisions and interest-rate swaps are reported in earnings, as other noninterest income in the consolidated income statements. There were no net gains or losses recognized in earnings related to yield maintenance provisions for years ended December 31, 2013 and 2012.

## NOTE 20 – SEGMENT INFORMATION

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

Accounting policies for segments are the same as those described in Note 1. Segment performance is evaluated using operating income. Income taxes are calculated on operating income. Transactions among segments are made at fair value.

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

| December 31, 2013                                               | Trust<br>Segment | Bank<br>Segment    | Retirement<br>Consulting<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
|-----------------------------------------------------------------|------------------|--------------------|-------------------------------------|----------------------------|------------------------|
| <b>Assets</b>                                                   |                  |                    |                                     |                            |                        |
| Cash and cash equivalents .....                                 | \$ 1,261         | \$ 26,272          | \$ 113                              | \$ (133)                   | \$ 27,513              |
| Securities available for sale .....                             | 3,983            | 418,876            | 0                                   | 126                        | 422,985                |
| Loans held for sale .....                                       | 0                | 158                | 0                                   | 0                          | 158                    |
| Net loans .....                                                 | 0                | 623,116            | 0                                   | 0                          | 623,116                |
| Premises and equipment, net .....                               | 91               | 17,034             | 62                                  | 0                          | 17,187                 |
| Goodwill and other intangibles .....                            | 5,639            | 0                  | 4,704                               | 0                          | 10,343                 |
| Other assets .....                                              | 598              | 34,635             | 211                                 | 580                        | 36,024                 |
| <b>Total Assets .....</b>                                       | <b>\$11,572</b>  | <b>\$1,120,091</b> | <b>\$ 5,090</b>                     | <b>\$ 573</b>              | <b>\$1,137,326</b>     |
| <b>Liabilities and Stockholders' Equity</b>                     |                  |                    |                                     |                            |                        |
| Deposits, borrowings and other liabilities .....                | \$ 339           | \$1,023,859        | \$ 815                              | \$ (694)                   | \$1,024,319            |
| Stockholders' equity .....                                      | 11,233           | 96,232             | 4,275                               | 1,267                      | 113,007                |
| <b>Total Liabilities and Stockholders' Equity .....</b>         | <b>\$11,572</b>  | <b>\$1,120,091</b> | <b>\$ 5,090</b>                     | <b>\$ 573</b>              | <b>\$1,137,326</b>     |
| <br>                                                            |                  |                    |                                     |                            |                        |
| December 31, 2012                                               | Trust<br>Segment | Bank<br>Segment    | Retirement<br>Consulting<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
| <b>Assets</b>                                                   |                  |                    |                                     |                            |                        |
| Cash and cash equivalents .....                                 | \$ 636           | \$ 37,191          | \$ 0                                | \$ (68)                    | \$ 37,759              |
| Securities available for sale .....                             | 4,695            | 459,246            | 0                                   | 147                        | 464,088                |
| Loans held for sale .....                                       | 0                | 3,624              | 0                                   | 0                          | 3,624                  |
| Net loans .....                                                 | 0                | 578,963            | 0                                   | 0                          | 578,963                |
| Premises and equipment, net .....                               | 100              | 18,329             | 0                                   | 0                          | 18,429                 |
| Goodwill and other intangibles .....                            | 6,032            | 0                  | 0                                   | 0                          | 6,032                  |
| Other assets .....                                              | 546              | 29,758             | 0                                   | 496                        | 30,800                 |
| <b>Total Assets .....</b>                                       | <b>\$12,009</b>  | <b>\$1,127,111</b> | <b>\$ 0</b>                         | <b>\$ 575</b>              | <b>\$1,139,695</b>     |
| <b>Liabilities and Stockholders' Equity</b>                     |                  |                    |                                     |                            |                        |
| Deposits, borrowings and other liabilities .....                | \$ 302           | \$1,022,092        | \$ 0                                | \$ (3,491)                 | \$1,018,903            |
| Stockholders' equity .....                                      | 11,707           | 105,019            | 0                                   | 4,066                      | 120,792                |
| <b>Total Liabilities and Stockholders' Equity .....</b>         | <b>\$12,009</b>  | <b>\$1,127,111</b> | <b>\$ 0</b>                         | <b>\$ 575</b>              | <b>\$1,139,695</b>     |
| <br>                                                            |                  |                    |                                     |                            |                        |
| For year ended 2013                                             | Trust<br>Segment | Bank<br>Segment    | Retirement<br>Consulting<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
| Net interest income .....                                       | \$ 45            | \$35,865           | \$ 0                                | \$ (14)                    | \$ 35,896              |
| Provision for loan losses .....                                 | 0                | 1,290              | 0                                   | 0                          | \$ 1,290               |
| Service fees, security gains and other noninterest income ..... | 5,667            | 7,838              | 627                                 | (218)                      | \$ 13,914              |
| Noninterest expense .....                                       | 4,899            | 31,875             | 863                                 | 1,420                      | \$ 39,057              |
| Income before taxes .....                                       | 813              | 10,538             | (236)                               | (1,652)                    | \$ 9,463               |
| Income tax .....                                                | 282              | 2,043              | (80)                                | (562)                      | \$ 1,683               |
| <b>Net Income .....</b>                                         | <b>\$ 531</b>    | <b>\$ 8,495</b>    | <b>\$ (156)</b>                     | <b>\$ (1,090)</b>          | <b>\$ 7,780</b>        |

|                                                                | Trust<br>Segment | Bank<br>Segment | Retirement<br>Consulting<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
|----------------------------------------------------------------|------------------|-----------------|-------------------------------------|----------------------------|------------------------|
| <b>For year ended 2012</b>                                     |                  |                 |                                     |                            |                        |
| Net interest income .....                                      | \$ 47            | \$36,871        | \$ 0                                | \$ (20)                    | \$ 36,898              |
| Provision for loan losses .....                                | 0                | 725             | 0                                   | 0                          | \$ 725                 |
| Service fees, security gains and other noninterest income..... | 5,571            | 7,192           | 0                                   | (185)                      | \$ 12,578              |
| Noninterest expense .....                                      | 4,918            | 30,024          | 0                                   | 822                        | \$ 35,764              |
| Income before taxes.....                                       | 700              | 13,314          | 0                                   | (1,027)                    | \$ 12,987              |
| Income tax.....                                                | 244              | 3,160           | 0                                   | (349)                      | \$ 3,055               |
| Net Income .....                                               | <u>\$ 456</u>    | <u>\$10,154</u> | <u>\$ 0</u>                         | <u>\$ (678)</u>            | <u>\$ 9,932</u>        |

|                                                                | Trust<br>Segment | Bank<br>Segment | Retirement<br>Consulting<br>Segment | Eliminations<br>and Others | Consolidated<br>Totals |
|----------------------------------------------------------------|------------------|-----------------|-------------------------------------|----------------------------|------------------------|
| <b>For year ended 2011</b>                                     |                  |                 |                                     |                            |                        |
| Net interest income .....                                      | \$ 41            | \$36,605        | \$ 0                                | \$ (49)                    | \$ 36,597              |
| Provision for loan losses .....                                | 0                | 3,650           | 0                                   | 0                          | 3,650                  |
| Service fees, security gains and other noninterest income..... | 5,422            | 7,304           | 0                                   | (187)                      | 12,539                 |
| Noninterest expense .....                                      | 4,833            | 28,237          | 0                                   | 658                        | 33,728                 |
| Income before taxes.....                                       | 630              | 12,022          | 0                                   | (894)                      | 11,758                 |
| Income tax.....                                                | 218              | 2,626           | 0                                   | (304)                      | 2,540                  |
| Net Income.....                                                | <u>\$ 412</u>    | <u>\$ 9,396</u> | <u>\$ 0</u>                         | <u>\$ (590)</u>            | <u>\$ 9,218</u>        |

Bank segment includes Farmers National Insurance.

#### NOTE 21 - QUARTERLY FINANCIAL DATA (UNAUDITED)

| <b>Quarter Ended 2013</b>                    | March 31        | June 30         | September 30    | December 31     |
|----------------------------------------------|-----------------|-----------------|-----------------|-----------------|
| Total interest income .....                  | \$ 10,266       | \$ 10,273       | \$ 10,122       | \$ 10,298       |
| Total interest expense .....                 | 1,298           | 1,234           | 1,274           | 1,257           |
| Net interest income .....                    | 8,968           | 9,039           | 8,848           | 9,041           |
| Provision for loan losses .....              | 255             | 170             | 340             | 525             |
| Noninterest income .....                     | 2,875           | 3,225           | 4,173           | 3,641           |
| Noninterest expense .....                    | 9,088           | 9,822           | 10,926          | 9,221           |
| Income before income taxes .....             | 2,500           | 2,272           | 1,755           | 2,936           |
| Income taxes .....                           | 495             | 404             | 143             | 641             |
| Net income .....                             | <u>\$ 2,005</u> | <u>\$ 1,868</u> | <u>\$ 1,612</u> | <u>\$ 2,295</u> |
| Earnings per share - basic and diluted ..... | \$ 0.11         | \$ 0.10         | \$ 0.09         | \$ 0.12         |

| <b>Quarter Ended 2012</b>                    | March 31        | June 30         | September 30    | December 31     |
|----------------------------------------------|-----------------|-----------------|-----------------|-----------------|
| Total interest income.....                   | \$ 10,886       | \$ 10,903       | \$ 10,630       | \$ 10,691       |
| Total interest expense .....                 | 1,665           | 1,583           | 1,529           | 1,435           |
| Net interest income .....                    | 9,221           | 9,320           | 9,101           | 9,256           |
| Provision for loan losses .....              | 0               | 400             | 325             | 0               |
| Noninterest income .....                     | 2,719           | 2,821           | 3,367           | 3,671           |
| Noninterest expense .....                    | 8,630           | 8,773           | 8,896           | 9,465           |
| Income before income taxes .....             | 3,310           | 2,968           | 3,247           | 3,462           |
| Income taxes .....                           | 790             | 682             | 758             | 825             |
| Net income .....                             | <u>\$ 2,520</u> | <u>\$ 2,286</u> | <u>\$ 2,489</u> | <u>\$ 2,637</u> |
| Earnings per share - basic and diluted ..... | \$ 0.13         | \$ 0.12         | \$ 0.13         | \$ 0.14         |

The Company sold certain investment securities and recognized security gains of \$597 thousand during the third quarter of 2013. A \$1.3 million charge was recorded during the third quarter of 2013 for severance costs. The Company sold certain investment securities and recognized security gains of \$1.1 million during the third and fourth quarters of 2012.

## NOTE 22—PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION

Below is condensed financial information of Farmers National Banc Corp. (parent company only). This information should be read in conjunction with the consolidated financial statements and related notes.

| December 31,                                     | 2013              | 2012              |
|--------------------------------------------------|-------------------|-------------------|
| <b>BALANCE SHEETS</b>                            |                   |                   |
| Assets:                                          |                   |                   |
| Cash .....                                       | \$ 1,849          | \$ 3,826          |
| Investment in subsidiaries.....                  |                   |                   |
| Bank .....                                       | 96,087            | 105,019           |
| Trust .....                                      | 11,233            | 11,707            |
| NAI.....                                         | 4,275             | 0                 |
| Securities available for sale .....              | 126               | 147               |
| Other .....                                      | 725               | 523               |
| TOTAL ASSETS .....                               | <u>\$ 114,295</u> | <u>\$ 121,222</u> |
| Liabilities:                                     |                   |                   |
| Other liabilities .....                          | \$ 932            | \$ 59             |
| Note payable.....                                | 350               | 350               |
| Other accounts payable .....                     | 6                 | 21                |
| TOTAL LIABILITIES.....                           | <u>1,288</u>      | <u>430</u>        |
| TOTAL STOCKHOLDERS' EQUITY .....                 | <u>113,007</u>    | <u>120,792</u>    |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY ..... | <u>\$ 114,295</u> | <u>\$ 121,222</u> |

| December 31,                                                                                | 2013            | 2012            | 2011            |
|---------------------------------------------------------------------------------------------|-----------------|-----------------|-----------------|
| <b>STATEMENTS OF INCOME</b>                                                                 |                 |                 |                 |
| Years ended December 31,                                                                    |                 |                 |                 |
| Income:                                                                                     |                 |                 |                 |
| Dividends from subsidiaries                                                                 |                 |                 |                 |
| Bank.....                                                                                   | \$ 4,333        | \$ 2,712        | \$ 1,654        |
| Trust.....                                                                                  | 980             | 0               | 0               |
| NAI.....                                                                                    | 0               | 0               | 0               |
| Interest and dividends on securities .....                                                  | 2               | 4               | 3               |
| Security gains/(losses) .....                                                               | 21              | 0               | (11)            |
| Other income.....                                                                           | 0               | 0               | 0               |
| TOTAL INCOME .....                                                                          | 5,336           | 2,716           | 1,646           |
| Interest on borrowings.....                                                                 | (16)            | (24)            | (52)            |
| Other expenses.....                                                                         | (1,659)         | (1,007)         | (834)           |
| Income before income tax benefit and undistributed subsidiary income .....                  | 3,661           | 1,685           | 760             |
| Income tax benefit.....                                                                     | 562             | 349             | 304             |
| Equity in undistributed net income of subsidiaries (dividends in excess of net income)..... |                 |                 |                 |
| Bank.....                                                                                   | 4,162           | 7,442           | 7,742           |
| Trust.....                                                                                  | (449)           | 456             | 412             |
| NAI .....                                                                                   | (156)           | 0               | 0               |
| NET INCOME.....                                                                             | <u>\$ 7,780</u> | <u>\$ 9,932</u> | <u>\$ 9,218</u> |

**STATEMENTS OF CASH FLOWS**

Years ended December 31,

Cash flows from operating activities:

|                                                                                  | 2013            | 2012            | 2011            |
|----------------------------------------------------------------------------------|-----------------|-----------------|-----------------|
| Net income .....                                                                 | \$ 7,780        | \$ 9,932        | \$ 9,218        |
| Adjustments to reconcile net income to net cash from operating activities: ..... |                 |                 |                 |
| Security (gains)/losses.....                                                     | (24)            | 0               | 0               |
| Impairment of securities.....                                                    | 3               | 0               | 11              |
| Equity in undistributed net income of subsidiaries .....                         | (3,557)         | (7,898)         | (8,154)         |
| Other.....                                                                       | (270)           | (20)            | (58)            |
| NET CASH FROM OPERATING ACTIVITIES .....                                         | <u>3,932</u>    | <u>2,014</u>    | <u>1,017</u>    |
| Cash flows from investing activities:                                            |                 |                 |                 |
| Proceeds from maturities of investment securities available for sale.....        | 56              | 0               | 0               |
| Purchase of National Associates, Inc.....                                        | (2,111)         | 0               | 0               |
| Capital contribution to subsidiaries .....                                       | 0               | 0               | (8,000)         |
| NET CASH FROM INVESTING ACTIVITIES.....                                          | <u>(2,055)</u>  | <u>0</u>        | <u>(8,000)</u>  |
| Cash flows from financing activities:                                            |                 |                 |                 |
| Purchase of treasury shares.....                                                 | (1,606)         | (42)            | 0               |
| Net proceeds from issuance of common shares.....                                 | 0               | 0               | 13,772          |
| Cash dividends paid.....                                                         | (2,248)         | (3,382)         | (2,241)         |
| Net changes in borrowings .....                                                  | 0               | (750)           | 0               |
| Proceeds from dividend reinvestment .....                                        | 0               | 243             | 504             |
| NET CASH FROM FINANCING ACTIVITIES .....                                         | <u>(3,854)</u>  | <u>(3,931)</u>  | <u>12,035</u>   |
| NET CHANGE IN CASH AND CASH EQUIVALENTS .....                                    | <u>(1,977)</u>  | <u>(1,917)</u>  | <u>5,052</u>    |
| Beginning cash and cash equivalents .....                                        | 3,826           | 5,743           | 691             |
| Ending cash and cash equivalents .....                                           | <u>\$ 1,849</u> | <u>\$ 3,826</u> | <u>\$ 5,743</u> |

**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

As of the end of the period covered by this Annual Report on Form 10-K, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective to ensure that the financial and nonfinancial information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, including this Annual Report on Form 10-K for the period ended December 31, 2013, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

Management's responsibilities related to establishing and maintaining effective disclosure controls and procedures include maintaining effective internal controls over financial reporting that are designed to produce reliable financial statements in accordance with GAAP. As disclosed in the Report on Management's Assessment of Internal Control Over Financial Reporting in the Company's 2013 Annual Report to Shareholders, management assessed the Company's system of internal control over financial reporting as of December 31, 2013, in relation to criteria for effective internal control over financial reporting as described in the 1992 "Internal Control—Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission and found it to be effective.

Crowe Horwath LLP, the Company's registered public accounting firm, has audited the Company's internal control over financial reporting as of December 31, 2013. The audit report by Crowe Horwath is located in Item 8 of this report.

There were no changes in the Company's internal controls over financial reporting (as defined in Rule 13a – 15(f) under the Exchange Act) that occurred during the year ended December 31, 2013, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation or material weaknesses in such internal controls requiring corrective actions.

**Item 9B. Other Information.**

None.

## PART III

### Item 10. Directors, Executive Officers and Corporate Governance.

The information required by Item 401 of Regulation S-K concerning the directors of the Company and the nominees for election as directors of the Company at the Annual Meeting of Shareholders to be held on April 24, 2014 (the “2014 Annual Meeting”) is incorporated herein by reference from the information to be included under the caption “Proposal 1 – Election of Directors” in Farmers’ definitive proxy statement relating to the 2014 Annual Meeting to be filed with the Commission (“2014 Proxy Statement”).

#### *Executive Officers of the Registrant*

The names, ages and positions of Farmers’ executive officers as of March 13, 2014:

| <u>Name</u>            | <u>Age</u> | <u>Title</u>                                                                                                                |
|------------------------|------------|-----------------------------------------------------------------------------------------------------------------------------|
| Carl D. Culp           | 50         | Executive Vice President and Treasurer of Farmers and Executive Vice-President and Chief Financial Officer of Farmers Bank. |
| Joseph Gerzina         | 58         | Senior Vice President and Chief Lending Officer of Farmers Bank                                                             |
| Mark L. Graham         | 59         | Executive Vice President and Chief Credit Officer of Farmers Bank                                                           |
| Kevin J. Helmick       | 42         | President and Chief Executive Officer of Farmers and Farmers Bank                                                           |
| Brian E. Jackson       | 44         | Senior Vice President and Chief Information Officer of Farmers Bank                                                         |
| Mark A. Nicaastro      | 43         | Senior Vice President and Director of Human Resources of Farmers Bank                                                       |
| Joseph W. Sabat        | 53         | Vice President and Controller of Farmers Bank                                                                               |
| Amber Wallace Soukenik | 48         | Senior Vice President and Chief Retail/Marketing Officer of Farmers Bank                                                    |

Officers are generally elected annually by the Board of Directors. The term of office for all the above executive officers is for the period ending with the next annual meeting.

#### *Principal Occupation and Business Experience of Executive Officers*

Mr. Culp has served as Executive Vice President and Treasurer since March 1996. Prior to that time, Mr. Culp was Controller of Farmers from November 1995 and was Controller of Farmers Bank from November 1995. Mr. Culp has 28 years of experience in finance and accounting in the banking industry, and is a certified public accountant.

Mr. Gerzina is Senior Vice President and Chief Lending Officer since February 2012, and brings 32 years of experience in commercial and private banking. Prior to joining Farmers Bank, Mr. Gerzina was a Managing Partner at Weather Vane Capital, and previously held the role of Senior Vice President and Regional Commercial Manager (2002-2009) with Huntington Bank. He was appointed as an executive officer of Farmers in 2012.

Mr. Graham has over 36 years of experience with Farmers Bank. During his tenure, Mr. Graham has held a variety of positions in Farmers Bank’s commercial loan department. Mr. Graham has served as Executive Vice President and Chief Credit Officer of Farmers Bank since January 2012; for the four years prior to that appointment, Mr. Graham served as Senior Vice President and Senior Lending Officer.

Mr. Helmick is the President and Chief Executive Officer of Farmers and Farmers Bank, a position he has held since November 2013. Prior to becoming President Mr. Helmick was Secretary of Farmers and Executive Vice President – Wealth Management and Retail Services of Farmers Bank since January 2012. Mr. Helmick has been with the Company for 18 years and has a retail and investment background, including an MBA and CFP designation. From 1997 through 2008, Mr. Helmick served as the Vice President and Program Manager for Farmers National Investments. In 2008 Mr. Helmick was promoted to Senior Vice President of Wealth Management and Retail Services where he was responsible for the management and oversight of Farmers National Investments, the retail investment area of Farmers Bank, Farmers Insurance, and all branch sales and operational functions.

Mr. Jackson is the Senior Vice President and Chief Information Officer of Farmers Bank, a position he has held since May 2009. Prior to coming to the Company, Mr. Jackson was Assistant Vice President and Information Technology Manager with Home Savings Bank since 1993. He has over 21 years of experience in the IT field. Mr. Jackson was appointed as an executive officer in 2012.

Mr. Nicastro is the Senior Vice President and Director of Human Resources of Farmers Bank, a position he has held since joining Farmers in July 2009. Prior to that appointment, Mr. Nicastro served as Staffing and Compliance Manager for Huntington National Bank (2007-2008) and Regional Human Resources Manager for Sky Bank from 2004 until 2007. Mr. Nicastro has an MBA, and has more than 16 years of experience in Human Resource Management from both large multi-national banks and regional community banks. He was appointed as an executive officer in 2012.

Mr. Sabat has served as Vice President and Controller of Farmers Bank since April 2006. Prior to coming to the Company, Mr. Sabat was with a regional public accounting firm. Mr. Sabat has 18 years of experience in the accounting, finance and auditing fields. He is a certified public accountant and was appointed as an executive officer in 2012.

Ms. Wallace Soukenik has served as Senior Vice President and Chief Retail/Marketing Officer for Farmers Bank since November 2013. In August 2008 Ms. Wallace Soukenik joined Farmers Bank as Senior Vice President and Director of Marketing. She has 24 years of experience in the Marketing field. Prior to joining the Company, Ms. Wallace Soukenik served as the Assistant Vice President of Marketing and Physician Relations at Trumbull Memorial Hospital, where she managed a \$14 million endowment, a \$1.5 million marketing budget and all physician contracts. She was appointed as an executive officer in 2012.

*Compliance with Section 16(a) of the Securities Exchange Act of 1934, as amended.*

The information required by Item 405 of Regulation S-K is incorporated herein by reference from the disclosure to be included under the caption “Section 16(a) Beneficial Ownership Reporting Compliance” in the 2014 Proxy Statement.

*Code of Business Conduct and Ethics.*

The Company has adopted a Code of Business Conduct and Ethics (the “Code of Ethics”) that covers all employees, including its principal executive, financial and accounting officers, and is posted on the Company’s website [www.farmersbankgroup.com](http://www.farmersbankgroup.com). In the event of any amendment to, or waiver from, a provision of the Code of Ethics that applies to its principal executive, financial or accounting officers, the Company intends to disclose such amendment or waiver on its website.

*Procedures for Recommending Directors Nominees.*

Information concerning the procedures by which shareholders may recommend nominees to Farmers’ Board of Directors is incorporated herein by reference from the information to be included under the caption “Director Nominations” in 2014 Proxy Statement. These procedures have not materially changed from those described in Farmers’ definitive proxy materials for the 2013 Annual Meeting of Shareholders.

*Audit Committee.*

The information required by Items 407(d)(4) and (d)(5) of Regulation S-K is incorporated herein by reference from the disclosure to be included under the caption “Committees of the Board of Directors – Audit Committee” in the 2014 Proxy Statement.

**Item 11. Executive Compensation.**

The information required by Item 402 of Regulation S-K is incorporated herein by reference from the disclosure to be included under the captions “Compensation Discussion and Analysis” and “Executive Compensation and Other Information” in the 2014 Proxy Statement.

The information required by Item 407(e)(4) of Regulation S-K is incorporated herein by reference from the disclosure to be included under the caption “Compensation Committee Interlocks and Insider Participation” in the 2014 Proxy Statement.

The information required by Item 407(e)(5) of Regulation S-K is incorporated herein by reference from the disclosure to be included under the caption “The Compensation Committee Report” in the 2014 Proxy Statement.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information required by Item 201(d) of Regulation S-K is incorporated herein by reference from the disclosure included under the caption “Proposal Four — Adoption And Approval Of The Farmers National Banc Corp. 2012 Equity Incentive Plan” in the 2012 Proxy Statement of the Company.

The information required by Item 403 of Regulation S-K is incorporated herein by reference from the disclosure to be included under the caption “Beneficial Ownership of Management and Certain Beneficial Owners” in the 2014 Proxy Statement.

**Item 13. Certain Relationships and Related Transactions and Director Independence.**

The information required by Item 404 of Regulation S-K is incorporated herein by reference from the disclosure to be included under the caption “Certain Relationships and Related Transactions” in the 2014 Proxy Statement.

The information required by Item 407(a) of Regulation S-K is incorporated herein by reference from the disclosure to be included under the caption “The Board of Directors — Independence” in the 2014 Proxy Statement.

**Item 14. Principal Accountant Fees and Services.**

The information required by this Item 14 is incorporated herein by reference from the disclosure to be included under the captions “Independent Registered Public Accounting Firm Fees” and “Pre-Approval of Fees” in the 2014 Proxy Statement.

**PART IV**

**Item 15. Exhibits, Financial Statement Schedules.**

*(a)(1) Financial Statements*

Item 8 Reference is made to the Consolidated Financial Statements included in Item 8 of Part II herein.

*(2) Financial Statement Schedules*

No financial statement schedules are presented because they are not applicable.

*(3) Exhibits*

The exhibits filed or incorporated by reference as a part of this Annual Report on Form 10-K are listed in the Exhibit Index, which follows the signature page and is incorporated herein by reference.

*(b) Exhibits*

The exhibits filed or incorporated by reference as a part of this Annual Report on Form 10-K are listed in the Exhibit Index, which follows the signature page and is incorporated herein by reference.

*(c) Financial Statement Schedules*

See subparagraph (a)(2) above.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the under signed, thereunto duly authorized.

FARMERS NATIONAL BANC CORP.

By /s/ Kevin J. Helmick  
Kevin J. Helmick, President and Chief Executive Officer

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

|                                                               |                                                                                    |                |
|---------------------------------------------------------------|------------------------------------------------------------------------------------|----------------|
| <u>/s/ Kevin J. Helmick</u><br>Kevin J. Helmick               | President, Chief Executive Officer and Director<br>(Principal Executive Officer)   | March 13, 2014 |
| <u>/s/ Carl D. Culp</u><br>Carl D. Culp                       | Executive Vice President, Secretary and Treasurer<br>(Principal Financial Officer) | March 13, 2014 |
| <u>/s/ Joseph W. Sabat</u><br>Joseph W. Sabat                 | Controller<br>(Principal Accounting Officer)                                       | March 13, 2014 |
| <u>/s/ Gregory C. Bestic</u><br>Gregory C. Bestic             | Director                                                                           | March 13, 2014 |
| <u>/s/ Anne Frederick Crawford</u><br>Anne Frederick Crawford | Director                                                                           | March 13, 2014 |
| <u>/s/ Lance J. Ciroli</u><br>Lance J. Ciroli                 | Chairman of the Board                                                              | March 13, 2014 |
| <u>/s/ Ralph D. Macali</u><br>Ralph D. Macali                 | Director                                                                           | March 13, 2014 |
| <u>/s/ David Z. Paull</u><br>David Z. Paull                   | Director                                                                           | March 13, 2014 |
| <u>/s/ Earl R. Scott</u><br>Earl R. Scott                     | Director                                                                           | March 13, 2014 |
| <u>/s/ Gregg Strollo</u><br>Gregg Strollo                     | Director                                                                           | March 13, 2014 |
| <u>/s/ Ronald V. Wertz</u><br>Ronald V. Wertz                 | Director                                                                           | March 13, 2014 |

The above-named directors and officers of the Registrant sign this Annual Report on Form 10-K by Kevin J. Helmick and Carl D. Culp, their attorney-in-fact, pursuant to Powers of Attorney signed by the above-named directors and officers, which Powers of Attorney are filed with this Annual Report on Form 10-K as exhibits, in the capacities indicated.

By

/s/ Kevin J. Helmick

Kevin J. Helmick

President, Chief Executive Officer and Director

(Principal Executive Officer)

/s/ Carl D. Culp

Carl D. Culp

Executive Vice President, Secretary and Treasurer

(Principal Financial Officer)

## INDEX TO EXHIBITS

The following exhibits are filed or incorporated by reference as part of this Annual Report on Form 10-K:

| Exhibit<br>Number | Description                                                                                                                                                                                                                                                                                                                                           |
|-------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1               | Articles of Incorporation of Farmers National Banc Corp., as amended (incorporated by reference from Exhibit 4.1 to Farmers' Registration Statement on Form S-3 filed with the Commission on October 3, 2001 (File No. 333-70806), and by reference from Exhibit 3.1 to Farmers' Current Report on Form 8-K filed with the commission on May 1, 2013. |
| 3.2               | Amended Code of Regulations of Farmers National Banc Corp. (incorporated by reference from Exhibit 3.2 to Farmers' Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2011 filed with the Commission on August 9, 2011).                                                                                                             |
| 10.1*             | Farmers National Banc Corp. 2012 Equity Incentive Plan (incorporated by reference from Exhibit 10.1 to Farmers' Quarterly Report on Form 10-Q for the quarter ended June 30, 2012 filed with the Commission on August 8, 2012).                                                                                                                       |
| 10.2*             | Farmers National Banc Corp. Cash Incentive Plan (incorporated by reference from Exhibit 10.1 to Farmers' Current Report on Form 8-K filed with the Commission on June 24, 2011).                                                                                                                                                                      |
| 10.3*             | Farmers National Banc Corp. Long-Term Incentive Plan (incorporated by reference from Exhibit 10.1 to Farmers' Current Report on Form 8-K filed with the Commission on June 29, 2011).                                                                                                                                                                 |
| 10.4*             | Farmers National Banc Corp. Form of 2012 Award Agreement under Long-Term Incentive Plan (incorporated by reference from Exhibit 10.6 to Farmers' Annual Report on Form 10-K for the year ended December 31, 2012 filed with the Commission on March 13, 2013).                                                                                        |
| 10.5*             | Farmers National Banc Corp. Form of 2013 Award Agreement under Long-Term Incentive Plan (filed herewith)                                                                                                                                                                                                                                              |
| 10.6*             | Nonemployee Director Compensation (filed herewith).                                                                                                                                                                                                                                                                                                   |
| 10.7*             | Farmers National Banc Corp. Form of Indemnification Agreement (incorporated by reference from Exhibit 10.1 to Farmers' Current Report on Form 8-K filed with the Commission on April 29, 2011).                                                                                                                                                       |
| 10.8*             | Farmers National Banc Corp. Executive Separation Policy (incorporated by reference from Exhibit 10.1 to Farmers' Current Report on Form 8-K filed with the Commission on November 14, 2013)                                                                                                                                                           |
| 10.9*             | Change in Control Agreement with Kevin J. Helmick (incorporated by reference from Exhibit 10.2 to Farmers' Current Report on Form 8-K filed with the Commission on November 14, 2013)                                                                                                                                                                 |
| 10.10*            | Form of Change in Control Agreements for Executive Officers (incorporated by reference from Exhibit 10.3 to Farmers' Current Report on Form 8-K filed with the Commission on November 14, 2013)                                                                                                                                                       |
| 21                | Subsidiaries of Farmers (filed herewith).                                                                                                                                                                                                                                                                                                             |
| 23                | Consent of Independent Registered Public Accounting Firm (filed herewith).                                                                                                                                                                                                                                                                            |
| 24                | Powers of Attorney of Directors and Executive Officers (filed herewith).                                                                                                                                                                                                                                                                              |
| 31.1              | Rule 13a-14(a)/15d-14(a) Certification of Kevin J. Helmick, President and Chief Executive Officer of Farmers (principal executive officer)(filed herewith).                                                                                                                                                                                           |
| 31.2              | Rule 13a-14(a)/15d-14(a) Certification of Carl D. Culp, Executive Vice President and Treasurer of Farmers (principal financial officer) (filed herewith).                                                                                                                                                                                             |
| 32.1              | Certification pursuant to 18 U.S.C. Section 1350 of Kevin J. Helmick, President and Chief Executive Officer of Farmers (principal executive officer) (filed herewith).                                                                                                                                                                                |
| 32.2              | Certification pursuant to 18 U.S.C. Section 1350 of Carl D. Culp, Executive Vice President and Treasurer of Farmers (principal financial officer) (filed herewith).                                                                                                                                                                                   |
| 101.INS           | XBRL Instance Document (filed herewith).                                                                                                                                                                                                                                                                                                              |
| 101.SCH           | XBRL Taxonomy Extension Schema Document (filed herewith).                                                                                                                                                                                                                                                                                             |

| <b>Exhibit<br/>Number</b> | <b>Description</b>                                                       |
|---------------------------|--------------------------------------------------------------------------|
| 101.CAL                   | XBRL Taxonomy Extension Calculation Linkbase Document (filed herewith).  |
| 101.LAB                   | XBRL Taxonomy Extension Label Linkbase Document (filed herewith).        |
| 101.PRE                   | XBRL Taxonomy Extension Presentation Linkbase Document (filed herewith). |
| 101.DEF                   | XBRL Taxonomy Extension Definition Linkbase Document (filed herewith).   |

\* Constitutes a management contract or compensatory plan or arrangement.

Copies of any exhibits will be furnished to shareholders upon written request. Request should be directed to Carl D. Culp, Executive Vice President and Treasurer, Farmers National Banc Corp., 20 S. Broad Street, Canfield, Ohio 44406.

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**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.farmersbankgroup.com](http://www.farmersbankgroup.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.

**Transfer Agent:** Registrar and Transfer Company, Attention: Stock Transfer Services, 10 Commerce Drive Cranford, NJ 07016

**Dividend Reinvestment Plan (DRIP):**

Registered shareholders can purchase additional common shares through Farmers' Dividend Reinvestment Plan. Participation is voluntary and allows for automatic reinvestment of cash dividends and the safekeeping of share certificates. To obtain a prospectus, contact the Registrar and Transfer Co. at 1-800-368-5948.

**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 Registrar and Transfer Co. at 1-800-368-5948.

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

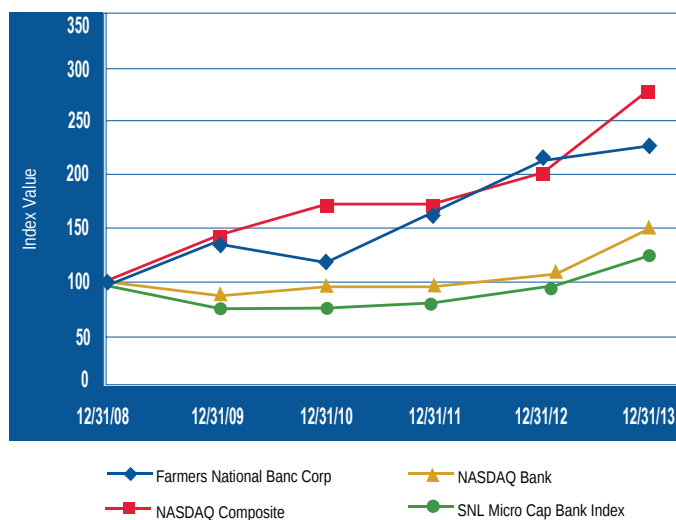
**Common Stock Listing and Information as to Stock Prices and Dividends:**

The Company's common shares trade on the NASDAQ Capital Market under the symbol FMNB. Set forth in the accompanying table are per share prices at which common shares have actually been purchased and sold in transactions during the periods indicated, to the knowledge of the Company. Also included in the table are dividends per share paid on the outstanding Company's common shares and any shares dividends paid. As of December 31, 2013, there were 18,775,980 shares outstanding and 3,422 shareholders of record of common shares.

**Investor Information****MARKET AND DIVIDEND SUMMARY**

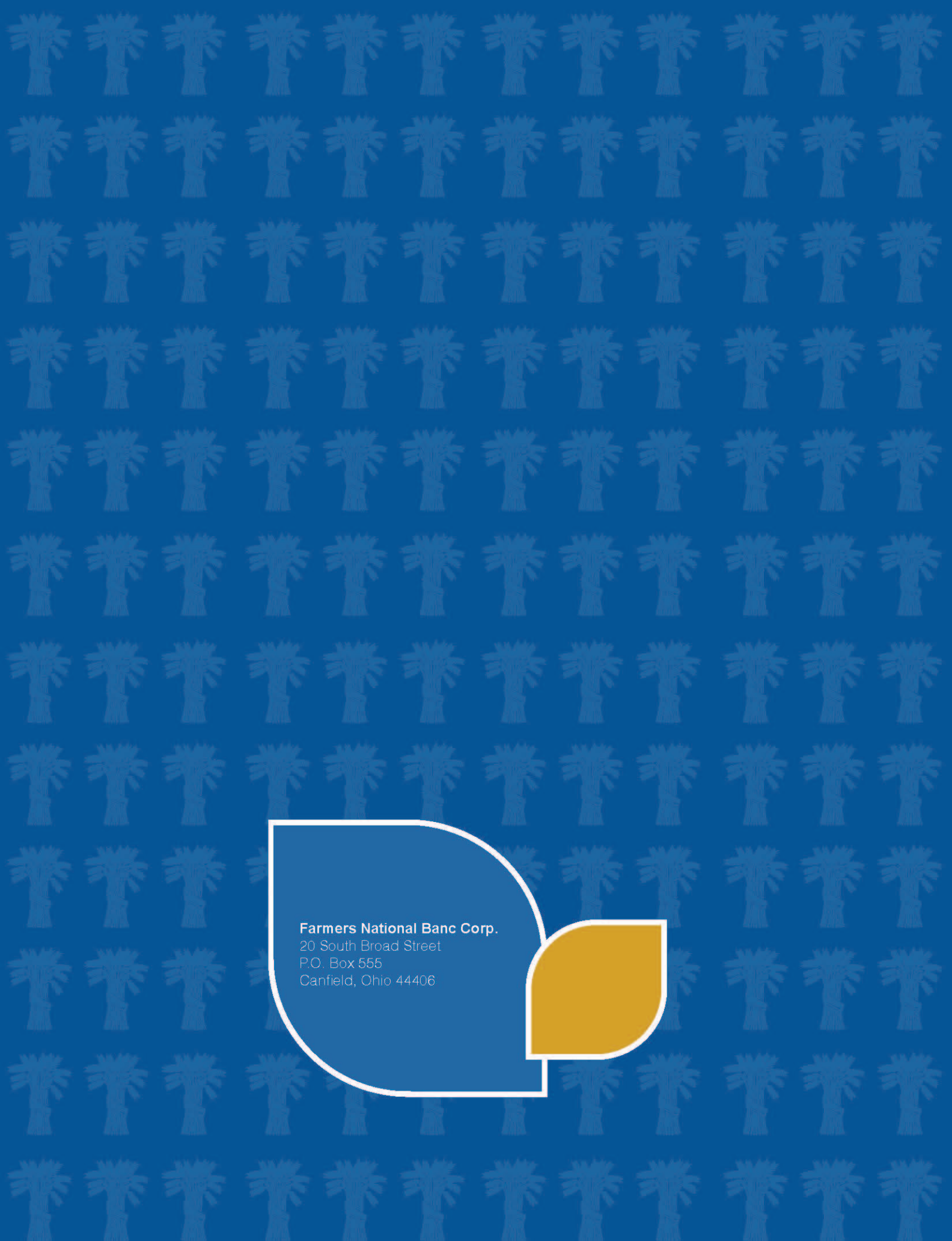
| Quarter Ending | High   | Low    | Dividend |
|----------------|--------|--------|----------|
| March 2013     | \$6.90 | \$6.13 | \$0.03   |
| June 2013      | \$6.70 | \$5.81 | \$0.03   |
| September 2013 | \$6.58 | \$6.10 | \$0.03   |
| December 2013  | \$6.59 | \$6.11 | \$0.03   |
| March 2012     | \$6.49 | \$4.85 | \$0.06   |
| June 2012      | \$6.85 | \$6.03 | \$0.03   |
| September 2012 | \$6.49 | \$5.50 | \$0.03   |
| December 2012  | \$6.77 | \$5.71 | \$0.06   |

The following graph compares the cumulative five year total return to shareholders on Farmers National Banc Corp.'s common shares relative to the cumulative total returns of the NASDAQ Composite index, the NASDAQ Bank index and the SNL Micro Cap Bank index. The graph assumes that the value of the investment in the Company's common shares and in each of the indexes (including reinvestment of dividends) was \$100 on 12/31/2008 and tracks it through 12/31/2013.

**TOTAL RETURN PERFORMANCE**

| Index                       | Period Ending |          |         |          |          |          |
|-----------------------------|---------------|----------|---------|----------|----------|----------|
|                             | 12/31/08      | 12/31/09 | 2/31/10 | 12/31/11 | 12/31/12 | 12/31/13 |
| Farmers National Banc Corp. | 100.00        | 141.36   | 115.32  | 161.86   | 208.78   | 224.82   |
| NASDAQ Composite            | 100.00        | 145.36   | 171.74  | 170.38   | 200.63   | 281.22   |
| NASDAQ Bank                 | 100.00        | 83.70    | 95.55   | 85.52    | 101.50   | 143.84   |
| SNL Microcap Bank Index     | 100.00        | 73.74    | 75.89   | 72.18    | 91.22    | 117.71   |

The stock price performance included in this graph is not necessarily indicative of future stock price performance.



**Farmers National Banc Corp.**  
20 South Broad Street  
P.O. Box 555  
Canfield, Ohio 44406