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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the

Securities Exchange Act of 1934

For the Quarterly period ended March 31, 2013

Commission file number 001-35296

FARMERS NATIONAL BANC CORP.

(Exact name of registrant as specified in its charter)

OHIO	**34-1371693**

(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No)**
20 South Broad Street Canfield, OH	**44406**
(Address of principal executive offices)	**(Zip Code)**

(330) 533-3341

(Registrant s telephone number, including area code)

Not applicable

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

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

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

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

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

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

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

Class	**Outstanding at April 30, 2013**
Common Stock, No Par Value	18,795,048 shares

CONSOLIDATED BALANCE SHEETS

FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES

(Unaudited)	(In Thousands of Dollars) **March 31, 2013**	**December 31, 2012**
ASSETS		
Cash and due from banks	$ 14,013	$ 14,209
Federal funds sold and other	43,299	23,550
TOTAL CASH AND CASH EQUIVALENTS	57,312	37,759
Securities available for sale	439,540	464,088
Loans held for sale	4,330	3,624
Loans	592,520	586,592
Less allowance for loan losses	7,508	7,629
NET LOANS	585,012	578,963
Premises and equipment, net	18,143	18,429
Goodwill	3,709	3,709
Other intangibles	2,225	2,323
Bank owned life insurance	15,658	15,541
Other assets	17,170	15,259
TOTAL ASSETS	$ 1,143,099	$ 1,139,695
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits:		
Noninterest-bearing	$ 139,412	$ 132,016
Interest-bearing	776,443	786,993
TOTAL DEPOSITS	915,855	919,009
Short-term borrowings	91,302	79,886
Long-term borrowings	10,357	10,423
Other liabilities	5,009	9,585
TOTAL LIABILITIES	1,022,523	1,018,903
Commitments and contingent liabilities		
Stockholders Equity:		
Common Stock - Authorized 35,000,000 shares in 2013 and 25,000,000 shares in 2012: issued 18,802,282 in 2013 and 2012	104,503	104,504
Retained earnings	10,124	8,683
Accumulated other comprehensive income	5,991	7,647
Treasury stock, at cost; 7,234 shares in 2013 and 2012	(42)	(42)
TOTAL STOCKHOLDERS EQUITY	120,576	120,792
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,143,099	$ 1,139,695

See accompanying notes

CONSOLIDATED STATEMENTS OF INCOME

FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES

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

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

See accompanying notes

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES

(Unaudited)	(In Thousands of Dollars) For the Three Months Ended **March 31, 2013**	**March 31, 2012**
NET INCOME	$ 2,005	$ 2,520
Other comprehensive income:		
Net unrealized holding gains (losses) on available for sale securities	(2,534)	(856)
Reclassification adjustment for (gains) losses realized in income	(14)	0
Net unrealized holding gains (losses)	(2,548)	(856)
Income tax effect	892	300
Unrealized holding gains (losses), net of reclassification and tax	(1,656)	(556)
COMPREHENSIVE INCOME	$ 349	$ 1,964

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

FARMERS NATIONAL BANC CORP. AND SUBSIDIARIES

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

See accompanying notes

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Principles of Consolidation:

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

Basis of Presentation:

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

Estimates:

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

Segments:

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

Comprehensive Income:

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

Recent Accounting Pronouncements

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

Securities:

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

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

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

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

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

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

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

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

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

Other-Than-Temporary-Impairment

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

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

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

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

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

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

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

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

Loans:

Loan balances were as follows:

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

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

Three Months Ended March 31, 2013

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

Three Months Ended March 31, 2012

(In Thousands of Dollars)	Commercial Real Estate	Commercial	Residential 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	230	13	72	145	(460)	0
Loans charged off	(85)	(42)	(245)	(249)	0	(621)
Recoveries	35	18	13	181	0	247
Ending balance	$ 5,060	$ 1,518	$ 1,642	$ 1,049	$ 177	$ 9,446

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

March 31, 2013

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

December 31, 2012

(In Thousands of Dollars)	Commercial Real Estate	Commercial	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses:						
Ending allowance balance attributable to loans:						
Individually evaluated for impairment	$ 129	$ 51	$ 0	$ 0	$ 0	$ 180
Collectively evaluated for impairment	3,263	1,402	1,569	951	264	7,449
Total ending allowance balance	$ 3,392	$ 1,453	$ 1,569	$ 951	$ 264	$ 7,629
Loans:						
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	$ 200,651	$ 97,112	$ 156,182	$ 132,647	$ 0	$ 586,592

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

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

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

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

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

Interest income recognized during impairment for both periods was immaterial.

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

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

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

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

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

Troubled Debt Restructurings:

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

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

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

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

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

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

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

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

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

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

Credit Quality Indicators:

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

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

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

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

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

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

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

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

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

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

Interest Rate Swaps

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

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

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

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

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

Earnings Per Share:

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

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

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

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

Stock Based Compensation:

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

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

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

Fair Value

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

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

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

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

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

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

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

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

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

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

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

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

(In Thousands of Dollars)	Carrying Value	Fair Value Measurements at December 31, 2012 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets				
Investment securities available-for sale				
U.S. Treasury and U.S. government sponsored entities	$ 67,978	$ 0	$ 67,978	$ 0
State and political subdivisions	95,288	0	95,288	0
Corporate bonds	2,128	0	2,128	0
Mortgage-backed securities-residential	236,218	0	236,207	11
Collateralized mortgage obligations				